# Why a Fiscal Stimulus May Fail and What To Do



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## Introduction

President-elect Obama is proposing a $775 billion fiscal stimulus to pull the economy out of the current recession. A fiscal stimulus has been recommended by many economists including several such as Dean Baker and Nouriel Roubini who correctly recognized the housing bubble and anticipated the associated recession. Unfortunately, there is good reason to be concerned that a fiscal stimulus will fail and may even, depending on the details of the stimulus plan, worsen the situation by creating additional inflation rather than employment and economic expansion.

In this paper, I will discuss the textbook Keynesian rationale for a fiscal stimulus. I will argue that the Keynesian theory is based on a manufacturing economy in which the bulk of manufacturing is performed within the nation whether the nation is the United States, the United Kingdom or some other industrial nation. This applied to the United States and to the United Kingdom where Keynes lived during the Great Depression. I will argue that the heavy outsourcing of manufacturing and also engineering, research, and development to China and other nations has created a different economy in which the fiscal stimulus may fail. Finally, I will suggest ways to ensure that the fiscal stimulus succeeds.

## Why a Fiscal Stimulus?

Most economists who are recommending a fiscal stimulus are basing their arguments on the textbook Keynesian theory of the economy and indeed the Great Depression. What is this theory? The first thing to understand about Keynesian economics is that it is demand driven. The customer is king. In general, businesses decide to employ people, invest, expand and so forth in response to demand from customers. The customers have to buy something or try to buy something to cause a business to expand. To be sure, not all businesses act this way, but the Keynesian theory is that most businesses in dollar or number of employees terms act this way. For the most part, the customers call the shots in Keynesian theory. If customers buy, businesses expand. If customers cut back, businesses shrink. The customers determine the overall level of business activity, not the businesses.

What does this mean? What it means is that a recession or depression starts when the customers cut back on purchases for some reason. This can be completely psychological in nature. The customers decide to save more or run out of goods that they want to purchase. It can also be a consequence of a financial crash such as the stock market crash of 1929 or a wealth effect from the housing price collapse now taking place. When the customers cut back on purchases, the businesses cut back and lay off employees. The laid off employees generally cut back on their purchases. Often they have to. This in turn leads to businesses making further cut backs and laying off more employees. A vicious circle can develop. The Keynesian theory is that this is what happened during the Great Depression.

One of the consequences of this is that during a recession or depression factories and other forms of production operate at below their actual capacity, sometimes far below. Businesses don't produce and they don't invest because there is no demand. The customers call the shots. The customers don't buy. The customers are saying: don't invest, don't expand, I won't buy anything. The customer is king.

The textbook Keynesian theory argues that during the Great Depression the United States and other nations tried expansionary monetary policy to lift the nation out of the Great Depression. In simple terms, the central bank, the Federal Reserve in the United States, lends money at very low rates to businesses to stimulate the economy. The textbook Keynesian theory says this attempt failed due to a "liquidity trap".

What is a liquidity trap? The idea is very simple. People, especially potential customers, are so scared that if they get any money they simply save or hoard the money. They do not go out and buy, which induces the businesses to expand production, hire employees, and invest in future capacity, technology, and so forth. Particularly in the Great Depression, people and businesses were so spooked and afraid that they did not actually spend the money made available by the central banks: the Federal Reserve and the Bank of England.

There is actually debate over whether this happened. The late monetarist economist Milton Friedman made a career out of blaming the Great Depression on monetary policy, that is, the central banks.

I'm not going to go into all of this here. I will focus on the textbook Keynesian theory. The Federal Reserve under Chairman Bernanke has been following the so-called monetarist prescription and throwing money principally at banks and financial firms for the last year or so, with no positive results. The current economy is acting like an economy in a textbook liquidity trap.

Again, in Keynesian economics, the customer is king. In general, businesses respond to the demands of the customer. In a liquidity trap, the customers are not buying. The businesses respond by cutting back, laying off employees, idling production capacity, and so, forth. The businesses will not invest money whether from tax cuts or the central bank or whatever in the absence of actual demand from the customers. The whole panoply of conservative and libertarian economic policies – tax cuts, supply side economics, loose monetary policy, and so forth – are expected to fail miserably during a liquidity trap.

In textbook Keynesian economics, the solution is for the government to step in and create demand. There are many ways the government can do this. For example, the government can simply give money to unemployed people who are in dire straits and will spend the money for goods and services because they have to. In the Great Depression, unemployment peaked at around 25%, one quarter, of the US population. Many of these people were in desperate straits. If the government makes money available to the unemployed either through direct handouts or make work programs, this will dramatically boost demand. The customer is king and the customer is buying.

In a liquidity trap, money handed out to the wealthy or to the comfortably employed may have little or no effect on the economy. This is because the money is saved and not spent on anything. Again, the customer is king. Even though money is available to invest, the businesses do not invest because they are afraid.

