The Market Has Spoken: Austerity Is Bad for Business

By Ellen Brown
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I*t used to be that when the Fed Chairman spoke, the market listened; but the Chairman has lost his mystique. Now when the market speaks, politicians listen. Hopefully they heard what the market just said: government cutbacks are bad for business. The government needs to spend more, not less. Fortunately, there are viable ways to do this while still balancing the budget.*

On Thursday, August 4, the Dow Jones Industrial Average fell 512 points, the biggest stock market drop since the collapse of September 2008.

Why? Weren't the markets supposed to rebound after the debt ceiling agreement was reached on Monday, avoiding U.S. default and a downgrade of U.S. debt?

So we were told, but the market apparently understands what politicians don't: the debt deal is a death deal for the economy.

Reducing government spending by $2.2 trillion over a decade, as Congress just agreed to do, will kill any hopes of economic recovery. We're looking at a double-dip recession.

The figure is actually more than $2.2 trillion. As Jack Rasmus pointed out on Truthout on August 4th:

Economists estimate the "multiplier" from government spending at about 1.5. That means for every $1 cut in government spending, about $1.5 dollars are taken out of the economy. The first year of cuts are therefore $375 billion to $400 billion in terms of their economic effect. Ironically, that's about equal to the spending increase from Obama's 2009 initial stimulus package. In other words, we are about to extract from the economy – now showing multiple signs of weakening badly – the original spending stimulus of 2009!

As others have pointed out, that magnitude of spending contraction will result in 1.5 million to 2 million more jobs lost. That's also about all the jobs created since the trough of the recession in June 2009. In other words, the job market will be thrown back two years as well.

We're not moving forward. We're moving backward. The hand-wringing is all about the "debt crisis," but the national debt is not what has stalled the economy, and the crisis was not created by Social Security or Medicare, which are being set up to take the fall. It was created by Wall Street, which has squeezed trillions in bailout money from the government and the taxpayers; and by the military, which has squeezed trillions more for an amorphous and unending "War on Terror." But the hits are slated to fall on the so-called "entitlements" – a social safety net that we the people are actually entitled to, because we paid for them with taxes.

The Problem Is Not Debt But a Shrinking Money Supply

The markets are not reacting to a "debt crisis." They do not look at charts ten years out. They look at present indicators of jobs and sales, which have turned persistently negative. Jobs and sales are both dependent on "demand," which means getting money into the pockets of consumers; and the money supply today has shrunk.

We don't see this shrinkage because it is primarily in the "shadow banking system," the thing that collapsed in 2008. The shadow banking system used to be reflected in M3, but the Fed no longer reports it. In July 2010, however, the New York Fed posted on its website a staff report titled "Shadow Banking." It said that the shadow banking system had shrunk by $5 trillion since its peak in March 2008, when it was valued at about $20 trillion – actually larger than the traditional banking system. In July 2010, the shadow system was down to about $15 trillion, compared to $13 trillion for the traditional banking system.

Only about $2 trillion of this shrinkage has been replaced with the Fed's quantitative easing programs, leaving a $3 trillion hole to be filled; and only the government is in a position to fill it. We have been sold the idea that there is a "debt crisis" when there is really a liquidity crisis. Paying down the federal debt when money is already scarce just makes matters worse. Historically, when the deficit has been reduced, the money supply has been reduced along with it, throwing the economy into recession.

Most of our money now comes into the world as debt, which is created on the books of banks and *lent* into the economy. If there were no debt, there would be no money to run the economy; and today, private debt has collapsed. Encouraged by Fed policy, banks have tightened up lending and are sitting on their money, shrinking the circulating money supply and the economy.

Creative Ways to Balance the Budget

The federal debt has not been paid off since the days of Andrew Jackson, and it does not need to be paid off. It is just rolled over from year to year. The only real danger posed by a growing federal debt is the interest burden, but that has not been a problem yet. The Congressional Budget Office reported in December 2010:

[A] sharp drop in interest rates has held down the amount of interest that the government pays on [the national] debt. In 2010, net interest outlays totaled $197 billion, or 1.4 percent of GDP–a smaller share of GDP than they accounted for during most of the past decade.

