Stimulus and Regulation to Promote a Renewed and Spirited World Economy[1]

By Robert J. Shiller[2]

Madam Chairperson, Excellencies, Distinguished Delegates, Ladies and Gentlemen:

The title of my talk conveys the fact that today I want to consider how we can *renew* the world economy after the financial crisis. And, more than that, I want to discuss how to sustain, in some countries, and recreate, in other countries, a *spirited* economy.

The word "spirited" is rarely used by economists to describe an economy. I have chosen to use that term for this address because of a view of the economy that I hold, that a fundamental driver of the economic success of nations has to do with the spirit of the people.

An economy needs *esprit de corps* just as an army or business does. John Maynard Keynes, in his classic 1936 book *The General Theory of Employment Interest and Money* took an ancient medical term, "animal spirits" (*spiritus animalis* in Latin, referring to the animating spirit that gets people to get up and go and do things) and said that fluctuations in these spirits drive economic successes and failures. My colleague George Akerlof and I wrote a book entitled *Animal Spirits How Human Psychology Drives the Economy and Why It Matters for Global Capitalism* (Princeton, 2009) which was a plea to regard the maintenance of a good level of animal spirits as a fundamental macroeconomic goal.

Achieving the proper economic spirit does not mean cheerleading by government officials to try to boost confidence. It does not mean groundless promises that the economy will

[1] Address before the Economic and Financial Committee, General Assembly of the United Nations, October 4, 2010.
[2] Arthur M. Okun Professor of Economics, Yale University and Professor of Finance, Yale School of Management, Research Fellow, National Bureau of Economic Research, and Chief Economist, MacroMarkets LLC.

recover. It means instead creating the kinds of conditions that will give people a salient reason for confidence. It means making ready to give economic stimulus as needed, and only as needed, to rescue collapsing institutions. Economic stimulus *must* not be overdone so that it encourages bubble thinking. Achieving the proper economic spirit also means establishing regulations that ensure trust and cooperation, and in so doing, that encourage genuine inspiration. It means promoting an atmosphere of fair dealing in business. Good faith in business has been respected for millennia: In ancient Rome it was called, in Latin, *bona fides*. In ancient China, Confucius said "The scholar does not consider gold and jade to be precious treasures, but loyalty and good faith."

But the recent financial crisis revealed many examples of lapses of *bona fides* in business. Some were perpetrated by mortgage brokers who urged terms on borrowers that were not in their best interest, or who facilitated fraudulent mortgage applications. Some were perpetrated by securitizers who sold to the investing public securities that they themselves knew were bad. Some were perpetrated by credit raters, who gave high ratings to securities that they had not properly investigated. Some were perpetrated by lax regulators, who did not stand up to abuses that were before their eyes. In truth, we should not be too severe in blaming these people, for they were caught up in the social forces of a boom that made it difficult to be straight and narrow. But we should work towards preventing such a situation from recurring.

Helping to achieve a spirit of *bona fides*, of good will and high expectations of each other can be considered a fundamental mission of the United Nations. The United Nations was founded at the end of World War II, a war which was widely viewed then as an indirect result of the troubling economic and social conditions of the Great Depression that had immediately preceded it. Indeed, the original charter of the United Nations recognizes this when it makes one of its goals the “conditions of stability and well-being which are necessary for peaceful and friendly relations among nations.”

Moreover, achieving such a spirit is fundamental to the success of all eight millennium development goals of the United Nations. Achieving these goals requires having the resources to spend on aims that in one way or another cost money, funds that may be limited if economic growth continues to falter. Moreover, the process I describe of producing a spirited economy entails directly promoting some of the aims of the millennium development goals, those goals related to justice and social progress.

For securing this spirit in the future, I want to stress two things in this talk.

One is that, even though the world economy has improved, in many countries more economic stimulus is still needed, or may yet be needed. More efforts need to be made for job creation, to restore the morale or “animal spirits” that underlie any successful economy. But we need also to manage the state of bubble thinking that still seems to play a role in the origins of this crisis, and that may soon play a role again. Managing stimulus in a way that supports an economy without encouraging speculative excess is a delicate thing. Recent government efforts to set up new agencies that will take responsibility for dealing with bubbles and preventing systemic collapse are steps forward, but the real test will come in seeing how they operate.

The second is that financial regulatory efforts should be fully engaged with the potential that modern financial markets offer, if we take account of basic principles of financial theory. They should not be trying to “rein in” healthy financial activities, but giving activities that are operating responsibly an even larger scope. One significant dimension for enlarging the scope of financial activities is making the technology of finance more available to everyone. That is, the thrust should be towards democratizing finance, making it available to all the people. The lesson from the crisis should not be that modern financial institutions are too complex and too dangerous. The lesson should be that our regulations need to help them become more modern and less susceptible to misuse.

