A SYMPOSIUM OF VIEWS

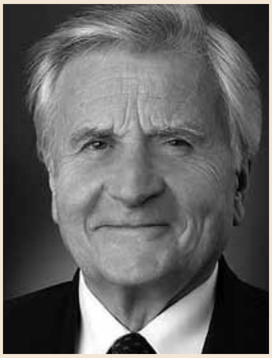
Is the World Ready For the Next Downturn?

In a provocative interview, former U.S. Treasury Secretary Larry Summers recently warned that developed world policymakers are ill-prepared for the next recession. He suggested that the current preoccupation with the avoidance of inflation is a mistake—"inflation is no longer the top issue." The top issue is maintenance of sound growth and getting to full employment.

Summers suggested that the expectation that interest rates will return to their historically normal levels before the next downturn is unlikely: "Downturns happen … when they happen, the normal playbook is to cut interest rates by 500 basis points, but there's not going to be that kind of room."

Is Summers correct that the industrialized world is unprepared? Or do the central banks have a range of tools beyond interest rates that can allow them to meet their inflation targets even during a recession? Then again, how much credibility is there to the chosen 2 percent inflation target? Over the last 600 years, global inflation has averaged 1 percent, with interest rates around 5 percent. Who chose today's 2 percent target rate—and why is it relevant?

More than a dozen prominent economic strategists offer their thoughts, followed by a response from Larry Summers.



The global economy would be placed in an extremely difficult situation. Remember Fisher, Minsky, and Knight.

JEAN-CLAUDE TRICHET

Former President, European Central Bank, Chairman of the Board, Bruegel Institute, Chairman, Trilateral Commission for Europe, and Honorary Chairman, Group of Thirty

In case the next downturn is around the corner, the global economy would be placed in an extremely difficult situation for three reasons.

First, in most economies—especially in advanced economies—the fiscal situation is already very difficult. The overall public debt outstanding as a proportion of GDP is significantly augmented in comparison with the pre-crisis level. As a consequence, the room for manoeuvre to counter the recession with fiscal policy would be practically non-existent in an overwhelming majority of advanced economies.

Second, in many economies and more particularly in advanced economies, the monetary policy tools to be utilized in case of a recession would be very limited. Even in the United States, further along in the normalization of monetary policy, interest rates are too low to effectively counter a recession. What is true in the United States is truer for most other advanced economies. And what is obvious in terms of interest rates is also true as regards many of the unconventional tools. The level of central banks' balance sheet portfolios of previous purchases is already very elevated, and the unconventional monetary policy weaponry still utilized suggests that the law of diminishing returns will considerably weaken the central banks' possible action.

Third, perhaps even more importantly, the successive crises which characterized the years 2007/2008/2010 were due to structural defects. With the benefit of hindsight, it is difficult to understand the pre-crisis blindness of most advanced economies *vis-à-vis* the persistent piling up of additional public and private debt outstanding and the generalized naïve belief in the financial market efficiency hypothesis. Also missed were the emerging new systemic risks associated with generalized financial interconnectedness and the surge of information technologies. Among these emerging risks was the formidable rapidity of the crisis contagion process within integrated global finance.

Does the international community understand now the urgent need to reinforce its defenses in anticipation of the next recession whenever it happens? No, as is demonstrated by a striking example: the persistent augmentation of global public and private financial leverage, year after year, since the crisis.

To conclude, my main recommendations to reinforce resilience would be the following:

- Substitute as much as possible equity to debt;
- Remember Irving Fisher and his debt deflation theory;
- Remember Hyman Minsky and his financial instability hypothesis;
- Remember Frank Knight and unquantifiable uncertainty;
- For central banks of the advanced economies: stick to your present definition of price stability, namely 2 percent in the medium and long run.

It is not by chance that major central banks have had the same definition (2 percent) of price stability since the crisis. In periods of high turbulence and high risk, major central banks decided to anchor medium- and long-term expectations as solidly as possible. The recommendations to abandon the 2 percent definition, or retain a higher or lower goal, ignore the importance of solidly anchoring expectations in the longer term.

Let us not now demolish the lessons drawn pragmatically by central banks in a highly turbulent period, namely a degree of rapprochement, which I called "conceptual convergence," of which the same 2 percent definition for medium- and long-term price stability (decided by the European Central Bank at its inception, by the Bank of England in 2003, by the U.S. Federal Reserve in 2012, and by the Bank of Japan in 2013) is a major component!

Larry Summers may be too quick to dismiss the Fed's ability to react.

