

Current Events



Armageddon Averted—Or Was It?

U.S. ECONOMIC ACTIVITY IS IN A BOTTOMING-OUT PROCESS, with increased auto production offsetting the declines in services. After their worst plunge since the Great Depression, GDP and industrial production are down 4% and 15%, respectively, from their peaks, both probably hitting troughs in the second quarter.

This doesn't mean the damage is light or the outlook rosy. Unemployment topped 14 million—nearly 10% of the labor pool—due to sudden job losses, from which many won't recover. Even assuming that an expansion started on the Fourth of July, when auto plants began reopening, nominal GDP in 2010 will be \$1.2 trillion less than was projected in many 2008 forecasts (\$14.4 trillion, not \$15.6 trillion), a devastating setback equivalent to 60 million \$20,000 cars.

Taking full advantage of the crisis, Washington has increased its already strong control over jobs and the allocation of capital. Employment nationwide is down 4%, yet the Washington, D.C. area has managed to maintain head count throughout the crisis. Housing, mortgages, the accounting system and bank lending decisions all suffered Washington takeovers. The government is now deciding which companies may issue FDIC-guaranteed debt, which chemical to use to destroy clunkers and whose auto dealerships to close. First mortgages normally take strong precedence over second mortgages, but even that key principle of contract law is at risk in Washington's vote-driven haste to modify mortgages and delay foreclosures.

Post-clunker auto demand depends more on Washington's next generation of expensive environmental subsidies than on designs or production costs. Giant corn markets hinge not on rainfall but on whether Brazil and the environmental lobby can get Washington to lower the tariffs blocking ethanol imports.

In one of its most intrusive expansions, Washington has become the nation's allocator of capital, setting detailed capital requirements and accounting rules in ways that channel credit to favored states, industries and uses. Small businesses and consumers are bearing the brunt of this credit market shift.

The alternative has been clear from the beginning: a focused credit market reopening after the Lehman fiasco, based on faster Fed asset purchases and more global capital to offset losses and deleveraging. This would have stopped the credit crunch suffered by small businesses and kept unemployment lower.

A good jobs and investment environment depends on a strong and stable currency, restrained federal spending, less harmful legislation, dependable contract law, limits on taxation and countercyclical capital regulation. These steps need to be sup-

ported by market processes that tend toward lower, not higher, equity and commodity volatility. On most points the Bush Administration went the other way: It spent heavily and encouraged market volatility by free-floating the dollar, repealing the uptick rule and protecting the opaque big-bucks credit-default-swap market. Paradoxically, it imposed pro-cyclical mark-to-market limits on regulatory capital as the bubble built and then deadly capital dilution after it popped. Instead of reversing these mistakes, the Obama Administration has maintained most Bush policies, while adding tax risks and even more spending.

Reversing the Capital Outflow

As a weak recovery takes hold, some will pat themselves on the back for averting Armageddon, even though the actual outcome is worse than almost any 2007 prediction. Instead of flooding our markets with capital, global investors will think of getting as far away from the U.S. and the dollar as possible. Commodities, currencies and foreign debt and equities have been hugely outperforming investments in the U.S. This lowers the cost of new capital abroad, even as we systematically increase our own cost of capital with tax increases, volatility and the erosion of contract law.

The flow of capital away from the U.S. is broad, deep and long-term. Investors can buy 20-year debt denominated in Brazilian reals or Chinese yuan, a monumental shift in the allocation of long-term capital. U.S. companies are shifting operations offshore in order to build and innovate more profitably. Meanwhile, the U.S. government is trapping billions of tech dollars—the lifeblood of innovation—offshore through an excessive repatriation tax. This is blocking much-needed industry consolidation, because an acquirer is forced to pay for the offshore cash without getting access to it.

A costless starting point for breaking the U.S. out of the Bush-Obama malaise would be to stabilize the dollar. In June 2008 Federal Reserve Chairman Ben Bernanke advocated a “strong and stable” dollar, a revolutionary step had it been implemented. Unfortunately, the idea was forcefully shelved during the subsequent G8 meetings.

The rush to buy commodities despite high prices and no yield is a loud speculative bet that Washington will keep pushing the dollar down in an extravagant attempt to save manufacturing jobs in toss-up states. As with the regulatory credit crunch, Washington's weak-dollar policy mistake could be reversed. If this happened, jobs and GDP would recover faster than they will on the current big-government, weak-dollar path. **F**



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