The Time is Overdue for the US to Sober Up on Spending and Industrial Policy

By Paul Sandison

Paul Kasriel's defence of QE (see Investment Postcards of 16 November 2010) is supremely misplaced because it will even further delay the end of denial and the necessary sobering up to what is needed to restart the US economy.

I also disagree with the thrust of Paul Kasriel's article. 5% of monetary expansion for the wrong reasons is far too much. This QE alone is not going to stimulate the economy and therefore will weaken the dollar and even if it does not then it risks creating inflation down the road. Ultimately, the amount of money in an economy should represent the value of goods and services being produced in the viable sector of the economy. It does not. The G20 members know that full well and it is in essence that which they have protested about. As the QE is pumped out and the economy continues to avoid a real restart the US dollar will decline and the viable core of the economy that is not artificially kept afloat by government funds will not expand and may even shrink.

The second point is that an additional 5% of money in the economy that is not spent on solid infrastructure projects will be wasted away on a temporary life support of the budgets of bankrupt cities and states. That support will run out by June next year. And then what?

Here I would like to move to a broader view. We have arrived at a historical juncture where the US government is impotent and has nothing left in its arsenal except QE. Following on from what Prieur wrote yesterday in Investment Postcards of the 15 November 2010, it ultimately comes down to: What policy measures are required to turn the economy into a growth path? This is the elephant in the room. QE will not turn the economy around, it will just kick the can down the road. Also, that QE debt has to be repaid. Whatever Paul Kasriel writes about creating money out of thin air, when the Fed buys Treasuries, the US Treasury has to pay that back one day. The Federal Reserve, a private bank, is giving the American taxpayer a loan.

Supplying sufficient liquidity is only one aspect of avoiding a Great Depression, and there is already enough liquidity *for the size of the economy that is still viable!* Banks, companies and private individuals are holding $1 trillion in reserves. Excess liquidity by itself is NOT the solution.

As Anna Schwartz (who together with Milton Friedman conducted their seminal analysis of the Great Depression decades ago) wrote a couple of years ago, Bernanke is fighting the Great Depression, not the present semi-deflationary environment which ultimately stems from the dirty banks still hiding toxic assets on their balance sheets (or off them).

Pumping in excess money into the economy will ultimately weaken the dollar, increase the public debt, irritate US trading partners, and stifle world growth but inflate the stock markets around the world, setting all up for a crash further down the road. As far as stimulating the economy towards growth is concerned this ultra excessive, misplaced and misdirected QE is indeed pushing on a string.

In sum:

There is no bang for the buck in the present US government and monetary policy. What is needed is a 1:1 effect. However much many right wingers in the US may hate it, the re-construction programme (Reconstruction Finance Corporation, RFC) under the new direction of Franklin Delano Roosevelt in 1933 gave a 1:1 effect. Over a decade the RFC and its successors turned the economy around and despite the vast war spending set the stage for the expansion of the 1950s.

Such a programme is a temporary affair, and does not mean the economy has become socialist. It just means the state has temporarily stepped in because the market failed and a bubble burst, which has been a regular state of affairs in capitalism since the early 1600s.

Although Europe is dependent on exports and can suffer if the US economy collapses, just as European economy has mainly suffered from the US export of toxic assets to British, German and Swiss banks, most of the developed European economies have fiscally oriented automatic stabilisers in place to kick in during a recession. These give an immediate 1:1 bang for the buck.

For example Sweden which has a 3% GDP growth right now and has raised its repo rate twice to dampen inflation and stabilise the expansion, allows homeowners and companies to repair, renovate and build with a 50% reduced tax on labour as soon as a recession is about to start. This temporarily vastly expands the building and renovation sector, provides jobs and brings in income tax to the state from all the additional workers who are gain new employment. This may sound puny and insignificant. It is not.

Every other home and business throughout the country jumps at the opportunity to get a lot of reconstruction and renovation done cheaply. The effect is powerful, immediate and country-wide. Of course it does not sound grand and dramatic, like the Bush tax cuts, TARP, and spending a lot of other people's money. There is no fanfare, but why should there be? It does the job very well.

Notice that the state does not actually payout any funds. It merely lowers the tax in a sector, but that lower tax in that sector is entirely offset by an increase in income tax revenues from the additional workers that are brought out of unemployment into the economy. For larger projects the state generally does not need to intervene by using taxpayers' money. It is sufficient for the government or the central bank to guarantee capital projects that are otherwise too big for individual companies and their banks to finance on their own.

It is therefore likely that despite the problems of Ireland and Greece caused through a lack of insight into the dangers of profligacy and policies to deal with overheating, in the long run the European area may cope with the aftermath of the Great Recession better than the US.

For the $3tr the US government has paid out through the Bush stimulus, the TARP, the Obama stimulus and the $2tr the Fed has paid out in QE in various ways, a 1933-type FDR reconstruction programme plus a European style automatic stabiliser system would have brought US unemployment down to 3% by the end of 2009, *and* improved infrastructure everywhere in the country *and* wiped out all the debt of the developing countries, eliminated hunger and established schools for all the world's children.

