Gliding into the Bush-Obama Depression

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Abstract

The G20 Summit was based upon a wrong diagnosis. It did not chance upon the right treatment. The prognosis is that we glide into a depression. The economic promise of the Obama Presidency is at peril.

Introduction

The G20 April 2 Summit Communiqué (2009) can be seen as the Swiss reaction to global warming. With less snow and shorter ski seasons, the tourists stay away and snow machines seem a quick fix. It buys some time though the machines burn fossil fuel and contribute to global warming. The current economic crisis was caused by too easy credit and the G20 see it as a solution to provide more credit.

The US Bureau of Economic Analysis BEA (2009) reports: "Real GDP increased 1.1 percent in 2008 (that is, from the 2007 annual level to the 2008 annual level), compared with an increase of 2.0 percent in 2007." Those "income" or "product" measurements do not quite reflect the losses in wealth from homes, shares and pension savings. In terms of the "state of the economy" people will tend to agree that 2007 was already a rather depressing year, and economic science is still looking for a good indicator to express this.

By common annual GDP standards the upcoming Depression would only start in 2009. If President Obama is unable to switch course, the upcoming depression deserves the "Bush-Obama Depression" label. Admittedly, all G20 participants are responsible for their own actions, also Mr. Berlusconi, but it helps to focus on the two major policy making culprits.

Let us consider some reactions to the Summit. Jeffrey Sachs (2009b) as a member of Secretary General Ban Ki-Moon's delegation is quite positive. However, earlier Sachs (2009a) was critical of the US plan on toxic assets. This problem hasn't been solved yet while this would be important for a recovery. The Economist (2009) states too: "(…) America's plan to clean up its banks, for instance, is still inadequate". Persaud (2009) is cautiously cheerful, and Wyplosz (2009) is guardedly skeptical: "It would be a tragedy that the summit ends up encouraging complacency." Baldwin (2009) is a welcome reminder that international trade is not quite the cause but rather the consequence of collapsing demand and deteriorating credit. Thus the Summit attention for trade is somewhat useful but not the essence.

I have read more reactions and it would distract to list them all. Apparently my own comment is distinctly different from all of these. It is: (1) that the Summit was based upon a wrong diagnosis, (2) that it did not chance upon the right remedy, (3) hence that the prognosis must be that we continue to glide into a major Depression, and (4) that the economic promise of the Obama Presidency is at peril.

This present comment is only a superficial review of the main lines of reasoning. I have collected my relevant papers at the weblink Colignatus (2009) and refer only this once. The given weblink provides the argumentation in depth.

Ad 1. The diagnosis

1.1 The economics of information

In this evolving depression, the various "crisis peak moments" (like Bear Stearns in August 2007) all had the property that the information was available but not properly collected and transformed into adequate policy.

A major point is that the Bush Administration financed the Attack on Iraq by implicitly borrowing from China. The US is a democratic state and China is an authoritarian state so that the burden for the more sensible policy would rest with the US. Instead, the US failed, but not for the lack of available information. The basic problem lies not within the financial realm but within the whole system of economic decision making, and in particular with the handling of information. Once you grasp the notion of a systematic failure in the current structure of democracy, a reconsideration of history will provide all the evidence needed for further confirmation.

The prevalent system of democracy with the Trias Politica of the Executive, Legislative and Judicial branches still allows too much leeway for the political process to manipulate information that is crucial for the living conditions of the people. This is an analysis that can be made in the field of Political Economy. The best solution found till now is the suggestion of an Economic Supreme Court (ESC), at the same constitutional level as the other branches.

1.2 Macro-economics by itself

In terms of macro-economics seen by itself, the diagnosis is that we face "repressed stagflation bursting into the open". Stagflation was repressed by deregulation running amok. When deregulation is put a stop to (with re-regulation), stagflation will break out into the open again.

The Great Stagflation since 1970 itself has been caused by information mismanagement as well. Proper management of information thus is required to get us out of this mess too.

If you don't have the right diagnosis then you may still chance upon the right remedy. In the present case it is highly unlikely that we will be so lucky.

Ad 2. The remedy

2.1 The economics of information

The proper remedy would be for each nation to create a constitutional amendment on an Economic Supreme Court. Thus the G20 Summit should not have been a gathering of the leaders and their ministers of Finance only but should also have included their constitutional jurists.

2.2 Macro-economics by itself

For macro-economics, the solution consists of (a) restoration of the optimal path by restructuring tax and social security to take away the macro-economic cause for the Great Stagflation, (b) to accept an appropriate reduction of the working week as a temporary measure to get to the optimal path. Thus the G20 Summit should also have included their ministers of Economic Affairs.

Currrently, the G20, in their money and finance mode of thinking, accept the rise of unemployment as inevitable. Unemployment is seen to rise to some 10% and in some countries even much higher. The G20 try to avoid it, of course, but apparently only over a longer horizon, while there is more urgency to bail out the banks.

The G20 intend to support demand and re-regulate finance. Demand is supposed to be supported by an expansion of the IMF. Re-regulation of the financial system indeed is required and may be interpretated as better handling of information in a sub-area. The measures however are inadequate.