SCOTT BESSENT

CIO and Founder, Key Square Capital Management

It is undoubtedly true that developed world policymakers will have a more limited toolbox when the next recession comes, but central bankers will also have had real-time experience evaluating the efficacy of nonstandard policies. However, the scope for easing policy across fiscal and monetary space differs between the major developed economies. This will have important implications for divergent economic performance and asset prices when a downturn arrives.

At the end of 2007, ten-year government bond yields were 4.0 percent, 4.3 percent, and 1.5 percent in the United States, Germany, and Japan, respectively. Today, ten-year government bond yields are near zero in Germany and Japan, and front-end interest rates are negative.

Further, additional European Central Bank bond purchases are effectively constrained by the 33 percent issuer limit, and the Bank of Japan appears increasingly concerned by the risks to financial stability from its ultra-accommodative stance. Indeed, even though Japanese trend inflation is well below the 2 percent target, the central bank may consider adjusting the yield curve upwards in the near future, reflecting Governor Kuroda's concerns over the "reversal rate."

In sum, when the next recession comes, the European Central Bank and the Bank of Japan will both have an extremely limited ability to react.

In contrast, while U.S. interest rates may peak at a lower level this cycle, Larry Summers may be too quick to dismiss the Fed's ability to react to the next downturn, and the effectiveness of the unconventional monetary policy tools that remain. In his June remarks at the Hutchins Center conference, he argues:

> *First, starting at a 2.5 percent rate on ten-year Treasuries, imagine that the economy goes into recession and that the Fed cuts short-term rates four or five times, bringing the Federal funds rate to 0.25 percent. If nobody does anything else, the ten-year rate will find its way down to the neighborhood of 1.5 percent. It is questionable how much extra stimulus would be developed by any further reduction in long-term rates below 1.5 percentage points. And that applies with respect to any monetary tool that might be developed.*

In the previous cycle, from December 2001 to November 2007, the ten-year U.S. Treasury yield averaged 4.4 percent. In the current cycle from July 2009 to present, the ten-year Treasury yield has averaged 2.4 percent, a reduction of approximately 200 basis points. It is unclear why a further 200 basis point reduction to 0.4 percent would not prove equally stimulating. And with the yield curve control tool currently employed by the Bank of Japan, such a reduction in U.S. interest rates is certainly possible. Indeed, the Fed itself engaged in yield curve caps from 1942–1951. While the Fed's blunt instrument of dropping overnight rates might be more limited than before, it is far from out of bullets.

The limits on monetary policy actually create more of an opportunity for fiscal policy.

JASON FURMAN

Professor of the Practice of Economic Policy, Harvard University's Kennedy School, Non-Resident Senior Fellow, Peterson Institute for International Economics, and former Chairman, President's Council of Economic Advisers

The United States and other advanced economies are likely to have less monetary space to fight the next recession. The flip side of this fact, however, is that we are likely to have more fiscal space to fight the next recession. The bigger concern is whether we will have the political will to use the tools we have.

The evidence is increasingly strong that equilibrium interest rates have come down throughout the world. The real ten-year rate on government bonds fell by more than 200 basis points in the major advanced economies between the early 1990s and 2007, even before any of the extraordinary measures taken to fight the financial crisis. Moreover, inflation has been effectively anchored at a lower level. That makes it unlikely that central banks will be able to cut rates by the 500 or 600 basis points that have been common in responding to past recessions. Quantitative easing, forward guidance, changed policy rules (for example, a higher inflation target or contingent price level targeting), and institutional shifts could all create more room for monetary policy.

We should be exploring all of the avenues to expand the potential for future monetary policy, but at the same time it is important to understand that the limits on monetary policy actually create more of an opportunity for fiscal policy. As has been understood since at least John Maynard Keynes, and developed more fully in recent research, fiscal policy can be particularly effective when interest rates are at an effective lower bound. If interest rates are stuck at zero, investment will not be crowded out by higher interest rates. In fact, it may even be crowded in as a stronger economy encourages investment through an accelerator mechanism and raises expected inflation rates, thus lowering real interest rates.

Some have argued that high levels of debt will constrain the ability to engage in discretionary countercyclical fiscal policy. Precisely the opposite is true. First, with lower equilibrium interest rates, the optimal sustainable debt is higher. Moreover, recent research has failed to find any difference in the effectiveness of fiscal expansions in highly indebted countries versus less-indebted countries.

In fact, in a highly demand-deficient economy with interest rates at the effective lower bound, a fiscal expansion can raise the debt, leaving the debt-to-GDP ratio lower according to a range of models by the International Monetary Fund, the Organisation for Economic Cooperation and Development, and economic researchers. The higher your debt-to-GDP ratio is, in fact, the more additional growth matters for debt dynamics.

