Back to the Future?

Things are looking grim indeed for the US economy. Unemployment is out of control—especially if you consider the U-6 (16.7%, up 0.2% in the last month) and Shadowstats (22%, up 0.3%) measures, which are far more realistic than the effectively public relations U-3 number that passes for the "official" unemployment rate (9.6%, up 0.1%).

The US is in a Depression, and the sooner it acknowledges that—rather than continuing to pretend otherwise—the better. Government action has attenuated the rate of decline, but not reversed it: a huge fiscal and monetary stimulus has put the economy in limbo rather than restarting growth, and the Fed's conventional monetary policy arsenal is all but depleted.

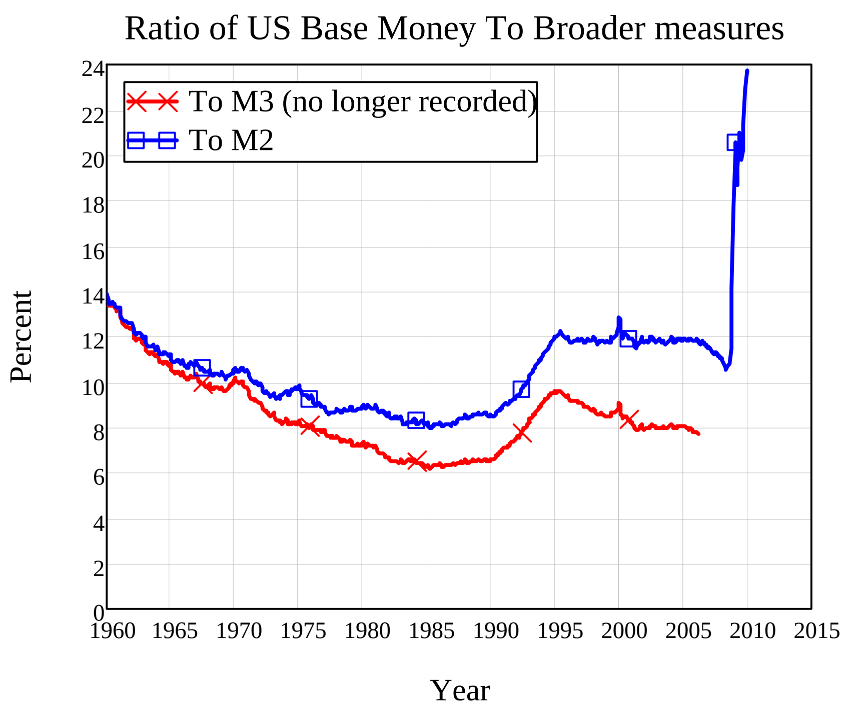
This prompted MIT professor of economics Ricardo Cabellero to suggest a more radical approach to monetary easing, in a piece re-published last Wednesday in Business Spectator (reproduced from Vox). Conventional "Quantitative Easing" involves the Treasury selling bonds to the Fed, and then using the money to fund expenditure—so public debt increases, and it has to be serviced. We thus swap a private debt problem for a public one, and the boost to spending is reversed when the bonds are subsequently retired. Instead, Caballero proposes

> a fiscal expansion (e.g. a temporary and large cut of sales taxes) that does not raise public debt in equal amount. This can be done with a "helicopter drop" targeted at the Treasury. That is, a monetary gift from the Fed to the Treasury. (Ricardo Caballero)

The government would thus spend without adding to debt, with the objective of causing inflation by having "more dollars chasing goods and services". This is preferable to the deflationary trap that has afflicted Japan for two decades, and now is increasingly likely in the US. So on the face of it, Cabellero's plan appears sound: inflation will reduce the real value of financial assets, shift wealth from older to younger generations, and stimulate both supply and demand by making it more attractive to spend and invest than to leave dollars languishing, and losing real value, in the bank.

