

“Stuff *the Beast*”

BY MICHAEL BOSKIN

Barack Obama's ultimate goal.

It is still too soon to gauge the full economic impact of President Barack Obama's implemented and proposed policies, but a preliminary read indicates limited short-term benefit at large long-term cost. The administration is exploiting a crisis atmosphere to enact a vast agenda that would reengineer the American economy, from autos and financial services to health care, energy, and the distribution of income.

Obama outsourced the details of the \$787 billion fiscal stimulus to Congress and, no surprise, the old barons of the House stuffed it with pork and social engineering. Several months later, only 4–6 percent of the funds have been spent, and the federal government is brow-beating state governments—for example, demanding that California rescind a small pay cut for some unionized workers or lose \$7 billion in stimulus funds. (Intervening in contractual relations ex post to enforce union demands is an emerging characteristic of the administration).

The foreclosure relief plan is off to an even slower start, and is likely to run into numerous problems concerning how to rework delinquent mortgages without inducing a lot more delinquencies.

So score the stimulus a very expensive, largely wasted opportunity. Instead, Obama could, for example, have suspended the payroll tax for a year, getting money directly into people's pockets quickly and decreasing the need for firms to lay off workers.

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Obama's long-run budget calls for much higher spending, higher taxes, and an explosion of debt that will crowd out borrowing in capital markets by private companies, state and local governments, and developing countries. Obama would add \$6.5 trillion to the United States' national debt, more than all previous presidents, from George Washington to George W. Bush, combined.

That is in addition to explicit tax hikes on income, capital gains, and dividends, the implicit ones on energy via cap-and-trade, and so forth. It appears that the Obama strategy is to "stuff the beast" (the mirror image of the tax-cutting "starve the beast" philosophy attributed to some of President Ronald Reagan's advisers),

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that is, to initiate massive spending and hide the true cost from citizens. The large deficits will eventually force much higher taxes, such as a national value-added tax similar to those in Europe, or gigantic increases in everyone's income taxes.

The Federal Reserve lowered its target federal funds rate to zero before Obama was inaugurated, and initiated many programs to try to revive credit markets, with mixed results (the commercial paper facility has helped, whereas others seem to have gotten off to less sanguine starts). The Fed's independence is a key component of its anti-inflation credibility, and a key test for Obama will be to support the Fed's efforts to withdraw the liquidity before substantial inflation pressures assert themselves several years from now.

The Obama administration also seems to be heading toward regulating derivatives and financial institutions deemed too big to fail. America does need a clearinghouse for derivatives, and a much higher percentage of derivative trading should take place on exchanges, rather than bilaterally over the counter. Any institution that is or could quickly become too big to

fail needs to have adequate capital (rising with size), and real-time continuous monitoring of risk, but these measures should be implemented without overbearing micromanagement.

Unfortunately, the Obama administration's decision to put the unions ahead of secured debt-holders in the orchestrated Chrysler bankruptcy risks rupturing the basic fabric of credit markets. But Treasury Secretary Timothy Geithner's much-ridiculed bank "stress tests" made sense (although one can argue that sufficiently dire scenarios were not included or that too much was negotiated with the banks, etc.). Determining the size of likely losses is necessary to decide whether banks' retained earnings from profitable ongoing operations and their ability to raise private capital will allow them to work down their toxic assets over time. If not, more draconian solutions will be necessary.

I support Geithner's plan to cooperate with private investors in dealing with the banks' toxic assets, because they make better business decisions than government bureaucrats. But the Fed's low-interest, non-recourse loans to buy up toxic assets have not yet caused a stampede of participants. Will banks be willing to part with the assets at a low enough price to attract private investment? And would doing so force larger write-downs, requiring banks, in turn, to ration credit—and thus harming the economy?

Obama has been better than feared on international trade. He was famously protectionist during the primaries, declaring he would unilaterally rewrite NAFTA. But, while he has continued his softer tone since the election, he has not even bothered to ask for fast-track trade-promotion authority, let alone try to pump new life into the Doha Round of global trade talks.

Obama is getting a large part of his agenda. Unfortunately, the numbers don't add up and he is laying twin time bombs with the explosion of federal government debt and inefficient government micromanagement of the economy. His call for immense deficits even once the economy is back to normal, funds are returned from the financial bailouts, and the United States is out of Iraq—is simply irresponsible.

The American economy will likely return to growth late this year and next, especially with all the monetary and fiscal stimulus (growth would have initially been slower and then much stronger without it), but it will still be an economy on a government lifeline. The big questions left unanswered are how far Obama wants to push the United States toward a European-style social-welfare state, how he intends to pay for it, and how much long-term economic damage will result? ◆