Rehabilitating macroeconomic sanity

The demand for the day should be restoring economic responsibility and social equity

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The current crisis has caused widespread suffering, and the suffering is far from over. We welcome signs of recovery from the crisis, but this will not end the need for continued sacrifice. A decade of irresponsible policies caused the crisis, and left many countries in an unsustainable position. The impact of attempts to remedy the mistakes of the past decade will be felt for another decade to come. Progressives need to respond to the crisis and its aftermath in a way that is both economically sensible and socially defensible.

We in the United States are living through a classic debt crisis. The roots of the crisis go back to 2001, when massive tax cuts drove the federal government from large-scale surpluses to huge deficits. This began an extraordinary surge in American foreign borrowing, which averaged between a half trillion and a trillion dollars a year between 2001 and 2007.

The borrowing binge was intensified by American monetary policy, as the Federal Reserve kept interest rates at unprecedentedly low levels. This encouraged households to join the borrowing bonanza, expanding housing and credit card debt at a dizzying pace. The five trillion dollars flooding into the country from abroad had the typical effects of an inflow of foreign funds: demand for hard goods rose, leading to an import surge and swelling the trade deficit, while demand for non-traded goods and services also rose, leading to a surge in the price of such non-tradables as healthcare, entertainment, education and housing.

As is typical in classical capital flow cycles of this sort, foreign borrowing sparked an economic expansion, which became a boom, which became a bubble, which has now burst. This pattern was common to a phalanx of deficit countries – the US, the UK, Spain, Ireland, countries in central and eastern Europe.

The American economic policies that caused the crisis all had political underpinnings. The Bush administration cut taxes to satisfy its wealthy base, and to appeal to middle-class voters, despite the clear knowledge that the inevitable deficits would be a heavy burden upon future generations.

The Fed's loose monetary policy almost certainly was designed to help get Alan Greenspan reappointed in May 2004, and to help get George W. Bush reelected in November 2004; interest rates began rising within weeks of the election. The regulatory laxity of the nation's ostensible financial guardians was enabled and encouraged by the undue influence of banks and other financial institutions on the agencies that were supposed to be regulating them.

The stabilisation phase of crisis management will be difficult, and it will be followed by a long, arduous phase of economic adjustment. The economic policy patterns of the past decade are no longer sustainable. For the past ten or more years, one large group of countries relied on massive borrowing from abroad to allow them to consume more than they produced, invest more than they saved, and have their governments spend more than they took in.

These relationships will have to be reversed. As adjustment takes hold, the deficit nations will have to produce more than they consume, save more than they invest, and have their governments take in more than they spend in current costs. All of this will almost certainly require stagnant or declining consumption, stagnant or declining real wages, stagnant or declining standards of living. The austerity we face will not be pretty, but it is close to unavoidable.

The reality bequeathed to us by a decade of recklessly negligent economic policies constrains the choices available to progressives. The macroeconomic reality requires austerity measures to reduce the imbalances and get our societies back on a healthier footing. We could attempt to match the crass short-sightedness of the Bush administration, but this would be imprudent and immoral. Progressives can and should take the lead in insisting that the current generation not visit its macroeconomic sins on its children.

But progressives can also attempt to redress some of the unjust distributional effects of the past decade's follies, and of the immediate crisis response. The upper ten per cent of the American income distribution benefited disproportionately from the tax cuts, deficit spending, and borrowing boom.

To add insult to injury, the cost of the crisis itself has fallen disproportionately on those who benefited least from the preceding boom. Some of this is inevitable, as with the measures needed to restore the financial system. It is a sad fact of any panic, including this one, that measures to bring the banking system back from the brink require bailing out the guilty in order to protect the innocent.

Yet there is no need for such an unjust burden of adjustment to continue. We can and should insist that policies to restore macroeconomic balance and financial sanity also restore social equity. Financial regulation, tax policy, and spending priorities should have as a prominent aim helping those in need – and taking from those who have profited the most from the excesses of the past decade. While such policies may not appear to be prominent on the agenda today, there is a powerful undercurrent of resentment centred on the inequitable nature of the adjustment process as currently structured.

There is nothing preordained about this inequity, and progressives would do themselves – and society – much good by insisting on a rebalancing both of the macroeconomy and of our social priorities.

Progressives can and should stand both for macroeconomic responsibility, and for helping those most in need and most neglected by past policy. These two requirements are economically and politically urgent; they are compatible with one another, indeed they complement one another. The demand of the day should be for economic responsibility and social equity.

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