

# Why Obama's plan is still inadequate and incomplete

By Martin Wolf, *Financial Times*, January 13 2009

Last week, President-elect Barack Obama duly unveiled his American recovery and reinvestment plan. Its title was aptly chosen, for Mr Obama spoke, astonishingly, as if the policies of the rest of the world had no bearing on the fate of the US. He spoke, too, as if a large fiscal stimulus would be enough to restore prosperity. If that is what he believes, Mr Obama is in for a shock. The difficulties he confronts are much deeper and more global than that.

I have little doubt that his advisers are telling the president-elect just this. The points they are – or should be – pressing on him are these.

First, the Japanese policymakers who told everyone the US was in danger of falling into a prolonged period of economic weakness were right. To understand why this is true, you need to read a brilliant book by Richard Koo of the Nomura Research Institute\*. In this, he explains how the combination of falling asset prices with high indebtedness forces the private sector to stop borrowing and pay down debt. The government then inevitably emerges as borrower and spender of last resort. Because the Japanese government knew this at least, the country suffered a prolonged recession rather than a slump.

It has long been argued that the US could not suffer like Japan. This is wrong. It is true the US has three advantages over Japan: the destruction of wealth in the collapse of the Japanese bubble was three times gross domestic product, while US losses will surely be far smaller; US non-financial companies do not appear grossly overindebted; and, despite efforts by opponents of marking assets to market, recognition of losses has come far sooner.

In other respects, however, the US is still more vulnerable than Japan, after its recent debt binge (see chart). The rest of the world's economy was big and dynamic enough to sustain Japan's exports, but the whole world is now in recession; moreover, the US is both a

deficit and a debtor country. Mrs Watanabe trusts her government. How far does she trust Uncle Sam? How far, indeed, does Hu Jintao?

Any complacency about US recovery prospects is perilous. Moreover, the fact that the US has a structural current account deficit has bearing on the second point Mr Obama's advisers must make. Fiscal stimulus is a necessary palliative for a debt-encumbered economy afflicted by falling asset prices. But the likely longevity and scale of the needed fiscal deficits are quite scary.

In last week's column ("Choices made in 2009 will shape the globe's destiny", January 6) I argued that the debt-encumbered US private sector would now be forced to save (see chart). The excess of income over expenditure in the private sector might be, say, 6 per cent of GDP for a lengthy period. If the structural current account deficit remained 4 per cent of GDP, the overall fiscal deficit would need to be 10 per cent of GDP. Moreover, this would be the structural – or full employment – deficit.

The Congressional Budget Office forecasts that US output will be 7 per cent below potential over the next two years, on unchanged policies. If so, the actual deficit should now be much larger than the structural one. It is easy to see, therefore, why the critics argue that the Obama plan for an additional fiscal stimulus of 5 per cent of GDP over two years is too small, even though the CBO forecasts a baseline deficit of 8.3 per cent of GDP this year. It is also easy to understand why many object strongly to tax cuts, since the more likely cuts are to be saved the larger the package must be – and, in addition, taxes will clearly have to rise in the longer term.

The bigger point, however, is not that the package needs to be larger, although it does. It is that escaping from huge and prolonged deficits will be very hard. As long as the private sector seeks to reduce its debt and the current account is in structural deficit, the US must run big fiscal deficits if it is to sustain full

employment.

That leads to the third point Mr Obama's advisers must make. This is that running huge fiscal deficits for years is indeed possible. But the US could get away with this only if default were out of the question.

At the end of the Napoleonic wars, the UK had a ratio of public debt to GDP of 270 per cent. This was brought down over a century: growth, the gold standard and the commitment to balanced budgets did the trick (see chart). The question is how much debt the US (or UK) can accumulate now. My guess is that the US could hope to run large deficits for years if these were used to finance the creation of high-quality assets. But the policy could not safely endure throughout a two-term presidency.

Yet, contrary to widespread belief in the US, a swift return to small fiscal deficits, high employment and rapid growth will not occur spontaneously. It is necessary to make structural changes in the US and world economies first. This is the last point Mr Obama's advisers must make.

What then are these changes?

First, there must be a credible programme for what Americans call "deleveraging". The US cannot afford years of painful debt reduction in the private sector – a process that has still barely begun. The alternative is forced writedowns of bad assets in the financial sector and either more fiscal recapitalisation or debt-for-equity swaps. It also means the mass bankruptcy of insolvent households and forced writedowns of mortgages.

All this would also lead to big one-off increases in public debt. But those increases would probably be much smaller than those generated by a decade of huge fiscal deficits. The aim is to have a slimmer and better-capitalised financial system and a healthier non-financial private-sector balance sheet, sooner rather than later. The troubled asset relief programme should be used for these purposes. It will need to be bigger.

