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Woe, the dismal scientists

By J Dwight , Populist Economics

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Well, it seems the "dismal scientists," otherwise known as economists, weren't pessimistic enough last summer.

Every year, leading economists gather in Grand Lake Stream, for fishing and idea-exchanging. After last year's confab at Leen's Lodge, I noted in a column called "Entering the Jurassic Market," they identified these trouble spots: "deteriorating home values, automaker woes, further bank failures, concerns about home equity losses still to come, the federal budget, energy prices and the prospect of rising unemployment."

They were generally right, but, only a few predicted the situation would get as bad as it did.

At one point in mid-September 2008, it looked like the banking system would collapse, taken down by the so-called ‘toxic mortgages', those ‘velociraptors' and ‘T-rex's' I wrote about. The Fed and the Treasury acted to stabilize the banking system. They were successful.

Those mortgage creatures have been killed off, and the labs they were made in effectively destroyed, but we are still dealing with after-effects: a stalled economy, high and raising unemployment, and diminished credit availability.

Alan Blinder, former vice chairman of the Federal Reserve Board, argued last weekend in an op-ed in the Wall Street Journal that the economy has bottomed and there is a "reasonable chance-that the second half of 2009 will surprise us on the upside...Three percent [growth in Gross Domestic Product] is eminently doable. Four percent is possible." That was Blinder's good news.

"That brings me to the bad news: The U.S. economy is bottoming...Layoffs abound...Companies go bankrupt...Tax receipts plunge...Jobs will take longer, perhaps much longer, to revive...it's a long, uphill climb to get out," he concluded.

Last year, at this time, a barrel of oil was about $145; as of this writing it is $67. Oil consumption worldwide has dropped by two million barrels between the summer of 2008 and the beginning of 2009; three million, since the summer of 2007. U.S. demand fell by

1.5 million barrels-per-day from June to December 2008.

Some postulate that rising demand in Asia, and lower production worldwide, are leading to higher prices. Chinese demand, some guess, is moving the price back up, unrest in Central Africa and the Middle East continue to disrupt production, and declining production in South America add to the upward pressure.

Demand for oil, and oil futures, as a hedge against expected resurgent inflation is another reason. Fiscal deficits being minted by the Obama Administration and Congress have increased federal debt to over $7 trillion. Some estimate the deficit will triple from 2008 by 2020 to $21 trillion; others think that level of crushing debt will be reached in less than five years.

Also, worries that policies like cap and trade and health care reform are expected to reduce economic growth and create massive dislocation in the workforce and economy. The concern is that such policies add to deficits, and inflation will accelerate in future years.

Paul McCulley, Managing Director of PIMCO, the largest fixed income manager in the world, wrote recently the United States could pursue a course of massive inflation. "America is in a liquidity trap, driven by private sector deleveraging borne of asset price deflation ... the answer act irresponsibly ... I see no reason to die from orthodoxy-imposed anorexia," McCulley says.

John Silvia, Chief Economist of Wells Fargo Securities, argues that Washington has "failed to recognize the structural changes in the economy and thereby continue to push pro-cyclical economic policies in the world of structural change."

Ideas like the "second stimulus" are a prime example of misguided policies. Increasing deficit spending along with proposals to radically alter health care, energy, trade and workplace rules "create high levels of anxiety among employees and employers," argues Silvia. More Keynesian-type spending and fiscal deficits also would "amplify the economic cycle and create risks on the upside for interest rates and inflation."

Silvia also notes that officials in other nations have been increasingly focused on the development of a currency alternative to the dollar. The dollar has declined since the passage of the first stimulus, stated Silvia, and more stimulus "will raise further doubts," which will lead to more devaluation of the dollar and "possible loss of our near-exclusive role as the world's reserve currency."

I agree with Silvia — we don't need more Keynesian-style irresponsible spending, coupled with policies that will create further uncertainty and unemployment and dislocation. There are four major reasons why I believe McCulley's position — more spending — is wrong:

• Radically increasing the money supply will cause economic disruption not only in the

U.S., but worldwide.

• The U.S. economy has bottomed without the aid of fiscal stimulus, much of which will be spent in 2010. Don't add more.

• The banking intervention has worked to stabilize the system. Let it continue.

• If the policies of the Democrats pass, the structural economic dislocation that's currently happening will not be remedied. Structural challenges are not solved by fiscal stimulus; rather, these just prolong and exacerbate the dislocation of workers and the economy.

The United States is at a crucial juncture for its recovery. Caution is warranted and radical political policies, I believe, would not have the politically or economically desired effects. There is much discussion about what else should be done.

Sometimes, doing nothing is the best choice. But then again, I'm just a dismal scientist.

J. Dwight is a SEC registered investment adviser and an advisory board member of the Maine Heritage Policy Center. He lives in Wilton. E-mail jdwight@gwi.net.