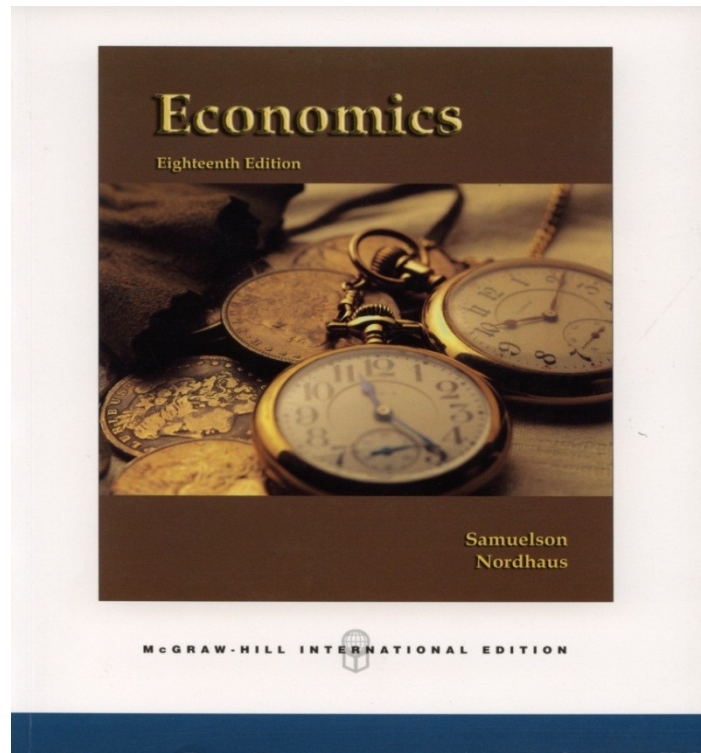


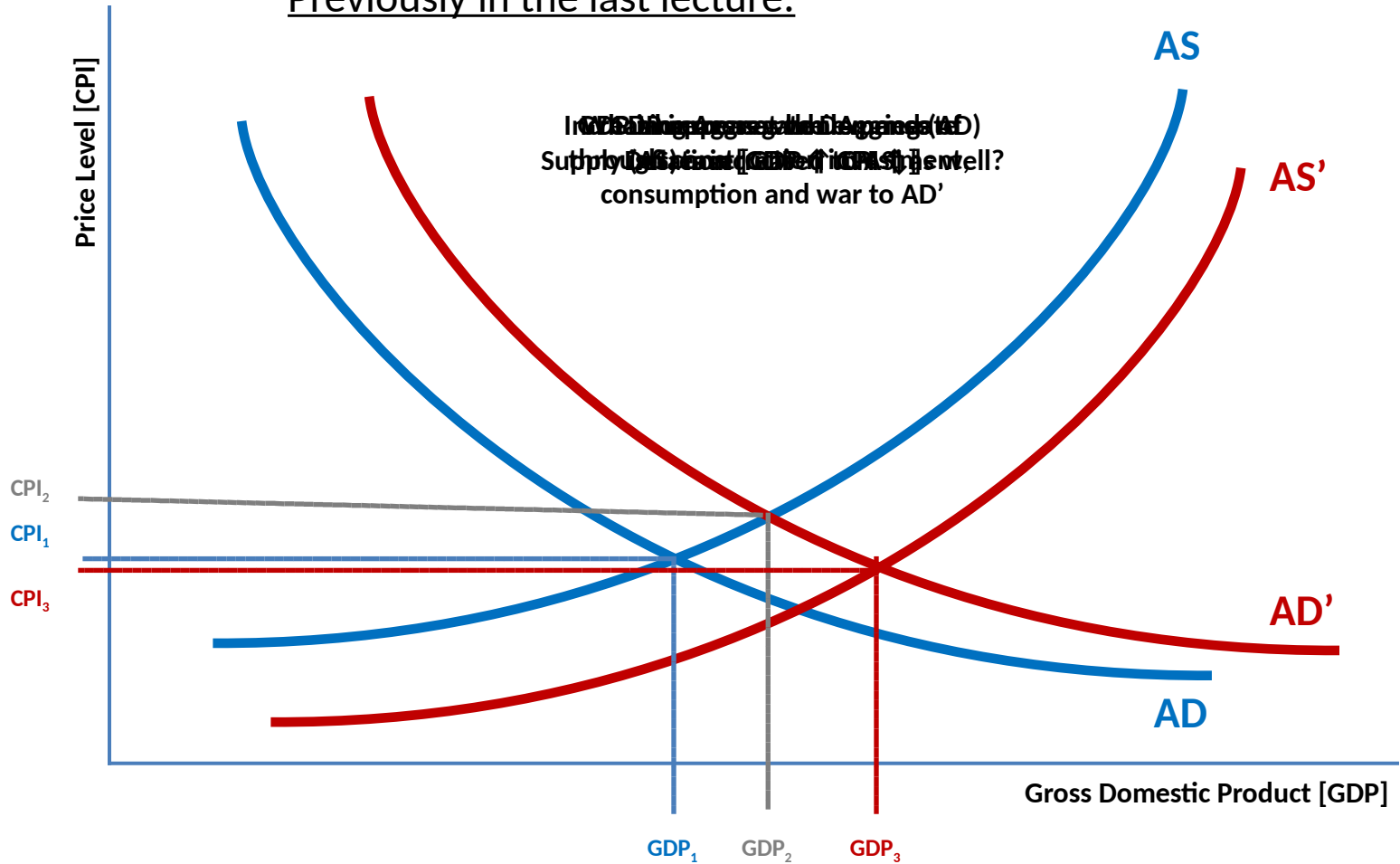


Samuelson P.A. and Nordhaus W.D. (2005).
Economics, 18th Edition. McGraw-Hill

Chapters to Cover – Part 5

- Chapter 20: Overview of Macroeconomics
- Chapter 21: Measuring Economic Activity
- Chapter 22: Consumption and Investment
- Chapter 23: Business Fluctuations and the
Theory of Aggregate Demand
- Chapter 24: The Multiplier Model
- Chapters 25 and 26 not covered

Previously in the last lecture:

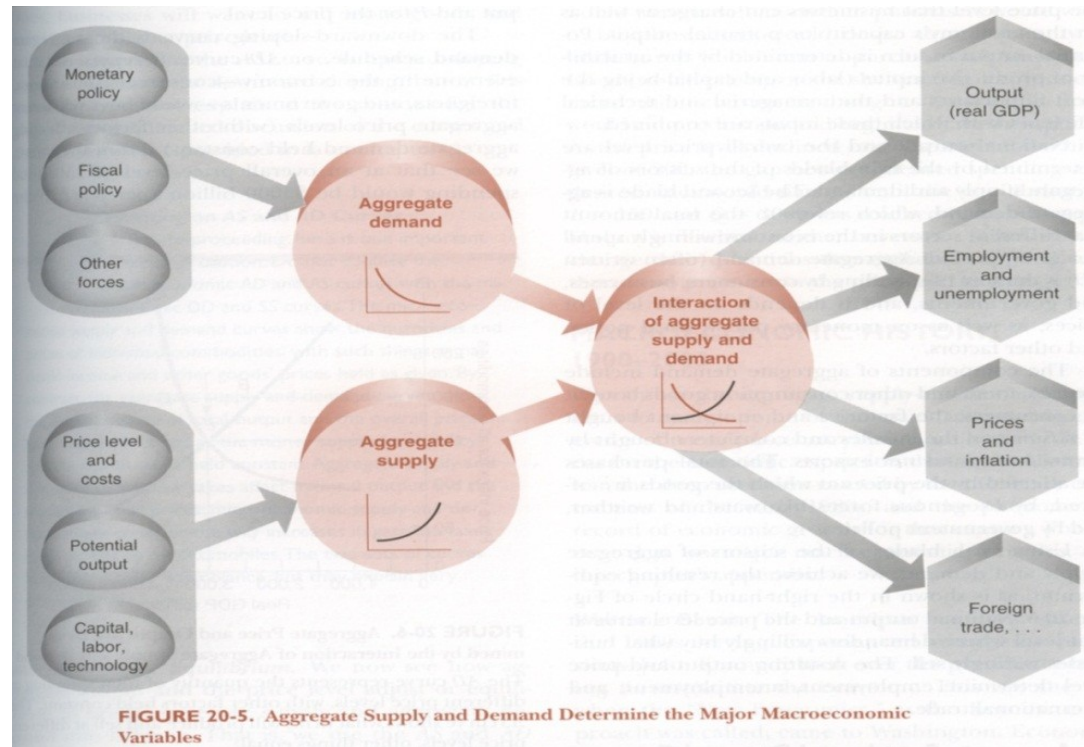


GDP is measured in 3 approaches in HK: (1) income, (2) production [construction] and (3) expenditure [investment and consumption]

Before We Continue

- With our demand management, let's have a look at the supply side.
- One macro-economics objective is to increase aggregate supply.

