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Consumer Spending is Flat, Unemployment is Rising: The Case for a Second Round of Economic Stimulus

By Mike Whitney
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Alan Greenspan has joined the ranks of the deficit hawks and is calling for austerity measures to reduce government spending. In an op-ed in last Thursday's Wall Street Journal titled "U.S. Debt and the Greece Analogy", Maestro Greenspan made the case for fiscal belt-tightening and disputed leading economists, like Nobel prize winners Paul Krugman and Joseph Stiglitz, who believe that the Obama administration should provide a second round of stimulus. In the opening paragraph, Greenspan dismisses the idea that cuts in government spending will push the economy back into recession. Here's an excerpt:

"I believe the fears of budget contraction inducing a renewed decline of economic activity are misplaced. The current spending momentum is so pressing that it is highly unlikely that any politically feasible fiscal constraint will unleash new deflationary forces."

The op-ed features the same circular logic which became Greenspan's trademark during his tenure at the Fed. The real point of the article does not become clear until the very end when the ex-Fed chief levels an attack on Social Security. Here's a clip:

"The federal government is currently saddled with commitments for the next three decades that it will be unable to meet in real terms. This is not new. For at least a quarter century analysts have been aware of the pending surge in baby boomer retirees.

We cannot grow out of these fiscal pressures. The modest-sized post-baby-boom labor force, if history is any guide, will not be able to consistently increase output per hour by more than 3% annually. The product of a slowly growing labor force and limited productivity growth will not provide the real resources necessary to meet existing commitments. (We must avoid persistent borrowing from abroad. We cannot count on foreigners to finance our current account deficit indefinitely.)

Only politically toxic cuts or rationing of medical care, a marked rise in the eligible age for health and retirement benefits, or significant inflation, can close the deficit. I rule out large tax increases that would sap economic growth (and the tax base) and accordingly achieve little added revenues." ("U.S. Debt and the Greece Analogy", Alan Greenspan, Wall Street Journal)

Greenspan has been riding the "private accounts" bandwagon for more than a decade. Not satisfied with having reworked Social Security (under Reagan) to serve as a de facto flat tax levied on the working poor; Maestro now wants to divert the Mississippi River of revenue-streams into Wall Street's coffers. "The major attraction of personal accounts is that they

can be constructed to be truly segregated from the unified budget, and therefore are more likely to induce the federal government to take those actions that would reduce public dis-saving," Greenspan opined in testimony before Congress in 2005.

Greenspan has allied himself with a small army of like-minded elites who continue to boost austerity as a path to growth and prosperity. Deficit hawkery has replaced supply-side theory as the latest viral-form of voodoo economics. It turns established economic principle on its head to achieve a given political objective. This is from Bloomberg:

"Governments have proven they can spur expansion by focusing their belt-tightening on spending cuts rather than tax increases, according to studies by Harvard University professor Alberto Alesina and Goldman Sachs Group Inc. economists Kevin Daly and Ben Broadbent.

"There have been mountains of evidence in which cutting government spending has been associated with increases in growth, but people still don't quite get it," Alesina said in an interview. He made a presentation to European finance chiefs on the topic during their April meeting in Madrid.

The key is an emphasis on cutting spending rather than raising taxes, said Goldman Sachs economists Broadbent and Daly in London. Lower spending means consumers and companies don't fear higher taxes, so demand accelerates. A smaller public sector also helps reduce borrowing costs and makes economies more competitive as fewer government workers lighten labor expenses." ("Cameron Bets on Growth From Austerity as U.S. Delays", Simon Kennedy and Rich Miller, Bloomberg)

Cutting spending reduces economic activity and slows growth. The Bloomberg article merely presents the rationale for class warfare. Fiscal strangulation is not the path to economic recovery. Still, the deficit hawks have mounted an impressive public relations campaign and have powerful friends at the Fed, the Treasury, the White House, and Brussels. In the U.S., President Obama has appointed former Republican Sen. Alan Simpson to head a bipartisan commission to "fix the federal government's long-term budget problems", which is code for gutting social programs. In the E.U., German Chancellor Angela Merkel has taken the lead promising to hack $80 billion from the country's modest deficits. Even Tokyo, after enduring 15 years of excruciating deflation, is planning to slash long-term government spending. The groundswell for hair shirts is steadily growing increasing the probability of another severe downturn.

Here's the problem: The bursting of the giant asset bubble pushed the economy into a long-term slump that required emergency action by the Central Bank. Fed chair Ben Bernanke's liquidity injections and zero rates helped to pull the financial system back from the brink, but households and consumers are still deep in the red. The deleveraging process is ongoing and will last for years. Obama must either increase government spending or succumb to grueling economic contraction.

