SED On-Demand

Squaring the Circle

– How to Achieve Full Employment *and* Small Government Deficits –

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Today's Problem with the US Economy

- Way-below-par GDP growth—especially given the stimulus of a huge government deficit
- The worst job market "recovery" of the past century
- Likelihood that GDP growth will remain sluggish, as will employment growth

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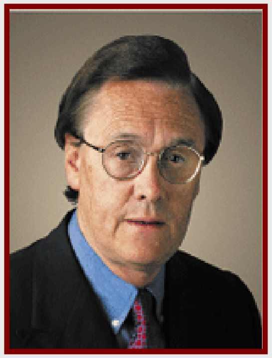

Origins of Today's Problem and Tomorrow's Prospects

- **Lackluster "animal spirits" in the private sector, driving both household and business spending, and private investment**

- **The huge "fiscal drag" required to shrink today's fiscal deficit of 10.7% of GDP back down to a normal and acceptable 3% of GDP**

- **NOTE: The US has never before experienced both of these adverse conditions during a recovery.**

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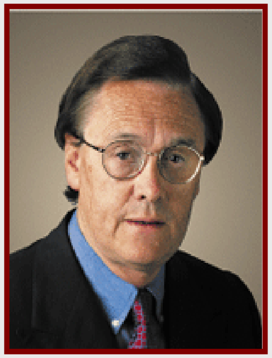

Background of the Origins of Today's Problem

- In our January 2010 report, we demonstrated from first principles (utilizing the flow-of-funds equations of National Income Accounting) exactly why the two developments cited on the previous page logically imply weak growth and job creation—not only now, but for at least six years to come.

- Briefly, recall from this report that

$$\Delta \text{ Government Deficit} = \Delta \text{ Net Private Savings}$$

in a closed economy with no trade. Δ denotes "change in as a % of GDP." (Since there will be little change in the US trade deficit and thus in net foreign capital inflows, we simplify matters by ignoring the trade sector.)

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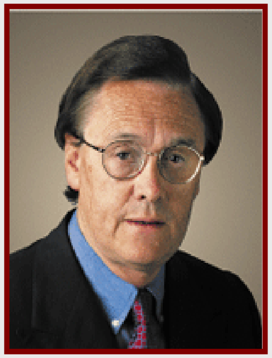

Background (cont'd)

- Since Net Private Savings *equals* National Income minus total Private Expenditures (including residential and business investment) by businesses and households, we can write:

  Δ Government Deficit = Δ[Nat'l Income – Private Expenditures]

- This implies that *IF* the US is determined to shrink its deficit by 8% of GDP, then Net Private Savings *must* shrink a corresponding 8%. This can occur in three ways:

  1. Private Expenditures (including investment) can rise by 8% of GDP more than national income—driven by strongly rekindled "animal spirits." Note that this can occur whether national income itself is rising rapidly or slowly. What matters is the *spread* between National Income and Private Expenditures.

  2. National Income can grow 8% slower than Private Expenditures grows (recession/depression??).

  3. Any mix of 1 and 2 above satisfying the 8% constraint.

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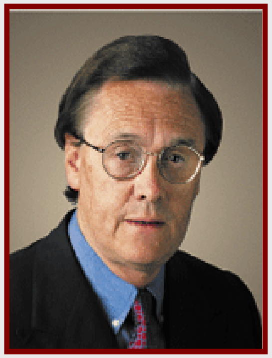

Background (cont'd)

- In a pessimistic era of flagging animal spirits, Private Expenditures neither are nor will grow rapidly, requiring that National Income grows very slowly—at a rate 8% lower as a % of GDP than Private Expenditures grow.

- *But recall from other National Accounting Identities, the growth of National Income IS the growth of GDP. Thus we have shown why it is almost certain that US GDP growth SHOULD and WILL be growing at a sub-par pace. Assuming the nation is committed to radically shrinking its fiscal deficit by 8% in the years ahead, the US might have to endure 0% GDP growth. Such is today's morass!*

- Regrettably, very high unemployment will be the price paid for an aggressive attack on the fiscal deficit under this scenario.

