



## Incremental Steps Toward a Radical Solution

*Simon Johnson observes that the Federal Reserve's policy of "quantitative easing" of monetary policy is a necessary step to combat deflation and rescue the economy.*

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Steve Weisman: Welcome to Peterson Perspectives. This is Steve Weisman Weisman at the Peterson Institute for International Economics. Our guest today is Simon Johnson, senior fellow at the Peterson Institute and professor of Economics at MIT. Simon, welcome. The Fed has lowered interest rates again. What's your latest thinking about whether this is going to have any effect on the downturn?

Simon Johnson: Well, it's going to have some effect. Obviously, the Fed is trying pretty hard to soften the recession. I don't think it's going to prevent a deep, pretty long recession and I don't think it's going to really help that much with the recovery.

Steve Weisman: Assuming that there's going to be a big fiscal stimulus package, is there anything else that the Fed can do or should do? There is talk that the Fed is embarking on a program of quantitative easing.

Simon Johnson: The Fed can do a lot of things. I don't think they're, by any means, out of bullets and one thing they can do is buy a lot of Treasury securities. They said in a statement today that they were seriously considering it. What happens in a fiscal stimulus is that you issue a lot of Treasury debt to finance the additional spending. If the Fed buys those Treasury securities, that's an increase on the asset side of the Fed's balance sheet matched by an increase on the liability side of the Fed's balance sheet, which to you and me is money. So, quantitative easing through, for example, purchasing Treasury securities can be tantamount to at least trying to increase the money supply. Technically, it's increasing the monetary base, which will be trying to push up or resist the fall in wages and prices that at the moment threatens to become a dangerous deflationary spiral.

Steve Weisman: So the Treasury issues securities and the Fed buys them?

Simon Johnson: The Fed can buy them. Also, the Treasury securities can be bought by other people. They can be bought by you and me. They can be bought by banks. They can be bought by the Chinese government, for example. So Treasury

securities don't have to end up with a matched line in increase in the money supply but they can end up that way, if that's what the Fed wants to do.

Steve Weisman: Let's ask just a mechanical question. How does this process actually lead to an increase in the money supply, and is that a good idea?

Simon Johnson: Well, let me answer the second question first. Yes, it would be a good idea to increase the money supply. Anything you can do to counteract falling wages and prices is a good idea in this situation and it would certainly have some potential, in fact, in that direction. How you do it is in the following way. You have to think of the money you supply as being an inverted pyramid. So there's a lot of money out there that's built on this base which is called the monetary base or high-powered money and those are liabilities of the Federal Reserve. Ordinarily, when they increase high-powered money, that has some filtering-through effect and money supply goes up. Right now, though, money supply is coming down because the credit system is contracting. It's part of the so-called deleveraging process, thanks to doing less business. And that tends to bring down the amount of money that's out there in the form of bank deposits. So the total money is coming down, the Fed is pushing up on high-powered money. Eventually, they'll get the job done. Eventually, they'll be able to push total money up and that will tend to raise wages and prices. They've got some distance to go though.

Steve Weisman: Is the Fed moving fast enough or in big enough steps toward that objective?

Simon Johnson: Well, I personally would prefer they moved somewhat more dramatically. I think the Bank of England, for example, has changed its policies a lot in the past month and Mervyn King is now signaling fairly effectively that they're going to be having a proinflation policy, at least pro-moderate inflation for the foreseeable future. The Fed hasn't quite got to that point for various reasons. They'd rather take an incremental approach. But it's incrementalism with a very radical sort of destination. They will do whatever it takes to get us out of this potentially deflationary spiral. Ben Bernanke understands better than anyone that to have wages and prices falling when you have debts that are fixed in nominal terms is incredibly dangerous and could cause 10 years of lost growth if not dealt with quickly and appropriately.

Steve Weisman: Will we ever hear a Fed chairman say that he is in favor of inflating the economy?

Simon Johnson: Yes! You could hear that. I think we're some distance from that. I think there's other language they can use to signal that. For example, they think the dollar should fall, could fall, that would be inflationary. They can signal that...

