Good-Bye Recession, Hello Slump

The U.S. recession officially ended in June 2009. With that, a normal post-recession boom failed to materialize. Instead, an unwelcomed slump ensued. Since the recession bowed out, the average annual GDP growth rate has been a paltry 1.6% – well below the long-run trend growth rate of 3.1%.

The economic policy prescriptions of the Obama administration – contrary to the President's oft-repeated assertions – have failed to mitigate the damage from the Panic of 2008-09. Rather, they have kept the patient in sick bay.

The first misguided advice was peddled by the fiscalists (Keynesians) who dominate the Washington, D.C. stage. According to them, increased government spending, accompanied by fiscal deficits, stimulates the economy. That dogma doesn't withstand factual verification.

Nothing contradicts the fiscalists' dogma more conclusively than former President Clinton's massive fiscal squeeze. When President Clinton took office in 1993, government expenditures were 22.1% of GDP, and when he departed in 2000, the federal government's share of the economy had been squeezed to a low of 18.2% (see the accompanying chart and table). And that's not all. During the final three years of the former President's second term, the federal government was generating fiscal surpluses. President Clinton was even confident enough to boldly claim in his January 1996 State of the Union address that "the era of big government is over."

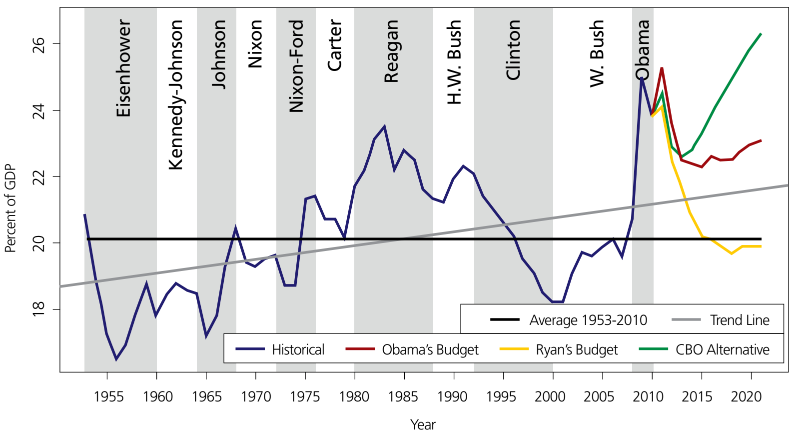
President Clinton's squeeze didn't throw the economy into a slump, as Keynesianism would imply. No. President Clinton's Victorian fiscal virtues generated a significant confidence shock, and the economy boomed.

As for President Clinton's proclamation about the era of big government being over, he obviously hadn't anticipated the uncontrolled government spending that would accompany former President George W. Bush's eight years in office and the truly shocking two-year's worth of government spending on President Obama's watch. All told, the George W. Bush and Obama administrations have added a whopping 5.6 percentage points to government spending as a proportion of GDP. The current federal government outlays are at 23.8% (see the accompanying chart and table). This is significantly above the average of 20.1%.

The U.S. economy remains in sick bay

The surge in government spending – coupled with President Obama's anti-market, anti-business and anti-bank rhetoric – does not inspire con-

Federal Expenditures as a Percent of GDP



Sources: Congressional Budget Office, Office of Management and Budget, House Budget Committee, National Commission on Fiscal Responsibility and Reform and Author's Calculations.

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by Steve Hanke

fidence. In consequence, the current U.S. fiscal stance has fueled a slump.

That said, it is important to stress what the fiscalists refuse to acknowledge: money dominates. When fiscal and monetary policies move in opposite directions, the direction taken by monetary policy will dictate the economy's course. During the Clinton era, fiscal policy was tight (confidence was "high") and monetary policy was accommodative. The economy boomed. Since the Panic of 2008-09, fiscal policy has been ultra expansionary, while the growth in the money supply has fallen from a peak annual growth rate of over 15% to an annual rate of contraction of over 5% (see the accompanying chart). No surprise that the economy suffered a serious recession and then became mired in a slump. With the current anemic money supply growth rate, it looks like the slumping economy – something I first warned about in my August 2010 column "Money Dominates" – will, unfortunately, be with us for the foreseeable future.

What makes that gloomy prognosis more likely is the prospect for continued muted growth in the broad measure of the money supply, M3. To understand this, we must understand the implications of the so-called Basel III capital-asset standards for banks, which are set by the Bank for International Settlements in Basel, Switzerland – a bank that counts the U.S. and twenty-six other countries as members.

