

The Limits of Fiscal Stimulus in the Current Recession

Version 1.0 Date: November 25, 2008

© John F. McGowan, Ph.D.

President-elect Obama, political leaders, economists, and business leaders are increasingly embracing a Keynesian fiscal stimulus, massive government deficit spending, as a cure for the current recession, citing, for example, the apparent success of World War II spending in pulling the United States out of the Great Depression. Hopefully, such an approach will work in the current crisis. However, some caution and concern is in order.

Traditionally, recessions and indeed depressions have involved large volumes of idled production capacity: factories closed or running at well below full capacity and so forth. This occurred during the Great Depression and has been a feature of most recessions. This means that when the government pursues fiscal stimulus through deficit spending as in World War II the expanded aggregate demand leads immediately to an expansion of real production of goods and services and employment, not inflation.

Over the last fifteen years, the United States has pursued a de facto policy of shipping a very high percentage of manufacturing and increasingly engineering and R&D overseas, especially to China. This means that the United States economy is closely coupled to China in particular. The United States does not have the idled manufacturing base typical of previous recessions and depressions. Instead, much of this manufacturing base is now in China and some other nations.

It is likely that the current financial fiasco will lead China to reevaluate its policy toward the US. China increasingly has the option of revaluing the yuan, the Chinese currency, and devaluing the dollar. In real, tangible terms, this means that China will no longer ship its manufactured goods to the US, but instead to its own people, for example to the restive rural population and also to resource rich nations such as Russia in exchange for raw materials, leaving the US out of the picture. It is also likely that China will retool its manufacturing away from the consumer items popular in the US and toward more practical gadgets useful to a rural farming population. China may also seek to counter US control of the vital Middle Eastern oil by developing energy production facilities within China such as solar arrays in the Gobi desert, hydroelectric facilities, and other power generation facilities.

If China chooses to revalue the yuan and devalue the dollar, this will result in immediate inflation in the US as gadgets and gizmos at Walmart, Target and other retailers suddenly become much more expensive. This also applies to computers, electronics, and many other items. The US will lose a significant fraction of its ability to boost real production through a fiscal stimulus. Thus, the fiscal stimulus may actually contribute to further inflation within the US, instead of the desired increase in real production of goods and services and employment.

So far, the United States has unwisely placed the financial cart in front of the real production horse, bailing out badly run mega-banks like Citigroup instead of dealing with such real economy issues as actual homes and their owners or automobile manufacturing. The several trillion dollar financial manipulations of the US Treasury and the Federal Reserve are almost completely focused on the derivatives securities financial markets. Essentially nothing has been done to rebuild or reconstruct the manufacturing base of the nation. The real possibility exists that the proposed fiscal stimulus will misfire and fail, particularly if (or more likely when) China revalues the yuan.

Since the current low manufacturing base economy is without historical precedent in the US, it is difficult to know what should be done. Certainly, one can hope that the proposed fiscal stimulus will work nonetheless. But, if it does not, economists and policy makers may not know how to proceed. It seems likely that any fiscal stimulus should be focused toward sectors of the economy where there is idled production capacity and toward rebuilding the production capacity where it is lacking.

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.

###