The economic fact is that even with high levels of debt, countries can't afford to not undertake a fiscal expansion in a severe, protracted downturn that exhausts the monetary ammunition. The economics is clear. My only worry is whether the political systems will follow through or instead get bogged down in a mistaken rush to austerity at just the wrong time.

Policy responses to the next crisis wielded by demagogues are just as likely to make things worse.

ROBERT BARBERA
Director, JHU Center for Financial Economics, and Economics Department Fellow, Johns Hopkins University

Preparing for the next crisis, in a world with a consistent history of crises, makes good sense. The fact that global central banks have limited scope for traditional short rate easing requires that we contemplate all possible macroeconomic responses to a downturn.

What can policymakers do? Until they hit zero, they can lower short rates. Via quantitative bond purchases, or via bond price targeting, they can lower long rates. They can cut taxes and/or increase government spending. They can relax regulatory restrictions. All of these actions, most agree, tilt economies toward higher short-term trajectories, but carry longer-term risks.

Asking whether or not we have room to exercise such policies, however, ignores a more troubling point. Except for monetary policy, the history of the past ten years is one of policymakers administering perverse policies, time and again.

In mid-2010, the Dodd-Frank Act became law. Designed to prevent a repeat of the financial system that led to the Great Financial Crisis, a laudable goal, it nonetheless restrained credit flow, with risk taking at once-in-a-generation lows. Over time, risk appetites returned, and by mid-2017, credit spreads and price-to-earnings ratios were back to near the levels in place in 2006. Right on cue, policymakers relaxed Dodd-Frank in ways that will make it harder for bank regulators to act when banks find new ways to evade capital rules. Maybe Dodd-Frank was a good idea. Maybe it was a bad idea. But putting it in place when the economy was weak in 2010, only to weaken it in 2018? Perfectly perverse.

The 2010 arrival of the Tea Party kept U.S. fiscal policy in gridlock for six years. Despite a faltering recovery and near-zero inflation, the Obama White House contemplated tightening fiscal policy, in a proposed deal with House Speaker John Boehner (R-OH). That deal fell through, but successive continuing resolutions ensnared federal spending in a straightjacket, amid fiscal tightening from state and local entities. In late 2017, however, with state and local belt tightening over and the jobless rate at 4 percent, a major tax cut was enacted alongside substantial defense and non-defense spending increases. There is a case to be made—not a persuasive one in my opinion, but a defensible one—that high U.S. debt levels justify fiscal rectitude. But fiscal restraint amid widespread economic weakness, followed by fiscal largess just as the economy nears full employment? Perfectly perverse.

What about the imposition of a trade war? Herein, one cannot argue about timing. Instead, consider that more than 1,100 economists, including fifteen Nobel Prize winners, signed a May 2018 letter protesting tariff impositions. For the vast majority of economists, imposing tariffs is perverse, nearly all of the time. Nonetheless, aggressive tariff imposition kicked off a trade war soon thereafter.

All of which suggests that policymakers may well extend perverse policy selection during the next downturn. Who can be sure we will not react to ballooning deficits by imposing a serious round of austerity? And amid newfound evidence of financial system excesses, populist rage might drive elected officials to rediscover the need for aggressive financial market regulatory restrictions. For good measure, we may also bemoan import levels and ramp up tariffs.

Is our toolkit limited? Perhaps. But wholesale policymaker rejection of deeply held macroeconomic precepts is the current state of affairs. In such circumstances, policy responses to the next crisis wielded by demagogues, even when crafted with access to the best tools, are just as likely to make things worse as they are to make things better.

The next downturn may bring a central banking crisis.

THOMAS MAYER

Founding Director, Flossbach von Storch Research Institute, and former Chief Economist, Deutsche Bank

The present upswing in the business cycle is the second-oldest since World War II. In the past, old upswings featured high interest rates and low public debt. This time is different: interest rates are low and debt is high. As a consequence, there is little room for normal stabilization policy to soften the eventual downturn in the cycle. We need to brace ourselves for an economic crisis, in which central banks will have to monetize large parts of outstanding debt to avoid debt deflation. The price could be a loss of confidence in fiat money.

