The risk of permanent stagnation

Recently there has been a lot of talk among U.S. economists about "green shoots" and "seeing the light at the end of the tunnel," popular ways of saying that the worst of the current recession is over and growth will probably resume late this year or early 2010. In Puerto Rico, however, economic indicators continue to hover in negative territory. For example, unemployment, bankruptcies and loan defaults are up; while car sales, cement sales, electricity consumption, and employment are all down. If this divergence continues and the U.S. and other large economies start growing early next year, while Puerto Rico is still mired in a recession, then we run the risk that higher interest rates and higher oil prices may quash the recovery in Puerto Rico and push our economy into a steady state of long-term stagnation.

Keynes was the first to conclude that an economy in a recession, or even in a depression, could stay there indefinitely. According to his General Theory (1936) there was nothing inherent in the economic mechanism to pull it out of recession and "equilibrium" could be achieved with significant, even massive, unemployment. The principal reason for this was (and is) that economic activity depends on investment. If business investment falls, then a spiral of contraction would begin, whereby enterprises lay off workers because there is no consumer demand for maintaining or increasing production relative to pre-recession levels. Higher unemployment would further depress the demand for goods and services, which in turn leads to even more lay offs, and so on in a vicious cycle.

Consumption could not be counted to lift up the economy from this vicious cycle for two reasons. First, aggregate spending power diminishes naturally when there is increasing unemployment. And, second, people tend to increase savings, and further reduce consumption, during recessions. According to Keynes, this tendency to increase savings during bad times was quite misguided, because "the object of saving is to release labor for employment on producing capital goods such as houses, factories, roads, machines and the like. But if there is a large unemployed surplus already available for such purposes, then the effect of saving is merely to add to this surplus and therefore to increase the number of the unemployed." Thus, an economy could be stuck in this cycle for quite a while.

Sergio M. Marxuach

Of course, Keynes' claim to fame lies in his proposal that government should pick up the slack if business was unable or unwilling to expand. An idea that seems to be nothing but common sense to us, but that was incredibly unorthodox at the time. Note, however, that Keynes did not advocate for just any kind of government spending. He explicitly favored spending on large public works for various reasons. First, government spending would be concentrated on building long-term assets, such as roads, bridges, hospitals, and schools, that would help sustain growth over the long term. Second, by putting large numbers of people to work, the government would sustain the purchasing power of the otherwise unemployed, thus jump-starting consumption. Finally, by generating new orders for construction and other materials, government would lead the way for a resumption of private business expansion.

During the recent recession in Puerto Rico, however, the government could not implement the Keynesian recipe in full due to the weak state of its government finances. As is well known, Puerto Rico is suffering a severe fiscal crisis, the result of bad decisions made over the last 20 or 25 years. In order to address this situation the government had to implement policies to reduce the long-standing deficit, which is precisely the opposite of what Keynes recommended to stimulate growth.

As an alternative, the current administration has engaged in a complicated policy minuet. On one hand, the government is cutting back on government spending and raising taxes, while on the other it simultaneously seeks to stimulate the economy through (1) a $500 million local stimulus package; (2) a $5 billion federally-financed stimulus package; and (3) promoting private sector investment through public-private alliances. In essence, the government is betting that the positive impact from the stimulus spending will outweigh the negative impact of the deficit reduction package.

The results of this mixed policy have been mostly negative so far. The expenditure cuts and tax increases have already adversely affected the economy, while the effect of the stimulus has been marginal, at least until now. The local stimulus plan is too diffuse and small to have any real impact. Meanwhile, Puerto Rico has done well in terms of obtaining approval of ARRA funds but federal disbursement of the money has been slow and it remains to be seen whether local government agencies have the administrative capacity to spend it quickly while preserving the requisite controls to avoid waste and corruption. Finally, the process for establishing public-private alliances has been slow and the list of projects identified so far is not precisely impressive.

So, there is a real risk that we may miss the recovery wave in the U.S. and slip into a state of permanent stagnation, with high unemployment and low growth for years to come. Simply put, we are on the Titanic and we know we are hitting the iceberg. In the interim, our government officials continue to engage in the same old petty politics and useless finger-pointing ... while that iceberg keeps getting closer and closer.

The author is Director for Policy Development at the Center for the New Economy, a Puerto Rico-based think tank. www.grupocne.org