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Big Spending and Easy Money Will Produce a Recovery

The question is whether policy errors will cause another dip

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Congress has just passed the outline of the president's $3.5 trillion budget. This comes on top of the $787 billion stimulus bill in February, and on top of an expansionary monetary policy. The question now is whether the combination will produce a real recovery.

Here we should look to three historical examples where aggressive monetary expansion was wedded to an aggressive fiscal policy: the U.S. during the mid-1930s, Germany through the 1930s, and Japan in the early 2000s. In each case there was a recovery, although policy errors led to significant setbacks. These episodes can help assess U.S. growth prospects, and the risks to a sustainable recovery.

The Great Depression in the U.S. came in two stages, a downturn from 1929-33 in which real GDP collapsed by 26.5% and unemployment rose to 25% from 3%, and a relapse in 1937-1938, with a 3.4% decline in real GDP and a rise in unemployment to 19% from 14%.

The first stage of the depression was associated with a collapsing equity bubble (1929), protectionist tariff legislation (1930), contractionary monetary policy (1931) and a sharp rise in tax rates (1932). Between 1934 and 1937, however, there was a rapid recovery, in part due to the severity of the downturn that preceded it. Real GDP expanded by 9.5% per annum, while the unemployment rate fell 11 percentage points.

The recovery was spurred in no small part by monetary policy. In 1933-34, the dollar was devalued against gold to $35 per ounce from $20.67 per ounce, which allowed the Fed to push reserves into the banking system. This allowed the Fed to finance FDR's deficits with the printing press. After falling at an average rate of 6.7% per year from 1930-33, the Consumer Price Index rose by an average 2.7% per year from 1934-37.

The stock market, which had collapsed by 86.2% between September 1929 and June 1932, rose more than fourfold in the five years between 1932 and the peak of the next business cycle in 1937. As is customary, the equity market bottomed nine months before the economy, while the corporate bond market bottomed 10 months before the business cycle trough.

Monetary and fiscal policy were abruptly tightened during 1936-37, with the Fed hiking reserve requirements and contracting the money supply just as tax rates rose and spending was paired back in an ill-fated attempt to balance the budget. The economy fell into recession while the stock market plunged 54%.

The German economy expanded rapidly in the 1930s, as large increases in government spending on public works, construction and rearmament were funded by deficits and easy money. The money stock grew at an average annual rate of 10% while government expenditures galloped by 30.7% a year. Real GDP expanded by about 10% per year. Unemployment disappeared. For a time the "German economic miracle" concealed Hitler's homicidal intentions. Still, Germany suffered from stagnant wages and low productivity. Business profits and investment did well, but consumer-goods industries languished as wages were restrained by the state.

On the other side of the Atlantic, FDR took the opposite track and tried to keep wages high by strengthening union power via the National Industrial Recovery Act (NIRA) and later the Wagner Act. This probably kept unemployment higher than it otherwise would have been.

And Japan? Its fiscal and monetary response to the twin collapse of equity and real-estate bubbles in early 1990s was poorly designed. Government spending was ramped up in the mid-1990s, but much of the spending was wasteful. Tax rates were raised along the way. The Bank of Japan didn't engage in quantitative easing until the early 2000s, more than a decade after the real-estate and equity bubbles had begun to burst.

Japan did have an economic recovery from 2004-07, and a rising stock market to boot. But the recovery was relatively weak, and it took a long time to emerge. Yet Japan's long recession and weak recovery may not be the compelling historical parallel for the U.S. that many believe it to be. Japan also suffers from structural difficulties that aren't relevant in the U.S. today. Its population growth has fallen to zero and is headed into negative territory. Liquidity growth, which slumped in Japan after its property and equity bubbles began to burst, has been on a very robust growth track in the U.S.

In sum, history suggests that a highly aggressive monetary policy married to a fiscal expansion will lead to recovery. The Treasury yield curve is steep and money supply growth has been rapid, a dynamic usually associated with an eventual pickup in economic growth. Credit spreads have begun to narrow, a sign risk aversion is easing. Industrial commodity prices, which plunged more than 60% during the second half of 2008, have been firming, a sign that global demand is stabilizing.

All of this suggests the economy will bottom during the second half of 2009 and post solid growth in 2010. But whether a robust recovery can be sustained is another matter.

U.S. tax rates are scheduled to rise in 2011, when the Bush tax cuts expire. This would be a small negative, all things being equal. But all things won't be equal. Ultimately the Fed will have to tighten money and begin to work down its bloated balance sheet. If this

occurs as tax rates are adjusting to a higher plateau, there's a real danger that what appears to be a robust expansion will flame out.

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