The problem we are now facing is the result of central banks' reliance on Keynesian macroeconomic theory for the pursuit of an inflation target. In the Keynesian model, money drops from heaven and savings are always equal to investment. This is a wrong representation of the real world. Money is created by banks for borrowers when they extend credit to them. Borrowers demand credit when the market interest rate declines below their expected return from the use of the borrowed money. With the new money, borrowers can buy capital goods for investment purposes without any new real savings. The increase of investment over saving, financed by new money, induces a credit-driven economic upswing. When excess demand leads to price inflation and higher interest rates, the upswing turns into a downswing, in which falling investment and credit demand induce a monetary contraction. It is the central banks' fiddling with interest rates in the pursuit of their inflation targets that creates continuous disequilibria between real savings and investment, which are balanced by monetary expansion and contraction. Thus, the policy of inflation targeting of central banks is built upon theory, which is blind to the mechanics of money creation and the saving-investment disequilibria associated with it. It also lacks empirical support for the assumed simple relationship between unemployment and inflation in the Phillips Curve.

As long as Keynesian economics is the shared mental model of most economists and almost all central bankers and politicians, we proceed from one financial crisis to another. The list is already fairly long: the stock market crash of 1987, the savings and loan crisis of the early 1990s, the bond market crash of 1994, the emerging market crisis of 1998, the dot.com crash of 2000–2003, and the financial crisis of 2007–2008. The list will only end when economists and policymakers realize the flaws of Keynesian economics. In the meantime, investors need to position themselves for the next turn in the credit cycle. The last downturn included a banking crisis. The next downturn may well bring a central banking crisis, as confidence in fiat money could be lost.

I am not confident that the Fed's monetary policy playbook is adequately prepared.

J. ALFRED BROADDUS

Former President, Federal Reserve Bank of Richmond

Knowing whether the world is ready for the next downturn is well beyond both my intellectual capacity and my pay grade. So let me ask more narrowly whether the Federal Reserve is ready.

Regrettably, I doubt it. To be sure, constructive actions have been taken. For all its flaws, the Dodd-Frank law has tightened the U.S. financial regulatory regime and at least addressed some aspects of the too-big-to-fail conundrum. These developments may reduce some of the fallout from a future downturn on overall financial stability.

But like a number of other monetary economists, I am not confident that the Fed's monetary policy playbook is adequately prepared for anything approaching the economic and financial shock of 2008–2009. I say this with considerable respect for Ben Bernanke's and the FOMC's monetary stewardship during the crisis and its immediate aftermath given the limitations of the policy tools at their disposal at that moment. While we can't know the counterfactual, arguably the several rounds of quantitative easing prevented a much worse outcome.

But the experience with QE—as my colleague Marvin Goodfriend and others have persuasively argued—also revealed its drawbacks. The substantially enlarged Fed purchases of Treasury securities moved the Fed dangerously close to the fiscal and federal debt management policy realms. Moreover, the Fed's purchases of housing-related securities opened the Fed to charges of interfering with the market's allocation of credit across economic sectors, not to mention exposing taxpayers to significant credit risk. And the lengthy time period required to distance the economy from the risk of deflation undermined the public's confidence in the Fed's ability to deal with deflation, and by extension, inflation.

Absent alternative policy approaches, the Fed would presumably have to double down on QE in the face of an impending future negative shock, which would magnify its drawbacks. It is reasonable to speculate that the Fed's credibility and independence would be forcefully challenged.

What to do? An at least potentially viable alternative is to remove the zero bound constraint on the Fed's traditional interest rate approach to conducting monetary policy—in Goodfriend's terminology, to "unencumber" interest rate policy—by using negative interest rate targets when needed in implementing policy. Even temporarily negative interest rate targets would be understandably controversial and would need to be approached cautiously and transparently. The logical case for considering them, however, is strong, and developing contingency plans for deploying them if necessary in a future crisis would strengthen the Fed's readiness for the next downturn.

The ability, experience, and ideology of Fed policymakers are a major source of uncertainty.

STEPHEN AXILROD

Financial Consultant, and author,* The Federal Reserve: What Everyone Needs to Know *(Oxford University Press, 2013)

The question as posed requires some clarification before it can be answered. One simply cannot know what will be the level of nominal interest rates when the next recession strikes, how severe the downward pressures will turn out to be, its international context, domestic economic and socio-political attitudes at the time, and so forth. However, the spirit of the question is quite clear. Will today's policymakers, insofar as they have revealed themselves, be capable of keeping the forthcoming recession (there will probably be one within, say, a year or so) on the moderate side, or certainly avoid worsening it?

The ability, experience, and ideology of policymakers are a major source of uncertainty at this time. The new chairman of the U.S. Federal Reserve has more regulatory than macro-economic experience. If recent policy experience makes you believe that good common sense on the regulatory front has become a more critical influence on the economy than in the past, that's something of a plus. The Fed's regulatory and credit market attitudes will need to be considered more intensively along with conventional open market operations in the period ahead.

