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Restore Confidence and Avoid a Global Economic Depression

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"… if financial markets are skittish and don't have confidence in a country's fiscal soundness, that is also going to undermine our recovery." President Barack Obama, June 27, 2011 (in a news conference at the conclusion of the Toronto G-20 summit)

"The U.S. government has to come to terms with the painful fact that the good old days when it could just borrow its way out of messes of its own making are finally gone." Xinhua, China's official state-run news agency, August 6, 2011

"Moderate inflation in the short run – say 6 per cent for two years … inflation is an unfair way of effectively writing down all non-indexed debts in the economy. … But it would significantly ameliorate the problems, making other steps less costly and more effective." Kenneth Rogoff, Harvard economist (December 2008)

"A budget deficit is inflationary if, and only if, it is financed in considerable part by printing money." Milton Friedman (1912-2006), American economist

"Inflationism … is not an isolated phenomenon. It is only one piece in the total framework of politico-economic and socio-philosophical ideas of our time. Just as the sound money policy of gold standard advocates went hand in hand with liberalism, free trade, capitalism and peace, so is inflationism part and parcel of imperialism, militarism, protectionism, statism and socialism." Ludwig von Mises (1881-1973), Austrian economist, On the Manipulation of Money and Credit, p. 48

"Inflation and credit expansion, the preferred methods of present day government openhandedness, do not add anything to the amount of resources available. They make some people more prosperous, but only to the extent that they make others poorer." Ludwig von Mises (1881-1973), Austrian economist, Bureaucracy p. 84

"Inflation is the fiscal complement of statism and arbitrary government. It is a cog in the complex of policies and institutions which gradually lead toward totalitarianism." Ludwig von Mises (1881-1973), Austrian economist, The Theory of Money and Credit, p. 468

"The inflationism of the currency systems of Europe has proceeded to extraordinary lengths. The various belligerent Governments, unable, or too timid or too short-sighted to secure from loans or taxes the resources they required, have printed notes for the balance." John Maynard Keynes (1883-1946), British economist, (The Economic Consequences of the Peace, 1919)

Financial markets show signs that they have lost confidence in politicians in both in the U.S. and in Europe. They have reached the conclusion that those presently in charge are not on top of things, and that either they don't understand the current economic problems their countries face or they lack the will or ability to bring forth the bold economic policies that would be required to solve them.

For one, the U.S. government looks like a ship in a storm without a captain, with President Obama and the Republican-influenced Congress stubbornly paralyzing each other. In Europe, politicians and central bankers seem to react to crisis and look like they are always behind a crisis when it occurs.

The trigger that may have persuaded many investors and consumers to adopt a more prudent approach took place on Friday August 5, 2011 when the credit agency Standard & Poor's finally downgraded the U.S. government long term debt from triple A to AA+, blaming the obvious incapacity of American politicians to come to grips with the government's fiscal crisis, let alone cure the nation's economic problems. Indeed, the previous week, American politicians had given the world a spectacle of rarely seen political buffoonery and confusion with some of them straight-jacketing themselves in signing ridiculous documents pledging to "never to raise taxes" while others were reverting to the primitive practice of using incantations to gods [http://www.huffingtonpost.com/2011/06/06/the-response_n_871829.html] to solve the nation's economic problems. —That's nothing to inspire confidence.

All this has been seen before, as it was in Japan some ten years ago. Indeed, on Saturday February 24, 2001, Standard & Poor's downgraded the government of Japan's long term debt from its top rating of AAA down a notch to AA+, blaming the lack of needed structural reforms and rising public debt. The Japanese economy was then mired in a slow growth environment with an aging population, and was recovering from a real estate debacle, while the government's fiscal deficits were approaching 10 percent of gross domestic product and its public debt/GDP ratio was 135 percent and rising. Indeed, Japanese debt kept rising and it was downgraded many times afterwards.

Just as the United States today, Japan then had a growing public-sector debt, large fiscal deficits that its politicians seemed unable to control and to top it all off, Japan had a troubled banking sector that was also overburdened with bad debt. —The Japanese economy has languished in a relative economic stagnation ever since. Its main stock market, the Nikkei, peaked at 38,957 in December 1989 and it is still presently much lower, i.e. below 10,000. Contrary to the U.S. government, however, whose debt is 40 percent owned by foreigners, Japanese government bonds were largely held domestically, thus insulating somewhat the country from international financial markets .

It must be recognized that the present day U.S. economy never really dug itself out of the economic recession that began in 2008, with the subprime financial crisis. It is true that the National Bureau of Economic Research (NBER) has announced that the economic recession officially lasted from December 2007 to June 2009. However, with hindsight, this may have been a premature call.

Indeed, while NBER focuses on a variety of different measures of economic activity to establish its official recession dates for the whole economy, periods of recession in the labor market have recently had a tendency to last much longer than the fluctuations in national

output. Presently, the U.S. official unemployment rate is still above 9 percent, as compared to 5 percent in early 2008, while the level of employment is some 6.8 million lower than it was in early 2008. (Of course, when considering discouraged unemployed workers and those forced to work part-time, the real unemployment rate in the U.S. is closer to 20 percent than to 10 percent.) Clearly therefore, from a labor market perspective, the U.S. economy is still in recession.