Increasing Aggregate Supply



Chapter 23

Business Fluctuations and the Theory of Aggregate Demand

Cycles

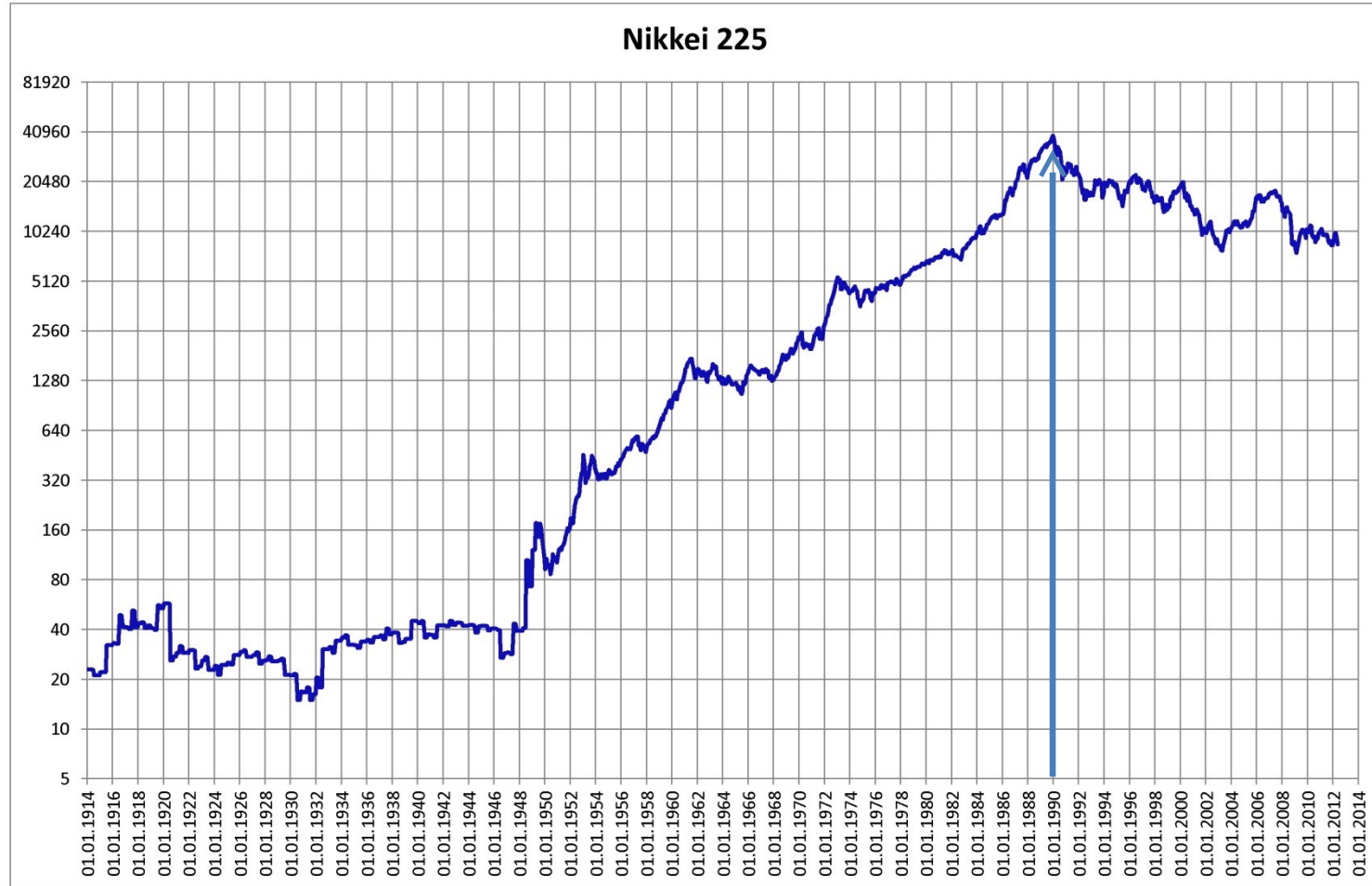
- Economic cycles:
 - Perfect timing of supply and demand is only an ideal.
 - There is always trade-offs between growth, inflation and employment.
 - Leading to business cycles, and then property cycles.

Economic Cycles

- High growth usually comes with inflation but low unemployment rate.
 - Hong Kong before 1997.
 - China in the last two decades: recent policies to cool down property speculation, dampening demand for properties, long regarded as hedge against inflation.
 - Hyperinflation: Germany in the early 40s, and China around the same time resulting in the rise of the Communist Party and the retreat of the Nationalist Party to Taiwan.
 - Exceptions: the world generally experienced high growth with LOW inflation: supply of cheap products from China, perhaps until now? The end of “population dividend”?

Economic Recessions

- Economic recessions usually come with low inflation or even deflation and unemployment.
 - Japan ever since 1990 after their property and stock collapse in 1990.
 - Hong Kong after 1997 and through the 2000's.
 - Exceptions: economic recessions and high inflation [stagflation]: The US and the UK in the 60s in the mid of the oil crisis – the rise of the oil countries.



Source: https://en.wikipedia.org/wiki/Nikkei_225

What is Business Cycles?

- Keynesian economics: aggregate demand affects output, employment and prices.
- Cycles are fluctuations in output, income and employment. The tell-tale signs of recession include:
 - Loss of consumer confidence.
 - Unemployment goes up.
 - Output falls and inflation slows down.
 - Business profits fall and stock prices drop or even collapse.
- Tell-tale signs of expansions?

Why?

- Exogenous and internal sources:
 - Exogenous [or external] sources include wars, oil prices, discoveries, scientific and technology breakthroughs leading to increases in **aggregate supply brought about by productivity improvements, or by release of labour supply** [[How China Became Capitalist.](#)]
 - endogenous [or Internal] sources come from within the economic system itself: expansions leading to recessions and then expansions again
 - High rental/capital values leading to over-supply of properties [when there could be unconstrained supply], coupled with “development lag”.
- Demand-induced cycles:
 - Induced by increase or decrease in aggregate demand resulting in increase or decrease of outputs respectively [imagine the AD-AS curves].

Forecasting Cycles

- Tell-tale signs of recession and expansion leading to construction of indices like consumer confidence index & the Purchasing Managers' Index [PMI] in the US ... etc.
 - **INDEX = $(P_1 \times 1) + (P_2 \times 0.5) + (P_3 \times 0)$**
 - P_1 = Percentage number of answers that reported an improvement.
 - P_2 = Percentage number of answers that reported no change.
 - P_3 = Percentage number of answers that reported a deterioration.
- Econometric modelling based on historical data: for example, output [GDP] is a function of a number of independent variables:
 - $Y = f(X\text{'s})$
 - Hundreds of simultaneous equations may be involved in some complicated models.

