TELLS THE FACTS AND NAMES THE NAMES

CounterPunch

JAN 1-15, 2009 ALEXANDER COCKBURN AND JEFFREY ST. CLAIR VOL. 16, NO. 1

# *The State of Economics*
# Where Economics Succeeds (mainly)

**By Paul Craig Roberts**

Here begins a three-part series on the successes and failures of economics. This first part presents economists' successes – microeconomics and macroeconomics. The second part deals with trade theory and the errors and misinterpretations that are deindustrializing the United States and destroying the ladders of upward mobility. The third part takes up the failure of economic theory and national income accounting to include the costs of using up natural capital.

This series is not intended to be exhaustive. It does not deal with all of economics or all of its problems. The purpose is to provide readers with a grasp of the two primary fields of economics and problems that are resulting in the failure of economic policy and, perhaps, threatening the sustainability of what economists regard as economic progress.

Economics can successfully explain the efficient allocation of resources by the price system and the allocation of investment by profitability. Relatively speaking, these successes are new. It was Alfred Marshall at the turn of the 20th century who explained price formation. Prior to Marshall, economists debated whether price was determined by the cost of production or by demand – what people were willing to pay. Marshall ended the controversy by pointing out that supply and demand are the two blades of the scissors. Together they determine price.

Profit is the normal return on capital. A normal profit depends on time and circumstances. It is the profit necessary to retain capital in an activity. If capital cannot earn a normal rate of return in

**ROBERTS** CONT. ON PAGE 5 COL. 2

# Obama's Team: ex-Harvard, pro-Biz, Pro-War and mostly a Slap in the Face to Obama's Base

**By Alexander Cockburn and Jeffrey St. Clair**

Obama's cabinet is drawing praise for all the wrong reasons, starting with the mad-dog right, like Anne Coulter who says she can't fault it or Karl Rove who heaped praise on Obama's economic team in a *Wall Street Journal* column. Move to the corporate mainstream, and there's measured congratulation for the respectability of Obama's team, pro-biz, pragmatic and, whether proximately from the Bush or Clinton administrations, often at source from Harvard.

So far as the progressive Obama base is concerned, it's been one bitter pill after another, starting with Rahm Emanuel (the only man in the Illinois congressional delegation to vote Yes to the war on Iraq), moving on to Hillary Clinton (another Yes on the war), Robert Gates, and the whole economic team. There was a brief ray of hope when Larry Summers didn't return to Treasury. Then he bobbed up as director of Obama's economic recovery team, formally known as the National Economic Council, based in the White House.

Contrast these desolate choices with what the progressives were given in the dawn of Clinton time. He didn't turn out to be much good, but Wisconsin Rep. Les Aspin, at the time he was nominated as secretary of defense, certainly had a reputation as a Pentagon critic. Environmentalists were exuberant when Bruce Babbitt, former head of the League of Conservation Voters, was given the Department of the Interior. It's true that Babbit did not match such expectations, but when he was nominated, the mining and cattle lobbies were mad with fury. At HUD there was Henry Cisneros, always in trouble but fairly progressive; at Labor – Robert Reich; at Agriculture – Mike Espy; at EPA – Carol Browner. As surgeon general we got Jocelyn Elders, a radical black woman who spoke her mind and was finally axed by Clinton for being honest about sex ed. We got Lani Guinier at the Justice Department, a terrific choice swiftly betrayed by the man who picked her, Bill Clinton. As number 2 at Health and Human Services, there was Peter Edelman, one of only three people in the Clinton administration who resigned over the onslaughts on the welfare system five years later.

Of course, as now, big business kept its mitts firmly on the essential levers: Treasury, the Fed.