Still, a chairman has only one vote, and, unconscionably, four vacancies remain on the Fed board. Thus the jury is surely out about the probable quality of Fed decision-making over the balance of this year and on. Moreover, given the real oddity of President Trump's appointment record, one has every right to worry. Nonetheless, the outlook of the newly appointed chairman, and new vice-chairman for bank supervision, do seem to fall within a fairly broad mainstream.

The regulatory and credit attitudes of Fed policymakers will probably be an important element in the timing and intensity of the next recession. The economic disaster following the 2007–2008 credit crisis was sparked in good part by the Fed's failure to assess properly the condition of the broad credit market, in particular its susceptibility to the contagion effects from a highly leveraged and interconnected market structure.

As to the quality of regulation, there is some hope that the Fed may prove to be a more conservative force than not in face of the apparent growing demand for deregulation. Some deregulation may be a good thing (the Dodd-Frank Act probably overdid regulation in the heat of its moment), but excessive unwinding of regulation certainly risks adverse effects. For one thing, it would come in an economy in which at least some animal spirits have finally been unleashed. There will be little if any additional need for the nation's spending also to be buttressed by greater access to roundabout means of financing, such as giving large banks more ease of entry into hedge fund-type activities and access to liquidity.

The Fed's monetary policy will be complicated not only by how to guide the evolving banking structure, but also by how much support it may or may not receive from fiscal policy. It appears that fiscal policy has loosed its major bolt far too early and not broadly enough. True, there remains a possibility of consumer-oriented tax cuts if needed to keep spending from falling too much or too long in a potential recession. But that raises uncertain political questions, with the unknown outcome of the forthcoming mid-term elections not far off.

Which, as often occurs, brings us right back to the Fed in such situations as the court of last resort. The Summers question becomes crucial at that point.

Will the Fed find itself with enough room to act promptly and effectively through open market operations to a weakening of spending when it comes? I should think so—but only for sure if it gathers its forces by continuing to raise the real overnight funds rate. It started on that course about two years too late, I would say. It has carefully raised the nominal rate for some time now, but the real rate remains close to zero. The current state of animal spirits in the economy would seem to argue for at least around a 2 percent real rate, and probably higher until there are real signs that it's time to hold back, in effect giving money away.

But in a way, the blind spot to moderate recession risk does not leave us in too bad a position. If the next downturn is not as virulent as 2008—say more of a 1991- or 2001-style recession, then the Federal Reserve's rate increases to that point might have the Fed funds rate to 3 percent or more by the time of the downturn. This would give room to cut rates—not as much as one would normally do, but significant nonetheless.

A serious downturn, though, would leave us in a difficult position. Some believe that the Fed could resort again to quantitative easing. The evidence from the last ten years, however, suggests the impact of QE was subtle even with massive QE. I don't see a return to unconventional monetary policy having such a material impact on the toolkit that it would be adequate for a significant downturn. And I don't think that making announcements about the inflation target will do much either. We have announced 2 percent for a decade or more without hitting it. Will the market care if we announce 2.5 percent or 3 percent or even 5 percent? If your weight loss goal is ten pounds and after six months you haven't lost any weight, announcing a new weight loss goal of twenty pounds will not engender confidence. It always comes back to credibility.

This current situation feels worse than normal.

AUSTAN GOOLSBEE

Robert P. Gwinn Professor of Economics, Booth School of Business, University of Chicago, and former Chairman, Council of Economic Advisers for President Obama

On the one hand, no, of course not. The world is never ready for the next downturn and downturns always come as a surprise. Futures markets, pundits, and forecasters have all proved terrible at predicting recessions with much advanced warning.

But this current situation feels worse than normal. First, we are clearly overconfident about the stability of the expansion given lurking dangers. Besides the possibilities of credit events in China or the European Union, there is a casual disregard here in the United States of the dangers of an escalating trade war and an attempt to deregulate the financial sector and lower capital standards on financial institutions.

Second, having just lived through the worst recession of our lifetimes, it seems we are checking the horizon and, not seeing another 2008, have concluded there is no risk of recession. Let us not forget that most recessions don't look like 2008 and come on relatively suddenly, often precipitated by specific events—popping bubbles, energy price shocks, overly aggressive central bank tightening, military actions, and so on.

Central banks may want to focus on promoting growth.