There is no other institution but the U.S. federal government that could, at least in theory, stir the economy from its current state of stagnation. Indeed, there is little that the central bank, the Fed, can do since it has already pushed short-term interest rates close to zero and has pumped into the economy all the liquidity it needs. Similarly, at the state level, most governments are very stressed fiscally speaking and they tend to lay off people, and thus they are contributing to the economic downfall.

Let's look briefly at the Fed's options.

Let's note that it is illusory to think that a central bank can solve a country's structural economic problems on its own through monetary means. This cannot be done. A central bank can facilitate economic growth, but it cannot create it.

For the time being, the Bernanke Fed has announced that it will keep short-term interest rates at near zero for at least another two years, after having pursued this very loose policy for the last three years, thus confirming in the minds of many investors that the ailing debt-ridden U.S. economy is dead in the water and that it resembles more and more the Japanese economy of the last twenty years.

In theory, of course, the Fed could keep printing new money, but this is unlikely to increase employment and economic growth, and may instead, in due time, have the reverse effect. In fact, the Bernanke Fed is already the largest holder of U.S. Treasury bonds ($1.6 trillion) after its numerous Quantitative Easing (QE) operations, ahead of foreign owners [http://www.treasury.gov/resource-center/data-chart-center/tic/Documents/mfh.txt] such as China ($1.2 trillion) and Japan ($0.9 trillion). This is equivalent to having lent new printed money to the Treasury or to have reimbursed other holders of Treasury bonds with newly printed money. Another way to look at this is to say that the Fed has been busymonetizing the US Treasury debt over the last two years, thus contributing to the demise of the U.S. dollar.

But, printing money above and beyond normal liquidity needs is a third-world recipe for disaster. This has been tried time and again with the same disastrous economic and political results, i.e. with inflation [http://en.wikipedia.org/wiki/Inflation] and even hyperinflation, [http://en.wikipedia.org/wiki/Hyperinflation] with a drop in national savings and investments, with the destruction of people's pensions and economic security, with an outflow of capital and finally, with the impoverishment of a nation. Inflation and hyperinflation are also the bedrocks on which dictators begin their ascent.

A good example is the German Weimar Republic in the 1920s and its hyperinflation policy: It gave rise to Adolf Hitler. Those who propose inflation, instead of sound and vigorous economic policies, as a solution to the U.S.'s structural problems—and to Europe's structural problems for that matter—should think twice about the consequences of such a foolish approach.

A small additional step that the Bernanke Fed can take (a thing that it has refused to do until now) would be to stop subsidizing large banks by paying interest on the excess reserves that they keep deposited at the Fed, after ironically having borrowed the same money from the Fed itself at near zero interest rate. That should be an outrage, but American politicians seem to be asleep at the switch.

That leaves the U.S. government with the task of stabilizing the economy.

Unfortunately, it has become a cliché to observe that the U.S. government is currently more or less dysfunctional, being deadlocked into a partisan and ideological stalemate that pits a lame duck democratic President against a rudder-less Republican dominated House of Representatives. That is the source of the crisis of confidence [http://www.buffalonews.com/editorial-page/article513761.ece] that has griped the markets recently. There is this uneasy feeling that nobody is in charge at a time when the economy is stagnating and could be teetering at the edge of an economic depression.

In the case cooler heads prevail, here are a few examples of reappraisals and bold policies that I alluded to before:

First of all, come to grips with the fact that the current fiscal deficit, besides the run-away cost of certain non-insurance based entitlements, can be attributed to three moves made over the last ten years:

1- The Bush-Cheney administration's tax cuts for the super rich in 2003 ($1 trillion);
2- The Bush-Paulson administration's and the Obama's administration gift to the largest banks (another $1 trillion);
3- The Bush-Cheney administrations' two wars in Afghanistan (since 2001) and in Iraq (since 2003) which have cost so far at least $1 trillion.

If ways could be found to curtail such unproductive expenditures, this would alleviate a lot of budget pressure and at least slowdown the rate of increase of the public debt.

Secondly, tax measures could be introduced to discourage American companies from exporting jobs abroad. Presently, through various schemes, most large American companies hardly pay any taxes on the earnings and profits they make by operating abroad. This put domestic job-creating investments at a big disadvantage. Non-repatriating profits, beyond a certain threshold, could be subject to a special assessment. Try it, and you will observe an inflow of job-creating capital into the U.S..

Thirdly, with aging social infrastructures crumbling, the government could embark on a ten-year Eisenhower-type infrastructure program. This would go a long way to rejuvenate the ailing construction industry.

A fourth avenue would be to reformulate immigration policies [http://en.wikipedia.org/wiki/Immigration_policy] in the current context of free international trade and high domestic unemployment. In such an environment when labor-intensive goods can be imported, the need for imported cheap labor is greatly reduced and limited to very specific industries, such as agriculture.

These are only a few examples of feasible measures that a prudent government could adopt when faced with economic and fiscal structural problems.

If the economy languishes for many years, or worse, if a full-fledged economic depression ensues, the economic losses in unemployment and in lack of economic growth would be much larger than the few measures mentioned above.

Think about it.

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