Bailouts, Stimulus Packages and Jobless Recovery: The Crisis of Wealth Destruction

Part I

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The financial crisis that broke out in the United States around the summer of 2007 and crested around the autumn of 2008 had destroyed US$34.4 trillion of wealth globally by March 2009, when the equity markets hit their lowest points.

On October 31, 2007, the total market value of publicly traded companies around the world reached a high of $63 trillion. A year and four months later, by early March 2009, the value had dropped more than half to $28.6 trillion. The lost $34.4 trillion in wealth is more than the 2008 annual gross domestic product (GDP) of the US, the European Union and Japan combined. This wealth deficit effect would take at least a decade to replenish even if these advanced economies were to grow at mid-single digit rate after inflation and only if no double-dip materialized in the markets. At an optimistic compounded annual growth rate of 5%, it would take more than 10 years to replenish the lost wealth in the US economy.

In the US, where the crisis originated after two decades of monetary excess that encouraged serial debt bubbles, the NYSE Euronext (US) market capitalization was $16.6 trillion in June 2007, more than concurrent US GDP of $13.8 trillion. The market capitalization fell by almost half to $7.9 trillion by March 2009. US households lost almost $8 trillion of wealth in the stock market on top of the $6 trillion loss in the market value of their homes. The total wealth loss of $14 trillion by US households in 2009 was equal to the entire 2008 US GDP.

As the financial crisis broke out first in the US in July 2007, world market capitalization took some time to feel the full impact of contagion radiating from New York, which did not register fully globally until after October 2007. In 2008 alone, market capitalization in EAME (Europe, Africa, Middle East) economieslost $10 trillion and Asian shares lost around $9.6 trillion.

Bailouts, Stimulus Packages and Jobless Recovery

As a result of over $20 trillion of government bailout/stimulus commitments/spending worldwide that began in 2008, the critically impaired global equity markets began to show tenuous signs of stabilization only two years later, by the end of 2009. Yet total world market capitalization was still only $46.6 trillion by the end of January 2010, $16.4 trillion below its peak in October 2007.
The amount of wealth lost worldwide in 2009 still exceeded 2009 US GDP of $14.2 trillion by $2.2 trillion. The NYSE Euronext (US) market capitalization was $12.2 trillion in January 2010, recovering from its low at $7.9 trillion in March 2009, but still $4.4 trillion below its

peak at $16.6 trillion in June 2007.

US GDP in first quarter 2009 fell 6.3% annualized rate while surging 5.7% in the fourth quarter, mostly as a result of public sector spending equaling over 60% of annual GDP. The US government bailout and stimulus package to respond to thefinancial crisis added up to $9.7 trillion, enough to pay off more than 90% of the nation's home mortgages, calculated at $10.5 trillion by the Federal Reserve. Yet home foreclosure rate continued to climb because only distressed financial institutions were bailed out, not distressed homeowners. Take away public sector spending, US GDP would fall by over 50%. This is the reason why no exit strategy can be expected to be implemented soon.

It took $20 trillion of public funds over a period of two-and-a-half years to lift the total world market capitalization of listed companies by $16.4 trillion. This means some $3.6 trillion, or 17.5%, had been burned up by transmission friction. Government intervention failed to produce a dollar-for-dollar break-even impact on battered markets, let alone generate any multiplier effect, which in normal times could be expected to be between nine and 11 times. In the meantime, with the exception of China's, the real global economy continues to slide downward, with rising unemployment and underemployment.

The massive government injection of new money managed to stabilize world equity markets by January 2010, but only at 73.5% of its peak value in October 2007. It still left the credit markets around the world dangerously anemic and the real economy operating on intensive care and life support measures from government. This is because the bailout and stimulus money failed to land on the demand side of the economy, which has been plagued by overcapacity fueled by inadequate workers' income, masked by excessive debt, and by a drastic reversal of the wealtheffect on consumer demand from the bursting of the debt bubble. The bursting of the debt bubble destroyed the wealth it buoyed, but it left the debt that fueled the bubble standing as liability in the economy.

