A Better Stimulus

By John F. McGowan

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The proposed fiscal stimulus plans are likely to fail due to the outsourcing of manufacturing, research and development, and other vital functions to China and other nations, which substantially undermines the Keynesian multiplier effect. A good fiscal stimulus needs to rebuild the US manufacturing base, research and development capabilities, and other atrophied components of the economy. Here is a better stimulus plan.

Introduction

The US appears on the verge of passing a two-year, roughly $800 billion (about $400 billion per year), fiscal stimulus plan in the wake of growing unemployment figures in January 2009. The justification for these plans is the textbook Keynesian economics. In Keynesian economics, the government should step in during a recession or depression and create demand by buying goods and services, especially goods. This creates a multiplier effect in which businesses hire workers to produce the goods. These workers then buy other goods and services, further stimulating the economy. Keynesian economics was developed during a period when the United States and the United Kingdom (Keynes was British) had substantial domestic manufacturing capabilities. In the present US economy, a large proportion of manufacturing has been outsourced to China and other nations, probably a larger proportion than official statistics indicate. In this environment, the multiplier effect may be substantially reduced or eliminated. For a fiscal stimulus to be effective, it probably must target existing idle manufacturing capacity and rebuild the manufacturing base. The proposed fiscal stimulus plans do not appear to do this.

In addition, Keynesian theory asserts that tax cuts, a significant part of all proposals, will not be effective in the current crisis. In particular, the Keynesian theory would indicate that the United States and the world are experiencing a "liquidity trap" in which businesses and households simply save their money rather than spend if at all possible. Thus, any additional funds from tax cuts would be saved and not spent. Businesses, facing sharply falling demand, will not invest money from tax cuts, the ostensible justification for the business tax cuts promoted by many Republicans and conservatives.

There is already evidence of this double whammy: a liquidity trap combined with a blunted multiplier. Most economists, including for example Mark Zandi of Moody's Economy.com, an adviser to the Obama Administration, predicted that the Bush Administration tax cut and rebate in early 2008 would avoid any recession[1]. Of course, these same economists have revised their models and predictions substantially in the last few months. To be fair, econometric models of all types have consistently proven to have very poor predictive power. Nonetheless, the qualitative experience from the tax cuts in early 2008 supports the theory that tax cuts will be saved, not spent, and will leave the US when spent.

The Federal Reserve under Chairman Bernanke, a monetarist, has pursued the extremely expansionary monetary policy promoted by Milton Friedman and other monetarists to combat the financial crisis. The economy remains in free fall with the federal funds rate at almost 0%. Banks and businesses are cutting back lending and investment despite infusions of trillions of dollars through the Troubled Assets Relief Program (TARP) and the numerous murky Federal Reserve programs created in the last year. This is the textbook Keynesian liquidity trap.

Think It Through

What this means is that any fiscal stimulus should be carefully designed to both stimulate the economy and rebuild the manufacturing base of the country. The US has repeatedly compounded the financial crisis through rash, knee-jerk decisions and public statements. President Bush invoked the specter of the Great Depression in his speech to the nation in a frantic effort to pass the Trouble Assets Relief Program (TARP) over massive public opposition. This was followed by repeated public course corrections by Treasury Secretary Paulson that further undermined public confidence, all in support of an ill-considered policy of rewarding and subsidizing gross incompetence.

Sadly, the Democratic leadership and the Obama Administration are so far engaged in a similar frantic effort to pass a comprehensive two-year fiscal stimulus plan in a few short weeks. This is unnecessary; fortunately, the stimulus plan will take time to implement and can still be changed in the weeks and months to come.

Instead, the government should stop and think through what it is doing for a few months. This should involve discussions with economists such as Dean Baker, Robert Shiller, Nouriel Roubini, and others who anticipated the financial crisis. This does not mean blindly accepting the policy recommendations of any particular expert, but it is silly not to listen to those who warned about the coming crash. The government should consult experts not affiliated with the banking industry and Wall Street. There should be public hearings and investigations into the roots of the crisis to make a more informed decision.

In the short run, the government can expand unemployment insurance, food stamps, and other existing programs to cushion the impact of the crisis. The government can impose a 180 day moratorium on home foreclosures to give it time to consider prudent actions. Instead of a massive bailout of insolvent banks, the government can delay bankruptcy proceedings and perhaps provide limited life support for insolvent banks while an orderly shutdown is planned.