What is Obama's progressive base getting by way of reward? The pickings are very slim. The whole *raison d'etre* of Obama's campaign in the primary phase – the period when the progressive constituency has to be allured – was to turn the page not only on Bush time but on Clinton time, to move on. So… we get Hillary Clinton, given the extra privilege of staffing the lower positions at State with her own people; we get Clinton's economic team of Summers, Rubin (today an informal advisor), Summers' former deputy Timothy Geithner, nominated as Treasury secretary. Geithner's heraldic quarterings display Kissinger Associates, Treasury in the administration of Bush Sr., service in the Clinton administration working for Rubin and Summers, then a stint at the IMF, followed by his most recent billet at the New York Fed, where his fingerprints are on three bad decisions – the bailout and sale of Bear Stearns, the bailout of AIG, and the decision to allow Lehman to go bankrupt.

Nowhere has business-as-usual been

more glaringly given the green light than at the Department of Defense. Anyone looking for change in America's political economy has to take on the Pentagon, a vast and steadily widening crater of corruption and Augean waste. Obama has simply kept on Robert Gates, who first made his name faking intelligence estimates at the CIA in Bush Sr.'s day, exaggerating Soviet military strenth and aggressive intentions. Nominated as Gates' number 2, presumptively as Gates' successor, is William Lynn. Appointed by Clinton as a Pentagon reformer in '98, Lynn – in the words of famed Pentagon employee/critic Chuck Spinney– "managed to construct a logically inconsistent and morally indefensible strategy to protect the unworkable status quo."

Dashed by the disasters at State and Treasury, the progressives looked for comfort at the Departments of Agriculture and Interior, which supervise vast slabs of the homeland. At Ag they got the former governor of Iowa, Tom Vilsack, who'd opposed Obama in the primaries and who is best known as being a fanatic lobbyist for genetically engineered biocrops and ethanol. He's Monsanto's pinup boy and comes factory guaranteed as a will-do guy for the agrochemical complex. For a moment, hope glowed from the transition team's office in Chicago, as the panel listened attentively to those lobbying for Raul Grijalva, a U.S. rep. from Arizona who is firstrate and has done more than anyone in recent years to root out scandal in Bush's scandal-sodden sojourn as custodian of the nation's forests, energy reserves and public waters. Rejected, Grijalva said accurately, "I think we [the progressives] are seen as convenient allies, not as necessary allies. It's an awkward position. We're taken for granted. We're not like Blue Dog Democrats, who threaten to vote against children and health care to get what they want. Maybe we need to do that."

In the end, Interior went to Colorado's senior senator, Ken Salazar. He's a born heel-clicker to the Money Power, always hatching deals with the coal industry and big ranching interests. He makes Bruce Babbitt look like Edward Abbey.

**Anyone looking for change in America's political economy has to take on the Pentagon, a vast and steadily widening crater of corruption and Augean waste.**

Are there any encouraging Obama picks? Her role may be to tell the unions that card check reform is a non-starter with Obama, but certainly California congresswoman Hilda Solis is a promising pick as Labor secretary. Solis is the daughter of poor Latin American immigrants: her father, a Mexican, was a shop steward with the International Brotherhood of Teamsters in Mexico, and her mother, a Nicaraguan, was a former assembly-line worker. A good left economist, Jared Bernstein of the Economic Policy Institute, is scheduled to be chief economist for Vice President Joe Biden. At the Justice Department, now destined to be ruled virtually 100 per cent by graduates of the Harvard Law School, the Office of Legal Counsel has been given to Dawn Johnsen, most recently at the University of Indiana Law School, Bloomington. This was the position held by the execrable John Yoo, friend of the thumbscrew and the water board. Johnsen has been a fierce assailant of Yoo's constitutional abuses, writing at one point, "Where is the outrage, the public outcry?! The shockingly flawed content of this memo, the deficient processes that led to its issuance, the horrific acts it encouraged, the fact that it was kept secret for years and that the Bush administration continues to withhold other memos like it – all demand our outrage." Johnsen has also attacked the Cheney-style "theory of a unified executive," otherwise known as untrammeled presidential power.

He's no radical, but the choice of Leon Panetta as CIA chief seems good. Panetta, from Monterey on California's central coast, bailed out the Clintons by becoming chief of staff after the organizational and political disasters of 1993. Panetta may turn out to be a good pick along the same lines as Stansfield Turner, back in Carter time. The other national security appointments are bad.