DEAN BAKER

Senior Economist, Center for Economic and Policy Research

It is unfortunate that central banks have become so enamored of their 2 percent inflation targets that they are prepared to deliberately slow growth in order to ensure that inflation does not rise above this pace. In addition to the needless loss of output and employment, this will leave central banks ill-prepared for the next recession.

With inflation at low levels going into a recession, central banks will have little ability to use traditional interest rate policy to boost the economy. When interest rates hit the zero lower bound, the low rate of inflation in the economy means that the real interest rate will be only slightly negative.

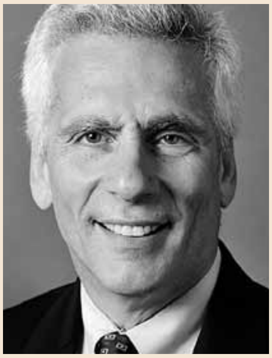
The fear of moving to a higher inflation rate as a target has little justification. There appears to be an idea among central bankers that even a modest increase in inflation from its extraordinarily low levels of recent years opens the door for continued acceleration leading to a wage price spiral.

While this story may reasonably well describe the 1960s and 1970s in most of the wealthy countries, economies have changed in the last four decades. They are far more open to international trade and, for better or worse, unions have much less bargaining power. This makes the prospect of a wage-price spiral highly unlikely.

It is also worth noting that central bankers hugely overestimate the importance of a stable and low inflation rate. While spiraling inflation is unambiguously an economic negative, it is difficult to see the bad consequences of an inflation rate that was allowed to rise to 3.0 percent or 4.0 percent, and remain more or less stable at this faster pace.

Countries with floating exchange rates with major trading partners, for example the United States and Canada, have managed to have decades of solid economic growth even as their currencies take large swings against each other. Few seem very concerned about fluctuations in currency values that can easily cause swings in the price of traded items by 10–15 percent or more.

If large and unpredictable price swings in traded goods doesn't disrupt the economy to any great extent, it is difficult to believe that a modest rise in the inflation rate would be very destabilizing. Given this reality, central banks may want to focus more on promoting growth and be willing to tolerate a modest increase in the inflation rate.



Good for Summers, but my worry is that we move to fiscal austerity.

JARED BERNSTEIN

Senior Fellow, Center on Budget and Policy Priorities, and former Chief Economist and Economic Adviser to Vice President Joe Biden

Larry Summers is doing the world a useful service by warning us how unprepared we may be for the next downturn. I would, however, focus more on potential shortcomings in the fiscal rather than the monetary response.

I will speak mostly of the U.S. case, though my arguments are transferable to other advanced economies.

Nobody's perfect, but the U.S. Federal Reserve is one of the few highly functional national institutions operating in the contemporary United States. The transition to Chairman Jerome Powell has been smooth and he continues the Fed's careful, data-driven campaign to slowly raise rates. I take Summers' point that monetary space may well be limited when we hit the next downturn, but I wouldn't overly focus on the 500 basis points from the "normal playbook," because the neutral rate is lower now.

A higher inflation target would provide some insulation against the lower bound on rates, but I'm much more worried about an inadequate fiscal response, both here and abroad.

At least two forces drive this concern. In the U.S. case, because we have engaged in a highly unusual degree of fiscal stimulus even as we closed in on full employment, our debt-to-GDP ratio is high and rising. Convincing research by Romer and Romer finds that at historically high debt ratios, say above 80 percent (about where the United States is now, and we're headed higher), the fiscal authorities do a lot less to offset the downturn. "The fall in GDP with fiscal space is just 1.4 percent. The fall in GDP following a crisis without fiscal space reaches a maximum of 8.1 percent."

It is important to recognize that the high debt-to-GDP constraint is one of perceived, not actual, fiscal space. Fiscal policy faces no limit analogous to the zero lower bound on interest rates, and recent research has found that if fiscal authorities fail to act forcefully in the face of a sizable output gap, debt-to-GDP may well worsen rather than improve. Moreover, since countercyclical fiscal interventions are temporary, they do not raise the long-term trajectory of the public debt (though they do raise the debt level).

Self-imposed fiscal constraints, also known as budget austerity, are thus the second worrisome force that may mitigate against an adequate fiscal response to the next downturn.

One final point that's germane to the U.S. case: As of late 2017, more than half of our states' unemployment insurance trust funds failed to meet the minimum standard for recession readiness (eleven of these states had less than half the recommended savings and California's system is in particularly bad shape).

So, good for Summers for sounding the alarm. Now it's up to us in the economic policy community to heed his warning and start educating fiscal policymakers about the difference between the actual and perceived limitations on fiscal space.

