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Economic Theory: Reasons For Sluggish Growth

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There are several competing explanations for the lackluster economic recovery. The classic Keynesian explanation, which is taught by rote to most undergraduates in their macroeconomics classes, is a shortfall in aggregate demand. This shortfall occurs as consumers increase their savings after a period of excessive credit availability, resulting in diminished consumption. The Keynesian solution to low aggregate demand is for the federal government to increase spending in order to counter the fall in private consumption.

This explanation has several problems, not least of which is that if consumers were spending excessively, why should government try to replicate such wasteful consumer spending? Given that government spending will be both political and inefficient, any attempt by government to offset excessive consumer spending will only yield even more unwise aggregate spending. That is, just as consumers realize they cannot spend excessively today without sacrificing future well-being, increased excessive government spending condemns society to remain on its wasteful path via excessive government borrowing. The deficit must be repaid by future generations, thereby reducing their consumption in order to repay the increased government debt burden. In fact, increased government spending to offset declines in private spending has only further reduced economic growth.

We are sometimes asked why we generally oppose government interventions. While we fully understand the theoretical arguments for how government interventions can improve economic outcomes, we are by nature empirical observers, relying on practical experiences and actual outcomes. We see government policymakers who – contrary to economic models – are no smarter than private decision-makers. Therefore there is no increased understanding of the nature of the problem in the shift from private decision-making to public decision-making. Further, government officials are at least as corrupt and venal as those in the private sector. They are also subject to heavy lobbying by private participants desiring to manipulate the government decision-making process to their own ends, rather than to improve economic well-being. These imperfections are conveniently omitted from the theoretical models that describe how government

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intervention and regulations will improve the economy. This is true of models that describe regulatory interventions, Fed policy, and spending and taxation decisions.

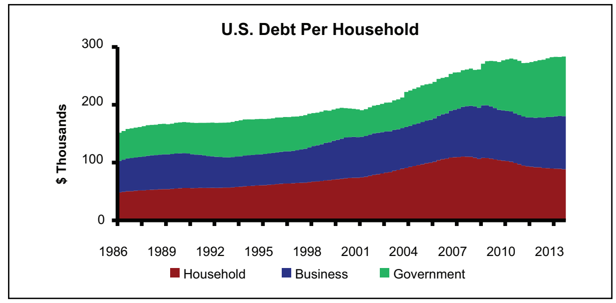
Many policies are implemented by government officials to protect their own interests and expand their fiefdoms. And the implementation of government decisions is done with the remoteness and lack of personal touch that characterizes every large bureaucracy. Government policies and regulations are hardly perfect, nor is their enforcement. In addition, the size of government increases the mischief associated with bad decisions. When we make a mistake, the reverberations are limited by the size of our operation. But if we are in charge of a government agency and make a mistake, it impacts the entire nation. Furthermore, the opportunity for abuse of sovereign powers to punish our enemies is dangerous. This is the reason why despots do so much harm.

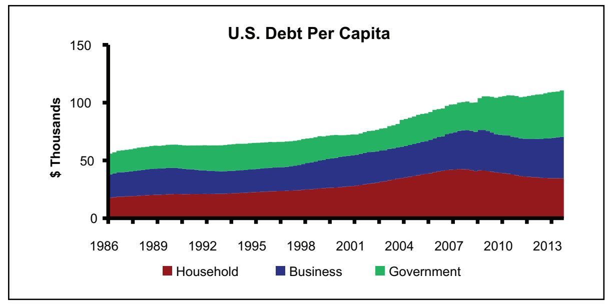
As Hayek noted, millions of private decision makers are a more effective means of gathering and processing the disparate and complex information in the economy. The fact that government searches for the "right" choice, rather than thousands of choices preferred by individuals, is a misguided "one-size-fits-all" approach. Finally, our observation is that even well-intended government policies rarely live up to the hype and are marred by human imperfection.

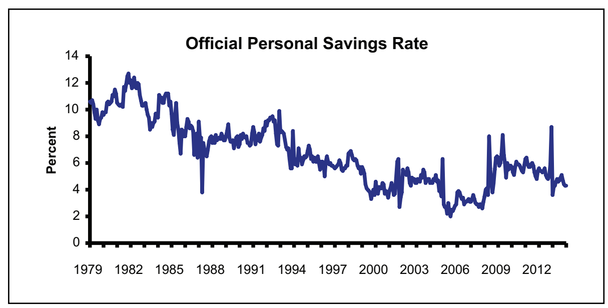
Another problem with this explanation is that most additional federal government spending merely substitutes for reduced state and local government spending, generating little net increase in total government spending. Furthermore, as consumers realize that they face increased future tax liabilities, they further increase their savings. Given the low U.S. savings rate today, it is hardly a compelling argument that the current source of our economic malaise is excessive private sector saving.

