BERKELEY — When an economy falls into a depression, governments can try four things to return employment to its normal level and production to its “potential” level. Call them fiscal policy, credit policy, monetary policy, and inflation.

Inflation is the most straightforward to explain: the government prints up lots of banknotes, and spends them. The extra cash in the economy raises prices. As prices rise, people don’t want to hold cash in their pockets or their bank accounts—its value is melting away every day—so they step up the pace at which they spend, trying to get their wealth out of depreciating cash and into real assets that are worth something. This spending pulls people out of unemployment and into jobs, and pushes capacity utilization up to normal and production up to “potential” levels.

But sane people would rather avoid inflation. It is a very dangerous expedient, one that undermines standards of value, renders economic calculation virtually impossible, and redistributes wealth at random. As John Maynard Keynes put it, “there is no subtler, no surer means of over-turning the existing basis of society than to debauch the currency. The process engages all the hidden forces of economic law on the side of destruction, and does it in a manner which not one man in a million is able to diagnose…” But governments will resort to inflation before they will allow another Great Depression—we just would very much rather not go there, if there is any alternative way to restore employment and production.

The standard way to fight incipient depressions is through monetary policy. When employment and output threaten to decline, the central bank buys up government bonds for immediate cash, thus shortening the duration of the safe assets that investors hold. With fewer safe, money-yielding assets in the financial market, the price of safe wealth rises. This makes it more worthwhile for businesses to invest in expanding their capacity, thus trading away cash they could distribute to their shareholders today for a better market position that will allow them to reward their shareholders in the future. This boost in future-oriented spending today pulls people out of unemployment and pushes up capacity utilization.

The problem with monetary policy is that, in responding to today’s crisis, the world’s central
banks have bought so many safe government bonds for so much cash that the price of safe wealth in the near future is absolutely flat—the nominal interest rate on government securities is zero. Monetary policy cannot make safe wealth in the future any more valuable. And this is too bad, for if we could prevent a depression with monetary policy alone, we would do so, as it is the policy tool for macroeconomic stabilization that we know best and that carries the least risk of disruptive side effects.

The third tool is credit policy. We would like to boost spending immediately by getting businesses to invest not only in projects that trade safe cash now for safe profits in the future, but also in those that are risky or uncertain. But few businesses are currently able to raise money to do so.

Risky projects are at a steep discount today, because the private-sector financial market’s risk tolerance has collapsed. No one is willing to buy assets and take on additional uncertainty, because everyone fears that somebody else knows more than they do—namely, that anyone would be a fool to buy. Although the world’s central banks and finance ministries have been devising many ingenious and innovative policies to stimulate credit, so far they have not had much success.

This brings us to the fourth tool: fiscal policy. Have the government borrow and spend, thereby pulling people out of unemployment and pushing up capacity utilization to normal levels. There are drawbacks: the subsequent deadweight loss of financing all the extra government debt that has been incurred, and the fear that too rapid a run-up in debt may discourage private investors from building physical assets, which form the tax base for the future governments that will have to amortize the extra debt.

But when you have only two tools left, neither of which is perfect for the job, the rational thing is to try both—credit policy and fiscal policy—at the same time. That is what the Obama administration is attempting to do right now.

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