GlobalResearch
Center for Research on Globalization

The U.S. Economy and Bad Government Policies

By Prof Rodrigue Tremblay

Global Research, August 01, 2008
1 August 2008

Region: USA
Theme: Global Economy

author's website: TheNewAmericanEmpire.com

> "I think the [US financial] system is basically sound, I truly do." George W. Bush, July 15, 2008

> "Since 1951, the budget of the Department of Defense each year exceeds the net profits of all U.S. corporations. So, in finance capital terms, that means that the management of that budget controls the largest single block of finance capital resources." Seymour Melman (1917–2004)

> "The first panacea for a mismanaged nation is inflation of the currency; the second is war. Both bring a temporary prosperity; both bring a permanent ruin. But both are the refuge of political and economic opportunists." Ernest Hemingway (1899-1961), (September 1932)

There have been many policy missteps over the last twenty some years, and this has amounted to a mismanagement of the U.S. economy. The result has been an unhealthy mixture of greed, shortsightedness and market manipulation. And now, all the chickens are coming home to roost and the crisis is deepening. This does not mean that the private side of the U.S. economy is not resilient and strong. It only means that government policies have often been misguided and have damaged the private economy and hurt the people economically.

Essentially, at the government level, each new economic crisis seems to have been "solved" by creating the conditions for the next one. This is particularly true in regards to regulation policy, monetary policy, and fiscal policy. Each time a policy choice had to be made, it seems that short-term benefits were often privileged at the expense of long-term costs.

First, let us consider regulation policy for the crucial financial sector. Over the last twenty years, U. S. deregulation of the financial sector has been based on developing what I would call predator financial capitalism, that is to say the systematic encouragement of excessive risk taking (moral hazard) and of corporate greed in general, the development of the pyramidal $2.5 trillion hedge fund industry, the practice of highly-leveraged buyouts (LBOs) of healthy companies with their own high-yield debt, also know as "bootstrap" investments, and the practice of program trading. Moreover, this was a system that was not only risky but also fraught with shady activities.

To accomplish this deregulation or non-regulation of the financial sector and to encourage the over-indebtedness of the U.S. economy, a whole series of safeguards that had been wisely established to prevent a repeat of the financial and economic disasters of the 1930's were dismantled and cast aside. The last one in line was the reckless abolition by the U.S.

Securities and Exchange Commission (SEC) of the speculative prevention rule called the downtick-uptick rule (which prohibited short-selling when stock prices were falling), in July 2006. Such safeguards had been put in place in order to avoid systemic financial instability, to make financial institutions more responsible to users and to avoid costly government bailouts when large financial institutions fail. Today, we are back to the 1930s with large financial institutions reaping huge profits and paying obscene salaries to their CEOs in good times and with government bailing them out with public money when things turn sour.

During the Reagan-Bush era of the 1980's, deregulation encouraged unsound real estate lending by Savings and Loans financial institutions (S&Ls) and this led to the 1986-1995 Savings and Loan associations crisis, when about $160 billion was lost, most of it through a $124.6 billion bailout by the U.S. Government.

The 1980s also saw the flourishing of vulture or predatory capitalism when financial operators were allowed to raid profitable companies and saddle them with the debt incurred to take them over. In 1989, for example, the corporate raider firm of Kohlberg Kravis Roberts (KKR) closed in on a $31.1 billion dollar hostile takeover of RJR Nabisco. It was, at that time, the largest hostile leverage buyout in history. The event was chronicled in the book (and later the movie), Barbarians at the Gate: The Fall of RJR Nabisco. To this day, nothing has been done to stop this practice that rewards irresponsible gambling and punishes prudent behavior. For the time being, however, it can be said that the practice of leveraged finance and of high-yield debt was somewhat stalled last August (2007) when the subprime crisis began to unfold.

At the center of current financial problems is the failure to adapt standard financial regulation to new financial institutions, such as broker-investment banks, off-shore based hedge funds and large derivatives markets that remain, for the most part, outside of the traditional authority of regulators. However, when things go wrong, as they did with Bear Stearns last March, their demise threatens to destabilize the entire financial system and handy government bailouts are quickly called in.

Second, let us consider monetary policy.

Over the last few years, U.S. monetary policy has resulted in a massive wealth transfer from savers, retirees and money holders in general to banks, mortgage lenders and debtors in general as the purchasing power of the dollar has plummeted. Last September, after the Bernanke Fed decided to drop interest rates as the U.S. dollar was already in the downtrend, I wrote, "foreign (dollar) investors have been 'taxed' by the American Fed's policy of benign neglect regarding the dollar."

