OFF THE NEWS

Barack Rumsfeld

After the publication of the Obama Administration's new "Defense Strategic Guidance" proposal, many private U.S. national security strategists note that the President's new agenda bears a lot of resemblance to the "Revolution in Military Affairs" approach proposed by Donald Rumsfeld, George W. Bush's first defense secretary. Rumsfeld suggested decreased levels of defense spending and a lean, highly trained, highly technological, special operations-oriented military that avoids "nation-building." Of course, in 2003, the Bush White House and the Central Intelligence Agency killed Rumsfeld's approach. If simply for budgetary reasons, the Administration now looks to be revisiting significant points of the strategic approach first offered by Rumsfeld. In its latest proposal, the Administration proposes huge drawdowns in deployments in Europe and the Middle East with a larger concentration of strategic assets in the Pacific Rim.

Odd Couple

Barack Obama

Donald Rumsfeld

Does a Government Need to Exist for Creditors to Make Interest Payments on Debt?

The question may no longer be whether the Greek government can pay by March 20 debt totaling €17.4 billion (a €14.4 billion bond and €3 billion in short-term bills). The issue may well be whether Greece even has an effective working government in place by the third week of March. Foreign observers in Athens say the Greek political system has broken out into outright war. Behind the scenes the situation is nothing less than political chaos, as ministers engage in attacks and counter-attacks in this uncertain period after the exit of prime minister and PASOK party chief George Papandreou.

Surprising Poll

A December 12 Gallup Poll showed that "big government" is viewed as the "biggest threat to the country" by 64 percent of the American people. In 2009, when President Obama entered office, that number stood at only 55 percent. Now the fear of "big government," an admittedly unspecified phrase, is widespread among Republicans (82 percent), independents (64 percent), and Democrats (48 percent).

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The Fed's and ECB's Dangerously High Leverage Ratios

The year 2009 was the first and only time that global GDP declined since the 1945–46 demobilization in the aftermath of World War II, and also the first and only time that global GDP declined since the world abandoned the gold exchange standard in 1971 and the entire world economy began operating on fiat currencies.

Declines in global GDP have always been extremely rare. From the beginning of the second industrial revolution to date, there have only been three occasions apart from 2009 when global GDP dropped: World War I, the Great Depression, and post-World War II. In each of these previous occasions, recovery followed the reduction of debt burdens, either via wartime wipeouts or via deflationary bankruptcy, or—as in the case of inter-war Germany—hyperinflation.

But the post-2009 recovery of global GDP is the sole instance in which the cause of the recovery was a massive expansion of central bank balance sheets and the even more massive expansion of debt:

- Between 2008 and now, global GDP increased by $2.9 trillion (4.7 percent) and global debt increased by $25.7 trillion (14 percent);
- The balance sheets of the Federal Reserve and the European Central Bank increased by 140 percent and 90 percent, respectively. China's central bank, with its idiosyncratic system, increased lending by about 100 percent.

In its first-ever encounter with negative GDP growth, the post-1971 global fiat money system responded with monetary and fiscal expansions on a scale that had been hitherto unimagined.

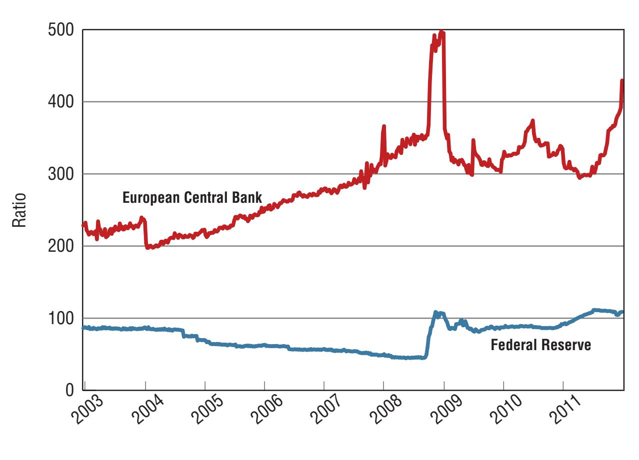
In order to grow in its present configuration, the global economy has depended absolutely on continuing monetary and fiscal expansion.

There are, however, clear limits to the post-2009 fiscal and monetary expansion. Every attempt to raise more tax revenue results in lower economic activity and shrinkage of the taxable base. It has already happened in Greece, Portugal, Spain, and Italy, where tax increases have been attempted. Eurozone tax revenues already are about 50 percent of GDP with no room to grow further. The United States, with less than 20 percent of GDP in tax revenues, is clearly at an advantage since the obstacles to raising more tax revenue are political and not objective as they are in the eurozone.

The limits to central bank balance sheet expansion are availability of qualified collateral and size of central bank capital. The eurozone, again, is where both of these limits appear to have been reached. Already one major eurozone bank, Belgium's Dexia, collapsed because it did not have enough qualified collateral to merit liquidity injections from the European Central Bank. The episode was a reminder of (and defines) that which limits the lender-of-last-resort role of central banks.