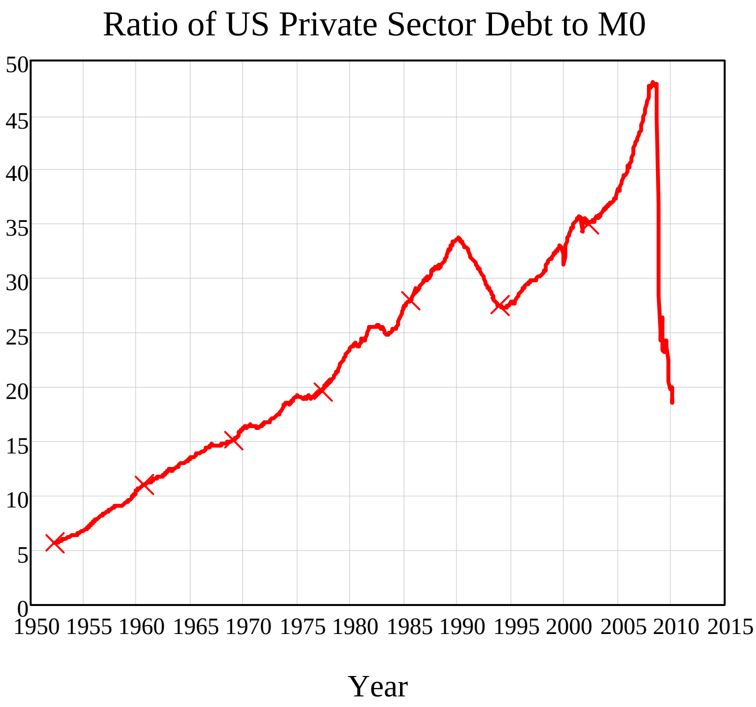
However, though this is indeed the right time to consider radical solutions, Cabellero's proposal would do only half the required job. Focusing on the good bit, one reason we got into this predicament in the first place was because private sector, debt-based money swamped public sector, fiat money. Ultimately we need to return to the public-private money balance we had in the 1950s and early 1960s.

But if getting "Back to the Future" was all we needed to do, then our problems would already be over, because Ben's Helicopter Drop of late 2008 has got us there already: the ratio of M0 to M2 is now almost 0.25, far higher than the 1960 level of 0.14, while the ratio to M3 is back where it was then (using Shadowstats data, which I can't publish here since it's proprietary).



So why aren't we "Back To The Future" already? Why isn't the economy booming once more, and why is inflation giving way to deflation?

Because, though the money supply is back to where it was in 1960, the debt to money ratio is utterly different. Even after Ben's Helicopter Drop, the debt to base money ratio is almost twice what it was in 1960, and over 3 times what it was back in the Golden Days of the 1950s.

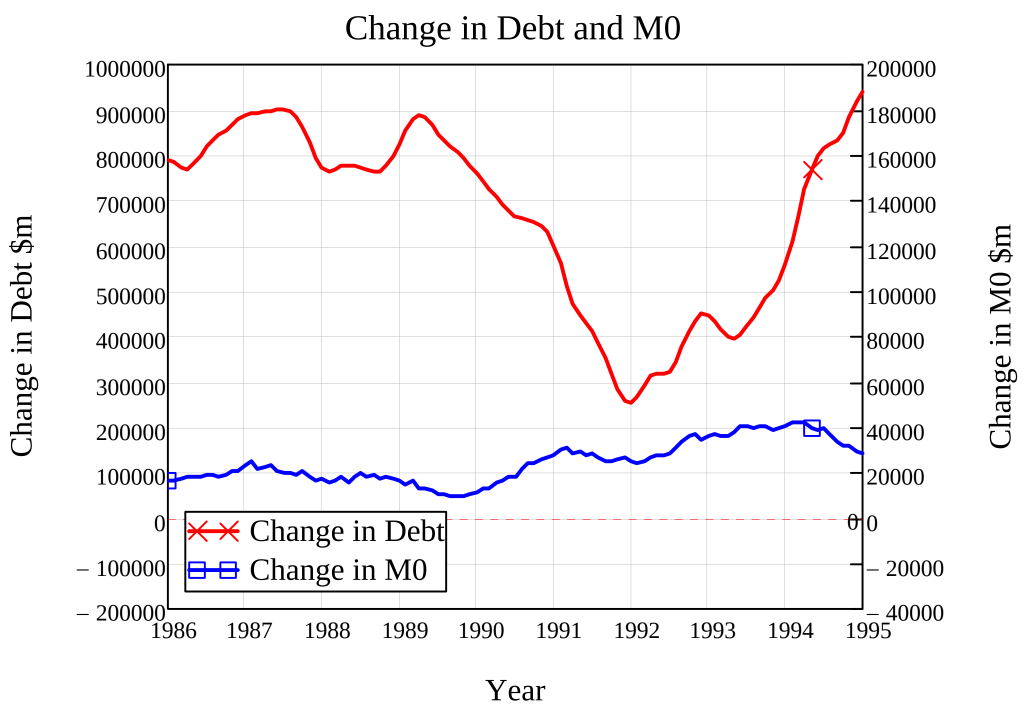


This points out the blind spot in the thinking of even progressive Neoclassicals like Cabellero, who are willing to consider unconventional policies: they don't understand how money is created in our credit-driven economy. Because of that, they don't appreciate how much of that credit has financed a glorified Ponzi Scheme rather than investment, nor do they comprehend the impact that private sector deleveraging is having on aggregate demand.