As of March, the average U.S. household's debt-to-disposable income ratio was 122% considerably lower than its peak of 131% at the beginning of 2008. Economists believe that that number will eventually return-to-trend at 100% which portends years of sluggish consumer spending and slow growth. With more families forced to cut back to patch their battered balance sheets, fiscal stimulus must increase or the economy will slip back into recession. Belt tightening now will only increase the deficits by reducing government tax

revenues. In a recent interview, Nomura economist Richard Koo was asked if the US should try to reduce their deficits by cutting back stimulus. Here's how Koo responded:

"Not until private sector deleveraging is over. At present, private sectors in the US, UK, Spain, Portugal, and Italy are still deleveraging. This means these countries should not try to reduce fiscal stimulus. Any attempt to cut deficit in these countries is likely to result in a weaker economy and a larger deficit as seen in Japan in 1997…. When private sector is deleveraging, money multiplier is negative at margin. No monetary stimulus will work in such an environment where people are trying to reduce debt, even with zero interest rates, in order to repair their damaged balance sheets.

Until people realize that they have contracted a completely different disease called balance sheet recession where the private sector is minimizing debt instead of maximizing profits, a constructive policy dialogue is not likely to be possible. Once the exact nature of the disease is understood, the remedy (sufficient and sustained fiscal stimulus until private sector balance sheets are repaired) will become obvious to everyone." ("Interview: Richard C. Koo, Nomura Research Institute", Acemaxx Analytics)

Koo does not believe that the current recovery is self sustaining. The rebound is stimulus-driven and merely reflects improvements in the financial sector (and the markets) which plunged after Lehman Bros collapsed. The heavy-lifting of repairing household balance sheets (which suffered losses of nearly $12 trillion) is still in its early stages. President Obama's $787 billion fiscal stimulus has helped a bit, but it's mainly been used to pay unemployment claims, provide tax cuts and to make up for the losses in state revenues. And while it is not true that the stimulus "has done nothing" as the deficit hawks claim (IHS Global Insight, Macroeconomic Advisers and Moody's Economy.com all estimate it created around 2.5 million jobs.) its effects have largely been canceled-out by the gigantic state budget gaps. Conservative economist Bruce Bartlett explains in the Washington Post:

"The Center on Budget and Policy Priorities estimates that in 2011, the states will have to come up with a total of $180 billion. These budget shortfalls are the equivalent of a massive anti-stimulus….And because they cannot run deficits to hold them over until their economies improve, they're cutting services and raising taxes. Using the data for 2009 and 2010, and then projecting for 2011 and 2012, the Center on Budget and Policy Priorities expects the total state shortfall will reach $610 billion. Because some of the federal stimulus dollars were saved rather than spent, the effective stimulus we've had has been less than the $789 billion that's often touted. It might even be less than $610 billion shortfall in the states. Which would mean the anti-stimulus overwhelmed the stimulus. Or, you could look at it in reverse: Nick Johnson, who directs the State Fiscal Project at CBPP, says that "the effect of the federal stimulus was to wipe out the negative effect of the state contraction."("You've seen the stimulus. Now, meet the anti-stimulus", Ezra Klein, Washington Post)

The Obama stimulus was a good start, but there's more work to be done. It prevented a downward spiral of falling asset prices and debt-deflation, but it wasn't big enough to put a dent in skyrocketing unemployment or lay the groundwork for another expansion. There needs to be a renewed commitment to long-term stimulus until households regroup and the economy gets back on track. Monetary policy alone will not succeed. The monetary transmission mechanism is on the fritz so reserves are piling up at the banks, but not getting into the hands of people who can generate more activity.

Consumer spending is flat, home prices are set to fall, unemployment will likely edge higher, private sector credit is still contracting, capacity utilization is far below pre-crisis levels, the CPI is slipping, and yields on US Treasuries are priced for deflation. The government must pick up the slack or their will be a general fall in prices that will trigger more layoffs, larger deficits, and social unrest. Premature fiscal consolidation can have unintended consequences as noted by Richard Koo:

"Pushing ahead with these misguided policies risks a collapse of social and economic foundations and could even threaten the survival of democratic structures."