The chart below depicts the evolution of the capital (in)adequacy of the European Central Bank and the Fed over the last decade. The world's two most important central banks—the generators of most of the world's liquidity—have leverage ratios at extremely dangerous levels. The Fed's ratio is twice as high as that of Lehman Brothers at the time of its bankruptcy and the ECB's is eight times as high. The ECB is further impaired by the fact that the quality of the assets on its balance sheet is inferior (especially after its purchase of toxic government bonds from Greece, Portugal, and Italy), and that quality will continue to deteriorate as the recession spreads across the eurozone.

—*Criton Zoakos*



Remembering Michael Mussa

Michael Mussa, who died January 15 after a long struggle with heart disease, left an indelible legacy at the Peterson Institute for International Economics and in the world of economics at large. Before joining the Institute in 2001 as a senior fellow in charge of our biannual forecasts, Mike was a legend at the International Monetary Fund, where he was chief economist for nearly a decade. At the Institute he was deeply engaged in all our activities for a decade and never failed to improve, and even inspire, our internal debates and written products.

Mike was a very popular and persuasive participant in our seminars and briefings, where he could be counted on for lucid analysis and pungent humor. "My favorite economic policy tool is prayer," he once said. "It is not demonstrably less effective than the others and it carries none of the bad side effects." In an essay on trade for the *American Economic Review* in 1993, he memorably wrote: "In Washington, the truth is just another special interest, and one that is not particularly well-financed."

Mike was probably best known to the outside world in recent years for his semi-annual global economic forecasts. In 2009, he challenged those who said there would be little or no recovery from the recession, and lately asserted he had been proven right even though the recovery has been disappointing largely because the housing sector remains weak. More recently, he expressed doubts about the efficacy of sizeable further economic and fiscal stimulus for the U.S. economy.

Mike was often scathing in his criticism of what he considered to be public policy failures in regulating financial institutions, responding to recessions, or rescuing troubled countries. As Mervyn King, governor of the Bank of England, noted, Mike "forced the international community to face up to the realities" of the Latin American debt crises of the late 1990s. "Mike refused to be intimidated by any political considerations," said King.

Michael Mussa

Mussa was one of the first economists to demonstrate empirically how the short-run variability of exchange rates differed systematically under alternative currency regimes. He also made important advances in the profession's understanding of how expectations rendered the behavior of exchange rates similar to that of other asset prices, such as equity prices. He argued that official intervention in exchange markets could affect exchange rates by changing the market's view about the future stance of monetary policy.

Born in Los Angeles in 1944, Mike had multiple careers. From 1986 to 1988, he served as a member of the Council of Economic Advisers under President Ronald Reagan. Previously, he had been a professor of economics at the University of Chicago Business School and at the University of Rochester. He also served as a visiting faculty member at the Graduate Center of the City University of New York, the London School of Economics, and the Graduate Institute of International Studies in Geneva, Switzerland. He received numerous honors and awards for his contributions to international economics, macroeconomics, monetary economics, municipal finance, and economic forecasting.

On the occasion of Mike's sixtieth birthday, the International Monetary Fund held a conference to acknowledge both his scholarly work and his ability to communicate difficult economic issues in a down-to-earth way, with a dose of good humor. We will miss his wit, his deep intellectual curiosity, and his knowledge about history, political science, and government. Most of all we will miss his friendship and vital presence as a colleague.

—C. FRED BERGSTEN
Director, Peterson Institute for International Economics

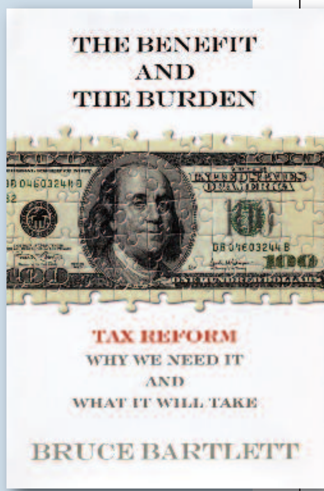
Tax Reform and 2012 U.S. Presidential Politics

"What is so far lacking in the tax reform effort is a compelling reason to enact any actual reforms, as opposed to cutting taxes again or just extending the Bush tax cuts for another year or two. Unfortunately political tactics are also a barrier to a deal. With 2012 being a presidential election year, both parties would like to be on the winning side of the tax issue. But what is the winning side?

In principle, everyone favors tax reform—as long as it doesn't take away their favorite deduction or credit or raise their taxes in any way. In principle, everyone favors tax simplification, base broadening, and lower rates. And in principle, everyone favors reducing the deficit, and a solid majority even support increasing taxes—as long as it's not on them. Action before the election is unlikely because both parties will want to campaign on tax reform, hoping that the election results will strengthen their hand.

That means 2012 will likely be a year like 1984, when tax reform was a topic of discussion, and important progress was made in narrowing the issues and finding common ground. But legislative action probably won't happen until 2013 or 2014. Remember, it took two full years for final congressional action on the Tax Reform Act of 1986 after the Treasury had already done a thorough analysis and put forward a detailed proposal."

—from Bruce Bartlett's new book, The Benefit and the Burden: Tax Reform—Why We Need It and What It Will Take *(Simon & Schuster, 2012)*



"The poor are getting poorer, but with the rich getting richer it all averages out in the long run."

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