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THE DOUBLE CRISIS

1.
The Obama Administration has inherited not one but two economic crises:
----The recession , which has a normal cyclical element but is much more severe than in all previous down cycles since the 1930s because of the lack of credit (caused by multiple bank and other financial failures)
---A structural crisis that has been building up over many years, in which both public and private demand in excess of tax revenues and household earnings was financed by accumulating debt both public and private.
This internal disequilibrium was necessarily matched by a corresponding external disequilibrium in which trade deficits financed by the sale of financial instruments were not cyclical and were not reversed by equivalent trade surpluses, so that US dollar instruments simply accumulated overseas.
2.
This means that there is no pre-crisis equilibrium structure to return to. Instead a new structure must be invented and then created. That creates a problem in itself. (See Addendum on the "methodological" problem)
3.
The Obama Administration need not invent anything new to deal with the economic recession as such--the usual remedies apply : tax cuts and/or deficit spending to increase demand. There are of course added risks because of the magnitude of the demand shortfall and its remedies.
4.
Nor will the Obama Administration have to invent anything new to deal with the credit crisis--between them, the US Treasury, the Federal Reserve, the British Treasury and the Bank of England have recently used every possible method to rehabilitate banks and other financial institutions: forced mergers of weak entities with strong ones ; the same + public guarantees for risky assets held by the weak entities; simple grants of money , in exchange for equity (de facto partial nationalization) and the acceptance of other conditions –most recently including the obligation to lend; purchase of risky assets to clean up the books of the sellers; simple nationalization is gaining increasing favor.
The problem as everyone understands is that surviving lending institutions want to make only very safe loans, and there are not many very safe loans that

can be made in an economy that is both slowing down severely (reducing the willingness to invest), and in which housing prices are continuing to fall (reducing the willingness of households to consume + increasing mortgage abandonments, which further weaken mortgage lenders)

5.

The structural crisis is entirely different because a substantially new structure for the *global* economy has to be invented in which the US can be a net exporter, in order to develop a new structure for the US economy.

6.

US households are in the process of reducing , not increasing debt. They were willing to increase their debt level when it was offset by rising housing values and to lesser degree , by rising stock-market values. Stock markets could in theory recover very fast, but housing values cannot recover (net of inflation) for several years at best, hence even if there are willing lenders and low interest rates, the willingness of US consumers to borrow must decline also—at a time when their income is itself declining. Instead of adding rising debt levels to (slowly) rising incomes to increase their demand, US consumers are subtracting debt repayments from declining incomes, thereby drastically reducing their demand.

7.

Public demand is set to increase with deficit spending but that cannot happen very fast so that total US demand public and private will still decline sharply during 2009.

8.

Absent action outside the US to increase demand, given the inevitable decrease in US demand, the global economy will be caught in a downward spiral that is very likely to be aggravated by protectionist measures embedded in subsidization schemes (that is happening as of now)

9.

Everywhere there are obstacles of one kind or another.

In some countries including Italy and Japan, very high levels of public debt prevent governments from stimulating demand by cutting taxes; in other countries , such as Germany, the public debt is not very high but there is no willingness to increase it by cutting taxes. In those countries demand could only be increased by facilitating increases in consumer debt levels, which are indeed unnecessarily low in some cases. But there are cultural obstacles, and the pessimistic atmosphere is a further obstacle.

In China, taxes are almost irrelevant and it is very high rates of saving that restrict demand. In China , the only possible remedy would be to provide state pensions to the disabled and to old people, on the assumption that people would not save so much if they had assured incomes when no longer working (functioning health-care systems might also be needed, and/or health insurance).

10.

In other words, the Obama Administration would have to be successful internationally to deal effectively with the internal problem of restructuring the US economy.

11.

At best, that is bound to be a very slow process even if all goes well and the relevant foreign governments do agree in principle on the need to increase demand --there are just so many steps, starting with the formulation of international economic policy within the Obama administration and ending with negotiations between the foreign governments involved on how to allocate the demand increase between them. Even after that, more time would be needed to implement the measures intended to increase local demand, e.g. China cannot be expected to create a system to pay disability and old-age pensions overnight, let alone a health-care system.

12.

As compared to the very big economic crisis, Afghanistan, Iraq, Israeli-Palestinian relations, even Iran's nuclear and terrorist-support activities, are all little crises for the Obama administration. Its foreign policy team has prepared policy schemes for all of them but Obama knows that only economic failure can ruin his presidency—and there is as yet no sound scheme to prevent that.

The "Methodological" Problem

1.

In a normal crisis, the aim of crisis-management is to go back to the pre-crisis situation.

That greatly simplifies things: even if the problems to be overcome are very severe, at least the goal is clear and uncontroversial (!) and nothing has to be invented to simply returning to the pre-crisis situation.

2.

But that cannot be the aim of US economy policy in the present crisis, because the pre-crisis situation required an inherently non-sustainable accumulation of foreign debt . (The only surprise was that the collapse did not come because foreign lenders refused to continue lending, but because of the internal dynamics of the US housing market: the boom originally caused by low interest rates made possible by foreign capital inflows imploded as all booms will).

3.

Not only the Obama Administration but other US decision-makers both public and private must therefore confront the very difficult problem of inventing a new structure for the US economy—and while a downward demand spiral is underway.

The sustainable new structure that must be defined will therefore be a moving target for some time--a great complication in itself .

4.

The methodological obstacle is that the analytical methods of macro-economics are useful to understand the workings of economic systems, not to design new ones.
Hence there is no common doctrine to unify opinions even among the Obama advisors, let alone among all the other public , private and international decision-makers who are also relevant, starting with members of the US Congress.
Finally, the instruments to affect change may be lacking, including protectionist measures prohibited by treaty.

5.

Only one thing is entirely certain : US households will continue to reduce their demand towards one of two new levels:
if the US dollar retains its value, down to a level below total post-tax incomes, in order to start repaying the accumulation of household debt;
if inflation accelerates thus liquidating the real value of debts, down to the level of current post-tax incomes.

6.

Either way, US purchases of durable goods will be significantly lower in the coming years as compared to the recent past, in spite of continuing population growth. How much lower at any one time will depend on the state of the economy –including foreign demand for US goods and services-- and all the other factors that determine discretionary income, including tax policies, commodity prices, health care prices and more. END