Basel III, among other things, will require banks in member countries to hold more capital against their assets than under the prevailing Basel II regime. While the higher capital-asset ratios that are required by Basel III are intended to strengthen banks (and economies), these higher ratios destroy money. In consequence, higher bank capital-asset ratios contain an impulse – one of weakness, not strength.

To demonstrate this, we only have to rely on a tried and true accounting identity: assets must equal liabilities. For a bank, its assets (cash, loans and securities) must equal its liabilities (capital, bonds and liabilities which the bank owes to its shareholders and customers). In most countries, the bulk of a bank's liabilities (roughly 90%) are deposits. Since deposits can be used to make payments, they are "money."

U.S. Federal Government Expenditures as a Percent of GDP

Rank	Administration	Percentage Point Change
1	Clinton	-3.9%
2	Eisenhower	-1.6%
3	Nixon	-0.9%
4	Reagan	-0.4%
5	Carter	0.3%
6	Kennedy-Johnson	0.7%
7	H.W. Bush	0.8%
8	Nixon-Ford	1.8%
9	Johnson	2.0%
10	W. Bush	2.5%
11	Obama	3.1%

Note: The rankings are from 1 (best) to 11 (worst).

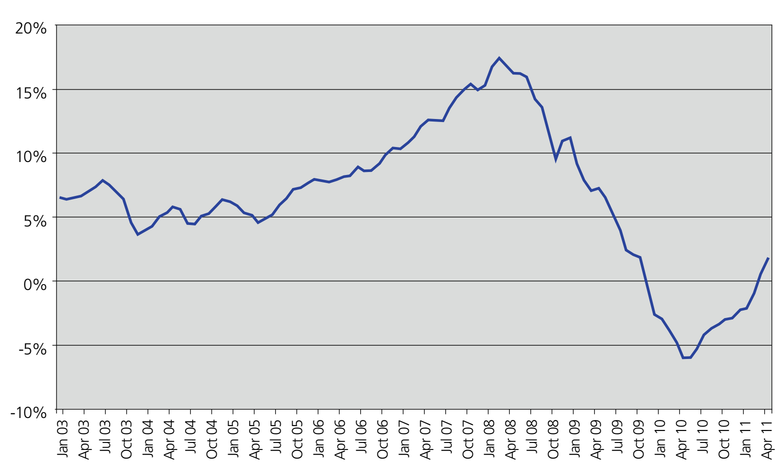
Sources: Congressional Budget Office, Office of Management and Budget, House Budget Committee, National Commission on Fiscal Responsibility and Reform and Author's Calculations.

Accordingly, most bank liabilities are money.

Under the Basel III regime, banks will have to increase their capital-asset ratios. They can do this by either boosting capital or shrinking assets. If banks shrink their assets, their deposit liabilities will decline. In consequence, money balances will be destroyed. So, paradoxically, the drive to deleverage banks and to shrink their balance sheets, in the name of making banks safer, destroys money balances. This, in turn, dents company liquidity and asset prices. It also reduces spending relative to where it would have been without higher capital-asset ratios.

The other way to increase a bank's capital-asset ratio is by raising new

U.S. Broad Money (M3)
Annual Growth Rate



Source: Shadow Government Statistics.

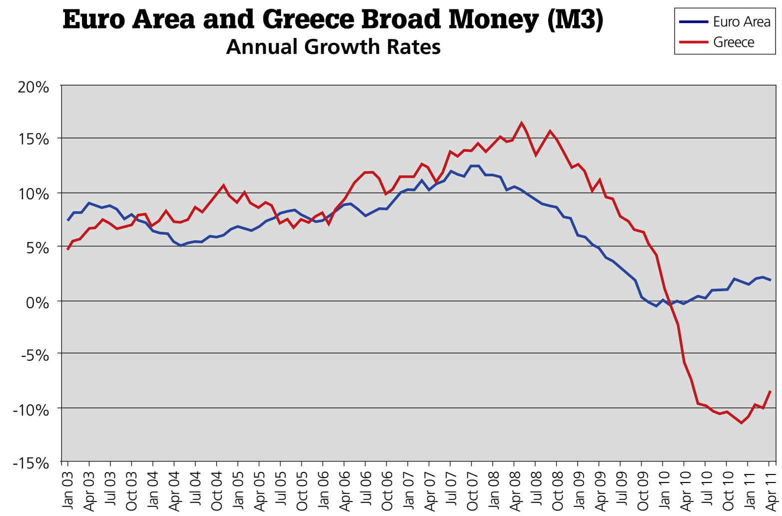
capital. This, too, destroys money. When an investor purchases newly-issued bank equity, the investor exchanges funds from a bank deposit for new shares. This reduces deposit liabilities in the banking system and wipes out money.

