

Sustainable Developments

The Need for Stable Policies

An exaggerated swing toward economic stimulus will only delay the return of sustainable prosperity

BY JEFFREY D. SACHS



The U.S. political-economic system gives evidence of a phenomenon known as “instrument instability.” Policy makers at the Federal Reserve and the White House are attempting to use highly imperfect monetary and fiscal policies to stabilize the national economy. The result,

however, has been ever more desperate swings in economic policies in the attempt to prevent recessions that cannot be fully eliminated.

President Barack Obama’s economic team is now calling for an unprecedented stimulus of large budget deficits and zero-interest rates to counteract the recession. These policies may work in the short term, but they threaten to produce still greater crises within a few years. Our recovery will be faster if short-term policies are put within a medium-term framework.

There is little doubt that unduly large swings in macroeconomic policies have been a major contributor to our current crisis. During the decade from 1995 to 2005, then Federal Reserve chairman Alan Greenspan overreacted to several shocks to the economy. When financial turbulence hit in 1997 and 1998—the Asian crisis, the Russian ruble collapse and the failure of Long-Term Capital Management—the Fed increased liquidity and accidentally helped to set off the dot-com bubble. The Fed eased further in 1999 in anticipation of the illusory Y2K computer threat. When it subsequently tightened credit in 2000 and the dot-com bubble burst, the Fed quickly turned around and lowered interest rates again. The liquidity expansion was greatly amplified following 9/11, when the Fed cut interest rates sharply (eventually to a low of 1 percent in June 2003) and thereby helped to set off the housing bubble, which has now collapsed.

We need to avoid destabilizing, short-term swings in policy. Massive deficits and zero-interest rates might temporarily perk up spending but at the risk of a collapsing currency, loss of confidence in the government, and growing anxieties about the government’s ability to pay its debts. That outcome could frustrate rather than speed the recovery of private consumption and investment. Although deficit spending in a recession makes sense, the deficits should remain limited (less than 5 percent of GNP), and our interest rates should be kept far enough above zero to avoid wild future swings.

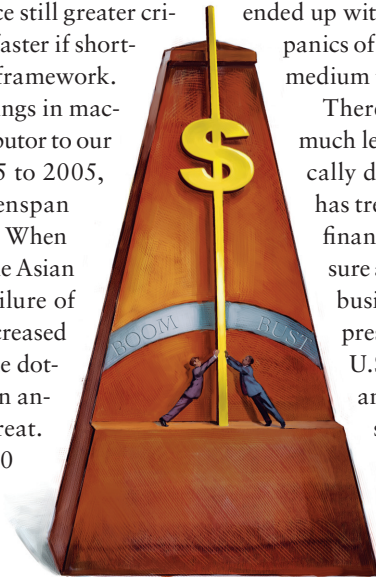
We should also avoid further gutting the government’s revenues with more tax cuts. Tax revenues are already too low to cover the government’s bills, especially when we take into account the unmet and growing needs for outlays on health, education, state and local government, clean energy, and infrastructure. We will in fact need a trajectory of rising tax revenues to balance the budget within a few years.

Most important, we should stop panicking. One of the reasons we got into this mess was the Fed’s exaggerated fear in 2002 and 2003 that the U.S. was following Japan into a decade of stagnation caused by deflation (falling prices). To avoid a deflation, the Fed created a bubble. Now the bubble has burst, and we have ended up with the deflation we feared! Panics end badly, even panics of policy; more moderate policies will be safer in the medium term.

There is little reason to fear a decade of stagnation, much less a depression. The U.S. economy is technologically dynamic and highly flexible. The world economy has tremendous growth potential if we do not end up in financial and trade conflict and if the central banks ensure adequate liquidity to avoid panicky runs on banks, businesses and sovereign borrowers. The Great Depression itself resulted from a horrendous run on the U.S. banking system in an era without deposit insurance and when the Fed and Congress did not understand the critical role of a lender of last resort.

In short, although the sharp downturn will unavoidably last another year or even two, we will not need zero-interest rates and megadeficits to avoid a depression or even to bring about a recovery. In fact, the long-term, sustainable recovery will be accelerated by a policy framework in which the budget credibly returns to near balance over several years, the government meets its critical responsibilities in social services, infrastructure and regulation, and the Fed avoids dangerous swings in interest rates that actually contribute to the booms and busts we seek to avoid. ■

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