Steve Weisman: Excuse me for interrupting, but tell us how the fall in the dollar could be inflationary.

Simon Johnson: Oh, the fall in the dollar would tend to push up prices. Prices of imports would go up. Right now, we've seen the opposite. We've seen the strengthening dollar, which tends to push down prices of imports. Ordinarily, we'd think that's a good thing. It means we can buy more stuff. But if it fits into an overall deflationary spiral, it's not a good thing. The weakening pound right now is feeding through into higher inflation in the United Kingdom and that is helping them break deflation or change people's expectations. I think the other thing that the Fed chairman can do, and Mervyn King is doing, is talk about inflation expectations and tell people that you expect inflation to be rising in the not-so-distant future and talk about the mechanisms through which that would be achieved. That will affect people's view of what kind of wage increases they should expect, for example, and ask for.

Steve Weisman: Would it be wise for either the Fed chairman or the Treasury secretary to send signals in favor of inflation? What sort of language would we expect?

Simon Johnson: Well, the language initially will be fairly indirect. There are risks certainly to this strategy. They don't want long-term rates to jump up, particularly following what you might call a fiscal-first strategy. So you want to do a fiscal stimulus and you'll issue a lot of debt. They'd like to issue that at low interest rates so they don't want inflation expectations to go up. But right now, Steve Weisman, the expected inflation in the 5-year inflation swap market expects prices to fall by about 0.5 percent a year for the next 5 years.

Steve Weisman: Can that be changed by actions?

Simon Johnson: Absolutely. Of course, it comes very much out of monetary policy, working with fiscal policy and also, I would emphasize, bank recapitalization. We need to have substantial progress on that front too. But if you do make progress on this front, you will turn it around. But on the other hand, if you don't put in place effective policies, you get a situation like Japan where over a 30-year horizon, inflation is expected to be negative right now. Then once it gets entrenched in people's expectations—"oh yes, my wage next year will be 1 percent lower than it is this year"—then you're on a very dangerous path and it will take you a long time to climb out of that one.

Steve Weisman: Of course the paradox is that Americans concerned about their own personal family's economic future are engaging in what they view to be virtuous behavior. They're deleveraging or paying off as many debts as they can and they're looking for lower prices. They're welcoming lower prices. But you're saying that in both of those cases, that virtuous behavior can lead to an overall crisis in the economy.

Simon Johnson: Yes, absolutely and it is a paradox, I agree. It's not just US consumers. It's also US firms whose talk about rebuilding their balance sheets means paying down their debts and holding on to cash. It's not just in the United States. It's also firms around the world. In emerging markets, for example, people are trying to pay down their debts and of course, there's an attempt to offset this increase in desired savings, if you like, by governments putting a fiscal stimulus out there. So that's government saving less or dissaving, to use the term economists prefer. So there's an offsetting increase in spending by governments because the private sector wants to spend less. But here's the problem: Most governments can't spend that much more because their balance sheets are not that good. They already have a lot of debt. It's a bit of an issue in the United States. It's much more of an issue in Europe, for example, in the eurozone. So the amount of fiscal stimulus the government can provide to offset the contraction of private spending is pretty small.

Steve Weisman: And what do you feel about the argument that the more governments spend in fiscal stimulus, actually that that robs people of confidence about the future of the economy?

Simon Johnson: It's definitely true if you go too far. People's confidence will be undermined. That's what people mean by saying there's a balance-sheet constraint. If the United States came out and said, "Right, we're going to do a 10 percent fiscal stimulus in one year"—which would be hard to implement by the way—if they said that, I think everyone's reaction would be, "Oh my goodness! This is too much. This is not good." And that's because we already have 40 percent of GDP as privately held government debt in this country. In Italy, debt is over 90 percent and in Greece, it's close to 100 percent of GDP. So you can see the room for fiscal stimulus in those countries is much more limited.

Steve Weisman: Can the global economy turn around with only those countries that have the capacity in terms of their debt limits to engage in fiscal stimulus?