Timing the Cycles, or Markets

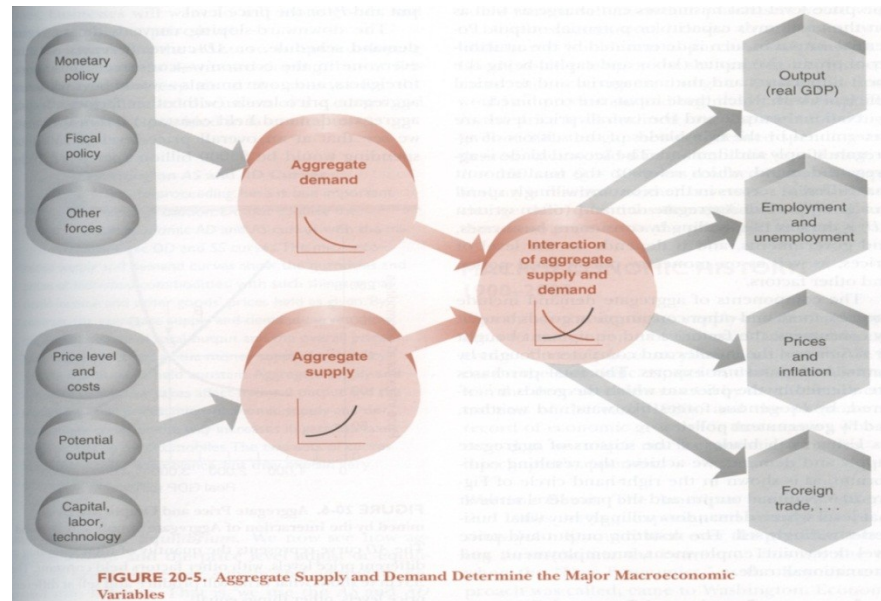
- Have been the million-dollar question:
 - Is it the time to buy or sell properties?
- Do we know we have reached the peak, or the peak is yet to come?

Chapter 24

The Multiplier Model

Macro-economics Management

- It has been either, very broadly speaking, the supply and the demand sides.



Source: Samuelson P.A. and Nordhaus W.D. (2005). *Economics*, 18th Edition. McGraw-Hill, p.415.

The Supply Side

- Encouraging private enterprises and privatization.
- Low tax, small government.
- Releasing their entrepreneurship, creativity and productivity.
- Reducing collective bargaining power of the trade unions and people's dependence on and expectation of social welfare.
- Best exemplified by “Thatcherism” and “Reganomics”, and the (Friedman's) monetary economics.

The Demand Side

- Privatization and de-regulation [the Big Bang in London under the Thatcher government] have led to incidences of “financial turmoil”.
- Demand side economics, or Keynesian economics has become “vogue” again.
- The government has the power and responsibility to “tame” the economic cycles by managing demand.
- Where there is not enough private demand, government should step in, even when it has to print money to finance the projects.
- The government has to rekindle the “animal spirits” and to stimulate the economy through the “multiplier”.

Output Determination

- Economy at equilibrium when total expenditure [consumption + investment] equals total output [GDP].
- Otherwise, economy in dis-equilibrium when the total expenditure is larger or smaller than the total output.
- BUT dis-equilibrium can persist for a long long time.

Keynesian Multiplier Model

- One dollar change in exogenous expenditures [investments] leads to more than a dollar change in GDP, when there are unemployed resources to employ.
 - Otherwise, what happens next?

The Multiplier



- mps = marginal propensity to save
- mpc = marginal propensity to consume
- By definition, $mps + mpc = 1$

The Multiplier

- Should governments adopt the Keynesian's approach to increase aggregate demand, to stimulate demand, even with borrowed money?

Affecting Aggregate Demand

- Fiscal policies [the Keynesian approach to macroeconomic policy].
- Empirical results show that the average multiplier for the first and second years is around 1.4 only, and declines further ever since [p.497].
- But recent studies in the US suggest a much lower [about 1 if not less]: wasting of public money?
- Highly simplified model in the book, as GDP is affected by the whole lot of factors including interaction with monetary policies and the capital/money markets both locally and internationally, and the supply side....

We're All Keynesians Again

By George Melloan

In 1935, six years after the 1929 Crash, the U.S. remained mired in the Great Depression—as it would be for five years more. At a congressional hearing, then Federal Reserve Chairman Marriner Eccles told Rep. Thomas Alan Goldsborough (D., Md.) that there was very little the Fed could do beyond what it was already doing to pull the country out of the doldrums.

"You mean you cannot push on a string," said the congressman.

"That is a very good way to put it," replied Mr. Eccles. "One cannot push on a string. We are in the depths of a Depression and beyond creating an easy money situation through reduction of discount rates, there is very little, if anything, that the reserve organization can do to bring about recovery."

The Fed is in that position once again. With a federal-funds interest-rate target near zero, the Fed has pumped tons of newly created dollars into the economy over the last four months. This has doubled the monetary base (bank reserves and currency), a phenomenal increase that has shocked market watchers and raised fears of inflation. But all economic indicators are flashing recession.

Last week brought the dispiriting news that the U.S. suffered a net loss of 2.6 million jobs in 2008, the most since 1945. Now 7.2% of the work force is idle. New factory orders, housing construction and retail sales have shriveled. Mortgage fore-

closures are rising.

Last year's crash was caused primarily by the deflation of a real-estate bubble that those two government-sponsored behemoths, Fannie Mae and Freddie Mac, had a large role in inflating. As the Japanese demonstrated in 1990, real-estate crashes cause far more collateral damage than mere stock-market slumps. It's amazing that the U.S. policy makers chose to ignore the danger, despite repeated warnings from these pages.

Between 2002 and the fall of 2007, funds raised in U.S. credit markets nearly doubled. Talk about a credit explosion! Easy money, much beloved by politicians and Wall Street, is a sure recipe for an asset bubble.

So the Fed is again in the position of "pushing on a string" and finding that nothing happens. Some economists describe this as a "liquidity trap." Money creation loses its stimulative power—vastly overrated even in ordinary times—because public demand for loans is weak. Americans are too strapped financially, too short on investment opportunities, or too concerned about the future to borrow. They prefer to save instead.

Some economists argue that "trap" is an inappropriate description. The new money the Fed has pumped into the economy to replace the financial-sector liquidity wiped out by the collapse of the bubble *has to go somewhere*, they point out. It has to end up in someone's bank account and banks have to quickly convert deposits (liabilities) into investments or go broke even faster than some have by loading up on polluted, mortgage-backed securities.

Maybe "liquidity malfunction" is a better term than "trap."

With 30-year mortgage rates now hovering near 5%, banks are spending a lot more of their time and resources responding to householder demands for refinancing at the lower rates. That doesn't do much for bank profits, but it does improve household balance sheets, cushioning to some degree the impact of the recession.

But what the Fed has mainly been doing since Black September has been transferring economic resources to government from the private sector on a massive scale. There is one thing the banks can do with their deposits if they can't find willing and qualified borrowers—the word "qualified" was rather neglected when Fannie and Freddie stood ready to buy any cats and dogs offered. They can put those deposits into U.S. Treasury securities.

Banks and investors around the world fleeing for safety have been doing just that, holding down federal borrowing costs, at least temporarily. The global flight for the presumed safety of Treasuries has also shored up the U.S. dollar in foreign-exchange markets, sending crude oil prices plunging. Because of the Treasury mania, 30-year Treasury bonds were yielding only 3.06% and the popular 10-year bond 2.39%.

So the Treasury has a good deal. The Fed pumps money into the economy by buying Treasuries with checks written on thin air. The Treasury quickly spends those dollars on the huge ongoing expenses of a government running a trillion dollar deficit. Recipients of its spending put the money into bank accounts and, presto, the money comes right back to the

**Nobody can
accuse the
government
and the Fed
of inaction.**

Treasury to finance yet more government spending.

The government is thus the main beneficiary of the phenomenal rise in the monetary base. The base remained relatively stable through the ups and downs of Fed interest-rate policies in this decade, until it went on its fourth-quarter skyrocket trip. For what it's worth, Fed Chairman Ben Bernanke, a student of the 1929 crash, has at least made sure that no one in the future will be able to accuse him of starving the economy into a Depression, as conventional wisdom has held that the Fed did 80 years ago.