Much of the new government money came from adding to the national debt, which taxpayers will have to pay back in future years. This money went to bail out distressed banks and financialinstitutions, which used it to profit from global "carry trade" speculation, as hot money that exploited interest rate arbitrage trades between economies. The toxic debts have remained in the global economy at face value, having only been transformed from private debts to public debts to prevent total collapse of the private sector. The debt bubble has been turned into a dense debt black hole of intense financial gravity the traps all light from appearing at the end of the recovery tunnel.

Much criticism by mainstream economists in the US has been focused on the controversial bailout of "too-big-to-fail" financialinstitutions that have continued to effectively resist critically needed regulatory reform by holding the seriously impaired economy hostage. Some critics have complained that government stimulus packages are too small for the task at hand. Only a few lonely voices have focused on public spending being directed at wrong targets. Yet such massive public spending has left manyeconomies around the world with looming sovereign debt crises.

The Critical Issue of Jobs

The US Labor Department reported that the economy gained 162,000 jobs in March 2010, compared with a revised reading of a 14,000 job loss in February. That makes March only the third month of gains since the recession began. A gain of 184,000 jobs had been

forecast for March. But despite missing forecasts, the March numbers were generally not viewed as disappointing by economists, because revisions in January and February readings added a combined 62,000 additional jobs. This is viewed as good news overall for an economy that has suffered a net loss of 8.2 million jobs since the start of 2008, a month after the official start of the “Great Recession”. This sentiment shows how weak expectation is among most forecasters. The unemployment rate remains stubbornly high, holding steady at 9.7%, matching mainstream economist expectations.

President Barack Obama immediately trumpeted the jobs report on April 2, asserting that the employment figures are signs that the government stimulus package implemented a year ago has reversed the loss of about 700,000 jobs a month that was taking place at that time. Ironically, this political spin underscores that even the mild improvement in jobs creation may be reversed as soon as the government’s stimulus program runs out, or when the central bank exits from its massive intervention in the market.

The president made his claim at a specially selected company in Charlotte, North Carolina, that makes membranes for lithium batteries, symbolizing the dependence on new green technologyfor economic recovery. The company received a $50 million matching grant from the $787 billion stimulus program in 2009 to expand one facility and to open another elsewhere in the state.

Still, the president had to admit that “government can’t reverse the toll of this recession overnight, and government on its own can’t replace the 8 million jobs that have been lost. The true engine of job growth in this country has always been the private sector. What government can do is create the conditions … for companies to hire again.”

Obama said many Americans are still suffering from the job losses of the last two years. But he said despite the damage done to the labor market during the recession, the economy is poised to start adding the jobs people need. “What we can see here, at this plant, is that the worst of the storm is over; that brighter days are still ahead,” the president said.

In response, Republican National Committee chairman Michael Steele issued a statement saying the jobs gain in March reported by the Labor Department is not a sign of economic health. “No matter what spin the White House puts on these job numbers, it is unacceptable for President Obama to declare economic success when unemployment remains at 9.7% and a large portion of the job growth came from temporary boost in government employment,” he said.

The president appeared to be putting the cart before the horse on the issue of environmentalism and economic growth. In reality, the full implantation of a green economy will likely increase unemployment from job losses in the old energy-intensive economy. Environmentalism, like universal healthcare, is an expensive movement, and can be introduced economically only with a strong economy. It is foolhardy to expect environmentalism to revive a seriously impaired economy.

The jobs report contained sobering readings for the depth of labor market distress that has built up over the last two years. There are 15 million workers counted as unemployed in March 2010, down 607,000 since the record high of October 2009, but still the fifth-highest total on record. The average period of unemployment now stands at eight months, a record duration that has put many working families under severe hardship.

Almost one million more workers have become too discouraged to continue looking for work and are no longer counted in the unemployment rate, even as the number of discouraged job seekers fell by 200,000 since February 2010.

The discouraging news is job contractions, which have largely been confined to the private sector, despite strained and shrinking government budgets. Many local governments are beginning to be forced to face employment cuts to deal with developing budget shortfalls.

While private-sector employment fell sharply in the past two years, the public-sector, civilian workforce continued growing until mid-2008, after which it remained essentially flat. As a result, while private-employment rolls are nearly 7% smaller than they were three years ago, public employment has grown by nearly 2%.

