Stop and *Rethink* Economic Policy

Governments seem hell-bent on creating a new Depression.

BY BERNARD CONNOLLY

The coronavirus has had appalling human consequences, both individual and social. But its macroeconomic impact could have been minimal—irrespective of reductions in recorded GDP occasioned by lockdowns and social-distancing restrictions—had governments bothered to analyze it and framed policies accordingly. Instead, they are shaping up, in summer 2020, to make the most catastrophic errors of macroeconomic policy since the early 1930s. In conditions in which social and political conflict are worryingly prevalent, both within and between countries, such mistakes would bring a real risk that the very worst aspects of the 1930s could be revisited.

GDP does not measure "happiness"; nor should it attempt to, for any such attempt would be the road to caesaropapist totalitarianism. There is a very meaningful sense in which a fall of even, say, 35 percent in GDP during lockdown periods does not matter in terms of macroeconomics—or more accurately, given the inadequate nature of government responses, need not have mattered. The lockdowns meant that consumption of a very wide range of services was impossible; the result was a very sharp fall in GDP (and of course there were also knock-on effects on business investment and residential construction). But the true first-round cost of the restrictions was a deferment of pleasure (and no doubt by far the biggest element of that deferment was in terms of the things which, with due deference to the Beatles, money just can't buy). In the case of some of those desirable non-marketed things, deferment may have meant abandonment (and, of course, the lockdowns created a great deal of social, emotional, educational, and mental-health suffering). That deferment, or even loss, of enjoyment becomes a macroeconomic problem only if there are second-round "multiplier" effects during and after the period of restrictions and if the fall in recorded GDP

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is accompanied by a reduction in the capacity to supply marketed consumption goods and services when the restrictions are lifted. That is, it is a problem if workers in the affected sectors lose their jobs and their incomes and thus cannot buy other goods and services to the extent that they normally would, and the firms for which they work go out of business (meaning that the supply of such services is reduced, at least for a time, from pre-coronavirus levels even when the restrictions are lifted, and "structural" unemployment increases). It is, to put it bluntly, an economic catastrophe and a prelude to Depression, rather than a macroeconomic "so-what?" event if policymakers get the response wrong.

The obvious policy response should have been for governments to fully replace the revenues forgone by firms and the self-employed as a result of the restrictions imposed by those governments, as long as firms did not reduce employment or wage rates from pre-virus levels. And to ensure an early positive effect, governments should have made immediate low-interest loans, continued as long as the restrictions lasted (and possibly even as long as much of their aggregate effect lasted), to firms and the self-employed, on self-certified application by those firms and self-employed, in anticipation of grants to be made once the data from various tax databases made possible a calculation of lost revenue. Underpayments, overpayments, and loans could be evened out (possibly with a substantial penalty interest rate on overpayments) once data were available.

Of course, there would be abuse. There would be scams. There would be certain perverse economic incentives. The process of creative destruction would be frozen for a time. But such action would have made sure that even a massive fall in GDP during the period of restrictions was, in meaningful macroeconomic terms, a "so what?" event rather than an economic cataclysm.

Instead, governments have tended to put in place furlough schemes that are temporary rather than advance arrangements or have increased and extended unemployment benefit schemes, combined with tax deferrals and various programs of loans to firms, not all of which have been in anticipation of grants. Such policies have certainly been a very great deal better than doing nothing. But they have deferred Keynesian slumps rather than preventing them. When the programs end, in circumstances in which social distancing rules or residual customer fear of infection are likely to make it impossible for many firms to restore anything like pre-pandemic revenues, the Keynesian downturn, social distress, and political strain will come, as will the loss of productive capacity.

This conclusion has nothing to do with so-called Modern Monetary Theory.

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How could that have been prevented without turning swathes of employees into work-shy spongers? It is perhaps still not quite too late, in the late summer of 2020, to put in place the alternative, preferable support mechanisms outlined above. Indeed, it is now easier in the important respect that more data on revenue shortfalls is now available. Then when, for instance, restaurants were allowed to re-open, they would be obliged to open for business or lose all government support. Their employees would have to report for work or lose wage payments. The restaurants would continue to be compensated for shortfalls of revenue caused by social distancing/customer caution for, say, six months. After six months, the authorities might reasonably consider—unless a vaccine of proven efficacy and "consumer" acceptability was not just on the horizon but ready for distribution—that the loss of, say, restaurant revenues was going to be permanent and that measures to stimulate demand for other areas of activity were going to be a more effective mitigant of damage to aggregate activity.

