

The Economy Again in Crisis Mode

August 5, 2011

“Debt crisis: stock markets panic” was the first entry to the *Guardian* on line in the aftermath of the Dow’s recent 4 percent rout. Bloomberg News noted that more than \$4.5 trillion has been erased from the value of equities worldwide since July 26th. The *Los Angeles Times* headlined that “Global sell-off intensifies pressure on governments to stave off recession.”

One could be forgiven for coming to the conclusion that it is primarily concern over the US debt “crisis” that lies at the root of this debacle. The economic collapse of Greece and Spain, imposed politically by the European banking system, certainly can be contained without massively deepening the recession. It is rather the agonizing lead up to the Obama administration’s wholesale capitulation to Tea Party demands which solidified the consensus political belief — parroting the IMF — that the market would discipline an errant US economy, with worldwide ramifications, by dumping government debt for any perceived reluctance to impose further austerity. The mainstream punditocracy sees in this massive collapse of stock values additional verification of that contention.

Yet nothing could be further from the truth. If investors feared the ability of the US government to “honor” its debt, it would have dumped Treasuries and fled to the stock market. The price of government paper would have cratered driving up interest rates. Stock market prices would have been launched through the stratosphere as investors sought safer havens for their capital. After all, we have been repeatedly reassured that profits have completely recovered and further expansion simply awaits believable confidence-building measures. The private sector, we have been told, has to have a reasonable expectation that it will not be saddled with massive future debt obligations in the form of taxes, state-induced inflation and higher interest rates due to the “crowding out effects” of government borrowing.

Well, they have been reassured and the world economy is tanking. Government paper is being devoured by investors. Interest rates continue to hover around zero. Yet the *Wall Street Journal* cluelessly concocts a swirl of self-contradictory explanations for this behavior. “Investors are getting pummeled by myriad factors: fears about a potential economic drag from the spending cuts, the risk of a downgrade on the US’s credit rating, signs of contagion in the euro zone spreading to larger economies and disappointing global data over the past several sessions.” One can only wonder how the risk of a degraded credit rating can be squared with the rush to Treasuries. How is the risk of euro zone contagion squared with the potential drag from spending cuts that the austerity mongers have imposed on their own constituent economies?

Capitalism is in the throes of massive deleveraging. The rate of return on assets in the American economy has dropped continuously by 75% since the mid 1960s despite ongoing increases in labor productivity. Without deleveraging — writing off capital values and rebalancing asset sheets — acceptable levels of profitability cannot be restored. The current expansion has been the weakest on record since World War II and the trend, in the words of economist Eric Tymoigne, “shows that each economic expansion since the 1980s has been weaker and weaker and the rate of decline has accelerated.” The private sector is not looking to expand until it squeezes out its excess capital, and the banks will have slim pickings in their search to find credit-worthy businesses until that is completed. The Fed’s response of Quantitative Easing — of a forced swap of treasuries for cash — did not reverse this process. It simply fed speculative stock market and commodities bubbles, with the fictitious profits associated with this trend now deflating. Yet this is the only tool left, since Obama has agreed to box the economy into a corner. And it is no tool at all.

It is an elementary accounting identity that when the private sector deleverages, the public sector must offset this contraction in spending if the economy as a whole is to expand. The Tea Party has repeatedly argued that private households are desperately trying to get their economic affairs under control and restore their savings. True enough. The great irony is, however, that without a massive expansion of the public sector, either through taxing and spending the idle balances of the wealthy or through additional accruals of deficits, this restoration of savings is all but impossible. This means that if the interests of the unemployed and dispossessed are not attended to by a massive program of public spending, the particular concerns of Tea Party adherents will also go unrealized. There is no way to disconnect the two as the Tea Party and the rest of us will now soon learn.