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Old Europe Is Right on Stimulus

Treasury Secretary Timothy Geithner heads to Europe today to lobby for a "global stimulus" from the G-20 countries that are holding an economic summit two weeks hence. This follows White House economic czar Larry Summers's weekend call for a "global stimulus," which leaders in Europe roundly rejected Monday. They were right to do so.

German Chancellor Angela Merkel and the other Europeans know whereof they speak, since a number of countries have decades of experience trying to spend in a vain attempt to boost growth. The Obama Administration came into office promising to listen to its friends and allies, so when Europe says *non* to gargantuan spending, maybe the President and his advisers should listen.

On the Road to Italy

U.S. debt held by the public as a share of GDP, 1940-2011



Note: Numbers for 2009-2011 are estimates

Source: Office of Management and Budget

After a meeting of Euroland finance ministers Monday, Luxembourg's Jean-Claude Juncker delivered the Continent's verdict on global stimulus. "Recent American appeals insisting that the European make an additional budgetary effort to combat the effects of the crisis were not to our liking," he said. That's putting it nicely. When the EU established the euro in 1999, it put in place strict limits on deficit spending and debt-to-GDP ratios. Those limits have not been universally honored within the currency bloc, but there's a reason they're there.

For decades, countries like Greece, Italy and Belgium had run up huge national debts trying to pay for social-welfare programs and keep their economies afloat at the same time. The chief result of these policies was a huge pile of IOUs. In Italy, the national debt stood at 107% of GDP in 1999. In Belgium and Greece it was 104%. Greece's fiscal house was so disordered that it was excluded from the first group of euro countries.

So from its founding, the euro zone insisted that countries not respond to every economic downturn by piling up debt. Budget deficits are supposed to be limited to 3% of GDP, and total debt to 60% of GDP. This has worked imperfectly, but debt ratios have for the most part come down or remained steady. Italy's debt-to-GDP ratio is now 96%. Greece is at 105%, while France and Germany have hovered around 50% and 40%, respectively. U.S. debt stood at 36% of GDP at the end of 2007 -- before the financial panic and stimulus started piling it on. (See the nearby chart.) The U.S. has run up \$1 trillion in publicly held debt in the past six months alone -- that's 7% of GDP right there. Calling on Europe to follow this example is like dangling a bottle of grappa in front of a recovering alcoholic.

While he's in the U.K., perhaps Mr. Geithner should also ask his European counterparts whether any of them have ever seen a 1.5 Keynesian "multiplier" in the wild. That's the idea -- promoted by Mr. Summers -- that every \$1 of deficit spending yields \$1.5 in economic growth. If that were true, Italy would be the richest country in Europe, instead of merely one of the most indebted.

And if the Treasury Secretary is looking for something to read on the plane, we recommend a [recent paper](#) by a trans-Atlantic team of four economists -- two Germans and two Americans. The authors -- John Cogan and John Taylor of Stanford and Tobias Cwik and Volker Wieland of Goethe University -- subject the Administration's stimulus to the most recent Keynesian scholarship.

The White House estimates of 3.6 million new jobs is based on an "Old Keynesian" model on the impact of government spending, while the new models adjust for the rational behavioral response to the stimulus by businesses and consumers. The White House figures, by economists Christina Romer and Jared Bernstein, also assume zero interest rates for a minimum of four years. The alternative assumes, more reasonably, that as growth returns interest rates will also rise.

What the four economists found is that the Administration's estimates for stimulus growth were six times as high as they could produce under a modern Keynesian simulation. By their estimates, the stimulus would produce, at most, 600,000 jobs and add perhaps 0.6% to GDP at its peak. That's nowhere near a multiplier of 1.5 and suggests the \$800 billion would have been better devoted to business tax cuts or fixing the financial system. That's \$1.3 million in spending per job, for those keeping score at home.


Our guess is that the Administration is itself worried that its stimulus will come up short, while it fears Congress won't abide another round. Already the outside intellectual godfathers of the Obama plan are denying paternity, claiming the biggest spending bill since World War II is "too small." (Talk about lacking the courage of your convictions.) So now they and Mr. Summers want the rest of the world to ride to the rescue by repeating our mistakes.

The problem isn't the size of Mr. Obama's fiscal stimulus but its design. If countries in Europe want to help the recovery, they'd do better to try marginal rate tax cuts on income and investment -- the sort of fiscal policy that actually changes incentives to work and invest. Then we could watch and see which approach encouraged recovery faster. But the last thing Europe should do is follow Larry Summers and the out-of-date Keynesians down the spending road to nowhere.

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