Capital

The Dark Side Of Stimulus

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People are worried about the economy, and they should be. They have been told to expect a strong rebound from our deep recession. The usual pattern is that recoveries mirror the strength of the decline--the steeper the drop, the more vigorous the rebound. It isn't happening. The latest employment report makes it clear that the economy is not adding jobs. State and local governments faced with declining revenues are being forced to cut employment, wages and services, and they are raising taxes wherever they can.

A little over a year ago the Obama administration passed a staggering $787 billion stimulus package designed to rescue the economy. More than half of that money has now been spent, and the economy is still just creaking along. But now people are realizing that there is a dark side to this spending orgy. It has to end, and then we have to pay the bill. If we need any reminders that the day of reckoning is coming we have only to look to Europe.

There is no point in arguing about how many jobs have been created or saved by stimulus spending. We don't get to rerun history, so we won't know what the path of employment would have been absent the stimulus package. Many in Congress would like to spend even more money to "do something" about the jobs problem. But nothing will solve the problem except economic growth. The problem we face is that the extraordinary deficits we created are likely to restrain economic growth in the future. We do have to honor that debt.

There are deficit deniers out there, like Paul Krugman, who think we can and should ignore deficits for a long time to come because we can continue to borrow at such low interest rates. This is the same behavior for which they excoriate households who accumulated too much mortgage and credit card debt. They also blasted Alan Greenspan and Ben Bernanke for enabling this irresponsible behavior by keeping interest rates too low for too long. But by all means let the Government borrow and spend at our current low interest rates to keep this economic recovery alive.

There is certainly some truth to the view that we can kick the can down the road for a bit longer. Why? Because the U.S. dollar is and will continue to be the world's reserve currency. It means that the U.S. can run a persistent current account deficit because other countries need dollars for reserves. This is also why we find it easy--even now with staggering deficits--to sell U.S. Treasuries at low interest rates. Every time markets get shaky, as they have in recent weeks, there is a flight to the safety of U.S. Treasury obligations. That reaffirms the belief in the long-term credibility of the U.S. and the viability of our debt.

But, here is the rub: That credibility is not assured to last forever, and we still have to pay off the debt. In order to continue to fund our deficit we have to be perceived to be on a sustainable fiscal path. We are not. To become sustainable we need to cut spending and increase revenues.

What are the options? As the economy improves, receipts will increase, but it will take a very robust recovery to make even a small dent in the gap. That leaves taxes and spending cuts as the main levers to restore sustainability. And how credible is it to assume that the Obama administration will confront the problem by decreasing spending? The feeding frenzy of special political interests that erupted around the stimulus package suggests the answer to that question.

The fiscal situation in much of Europe is also unsustainable. But what differentiates Europe from the U.S. is that market pressures are forcing them to confront their problems in a more timely way. The specter of sovereign debt default by Greece and the fiscal problems of Spain, Portugal, Ireland and the U.K. have had a sobering affect on their governments. Financial markets have displayed increasing volatility and interbank lending rates are rising, suggesting that there is growing concern about the soundness of the banking system. European banks hold several trillion euros' worth of sovereign debt on their balance sheets.

The European Union's proposed solution to the problems of Greece and the other fiscally challenged members who might lose access to capital markets is something of a charade. It won't prevent a Greek default, but it will cushion the impact on banks and give other countries time to impose some fiscal austerity. In response to the market pressures many countries--Ireland, Greece, Spain, Portugal, the U.K. and Germany--have announced new austerity budgets.

And how has the U.S. responded? By criticizing Germany and others for not doing as we are and continuing deficit-financed stimulus spending. Indeed, German has been criticized openly and often--most recently by the *New York Times*--for not contributing their fair share to the global stimulus. Fiscal responsibility is viewed as bad global citizenship. Timothy Geithner has been urging other G20 members to view fiscal responsibility as a "medium term" goal and to not abandon stimulus spending. Whatever you do, don't be responsible now!

Markets and consumers are much smarter than politicians. That is why they are jittery. You don't have to be a rocket scientist to realize that the stimulus has not delivered the big bang people hoped for and that we can't afford more stimulus. And only the most delusional believe that the Obama administration can put us on a sustainable fiscal path and still keep the president's promise not to raise taxes on the middle class. People have good reasons to be anxious.

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