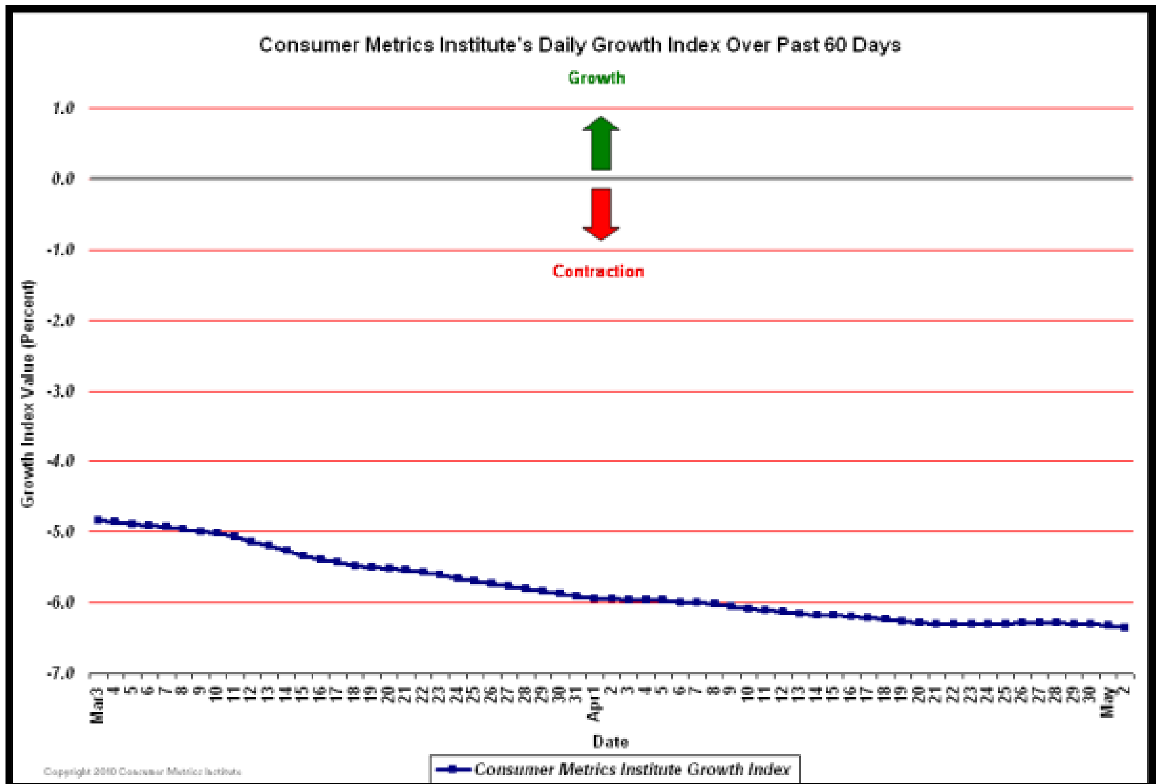
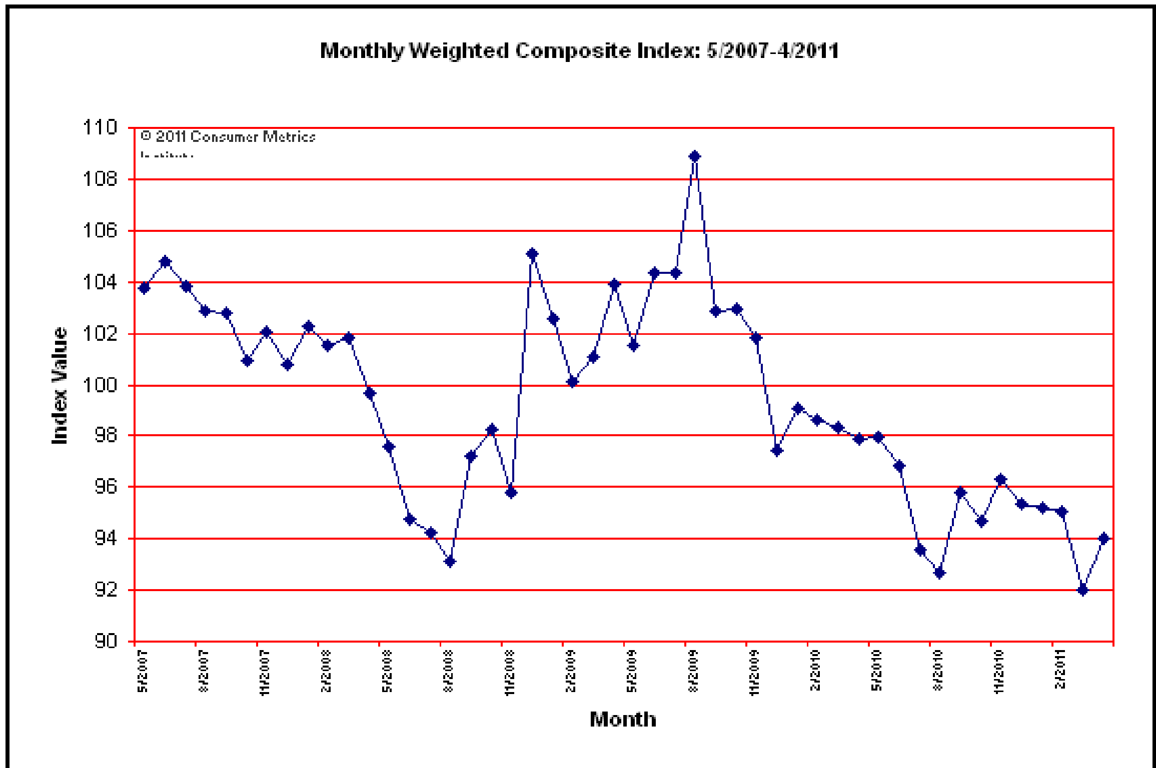
Consumer Metrics Institute Members News