Increased economic stimulus and improved financial regulatory efforts require international coordination. Stimulus in one country alone tends to spill over to another and thus to have weakened impact at home. Financial regulatory efforts in one country alone tend somewhat to be ineffective, as they may merely drive the venue for financial activity out of the home country. There is thus a fundamental role for organizations like the United Nations to help set the standards for such policies.

The Present State of the World Economy

The world economy remains in a weak and vulnerable state following the financial crisis that began in 2007. Three years after the first shocks of that crisis turned up in the market for securitized subprime loans in the United States, there are worries that the recovery may be very slow.

According to a paper presented September 13 at a joint International Labour Organization-International Monetary Fund conference in Norway, there has been an increase in the number of unemployed worldwide of approximately 30 million people since 2007. About three quarters of the newly unemployed 30 million are in “advanced” countries, the remainder in “emerging” countries.

As a percent of world population, thirty million unemployed individuals may seem small, since it is on the order of one percent of the world’s labor force. Moreover, the report from

Norway suggests that unemployment problems seem to have relatively spared the emerging countries.

But, massive unemployment is more of an advanced country phenomenon. For example, in societies that are more agricultural, unemployment is more likely to be expressed as underutilization of labor rather than outright unemployment. Advanced countries tend to have more generous unemployment insurance and other benefits to reduce the impact of unemployment, and hence more people tolerate being unemployed rather than accept very marginal and undesirable employment. In poorer regions of the world unemployment is considered a luxury that cannot be afforded. The ILO/IMF unemployment numbers most likely do not reflect the full scale of lost employment opportunity in the emerging countries.

Even though a recovery has been underway, IMF data show that world real gross domestic product (GDP) has increased a total of only two percent in the two years between the first quarter of 2008 and the first quarter of 2010. World GDP hasn't come close to catching up with the long-term trend. If world GDP had increased at the trend rate of growth shown by the IMF data from 1987 to 2007, 3.5% a year, it would be five percent higher than it is now.

There is reason to believe that it is misleading to accept at face value the estimated 30 million increase in world unemployment since 2007. Arthur Okun, an economic advisor to U.S. President Lyndon Johnson, discovered a close relationship between the percentage change in GDP and the change in the unemployment rate in the United States. If we apply the same Okun's law relationship between GDP growth and unemployment that is seen in the United States, the decline in world GDP growth rates after the first quarter of 2008 suggests (if the same kind of unemployment phenomenon occurred worldwide as occurs in the United States) that the world unemployment rate should be about 2% higher than it was at the beginning of 2008. This suggests that the ILO/IMF estimated 30 million new unemployed greatly understates the true loss of opportunity reflected by the current economic situation.

Animal Spirits

The present crisis was caused substantially by bubbles. Just prior to the beginnings of the crisis in 2007, there had been stock market bubbles in most countries, home price bubbles in many countries, and bubbles in the price of energy and many commodities that affected much of the world. Speculative bubbles are in a sense social epidemics. Their contagion rate is amplified by the focal point for public attention – attention created by the spectacle of rapid price increases that are enriching a segment of the population, and leaving others behind.

The phenomenon of animal Spirits has a number of elements that George Akerlof and I detailed in our book. A great deal of scholarly research in behavioral economics over the past twenty years informs our newly-refined concept of animal spirits.

Central among factors contributing to healthy animal spirits is business confidence, an optimistic belief in the future and as well an opinion that others share this optimistic belief, and hence an expectation that business ventures will have a real chance to succeed. The growth of confidence in a bubble time can become excessive, and during this growth period people may let their guard down, fail to check out facts in their zeal to be part of a boom. This leaves many people open to victimization, and corruption and bad-faith business dealings flourish during a boom. The contagion of the boom is facilitated by stories, stories of businesses successes and of a bold new economic era, spread by the news media and by word of mouth, which put an animating factor that is beyond healthy bounds.

Managing our way out of here means managing confidence. Unfortunately, doing this means trying to manage human psychology, a difficult task. National leaders instinctively try to do this, in their talk, and in their consideration of the effect their potential actions might have on confidence. Akerlof and I stressed that the progress of confidence in an economy depends as well on a perception that our leaders have created a system that is basically fair and just.

The need for Stimulus

In countries with still high unemployment rates, we need to do fiscal stimulus. This can be done effectively if it is focused on the kinds of fiscal expenditures that help most in maintaining animal spirits. An important part of it is keeping *jobs*, for unemployment (along with underemployment) is the great killer of confidence.