Support might be ended sooner than that if aggregate economic data suggested that Keynesian recession had been avoided or was ending: indicators of that might be a level of GDP that had recovered to, say, 97.5 percent of pre-virus levels, or job vacancies and voluntary quits that had recovered very substantially, or an increasing inflation rate (which would be an indication that the structure of demand had shifted to such an extent that much previous supply capacity, in sectors affected by changes in consumer habits, was now economically obsolete). As long as the period of extended support lasted, employers would be responsible for paying employees, but their continued receipt of government

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support would still be contingent on their not sacking people or reducing wages. After one of the two thresholds (time; aggregate economic data) had been reached, all government support schemes would end.

It is of course true that to the extent that there were permanent changes in the structure of demand, some businesses would need more employees, some fewer. But it is nonsense to think that this sort of structural change could happen smoothly in conditions of true recession, potentially of 1930s-like depression, of the sort that would be brought about by the current intentions of governments.

How could such extended support schemes be paid for? There are no free paid holidays any more than there are free lunches. But such a scheme in a country (as opposed to the virus and its attendant restrictions on activity) would not impose a cost on the country as a whole. The schemes could be financed rather easily, from a public finance point of view at least. Suppose that at least some support measures had to continue for six months after all government-imposed restrictions ended and, extremely pessimistically, that the cumulative loss of recorded GDP were, say, 25 percent. The total budgetary "cost" (the additional government debt incurred), taking into account additional government expenditure on health measures during this six-quarter period, might then be equivalent to about 30 percent of one year's potential GDP.

But it is extremely important to recognize that the full-replacement-of-income strategy would not involve additional absorption of resources by the government—it would be a matter of transfers, from the population as a whole in the future to a section of that population now, a section suddenly put at risk of penury by government restrictions. Any nation—a network of mutual responsibilities and loyalties—worthy of the name (unlike the European Union) should take effective measures to prevent such penury, not least to avoid the social and political fracturing that in the 1930s led to authoritarianism and war.

Such transfers are quite different from the fiscal impact of wars, which do involve additional government absorption of resources. When a deficit represents additional absorption, the intertemporally appropriate rate to apply to the increased government debt is, except in very small countries, close to the country's rate of household time discount. But when a deficit represents transfers (and those transfers do not lead to a bringing-forward of private spending but instead forestall a putting-off of private spending on things not restricted by lockdowns), the appropriate rate is the real interest rate on government debt.

Given real interest rates that are, unfortunately, zero or negative in most countries (a symptom of the intertemporal disequilibrium created by central banks), the future path of the fiscal balance, once support measures have eventually ended, required for intertemporal neutrality would be unchanged in most countries. There would be no additional need for fiscal "austerity," no need for debt default, and no need for inflation. This makes sense intuitively. If there is no additional absorption in the present (relative to the no-restrictions baseline)—that is, if there is no bringing-forward of spending from the future—there is no need for future spending, in the economy as a whole, to be lower than it would otherwise have been. The cost of the restrictions to the economy as a whole would then clearly be seen to be a one-off deferment or loss of enjoyment (including enjoyment not only of things that money can buy but also of things it can't). But bygones are bygones; they no longer matter.

Importantly, this conclusion has nothing to do with so-called Modern Monetary Theory; and zero or negative real rates should be bemoaned, not celebrated. Would things be different if one did take the rate of household time discount as the interest rate applicable to increased public debt? Assuming a rate of 2.5 percent (this seems a reasonable assumption given the very long run of experience in capitalist economies), the annual budgetary cost would be about 0.75 percent of GDP in perpetuity, even in the ultra-pessimistic scenario of additional government debt equivalent to 30 percent of GDP. That would certainly not be insignificant. But it would not be a budgetary or economic policy game-changer.

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There are distributional consequences, of course, if the government of a country supporting incomes during and after a period of restrictions adopts the real rate of interest as the intertemporally appropriate one. In that case, the population in general is, via the government, financing many people's consumption at a rate of interest below the aggregate rate of household time discount. The losers are debt-holders who are providing finance (again via the government) for that consumption at a rate below their rate of time discount. Why are they apparently choosing to do that? All this comes back, of course, to the question of how such low (in fact very widely negative) real rates of interest and bond yields persist and indeed are destined to go even lower on a trend basis. The answer is the intertemporal disequilibrium created by central banks.

What a mess we are in, virus or no virus. But the mess will be made frighteningly, horrifically worse by the catastrophic plans by governments to pull the plug on their economies. Governments and their blinkered economic advisers seem hell-bent on creating a new Depression and everything that might very well come with it. ◆