Some fires are best left to burn out

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Forest fires are judged to be nasty, especially when one's own house or life is threatened, or when grave harm is being done to tourist attractions. The popular conviction that fires are an unqualified evil reached its zenith after a third of Yellowstone Park in the US was destroyed by fire in 1988. Nevertheless, conventional wisdom among forest managers remains that it is best to let natural forest fires burn themselves out, unless particularly dangerous conditions apply. Burning appears to be part of a natural process of forest rejuvenation. Moreover, intermittent fires burn away the undergrowth that might accumulate and make any eventual fire uncontrollable.

Perhaps modern macroeconomists could learn from the forest managers. For decades, successive economic downturns and even threats of downturns ("pre-emptive easing") have been met with massive monetary and often fiscal stimuli. This was the case when the global stock market crashed in 1987, and it was repeated when the property boom in many countries collapsed in the early 1990s. Interest rate rises were put on hold during the Asian crisis of 1997, even though traditional indicators said some industrial countries were overheating. Rates were then sharply reduced in 1998, after the collapse of the hedge fund Long-Term Capital Management, and were lowered again when the stock market collapsed in 2001. Today, policy rates in most industrial countries are close to zero, in response to the financial crisis.

What needs reflection, against this backdrop, is whether the policy re-action to each successive set of difficulties laid the foundations for the next one. Worse, the encouragement by lower interest rates of debt accumulation and spending imbalances was the equivalent of allowing undergrowth to accumulate in a forest. This undergrowth not only made subsequent downturns more dangerous; it also made the available policy instruments less reliable in response. Looking back over successive cycles, interest rates have had to be reduced with ever more vigour to get the same (and sometimes reduced) response from spending. Most recently, new and untried policies such as quantitative and credit easing have had to be introduced. Logically, the end point of such a dynamic process would seem to be the mother of all fires and few if any means of resistance.

The current Keynesian mindset rightly observes that we have a shortage of aggregate demand. It then concludes that demand stimulus, from whatever quarter, is to be welcomed. However, in addition to the undergrowth problem on the demand side, we can also have an undergrowth problem on the supply side. This was the core of Friedrich Hayek's position when he debated Keynes in the early 1930s. In response to demand stimulus over recent decades, with investors implicitly assuming that the future would be like the recent past, there has been a massive increase in supply potential in many industries. The upshot is that many of them are now too big and must be wound down. This applies to automobile production, banking services, construction, many parts of the transport and wholesale distribution industries, and often retail distribution as well. Similarly, many countries that relied heavily on exports as a growth strategy are now geared up to provide goods and services to heavily indebted countries that no longer have the will or the means to buy them.

In this supply side context, policies such as "cash for clunkers" and value added tax cuts in countries with very low household saving rates and massive trade deficits are clearly sub-optimal. So too, in countries with large trade surpluses, is resistance to exchange rate appreciation along with a continuing reliance on export demand. Such policies are equivalent to trying to resuscitate a patient long since dead. Not only will time prove that such attempts are futile, but they also impede the desirable adjustment from declining industries to those that should be expanding. In effect, relying solely on macroeconomic stimulus may well head off a more violent downturn, but only at the expense of a more protracted recession. Maybe this is the principal lesson to be drawn from Japan's almost two decades of sub-par performance. Indeed, resisting structural adjustment could also imply a decline in the level of "potential growth" in the years ahead. This would bring with it the threat of a stagflationary outcome, if the demand stimulus from Keynesian policies were not to be adjusted downwards in consequence.

Where to go from here? In terms of future crisis management, governments should give more weight to the longer-term implications of their policies. Those that threaten to make future crises more costly, or that impede required structural adjustments, should be moderated. Such inter-temporal trade-offs imply, from time to time, accepting a temporary economic downturn to avoid even bigger future costs. In this sense, good crisis management also contributes to crisis prevention.

But still more might be done with crisis prevention. Just as good forest management implies cutting away underbrush and selective tree-felling, we need to resist the -credit-driven expansions that fuel asset bubbles and unsustainable spending patterns. Recent reports from a number of jurisdictions with well-developed financial markets seem to agree that regulatory instruments play an important role in leaning against such phenomena. What is less clear is that central bankers recognise that they might have an even more important role to play. In light of the recent surge in asset prices worldwide, this issue needs urgent attention. Yet another boom-bust cycle could have negative implications, social and political, stretching beyond the sphere of economics.

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