A calm, measured response avoiding panicked comparisons to the Great Depression will help restore public confidence. Despite the many problems that we face, the economy and technological base of the US is much larger on a per capita basis than in 1929. Our standard of living is much higher than in 1929. It will take multiple further bad decisions to create a comparable global catastrophe.

The Perils of TARP

The Troubled Assets Relief Program (TARP) and its irresponsible promotion by politicians and business leaders probably transformed a serious banking crisis into a global economic meltdown. Sadly, the government is continuing TARP, has floated the idea of a "bad bank" that would substantially expand TARP, and is suggesting other expansions of TARP.

TARP and the Federal Reserve's massive covert bailout of incompetent Wall Street firms divert trillions of dollars from productive sectors of the economy to demonstrably incompetent organizations.

To the extent that sound banks have been forced to accept TARP funds, as has been reported in the press, TARP spreads the stigma of incompetence to banks that exercised prudent judgment and further undermines the financial system and the economy.

TARP has caused a national panic and undermined confidence in the financial system, the economy, and the federal government, especially the US Treasury and the Federal Reserve. Please note that I do not equate the major TARP recipients such as Citigroup, Goldman Sachs, Morgan Stanley and others with the financial system. The financial system includes thousands of banks, many of which exercised better judgment than the TARP recipients.

TARP provides funds for the TARP recipients to take over banks and other financial institutions that exercised sound judgment, lay off bank and financial executives who have exercised sound judgment, and otherwise increase the power of people who either do not know what they are doing or are deliberately destroying the US and global economy.

Foreign creditors and potential creditors such as China, if they have any sense, can only be alarmed by the US policy of rewarding gross incompetence represented by TARP and most of the Federal Reserve's programs to date. This can only contribute to a catastrophic crash of the dollar and US bonds in the near future.

TARP has been justified by the claim that removing so called "toxic assets" from the TARP recipients' balance sheets will bring private capital back into these banks from some unidentified source. Banking is a service industry. The problem with the TARP recipients is not just the toxic assets but the toxic asset managers who purchased the assets. So long as these toxic asset managers remain in place no private investor or foreign government *in their right mind* would invest in these banks.

Computers are now so powerful that the substantive financial transactions of the entire US population (300 million), perhaps one trillion transactions per year (10 transactions per day X 365 days X 300 million Americans), can be handled by at most a room full of high end computers costing at most a few million dollars. In fact, in principle, a single laptop with a large hard disk has the computing power, memory, and disk space to handle this volume of financial transactions. DVD video playback, something easily handled today, has similar computational requirements and uses sophisticated mathematics that actually works unlike the dubious financial models used on Wall Street. There are various technical reasons such as handling the peak transaction load that a single laptop probably could not run the financial system; a room full of computers would probably be required in reality. There is no excuse for a "financial system" (the TARP recipients) that costs trillions of dollars of public money to keep operating.

A better fiscal stimulus should leave TARP and similar programs behind. The bad assets need to be written off and the financial system reset. Of course, the Federal Reserve should act as a lender of last resort for solvent banks as originally designed. The FDIC should fulfill its obligations to safeguard ordinary depositors.

A Phased Revaluation of the Yuan

The United States should work with China to revalue the yuan and reduce the excessive price of the dollar in other currencies. A phased revaluation over a two year period of time would give US firms time to locate or recreate domestic manufacturing and would make it easier for China to retool its now vast manufacturing and R&D capabilities for the needs of the China's rural population. China's industry is currently structured to provide consumer and other goods for the affluent US population. The poorer rural population in China will obviously have different, more practical needs (more like the US rural population in the 1920's and 1930's). Where appropriate, the United States could provide technical and marketing expertise to assist in providing goods and services to China's rural population. If China is uncooperative, the United States can take unilateral action by imposing tariffs on Chinese goods and services, phasing these tariffs in over two years to provide an orderly transition for both the US and China (and other nations). However, a revaluation of the yuan is in the interests of both the US and China.