When you get beyond the magical element of the creation of money in Economics 101 you learn that you have to ask yourself what this money is being created for, and what is the alternative cost of what you are going to use the money for. In the present case, liquidity that is not deployed in creating industry and creating infrastructure that will create goods and services will either cause inflation, or a weakening of the currency, or both. Pumping money into the economy to prop up banks and refloating the deficit budgets of cities and states does not automatically result in new wheels starting to turn. If banks are trying to repair their toxic balance sheets, the money will sit there and go nowhere. If small businesses cannot expand anyway because they do not have the customers and they therefore do not have the need for a loan from the bank, liquidity will not help them or the economy.

What the US government and the Fed have done is in effect to borrow from taxpayers and future generations and squandered this vast amount to temporarily prop up failing banks (how capitalist is that?), and those cities and states that have for 30 years selfishly refused to balance their budgets through an ideologically insane anti-tax policy, and thereby ruined the economy by setting it on a slippery slope to implosion. This is the ugly face of socialism. A centrally-directed race to the bottom - to the lowest common denominator standard of goods and services that was the hallmark of Soviet Socialism.

Until the US rids itself of its senseless paranoia for government work and reconstruction programmes then it will just go from bad to worse. It will be ghastly to watch but we shouldn't be surprised if city after city and state after state begin to collapse around in 6 months time or as soon as the 3rd, 4th and 5th Fed QE has had little effect, say in 18 months time. If the US continues down this insane path I reckon June and the whole of H2 2012 will be the time of reckoning.

It may even happen before that. It is already becoming more and more difficult to issue Treasury Bonds. The whole world is now fully aware that longer term bonds are a very risky proposition because US debt is out of control. This carries the double risk of default and/or that the US inflates its way out of its debt, either way putting all those holding US Treasuries in the suckers' camp.

President Obama had the nerve to say at the G20 that the world cannot expect the US to pull it out of the recession. In other words the US wants to export more and import less. This is nothing less than the 2010 US Declaration of Protectionism and a clear indication that Obama has learned nothing of the destructive role of protectionism in the 1930s. If he takes further steps down that road he will soon learn that every other trading partner can also play that game. It is a simple matter for the US trading partners to raise barriers to the US and no other country. The US risks isolating itself economically while the rest of the world carries on trading and growing without it.

The real underlying problem is that sufficient influential people in the US do not have the intellectual honesty to reflect and see that it has brought this crisis on itself. Instead they continue to chase scapegoats, shadows and red herrings to make responsible for the country's woes. They thought they could continue with their self-delusion. But the G20 did not buy the US proposal that China was the bad guy. Instead it pointed at the US's own ultra-excessive QE as a cause of the weakening of the dollar, something which immediately makes the exports of other countries more expensive and therefore liable to decline. The US can no longer (with the help of US policy apologists like Martin Wolf of the Financial Times) fool the world into following its crusades against the scapegoat of the day.

For the reality that very many people around the globe can see, even if it is blind to it, is that the mighty US empire, egged on by the CNBC, the Financial Times and its irrelevant articles, is day by day imperceptibly but gradually imploding through its own self-indoctrination and fundamentalist beliefs, nothing else.

It is not the reds (the Soviet empire collapsed 21 years ago), it is not the people, or Al Qaeda, or the Chinese, or the EU, or the weather, or Mexico, or aliens in outer space, that mean the US cannot cure the banking system and the recession and cannot restructure the economy, but the collective right-wing instigated paranoia for the following:

1 A federal government take-over, restructuring and reprivatisation of the large banks once and for all. This involves a complete clean out of the toxic assets, putting them in a separate vehicle until such time in the future when the assets can be realised at par. The immediate re-privatisation of those same banks. Why did both the Bush and Obama governments never do this? Not because they really believed that to do so would be a first act of communism, but because if the shareholders were wiped out then their friends across the entire US super-rich upper class would lose their investments in the rotten banks.

So they made the taxpayers, the ordinary Americans, foot the bill. These shocking acts will reverberate down the annals of time, and will never rehabilitate themselves. The bill for this monstrous series of actions will be very costly for the country, however. Until the banks are cleansed, investors will not have sufficient confidence in the financial system and the effective restart of the economy will not begin. Anna Schwartz was perfectly correct. The financial system is the powerhouse of the economy. The economy works because individual people are confident enough to take risks and invest or start new businesses if the economy is stable and if the government has an industrial policy which promotes opportunities, growth and employment.

However, the US government does not at present have an industrial policy which sufficiently promotes opportunities, growth and employment. It has vastly underestimated the amount that should have been spent on stimulating industry and instead overwhelmingly using its funds to prop up rotten banks and debt-ridden cities and states. Furthermore an economy cannot be stable if the financial system is broken or impaired. If there is reason to doubt it is fragile and could break down, and there is, then the entrepreneurial spirit will not appear in the larger economy.

2 Just as in FDRs day, after his predecessor Herbert Hoover the well meaning philanthropist did little to stimulate the US economy for four years, the only remaining solution for FDR was state-funded reconstruction programmes and government-initiated tax breaks for certain industrial sectors of the economy that could create new work throughout the economy. This time, however, due to the vast amounts already spent, I fear the time is coming when not even these projects can be financed. The US is deeply in the red, I am afraid. Far deeper than most have imagined. The sooner it wakes up from its illicit and highly foolish drunken spree the better for all.

Paul Sandison, 63, is a social critic of contemporary society. Although born in South Africa, he has lived in Europe for nearly 40 years. His forebears include an ancient ancestor to King Niall of Ireland and Charlemagne. Paul is currently promoting American and European arrangements of contemporary Irish music. His hobbies are reading, development economics and jogging.