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Michel Chossudovsky and Andrew Gavin Marshall (Editors)

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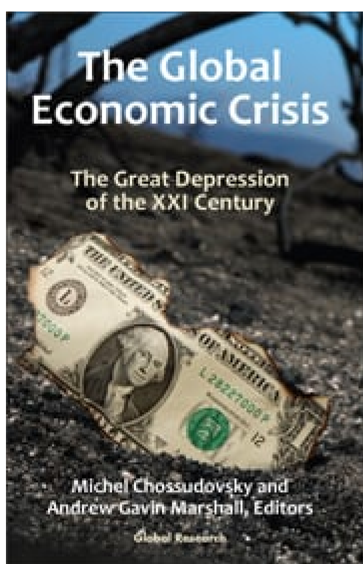

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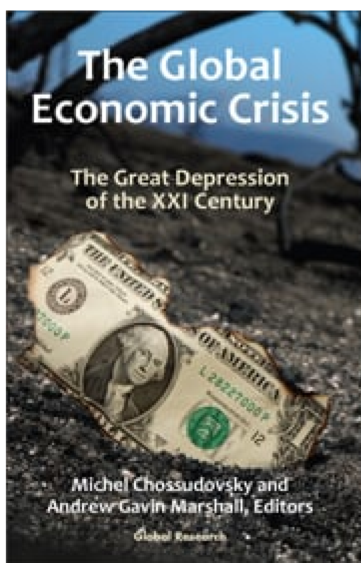

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The Great Depression of the XXI Century

Michel Chossudovsky and Andrew Gavin Marshall (Editors)

TO READ THE PREFACE CLICK HERE

TABLE OF CONTENTS

Preface Michel Chossudovsky and Andrew Gavin Marshall

PART I THE GLOBAL ECONOMIC CRISIS

Chapter 1 The Global Economic Crisis: An Overview Michel Chossudovsky
Chapter 2 Death of the American Empire Tanya Cariina Hsu
Chapter 3 Financial Implosion and Economic Stagnation John Bellamy Foster and Fred Magdoff
Chapter 4 Depression: The Crisis of Capitalism James Petras
Chapter 5 Globalization and Neoliberalism: Is there an Alternative to Plundering the Earth? Claudia von Werlhof
Chapter 6 The Economy's Search for a "New Normal" Shamus Cooke

PART II GLOBAL POVERTY

Chapter 7 Global Poverty and the Economic Crisis Michel Chossudovsky
Chapter 8 Poverty and Social Inequality Peter Phillips

PART III WAR, NATIONAL SECURITY AND WORLD GOVERNMENT

Chapter 9 War and the Economic Crisis Michel Chossudovsky
Chapter 10 The "Dollar Glut" Finances America's Global Military Build-Up Michael Hudson
Chapter 11 Martial Law, the Financial Bailout and War Peter Dale Scott

Chapter 12 Pentagon and Intelligence Black Budget Operations Tom Burghardt
Chapter 13 The Economic Crisis "Threatens National Security" in America Bill Van Auken
Chapter 14 The Political Economy of World Government Andrew Gavin Marshall

PART IV THE GLOBAL MONETARY SYSTEM

Chapter 15 Central Banking: Managing the Global Political Economy Andrew Gavin Marshall
Chapter 16 The Towers of Basel: Secretive Plan to Create a Global Central Bank Ellen Brown
Chapter 17 The Financial New World Order: Towards A Global Currency Andrew Gavin Marshall
Chapter 18 Democratizing the Monetary System Richard C. Cook

PART V THE SHADOW BANKING SYSTEM

Chapter 19 Wall Street's Ponzi Scheme Ellen Brown,
Chapter 20 Securitization: The Biggest Rip-off Ever Mike Whitney

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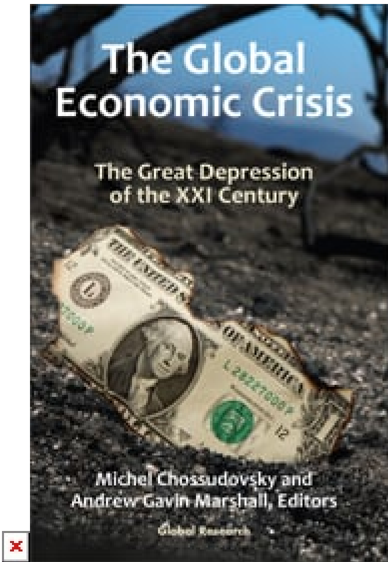

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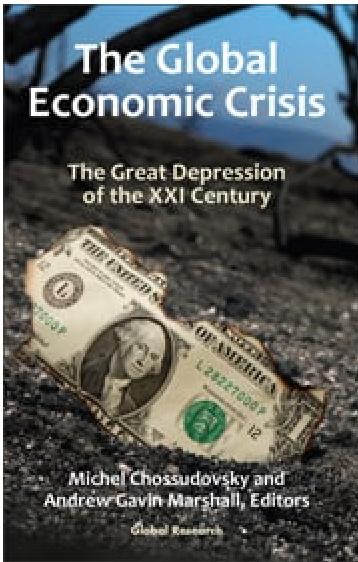

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