Keynesians were banished in the 1980s by Reaganomics but made a comeback years ago and again control U.S. levers of power. They argue that massive deficit spending by the federal government is the right policy for these times. Paul Krugman of the New York Times has asserted that the Great Depression lasted 10 years because the New Deal didn't spend *enough*. Japan tried to spend its way out of its post-bubble malaise in the 1990s but ended up with a mountain of debt and a "lost decade" of little or no economic growth. Nevertheless, the incoming Obama administration is promising close to a trillion dollars in fiscal stimulus, and the Bernanke Fed seems to believe the way to deal with a collapsed bubble is to reinflate it. That of course takes no account of how we got the bubble in the first place.

Well, there's a lot of high-powered money out there in the huge monetary base the Fed has created. It's at the Treasury's disposal. All that can be said to the Keynesians is, "better luck than last time."

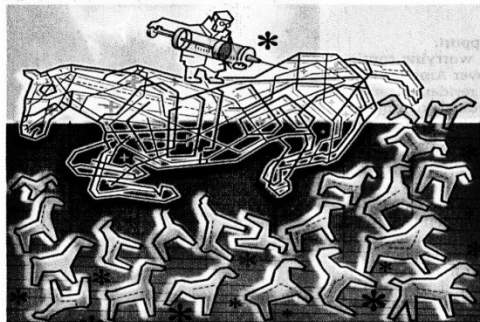
Mr. Melloan is a former deputy editor of the Journal's editorial page.



John Maynard
Keynes

Economics focus | Much ado about multipliers

Why do economists disagree so much on whether fiscal stimulus works?



IT IS the biggest peacetime fiscal expansion in history. Across the globe countries have countered the recession by cutting taxes and by boosting government spending. The G20 group of economies, whose leaders meet this week in Pittsburgh, have introduced stimulus packages worth an average of 2% of GDP this year and 1.6% of GDP in 2010. Co-ordinated action on this scale might suggest a consensus about the effects of fiscal stimulus. But economists are in fact deeply divided about how well, or indeed whether, such stimulus works.

The debate hinges on the scale of the “fiscal multiplier”. This measure, first formalised in 1931 by Richard Kahn, a student of John Maynard Keynes, captures how effectively tax cuts or increases in government spending stimulate output. A multiplier of one means that a \$1 billion increase in government spending will increase a country’s GDP by \$1 billion.

The size of the multiplier is bound to vary according to economic conditions. For an economy operating at full capacity, the fiscal multiplier should be zero. Since there are no spare resources, any increase in government demand would just replace spending elsewhere. But in a recession, when workers and factories lie idle, a fiscal boost can increase overall demand. And if the initial stimulus triggers a cascade of expenditure among consumers and businesses, the multiplier can be well above one.

The multiplier is also likely to vary according to the type of fiscal action. Government spending on building a bridge may have a bigger multiplier than a tax cut if consumers save a portion of their tax windfall. A tax cut targeted at poorer people may have a bigger impact on spending than one for the affluent, since poorer folk tend to spend a higher share of their income.

Crucially, the overall size of the fiscal multiplier also depends on how people react to higher government borrowing. If the government’s actions bolster confidence and revive animal spirits, the multiplier could rise as demand goes up and private investment is “crowded in”. But if interest rates climb in response to government borrowing then some private investment that would otherwise have occurred could get “crowded out”. And if consumers expect higher future taxes in order to finance new government borrowing, they could spend less today. All that would reduce the fiscal multiplier, potentially to below zero.

Different assumptions about the impact of higher government borrowing on interest rates and private spending explain wild variations in the estimates of multipliers from today’s stimulus spending. Economists in the Obama administration, who assume that the federal funds rate stays constant for a four-year period, expect a multiplier of 1.6 for government purchases and 1.0 for tax cuts from America’s fiscal stimulus. An alternative assessment by John Cogan, Tobias Cwik, John Taylor and Volker Wieland uses models in which interest rates and taxes rise more quickly in response to higher public borrowing. Their multipliers are much smaller. They think America’s stimulus will boost GDP by only one-sixth as much as the Obama team expects.

When forward-looking models disagree so dramatically, careful analysis of previous fiscal stimuli ought to help settle the debate. Unfortunately, it is extremely tricky to isolate the impact of changes in fiscal policy. One approach is to use microeconomic case studies to examine consumer behaviour in response to specific tax rebates and cuts. These studies, largely based on tax changes in America, find that permanent cuts have a bigger impact on consumer spending than temporary ones and that consumers who find it hard to borrow, such as those close to their credit-card limit, tend to spend more of their tax windfall. But case studies do not measure the overall impact of tax cuts or spending increases on output.

An alternative approach is to try to tease out the statistical impact of changes in government spending or tax cuts on GDP. The difficulty here is to isolate the effects of fiscal-stimulus measures from the rises in social-security spending and falls in tax revenues that naturally accompany recessions. This empirical approach has narrowed the range of estimates in some areas. It has also yielded interesting cross-country comparisons. Multipliers are bigger in closed economies than open ones (because less of the stimulus leaks abroad via imports). They have traditionally been bigger in rich countries than emerging ones (where investors tend to take fright more quickly, pushing interest rates up). But overall economists find as big a range of multipliers from empirical estimates as they do from theoretical models.

These times are different

To add to the confusion, the post-war experiences from which statistical analyses are drawn differ in vital respects from the current situation. Most of the evidence on multipliers for government spending is based on military outlays, but today’s stimulus packages are heavily focused on infrastructure. Interest rates in many rich countries are now close to zero, which may increase the potency of, as well as the need for, fiscal stimulus. Because of the financial crisis relatively more people face borrowing constraints, which would increase the effectiveness of a tax cut. At the same time, highly indebted consumers may now be keen to cut their borrowing, leading to a lower multiplier. And investors today have more reason to be worried about rich countries’ fiscal positions than those of emerging markets.

Add all this together and the truth is that economists are flying blind. They can make relative judgments with some confidence. Temporary tax cuts pack less punch than permanent ones, for instance. Fiscal multipliers will probably be lower in heavily indebted economies than in prudent ones. But policymakers looking for precise estimates are deluding themselves. ■

A list of relevant papers is available at Economist.com/multipliers

The Stimulus Didn't Work

By John F. Cogan,
John B. Taylor
And Volker Wieland

Is the American Recovery and Reinvestment Act of 2009 working? At the time of the act's passage last February, this question was hotly debated. Administration economists cited Keynesian models that predicted that the \$787 billion stimulus package would increase GDP by enough to create 3.6 million jobs. Our own research showed that more modern macroeconomic models predicted only one-sixth of that GDP impact. Estimates by economist Robert Barro of Harvard predicted the impact would not be significantly different from zero.

Now, six months after the act's passage, we no longer have to rely solely on the predictions of models. We can look and see what actually happened.

Consider first the part of the package that consists of government transfers and rebates. These include one-time payments of \$250 to eligible individuals receiving Social Security, Supplemental Security Income, veterans benefits or railroad retirement benefits—and temporary reductions in income-tax withholding for a refundable tax credit of up to \$400 for individuals and \$800 for families with incomes below certain thresholds. These payments, which began in March of this year, were intended to increase consumption that would help jump-start the economy.

The nearby chart reviews income and consumption through July, the latest month this data is available for the U.S. economy as a whole.

Consider first the part of the chart pertaining to the spring of this year and observe that disposable personal income (DPI)—the total amount of income people have left to spend after they pay taxes and receive transfers from the government—jumped. The increase is due to the transfer and rebate payments in the 2009 stimulus package. However, as the chart also shows, there was no noticeable impact on personal consumption expenditures. Because the boost to income is temporary, at best only a very small fraction was consumed.