The boost in public-sector employment helped cushion the shock of recession. Average wages of public employees are relatively unaffected by economic conditions compared with more-elastic wages in the depressed private sector. Federal workers earned an average salary of $67,691 in 2008 for comparable occupations in both local governments and the private sector, according toBureau of Labor Statistics data. The average pay for the same mix of jobs in the private sector was $60,046 in 2008, the most recent data available. For private-sector workers above the average range but making below $200,000, the decline in wages is much greater and unemployment rates much higher.

Federal health, pension and other benefits are worth four times what private workers on average enjoy. Even relatively lower-paidstate and local government workers have higher total compensation than private workers in comparable jobs when the value of benefits is included.

In hailing the latest jobs news, President Obama warned that “it will take time to achieve the strong and sustained growth that we need.”

Larry Summers, director of the Obama White House’s National Economic Council, told the Financial Times in a April 2 interview that “post-bubble de-leveraging crises of the kind that the president inherited are a serious economic affliction that doesn’t get cured overnight … and there is still an enormous challenge around job creation.”

Market and democratic fundamentalism

Market fundamentalism places unwarranted faith in the mythical self-correcting power of unregulated markets driven solely by the no-holds-barred, winner-takes-all self-interest of unruly market participants risking other people’s money for private profit. It has also given birth to democratic fundamentalism, its political twin in capitalistic democracies.

This democratic fundamentalism, which places unwarranted faith in the wisdom of the majority popular vote on complex technical problems that most voters do not fully understand, has put an impossible demand on government to reduce the fiscal deficit while at the same time reducing taxes and increasing popular entitlement and defense expenditures. Democratic fundamentalism has rendered government in capitalistic democracies impotent in solving the fiscal crisis created by market fundamentalism.

Political campaigns in capitalistic democracies has mutated into a tactical propaganda war in which special interest groups with the most money to finance the manipulation of public

opinion can exert the strongest influence on policy formulation, often at the expense of the common good and the national interest. The financial sector's effective resistance to critically needed regulatory reform by the US Congress is the latest example. The recent decision by the US Supreme Court on constitutional protection for corporations to freely spend on political campaigns is another example of democratic fundamentalism.

Supreme Court Confuses Money With Speech

Overruling two important precedents about the First Amendment free-speech rights of corporations, a bitterly divided court in a recent five-to-four decision validated the First Amendment's most basic free speech principle – that the government has no business regulating political speech. The dissenters said that allowing corporate money to flood the political marketplace would corrupt democracy.

The ruling, Citizens United v Federal Election Commission, No 08-205, overruled two precedents: Austin v Michigan Chamber of Commerce, a 1990 decision that upheld restrictions on corporate spending to support or oppose political candidates, and McConnell v Federal Election Commission, a 2003 decision that upheld the part of the Bipartisan Campaign Reform Act of 2002 that restricted campaign spending by corporations and unions.

The 2002 law, usually called McCain-Feingold, banned the broadcast, cable or satellite transmission of "electioneering communications" paid for by corporations or labor unions from their general funds in the 30 days before a presidential primary and in the 60 days before the general elections.

McCain-Feingold, as narrowed by a 2007 Supreme Court decision, applied to communications "susceptible to no reasonable interpretation other than as an appeal to vote for or against a specific candidate".

The ruling represented a sharp doctrinal shift, and it will have major political and practical consequences. Specialists in campaign finance law said they expected the decision to reshape the way elections were conducted. The decision will be felt most immediately in the coming midterm elections, given that it comes just two days after Democrats lost a filibuster-proof majority in the senate and as popular discontent over government bailouts and corporate bonuses continues unabated.

President Obama called the decision "a major victory for big oil, Wall Street banks, health insurance companies and the other powerful interests that marshal their power every day in Washington to drown out the voices of everyday Americans."

Freedom in society has a social dimension. A person's freedom cannot be practiced by limiting the freedom of others. The concept of freedom of political speech has long incorporated the concept of equal time. One person's right to verbally attack another person exists only if the right of the attacked person to response is guaranteed. The concept of equal time is well established in the media during political campaigns. In that sense, the Supreme Court decision appeared to be as logical as the sound of one hand clapping. Corporations have every right to spend their money to promote their special political views, but it should be required also to pay for the equal time of the opposition's right of free speech so that the lack of money will not be the cause of lost of freedom of speech.