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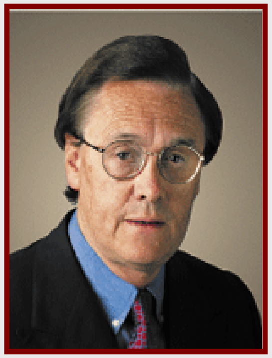

Mr. President: These Are Your Choices

1. **Focus primarily on deficit reduction and accept the high unemployment tradeoff just sketched. This may make the bond market happy, and citizens miserable.**

2. **Ignore the deficit, leave it *unchanged* as you did this current year, stimulate GDP growth by doing so, and say "to hell" with the bond market vigilantes.**

3. **"Muddle Through" with a compromise of reducing the deficit by only 4% of GDP down to about 6.5% of GDP. Via the previous analysis, this will permit GDP growth itself to be stronger—even though it will still be far too weak to make much of a dent in the job market.**

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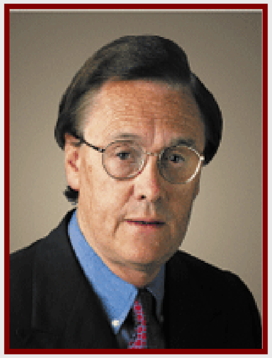

Solution: Having Your Cake and Eating it Too

- **Mr. President: Between the time when I gave you the bad news last January (summarized above) and June 2010, I had an epiphany. I realized that my analysis was incomplete, and as a result, wrong. New speculations on my part, when combined with a deep and far-reaching generalization of the very meaning of fiscal policy, led me to the following realization:**

  FUNDAMENTAL PROPOSITION: It is possible during this ostensibly "lost decade" for the US *BOTH* to radically reduce its deficit *AND* to achieve full employment *AND* to significantly raise productivity and GDP growth. In short, you can have your cake and eat it too. All of it.

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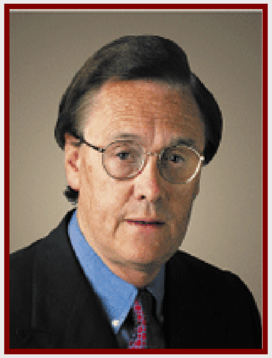

The Structure of What Follows

- First, we summarize the extremely important work of Kenneth Arrow and Mordecai Kurz in 1970. They generalized and unified the three different branches of macroeconomics. [*Public Investment, The Rate of Return and Optimal Fiscal Policy*]

- Second, we set forth our proposed solution to today's US economic crisis. The required policies are inspired by this surprisingly little-known Arrow-Kurz analysis.

  NOTE: The policy solution we arrive at required us to fundamentally *redefine* two terms: "deficits" and "private versus public investment." This approach to problem solving is often utilized in pure mathematics and in the natural sciences.

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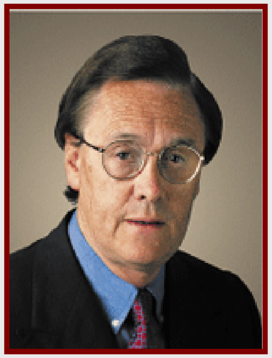

The Disarray in Macroeconomics Prior to 1970

KEYNESIAN THEORY
(Deficit Management)

GROWTH THEORY
(The Optimal Consumption/ Investment Tradeoff)