This is exactly what one would expect from “permanent income” or “life-cycle” theories of consumption, which argue

that temporary changes in income have little effect on consumption. These theories were developed by Milton Friedman and Franco Modigliani 50 years ago, and have been empirically tested many times. They are much more accurate than simple Keynesian theories of consumption, so the lack of an impact should not be surprising.

Consider next the government-spending part of the stimulus package. The Obama administration points to the sharp reduction in the decline in real GDP from the first to the second quarter of 2009 as evidence that the package is working. Economic growth was minus 6.4% in the first quarter and minus 1% in the second quarter, so the implied improvement of 5.4 percentage points is indeed big. But how much of that improved growth rate can be attributed to higher government spending due to the stimulus? If we rely on predictions of models, again we see disagreement and debate.

According to our research, the increase in government spending would add less than a percentage point, a relatively small portion. The model predictions cited by the administration's economists suggest a much larger portion: two to three percentage points. Prof. Barro's model predicts zero.

So let's look at the data on the contributions of government spending and other components of GDP to the 5.4 percentage-point improvement. By far the largest positive contributor to the improvement was investment—which went from minus 9% to minus 3.2%, an improvement of 5.8% and more than enough to explain the improved GDP growth. Investment by private business firms in plant, equipment and inventories, rather than residential investment,

were the major contributors to the investment improvement. In contrast, consumption was a negative contributor to the change in GDP growth.

One is hard put to see what specific items in the stimulus act could have arrested the decline in business investment by such a magnitude. When one looks at monthly investment indicators—such as

Direct evidence of an impact by government spending can be found in 1.8 of the 5.4 percentage-point improvement from the first to second quarter of this year. However, more than half of this contribution was due to defense spending that was not part of the stimulus package. Of the entire \$787 billion stimulus package, only \$4.5 billion went to federal purchases and \$17.7 billion to state and local purchases in the second quarter. The growth improvement in the second quarter must have been largely due to factors other than the stimulus package.

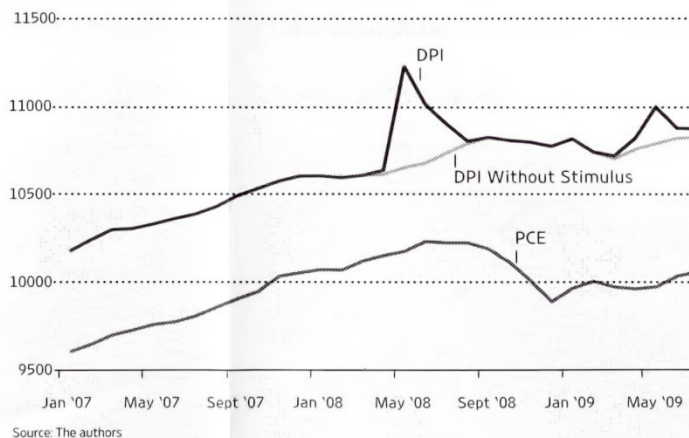
Incoming data will reveal more in coming months, but the data available so far tell us that the government transfers and rebates have not stimulated consumption at all, and that the resilience of the private sector following the fall 2008 panic—not the fiscal stimulus program—deserves the lion's share of the credit for the impressive growth improvement from the first to the second quarter. As the economic recovery takes hold, it is important to continue assessing the role played by the stimulus package and other factors. These assessments can be a valuable guide to future policy

makers in designing effective policy responses to economic downturns.

Mr. Cogan, a senior fellow at the Hoover Institution, was deputy director of the Office of Management and Budget under President Ronald Reagan. Mr. Taylor, an economics professor at Stanford and a Hoover senior fellow, is the author of “Getting Off Track: How Government Actions and Interventions Caused, Prolonged and Worsened the Financial Crisis” (Hoover Press, 2009). Mr. Wieland is a professor of monetary theory at Goethe University in Frankfurt, Germany.

Rebates Fail to Jump-Start Consumption

(DPI = disposable personal income; PCE = personal consumption expenditures)



new orders for nondefense capital goods—one sees a flattening out starting early in the first quarter of 2009, well before the package went into operation. The free fall of investment orders caused by the financial panic last fall stabilized substantially by January, and investment has remained relatively stable since then. This created the residue of a very large negative growth rate from the fourth quarter of 2008 to the first quarter of 2009, and then moderation from the first quarter to the second of 2009. There is no plausible role for the fiscal stimulus here.

Stimulus Spending Doesn't Work

By Robert J. Barro
And Charles J. Redlick

The global recession and financial crisis have refocused attention on government stimulus packages. These packages typically emphasize spending, predicated on the view that the expenditure “multipliers” are greater than one—so that gross domestic product expands by more than government spending itself. Stimulus packages typically also feature tax reductions, designed partly to boost consumer demand (by raising disposable income) and partly to stimulate work effort, production and investment (by lowering rates).

The existing empirical evidence on the response of real gross domestic product to added government spending and tax changes is thin. In ongoing research, we use long-term U.S. macroeconomic data to contribute to the evidence. The results mostly favor tax rate reductions over increases in government spending as a means to increase GDP.

For defense spending, the principal long-run variations reflect the buildups and aftermaths of major wars—World War I, World War II, the Korean War and, to a much lesser extent, the Vietnam War. World War II tends to dominate, with the ratio of added defense spending to GDP reaching 26% in 1942 and 17% in 1943, and then falling to -26% in 1946.

Wartime spending is helpful for estimating spending multipliers for three key reasons. First, the variations in spending are large and include positive and negative values. Second, since the main changes in military spending are independent of economic developments, it is straightforward to isolate the direction of causation between government spending and GDP. Third, unlike many other countries during the world wars, the U.S. suffered only moderate loss of life and did not experience massive destruction of physical capital. In addition, because the unemploy-

ment rate in 1940 exceeded 9% but then fell to 1% in 1944, there is some information on how the multiplier depends on the strength of the economy.

For annual data that start in 1939 or earlier (and, thereby, include World War II), the defense-spending multiplier that applies at the average unemployment rate of 5.6% is in a range of 0.6-0.7. A multiplier

less than one means that, overall, other components of GDP fell when defense spending rose. Empirically, our research shows that most of the fall was in private investment,

with personal consumer expenditure changing little.

Our research also shows that greater weakness in the economy raises the estimated multiplier: It increases by around 0.1 for each two percentage points by which the unemployment rate exceeds its long-run median of 5.6%. Thus the estimated multiplier reaches 1.0 when the unemployment rate gets to about 12%.

To evaluate typical fiscal-stimulus packages, however, nondefense government spending multipliers are more important. Estimating these multipliers convincingly from U.S. time series is problematical, however, because the movements in nondefense government purchases (dominated since the 1960s by state and local outlays) are closely intertwined with the business cycle. Thus the explanation for much of the positive association between nondefense spending and GDP is that government spending in-

creased in response to growing GDP, rather than the reverse.

The effects of tax rates on GDP growth can be analyzed from a time series we've constructed on average marginal income-tax rates from federal and state income taxes and the Social Security payroll tax. Since 1950, the largest declines in the average marginal rate from the federal individual income tax occurred under Ronald Reagan (to 21.8% in 1988 from 25.9% in 1986 and to 25.6% in 1983 from 29.4% in 1981), George W. Bush (to 21.1% in 2003

For data that start in 1950, we estimate that a one-percentage-point cut in the average marginal tax rate raises the following year's GDP growth rate by around 0.6% per year. However, this effect is harder to pin down over longer periods that include the world wars and the Great Depression.

It would be useful to apply our U.S. analysis to long-term macroeconomic time series for other countries, but many of them experienced massive contractions of real GDP during the world wars, driven by the destruction of capital stocks and

institutions and large losses of life. It is also unclear whether other countries have the necessary underlying information to construct measures of average marginal income-tax rates—the key variable for our analysis of tax effects in the U.S. data.