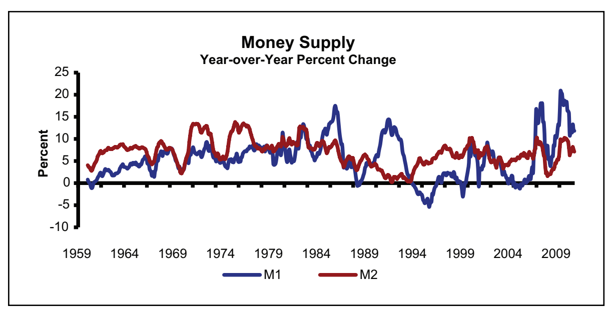
A related rationale is that slow economic growth is the result of a lack of liquidity. This is a view embraced by the Fed, leading them to effectively lower the short-term rate to zero and inject massive liquidity into money center banks. A temporary liquidity squeeze may be a plausible explanation for the economic slowdown in late 2008 and very early 2009, when confidence in the financial system was near zero and bank runs seemed possible. However, it is highly unlikely that illiquidity is still the source of today's sluggish growth, after a five-fold increase in the monetary base and five years of negative real interest rates.

Almost all of this liquidity created by the Fed was given to 12 money center banks rather than to "the banking system." As a result, the Fed's efforts to reduce the risk of "too big to fail" have produced a U.S. banking system that is more concentrated than at any time in history. These money center banks have approximately $4 trillion









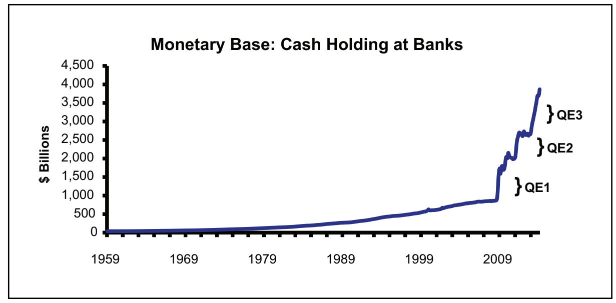
more in deposits and $2.6 trillion more in reserves than they did six years ago; yet their outstanding loans to the private sector are largely unchanged.

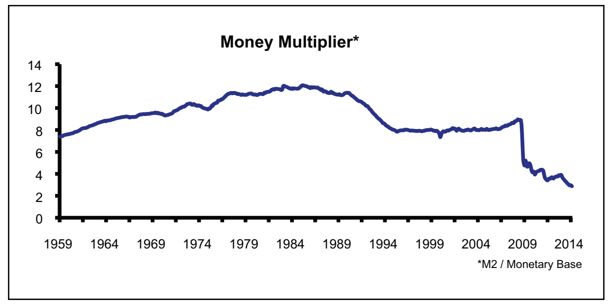
Over the past year, total U.S. bank credit is up by just 1.9% ($90 billion), bank holdings of U.S. government securities have fallen by $100 billion, commercial and industrial loans have risen by 8% ($120 billion), consumer loans are up by 3% ($34 billion), and commercial real estate loans are up by 3.7% ($53 billion). Thus, private lending is up by just $207 billion as a result of the nearly $1 trillion that was injected by the Fed: a 0.2x money multiplier versus a statutory multiple well in excess of 7x. This lending activity to the private sector is basically the same as the growth in (nominal) GDP, meaning that despite more than $1 trillion (30%) in additional liquidity, private lending by banks relative to the economy is unchanged. Most of the injections by the Fed have gone into excess reserves held at the Fed, which bestow a $6 billion annual gift to the profits of these banks for doing nothing.

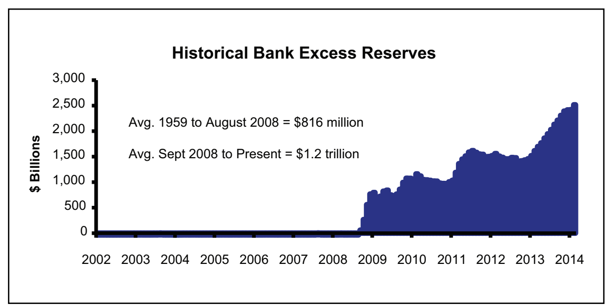
Banks today are no longer serving their role of creating “local credit,” as massive money center banks are incapable of small-scale local lending. Although the Fed has provided stunning amounts of money to lend, it is paying the money center banks handsomely not to lend. Further, the Fed punishes banks if they suffer a loan loss, pillories them if they foreclose, and subjects them to stress tests that can most easily be satisfied by not lending. In short, banks no longer serve the purpose for which they were chartered.