A Technical Rally Is Not a Sign of Recovery

In the US, a technical trading rally in the equity markets in spring 2010, rising some 60% from their lows in February of 2009, is interpreted by wishful bulls as a promising sign of a recovery of the financial markets. The bulls ignore the obvious fact that the rally has been brought on by massive government bailouts and stimulus packages. The technical rally still leaves asset prices at some 25% below their pre-crisis peak in June, 2007. While bull-market cheerleaders tout this fact as a continuing buying opportunity, objectively it is still difficult to spot any credible signs of fundamental recovery.

Yet there is a price to be paid for the technical rally. Government balance sheets worldwide are now burdened with huge amounts of toxic debt, many in amounts larger than their annual GDP figures. This toxic debt, now shifted from the private sector to the public sector, cannot be made good without new serial bubbles. This technical trading rally in the US equity markets is clearly and fundamentally unsustainable and will peter out as soon as a promised exit strategy from government intervention is implemented by the Treasury to preserve and restore the private sector.

Since most corporate profits in recent years have come from operational cost savings in the form of stagnant wages, layoffs and artificially low interest rates, a new massive wave of corporate failure will hit the anemic economy when government stimulus spending slows or when interest rates are raised by the Fed to deal with pending inflation of its own making. The resultant tidal wave of corporate bankruptcies can only be avoided with more government bailouts to restructure dysfunctional business models.

Fiscal deficits, tax cuts, National Debt, and interest ratesCalls for raising interest rates to dampen debt-pushed inflation are heard from nonpartisan sources. The Congressional Budget Office (CBO) estimated that President Obama’s proposed budget would add more than $9.7 trillion to the national debt over the next decade, with proposed tax cut accounting for nearly a third of that shortfall.

The Obama fiscal deficit is expected to be $1.5 trillion in 2010, at 10.3% of GDP and a post-World War II record. It is expected to be $1.3 trillion in 2011. But the CBO is considerably less sanguine about future years, predicting that deficits would never fall below 4% of GDP under Obama’s current and expected fiscal policies and would begin to grow rapidly after 2015. Deficits of that magnitude would force the Treasury to continue borrowing at prodigious rates, sending the national debt soaring to 90% of GDP by 2020. Interest payments on the debt would also skyrocket by $800 billion annually over the same period.

The CBO report identifies Obama’s tax-cut agenda as by far the biggest contributor to the projected budget gaps. As part of his campaign pledge to protect families making less than $250,000 a year from new taxes, the president is proposing to prevent the alternative minimum tax from expanding to ensnare millions of additional taxpayers through inflation induced bracket creep. Obama also wants to make permanent a series of temporary tax cuts enacted during the Bush presidency, which are scheduled to expire at the end of 2010. Over the next 10 years, Obama tax policies are projected to reduce revenues and increase outlays for refundable tax credits by a total gap of $3 trillion. Combined with escalating interest payments on large cumulative fiscal deficit, the tax cuts account for the entire increase in deficits that would result from Obama’s tax proposals.

Other policy expenditures, such as Obama’s health-care reform program and a plan to

dramatically expand the federal student loan program, would have significant effects on the budget, but these programs generally would be self-financed and therefore are not expected to drive deficits higher. They would only expand the public sector in the economy, a trend that liberals and progressives think is positive and neo-liberals and conservatives think is negative.

Obama tried to convene a special bipartisan commission to develop measures to bring deficits down to 3% of GDP. The response from Republicans has not been overwhelming as they do not want to share responsibility for Obama's deficit. However, the CBO report shows that Obama could accomplish that goal simply by letting the Bush tax cuts expire at the end of 2010 to pay for revenue losses expected from proposed changes to the alternative minimum tax.

In March 2009, the CBO estimated that US gross debt will rise from 70.2% of GDP in 2008 to 101% in 2012, while the economy is expected to stay in open-ended recession with unacceptably high unemployment at over 10%. The US is now one of the highest debtor nations in the world. The reason the US, unlike other countries, does not face the prospect of default is because of dollar hegemony under which US debts are all denominated in dollars that the US Treasury can print at will. Yet such levels of public debt, if wasted on the supply side to exacerbate supply/demand imbalance, cannot be sustained without economic penalties.