PUBLIC FINANCE THEORY

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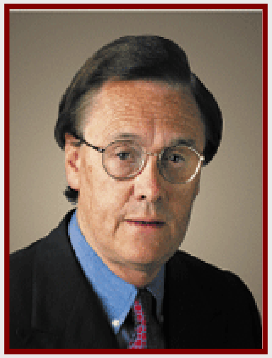
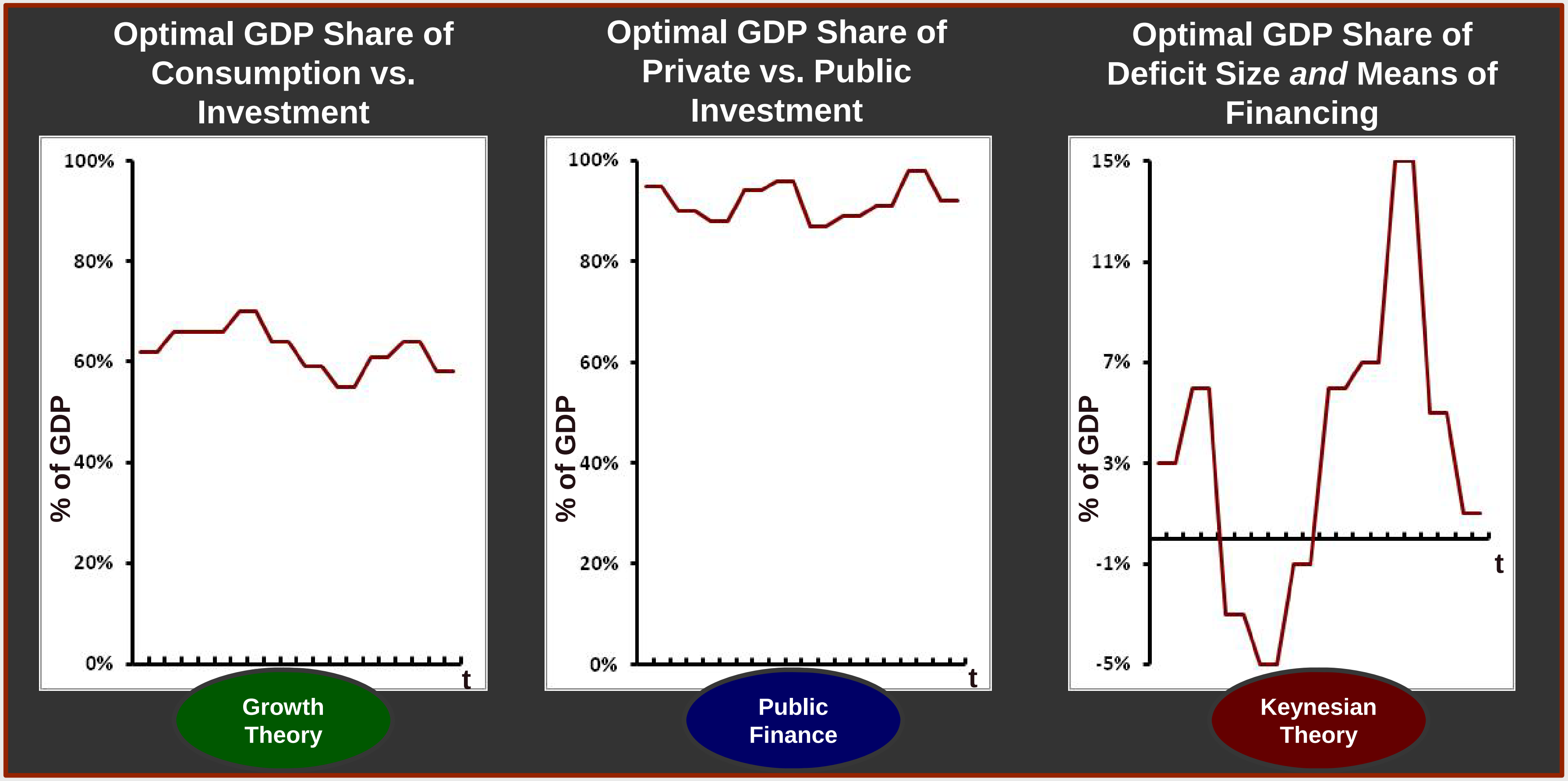


The Arrow-Kurz Generalization and Unification



NOTE: These three optimal "policy functions" are interdependent and thus must be solved for *simultaneously.* Macroeconomics is now unified.

Mr. President: The Proposed Solution

The solution lies not in reducing the deficit for 15 years, but in fundamentally reconfiguring the expenditures that generate it.

Recall that there are three different kinds of government spending that (given government revenues) generate deficits:

1. Transfer payments for consumption subsidization
2. Digging ditches to nowhere (*bad* public investment)
3. Digging ditches to somewhere (*good* public investment)

The bond market only looks favorably upon type 3 spending.

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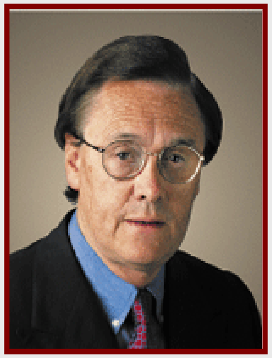

The Policies Required to Square the Circle

1. Keep the deficit at 10.5% of GDP for the next 15 years.
2. Reconfigure government spending so that 10.5% of GDP each year is "good" *public* investment. No animal spirits needed.
3. Recall from the Arrow-Kurz analysis that "good" public investment requires investment in projects with *high* rates of return on capital invested. No boon doggles allowed!
4. Extend the Arrow-Kurz analysis via the Macquarie Bank (Australia) model so that a good portion of these projects can eventually be privatized.
5. Understand that the bond market will not view deficits resulting from such investments as problematic. Rather, they will see the true deficit as merely the *amortized* portion of the new public investments. Thus, the nominal $1.5 *trillion* deficit becomes a negligible $30 *billion* deficit.

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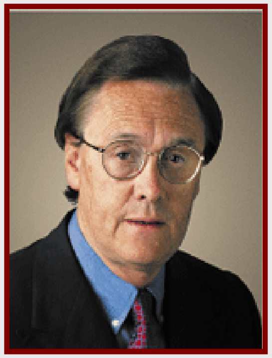

An Aside on the Rate of Return on Public vs. Private Investment

Three reasons why greater public infrastructure spending is so attractive to the US (and to the UK) at this moment:

1. The US has deferred spending on bullet trains, oil refineries, energy grids, basic research, airline terminals, and roadwork—thus *raising* the return from such investments today.

