The dog's breakfast of an Obama stimulus package will cause another Great Inflation to follow the Big Recession, says DEEPAK LAL

There seems to be no end to the US financial crisis. Its deflationary effects are now spreading to the global real economy. With the new US administration's ratcheting up the invective on Chinese 'currency manipulation' (as predicted in my last column) the threat of rising protectionism and the conversion of what is now an unavoidable global recession into something really nasty is rising. Hence the financial crisis and its deflationary consequences need to be brought to end.

First, consider the banking crisis. It is now apparent that the attempt to recapitalize UK and US banks through publicly acquired preference shares has failed. The banks have merely used this public capital to hold on to their toxic assets and to continue in their bad old ways. Gordon Brown, who as the self-proclaimed global saviour of the financial system first implemented such a scheme in the UK, is throwing more public capital into UK banks. He and other governments have belatedly recognized they misdiagnosed the problem, as being the illiquidity rather than the insolvency of their banks due to the holdings of toxic assets into which the US sub-prime mortgages had been packaged. With the US (and UK) housing markets continuing to fall like a stone, the value of these mortgage-based securities keeps declining, reducing the capital of the banks, and worsening their balance sheets. As it will take some time for the housing market to stabilize, it is necessary to remove the toxic assets from their balance sheets, before the banks can be restored to health.

The various plans being proposed to deal with the toxic assets are problematic. As George Soros has noted (in the FT, Jan 23) they involve either partially nationalizing the banks, or keeping them private but nationalizing their toxic assets in a public 'bad' bank. The former solution would inject public equity capital but require the bank's toxic assets to be 'marked to market', along with the suspension of the Basel minimum capital requirements. The latter solution would convert them into the equivalents of the failed Freddies, with the government forcing them to lend on uneconomic terms in the 'public interest'. It is difficult to predict which of these two options the Obama administration will choose, but with the recognition of the insolvency of banks caused by their toxic assets, a solution will be found, with taxpayers ultimately underwriting the estimated $1 trillion of losses remaining to be taken on these toxic assets.

By contrast, the proposed nearly trillion dollar stimulus package to reflate the US economy is a 'dog's breakfast'. It contains genuinely reflationary measures like the proposed tax cuts and financial aid to the states, along with numerous handouts to various rent seekers as well as long-term infrastructure projects which should be justified in terms of their long-term net economic benefits and not as a means to smoothen the trade cycle. General tax cuts, perhaps more extensive and larger than those proposed, would be an appropriate reflationary measure, as would increased federal grants to the states — which also amount to a tax cut as with the fall in tax revenues in the recession, the states would otherwise have to raise taxes to meet their mandated balanced budget requirement. The proposed spending increases have predictably brought a host of rent seekers to lobby for their pet projects. My favourite being the bid by the pornographer Larry Flynt for $7 billion to bail out his industry to alleviate the sorrows of the unemployed!

Not surprisingly, this stimulus package (particularly the increased spending on new entitlement programs and infrastructure) is being hailed by its supporters as a return to Keynesianism. There is little dispute that a large fiscal stimulus is needed. Instead, the political battle lines are being drawn with the Democrats demanding more public spending, the Republicans larger tax cuts. There are two recent empirical studies which should provide some evidence to resolve this issue for the open-minded. If the purpose of the stimulus package is to raise aggregate demand by roughly the amount it has fallen because of the financial crisis, Valerie Ramey finds that from historical US data, the multiplier for public spending is not large: $1 in public spending raises GDP by $1.4 (“Identifying Government Spending Shocks: It’s all in the timing”, UC, San Diego, June 2008). Whilst Christina and David Romer’s study of the effect of tax changes on aggregate demand found that a $1 tax cut raises GDP by $3 (“The Macroeconomic Effects of Tax Changes”, UC, Berkeley, November 2008). Though it should be added that since being nominated as Obama’s Chair of the CEA, Christina Romer seems to have changed her tune and fallen into line (see C Romer and J Bernstein: “The Job Impact of the American Recovery and Reinvestment Plan”, January 10, 2009), with the claim that the proposed package will lead to the creation of over three million jobs by the end of 2010. But as many observers have noted, “The total package is so diffuse, it costs $223,000 to create a single job” (D Brooks: “The First Test”, NYT, January 23).

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Nor is the belief underlying the package, that increased public spending on infrastructure is an appropriate Keynesian response to a recession, supported by the master’s own writings. Thus Keynes wrote in 1942: “Organized public works, at home and abroad, may be the right cure for a chronic tendency to a deficiency of effective demand. But they are not capable of sufficiently rapid organization (and above all cannot be reversed or undone at a later date), to be the most serviceable instrument for the prevention of the trade cycle” (Collected Works, vol. XXVII, p.122). A point reinforced by the Congressional Budget Office’s assessment of the planned Obama infrastructure spending.

Finally, Keynes joined Hayek at the start of the Second World War in urging that the inflationary consequences of its financing should be countered by a general tax rise, rather than the price controls and rationing which were adopted. But just as they were ignored, I expect the dog’s breakfast of a stimulus package will be enacted (for Obama has bluntly told the Republicans: “I won”). The consequent rise in the US structural deficit will lead to the Big Recession being followed by another Great Inflation. It is time to buy the US government’s inflation-protected TIPS which currently are pricing in a massive deflation!