We're Laying the Groundwork for Recovery

By Ben S. Bernanke

As Americans well know, the challenges we now face in the financial markets and in the economy are both extraordinarily complex and historic in scope. I firmly believe, however, that with the actions policy makers are announcing today, we will be able to meet those challenges.

> The necessary policy tools are in place.

Our strategy will continue to evolve and be refined, and we will adapt to new developments and the inevitable setbacks. But we will not stand down until we have achieved our goals of repairing and reforming our financial system, and thereby restoring prosperity to our economy.

Over the past year, the Federal Reserve has actively used all its powers and authority to try to help our economy through this difficult time. Central banks around the world have also consulted closely and cooperated in unprecedented ways to reduce strains in financial markets and to bolster our economies. We will continue to do so. However, clearly the time had come for a more comprehensive and broad-based solution.

History teaches us that government engagement in times of severe financial crisis often arrives very late, usually at a point at which most financial institutions are insolvent or nearly so. In these conditions, the consequences and costs of inertia and inaction can be staggering. Fortunately, that is not the situation we face today.

The Congress and the administration acted at a time when the great majority of financial institutions, though stressed by highly volatile and difficult market conditions, remain capable of fulfilling their critical function of providing new credit for our economy. Their prompt passage of the financial rescue legislation made possible the critical measures that were announced yesterday. These steps will allow us to restore more normal market functioning, and encourage private capital to further support the reinvigoration of financial markets.

I also find it heartening that we are seeing not just a national response but a global response to the crisis, commensurate with its global nature. Indeed, this weekend, the finance ministers and central bankers of the G-7 industrialized countries announced a comprehensive plan to unfreeze credit and money markets, increase capital in banks and other financial intermediaries, and protect deposits. Each of these governments is now moving quickly to put their own specific measures in place. The announcements we make yesterday are consistent with the G-7's statement of principles.

As in all past crises, at the root of the problem is a loss of confidence by investors and the public in the strength of key financial institutions and markets. This has had cascading and unwelcome effects on credit availability for households and businesses, and on the value of savings. Under these circumstances, steps to restore confidence in our institutions and markets will go far toward resolving the current market stress. Our economy will not be able to function at its best unless and until financial market stability returns. The bold actions taken by the Congress, the Treasury, the Federal Reserve, the Federal Deposit Insurance Corporation and other agencies, together with the normal recuperative powers of the financial markets, will lay the groundwork for financial and economic recovery.

The most immediate responsibility of policy makers and elected officials is to restore confidence in our credit markets. Even as we do this, we must begin to consider long-term reforms that will mitigate similar crises in the future. A comprehensive review of our regulatory structures is an essential task in the coming year. The events of the past year or two have highlighted regulatory gaps and deficiencies that we must address to improve the structure of our markets and the resiliency of our economy. As we recover from the current crisis, it will be important to address these issues as soon as possible, to develop a regulatory structure that will better respond to future economic challenges.

Policy makers here and around the globe have taken a series of extraordinary steps. Americans can be confident that every resource is being brought to bear: historical understanding, technical expertise, economic analysis and political leadership.

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I am not suggesting the way forward will be easy. But the tools are in place to respond effectively and with force. These tools will bolster the capital of our financial institutions, restore confidence in their debt, and offer increased access to funding for businesses. Their application, together with the underlying power and resilience of the American economy, will help to restore confidence to our financial system and place our economy back on a path to vigorous growth.

Mr. Bernanke is chairman of the Federal Reserve.

The Wrong Plan for Australia

By Stephen Kirchner

SYDNEY—Australian Prime Minister Kevin Rudd has just unveiled a fiscal stimulus plan worth 10.4 billion Australian dollars ($7.4 billion). At around 1% of GDP, it's bold. Will it work? Probably not as intended.

The plan consists of a set of handouts for politically appealing groups, such as old-age pensioners and families with children. There's also a big boost to infrastructure spending. It's a dramatic change for a government that as recently as May was hewing to the tightest fiscal policy since 1970-71, with a budget surplus of 2.1% of GDP. That budget was designed to put downward pressure on inflation. Taken together with the Reserve Bank of Australia's one-percentage-point easing at the beginning of the month, the new stimulus package points to a major reassessment of economic risks on the part of Australian policymakers. Growth has replaced inflation as the top concern.

Mr. Rudd's plan might look like a solution in search of a problem. Economic growth is set to slow, but Australia's real economy has yet to show significant stress from the global financial crisis. Financial institutions remain sound, and confidence has been boosted by the weekend's coordinated move by Australia and New Zealand to insure deposits. Monetary policy has already responded aggressively and a sharp fall in the Australian dollar exchange rate relative to the U.S. dollar is performing its traditional function of insulating Australia from external economic shocks.

There's certainly room for stimulus measures. But there are risks to stimulus, too. Timing fiscal stimulus measures so they take effect when they are most needed is difficult. Get the timing wrong and these measures could end-up being pro- rather than counter-cyclical.

A case in point is the government's proposal to accelerate its infrastructure spending agenda. Even with an accelerated timetable, work on these projects will not commence until well into 2009, with much of the spending not seen until even later, when Australia may already be through the feared economic downturn. Infrastructure spending decisions made in a crisis atmosphere might not be evaluated to the highest standards. Australia could be saddled with some wasteful rather than productivity-enhancing infrastructure projects.