2. Only the government *can* carry out such needed investments. For the private sector *cannot* capture in its rate of return estimates the large "externalities" and "spillover effects" associated with projects like the interstate highway system, and the Kennedy space shot.

3. The time-discount rate appropriate for government investment spending is *lower* than that for private sector investment because of government's ability to "pool risks," as proven by Kenneth Arrow and Robert Lind in a classic 1970 article.

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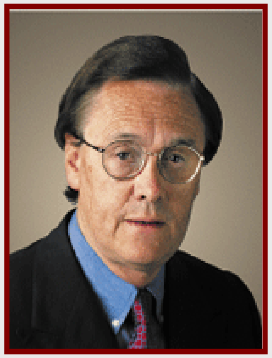

Additional Benefits of the Proposed Solution

1. **Switching $1.5 trillion of current government spending into investment spending will trigger remarkably high accelerator and multiplier effects. This will trigger an accelerating reduction in the unemployment rate which current transfer payment spending cannot.**

2. **The sharply increased investment in much-needed (i.e., high-yielding) projects logically implies a significant rise in productivity. This implies still faster growth of output *and* wealth.**

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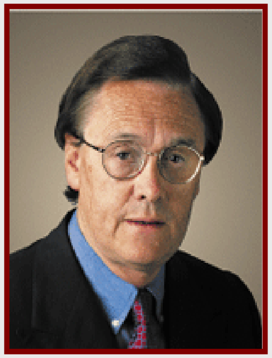

Conclusion

The proposed policies should generate a self-sustaining "virtuous cycle" leading to rapid GDP growth, full employment, rising productivity, and a superior economy with a reduced consumption sector and increased investment sector.

Importantly, the right mix of consumption versus investment and of public versus private investment can be achieved. The message of the Arrow-Kurz reformulation of macroeconomics is that we should strive with all our power to achieve precisely these rebalancings. Proper policies can do so.

Ironically, America is much blessed by its genuine *need* for this vastly increased public investment lying at the heart of this mandate. So is England. Japan and parts of Europe are not, as they have not deferred public investment.

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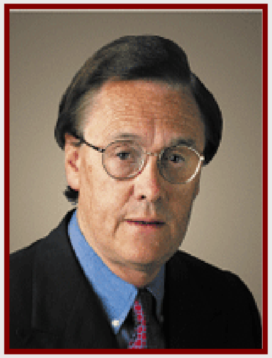

Political Feasibility of the Proposed Solution

<u>Cynics-to-Woody</u>: "Woody, this analysis is brilliant, but there is no chance in Hades that our divided government would ever agree upon such a solution."

<u>Woody-to-Cynics</u>: "Really? Just as it was inconceivable that the democrat John F. Kennedy could cut taxes, risking higher deficits when he came into office? Just as Clinton could pass NAFTA and 'end welfare as we know it'?

You forget that, while many contentious policies seem to be zero-sum games with no prospects to compromise, this turns out not to be the case. Far more bipartisan compromises are reached than not reached in the history of democratic governments as political scientists remind us."

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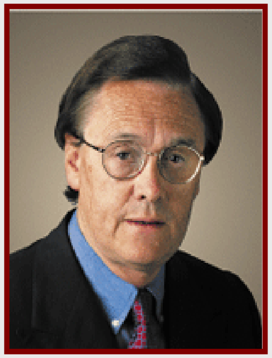

Political Feasibility (cont'd)

Cynics-to-Woody: "Then what do you see as the scope for compromise in your proposals?"

Woody-to-Cynics:

- "The Left can claim that this programme represents the triumph of Big Government. 'Endless stimulating deficits forever, Amen!'"
- "The Right can claim the programme to be a triumph of the elimination of deficit spending properly understood of the rationalization of public finances. Furthermore, the Right will understand that the prospect of privatizing the investments downstream will significantly reduce the *stock* of US debt when this is most needed because of the entitlements crisis."
- "Both the Left and the Right will confront their electorates and be able to say: 'Your kids will finally have jobs.'"

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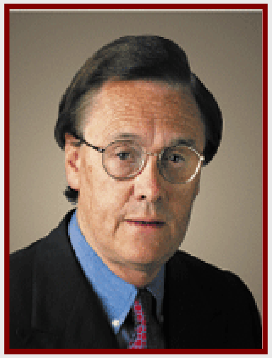

Answered Prayers
– The Political Timeline –

The proposed policy solutions will receive no political traction for the next four years largely due to their novelty. However, by 2014, when battle lines are being drawn for the 2016 presidential election, the hopelessness of the Obama “muddle through” jobless recovery will become politically intolerable.

I will work personally to the extent that I can with both parties to suggest that the Arrow-Kurz framework offers politicians the ultimate solutions to their own problems, and to the problems of the nation.

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