Towering at Obama's other elbow from Emanuel looms National Security Advisor Jim Jones, a Marine, mustar keen on NATO expansion. As his special assistant on the Middle East, Obama has selected Dan Kurtzer, ambassador to Egypt under Clinton and Israel under George Bush Jr. Kurtzer allegedly helped write Obama's notorious piece of groveling to the Israeli lobbying organization AIPAC in June 2008. As National Intelligence director, we're scheduled to get Admiral Dennis Blair, recently exposed on the *CounterPunch* site as abetting the Indonesian generals in the infamous butchery known as the Church Killings in East Timor. After he retired from the Navy, Blair joined the board of directors of the EDO, he was serving as head of a Pentagon board – the Institute for Defense Analyses – which was evaluating the F-22 contract, and endorsed another three years of subsidies for the program. Blair did not disclose his board membership and got publicly reprimanded by the Pentagon's inspector general.

At almost every level, Obama's choice have been calibrated to appease the establishment, from the financial markets (or what's left of them), to the press (or what's left of it), to the think tanks and lobbyists of Washington (as strong as ever). As an agent of change – we do not even mention hope – the age of Obama looks wan. Perhaps worsening economic circumstances will force Obama into uncharted territory. **CP**

**CounterPunch**

EDITORS
**Alexander Cockburn**
**Jeffrey St. Clair**

ASSISTANT EDITOR
**Alevtina Rea**

BUSINESS
**Becky Grant**
**Deva Wheeler**

DESIGN
**Tiffany Wardle**

COUNSELOR
**Ben Sonnenberg**

CounterPunch
PO Box 228
Petrolia, CA 95558
1-800-840-3683
counterpunch@counterpunch.org
www.counterpunch.org

## *Cross-Country Diary*

# From Junk to the Secrets of Jekyll Island

### By Alexander Cockburn

As with so many of my drives across the country in the past, I began in the northwest corner of South Carolina, where Wilbur, an old friend, of mine owns a small trailer park, across the road from the acres where he used to have his inventory of mostly 60s Imperials and Chryslers, before the value of land went up and the price of scrap went through the roof. It's why these days you see fewer junkyards with old cars in them than you used to. Back last November when I was staying with Wilbur and his wife Charlene, in Landrum, South Carolina, you could take a 4000 lb car to the shredder and get $12 a pound, around $500, with the metal shipped off to China. Now, with the recycling business in China at a standstill, the price has dropped to $2 per lb.

Mind you, car manufacturers have always hated the junkyards. Ford used to buy them up just to put them out of business. The less old inventory in circulation, the better the manufacturers do. One of the first acts of Harold Wilson's 1964 Labour government in Britain was to introduce the 7-year MOT test, which wiped out the cheap old car market. I had two cars when I was at Oxford just before Wilson got in, a 1937 Riley and a 1946 Wolseley. Both cost me less than 50 pounds. These days in the U.S. you see a fraction of the old cars I used to meet on the roads when I began driving around America in the 70s. Back then, the highways were vivid with the sheens of the 50s and 60s, the fins, the chrome, the concave body lines of Elwood Engel, the tumid degeneration from 60s lines as we headed into the 70s. There were three- tone color packages in the 50s and paisley roofs. The options on a mid-50s Bel-Air were virtually infinite. These days: nothing but monotone Honda Accords, Subarus and Camrys as far as the eye can see.

So these days Wilbur devotes the time he used to spend packaging up moulding strips and engine parts for the UPS driver to fixing things in his trailers, approaching late payers at the start of the month, sometimes with one hand hovering near the .32 he keeps in his back pocket in case – as has happened more than once – the late payer has become dangerous. Trailer park management is a tough business, leading the veteran toward a skeptical posture about protestations of good faith and square dealing.

