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Don't Believe the Stimulus Scaremongers

Americans are losing faith in the fairness and wisdom of economic policy.

By [AMAR BHIDÉ](#)

Our ignorance of what causes economic ailments -- and how to treat them -- is profound.* Downturns and financial crises are not regular occurrences, and because economies are always evolving, they tend to be idiosyncratic, singular events.

After decades of diligent research, scholars still argue about what caused the Great Depression - - excessive consumption, investment, stock-market speculation and borrowing in the Roaring '20s, Smoot-Hawley protectionism, or excessively tight monetary policy? Nor do we know how we got out of it: Some credit the New Deal while others say that that FDR's policies prolonged the Depression.

Similarly, there is no consensus about why huge public-spending projects and a zero-interest-rate policy failed to pull the Japanese out of a prolonged slump.

The economic theory behind the nearly \$800 billion stimulus package may be cloaked in precise mathematics but is ultimately based on John Maynard Keynes's speculative conjecture about human nature. Keynes claimed that people cope with uncertainty by assuming the future will be like the present. This predisposition exacerbates economic downturns and should be countered by a sharp fiscal stimulus that reignites the "animal spirits" of consumers and investors.

But history suggests that dark moods do change on their own. The depressions and panics of the 19th century ended without any fiscal stimulus to speak of, as did the gloom that followed the stock-market crash of 1987.† Countercyclical fiscal policy may or may not have shortened other

* The original introduction to this article noted how little we knew about the efficacy of medical treatments – as David Eddy has long pointed out, less than a quarter of treatments have been validated by objective evidence. Our ignorance of how to treat economic ailments is understandably much greater: Downturns and financial crises are far less frequent – and more ‘one of a kind’ – than heart attacks.

† Some bloggers have chosen to misconstrue this statement to mean that I favor “doing nothing.” This is obviously untrue, as the rest of article makes clear. This sentence merely disputes the assertion that a revival of animal spirits *requires* a large fiscal stimulus.

recessions; there are too few data points and too much difference in other conditions to really know.*

Unfounded assertions that calamitous consequences make opposition to the rapid enactment of a large stimulus package "inexcusable and irresponsible" are likely to offset any placebo effect the package might have. Shouting "fire" in a crowded theater, as our last Treasury secretary did to peddle the Troubled Asset Relief Program (TARP), didn't restore financial confidence. Similarly, a president elected on a platform of hope isn't likely to spark shopping sprees by painting a bleak picture of our prospects.

Stimulus therapy poses great risks. Years of profligacy have put the federal government in a precarious financial position. We don't have the domestic savings to finance much larger budget deficits. Unlike the Japanese, Americans don't have much stashed away under their mattresses: We are reliant on capital inflows from abroad. An insurrection by bond vigilantes or the long-predicted run on the dollar triggered by fears of a flood of new government debt is a real possibility.

Large increases in public spending usurp precious resources from supporting the innovations necessary for our long-term prosperity. Everyone isn't a pessimist in hard times: The optimism of many entrepreneurs and consumers fueled the takeoff of personal computers during the deep recession of the early 1980s. Amazon has just launched the Kindle 2; its (equally pricey) predecessor sold out last November amid the Wall Street meltdown. But competing with expanded public spending makes it harder for innovations like the personal computer and the Kindle to secure the resources they need.

Hastily enacted programs jeopardize crucial beliefs in the value of productive enterprise. Americans are unusually idealistic and optimistic. We believe that we can all get ahead through innovations because the game isn't stacked in favor of the powerful. This belief encourages the pursuit of initiatives that contribute to the common good rather than the pursuit of favors and rents. It also discourages the politics of envy. We are less prone to begrudge our neighbors' fortune if we think it was fairly earned and that it has not come at our expense -- indeed, that we too have derived some benefit.

To sustain these beliefs, Americans must see their government play the role of an even-handed referee rather than be a dispenser of rewards or even a judge of economic merit or contribution. The panicky response to the financial crisis, where openness and due process have been sacrificed to speed, has unfortunately undermined our faith. Bailing out AIG while letting Lehman fail -- behind closed doors -- has raised suspicions of cronyism. The Fed has refused to reveal to whom it has lent trillions. Outrage at the perceived use of TARP funds to pay bonuses is widespread.

The Obama administration assures us that it will only fund "worthwhile" and "shovel-ready" projects. But choices will have to be made by harried and fallible humans; witness the nominees

* In 1981, the Thatcher government in the U.K. cut public spending during a recession -- a ["decisive break with the Keynesian past"](#) according to the *Economist*. Did this prolong the recession, or set the stage for the resurgence of the British economy?

who failed to calculate their taxes properly. What's more, subjecting projects to scrutiny conflicts with a strategy of sparking the economy with a jolt of new spending. We may get the worst of all worlds -- savvy and well-connected operators get funding while good projects languish.

The alternative isn't, as the stimulus scaremongers suggest, to turn our backs to the downturn. We do have mechanisms in place to deal with economic distress. Public aid for the indigent has been modernized and expanded to provide a range of unemployment and income-maintenance schemes. Bankruptcy courts and laws give individuals another chance and facilitate the orderly reorganization or liquidation of troubled businesses. The FDIC has been dealing with bank failures for more than 70 years, and the Federal Reserve has been empowered to provide liquidity in the face of financial panics for even longer.*

These mechanisms are not perfect or to everyone's taste -- liberals and conservatives obviously disagree about their scope and generosity -- but they have been forged through a much more deliberate, open process than the stimulus bill or TARP. Legislators, the executive branch, judges, competing interest groups and the press have all had their say in their initial design and evolution. As a result there may be occasional mistakes and fraud but not widespread favoritism.

If the current crisis is indeed unprecedented, why not increase the funding and resources to battle-tested measures? When earthquakes or tsunamis strike, we rush in more doctors and supplies. We don't use untested medical procedures or set up new relief agencies on the fly.

Increasing unemployment insurance, bankruptcy judges, and the FDIC's capital and staff would certainly cost money, but these targeted expenditures would be much smaller than grandiose measures to revive overall confidence. And while the cautious approach might lead to a slower recovery, we wouldn't jeopardize the venturesome, pluralistic foundations of our long-run prosperity.

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* And in the last half century, the Fed has also routinely eased monetary policy during recessions. Many would argue that this has been a far more "counter-cyclical" policy than fiscal stimulus packages. Though of course, no one knows if monetary policy is more effective than fiscal policy, monetary easing at least has the merit that it does not direct favors towards specific individuals or businesses, the way public spending programs often do.