
Confronting the Fiscal Bogeyman

By Barry Eichengreen Wed, Mar 16, 2016

'The solution... is to fix the problem of deficient demand not by attempting to further loosen monetary conditions, but by boosting public spending,' says our guest columnist, an economist and author of many books on the global economy.



The world economy is visibly sinking, and the policymakers who are supposed to be its stewards are tying themselves in knots. Or so suggest the results of the G-20 summit held in Shanghai at the end of last month.

The International Monetary Fund, having just downgraded its forecast for global growth, warned the assembled G-20 attendees that yet another downgrade was pending. Despite this, all that emerged from the meeting was an anodyne statement about pursuing structural reforms and avoiding beggar-thy-neighbor policies.

Once again, monetary policy was left—to use the now-familiar phrase—as the only game in town. Central banks have kept interest rates low for the better part of eight years. They have experimented with quantitative easing. In their latest contortion, they have moved real interest rates into negative territory.

The motivation is sound: someone needs to do something to keep the world economy afloat, and central banks are the only agents capable of acting. The problem is that monetary policy is approaching exhaustion. It is not clear that interest rates can be depressed much further.

Negative rates, moreover, have begun to impair the health of the banking system. Charging banks for the privilege of holding reserves raises their cost of doing business. Because households can resort to safe-deposit boxes, it's hard for banks to charge depositors for safekeeping their funds.

In a weak economy, moreover, banks have little ability to pass on their costs via higher lending rates. In Europe, where experimentation with negative interest rates has gone furthest, bank distress is clearly visible.

The solution is straightforward. It is to fix the problem of deficient demand not by

attempting to further loosen monetary conditions, but by boosting public spending. Governments should borrow to invest in research, education, and infrastructure. Currently, such investments cost little, given low interest rates. Productive public investment would also enhance the returns on private investment, encouraging firms to undertake additional projects.

Thus, it is disturbing to see the refusal of policymakers, particularly in the US and Germany, to even contemplate such action, despite available fiscal space (as record-low treasury-bond yields and virtually every other economic indicator show). In Germany, ideological aversion to budget deficits runs deep. It is rooted in the post-World War II doctrine of “ordoliberalism,” which counseled that government should enforce contracts and ensure adequate competition but otherwise avoid interfering in the economy.

Adherence to this doctrine prevented postwar German policymakers from being tempted by excesses like those of Hitler and Stalin. But the cost was high. The ordoliberal emphasis on personal responsibility fostered an unreasoning hostility to the idea that actions that are individually responsible do not automatically produce desirable aggregate outcomes. In other words, it rendered Germans allergic to macroeconomics.

The aging of the German population then made it seem urgent to save collectively for retirement by running surpluses. And an exceptional spate of budget deficits following German reunification in 1990 appeared only to aggravate, not solve, reunified Germany’s structural problems.

Ultimately, hostility to the use of fiscal policy, as with many things German, can be traced to the 1920s, when budget deficits led to hyperinflation. The circumstances today may be entirely different from those in the 1920s, but there is still guilt by association, as every German schoolboy and girl learns at an early age.

The US did not experience hyperinflation in the 1920s—or at any other time in its history. But for the better part of two centuries, its citizens have been suspicious of federal government power, including the power to run deficits, which is fundamentally a federal prerogative. From independence through the Civil War, that suspicion was strongest in the American South, where it was rooted in the fear that the federal government might abolish slavery.

In the mid-twentieth century, during the civil rights movement, it was again the Southern political elite that opposed the muscular use of federal power. Starting in 1964, in

conjunction with Democratic President Lyndon Baines Johnson's "New Society," the government threatened to withhold federal funding for health, education, and other state and local programs from jurisdictions that resisted legislative and judicial desegregation orders.

The result was to render the South a solid Republican bloc and leave its leaders antagonistic to all exercise of federal power except for the enforcement of contracts and competition—a hostility that notably included countercyclical macroeconomic policy. Welcome to ordoliberalism, Dixie-style. Wolfgang Schauble, meet Ted Cruz.

Ideological and political prejudices deeply rooted in history will have to be overcome to end the current stagnation. If an extended period of depressed growth following a crisis isn't the right moment to challenge them, then when is?

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