Interest payments on the skyrocketing national debt will be a serious obstacle to reducing the fiscal deficit even if interest ratesstay low – an impossible prospect because of the endogenous monetary rule of the effect of rising public debt on inflation, which Milton Friedman define as always and everywhere a monetary phenomenon – i.e. excess supply of money.

The Lesson From the Great Depression

The Fed's institutional perspective since the Great Depressionhave been largely formed by Milton Friedman's counterfactual conclusion that aggressive monetary easing after the 1929 crash could have prevented the Great Depression, though the validity of this conclusion has never been verified by events, nor has its unintended consequences been adequately analyzed.

The caveat in Friedman's monetary cure is that it requires a fiscal surplus, which would be difficult if not impossible to achieve in a depression. Events have shown that the Great Depression was finally ended by war production, not by Fed monetary or fiscal measures during the New Deal era.

Yet while the laws of finance can sometimes be violated with delayed penalty, they cannot be permanently overturned. The fact remains that central banks cannot repeatedly use easy money to fund serial debt bubbles without accumulating fatal consequences.

While undetected debt can be disguised as phantom equity through creative accounting in structured finance, it remains as liabilities in the real world that need to be reckoned with at the end of the day. Risk can be transferred globally system-wide to become less visible, but it cannot be eliminated by simply hiding it. Widely dispersed risk throughout the financial system will lead to an under-pricing of risk to give unsuspecting investors a false sense of security. In fact, thousands of small holes all over the hull will sink a ship faster than one big

hole in one compartment that can be effectively sealed off. The result will be a sudden global financial meltdown when the massive Ponzi scheme of magical liquidity released by central banks is finally exposed.

Two Phases of the Great Depression

It is useful to remember that there were two phases of the Great Depression. The first phase started with the stock market crash in October 1929 during Hoover's one-term presidency (1929-1933). It lasted 43 months, until five months after Franklin D Roosevelt became president in 1933, with a GDP decline from peak to trough of 36.21%, unemployment reaching an all-time high 25.36% and severe deflation as measured by the Consumer Price Index falling 27.17%.

In this phase of the Great Depression, central bankers learned that deflation was more deadly to the economy than inflation was to the government, a fact incontrovertibly demonstrated by the rise of Fascism in a Germany caught in the quick sand of hyperinflation, and the subsequent recovery of the German economy under the National Socialist full-employment strategy supported by sovereign credit. While the economic decline of first phase of the Great Depression was arrested by New Deal programs, the US economy was far from being on any recovery track by 1937, four years of Roosevelt came into office.

The second phase of the Great Depression began in 1937 during the New Deal era after the Fed doubled bank reserve requirements in 1936 to ward off anticipated inflation. The economic contraction of this phase lasted 13 months, until 1938, with a decline in GDP of 10.04%, unemployment reaching 20% and deflation moderating as measured by the CPI, falling only 2.8%.

Still, price deflation caused by tight monetary policy by Treasury secretary Henry Morgenthau (in office from 1933 to 1945) aborted the New Deal recovery, even under a Keynesian fiscal policy tilt towards deficit financing of demand management. As Roosevelt's Treasury secretary, Morgenthau was instrumental in setting up the Works Progress Administration and the Public Works of Art Project in the 1930s to moderate unemployment. But the economy did not recover until the start of World War II.

Eccles – Keynesian Evangelist Before Keynes

This second phase of the Great Depression can be blamed on the early policies of the Federal Reserve under Marriner S Eccles (in office from November 15, 1934 to January 31, 1948). Eccles, the president of tiny First National Bank of Ogden, Utah, became nationally famous through his successful effort to save his bank from collapse in the late summer of 1931.

Eccles defused the panic of depositors outside of his bank by announcing that his bank would stay open until all depositors were paid. He also instructed his tellers to count every small bill and check every signature to slow the prospect of his bank running out of cash. A mostly empty armored car carrying all First National's puny reserves from the Federal Reserve Bank in Salt Lake City arrived conspicuously while Eccles announced that there was plenty of money left where it came from, which was true except for the fact that none of it belonged to First National. The crowd's confidence in First National was re-established and Eccles' bank survived on a misleading statement that in a vigorous investigation would have

been considered criminally fraudulent.