April 29, 2011: Bottoming at New Record Lows, Plus Debt/GDP End-Games via Insurrection

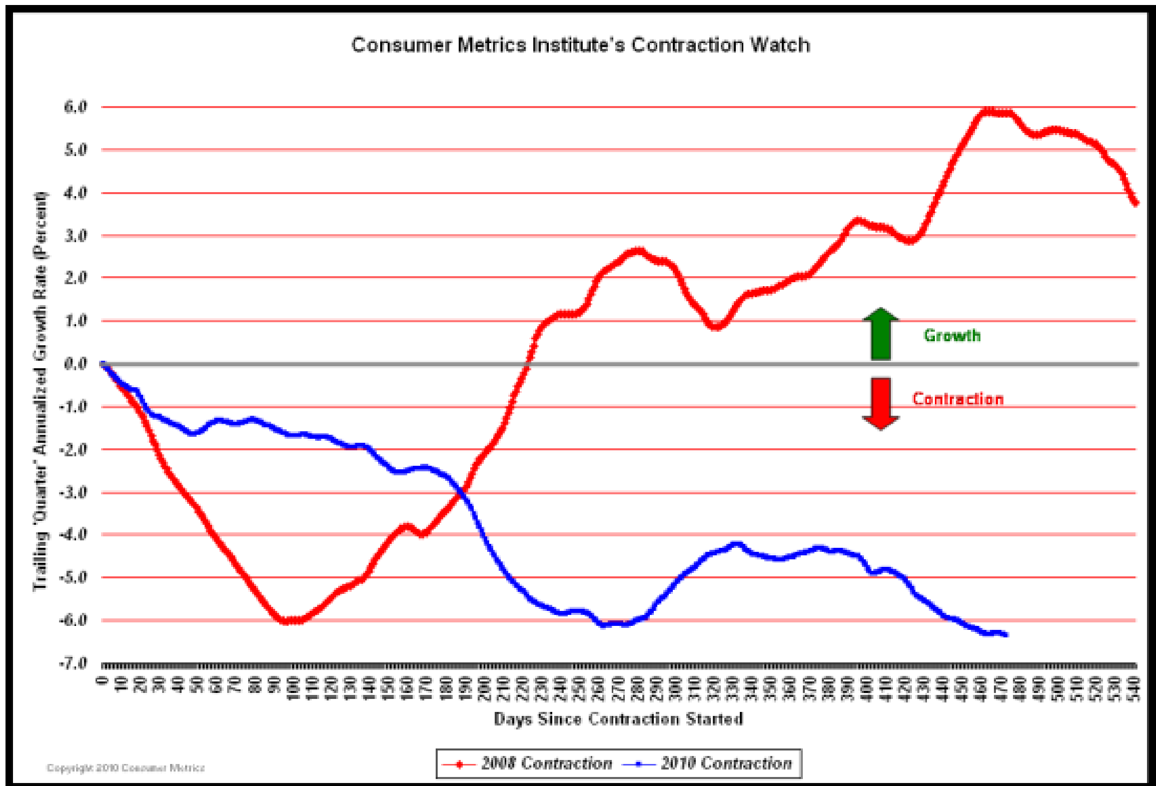
On April 26, 2011 our Daily Growth Index nudged up slightly from its record year-over-year contraction rate of -6.31%, where it had hung for several days:



For the moment this may be a bottom forming movement, but it is equally likely to be just more bottom-bouncing as the consumers we track continue to lack enthusiasm for increased spending. Put into the context of the past 48 months (covering the entire "Great Recession"), the recent weakness in consumer demand clearly surpasses the lowest levels that we monitored in 2008:



As we have mentioned before, our "Contraction Watch" follows the Daily Growth Index and compares it on a day-by-day basis with the same index during the dip created by the "Great Recession" (with the plotting for each event starting on the first day that the Daily Growth Index started to contract). We feel that this single chart is perhaps the best way to visualize what has been happening with the consumers that we monitor, and that chart is still not showing any signs of a sustainable consumer driven "recovery":



With the BEA confirming in their "Advance" estimate of 2011's first quarter GDP that the recovery is at best anemic (and arguably nonexistent when more realistic price "deflaters" are used) we are beginning to believe that we may not be quite as delusional as some people have thought. Sadly, that is a really scary thought.

Fixing the Debt/GDP Ratio via Insurrection

In several recent articles we have explored potential solutions to the sovereign debt excesses in the United States, including some that were mundane, some more imaginative, and others requiring modest regime change. The premise behind the modest regime changes was that without the 2007-2008 financial crisis there wouldn't be a near-unity debt/GDP ratio in the first place, and that by fixing the U.S. financial system through a latter-day Glass-Steagall the economy could recover sufficiently to allow a sweeping deficit reduction plan (e.g. Simpson-Bowles) to ultimately moderate the debt/GDP ratio into something that can be sustained indefinitely.

Unfortunately that scenario is problematic, because it requires both long term political resolve and a patient (and docile) electorate.

At least twice before a less patient American electorate has brought about radical political change -- bringing to power Franklin Roosevelt in 1932 and Andrew Jackson a century earlier. However, despite the similar scales of political upheaval, those two regime changes were triggered by vastly different voter concerns:

-- The 1932 election occurred primarily in a backdrop of economic despair. For the most part the electorate felt that the deflationary depression was a shared experience that had spared no one -- even if the wealthy still managed to put food on their tables. The anger was directed at perceived inaction and ineptitude at a time of economic calamity. That sense of economic despair was so great (and persistent) that by 1941 Roosevelt had to incorporate the freedom from "want" into his core set of Four Freedoms.

-- On the other hand the populist Jacksonian elections were not primarily about economic despair, but instead about *perceived economic oppression*. In fact the pre-Jacksonian economy appears to have been muddling along, but without the general population participating in the upside to any great extent. As a consequence Jackson rode to power on electoral feelings of betrayal at the hands of predatory political and economic institutions (e.g., Nicholas Biddle's Second Bank of the United States).

GENERAL JACKSON SLAYING THE MANY HEADED MONSTER.

If the primary purpose of any government is to protect its citizenry, it could be argued that the "progress" of civilization has consisted of a gradual broadening of the types of protection provided -- perhaps initially only from pillaging foreign armies, before progressively extending the list of predators to feudal warlords, absolute monarchies, entrenched theocracies, corrupted judiciaries and prejudiced majorities. In this sense the concept of predation has been continually evolving towards greater inclusiveness, and at any given time it may be just as hard to precisely characterize as the concept of obscenity that Justice Potter Stewart famously struggled to define:

"... perhaps I could never succeed in intelligibly (defining obscenity). *But I know it when I see it* ..."

The Jacksonian electorate clearly knew predation when they saw it.

The lesson from 1832 is relevant today: well crafted sound bites can tap into a feeling of governmental betrayal and propel a populist political movement into power -- simply because a sense of scorned trust is far more visceral and immediate than any distant concerns about deficits, debt or taxation. There may well be a vast untapped American disquiet over financial predation and failed oversight that a sufficiently charismatic candidate could foment into outrage -- setting the stage for radical sovereign debt end-games that become empowered through political insurgency.

(Franklin Roosevelt's Four Freedoms from January 1941 included both the freedom from fear and the freedom from want. During sharp economic downturns fear and want are probably inseparable among those in greatest need. But for the sake of the arguments below we are assuming that the U.S. economy will continue to muddle through, and that the vast majority of the U.S. electorate will not be suffering the kinds of acute fear and want that formed the backdrop for the 1932 election. Nevertheless, we feel that a strong sense of loss will remain -- and be available for potential political manipulation into a populist insurgency reminiscent of Jackson's 1832 election.)

