State-Wrecked: The Corruption of Capitalism in America

See 55 minute interview: http://youtu.be/Zi1g_PmtQHA

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The Dow Jones and Standard & Poor's 500 indexes reached record highs on Thursday, having completely erased the losses since the stock market's last peak, in 2007. But instead of cheering, we should be very afraid.

Over the last 13 years, the stock market has twice crashed and touched off a recession: American households lost $5 trillion in the 2000 dot-com bust and more than $7 trillion in the 2007 housing crash. Sooner or later — within a few years, I predict — this latest Wall Street bubble, inflated by an egregious flood of phony money from the Federal Reserve rather than real economic gains, will explode, too.

Since the S.&P. 500 first reached its current level, in March 2000, the mad money printers at the Federal Reserve have expanded their balance sheet six-fold (to $3.2 trillion from $500 billion). Yet during that stretch, economic output has grown by an average of 1.7 percent a year (the slowest since the Civil War); real business investment has crawled forward at only 0.8 percent per year; and the payroll job count has crept up at a negligible 0.1 percent annually. Real median family income growth has dropped 8 percent, and the number of full-time middle class jobs, 6 percent. The real net worth of the "bottom" 90 percent has dropped by one-fourth. The number of food stamp and disability aid recipients has more than doubled, to 59 million, about one in five Americans.

So the Main Street economy is failing while Washington is piling a soaring debt burden on our descendants, unable to rein in either the warfare state or the welfare state or raise the taxes needed to pay the nation's bills. By default, the Fed has resorted to a radical, uncharted spree of money printing. But the flood of liquidity, instead of spurring banks to lend and corporations to spend, has stayed trapped in the canyons of Wall Street, where it is inflating yet another unsustainable bubble.

When it bursts, there will be no new round of bailouts like the ones the banks got in 2008. Instead, America will descend into an era of zero-sum austerity and virulent political conflict, extinguishing even today's feeble remnants of economic growth.

THIS dyspeptic prospect results from the fact that we are now state-wrecked. With only brief interruptions, we've had eight decades of increasingly frenetic fiscal and monetary policy activism intended to counter the cyclical bumps and grinds of the free market and its purported tendency to underproduce jobs and economic output. The toll has been heavy.

As the federal government and its central-bank sidekick, the Fed, have groped for one goal after another — smoothing out the business cycle, minimizing inflation and unemployment at the same time, rolling out a giant social insurance blanket, promoting homeownership, subsidizing medical care, propping up old industries (agriculture, automobiles) and fostering new ones ("clean" energy, biotechnology) and, above all, bailing out Wall Street — they have now succumbed to overload, overreach and outside capture by powerful interests. The modern Keynesian state is broke, paralyzed and mired in empty ritual incantations about stimulating "demand," even as it fosters a mutant crony capitalism that periodically lavishes the top 1 percent with speculative windfalls.

The culprits are bipartisan, though you'd never guess that from the blather that passes for political discourse these days. The state-wreck originated in 1933, when Franklin D. Roosevelt opted for fiat money (currency not fundamentally backed by gold), economic nationalism and capitalist cartels in agriculture and industry.

Under the exigencies of World War II (which did far more to end the Depression than the New Deal did), the state got hugely bloated, but remarkably, the bloat was put into brief remission during a midcentury golden era of sound money and fiscal rectitude with Dwight D. Eisenhower in the White House and William McChesney Martin Jr. at the Fed.

Then came Lyndon B. Johnson's "guns and butter" excesses, which were intensified over one perfidious weekend at Camp David, Md., in 1971, when Richard M. Nixon essentially defaulted on the nation's debt obligations by finally ending the convertibility of gold to the dollar. That one act — arguably a sin graver than Watergate — meant the end of national financial discipline and the start of a four-decade spree during which we have lived high on the hog, running a cumulative $8 trillion current-account deficit. In effect, America underwent an internal leveraged buyout, raising our ratio of total debt (public and private) to economic output to about 3.6 from its historic level of about 1.6. Hence the $30 trillion in excess debt (more than half the total debt, $56 trillion) that hangs over the American economy today.