We have a classic paradox of the trough: so many pigs have fed so long the farm is threatened.

THOMAS FERGUSON

Professor Emeritus, University of Massachusetts, Boston, and Director of Research, Institute for New Economic Thinking

Complaints that we won't be able to cut interest rates low enough to get out of the next recession irresistibly bring to mind the story of the kid who killed his parents and then begged the court for mercy on grounds that he was an orphan.

Why we are in this predicament is obvious, or should be: Faced with the inescapable fact after 2008 that the magic of the marketplace was never going to stave off economic collapse, central banks broke with free market fundamentalism and start doing fiscal policy. In a normal democratic regime, these sorts of decisions would be debated by political parties and approved by parliaments. But in case you haven't noticed, most of us no longer live in normal democratic regimes. Overwhelming pressure to hold the line or actually cut taxes on higher incomes and corporations dominates budget policy across the OECD. The result is that legislators pass the buck as financial and other interests pass bucks to them. They sit back, and let unelected central banks do most of the heavy lifting.

Now we have a classic paradox of the trough, not the commons: so many pigs have fed so long that the farm itself is threatened.

There is, of course, a simple way out and we all used to know it, before nonsense macro came to dominate official discourse and much of mainstream economics. The conventional "policy space" needs to be enlarged: Use fiscal policy, big time, as central banks (and a few countries, *soto voce*) did after 2008. If you really hate taxes, design spending programs to take advantage of balanced budget multipliers, though those are unlikely to be enough. But get back to using fiscal policy as well as monetary policy and then the problem becomes manageable. This can have the side benefit of avoiding a huge pile-up of government debt, since few things are so disastrous to public debt levels as years of austerity. It will also do more to promote justice and social peace than any amount of preaching about the virtues of political centerism.

The views expressed here are the author's own.

The canonical role of national central banks in inflation control has been out of date for decades.

JAMES K. GALBRAITH

Lloyd M. Bentsen, Jr., Chair in Government/Business Relations, Lyndon B. Johnson School of Public Affairs, University of Texas at Austin

Galbraith's Law—mine in this instance*—states that in economics, a thought has not been thought until the right person has thought it. Professor Summers' declaration that "inflation is no longer the top issue" is a nice example.

Actually, inflation disappeared from the advanced economies by the middle 1980s. Why? In a moment of fleeting clarity, in his memoir, Alan Greenspan explained: the collapse of the Soviet Union generated a commodity glut, and then China flooded world markets with low-cost consumer goods. To this, let's add the digital revolution and ensuing fall in the price of capital equipment, plus, for the moment, fracking. These are all global factors and they tell us that the end of inflation was a global event.

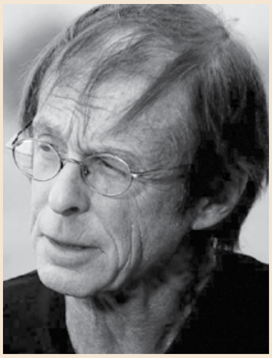
Thus, the canonical role of national central banks in inflation control has been out of date for decades. It's a matter of the little Dutch boy preening himself, years on end, while never peeking over the dike to notice that the lake is dry. Nor can central banks push up the inflation rate to meet a target in the face of deflation. Japan has been attempting this for years, with no success; quantitative easing (there and here) simply pumped the banks full of reserves they could not and did not use.

Summers is right to notice that interest rates aren't going to revert to the levels of the inflation era. Without the inflation, why should they? Central bankers cook up reasons—such as "reloading," based on a statistical notion of "normal—to justify talk about raising rates. But when they turn to doing it, they discover that their longstanding zero interest rate policy has flattened the yield curve, and a push at the short end brings financial havoc. Thus, in attempting to prepare for the next recession, they run the risk of bringing it on. The words of the poet once again ring true:

The Moving Finger writes; and, having writ,
Moves on: nor all thy Piety nor Wit
Shall lure it back to cancel half a Line,
Nor all thy Tears wash out a Word of it.

—The Rubáiyát of Omar Khayyám.
Quoted by P.G. Wodehouse and
other readers of great poetry.

**My father had several Galbraith's Laws, of which my favorite was, "a person with money to lend generally has more money than a person who does not have money to lend."*



Fiscal and monetary policies are already in place to raise the supply side potential of the economy.

ALLEN SINAI
Chief Global Economist and President, Decision Economics, Inc.

No! The world is not ready for the next downturn.

One reason is that a U.S. and global downturn is not on the horizon. There is no reason to get ready for an economic downturn, a recession, when the path of growth in the U.S. and world economies is moving up and the peak in growth, let alone a decline in the level of activity, is not indicated by the data nor underlying fundamentals.

