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First Trust

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Monday Morning Outlook

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Obama: Try Spending Surge, Because "Deficits Don't Matter"

With economists of all stripes worried about a "liquidity trap," the typical map of political ideology has been swept under the intellectual rug. John Maynard Keynes posited that in a liquidity trap, consumers and businesses are so fearful to spend or invest, that they hoard cash. And because the Federal Reserve cannot lower interest rates below zero, it runs out of room to force more money into the economy.

Keynes said that when an economy falls into such a trap the government must spend because individuals and businesses won't. Milton Friedman disagreed and said that the Fed is never powerless and could always use "quantitative easing" – often referred to as dropping money from helicopters – to overcome the fact that interest rates could not go below zero. Friedrich Hayek said prices and wages should be allowed to find their own equilibrium, and that government intervention was actually central planning.

For today's crisis, just about every potential tool in the toolbox is being used. Politicians are embracing Keynes and Friedman, but Hayek is being ignored.

The Federal Reserve's balance sheet has expanded from less than $900 billion at the end of August to more than $2.1 trillion today – a historic increase. In the past two months, the Federal budget deficit totaled $408 billion on a cash basis. For the full fiscal year it may grow to as much as $1 trillion. Add to this the likelihood of an auto-company bail out, and a new very large (possibly $600 billion) stimulus package proposed by the Obama team.

President-elect Obama says that all of this spending is necessary to boost an economy that is likely to get worse before it gets better. He also told *Meet The Press* that deficits don't matter, saying "we can't worry, short-term, about the deficit." He added that we need to make sure any "stimulus plan is large enough to get the economy moving."

But temporary government programs almost always become permanent. And, any money that the government spends must be borrowed or taxed from someone else. To the extent that the government takes money from profitable companies and productive individuals to give to unprofitable companies, the economy will be harmed.

In addition, when government-directed money enters the economy, political motivations rule the day. For example, a window manufacturer closed down in Chicago recently when Bank of America decided to stop financing the business. Workers are protesting and members of Congress are saying that because BoA got money from Treasury it should use those funds to support the manufacturer. In other words, politics has entered the free market in an even more intrusive way.

This is all avoidable. We still believe that mark-to-market accounting rule changes could help heal the economy in short order. But that is not all that could be done. If deficits don't really matter in the short-term, then maybe some serious changes in tax policy should be considered, not just more spending.

Why not eliminate corporate taxes all together? During FY2008, the US Treasury collected $304 billion in corporate taxes – elimination would cost roughly half of what the Obama stimulus plan may cost and just 30% of this year's budget deficit. Imagine how the elimination of corporate taxes would change investor perceptions about investment, even for auto companies. Another option would be full (100%) expensing for any investment made by any company in 2009. This would encourage spending and investment.

Individual income tax receipts were $1.15 trillion in FY2008. A 50% reduction in tax rates would cost less than the Treasury's TARP proposal. Lower tax rates would take the sting out of any pay cuts unionized workers at auto companies might be forced to accept. Another option would be to allow all capital losses by individuals to be written off in full for 2008, rather than limiting them to just $3,000. This would limit the selling of profitable investments this year to absorb those losses for tax purposes only.

There are many positive alternatives (including these) that are not being formally discussed. This is a mistake. And more to the point, the last time the government tried to bail out the economy with drastic action, we ended up in the Great Depression. If we really want to "change" the way government and the private sector interact, why is the US government still trying the same old policies that failed in the past? Tax cuts have worked before, so if deficits don't matter, why not try a different kind of surge – a private-sector, incentive-creating one?

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Date/Time (CST)	U.S. Economic Data	Consensus	First Trust	Actual	Previous
12-10 / 1:00 pm	Treasury Budget - Nov	-$171.0 Bil	**-$171.0 Bil**		-$237.2 Bil
12-11 / 7:30 am	Int'l Trade Balance - Oct	-$53.5 Bil	**-$53.8 Bil**		-$56.5 Bil
7:30 am	Import Prices - Nov	-5.0%	**-5.9%**		-4.7%
7:30 am	Export Prices - Nov	-1.5%	**-1.6%**		-1.9%
7:30 am	Initial Claims - Dec 6	525K	**523K**		509K
12-12 / 7:30 am	Retail Sales - Nov	-2.0%	**-1.3%**		-2.8%
7:30 am	"Core" Retail Sales - Nov	-1.8%	**-1.0%**		-2.2%
7:30 am	PPI - Nov	-2.0%	**-2.6%**		-2.8%
7:30 am	"Core" PPI - Nov	+0.1%	**+0.2%**		+0.4%
7:30 am	Business Inventories - Oct	-0.2%	**-0.3%**		-0.2%
8:45 am	U. Mich. Consumer Sentiment	54.9	**56.0**		55.3