Given a populist political upheaval that carries with it a mandate to reform the abuses that led to the financial crisis of 2007-2011, several "unthinkable" sovereign debt "end-games" suddenly become plausible:

-- **Simpson-Bowles Express**

There are no debt "end-games" for institutions when the annual expenditures represent nearly twice the annual revenues (according to the U.S. Government Accountability Office (GAO), Fiscal Year 2010 (FY-2010) U.S. government expenditures represented about 30% of GDP (still less than the European average), while revenues ran about 15.5% of GDP -- the lowest federal level among OECD countries).

A Simpson-Bowles scale solution to this imbalance is generally premised on aggressively curbing spending while "promoting economic growth and competitiveness" through tax code reforms that reduce marginal corporate and individual tax rates while simultaneously broadening the taxable base by eliminating many types of deductions that the Simpson-Bowles commission characterized as "back door spending hidden in the tax code." The targeted caps for both revenue and spending are to be balanced at 21% of GDP -- meaning that expenditures as a percentage of GDP would be cut about 33% (relative to FY-2010) while revenues as a percentage of GDP would be raised by about 33% (again relative to FY-2010 -- and despite the much publicized statutory reduction in marginal tax rates).

Looking at the numbers in more detail, Social Security and core Medicare expenses are not *currently* aggravating this problem, since together they run a slight surplus and are about 8% of GDP. Other "mandatory" FY-2010 expenditures (e.g., Medicaid and interest payments) total 7% of GDP, and total "discretionary" spending represents the other 15% of GDP. The beauty in these numbers is that the Social Security and Medicare "third-rails" of instant political death are not

current budgetary problems, and even the standard Simpson-Bowles package proposes that their longer term sustainability can be addressed without draconian measures.

But to reduce spending to 21% of GDP, about 9% of GDP would have had to have been cut from the FY-2010 budget, and presumably it would have had to come from the 22% of GDP that is was not Social Security or Medicare -- cuts totaling a staggering 41% of the "other mandatory" and "discretionary" parts of the budget. Similarly, if total U.S. governmental FY-2010 revenue was to have been 21% of GDP, aggregate taxes would have had to increase 33%.

These kinds of numbers are draconian, and they may be politically difficult even during the initial "slash and burn" stage of a political upheaval. But if we provide a relatively minor 21st century populist re-engineering of the U.S. Constitution, we can make "unthinkable" economic decisions routine, quick and "Pontius Pilate" friendly to dithering politicians**:**

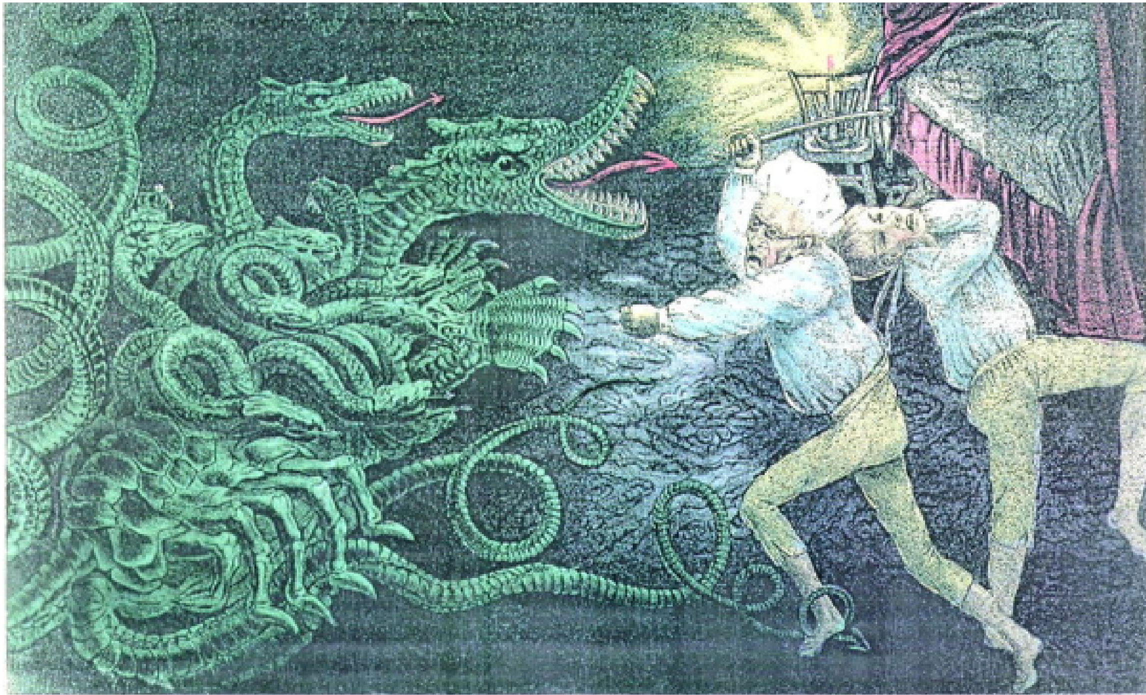
Suppose for a moment that a Balanced Budget Amendment is added to the U.S. Constitution that provides for a couple of unique features**:** any budgetary deficits that can't be funded from previous surpluses would have to be funded from a self-expiring surtax approved via an Estonian style ad hoc on-line referendum. Suppose further that the referendum need not be a simple up/down vote, and that multiple budget balancing proposals could be on the ballot with the winner selected by proportional voting.