Money and credit aren't substitutes for real measures and carry the risk of inflation. Monetary and fiscal measures are known as "pushing on a string". Another analogy is "you can bring a horse to the water but not make it drink". An allocation of SDR falls into this category. There is no quick and reliable channel from the government to the micro level. The G20 measures only prevent a collapse just now and buy some more time but also allow the rot to creep in more deeply.

PM 1. SDRs are also dubious since they are a political way out of hard choices. When a government is faced with austerity, taxation, debt or printing money, it seems a political relief to be able to get or borrow SDR from an institution that does the printing (under joint responsibility with others in the same boat). SDRs sound austere and seem to prevent critical questions. But if we had a world parliament then the critical questions would surface. It is not a pretty sight to see democratic nations take advantage of a non-democratic situation.

PM 2. Eastern Europe has been compared to the subprime lending in the US. Western European banks and their local subsidiaries have been lending in euro's, shifting the exchange rate risk towards the Eastern Europeans. IMF support to Eastern Europe is an indirect bail out for those Western banks. It may provide some immediate relief for Eastern Europe when it is allowd to repay IMF debt over a longer period but it also reduces real investments over a longer period. Why not let Western banks suffer ?

PM 3. In Baldwin (2009) I miss that trade restrictions are an excellent way to cause surplus (exporting) countries to stop exporting their unemployment and to refocus on their internal market. It is important to remember the Skidelsky (2000) biography of Keynes: while the intuitive idea of political policy makers is to think that the deficit (importing) country is to blame and has to adjust, the better analysis is that the surplus (exporting) country has a responsibility to adjust. After World War II the major exporter was the US and Keynes's argument might have seemed self-serving but it makes excellent economic sense by itself and now China can use its advice.

Ad 3. The prognosis

3.1 The economics of information

It is merely an exercise in logic that if the patient does not get proper treatment then he or she is unlikely to recover. In this case the G20 slow down the collapse. Will there be a recovery ?

Admittedly, the future may bring surprises that reduce the requirement to adapt our system of democracy. A discovery of cheap energy. A biotechnological revolution. Emerging nations may get their act together and replace the collapsing West. Google creates the first network that can think for itself so that people need only log in to get benevolent advice. To mention only a few scenario's. But if we stick to common economic analysis then the following would be expected to happen.

3.2 Macro-economics by itself

In the US, the Geithner-Summers bail out plan for the toxic assets is not a good plan and thus fails. Congress and taxpayers protest and it becomes ever more costly to sort out the mess. In the world, the G20 approach prevents immediate collapse but does not generate a recovery. Unemployment rises all over the world. More plans and funds are required. Quantitative easing causes inflation to rise. Inflation and more borrowing causes rates of interest to rise, reducing investments. Consumers rather reduce debt than spend. Instability increases risks. Increasingly risk-averse investors and banks reduce investments as well.

PM. Current long-term rates of interest are surprisingly low and TIPS are surprisingly high. Apparently my expectations are out of sync with the markets – but markets are also bureaucratic pension funds.

Ad 4. The Obama Administration

President Obama selected his main economists from the Greenspan – Rubin – Summers – Geithner (GRSG) school of money and finance. Perhaps this was unavoidable given the Bush legacy, the seeming economic success and the "crisis peak moments" that may have suggested that the problem lay in the area of money and finance. Obama still relies on this school to clean up the mess they created. This is dubious however, as explained.

For the first quarter of 2009 one cannot evade the impression of groupthink in the Obama-Summers-Geithner team. There was some input from UK Prime Minister Brown but he had been a supporter of deregulation as well, needed to maintain a competitive edge for the City of London, and depended upon US leadership to prevent an Icelandic collapse of the UK economy. Brown was not the best advisor in place to advise the US how to deal with 10% unemployment.

Does Obama have an alternative ? He must choose from US economists. Leonhardt (2008) refers to the "Battle of the Bobs" between Robert Rubin and Robert Reich during the Clinton Administration, that apparently Rubin won. Reich now has won the argument that deregulation has turned out to be disastrous. But that does not imply that he was right on intervention in the market to directly do something about unemployment. Conditional on the state of economic theory in the US, the "Battle of the Bobs" still is undecided. Robert Reich still hasn't won the argument that the government should step in with an interventionist agenda, since his argumentation is unconvincing. But that does not mean that Robert Rubin has won the argument that it shouldn't. When unemployment rises to 10% society better steps in, and for sure if it stays this high during a number of years. The real US problem is their state of economic theory. It is OK that the two Bobs discuss with each other but it is not OK that they are not open to a discussion with others.

President Obama apparently still listens to the Summers & Geithner approach to unemployment. This is quite dubious too. Summers & Geithner namely do not have much of an argument but only a conviction. Obama thus eloquently fights for his agenda but sees it killed by dwindling prospects – that are caused by his choice of his team and their inclination to groupthink.

Conclusions

The conclusions are stated in the abstract.

It must be recalled that this comment only gives the main lines of reasoning. The weblink referred to shows how to deal with unemployment both for a structural solution to the Great Stagflation and for the urgent short run.

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