Is Fiscal Policy the Magic Bullet?

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Max Wolff
Senior Economist
The Beryl Consulting Group LLC

Last February I wrote to you about how mistaken it was to see monetary policy and Fed intervention as magical cures for structural and solvency crises. Sadly, very little has changed in the market trade. Stocks have collapsed, still many believe in magical governmental cures. This time is it the President-elect and fiscal policy that are to prove the magic bullet? This delusion will end at least as badly as the magical monetary policy, permanently high home prices and endlessly expanding equity multiple bubbles.

Why? Can't we just will a rebound and trade it into existence? The answer is yes and no. Yes, we can use future tax receipts and what remains of our good global name to borrow over $1 trillion per year. Yes, the Fed can continue to increase its balance sheet by several hundred billion dollars a month. Yes, it appears that terrified investors - many from overseas - will loan to us at shockingly low rates of interest in a currency that we are actively destroying. Perhaps the $3 trillion we have sold to foreign central banks and agencies will expand by a trillion or two? Maybe China will want to buy another $693 billion in US government obligations as her economy slumps and her exports stall? Yes, we can sell our past credit errors to the government. Some of us can even front run government purchases or trade ahead of multitudes of eager and ill informed rebound seekers.

No, none of this allows rebalancing or true macroeconomic recovery to even start. This is nothing short of a bigger, more dangerous and more state directed effort to recreate the bubble. Sure, it will be a new bubble in Treasuries, mortgage backed securities assured by the greatest debtor in world history - the US government. We now all know the last bubble recently exploded, spraying economic shrapnel across the entire world. Or do we? I guess doing it all over again with fiscal policy, Fed quantitative easing and a new President will successfully suspend the laws of price gravity.

Fiscal policy - like credit expansion - allows money to be borrowed and spent now against future profits, earnings and reduced spending. Like the credit it relies on, fiscal policy injects more spending today at the cost of less spending tomorrow. The only way out of that is to default tomorrow. Our macro economy is collapsing under the strain of consumers living within their means. We borrowed and bought too many houses at too high prices. We borrowed and bought too many cars at too high prices. We borrowed and bought too many of everything at too high prices. We did this by borrowing all the money on earth that was not nailed down by restriction or prudential lending standards. Where and when possible, we used our diplomatic, economic and military might to pry free and borrow the monies that were nailed down.

In 2007, the US imported 49.2% of globally imported capital. In 2006, we imported 60% of globally imported capital. In 2005, we imported 65% of globally imported capital. Healing means Americans must earn and save more than they spend for several years. We must buy less and make more for sale to the world. The flip side of this coin is that others will have to save less, spend more and allow greater import penetration. That is what rebalancing would look like.

It means housing prices fall until they are affordable without byzantine credit products or massive Fed interventions. It means higher wages, slower growth and lower profits. Thus, profits fall as economic growth declines. This means lower equity prices. Foreign export operations shrink and are converted to domestic production. Fiscal policy is required to cushion and co-ordinate painful and potentially prolonged transition. That will be true at home and abroad. Wise fiscal policy will target making the transition possible while minimizing unemployment, suffering and political instability.

Less than sage fiscal policies will try to unilaterally shift pain to other nations or re-inflate bubbles. The worst thing America can do, having exhausted global supplies of loanable funds for consumer credit (2007-2008) we could embark on a new form of the same unsustainable and eventually ruinous distortion.

We could move the giant bleeding debt sore onto the government's books and try to run down Uncle Sam's credit. This will buy some time, perhaps even a few years, to keep doing what we really can't afford to keep doing. Or, we can stop, confront and tackle the challenges presented by a long overdue structural rebalancing of the US position in a globalized world. The latter might well renew and re found America's prosperity, place and position. It will be painful, fraught and take several years. The alternative many now see as panacea will eventually cripple the US and global economies.