This explosion of borrowing was the stepchild of the floating-money contraption deposited in the Nixon White House by Milton Friedman, the supposed hero of free-market economics who in fact sowed the seed for a never-ending expansion of the money supply. The Fed, which celebrates its centenary this year, fueled a roaring inflation in goods and commodities during the 1970s that was brought under control only by the iron resolve of Paul A. Volcker, its chairman from 1979 to 1987.

Under his successor, the lapsed hero Alan Greenspan, the Fed dropped Friedman's penurious rules for monetary expansion, keeping interest rates too low for too long and flooding Wall Street with freshly minted cash. What became known as the "Greenspan put" — the implicit assumption that the Fed would step in if asset prices dropped, as they did after the 1987 stock-market crash — was reinforced by the Fed's unforgivable 1998 bailout of the hedge fund Long-Term Capital Management.

That Mr. Greenspan's loose monetary policies didn't set off inflation was only because domestic prices for goods and labor were crushed by the huge flow of imports from the factories of Asia. By offshoring America's tradable-goods sector, the Fed kept the Consumer Price Index contained, but also permitted the excess liquidity to foster a roaring inflation in financial assets. Mr. Greenspan's pandering incited the greatest equity boom in history, with the stock market rising fivefold between the 1987 crash and the 2000 dot-com bust.

Soon Americans stopped saving and consumed everything they earned and all they could borrow. The Asians, burned by their own 1997 financial crisis, were happy to oblige us. They — China and Japan above all — accumulated huge dollar reserves, transforming their central banks into a string of monetary roach motels where sovereign debt goes in but never comes out. We've been living on borrowed time — and spending Asians' borrowed dimes.

This dynamic reinforced the Reaganite shibboleth that "deficits don't matter" and the fact that nearly $5 trillion of the nation's $12 trillion in "publicly held" debt is actually sequestered in the vaults of central banks. The destruction of fiscal rectitude under Ronald Reagan — one reason I resigned as his budget chief in 1985 — was the greatest of his many dramatic acts. It created a template for the Republicans' utter abandonment of the balanced-budget policies of Calvin Coolidge and allowed George W. Bush to dive into the deep end, bankrupting the nation through two misbegotten and unfinanced wars, a giant expansion of Medicare and a tax-cutting spree for the wealthy that turned K Street lobbyists into the de facto office of national tax policy. In effect, the G.O.P. embraced Keynesianism — for the wealthy.

The explosion of the housing market, abetted by phony credit ratings, securitization shenanigans and willful malpractice by mortgage lenders, originators and brokers, has been well documented. Less known is the balance-sheet explosion among the top 10 Wall Street banks during the eight years ending in 2008. Though their tiny sliver of equity capital hardly grew, their dependence on unstable "hot money" soared as the regulatory harness the Glass-Steagall Act had wisely imposed during the Depression was totally dismantled.

Within weeks of the Lehman Brothers bankruptcy in September 2008, Washington, with Wall Street's gun to its head, propped up the remnants of this financial mess in a panic-stricken melee of bailouts and money-printing that is the single most shameful chapter in American financial history.

There was never a remote threat of a Great Depression 2.0 or of a financial nuclear winter, contrary to the dire warnings of Ben S. Bernanke, the Fed chairman since 2006. The Great Fear — manifested by the stock market plunge when the House voted down the TARP bailout before caving and passing it — was purely another Wall Street concoction. Had President Bush and his Goldman Sachs adviser (a k a Treasury Secretary) Henry M. Paulson Jr. stood firm, the crisis would have burned out on its own and meted out to speculators the losses they so richly deserved. The Main Street banking system was never in serious jeopardy, ATMs were not going dark and the money market industry was not imploding.

