Crises of Governments

SUMMARY

- The ‘Great Recession’ has been particularly deep. In the USA, the loss of GDP relative to trend growth has been 9 per cent. The recovery from recession has also been much slower than the recovery from the recessions of the early 1980s and early 1990s. After those recessions, the USA achieved economic growth of 4.3 per cent and 3.6 per cent respectively.
- The slump has not been nearly as bad as the US Great Depression, though the fall in stock market values of over 50 per cent was the second-largest in history. This compares with a fall in the stock market of 79 per cent during the Great Depression. Furthermore, house prices have fallen by 37 per cent since the financial crash.
- One of the major causes of the crash was the boom in securitisation whereby inherently risky loans were packaged together and sold as very low-risk securities. This was strongly encouraged by the government; Fannie Mae and Freddie Mac, the government agencies responsible, should be privatised.
- The US government was right to bail out the systemically risky banks. However, other aspects of the fiscal stimulus package were misguided for various reasons.
- In general a fiscal stimulus package might raise output in the very short run but the long-term fiscal multiplier is negative.

This leads growth to stall after an initial increase, as is happening at the moment.

- If fiscal stimulus packages are to be used at all then they should be based around reducing taxes so that the tax reductions stimulate work, investment and enterprise. While some of the spending increases have just been a waste of money, others have been very damaging. For example, the significant lengthening of the duration of unemployment payments has caused a rise in the unemployment rate of between 1 and 2 per cent.
- Spending and welfare programme entitlements grew rapidly under President George W. Bush and that growth has continued under President Obama. In many respects, as far as economic policy is concerned, Bush and Obama are 'twins', just as Reagan and Clinton were 'twins'.
- There should be concerns about the exit strategy from the process of quantitative easing. It will be difficult for central banks to avoid both inflation and recession.
- The next crisis will be a crisis of government debt. This debt consists of both explicit borrowing and also of entitlements through social security programmes that have been dramatically expanded under Presidents Bush and Obama. This crisis of government debt is not just a US problem.
- The coming crisis can be addressed in the USA only by reforming entitlement programmes and also by tax reform to reduce 'tax expenditures' or special exemptions from taxes for certain types of economic activity. In the EU, fiscal and monetary policy need to be decoupled so that member states do not become responsible for each other's borrowing.