In textbook Keynesian theory, there is a *multiplier effect* for a fiscal stimulus during a recession or depression. The fiscal stimulus results in more goods and services being purchased. The businesses making the goods and services hire employees to manufacture the goods and provide the services. These new employees, often recently unemployed people who need to buy things, in turn purchase goods and services, leading to more employment and real production. This is likely to occur when there is significant idled capacity. In this case, there can be a large multiplier. For example, one billion dollars in government spending can turn into several billions of dollars in GDP; it is multiplied.

In the textbook Keynesian theory, the Great Depression in the United States was alleviated by the New Deal fiscal stimulus programs during the 1930's but not fixed. It took the massive deficit spending and stimulus of World War II to pull the nation out of the Great Depression. The textbook Keynesian theory is that the New Deal, prior to World War II, did not do enough, did not spend enough money to pull the country out of the Depression.

Economists like Nouriel Roubini and Dean Baker who are arguing for a fiscal stimulus are applying the textbook Keynesian theory that they learned in school to the current economic downturn. That theory says that the federal government should stimulate the economy to create demand. The customer is king. The customer needs to be buying to cause businesses to expand production and employment.

President-elect Barack Obama appears to be following the advice of economists trained in the Keynesian tradition in promoting a fiscal stimulus.

## The Modern Economy is Different

The United States and the United Kingdom in the 1930's when John Maynard Keynes formulated his theory were manufacturing economies in which the bulk of manufacturing took place within the nation. This has become less and less true over the intervening eighty years. In particular, the manufacturing sector in the United States has shrunk as a proportion of the Gross Domestic Product (GDP). It is probably less than fifteen percent, maybe even ten percent now.

For example, the United States Department of Labor Bureau of Labor Statistics (BLS) employment figures for December 2008 list total employment in the United at 143 million. Manufacturing jobs are only 13 million. Only about nine percent of jobs are manufacturing jobs in the United States. It is actually difficult to tell from the United States Department of Commerce Bureau of Economic Analysis (BEA) GDP figure for December 2008 what proportion of the GDP is manufacturing output. The manufacturing output unlike corporate profits (also in the report) is not broken out as a category of the GDP. In the report on corporate profits, the *"corporate profits with inventory valuation and capital consumption adjustments"* for the third quarter of 2008 are listed as $1.51 trillion. The total manufacturing profits for the same period are given as $272.6 billion. That is almost eighteen percent of corporate profits.

One should wonder about these official figures. Our everyday experience is that there is very little manufacturing left in the United States. As a resident of Northern California, the San Francisco Bay Area, I observe almost no significant manufacturing facilities of any kind in this area. There are only a few small food processing related facilities in a vast area around San Francisco. Similarly, when I lived in the New York City area in 2002-2003, it was easy to see that almost all of the manufacturing in the greater New York area had been dismantled or abandoned. For example, there used to be substantial manufacturing in Jersey City which is directly opposite Manhattan. In fact, there used to be substantial specialty manufacturing in Manhattan itself. Again, this manufacturing base appears to have been dismantled or discarded in the last ten or fifteen years. Whatever the official figures show and they are not promising, the actual experience in most parts of the nation is that there is very little manufacturing of goods in the United States. Nearly all goods found in retail establishments, whether these are labor intensive goods or not, appear to be from China and some other nations.

In reality, the United States appears to have a very different economy from the economy of the US or the United Kingdom (Keynes was British) in the 1930's. The Keynesian economic theory of a fiscal stimulus is based in part on the presence of idled production capacity, usually within the nation. Why is this important? Let's say that the government gives money to unemployed or other people who are likely to spend it, or directly purchases goods from businesses. The customer is king. Demand rules. The government needs to create demand. If there are several companies with idled production capacity, they have a choice, they can produce the good at its current price or they can raise prices. If the company raises its price, it faces competitors who do not raise their price and simply produce more because they have idled production capacity. In fact, there should be little or no inflation. The fiscal stimulus creates real increases in production and employment. Arguably, this was the situation in the Great Depression and many post World War II recessions.

The following discussion assumes that in fact the United States has outsourced the vast bulk of its manufacturing to China and some other nations. The situation is probably worse than the official figures indicate. It is important for the discussion to realize that China is manufacturing and exporting to the United States many goods that are not labor intensive, where China does not have a comparative advantage: kitchen utensils, hardware, computer equipment, and so forth. How is China doing this? Many goods from China are low quality, using plastic instead of wood or metal, using thin and flimsy plastic instead of thicker and higher quality plastic, and so forth. This alone probably cannot account for the production of these goods. It is likely that China is heavily subsidizing its manufacturing of capital intensive goods. This requires diverting resources such as energy from the populous rural areas in China. These subsidies probably underly many reports of unrest in rural China. It is likely that these subsidies are not sustainable polices for China.

A fiscal stimulus in the modern US economy will translate into purchases of goods from China (and some other nations). The money will go to China. This may stimulate China and result in some jobs in China. However, the Chinese have nothing to buy from the US. Many of the dollars will end up parked in low or zero return assets such as Treasury Bills in China. The normal multiplier effect in Keynesian theory will not occur. The effect of the fiscal stimulus will be blunted and much weaker than fiscal stimuli during previous recessions.