Focusing on policies to deal with the next downturn is premature—instead, the emphasis should now be to maximize sustainable growth with reasonable price stability. No cart should be put before the horse here!

Policies that will raise sustainable growth, that is, potential output, and thus permit stronger actual growth should be the focus—increasing and maintaining stronger supply-side growth that can bring a higher full employment growth path with relatively low price inflation.

How can this be done?

Already, fiscal and monetary policies are in place to raise the supply side potential of the economy along with increasing aggregate demand.

Principal are the business tax reductions of Trumponomics legislated late in 2017.

Reductions in statutory and thus effective corporate tax rates, a full expensing of depreciation on capital equipment outlays, and the tax inducement to repatriate funds held abroad are providing a powerful stimulus to growth—both potential and actual.

This collection of business tax reductions gives a fillip to business earnings and cash flow, and provides the finance for increased capital spending, mostly now on productivity-enhancing information technology, and the private sector funds flows that result from a unique U.S. environment of risk taking, entrepreneurship, then enterprise, and higher potential growth as a consequence.

In addition, increased liquidity for business and individuals, for nonfinancial corporations arguably the greatest infusion of cash flow in history, not only provides stimulus to capital spending and capital formation that are labor-saving and productivity-enhancing, and thus a stimulus to potential growth, but also add to aggregate demand and hiring. Higher after-tax returns to saving and a lower after-tax cost of capital for business and individuals incent the supply of labor and formation of new businesses, the life blood for the economy throughout the history of U.S. capitalism.

There will be room for standard macro policies to be stimulative through the medicine of federal funds rate interest rate reductions and the new medicine of monetary stimulus from increases in the Federal Reserve's balance sheet after maximum full employment growth has been achieved.

Finally, when a downturn does occur, if for the usual reasons, that is in most post-World War II business cycles except for three (1990, 2000–2001, and 2006–2008), where price inflation and interest rates previously will have moved quite high and brought about a recession, easier monetary policy, increased fiscal stimulus, and the necessary private sector adjustments of real and financial excesses can be utilized to end the downturn. ◆

THE INTERNATIONAL ECONOMY
THE MAGAZINE OF INTERNATIONAL ECONOMIC POLICY
220 I Street, N.E., Suite 200
Washington, D.C. 20002
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Lawrence Summers

Summers Responds

Don't break out the champagne yet.

I am glad to see that the commentators share my sense of concern about the capacity of policy and the will of policymakers to respond to the next downturn. I am more anxious than most for several reasons.

First, I take a less favorable view of the last few years than many. While the crash of 2008 was contained more quickly than could reasonably have been expected, policy—between fiscal and monetary—was cumulatively understimulative between 2010 and 2015. This is not widely accepted, which makes me less than confident that policy will do better next time.

Second, as several commentators note, next time more of the stabilization burden will fall on fiscal policy because of limits on how much rates can be brought down. The risks that appropriate actions will not be taken because of some combination of misguided concern about excessive government debt and Washington dysfunctionality seem high. Recall that even with a major financial crisis under way, a new president with a strong mandate, and that president in possession of Congressional majorities, the passage of the too-small and too-temporary Recovery Act was a close run thing.

Our current prosperity is far more brittle than many suppose.

Third, if the next downturn involves major strains in the financial system, I worry about the capacity of the federal government to respond. Dodd-Frank curtails in important ways the U.S. Federal Reserve's capacity to support troubled institutions even at moments of systemic risk. Getting the Troubled Asset Relief Program of the next crisis through Congress could well be impossible given breakdowns in trust and increased polarization. Moreover, the current Treasury is the most policy-inexperienced in decades, and President Trump cannot be relied on to support necessary responses in a financial crisis as his predecessors did.

Fourth are the global issues. Concerted international action is often central to addressing downturns as it was in 2009, where the 2009 London G20 summit looks in retrospect to have been an important turning point, and the extension of dollar credits globally by the Fed was essential. Such efforts require American leadership and a willingness of others to join in a global effort. The president's recent moves to destabilize a dangerous Turkish financial situation are only the latest of many signals that the Trump Administration is not interested in supporting global cooperation.

The economy today looks strong. But as in the late 1920s, storm clouds may be gathering even as output and employment grow and markets perform well. Our current prosperity is far more brittle than many suppose. Excessive complacency followed by a combination of protectionism, probusiness ideology, and ugly nationalism led to catastrophe in 1929 and thereafter. It could happen again. ◆