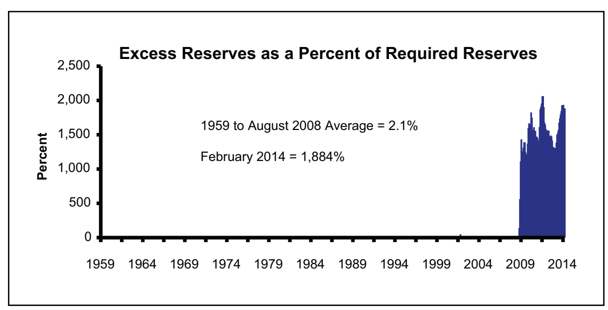
Wild manipulation of the capital markets to deal with a supposedly temporary liquidity problem has reduced economic efficiency and resulted in seemingly permanent capital market distortions. Thus while the Fed’s zero interest rate policy over the last five years saved the federal government more than a trillion dollars in interest payments, non-financial corporations an additional $350 billion, and banks approximately $250 billion, it has deprived insurance companies and pension funds of roughly $250 billion in interest income, households some $400 billion, and the rest of the world about $600 billion. That is, every dollar saved by one party due to artificially low interest rates has cost someone else an equal amount of income. Artificial interest rate policies redistribute income rather than stimulate the economy, and do so at the cost of considerable capital market distortion. This artificial interest rate environment has greatly increased economic uncertainty about what happens when the distortions end. And uncertainty dampens entrepreneurial risk-taking and economic growth.

A third explanation of sluggish economic growth is attributable to a Keynesian disciple, Albert Hanson, who argued that secular stagnation of economic productivity causes firms to reduce investment,

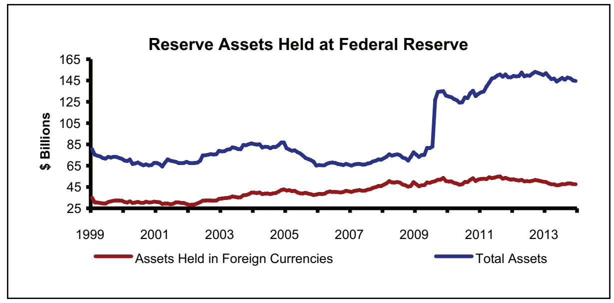


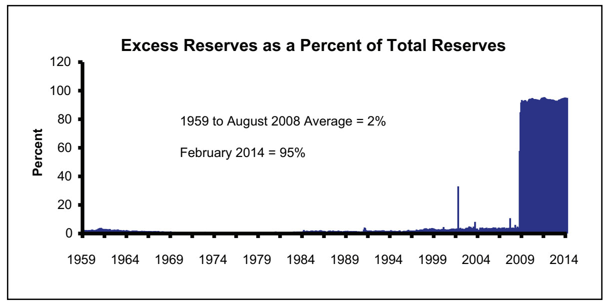






causing lower growth. Proponents of secular stagnation suggest that the government solve this growth shortfall by increased spending to offset reduced private investment activity. But why should the government seek to offset rational reductions in investment? The government does not possess divine wisdom about how much to invest, much less where to invest. Instead, increased government spending will be inefficient and political, creating a further drag on economic growth. And as is the case with all Keynesian government spending proposals, this deficit spending leaves future generations burdened and encourages the current generation to further reduce its spending, to offset concern about future tax liabilities. As Milton Friedman so pithily stated years ago about Keynesian spending rationales, "If you substituted the words 'An All-Knowing Omnipotent Being' for the word 'Government,' their meaning would be unchanged." He of course added that "there is no such thing as a free lunch."





Our (minority) view of our slow economic growth to date is that it is the result of the extreme uncertainty created by the frenzied activities of an abnormally activist and decidedly non-omnipotent (and highly political) government in the face of a cyclical decline somewhat larger than normal (but no more severe than that of 1980-1982). That is, slow economic growth has resulted not from some set of elegant macroeconomic equations, but rather as the direct outgrowth of very microeconomic decisions by households and business risk-takers in the face of outsized uncertainty and ever-changing rules. Note that this microeconomic approach to economic growth is at odds with traditional macroeconomics. But then traditional macroeconomics remains wildly removed from the real world, in which economic growth results from the risk-taking of millions of individuals, not grand macro policy actions. The best policies for growth are predictable (as opposed to serially interventionist) rules of the game. Until this occurs, growth will remain muted.