Instead, the White House, Congress and the Fed, under Mr. Bush and then President Obama, made a series of desperate, reckless maneuvers that were not only unnecessary but ruinous. The auto bailouts, for example, simply shifted jobs around — particularly to the aging, electorally vital Rust Belt — rather than saving them. The "green energy" component of Mr. Obama's stimulus was mainly a nearly $1 billion giveaway to crony capitalists, like the venture capitalist John Doerr and the self-proclaimed outer-space visionary Elon Musk, to make new toys for the affluent.

Less than 5 percent of the $800 billion Obama stimulus went to the truly needy for food stamps, earned-income tax credits and other forms of poverty relief. The preponderant share ended up in money dumps to state and local governments, pork-barrel infrastructure projects, business tax loopholes and indiscriminate middle-class tax cuts. The Democratic Keynesians, as intellectually bankrupt as their Republican counterparts (though less hypocritical), had no solution beyond handing out borrowed money to consumers, hoping they would buy a lawn mower, a flat-screen TV or, at least, dinner at Red Lobster.

But even Mr. Obama's hopelessly glib policies could not match the audacity of the Fed, which dropped interest rates to zero and then digitally printed new money at the astounding rate of $600 million per hour. Fast-money speculators have been "purchasing" giant piles of Treasury debt and mortgage-backed securities, almost entirely by using short-term overnight money borrowed at essentially zero cost, thanks to the Fed. Uncle Ben has lined their pockets.

If and when the Fed — which now promises to get unemployment below 6.5 percent as long as inflation doesn't exceed 2.5 percent — even hints at shrinking its balance sheet, it will elicit a tidal wave of sell orders, because even a modest drop in bond prices would destroy the arbitrageurs' profits. Notwithstanding Mr. Bernanke's assurances about eventually, gradually making a smooth exit, the Fed is domiciled in a monetary prison of its own making.

While the Fed fiddles, Congress burns. Self-titled fiscal hawks like Paul D. Ryan, the chairman of the House Budget Committee, are terrified of telling the truth: that the 10-year deficit is actually $15 trillion to $20 trillion, far larger than the Congressional Budget Office's estimate of $7 trillion. Its latest forecast, which imagines 16.4 million new jobs in the next decade, compared with only 2.5 million in the last 10 years, is only one of the more extreme examples of Washington's delusions.

Even a supposedly "bold" measure — linking the cost-of-living adjustment for Social Security payments to a different kind of inflation index — would save just $200 billion over a decade, amounting to hardly 1 percent of the problem. Mr. Ryan's latest budget shamelessly gives Social Security and Medicare a 10-year pass, notwithstanding that a fair portion of their nearly $19 trillion cost over that decade would go to the affluent elderly. At the same time, his proposal for draconian 30 percent cuts over a decade on the $7 trillion safety net — Medicaid, food stamps and the earned-income tax credit — is another front in the G.O.P.'s war against the 99 percent.

Without any changes, over the next decade or so, the gross federal debt, now nearly $17 trillion, will hurtle toward $30 trillion and soar to 150 percent of gross domestic product from around 105 percent today. Since our constitutional stasis rules out any prospect of a "grand bargain," the nation's fiscal collapse will play out incrementally, like a Greek/Cypriot tragedy, in carefully choreographed crises over debt ceilings, continuing resolutions and temporary budgetary patches.

The future is bleak. The greatest construction boom in recorded history — China's money dump on infrastructure over the last 15 years — is slowing. Brazil, India, Russia, Turkey, South Africa and all the other growing middle-income nations cannot make up for the shortfall in demand. The American machinery of monetary and fiscal stimulus has reached its limits. Japan is sinking into old-age bankruptcy and Europe into welfare-state senescence. The new rulers enthroned in Beijing last year know that after two decades of wild lending, speculation and building, even they will face a day of reckoning, too.