As banks ramp up in the anticipation of the introduction of Basel III in January 2013, we observe stagnation in the growth of broad money measures. And if that isn't bad enough, Federal Reserve Governor Daniel Tarullo has suggested that capital-asset ratios for some larger U.S. banks should be mandated to be set at higher levels than those imposed by Basel III. Governor Tarullo's views appear to be widely shared by his colleagues at the Federal Reserve and most who inhabit the environs of Washington, D.C.

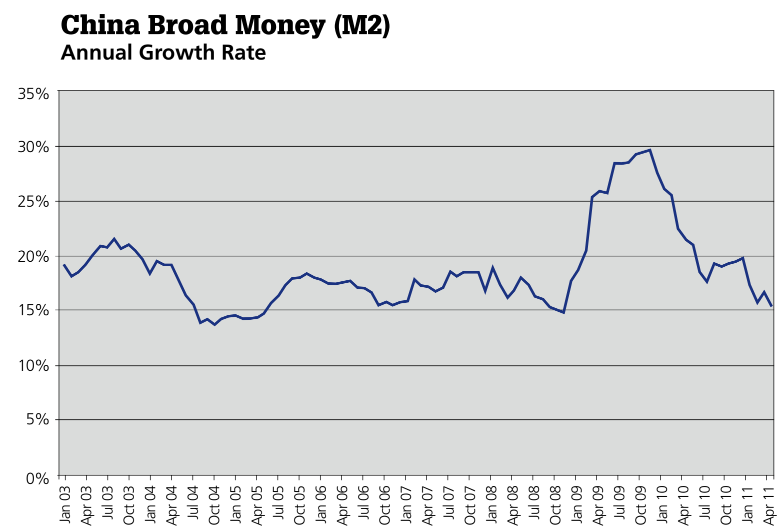
The suggestion of ultra-high capital-asset ratios for some banks will not go down without a fight, however. Indeed, Jamie Dimon, Chairman and CEO of JPMorgan Chase & Co. recently confronted the Chairman of the Federal Reserve Ben S. Bernanke. Dimon argued that excessive bank regulation, including ultra-high capital-asset ratios would put a damper on money supply growth and the U.S. economy. While Dimon might have been arguing JPMorgan's book, he was on the right side of economic principles and Chairman Bernanke was on the wrong side.

Banks in the eurozone come under the purview of Basel III. Like banks in the U.S., eurozone banks are shrinking their risk assets relative to their equity capital, so that they can meet Basel III. Broad money growth for the euro area is barely growing and moving sideways (see the accompanying chart). And Greece, which is at the epicenter of Europe's current crisis, is facing a rapidly shrinking money supply. These money supply numbers will ultimately be the spike that is driven into the heart of the Greek economy and the false hopes of a peaceful resolution of Greece's fiscal woes. Greece will be yet another case in which money dominates.

In China, money matters, too. During the 1995-2005 period, when China fixed the yuan-U.S. dollar exchange rate at 8.28, China's overall inflation rate mirrored that of the U.S. and was relatively "low." Once China caved in to misguided pressure – notably from the U.S., France and international institutions, like the International Monetary Fund – and allowed the yuan-U.S. dollar exchange rate to wobble around,



Sources: European Central Bank and Bank of Greece.



Sources: International Monetary Fund, International Financial Statistics, June 2011 and People's Bank of China.

problems arose. The money supply growth rate surged in the wake of the Panic of 2008-09. And as night follows day, inflation has raised its ugly head in China. The monetary authorities are scrambling to cool down the inflationary pressures by slowing monetary growth – from almost 30% per annum to 15%.

The combination of Basel III (or Basel III, plus) and China's attempt to squeeze inflation out of the economy via tighter money leads to a less than encouraging money supply picture. Good-bye recession, hello slump.

Steve H. Hanke is a Professor of Applied Economics at The Johns Hopkins University in Baltimore and a Senior Fellow at the Cato Institute in Washington, D.C.