In his 1999 book about the protracted "jobless recovery" that followed the 1990-91 recession, Truman Bewley showed through a lengthy series of interviews that a loss of morale was one of the major issues that generated unemployment and that held back spending that might bring back jobs. Indeed, reading about these morale issues back then suggests an important reason that jobs came back so slowly after the 1990-91 recession, and why they may come back slowly after the financial crisis that began in 2007. Morale is Bewley's word for the animal spirits that I emphasize here.

Concerns about rising national debt are valid, but we have to keep those concerns in perspective.

Resistance to renewed stimulus spending lately has taken the form of concern that increasing government debt on its own can create a crisis in confidence that offsets any advantage to stimulus spending. Conversely, it is argued that fiscal consolidation, raising taxes and/or cutting expenditures and thereby cutting the government deficit may even have an expansionary effect, through its effect on reducing the public concerns about outstanding national debt.

But the latest International Monetary Fund *World Economic Outlook* confirms that fiscal consolidation usually weakens the economy. There are some exceptions when the country has sovereign debt credibility problems. But for most high unemployment countries, the issues of national debt can still take a back seat to the issue of stimulus.

Moreover, the stimulus-induced increase in sovereign debt of many countries that has become a source of popular concern after the Greek debt crisis broke out in late 2009 can be handled with improved financial arrangements. We should be moving away from continued reliance on old forms of government financing. Canadian economist Mark Kamstra and I have been arguing that in the future governments should issue GDP linked bonds or even more directly, shares in GDP, as a way of raising money. Doing so will lower the implicit leverage that governments place on their taxpayers, lower the risk of insolvency that governments face, and allow for a better diversification of risks.

Nations should be planning now on how another round of stimulus should be undertaken. We have learned from the recent stimulus that much needs to be done to get effective stimulus plans to swing into gear. Government agencies (such as the Federal Employment Reserve Authority proposed by Prof. Martin Shubik of Yale University) need to be assigned the task now of making contingency plans for even more stimulus than is needed now. Governments need to be thinking about how to do economic stimulus that has the most effect relative to cost in terms of job creation.

Stimulus can also take the form of bailouts of systemically important financial institutions or of individuals whose economic situation in the financial crisis suggests an economic injustice that may harm our sense of civil society.

Bailouts appear actually to have been the cheapest form of stimulus, giving the biggest bang for buck. In the United States, the Troubled Asset Relief Program, created by the U.S. Congress in 2008 to provide $700 billion that was ultimately used for government support through purchases of assets or shares in failing banks, other financial institutions and automobile companies, has just finished its second and final year. According to news stories about a briefing from Secretary of Treasury Timothy Geithner to President Obama, the program will have cost, in terms of taxpayer money lost, no more than $50 billion. Some speculate that when the program finally completes, it will be found to have turned a profit, that is, have negative cost to taxpayers. And while there is no way to prove it, this program is widely credited with having prevented a Great-Depression-style house-of-cards collapse.

If the government stands too ready to bail out failing businesses, it runs the risk of creating a "too big to fail" problem, giving large systemically important firms an advantage relative to smaller businesses, and thereby creating entrenched interests that are the enemy of a spirited and innovative economy. But, the example of the TARP program illustrates that that has hardly been the case recently

Governments around the world should set authority in place for more such bailouts, so that they can quickly act if newly falling asset prices or other shocks to the economy create another round of systemic risks.

Financial Regulation

I am a member of the Squam Lake Group, a group of U.S. university professors who convened first at a lake in New Hampshire in 2008 to discuss the financial crisis. We have argued that reform of financial regulations is high on the agenda of actions needed

But the Squam Lake economists were in favor of regulation only if it is squarely motivated by some two basic economic principles that differ rather substantially from the core capitalist principles that have long been taken for granted as accepted in the United States and other advanced economies.

One of these principles is that regulation should be motivated by the potential for systemic problems. Mainstream financial theory has not taken into account the vulnerability of financial systems to risks of collapse of the entire system. This "externality" is not part of the theory. Financial theory that does not take such a vulnerability into account is incomplete, and needs to be revised. Because of inevitable systemic problems, bailouts will be necessary, but other steps need also to be taken to reduce the systemic vulnerability itself.

The second principle is that regulation should be devised to encourage financial firms to internalize as much as possible the cost of bailouts. The Basel III proposals for bank capital requirements work somewhat in accordance with this principle, but more yet needs to be done. Among the Squam Lake proposals were that a form of contingent capital for banks should be encouraged by regulators so that capital would suddenly be forthcoming, from the bondholders in the firm, in a systemic financial crisis. Another Squam Lake proposal was that there should be a regulation that a part of executive salaries should be held back for a number of years, and not paid if there is a government bailout of the firm.