(Yes, we understand that not everyone would have on-line access to such proposed ballots, but we also know that public access to the ballots could be provided at historical polling locations. Surely the United States could study the technologies and methodologies utilized in Estonia and mimic those should its own technological wherewithal prove inadequate.)

The political beauty of such an arrangement is that dithering incumbents could remain off the record on truly hard decisions, while a range of possible budgetary choices could be offered to the voting public. Direct participation democracy is the ultimate populism, providing a backup to the standard representational republic model when vested interests or gridlock might otherwise prevail.

-- **Glass Steagall on Steroids**

(In the 1832 election Andrew Jackson rode public outrage at predatory practices within an elitist financial system to a landslide victory. Similar outrage can be found in the popular media today. For the purposes of this discussion we will assume that such an outrage provides the mandate and agenda for the regime change that enables previously "unthinkable" sovereign debt end-games -- even if the debt problem itself is not the primary focus of the populism. Given that outrage, it is inconceivable that a new populist regime would not radically alter the current banking system.)



A hard implementation of a Simpson-Bowles 21%-share of GDP balanced budget would have sucked about 14.5% of GDP out of the FY-2010 U.S. economy through savage Federal spending cuts and enormous tax hikes -- over three times the GDP peak-to-trough contraction experienced in 2007-2009. Again, Simpson-Bowles is premised on capped deficits coupled with economic stimulation -- achieved in the orthodox Simpson-Bowles scenario through tax code reforms. The economic boost provided by a streamlined tax code would hopefully offset the adverse impact of a phased implementation of the spending cuts and revenue hikes, although it is not clear how a 5.5% net increase in total tax revenue can be stimulative -- regardless of how "clean" the new tax code may be.

Given a Jacksonian scale political upheaval, is is possible that economic stimulation could also be achieved through financial system reforms?

If the recent GDP reports are any reliable indication, the current financial system has utterly failed to functionally implement the Federal Reserve's unprecedented attempts to stimulate this economy. Some of that is clearly the result of reduced end-user appetite for expanded credit (a phenomenon that some analysts have labeled "credit revulsion"). But at least some portion of that failure has been the result of monetary flow structural issues, undocumented (and unresolved) impairments and self interest on the part of the largest U.S. banking institutions.

Suppose for a moment that a new populist regime decides to go beyond reinstating Glass-Steagall? What if "Too Big To Fail" becomes regarded as much more than a self-reinforcing moral hazard -- making such institutions a threat to national security as well? What if the entire "financialization" of the U.S. economy is deemed economically unhealthy at best, and a self-enriching tool of privileged and predatory institutions at worst?

The depository institutions under a new Glass Steagall could be regulated in a number of ways to prevent them from becoming "Too Big To Fail." Examples might include withholding FDIC insurance coverage from multi-state banks (or alternately, banks with deposits exceeding a

certain share of total system wide deposits). Similarly, under a counter-intuitive presumption that larger is inherently riskier, depository banks could have their reserve ratio requirements rise as their client deposits grow.

Another sort of Glass-Steagall firewall could also be constructed with investment houses, prohibiting firms transacting on behalf of clients from also trading on their own accounts. The premise here would be that firms trading on behalf of clients shouldn't be able to leverage those trades (or advance knowledge of those trades) for their own benefit.

The safety related purposes of such reforms of the U.S. financial system would be to distribute underwriting risks, minimize moral hazards and reduce predatory practices. And if provided with strong incentives to not hoard Federal Reserve provided reserves, smaller banks would be to provide a more efficient channel between any newly created Federal Reserve credit and the agents of real commerce that need it -- by removing the liquidity leeches from the credit pipeline.

Next: De-Financializing the Economy ...

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