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America's economy

Aspirin, not morphine

Jan 3rd 2008

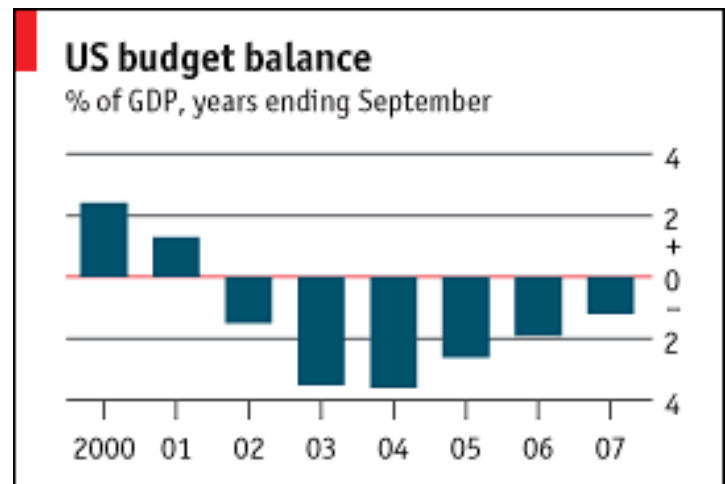
From The Economist print edition

America's economy will be weak in 2008, but policymakers should dispense the pain-killers with care

MORE drugs do not always speed a patient's recovery. And strong medicine can have unpleasant side-effects. These medical homilies are worth bearing in mind as America's economy enters 2008. With a year of weak growth in prospect and a high risk of recession, the clamour for action is getting louder. Critics charge that the Federal Reserve, which in recent months has cut its short-term policy rate by one percentage point, to 4.25%, has been far too cautious. An economy at risk, the argument goes, needs much cheaper money, and quickly.

In recent weeks luminaries such as Larry Summers, treasury secretary in the Clinton administration, and Martin Feldstein, a Republican economist, have also called for fiscal stimulus. Mr Feldstein wants a tax cut that would automatically kick in if employment fell for three consecutive months. Mr Summers wants a fiscal boost worth \$50 billion-75 billion. Congressional Democrats are working on a stimulus of temporary tax cuts and spending increases. The White House is said to be exploring a fiscal package.

The political appeal of a stimulus is easy to understand. It is an election year and Americans are feeling increasingly pinched. The economy has soared to the top of voters' priorities; approval of Mr Bush's handling of it has fallen to a record low; and one poll suggests that Americans are already gloomier than they were during the 2001 recession.



But does speedier action make economic sense? In a recent speech Mr Summers argued that America risked the worst downturn since the early 1980s. Failing to deal with this, he argued, would be far costlier than loosening policy too much to avert it. If overly loose monetary policy created "undue inflation pressures", they could be countered at a "moment of much less financial peril". A "timely", "temporary" and "targeted" fiscal boost could complement more monetary easing without compromising America's long-term budget health. This argument hinges on three questions: How vulnerable is the economy? What is the price of overdoing monetary easing? Will politicians design a sensible stimulus package? Each, on closer inspection, argues against rushing to action.

Cold-shower treatment

No one doubts that 2008 will be hard. The combination of a weakening labour market, slipping house prices, tighter credit and higher fuel costs will weigh on domestic spending. The price of oil hit \$100 a barrel this week (see [article](#)). House prices have fallen by 5% from their peak and by all accounts have far further to go. A pessimistic survey of manufacturing published on January 2nd only deepened the gloom.

And yet, although tumbling house prices and a sharp credit contraction could indeed pull the economy into a noxious downward spiral, the evidence of such an economic disaster is, as yet, slim. The last reading of consumer spending, in November, was surprisingly strong. The stickiness of house prices suggests the drag on consumer spending will be long and grinding, not sudden and sharp. And it is worth remembering that slower domestic spending and higher saving is exactly what America needs to correct its current-account deficit.

Anyway, insuring against calamity can be costly. The last time the Federal Reserve slashed interest rates to shore up the economy, between 2001 and 2003, it sowed the seeds of today's housing mess. Although a housing and credit collapse would be deflationary, preempting that risk too dramatically could be inflationary. Consumer prices are rising uncomfortably fast, and people's expectations of future inflation, by some measures, have inched upwards. If central bankers allow inflation expectations to become unhinged, they will have a nasty, protracted problem on their hands. That is why the Fed's measured pace of interest-rate cuts is prudent.

If America's economy falls into a long slump, then of course politicians should grasp the fiscal lever. That is one way to reduce the pressure for extreme monetary easing. Cash-strapped consumers in depreciating houses might respond more forcefully to tax cuts than lower interest rates. And if the mortgage mess gets bad enough, a public bail-out—say by using institutions such as the Federal Housing Administration—may prove a less damaging palliative than heavy-handed government rewriting of mortgage contracts.

But none of this means it is right to act now. With private spending weakening, not slumping, there is no case for a fiscal offset. Although America's budget deficit, at 1.2% of GDP, is not enormous, the room for manoeuvre is smaller than in 2001, when Mr Bush

sold his tax cuts as a stimulus. Partly as a result, Congress is contemplating only modest actions—such as a tax rebate, more food stamps, perhaps some infrastructure spending. It is likely to be a vain exercise: unnecessary if the downturn is mild, but insufficient to deal with a truly dire mess. Like good doctors, policymakers ought to plan for the worst. But, for now, they should keep their strongest pills locked away.

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