PROJECT SYNDICATE
AN ASSOCIATION OF NEWSPAPERS AROUND THE WORLD

Has America Lost its Mojo?

by Kenneth Rogoff

Cambridge – You know that American self-confidence is shaken when even the President starts expressing fear that the financial crisis may turn out worse than the Great Depression of the 1930's. George Bush is not alone in worrying that things might get a lot worse before they get better. A growing number of savvy business people are also starting to wonder whether the United States will be able to right its economy anytime soon.

Professional forecasters are considerably more sanguine, with the consensus forecast for US growth in 2009 at around -1.5%, after a similar contraction in the second half of 2008. This would be a painful recession, but far short of the 10-15% output drop normally associated with a full-blown depression. Of course, economic forecasters have generally been far too optimistic at every turn of late, so the public is understandably leery of their prognostications.

Consensus forecasts do still seem optimistic. With its financial system on life support, housing prices continuing to plummet, and unemployment rising, the US economy is looking more vulnerable than it has at any time since the 1970's, and perhaps since World War II.

Still, it must be noted that negative output growth for more than two years is a relatively rare event, even in the aftermath of severe banking crises. Historical statistical relationships are perhaps cold comfort in a downturn that now seems so insidiously different from previous catastrophes. But they should not be dismissed. Japan may have taken what seemed like forever to recover from its 1990's crisis, but it is an exception – the crisis occurred as the Japanese economy needed to restructure in the face of the huge challenges posed by China's emergence.

The complete policy paralysis that has prevailed during the interregnum between Presidents Bush and Obama has not helped. US policy has devolved into a sort of "wheel of fortune" game for financial firms. One day you get bankruptcy, another day loans with few strings attached. One hopes that President-elect Obama's all-star economic team will at least adopt a coherent and consistent policy. Consistency alone would be a big boost for confidence.

The basic elements of a recovery package include, first and foremost, a rational approach to rebooting the financial system. This means mark-to-market pricing of assets, restructuring and recapitalizing banks, and a new approach to regulation that allows creativity while better protecting the public against some of the madness that has prevailed for more than a decade. Help for housing is required to prevent overshooting in home prices, as is massive macroeconomic stimulus, including a moderately inflationary monetary policy.

A number of leaders, most prominently German Chancellor Angela Merkel, are understandably worried about the longer-term consequences of aggressive macroeconomic stimulus. These concerns are valid, even more so given government's growing role in the economy. But, as in wartime, one hopes these effects are temporary. Besides, is inaction a real alternative?

Prior to the 1950's, output drops of 15-20% in a single year were routine (admittedly, national income accounting was more primitive.) A number of academic economists say we should simply tough it out as we did back then. Recessions have important cleansing effects, helping to facilitate painful restructuring.

But today's social, economic, and political systems – at least in developed countries – are unable to withstand a peacetime decline in output of 15-20% within a short period. Massive stimulus and intervention – the US Federal Reserve's current stance – is unavoidable. One can only hope that the state can get out of the economy half as fast as it is getting in. Nevertheless, the distinct possibility that stimulus and restructuring may work is further cause to hope that the deepening recession will not morph into a full-blown depression.

The US may be ground zero for the global financial crisis, but it is not the only country riven by self-doubt. Britain, Ireland, and Spain each face financial crises of a similar magnitude. Some countries that depend on energy exports, particularly governance-challenged ones such as Russia and Venezuela, are experiencing even worse downturns. Even once-invulnerable China must contemplate a halving of its growth rate. Europe and Japan do not have quite as complex financial messes as the US. But these regions are nevertheless mired in recession. The global economy is in a pickle.

But, just as optimists were too sanguine in the boom, ultra-pessimists probably go too far in forecasting a depression around the corner. 2009 will be a tough year. Yet, absent a large-scale conflagration, there is a fair chance that 2010 will see a restoration of weak growth in the US, Europe, and Japan, and probably robust growth in most emerging markets. The US economy may have lost a fair chunk of its mojo, but it will require a lot more bad luck and policy blunders to get to a second worldwide Great Depression.

Kenneth Rogoff is Professor of Economics and Public Policy at Harvard University, and was formerly chief economist at the IMF.