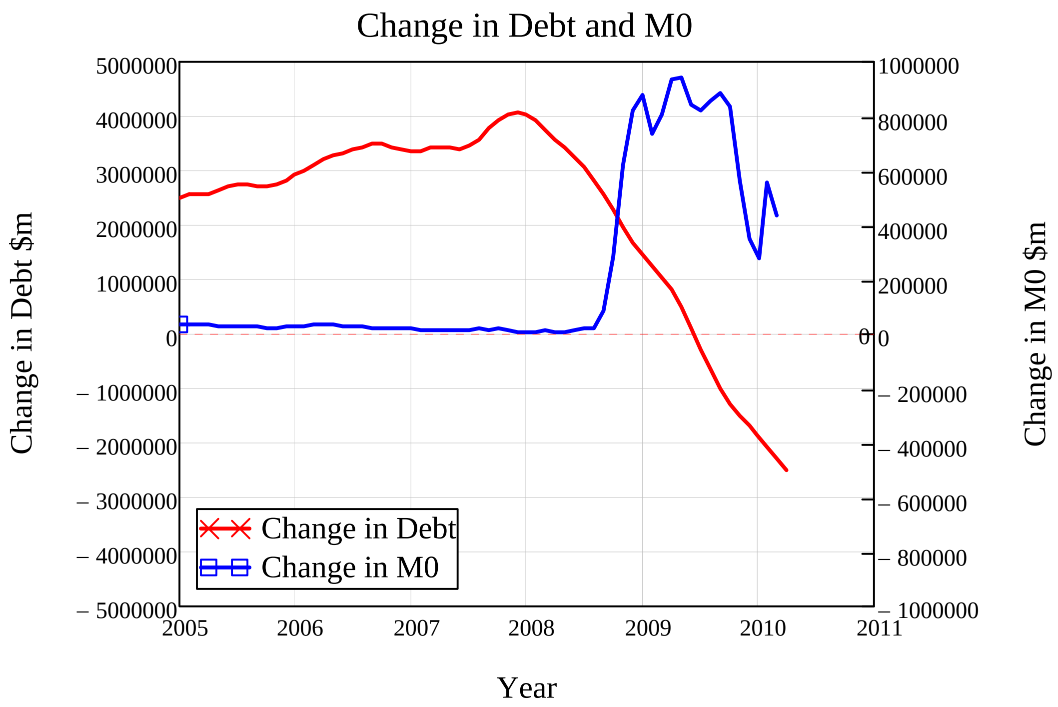
I've covered the first topic ad nauseam in my post "The Roving Cavaliers of Credit", so I won't repeat myself here. Instead I'll focus on the obvious message from the above chart: if the government simply pumps its money into the system without restraining the financial system from financing speculation on asset markets, the best we can hope for is a repeat of this crisis, on an even larger scale, some years down the track. To see that, all we have to do is look at what happened back in the 1980s.

The Debt to M0 ratio, which had risen sixfold since the 1950s, went into sudden reverse as the economy imploded when the Savings and Loans fiasco ended. The growth of debt collapsed, and the State tried to rescue the financial sector from its follies by fiscal policy and boosting the money supply. That rescue ultimately succeeded when the recession of the 1990s finally ended, but since finance was emboldened rather than reformed, it simply financed two further fiascos: the DotCom madness and then the Subprime scam.

The reason why the 1990s rescue isn't working this time stands out more clearly when you look at the changes in debt and M0 in raw dollar terms (the scale of the change in M0 is 1/5th that for the change in debt in next two graphs). In the 1990s crisis, the rate of growth of private debt slowed by 2/3rds, but it didn't actually fall; and a quadrupling of the rate of growth of M0 (starting half a year after debt growth slowed down) was enough, after several years, to let the Wall Street party resume.



This time, the change in debt has turned solidly negative—having growth at up to $4 trillion p.a., it is now shrinking at over $2 trillion. Ben's far larger quantitative easing (when compared to Alan's back in 1990-94) simply hasn't been enough to fight a private sector that is now seriously deleveraging.



QE2 could nonetheless work, if Cabellero's plan was executed with gusto. But if all we do is effect a monetary rescue, and yet leave the finance sector untouched, then it will reborn once again as an even bigger Ponzi Scheme.

Do we really want to go through all that again?

I'll explain two truly major financial reforms that could prevent another credit and asset bubble in a subsequent piece.