Simon Johnson: Well, there will be some fiscal stimulus. There is already in the works some fiscal stimulus. The IMF has called for 2 percent of global GDP as a stimulus. I think realistically, they'll get meaningful stimulus closer to 1 percent, perhaps a little bit under 1 percent. It's better than zero but it's nowhere near enough to offset this increase in precautionary savings. Think about it like this: The patient just had a heart attack, a terrible scare, a big health scare. And the doctor says, "You're fine. Go back to work. Go back to your normal business. The drugs will take care of it. We sorted out the credit system. Don't worry. Be happy." No one believes that. Everyone says, "Oh my goodness! All kinds of bad things can happen. Perhaps I won't have a job next year." And once you start thinking like that, of course, you want to be more careful in your spending. You have some precautionary savings. The problem is, that's OK. That's always happening somewhere in the world at some point in time.

But when everyone in the world goes into a synchronized savings attempt like we're facing now, the result is going to be a prolonged slowdown.

Steve Weisman: I want to ask you one more thing. You've said that although this was an asset bubble of many years in the making, it wasn't inevitable that it end certainly this way. What do you think was the most important turning point in destroying people's confidence?

Simon Johnson: Well, the most important turning point was obviously what happened with the failure to bail out Lehman and then the way in which AIG was saved in which senior creditors took a big hit. So people at that point got very frightened of everything to do with credit. And they think that some things are too big to fail. But when they fail, the creditors will lose a lot of money, which is the experience from AIG. So that really was the trigger. But I would emphasize that the tinder for this massive fire is global. I mean, this is, I'm afraid, a big misconception outside the United States. People say, "Oh! Look at all the bad things the United States did. The United States has created this huge global problem." Well, the United States can't create a global problem. The United States can create its own problems. They've become global because European banks got involved. They took on far too much of the collateralized debt obligations, for example. European banks are holding up, propping up half of the losses, total losses by the time we're done with losses just from US mortgages.

Steve Weisman: And emerging markets also took similar risks.

Simon Johnson: Emerging markets took those risks but they took other risks too. So if you lend to people who were exporting to the United States and to Europe and those economies are now slowing down, you're going to get bad loans out of that. You can't be too literal, too narrow-minded in thinking about the miscalculation of risks here. It was deep. It was profound. Everyone got very leveraged. Everyone was taking a big bet on continued global growth. If you like, it was a meta-bubble, OK, in which the US housing bubble is one obvious manifestation. The meta-bubble was everyone said, "Hey, we're going to have great growth and we can debt finance it." Okay. If you had equity financed it, it could still have collapsed, it could still come down a lot. But debt financing gives you a lot of discontinuity. People default, and when they default, in most bankruptcy systems, they stop paying. You lose a lot of value and you take a big step down. And we built this interconnected financial system, a globalized financial system. We can't handle it, OK. We can't handle it on the downturn. That has become completely evident. We've dug a big hole. It's going to take a long time to climb out of it.

Steve Weisman: We're having sort of a global nervous breakdown. How many years is it going to take to get out of this?

Simon Johnson: I don't know. It depends, I think, a large part on the Europeans. The Obama administration understands, I think, all of this and they will move in an incremental fashion to radical solutions. It will take them 6 to 9 months but they will throw everything they can at it and it'll help turn things around. The problem is that the Europeans are in denial. When I tell them, when I talk to the Europeans about this, talk to senior European policy makers...

Steve Weisman: Not the British but other Europeans....

Simon Johnson: Yes, I suppose it's Europe without Britain again.

Steve Weisman: We in the United States still think of Britain as part of Europe.

Simon Johnson: Yes, that's right. So it's continental Europe as they call it.

Steve Weisman: Continental denial.

Simon Johnson: Yes, it is a great continental denial. When I explain these points or make these points to Europeans, they get angry with me. They say this can't possibly be true. This is a US problem. The United States created this problem. The United States has to deal with it. Now, the United States is 20 to 25 percent of the world economy. The United States cannot create global problems. Global decisions create global problems.

Steve Weisman: Well, Simon Johnson, thank you again for giving us your latest temperature taking of the economy and where we're headed. We'll have you back periodically, as always. Thanks again for joining us on Peterson Perspectives.

Simon Johnson: My pleasure.