The interest burden will increase if the federal debt continues to grow, but that problem can be solved by mandating the Federal Reserve to buy the government's debt. The Fed rebates its profits to the government after deducting its costs, making the money nearly interest-free. The Fed is already doing this with its quantitative easing programs and now holds nearly $1.7 trillion in federal securities.

If Congress must maintain its debt ceiling, there are other ways to balance the budget and avoid a growing debt. Ron Paul has brought a creative bill that would eliminate the $1.7 trillion deficit simply by having the Fed tear up its federal securities. No creditors would be harmed, since the money was generated with a computer keystroke in the first place. The government would just be canceling a debt to itself and saving the interest.

The Trillion Dollar Coin Alternative

The most direct solution to the debt problem is for the government to fund its budget with government-issued money. One alternative would be for the Treasury to issue U.S. Notes, as was done in the Civil War by President Lincoln.

Another alternative was suggested in my book Web of Debt in 2007: the government could simply mint some trillion dollar coins. Congress has the Constitutional power to "coin money," and no limit is put on the value of the coins it creates, as was pointed out by a chairman of the House Coinage Subcommittee in the 1980s.

This idea is now getting some attention from economists. According to a July 29th article in the Johnsville News titled "Coin Trick: The Trillion Dollar Coin":

The idea just started to get serious traction the last few days as the debt stalemate has grown more intense and partisan. Yale constitutional law professor Jack Balkin floated it as an option in a CNN op-ed yesterday (July 28th).

Today the idea has gone mainstream. It is covered by NY Magazine, CNBC, and The Economist. Even Nobel economist Paul Krugman of the NY Times has weighed in. Annie Lowrey of Slate discusses it as one of several gimmicks the government could use to resolve the debt-ceiling debacle. Krugman added:

These things [like coin seigniorage] sound ridiculous — but so is the behavior of Congressional Republicans. So why not fight back using legal tricks?

The debt ceiling itself was a legal trick, a form of extortion based on a century-old statute that conflicts with the Constitution. However, said the Johnsville News article, "coin seigniorage is not a scam. It is legal . . . . This plan looks like it might be Obama's ace in the hole . . . ."

The article cites Warren Mosler, founder of MMT (Modern Monetary Theory), who reviewed the idea in a January 20th blog post and concluded it would work operationally.

Scott Fullwiler, associate professor of economics at Wartburg College, also did a comprehensive analysis and concluded that the trillion dollar coin alternative was unlikely to result in inflation. Comparing it to Ron Paul's plan, he wrote:

This option is much like Ron Paul's proposal—actually identical in terms of the effect on the debt ceiling and the Treasury—except that his proposal would destroy all of the Fed's capital (and then some), which is a potential problem politically . . . though not operationally, and which the Fed is therefore very unlikely to agree to.

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On the inflation question, just because the Treasury has money in its account doesn't mean it can spend the funds. It needs the usual Congressional approval. To keep a lid on spending, Congress just needs to be instructed in basic economics. They can spend on goods and services up to full employment without creating price inflation (since supply and demand will rise together). After that, they need to tax — not to fund the budget, but to pull excess money back in and avoid driving up prices.

Spending More While Borrowing Less

In an economic downturn, the government needs to spend more, not less, as history shows. This can be done while still balancing the budget, simply by taking back the government's Constitutional power to issue money.

The budget crisis is an artificial one, and the current "solution" will only guarantee a deeper recession and more widespread suffering. Rather than obsessing over deficits and debt, the government needs to turn its focus to jobs, sales and quality of life.

***Ellen Brown** is president of the Public Banking Institute and the author of eleven books. She developed her research skills as an attorney practicing civil litigation in Los Angeles. In Web of Debt, she turns those skills to an analysis of the Federal Reserve and "the money trust." Her websites are http://WebofDebt.com and http://PublicBankingInstitute.org.*

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