The bottom line is this: The available empirical evidence does not support the idea that spending multipliers typically exceed one, and thus spending stimulus programs will likely raise GDP by less than the increase in government spending. Defense-spending multipliers exceeding one likely apply only at very high unemployment rates, and nondefense multipliers are probably smaller. How-

ever, there is empirical support for the proposition that tax rate reductions will increase real GDP.

Mr. Barro is a professor of economics at Harvard. Mr. Redlick is a recent Harvard graduate. This op-ed is based on a working paper issued by the National Bureau of Economic Research in September.



World War II defense spending offers a good measure of stimulus effects.

from 24.7% in 2000), and Kennedy-Johnson (to 21.2% in 1965 from 24.7% in 1963). Tax rates rose particularly during the Korean War, the 1970s and the 1990s. The average marginal tax rate from Social Security (including payments from employees, employers and the self-employed) expanded to 10.8% in 1991 from 2.2% in 1971 and then remained reasonably stable.

OPINION: REVIEW & OUTLOOK

The Keynesian Dead End

The G-20 meeting in Toronto was advertised as a showdown between the U.S. and Europe over more spending “stimulus,” and so it was. But the larger story is the end of the neo-Keynesian economic moment, and perhaps the start of a healthier policy turn.

For going on three years, the developed world’s economic policy has been dominated by the revival of the old idea that vast amounts of public spending could prevent deflation, cure a recession, and ignite a new era of government-led prosperity. It hasn’t turned out that way.

Now the political and fiscal bills are coming due even as the U.S. and European economies are merely muddling along. The Europeans have had enough and want to swear off the sauce, while the Obama Administration wants to keep running a bar tab. So this would seem to be a good time to examine recent policy history and assess the results.

* * *

Like many bad ideas, the current Keynesian revival began under George W. Bush. Larry Summers, then a private economist, told Congress that a “timely, targeted and temporary” spending program of \$150 billion was urgently needed to boost consumer “demand.” Democrats who had retaken Congress adopted the idea—they love an excuse to spend—and the politically tapped-out Mr. Bush went along with \$168 billion in spending and one-time tax rebates.

The cash did produce a statistical blip in GDP growth in mid-2008, but it didn’t stop the financial panic and second phase of recession. So enter Stimulus II, with Mr. Summers again leading the intellectual charge, this time as President Barack Obama’s adviser and suggesting upwards of \$500 billion. When Congress was done two months later, in February 2009, the

amount was \$862 billion. A pair of White House economists famously promised that this spending would keep the unemployment rate below 8%.

Seventeen months later, and despite historically easy monetary policy for that

entire period, the jobless rate is still 9.7%. Last Friday, the Bureau of Economic Analysis once again reduced the GDP estimate for first quarter growth, this time to 2.7%, while economic indicators in the second quarter have been mediocre. As the nearby table shows, this is a far cry from the snappy recovery that typically follows a steep recession, most recently in 1983-84 after the Reagan tax cuts.

The response at the White House and among Congressional leaders has been . . . Stimulus III. While talking about the need for “fiscal discipline” some time in the future, President Obama wants more spending today to again boost “demand.” Thirty months after Mr. Summers won his first victory, we are back at the same policy stand.

The difference this time is that the Keynesian political consensus is cracking up. In Europe, the bond vigilantes have pulled the credit cards of Greece, Portugal and Spain, with Britain and Italy in their sights. Policy makers are now making a 180-degree turn from their own stimulus blowouts to cut spending and raise taxes.

To put it another way, Germany’s Angela Merkel has won the bet she made in early 2009 by keeping her country’s stimulus far more modest. Mr. Obama found a

political stonewall in Toronto when he pleaded with his fellow leaders to join him again for a spending spree.

Meanwhile, in Congress, even many Democrats are revolting against Stimulus III. The original White House package of

jobless benefits and aid to the states had to be watered down several times, and the latest version failed again in the Senate last week. (See below.) Mr. Obama is having his credit card pulled too—not by the bond markets, but by a voting public that sees the troubles in Europe and is telling pollsters that it doesn’t want a Grecian bath.

* * *

The larger lesson here is about policy. The original sin—and it was nearly global—was to revive the Keynesian economic model that had last cracked up in the 1970s, while forgetting the lessons of the long prosperity from 1982 through 2007. The Reagan and Clinton-Gingrich booms were fostered by a policy environment for most of that era of lower taxes, spending restraint and sound money. The spending restraint began to end in the late 1990s, sound money vanished earlier this decade, and now Democrats are promising a series of enormous tax increases.

Notice that we aren’t saying that spending restraint alone is a miracle economic cure. The spending cuts now in fashion in Europe are essential, but cuts by themselves won’t balance annual deficits reaching 10% of GDP. That requires new revenues from faster growth, and there’s a danger that the tax increases now sweep-

ing Europe will dampen growth further.

President Obama’s tragic mistake was to blow out the U.S. federal balance sheet on spending that has produced little bang for the buck. The fantastical Keynesian notion (the “multiplier”) that \$1 of spending produces \$1.50 in growth was long ago demolished by Harvard’s Robert Barro, among others. That \$1 in spending has to come from somewhere, which means in taxes or borrowing from productive parts of the private economy. Given that so much of the U.S. stimulus went for transfer payments such as Medicaid and unemployment insurance, the “multiplier” has almost certainly been negative.

With the economy in recession in 2008 and 2009, we argued that some stimulus was justified and an increase in the deficit was understandable and inevitable. However, we also argued that permanent tax cuts aimed at marginal individual and corporate tax rates would have done far more to revive animal spirits, and would have led to a far more robust recovery.

* * *

What the world has now reached instead is a Keynesian dead end. Americans are told to let Congress continue to spend and borrow until the precise moment when Mr. Summers and Mark Zandi and the other architects of current policy say it is time to raise taxes to reduce the huge deficits and debt that their spending has produced. Meanwhile, individuals and businesses are supposed to be unaffected by the prospect of future tax increases, higher interest rates, and more government control over the economy.

A better economic policy will have to await a new Congress, which we hope at a minimum can prevent punishing tax increases. But for now the good news is that voters and markets are telling politicians to stop doing what hasn’t worked.

After Deep Recessions

Quarterly GDP growth, seasonally adjusted on an annual basis

1982		2009	
IV	0.3%	III	2.2%
1983		IV	5.6
I	5.1	2010	
II	9.3	I	2.7
III	8.1		
IV	8.5		

Source: Commerce Dept., Bureau of Economic Analysis

Keynes at Home, Smith Abroad

By Fredrik Erixon
And Razeen Sally

Policy makers around the world have been trying to forge a new consensus amid the global economic crisis: John Maynard Keynes at home and Adam Smith abroad. The idea is that greater government intervention in the domestic economy is needed, but that on a global scale free trade is critical to recovery, even if squaring the two requires stronger international policy coordination. Proponents think this new consensus has worked. Hardly. The revival of big government in domestic policy inevitably will spill into a new age of protectionism.

This argument may seem counterintuitive, given that the protectionist response to the global economic crisis has been muted so far. A relatively small number of developing countries have raised tariffs, and only on a limited range of products—mainly dairy, iron and steel, cars and car parts, chemicals and plastics, and textiles and clothing. The use of nontariff barriers such as import licensing, onerous safety requirements and other regulations has also increased only moderately. New antidumping and “safeguard” investigations increased by 31% in the first half of 2009, but overall levels are still lower than they were before 2001.

Trade-restricting measures in agriculture, textiles and clothing—longtime bastions of protectionism—have also been remarkably mild to date. Apart from financial services, new protectionism in services sectors has been largely absent. Some developing countries have increased subsidies to banks and industrial firms, but not nearly to the same extent as developed countries. And several developing countries have liberalized in response to the crisis, for instance Mexico on import tariffs and Malaysia on restrictions to foreign direct investment in service sectors. The world has been spared a repeat of the

1930s, when government responded to deep recessions or depressions by erecting en masse severe protectionist barriers.