Eccles was a quintessential frontier entrepreneur of the US West and politically a Western Republican. Beginning with timber and sawmill operations, his family's initial capital came in the form of labor and raw material. He learned from his father, an illiterate who immigrated from Scotland in 1860, that the way to remain free was to avoid becoming indebted to the northeastern banks, which were in turn much indebted to British capital. Among Eccles' assets of railroads, mines, construction companies and farm businesses was a chain of local banks in the West.

Immersed in an atmosphere of US populism that was critical of unregulated capitalism and Northeastern "money trusts", Eccles viewed himself as an ethical capitalist who succeeded through his hard works and wits, free of oppression from big business trusts and government interference.

A Mormon polygamist, the elder Eccles had two wives and 21 children, which provided him with considerable human capital in the labor-short West. The young Eccles, at age 22 and with only a high-school education, had to assume the responsibilities of his father when he died suddenly. The Eccles construction company built the gigantic Boulder Dam, begun in 1931 and completed in 1936, renamed from Hoover Dam in the midst of the Depression and re-renamed Hoover Dam in 1941.

The market collapse of 1929 caught the inner-directed Eccles in a state of bewilderment and despair. Through eclectic reading based on common sense, he came to a startling awareness: that despite his father's conservative Scottish teachings on the importance of saving, individuals and companies and even banks, ever optimistic in their own future, tended to contribute to aggregate supply expansion to end up with overcapacity through excessive savings for investment.

It was obvious to Eccles that the problem of the 1930s was that too much money had been channeled into savings and too little into spending. This new awareness, albeit not early enough to save him from early policy error in the first two years as Fed chairman, like Saint Paul's vision on the way to Damascus, led Eccles to a radical conclusion that contradicted all that his conservative father had taught him.

From direct experience, Eccles realized that bankers like himself, by doing what seemed sound on an individual basis, by calling in loans and refusing new lending in hard times, only contributed to the financial crisis. He saw from direct experience the evidence of market failure. He concluded that to get out of the depression, government intervention – something he had been taught was evil – was necessary to place purchasing power in the hands of the public which, together with the economy and the financial system, was in dire need. In the industrial age, excessively unequal distribution of income and excessive savings for capital investment always leads to the masses exhausting their purchasing power, unable to sustain the benefits of mass production that such savings brought.

Mass consumption is required by mass production. But mass consumption requires a fair distribution of new wealth as it is currently produced (not accumulated wealth) to provide mass purchasing power. By denying the masses necessary purchasing power, capital denies itself the very demand that would justify itsinvestment in new production. Credit can extend purchasing power but only until the credit runs out, which would soon occur without the support of adequate income.

Eccles' epiphany was his realization that Calvinist thrifty individualism does not work in a modern industrial economy. Eccles rejected the view of his fellow bankers that depressions are natural phenomena and that in the long run the destruction they wreak is healthy and government intervention only postpones the needed elimination of the unfit, thereby in the long run weakening the whole system through support for their survival.

Eccles pragmatically saw that money is not neutral, and it has an economic function independent of ownership. Money serves a social purpose if it circulates widely through transactions and investments, and is socially harmful if it is hoarded in idle savings, no matter who owns it. Liquidity is the only measure of the usefulness of money. The penchant for capital preservation on the part of those who have surplus money has a natural tendency to reduce liquidity in times of deflation and economic slowdown.

The solution is to start the money flowing again by directing it not toward those who already have a surplus of it in relation to their consumptive needs, but to those who have not enough. Giving more money to those who already have too much would take more money out of circulation into idle savings and prolong the depression.

The solution is to give money to the most needy, since they will spend it immediately. The only institution that can do this transfer of money for the good of the system is the federal government, which can issue or borrow money backed by the full faith and credit of the nation, and put it in the hands of the masses, who would spend it immediately, thus creating needed demand.Transfer of money through employment is not the same of transfer of wealth. Deficit financing of fiscal expenditure is the only way to inject money and improve liquidity in a stalled economy. Thus Eccles promoted a limited war on poverty and unemployment, not on moral but on utilitarian grounds.

