

## How to Avoid A Second, Deeper Recession: An Engineering Approach

Among those who really understand finance and economics (like the Financial Times), concern has been rising about the risk of a second, deeper recession, just as we start to emerge from the first. Some talk about a “double dip” recession, as a return to high oil prices and some issues with commercial real estate begin to bite. Consumer fears have been a major cause of the first recession – and it’s easy to see how fears would be magnified if, instead of a recovery, people start to experience more problems. Certainly such a second, deeper recession would cause problems for everyone, from the humblest immigrant worker through to high-level incumbents of both political parties.

When life is very scary and threatening, people often fall into wishful, magical thinking and “perpetual motion” kinds of schemes. (This is psychology 101. Graduate level psychology says something about how to overcome these tendencies, but that’s a subject for another day.)

To prevent a “second dip,” most economists would say it’s simple to understand what we need – some kind of “second stimulus,” either through government spending or through monetary policy, which raises demand in the economy. But government spending causes deficits or worse, and monetary policy has its limits. The US government budget deficit is reaching really scary levels, and it is even more scary to consider what happens if we need to keep relying on more and more deficit to compensate for less and less consumer confidence. We have already pretty much reached zero fundamental interest rates; in practical terms, that means that “we have pushed the accelerator pedal all the way to the floor already.”

So what can we do? This is very serious.

Many in the financial world can be very clever when it comes to shell games. “Perpetual motion” types of schemes have already begun to appear, some perhaps with an aura of elaborate bookkeeping and mathematical care. But at the end of the day, new demand has to come from somewhere. We have to ask – who ultimately pays?

Another “perpetual motion” scheme involves “green jobs.” There is a kind of green job which can help – but many of the advocates of green jobs do not understand the basic economic principles here. If you have two technologies, one which uses 1000 people to screw in a light bulb, and one which uses only one, which is better for the economy? Some environmentalists do not really understand why it doesn’t help the economy to make that first choice. The first choice is basically equivalent to paying for one person to screw in a light bulb, and then sending out random welfare checks to 999 others. But we don’t need “green projects” to send out welfare checks; there are easier ways to do that. It is very sad that, even today, huge coalitions try to get government funding for projects based on the claim that they “create more jobs” than a more efficient technology to achieve the same goal.

So how can we do it right? How can we find an engineering approach to solve this problem?

To begin with, we can get a better understanding of the deficit problem. We can ask: “How far can we afford to let the deficit grow anyway? How much is too much?” (More precisely, an engineer would want to know the “objective function” --- exactly how we make the tradeoff between unemployment and deficits.) Latin America has a lot of rich experience with deficits, which can give us a handle on this question. For example, there is a book on “reforming the reforms” by Ricardo Ffrench-Davis of the University of Chile which provides deep insights into what is at stake. The book is worthy of deeper study than I have given it... but there is one key lesson which emerges: we need to pay just as much attention to the international deficit of the US, the balance of payments, as we do to the federal government deficit. It really matters whether we owe to the money to ourselves or we owe it to others. The challenge we face is to raise demand WITHOUT imposing too much burden EITHER on the federal deficit OR on the balance of payments. This is like chemical engineering, where we need to find technologies which respect the limits BOTH on total energy use ( $\Delta H$ ) AND on total free energy use ( $\Delta G$  or  $H$ ) – two factors at once.

Thinking about this dilemma – I suddenly realize that I have already found a big part of the solution already, through work motivated by national security concerns. In the final paragraph at [www.werbos.com/energy.htm](http://www.werbos.com/energy.htm), I have posted an outline, details, and explanation of a multipronged strategy to zero out our need to import oil at the soonest possible time. Even now, our national oil bill is running at about \$350 billion PER YEAR – but if oil goes back to \$150 per barrel or more, as we would expect in a true economic recovery, it goes back to \$700 billion per year. If the balance of payments constraint is half of what really holds us back in restoring demand – then a concrete, realistic strategy to save us more than \$350 billion per year on that constraint really changes the game.

But does the plan also cost something in terms of federal deficit? It does include some tax incentives (mainly continuations of existing incentives). For myself, I would propose that gasoline taxes be adjusted by formula in the future, to compensate for these additional incentives. That way, the whole thing is revenue neutral.

Equally important to conservatives: every penny of general tax increase is offset by a net decrease of taxes, through widely available tax breaks; there is no net increase in taxes.

Then here are the neat consequences. The entire package – including even the gas tax part – strongly encourages new investment in the private sector, to make the transition to a more sustainable and efficient economy. It stimulates economic demand – what we need most to avoid a deeper recession – without any net increase in the federal deficit, and with a substantial improvement in future balance of payments.

How could this not be perpetual motion? Think about it. We have reached the limits of monetary policy because of a lack of good investment projects even at low interest rates. This “change of game” is creating new projects for that money to go into. They are very solid investment projects, because they produce a new private sector infrastructure for a commodity we know we will need (car fuel). What’s more, the multiplier effects cut differently. There is a reduction in money going to oil imports, which went out of the US. But there is an increase in money going to US production, which sends multiplier effects into the US. Because we get large demand multiplier effects in what we are increasing, while there were low multipliers in what we are reducing, we get a strong net increase in demand without a net increase in spending.

What’s more – because of the logic of the oil market, almost all of the benefits start immediately. About half the world oil price of \$150/barrel was due to legitimate foresight about future supply and demand. As soon as we set ourselves firmly on a course to change those future conditions, we cut our national oil bill in half. (People have often tried to use jawboning, subsidies and political force to hold down oil prices; those things do more harm than good, but here we are taking a rational market-based approach.) And the expansion of investment starts now – at a time when we really need it.