But the parallel is with the 1970s, not the 1930s. In the '70s, governments increased domestic interventions—fiscal-stimulus packages, subsidies to certain sectors, labor-market and capital-market restrictions—in response to oil-price hikes and other external shocks. This spilled over into protectionism, mainly through nontariff barriers such as discriminatory subsidies, “buy local” government-procurement initiatives, “voluntary export restraints” and “orderly market arrangements.”

This so-called managed trade or new protectionism lasted well into the 1980s, affecting about half of international trade. Global trade dipped after decades of solid growth—volumes actually shrank in 1976 and 1983, with anemic growth well under 5% between 1981 and 1987. This deepened and prolonged economic stagnation; global GDP growth was under 3% in 1974-5 and 1980-83. This kind of creeping protectionism, manifested in complex regulatory barriers and emerging slowly, insidiously, from bigger, more arbitrary government at home, is the big danger now.

Today's creeping protectionism is taking many forms. In developed countries, bailed-out banks are lending less abroad to concentrate on home lending—either to curry favor preemptively with politicians or with the direct encouragement of their home governments. Global cross-border lending by banks fell by \$4.8 trillion in the last nine months of 2008, the sharpest fall on record. Inevitable national re-regulation of financial markets threatens to fragment global finance, with extremely worrying consequences for cross-border flows of

trade, investment and people. Manufacturing subsidies—90% of which have gone to the automobile industry since the beginning of the crisis in September 2008—are also intended to boost production and employment at home, potentially threatening overseas production and employment.

While that kind of subsidy protectionism is a game played mostly by developed countries, developing countries are finding protectionist means of their own. Some developing countries have imposed new import-licensing restrictions. Foreign-in-

countries; discriminatory subsidies to domestic producers of renewable energy; and artificially high fuel-efficiency standards.

* * *

The short-term challenge is to contain new protectionism, especially regulatory barriers issuing from domestic crisis interventions that spill over the border. If it is not contained, it will increasingly hinder cross-border trade and investment and will exacerbate global economic turbulence, compromising a healthy recovery. Policy makers can start by containing the expansion of government at home, including fiscal-stimulus and financial-regulation packages with embedded protectionism.

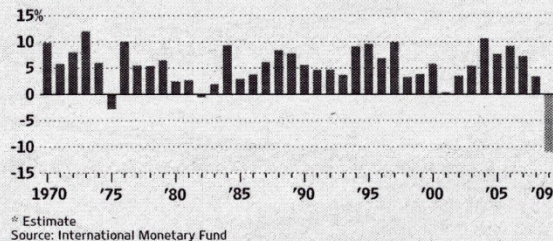
Looking beyond the immediate crisis, there remains a strong case for further market-based reforms, including liberalization of international trade and investment. Reduction of what are still relatively high barriers to trade, foreign investment and the cross-border movement of people holds out the promise of higher growth, significant poverty reduction and improvements in human welfare. The biggest challenge is to push forward with trade-related domestic reforms such as labor-market and public-sector liberalization where progress to date has been too slow. These reforms, relating to the domestic business climate, affect foreign as well as domestic trade, and foreign as well as domestic investment.

Contra the new consensus, big government, with its inevitable protectionist spillover, is a bigger medium-term danger to the world trading system than short-term protectionist pressures from the recent contraction of global demand. Limits to government intervention and a well-functioning market economy at home are prerequisites to open markets and economic globalization abroad.

Messrs. Erixon and Sally are co-directors of the European Centre for International Political Economy in Brussels.

Ebb and Flow

Annual percentage change in world trade volume, 1970-2009



vestment restrictions have increased in both developed and developing countries. Though antidumping actions have not increased to alarming proportions yet, there are signs that they will escalate over the next year. China is the main target of this kind of protectionism—more than 75% of antidumping investigations launched in the first half of this year are aimed at Chinese exports.

The World Trade Organization noted in studies on crisis-related protectionism in March and July this year an increase in discretionary, anti-import applications of product- and food-safety standards. This is a harbinger of greater standards protectionism to come. That includes green protectionism: U.S. and EU threats of carbon tariffs to enforce cap-and-trade schemes and impose carbon-emission reductions on developing

Wen vows to continue China's stimulus efforts

BY JASON DEAN
AND AARON BACK

DALIAN, China—Chinese Premier Wen Jiabao vowed to continue his government's aggressive stimulus efforts, saying the world's third-largest economy faces persistent problems and uncertainties from the global recession despite an upturn in growth.

Speaking to business leaders and others at a World Economic Forum meeting in this northeastern Chinese port city, Mr. Wen reaffirmed the government's confidence that it can reach 8% growth in gross domestic product this year, and said Beijing's efforts to propel growth have been "timely, forceful and effective."

"But the pickup in China's economy remains unstable, unconsolidated and imbalanced," he said. He pointed to uncertainties that continue to cloud the global economic outlook, and said China's economy faces challenges ranging

Please turn to page 19



Premier Wen Jiabao, speaking at the opening of the World Economic Forum meeting in China, vowed to continue the country's stimulus efforts.



Chinese Premier Li Keqiang delivers a speech at the World Economic Forum.

WORLD NEWS: ASIA

China Builds Hopes on 'Social' Housing

One of the biggest public-housing projects in history will help determine whether China can remake its real-estate sector fast enough to prevent its economy from flaming out.

By James T. Areddy
in Chongqing, China, and
Bob Davis in Beijing

China is in the midst of a crash program to build 36 million subsidized apartments by the end of 2015. The goal is twofold: to head off social unrest by ensuring decent places to live for low-wage workers, but also to cushion an expected fall in high-end construction—the result of policies to tame property speculation—by ramping up construction at the low end: “social” housing.

Such housing is the government’s “No. 1 priority when it comes to support economic growth, ensure social stability and bring down average housing prices,” UBS analysts Tao Wang and Harrison Hu said in a recent note.

Major questions hang over the Chinese economy, one of the world’s key growth drivers amid Europe’s troubled finances and slow growth in the U.S. On Sunday, the Chinese government’s official survey of purchasing managers showed a rebound in manufacturing in December, with the index rising to 50.3 from 49 in November, above the 50 reading that marks expansion.

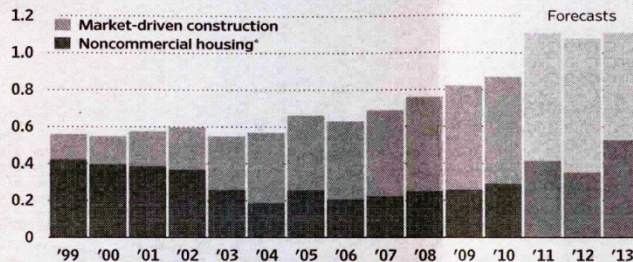
But a separate report on Friday from HSBC Holdings PLC, which more closely measures small and midsize businesses, showed manufacturing continuing to contract last month. Such businesses account for as much as 80% of employment in China and most of its economic output, some estimates say, but they’ve had a harder time accessing credit than state-owned companies. The HSBC Purchasing Managers Index for December came in at 48.7, up from 47.7 in November.

Beijing’s trading partners are

The Home Front

China is boosting subsidized housing to help keep its construction sector humming as the country’s economy slows.

Housing completions, in billions of square meters



*Social housing plus worker dormitories and apartments not built by commercial developers
Source: CEIC, GK Dragonomics estimates

much steel annually as the U.S., Japan and Germany combined, Ms. Wang notes. Glass, concrete, energy, furniture, home appliances and other industries also rely on China’s housing market. In China, those sectors account for more than 25% of GDP, and the social-housing push thus aims to be a form of economic stimulus that could spell the difference between a gentle slowing of China’s growth and a sharp plunge.

But the vast experiment faces a number of pitfalls—including inflated accounts of progress, shoddy construction and problematic financing—that could risk damaging a crucial economic engine.