THE state-wreck ahead is a far cry from the "Great Moderation" proclaimed in 2004 by Mr. Bernanke, who predicted that prosperity would be everlasting because the Fed had tamed the business cycle and, as late as March 2007, testified that the impact of the subprime meltdown "seems likely to be contained." Instead of moderation, what's at hand is a Great Deformation, arising from a rogue central bank that has abetted the Wall Street casino, crucified savers on a cross of zero interest rates and fueled a global commodity bubble that erodes Main Street living standards through rising food and energy prices — a form of inflation that the Fed fecklessly disregards in calculating inflation.

These policies have brought America to an end-stage metastasis. The way out would be so radical it can't happen. It would necessitate a sweeping divorce of the state and the market economy. It would require a renunciation of crony capitalism and its first cousin: Keynesian economics in all its forms. The state would need to get out of the business of imperial hubris, economic uplift and social insurance and shift its focus to managing and financing an effective, affordable, means-tested safety net.

All this would require drastic deflation of the realm of politics and the abolition of incumbency itself, because the machinery of the state and the machinery of re-election have become conterminous. Prying them apart would entail sweeping constitutional surgery: amendments to give the president and members of Congress a single six-year term, with no re-election; providing 100 percent public financing for candidates; strictly limiting the duration of campaigns (say, to eight weeks); and prohibiting, for life, lobbying by anyone who has been on a legislative or executive payroll. It would also require overturning Citizens United and mandating that Congress pass a balanced budget, or face an automatic sequester of spending.

It would also require purging the corrosive financialization that has turned the economy into a giant casino since the 1970s. This would mean putting the great Wall Street banks out in the cold to compete as at-risk free enterprises, without access to cheap Fed loans or deposit insurance. Banks would be able to take deposits and make commercial loans, but be banned from trading, underwriting and money management in all its forms.

It would require, finally, benching the Fed's central planners, and restoring the central bank's original mission: to provide liquidity in times of crisis but never to buy government debt or try to micromanage the economy. Getting the Fed out of the financial markets is the only way to put free markets and genuine wealth creation back into capitalism.

That, of course, will never happen because there are trillions of dollars of assets, from Shanghai skyscrapers to Fortune 1000 stocks to the latest housing market "recovery," artificially propped up by the Fed's interest-rate repression. The United States is broke — fiscally, morally, intellectually — and the Fed has incited a global currency war (Japan just signed up, the Brazilians and Chinese are angry, and the German-dominated euro zone is crumbling) that will soon overwhelm it. When the latest bubble pops, there will be nothing to stop the collapse. If this sounds like advice to get out of the markets and hide out in cash, it is.

David A. Stockman is a former Republican congressman from Michigan, President Ronald Reagan's budget director from 1981 to 1985 and the author, most recently, of "The Great Deformation: The Corruption of Capitalism in America."

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One person wrote, "When did Hayek's policies ever work. Well, they worked quite well after Reagan instituted a mild form of them.

In return, I ask, "When did Keynes policies ever work?"

http://newsroom.ucla.edu/portal/ucla/FDR-s-Policies-Prolonged-Depression...

Also, read Amity Shlaes, "The Forgotten Man," and Jim Powell's "How FDR & the New Deal Prolonged the Great Depression."

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Krugman:

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Cranky Old Men

Shorter David Stockman:

We've been doomed, yes doomed, ever since FDR took us off the gold standard and introduced unemployment insurance. What about those 80 years of non-doom? Just a series of lucky accidents. Now we're really doomed. I mean it!

Actually, I was disappointed in Stockman's piece. I thought there would be some kind of real argument, some presentation, however tendentious, of evidence. Instead it's just a series of gee-whiz, context- and model-free numbers embedded in a rant — and not even an interesting rant. It's cranky old man stuff, the kind of thing you get from people who read Investors' Business Daily, listen to Rush Limbaugh, and maybe, if they're unusually teched up, get investment advice from Zero Hedge.

Sad.

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However, note that Dr. Krugman provides no cogent countervailing theory or evidence against to Mr. Stockman's arguments of crony capitalism.