The Panic, Round Two: What Would Reagan Do?

*Giant pools of capital are sitting idle in unproductive deposits or inflation hedges. They could easily fund job growth if real, after-tax prospects improved.*

By DAVID MALPASS

When Ronald Reagan became president, the world had too much inflation, i.e., too much money chasing too few goods. Economists argued for higher taxes to sop up extra demand. Instead, Reagan chose to cut tax rates to encourage more output and pursued a strong-dollar policy. The result was more goods and a better balance between the supply and demand for the dollar. The malaise ended 18 months into his administration, with inflation declining gradually for nearly 20 years.

We now face a different, equally severe problem—too much government spending and debt. It is disrupting job growth and financial markets across the industrialized world. The current policy response is to keep interest rates super-low for big borrowers (saving governments billions at the expense of savers), increase government spending, and then apply large tax increases.

This approach isn't working. It is rapidly reducing the capital in small businesses and holding back hiring. The result is very fast growth in the national debt, the opposite of the desired outcome. The Congressional Budget Office projects that under the Obama budget unveiled in February, spending will increase to $3.6 trillion in 2010 and $5.7 trillion in 2020 from $3 trillion in 2008.

This plan for profligate government spending creates $20 trillion in marketable Treasury debt by 2020, nearly 2.5 times today's $8.4 trillion burden. It would amount to 90% of the nation's annual output. The International Monetary Fund (IMF) estimates for the U.S. debt are even higher—107% of GDP by 2020, based on its less rosy assumptions about debt service as debt levels rise.

All the forecasts are at nosebleed levels by any economic standards, yet they don't count the debt on taxpayers from unfunded benefit programs and Washington's huge money-losing mortgage institutions, Fannie Mae and Freddie Mac. In effect, we're in a debt hole the size of the Grand Canyon yet current economic wisdom is to dig deeper with more "fiscal stimulus." Transfer payments already...
exceed 18% of the nation’s personal income, shifting trillions in income from more productive parts of the economy to less productive.

Adding to the strain on the private sector, Washington is using complex, heavily lobbied backroom processes to pass huge regulatory expansions. The health-care reform bill alone was a whopping 2,700 pages; the nearly finished financial reform bill is expected to top 2,000 pages. Washington may pass hundreds of pages of tax law late this year, claiming a middle-class tax cut. But with the expiration of the Bush tax cuts most Americans will pay as much or more in taxes in 2011 as in 2010. Congress’s rationale for allowing a tax increase during hard economic times is the erroneous belief that U.S. growth and investment aren’t very sensitive to tax rates. The reality is that the private sector takes the hit.

A more effective approach would be to restrain government spending in both the U.S. and Europe in order to attract more private-sector investment. Sadly, most politicians and government officials will undercut that approach, preferring taxes on the rich and value-added taxes rather than reductions in government expenditures.

Instead of tackling the spending problem, most governments are still trying to cover it up. Even if Greece implements its bailout deal with the IMF, taxes and government spending there will rise despite the deep recession. Gross debt will rise to $436 billion in 2015 from $379 billion in 2010. This explains the market's disappointment with the program. The private sector gets to cash in some of its Greek paper, but Greece is left owing ever more to the IMF and other euro-zone governments.

World financial markets react quickly to changes in the growth outlook. This is a two-edged sword. When constructive changes are underway, there’s an immediate reward—higher prices for stocks and bonds mean a lower cost of capital, creating more jobs, profits and tax payments. When growth conditions deteriorate, however, financial markets tend to pile on as we’ve seen in recent weeks. Persistent financial market weakness means a higher cost of capital and less job growth.

The U.S., Japan and Europe need to tap into the constructive side of this momentum-driven feedback loop. There’s a global competition for capital that the U.S. and Europe are losing to Asia and other emerging markets. At present, world financial markets are intensely focused on debt and government spending commitments, yet we keep adding to spending and debt at a rapid clip.

Governments can’t completely solve the spending excesses overnight, but markets would react positively to a process of constructive change. If government leaders in the U.S. or Europe announced meaningful cuts in government spending or even a credible process to reduce the rate of increase—not a commission or a legislative rule, but concrete executive action—markets would celebrate and public applause would encourage more decisive action.

As Asia is showing, the pool of investable capital is practically unlimited for countries on the ascent. Giant pools of capital are sitting idle—corporate and bank cash, chock-full money-market funds, and unproductive inflation hedges like gold and oil exchange-traded funds that could easily fund job growth if real after-tax prospects improved.

With U.S. unemployment at nearly 10% and Washington policies still starving small businesses of capital, the U.S. faces immense challenges to substantive growth. Yet global growth and job creation is a dynamic process in which capital flows to countries and companies that provide a good after-tax return. It’s not a zero-sum game pitting one country or company against another. As Reagan understood, true leadership requires stating goals and taking decisive action, in this case reducing government spending substantially enough to convince the private sector to invest again.

Mr. Malpass, deputy assistant treasury secretary in the Reagan administration, is president of Encima Global LLC and a Republican candidate for U.S. Senate in New York.

5/25/10 8:27 PM

http://online.wsj.com/article/SB10001424052748704113504575264940533857802.html

Page 4 of 4