> Mr. Rudd's 'stimulus' is anything but.

Other aspects of Mr. Rudd's plan are at odds with what government should be doing in the current environment. The plan provides $1.5 billion in grants to first-time home buyers. It would double the grant amount to buyers of existing homes, while tripling the grant to buyers of newly built homes. The latter measure will be useful in addressing the chronic housing shortage that has driven housing affordability in Australia to record lows and seen rising rents makes a significant contribution to inflation.

The grant to buyers of existing homes, however, will serve only to bid up the prices of existing properties, the opposite of what is needed to improve housing affordability. This will benefit existing home owners rather than new home buyers, and has little value as a stimulus measure because it merely transfers wealth from buyers to current owners rather than encouraging new housing supply.

In other respects, the plan moves away from, not toward, broader structural reforms important to the long-term health of the economy. Consider the lump-sum payment to old-age and other pensioners, scheduled for December. Single pensioners will receive a one-time payment of A$1,400, while couples will receive A$2,100. The government calls this a "down payment on long-term pension reform," but it leaves the long-term future of pension reform an open issue. The focus for future reform needs to be on reducing dependence on the government pension. This means making the pension less rather than more attractive, so as to encourage people to save for their retirement.

Similarly, the government will make a one-off A$1,000 payment for each child in eligible families. While this may have some value as a short-term economic stimulus measure, it does not address some of the long-term issues clouding the family payments system, including the disincentives to labor-force participation.

The biggest problem with the stimulus plan, however, is something that's not in it—tax relief. That too has been left to a future review by the Treasury Secretary, Ken Henry. There had been speculation the government might introduce a one-off tax rebate. Since the government says it is making "down payments" on future reform, a tax rebate would have provided a welcome signal of the government's commitment to this vital policy area. A tax rebate would diffuse more broadly than one-off welfare payments and reward labor-force participation rather than welfare dependence.

Short-term stimulus measures need not conflict with the imperatives of long-term structural reform. The government should have used the global financial crisis to gain increased traction for a long-term structural reform agenda that will provide lasting economic security, and not just a short-term boost to spending. The biggest flaw of Mr. Rudd's plan is all the opportunities it missed.

Mr. Kirchner is a research fellow at the Centre for Independent Studies.

Prizing Krugman

By David R. Henderson

The Royal Swedish Academy of Sciences announced Monday that the 2008 winner of the Nobel Prize in Economic Sciences is Paul Krugman. A professor at Princeton University, Mr. Krugman is known to the American public mainly for his column in the New York Times, which reflects his highly partisan political views more than his solid economic understanding. Nevertheless, he is an original theorist in international trade and economic geography. His excellent book, "Pop Internationalism" (1997), and his popular articles of the 1990s make a strong case for free trade.

But Mr. Krugman's defense of free trade is not what earned him the Nobel Prize. Rather, he was honored for his work in the late 1970s explaining patterns of international trade, and for his work in the early 1990s on economic geography.

In the late 1970s, Mr. Krugman noticed that the accepted model economists used to explain patterns of international trade did not fit the data. The Hecksher-Ohlin model predicted that "capital-rich" countries would export capital-intensive goods and import labor-intensive goods from "labor-rich" countries. Mr. Krugman noticed that most international trade takes place between countries with roughly the same ratio of capital to labor. Capital-intensive Sweden, for example, exports cars to capital-intensive America, while Swedish consumers also import cars from America.

Mr. Krugman's explanation is based on economies of scale. Both Volvo and General Motors reduce average costs by producing a large output in particular niches of the market. In presenting his trade model, Mr. Krugman planted the seeds for his later work in economic geography, in which he tried to explain the location of economic activity.

He summarized his basic finding as follows: "Because of economies of scale, producers have an incentive to concentrate production of each good or service in a limited number of locations. Because of the cost of transacting across distance, the preferred locations for each individual producer are those where demand is large or supply of inputs is particularly convenient—which in general are the locations chosen by other producers. Thus [geographical] concentrations of industry, once established, tend to be self-sustaining."

In his popular writing, Paul Krugman is at his best when defending free trade. My favorite example is his "Ricardo's Difficult Idea," published in the mid-1990s, in which he shares a frustration many of us economists have felt—that the vast majority of noneconomist intellectuals don't understand David Ricardo's famous insight about free trade almost 200 years ago.

Ricardo grasped that people will specialize in producing the goods and services in which they have a comparative advantage. The result is that we never need to worry about low-wage countries competing us out of jobs; the most they can do is change those goods and services in which we have a comparative advantage. Mr. Krugman points out that most noneconomist intellectuals are unwilling to take even 10 minutes to understand this.

Another strong point Mr. Krugman made in his Ricardo article (and elsewhere): If labor's share of national income is relatively constant (as it has been for about the last 80 years), then increases in productivity must cause real wages to increase. (Wages, as he noted, also include benefits.)

That kind of common-sense clarity seems noticeably absent in his New York Times columns, in which he often attacks the motives of people who disagree with him and even calls them "liars." This deserving Nobel recipient could set a better example when it comes to academic—indeed basic human—courtesy.

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