I have also a third principle, which I have already mentioned, namely that government policy should be aimed at furthering the democratization of finance. This means making sure that the full advantage of modern financial theory and risk management really works for the people, all the people. It means, for example, solving whatever problems inhibited so many people in Haiti from having proper insurance against earthquakes, or so many people in Pakistan from having proper insurance against floods. It means taking steps to encourage personal saving and investment plans that reach everyone, and that are really in the interest of all the people, not plans that are cynically constructed by salespeople who are merely looking for what will sell.

In order to make the democratization of finance really take hold, we need also to subsidize financial advice for every person. Financial advice is already subsidized by tax codes, in that it is deductible from income taxes as a business expense. But such subsidies primarily reach high income people, not those lower income people who are getting virtually no financial advice at all. The importance of providing medical care to everyone is widely recognized around the world today. The importance of providing financial care is less recognized. But, perhaps the recent crisis will awaken us to the importance of such care, for everyone.

Conclusion

It is inspiring to see the number of countries that have undertaken rapid stimulus packages and financial reforms in response to this crisis.

But, in reality, most of the stimulus was temporary and most of the regulatory reforms were incremental. This is entirely to be expected. The financial system that underlies a modern economy is immensely complex, the product of centuries of progress in designing financial institutions that work for real people. The crisis has awakened us to the shortcomings of this system, but has not with equal alacrity told us what should be done to move it further forward.

The process will take years, and it will take political support that may fade as the worst part of this financial crisis falls behind us.

The United Nations can be a force to help keep the impetus for the right kinds of stimulus and reform, using its influence to keep these the necessary steps on the agenda for as long as there continue to be significant risks to our animal spirits and our shared prosperity

References

Akerlof, George A., and Robert J. Shiller, *Animal Spirits: How Human Psychology Drives the Economy and Why It Matters for Global Capitalism*, Princeton University Press, 2009.

Bewley, Truman, *Why Wages Don't Fall During a Recession*, Cambridge: Harvard University Press, 1999.

International Monetary Fund, *World Economic Outlook*, October 2010, Chapter 3," Will It Hurt? Macroeconomic Effects of Fiscal Consolidation," http://www.imf.org/external/pubs/ft/weo/2010/02/pdf/c3.pdf

International Monetary Fund and International Labour Organization, "The Challenges of Growth, Employment and Social Cohesion," background paper for the Joint ILO-IMF conference in cooperation with the office of the Prime Minister of Norway, September 2, 2010, http://www.osloconference2010.org/discussionpaper.pdf.

Kamstra, Mark, and Robert J. Shiller, "Trills versus T-Bills: It's Time to Replace Part of Government Debt with Shares in GDP," *Economists' Voice,* 2010. http://www.bepress.com/ev/vol7/iss3/art5/

Shiller, Robert J., *Subprime Solution*: *How Today's Global Financial Crisis Happened and What to Do about It*, Princeton: Princeton University Press, 2008.

Shubik, Martin, "A Proposal for a Federal Employment Reserve Authority," Levy Institute, Bard College, 2009. Martin, http://www.levyinstitute.org/pubs/pn_09_05.pdf

Economists predict a recession far worse than anything since World War II . France, Italy and Spain, the blocâ€™s second-, third- and fourth-largest economies, are expected to suffer the most, clocking in contractions of around 10 percent this year. Advertisement. Continue reading the main story. Greece and other smaller economies that are still recovering from the last recession will also be badly affected by the downturn. But heavy debt loads in many of these nations make them reluctant to amass yet more debt, and their budgets arenâ€™t sufficient to self-fund their recoveries. That led them to transforming the national economy and. integrating into the world economy. The creation. of an innovation system based on the use of. market mechanisms and an active state science, technology and innovation policy should be the. basis for the development of knowledge-based.Â experience of the formation and use of the state. system of stimulation and regulation of innovation. processes in foreign countries. Aims of paper.Â To indirect methods of stimulating and. regulating innovation processes should be. attributed Economic stimulus is a conservative approach to expansionary fiscal and monetary policy that relies on encouraging private sector spending to make up for losses of aggregate demand. Fiscal stimulus measures are deficit spending and lowering taxes; monetary stimulus measures are produced by central banks and may include lowering interest rates.Â The concept of economic stimulus is mostly associated with the theories of 20th-century economist John Maynard Keynes, and his student Richard Kahnâ€™s concept of the fiscal multiplier. A recession, according to Keynesian economics, is a persistent deficiency of aggregate demand, where the economy will not self-correct and instead can reach a new equilibrium at a higher rate of unemployment, lower output, and/or slower growth rates.