Now, the interesting thing is, Eccles, who never attended university or studied economics formally, articulated his pragmatic conclusions in speeches a good three years before Keynes wrote his epoch-making The General Theory of Employment, Interest, and Money (1936). John Galbraith in his Money: Whence It Came, Where It Went (1975) explained: "The effect of The General Theory was to legitimize ideas that were in circulation." With scientific logic and mathematical precision, Keynes made crackpot ideas like those promoted by Eccles respectable in learned circles, even though Keynes himself was considered a crackpot by New York Fed president Benjamin Strong as late as 1927.

In a single testimony in 1933, Eccles in his salt-of-the-earth manner convinced an eager US Congress of his new economic principle. He outlined a specific agenda for how the federal government could save the economy by spending more money on unemployment relief, public works, agricultural allotment, farm-mortgage refinancing, settlement of foreign war debts, and so forth.

Eccles also proposed structural systemic reform for achieving long-term stability: federal insurance for bank deposits, minimum wage standards, compulsory retirement pension schemes – in fact, the core program that came to be known as the New Deal.

Eccles also helped launched the era of liberal credits, through government guarantee mortgages and interest subsidies, making middle-class and low-income home ownership a reality. It was not a plan to do away with capitalism as much as it was to save capitalism from itself. Eccles' plan was to give the masses high income on which liberal credits could finance a nation of homeowners. It was fundamentally different from the neo-liberal

program of depressing worker income through cross-border wage arbitrage while financing home ownership with subprime mortgages.

Eccles also rescued the Federal Reserve System from institutional disgrace. For this, the Fed building in Washington has since been named after him. The evolution of political economy models in the early 1930s, a crucial period of change in the supervision and regulation of the financial sector, can be clearly seen in the opposing policies of the Hoover and Roosevelt administrations. It resulted in a change of focus in the Federal Reserve Board from orthodox sound money initiatives to a heterodox Keynesian outlook, which was reversed by the monetarism of Milton Friedman. Under Eccles, the push toward centralizing the monetary powers of the Federal Reserve System at the Board, away from the regional Federal Reserve Banks, was implemented.

With support from Roosevelt, despite bitter opposition from big money center banks, Eccles personally designed the legislation that reformed the Federal Reserve System, the central bank of the United States founded by Congress in 1913 (by the Glass-Owen Federal Reserve Act), to provide the nation with a safer, more flexible, and more stable monetary and financial/banking system. An important founding objective of the original Federal Reserve System had been to fight inflation by controlling the money supply through setting the short-term interest rate, known as the Fed Funds Rate (FFR), and bank reserve ratios. By 1915, the Fed had regulatory control over half of the nation's banking capital and by 1928 about 80%.

The Banking Act of 1935, designed by Eccles, modified the Federal Reserve Act by stripping the 12 district Federal Reserve Banks of their autonomous privileges and veto powers and concentrated monetary policy power in the seven-member board of governors in Washington. Eccles served as chairman for 14 years while he continued to function as an inner-circle policymaker in the White House. The Fed under Eccles had no pretension of political independence. Galbraith described the Fed under Eccles as "the center of Keynesian evangelism in Washington".

Morgenthau and the Bretton Woods Conference

To finance World War II, Morgenthau initiated an elaborate marketing system for war bonds. He arranged unlimited Federal Reserve support for Treasury borrowing to allow it to stand ready to buy all war bonds not bought by the public at a pre-agreed yield to keep interest rates low. The War Bond program raised $185 billion at below market interest rates to finance the war.

Morgenthau made his most significant contribution as chairman of the Bretton Woods Conference in New Hampshire, in 1944. Thisconference, the keystone of postwar international finance architecture, established the International Monetary Fund (IMF) and the International Bank for Reconstruction and Development (World Bank) and pegged all international currencies to the US dollar at a fixed rate worked out between central banks. The dollar was in turn pegged to gold at $35 per ounce. US citizens were forbidden by law to own gold or to speculate on its monetary value. Morgenthau resigned shortly after the accession of Harry S Truman to the presidency. The Bretton Woods monetary regime collapsed in 1971 when president Richard Nixon suspended the dollar from gold.

The economy finally recovered on heavy war spending in 1941. Yet a short recession took place in 1945 as war production began to wind down for the European theater. It lasted

eight months, with GDP declining 14.48%, unemployment reaching 3.4% even before troops were fully discharged, and inflation of 1.69% as war-time wage-price control began to be phased out.

Next: Two different Bank Crises – 1929 and 2007

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