One of China’s most ambitious social-housing efforts is under way in the southwestern metropolis of Chongqing. Last month, Xiang Yunkun, a 26-year-old factory worker, moved into a two-bedroom rental there for just \$85 a month. He snagged the apartment after entering a lottery for people with monthly earnings of less than 2,000 yuan, or \$315, and living in less than 13 square meters. His new apart-

ment mismanaging the social-housing effort. While the central government set the housing goal, it has largely left the implementation and financing to local governments, which get much of their revenue by selling land to developers for luxury apartments, not low-profit housing.

There is widespread suspicion that Chinese municipalities are inflating the number of apartments they are building, or relabeling projects already under construction as social housing. In November, for instance, the Ministry of Housing said work on foundations was sufficient to qualify as “housing starts,” prompting derision that it was counting holes in the ground. Of 30 developers surveyed by Standard Chartered Bank, 21 said that less than 30% of the social housing being built was actually new construction.

The social-housing project may also lead to loans that turn bad a few years down the road. “The lion’s share of the funding comes from the [state-owned] banking system,” said He Fan, an economist at the Chinese Academy of Social Sciences. While

which “will be a heavy burden for banks,” he said.

Chongqing alone plans 40 million square meters, or 430 million square feet, of subsidized apartments. That’s about 690,000 apartments the size of Mr. Xiang’s 58-square-meter abode, though many will be larger. The sprawling municipality has lots of land at its perimeter to devote to the effort. Chongqing also hopes to turn a wave of migration into a labor pool for the low-wage manufacturing it is trying to lure from coastal areas. For this to work, cheap housing is a must.

There is plenty of evidence of rushed efforts. Wang Yulan, a 56-year-old retiree, moved into her new city-built apartment in a 33-floor Chongqing tower three months ago and immediately found a broken cupboard hinge, leak stains on both sides of her short foyer and badly misaligned window sills.

Mayor Huang Qifan dismisses criticism: “It is just like using a magnifying glass to check the quality of the skin of a beautiful lady.”

Mr. Huang has chosen a risky strategy: locating the bulk of the housing many kilometers from the crowded downtown in the hope it will eventually develop into new centers of activity. Chinese policy makers’ build-it-and-they-will-come approach has worked in some cases, most prominently Shanghai’s Pudong district. But in others it has led to “ghost cities”: neighborhoods devoid of tenants or employers.

Critics point to a proliferation of ghost cities as evidence that China’s real-estate market is a bubble that’s bound to burst in a way that will badly damage the Chinese economy.

A looming supply of cheaper housing may be one factor now undercutting demand for property and also prices. In Shanghai, China Overseas Land recently discounted a batch of apartments by 25%. Nationwide in November, apartment prices were 0.17% lower than the previous

new apartments may sell for about 30% less in 2012 than in 2011.

“The country will maintain its unswerving stance of the regulation of the property market next year to make housing prices return to a reasonable level,” the China’s Politburo, the Communist Party’s top decision-making body, said Dec. 9.

To compensate the government is doubling down on its bet on social housing.

Set more than 40 kilometers from Chongqing’s downtown, Xiyong Micro-Machinery Industry Park Low-Cost Housing Project consists of more than 55 buildings topping 30 floors, each pale green with white trim and some draped with red banners with hammer-and-sickle logos. The nearly complete project consists of 20,000 two-bedroom and studio apartments, each furnished with a stove and toilet-shower room, but no hot water or closets. Refrigerators may need to go in the living room. Many units have patios.

Outside the gate, a new bus shelter awaits a yet-to-come route. A subway is planned, but not until 2013. A villa development and the “Premier Intellectual City” mall flank the project. Nearby, workers are finishing an electronics factory. Across the nearby quiet eight-lane byway is farmland. It is a far cry from the glitzy \$3.5 billion apartment-hotel-mall project just announced for downtown Chongqing.

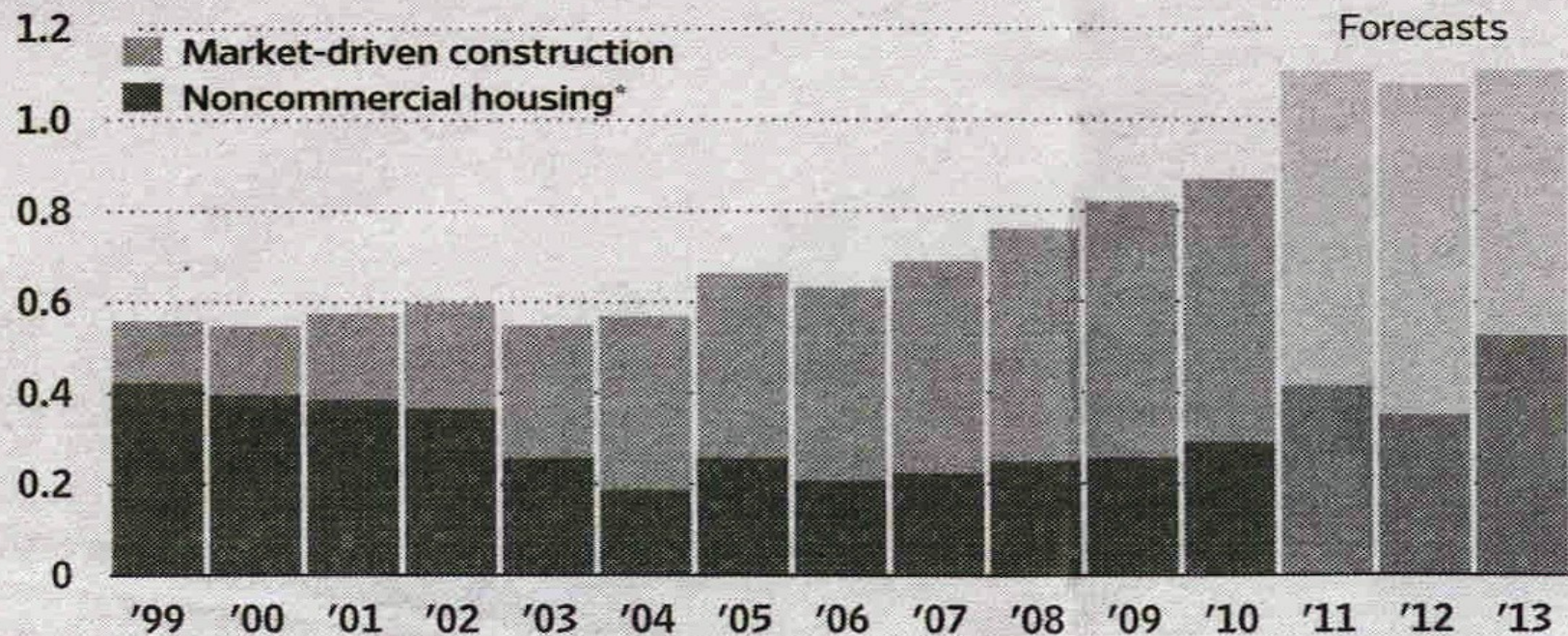
Rosealea Yao, a real-estate specialist at Dragonomics Research in Beijing, is skeptical that projects in the deep suburbs will generate enough revenue to cover the interest on the loans. Many of the apartments are too small, she adds, to persuade migrants to bring their families to live with them.

The Chongqing city government says it can comfortably finance the projects and would subsidize its cost. “We don’t have to worry about a bubble or nonperforming assets,” said a statement by the mayor’s office.

The Home Front

China is boosting subsidized housing to help keep its construction sector humming as the country's economy slows.

Housing completions, in billions of square meters



*Social housing plus worker dormitories and apartments not built by commercial developers

Source: CEIC, GK Dragonomics estimates

And Lastly:

- A reminder from Ronald Reagan:
 - <http://www.youtube.com/watch?v=cEuil2PbSWQ>

Chapters NOT Assigned to Read

And Why?

Chapters 25 & 26

- Chapter 25 - Financial markets and the special case of money
 - You'll study it in your courses on land and urban economics, property investment and finance courses. Read the chapter next year.
- Chapter 26 – Central Banking and Monetary Policy
 - Likewise, subject matters to be covered in your next year.

End of Textbook Revision

READ THE BOOK!