The situation is even worse if China decides, as I suspect it will, to revalue the yuan against the dollar and decouple its manufacturing economy from the US. Why would China do this? The simple reason is that China increasingly doesn't need to buy anything from the US. It makes much more sense for China to manufacture goods for its own population, primarily in rural areas. There are also good reasons for China to forge closer relations with Russia and purchase oil and other natural resources from Russia.

In this case, a fiscal stimulus may result in Americans attempting to purchase goods from the limited manufacturing base in the United States. In many cases, for many types of goods, the manufacturing base is either non-existent or producing at capacity. It may well be, for example, that all nails are produced in China. If Americans have to purchase nails in the US, the few remaining nail factories will be unable to meet the swelling demand. Consequently, the fiscal stimulus will not merely be blunted but in fact result in heavy inflation and little or no increase in real production and employment.

### What Not To Do

The Keynesian theory is that the Great Depression was, in fact, ended by the massive fiscal stimulus, deficit spending, of World War II. It is not at all inconceivable that pressures will arise in the United States and other nations to go to war as a solution to the economic downturn. In fact, we already see crises developing that may contribute to this: the terrorist attack in Mumbai, the war in the Gaza strip, and so forth. In particular, if China revalues the yuan unilaterally, there could be pressure in the US to invade China to force China to continue to support the US economy through subsidized goods exported to the US. Lest one think this ludicrous, consider the repeated arguments that the war in Iraq would pay for itself and result in much cheaper oil prior to the 2003 invasion. We all know how well that has worked out. Of course, the primary stated reason for invading or "liberating" China would not be economic: fears of Chinese weapons of mass destruction, alleged Chinese complicity in a terrorist attack, human rights violations in China, imposing democracy on China, and so forth.

We – the United States, the entire world – do not need to do this. The weapons that we now have are much more destructive than those used in the Second World War. Many nations have nuclear capability or could easily develop this capability: Russia, China, US, Pakistan, India, Israel, UK, France, Japan, Sweden, several other European nations, and so forth. Many nations have demonstrated the ability to put payloads in orbit, which means they have intercontinental ballistic missiles: US, Russia, Israel, India, China, Japan, and some others. A major war would probably kill anywhere from hundreds of millions of people to the entire human race. The return on investment would almost certainly be extremely negative.

The human race as a whole has very little experience with the use of nuclear weapons in war. They have, as far as we know, only been used twice in war: Hiroshima and Nagasaki. Above ground tests appear to have been almost completely ended or banned for some reason. Fears of radioactive fallout were and are typically cited for the global cessation of nuclear testing. Even underground testing appears rare. Of course, almost everything about nuclear weapons is classified, so it is difficult to know the truth and what governments actually know about these weapons is not certain. Most discussions assume that governments are telling the truth about what these weapons can do, how they work, their origins, and what the governments actually know.

## What To Do

The United States needs to rebuild its manufacturing base as rapidly as possible. Many of the specific elements of the proposed fiscal stimulus plan do not appear to address this: "green" retrofitting of buildings, more money for teachers, infrastructure repairs and expansions, and so forth. These are not necessarily bad, but they do not address the almost non-existent manufacturing base of the United States. For this reason, it is very possible that the fiscal stimulus as currently envisioned will misfire, even backfire.

Probably, the United States should work with China to revalue the yuan against the dollar in an orderly fashion that enables both nations to retool with as little hardship as possible. One way would be a phased revaluation over a two year period. China will need to retool its manufacturing base for the needs of a rural agrarian population which differ from the affluent American population. Similarly the United States needs to switch from service and retail to a stronger manufacturing base. Businesses like WalMart which are large employers will set up domestic factories as the yuan is revalued. Ideally one wants to provide an orderly transition from vanishing retail and service jobs to hopefully better paying manufacturing jobs.

Any fiscal stimulus needs to be focused in some way on businesses where the United States has idle capacity or to fund the construction or expansion of factories in areas where the United States has little or no idled capacity. It is hard to see how to do this other than a program of government loans, grants or other subsidies to specific manufacturing companies – not unlike the bailout of the automobile industry. The government itself could adopt a strong "Buy American" requirement in government acquisitions and government funded programs to encourage the US manufacturing base without favoring specific companies.

The United States can also limit the current downturn by taking measures to prevent a wave of foreclosures and a negative bubble in housing, which will worsen the downturn and may turn it into a true depression. It is important to distinguish preventing a foreclosure from attempting to prop up housing prices. Housing prices remain high in some bubble markets. Housing prices need to drop to long term sustainable levels. The government should not prevent this. However, there is no need to evict people from their homes and flood the market with millions of foreclosed homes to do this. One simply reduces the principal amount of the mortgages, most written during the bubble, to the long term market price. There are several proposals to do this, such as Dean Baker's proposal giving mortgage holders a right to rent their home at current market rental rates. Most Americans, including those with homes who did not get sucked into the bubble, will benefit from this. A flood of foreclosures will lower the value of everyone's house, hurting many people who are not overextended and threatening to expand the housing downturn into a depression.

## About the Author

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