Revaluing the yuan means that dollars spent in the US will stay in the US and create the Keynesian multiplier effect. Revaluing the yuan decouples China's flagging economy from the US. China can then pursue its own stimulus program adapted to Chinese needs independent of the US. Revaluing the yuan can enrich the rural population in China and create a market for Chinese goods and services in China.

Revaluation of the yuan avoids micromanagement of purchasing decisions by government programs and businesses such as arbitrary "Buy American" provisions or politically motivated bailouts of specific manufacturing companies.

A catastrophic unplanned precipitous crash in the dollar would leave China abruptly with little or no market for goods and services optimized for the US. Simultaneously, the US businesses dangerously dependent on China for manufacturing would face a dearth of domestic suppliers and sharply increased prices. An orderly phased revaluation of the yuan would avoid this nightmare scenario for both nations.

Preventing a Negative Bubble in Housing and Other Assets

The US government failed to either prevent or prudently deflate the housing bubble even after it became painfully obvious. This is one of the major roots of the current crisis. After careful deliberation, the government should probably take measures to prevent a negative bubble in housing and other assets. This would probably take the form of a foreclosure mitigation program. The goal should not be to prop up inflated housing prices. Housing prices need to fall to realistic sustainable levels. The goal is to prevent housing prices from continuing to fall below their "real" level due to panic selling and other bandwagon effects. A negative bubble in housing, which would probably spread to other assets, could drag many businesses and households not directly affected by the housing bubble under. While a substantial number of foreclosures are probably unavoidable, mortgages should be modified to enable families to remain in their primary residence without an undeserved windfall.

Research and Development

One of the alleged issues with the current fiscal stimulus plans is the alleged absence of "shovel-ready" construction projects. The federal government has many other ways to increase spending on goods and services immediately. Notably, the US government currently spends around $100 billion on research and development programs such as Department of Defense (DOD) programs, the National Aeronautics and Space Administration (NASA), the Department of Energy (DOE), the National Institutes of Health (NIH), the National Science Foundation (NSF) and many others. Many of these programs involve requests for proposals where investigators propose research projects in a competition. Only one or a few of these proposals are accepted due to budget constraints. Thus, most of these programs have large numbers of unfunded proposals available. The government could provide funds to fund more proposals already submitted. Research and development projects employ not only scientists and engineers but also technicians and many other people. They often employ machine shops and custom manufacturing facilities. This is an excellent way to rebuild both the manufacturing and research and development capacity of the US.

Other Government Programs

The US government has many procurement and acquisitions programs as well as other proposal driven programs with substantial numbers of unfunded proposals. With a few months of careful review, the government can identify these programs and increase funding, especially selecting those programs that boost domestic manufacturing, research and development, and other atrophied components of the economy.

The federal government can spend large amounts of money on goods (or services). For example, the federal government could simply purchase new automobiles and trucks to replace its current fleet of vehicles, selling or giving away the older vehicles. The federal government is mostly offices. The federal government can buy all new office equipment – desks, computers, telephones, chairs, copiers, etc. – by the end of this fiscal year. Many government agencies have significant number of workers in trailers or cheap prefab buildings because major construction of needed office buildings has not previously been approved. Of course, the Department of Defense as conservative economist Martin Feldstein has argued can spend money at an astonishing rate. Who, in fact, seriously doubts that a major government agency could find a way to spend $100 billion or, for that matter $1 trillion, by the end of the fiscal year (October 2009)? That is what federal agencies do – spend money.

Conclusion

The United States can construct a fiscal stimulus plan that is much more likely to produce the desired effects than the current stimulus plans with a few months of careful deliberation. There is still time to reconsider and change direction. The United States should change direction and do so in a calm, measured way after a few months of careful deliberation and public discussion.

About the Author

John F. McGowan, Ph.D. is a software developer, research scientist, and consultant. He works primarily in the area of complex algorithms that embody advanced mathematical and logical concepts, including speech recognition and video compression technologies. He has many years of experience developing software in Visual Basic, C++, and many other programming languages and environments. He has a Ph.D. in Physics from the University of Illinois at Urbana- Champaign and a B.S.in Physics from the California Institute of Technology (Caltech). He can be reached at jmcgowan11@earthlink.net.

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[1] Mark M. Zandi, *Assessing the Macro Economic Impact of Fiscal Stimulus 2008*, Moody's Economy.com, January 2008 (Accessed February 8, 2009)