Since then, the Bernanke Fed has gone much further. It has pushed the Federal funds rate to the 2 percent level from the 5.25 percent level it was in mid-September 2007. In so doing, by pushing real interest rates deep into negative territory and by depreciating the U.S. dollar, the Fed has heavily taxed retirees and savers in its rush to shore up American financial institutions. Indeed, it can be said that the semi-private Fed has been floating American financial problems in a sea of new money by running the printing press.

The act of printing excessive amounts of bills is the worst enemy of sound money. It is a way to destroy fiat currencies. It is the main source of inflation and, sometimes, of hyperinflation. In the end, we know that it robs people of their savings and lowers their standards of living.

Paradoxically, while the Fed is lending heavily to financial institutions in trouble by discounting their bad subprime loan paper through its so-called new special lending facilities (at 2% annual interest rate), banks become more selective in extending credit to borrowers, forcing companies and consumers alike to cut down on their investment and consumption projects.

The economy is thus placed in a sort of “liquidity trap” where everybody wishes to remain short term and liquid. There is a lot of money around, as the monetary base, or “High-powered money”, is increasing rapidly, certainly enough to feed inflation, depreciate the U.S. dollar and push long term bonds down (long term interest rates are on their way up), but banking credit as such remains scarce and may be getting more scarce as banks attempts to recapitalize themselves.

What the Bernanke Fed is doing nowadays is a continuation, although at a much higher level, of what the Greenspan Fed did in the late 1990’s. At that time, then Fed Chairman Alan Greenspan reacted to the collapse of an investment firm specializing in hedged funds, Long-Term Capital Management, by pumping large amounts of liquidity into capital markets and by lowering interest rates. This approach was called a “Greenspan put”, because it had the effect of guaranteeing the profitability of many risky financial operations that otherwise would have failed. That policy paved the way for the dot-com stock market bubble of 1999-2000.

In the same spirit, some refer to the Fed’s bailouts of troubled investment banks as a sort of Bernanke put, because of the Fed’s aggressive policy of reducing interest rates to fight market falls or to bail out financial companies in trouble.

Because of the current economic slowdown, the inflationary consequences of such a policy is not apparent yet, but it could be the foundations of future inflation down the road. Let us keep in mind that historically-low interest rates, lax lending standards, and inadequate regulation were behind the U.S. housing bubble. The seeds are now sown for the next bubble.

Third, let us look quickly at fiscal policy.

The Bush-Cheney administration’s fiscal policy has been characterized by budget deficit upon budget deficit, whatever the state of the economy. In its entire eight years in office, in fact, it has never balanced the budget. On the contrary, it has even spent the budget surplus that it inherited from the Clinton administration. And it has announced that it plans to leave the coming administration with a record 2009 deficit of half a trillion dollars. Indeed, the previous Bush-Cheney administration’s record was its 2004 $413 billion deficit.

Although such deficits at about 3.3 percent of the gross national product (GDP) are lower than the 6.0 percent of GDP we saw in the early 1980’s, they are cumulative, and they have occurred at a time when U.S. foreign indebtedness is much higher and the U.S. dollar much weaker. It can be said that they have contributed to weakening the United States and making it more vulnerable to economic and financial shocks.

Conclusion

In economics, bad decisions and bad policies do not always result in immediate negative consequences. It takes time for them to work their way through the economy and produce their corrosive effects. Many of the current economic and financial problems of today are the result of bad policies of the past.

Rodrigue Tremblay is professor emeritus of economics at the University of Montreal and can be reached at rodrigue.tremblay@yahoo.com

He is the author of the book 'The New American Empire'

Visit his blog site at: www.thenewamericanempire.com/blog.

Author's Website: www.thenewamericanempire.com/

Check Dr. Tremblay's coming book "The Code for Global Ethics" at: www.TheCodeForGlobalEthics.com/

http://www.TheNewAmericanEmpire.com/tremblay=1091

The original source of this article is Global Research
Copyright © Prof Rodrigue Tremblay, Global Research, 2008

Comment on Global Research Articles on our Facebook page

Become a Member of Global Research

Articles by: **Prof Rodrigue Tremblay**

Disclaimer: The contents of this article are of sole responsibility of the author(s). The Centre for Research on Globalization will not be responsible for any inaccurate or incorrect statement in this article. The Centre of Research on Globalization grants permission to cross-post Global Research articles on community internet sites as long the source and copyright are acknowledged together with a hyperlink to the original Global Research article. For publication of Global Research articles in print or other forms including commercial internet sites, contact: publications@globalresearch.ca

www.globalresearch.ca contains copyrighted material the use of which has not always been specifically authorized by the copyright owner. We are making such material available to our readers under the provisions of "fair use" in an effort to advance a better understanding of political, economic and social issues. The material on this site is distributed without profit to those who have expressed a prior interest in receiving it for research and educational purposes. If you wish to use copyrighted material for purposes other than "fair use" you must request permission from the copyright owner.

For media inquiries: publications@globalresearch.ca