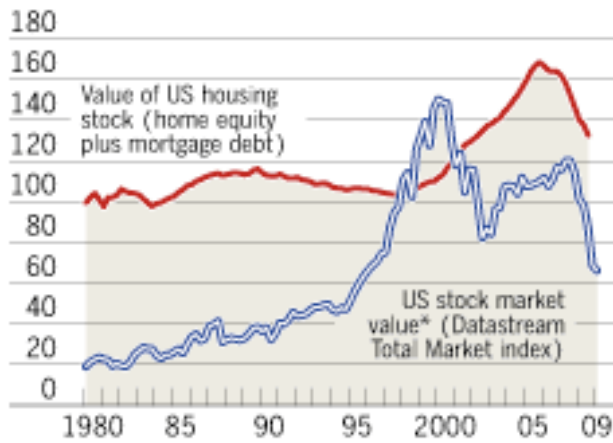
Second and most important, the structural current account deficit has to diminish. The US private sector is no longer in a position to run huge financial deficits as an offset to the demand-draining external deficits. The public sector can do so only for a few years. In the long run, the world economy must be sustainably and healthily rebalanced. This is a huge challenge for international economic diplomacy. It is also an essential element of sound domestic policy.

Mr Obama must be fully persuaded of these last points. If the fiscal deficits are to fall sharply in the medium term, as they need to, the new president needs effective programmes for private sector deleveraging and global reform and adjustment. The fate of the US cannot be determined in isolation. What this should mean will be the subject of next week's column.

*\*The Holy Grail of Macroeconomics: Lessons from Japan's Great Recession (Wiley, 2008)*

## Value of US housing stock and equity market

As a % of GDP

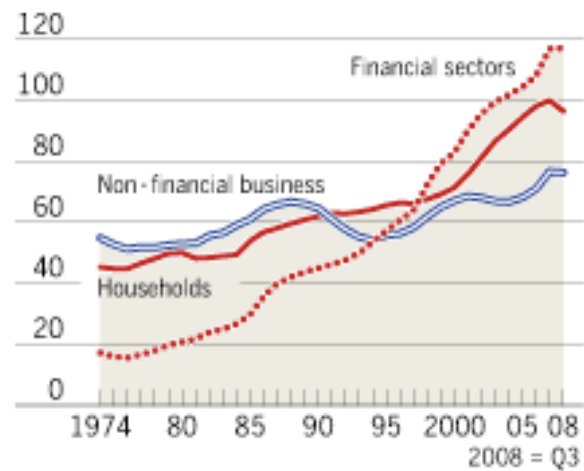


\* Updated using Consensus forecasts for GDP

Sources: Federal Reserve; Freddie Mac; Consensus Economics

## US private sector debt

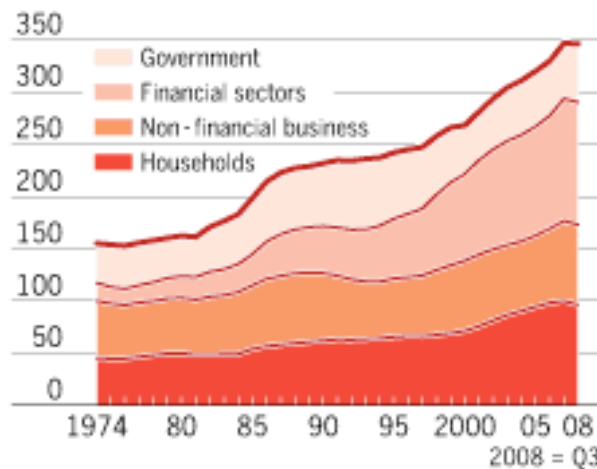
As a % of GDP



Sources: Federal Reserve; BEA

## US sectoral debt ratios

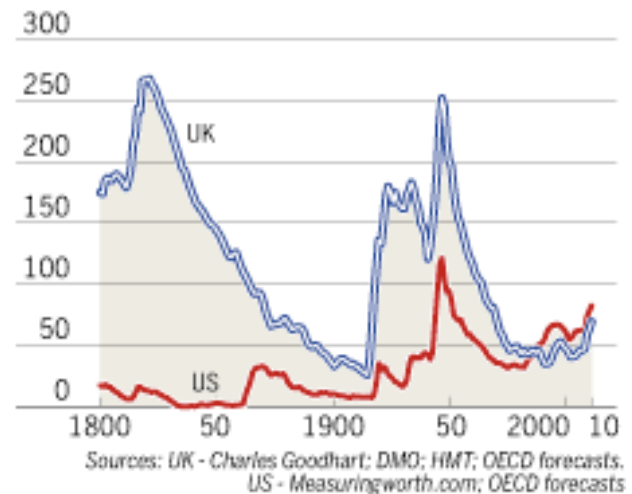
As a % of GDP



Sources: Federal Reserve; BEA

## Public debt in the US and UK

As a % of GDP



Sources: UK - Charles Goodhart; DMO; HMT; OECD forecasts.  
US - Measuringworth.com; OECD forecasts