Wilbur described to me how, in his trailer park, by the late summer of 08, as local factories started closing, long-term tenants said goodbye and went on the road in search of work. The vacant trailers were soon filled by families walking away from mountains of mortgage debt and foreclosed homes. They live on budgets so tight, Wilbur says, that they can just make the $500 monthly rental, but $550 puts them under. He pointed to one where an older man had just arrived from Michigan, 650 miles north up Interstate 75, heart of the U.S. auto industry and already in economic ruins long before the major auto companies went begging for bailout in Washington, D.C. States in the industrial heartlands, like Michigan or Ohio, have been reeling for years as the factory owners redeployed to China, but others like New York or California or Washington and Oregon in the Pacific Northwest now face budgetary implosion and cuts in services of up to 25 per cent.

**My own ancestor, Admiral Sir George Cockburn, similarly offered freedom to slaves working for the British force.**

I'd stopped by to say hello to Wilbur and his wife and to pick up a 1989 Ford Festiva, essentially a Kia, designed in part by Mazda, ordered up by Ford to get its fleet's mileage averages up. It's a nippy little thing and turned in an initial highway performance of 38 mpg. Years ago I didn't care much about mpg statistics.The first car I ever drove out of Wilbur's yard was back in the early 80s, a Chrysler Newport wagon with a 383 engine, with a rare, factory-installed straight shift, apparently designed for the cops. It was certainly a very fast car, doing about 18 mpg to the gallon.

I said goodbye to Wilbur and Charlene and bowled along in the Festiva in the Wednesday, pre-Thanksgiving traffic southeast on I-26 through Columbia, then south on I-95, finally east over the causeway onto St. Simons Island, a place of exceptionally beautiful oaks, with extensive black neighborhoods, some with "Don't ask, won't sell" signs on their gates. On Thanksgiving night, after writing down Jonathan Lubell's account of the unsuccessful efforts of the Harvard Law School to make him and his brother testify to the Jenner Committee and name names (chronicled in the last issue of this newsletter), I dipped into a book Dee Lubell lent me, *Slavery and Rice Culture in Low Country Georgia*, by Julia Floyd Smith.

"Maroon camps," composed of escaped slaves, dotted the coast of Georgia, as in other states from Florida up to Virginia. There were also many Indian/African sanctuaries. During the Revolutionary War, slaves worked effectively for the British as spies, guides and couriers. When the British quit Savannah in the summer of 1782, they evacuated 7,210 of their black allies from Georgia, and 5,327 from Charleston, S.C. The following year, with the Treaty of Paris that recognized American independence, the British


**Subscription Information**

Subscription information can be found at www.counterpunch.org or call toll-free inside the U.S. 1-800-840-3683

**Published twice monthly except July and August, 22 issues a year.**

1- year hardcopy edition $45
2- year hardcopy edition $80
1- year email edition $35
2- year email edition $65
1- year email & hardcopy edition $50
1- year institutions/supporters $100
1- year student/low income, $35

Renew by telephone, mail or on our website. For mailed orders please include name, address and email address (if applicable) with payment. To renew by phone 1-800-840-3683 or 1-707-629 3683. Add $17.50 per year for subscriptions mailed outside the U.S.A.

**Make checks or money orders payable to:**
CounterPunch
Business Office
PO Box 228, Petrolia, CA 95558

withdrew from New York City, and 3,000 blacks left with them, mostly heading to Canada and Jamaica.

On the other side, General Nathanael Greene, commanding the Continental Army in the South, proposed enlisting four black regiments, offering each recruit freedom from slavery, with $1,000 per slave going to the owner in compensation. Horrified at the notion of putting guns in the hands of blacks, the Georgian and Carolinian slave owners wouldn't hear of the idea. In the war of 1812, my own ancestor, Admiral Sir George Cockburn, similarly offered freedom to slaves working for the British force, and found many recruits eager to accept the invitation, often asking specifically for deployment "in stations facing their former masters."

After a tour of St. Simon's Island, the Lubells and I crossed a bridge and a causeway to another of the four Golden Isles, Jekyll Island, where, two days earlier, locals had unveiled a sculpture of three large, curved sails, representing *The Wanderer*, the last slave ship known to have landed in those parts, docked on the south end of Jekyll Island in November 1858, fifty years after Congress had officially outlawed the slave trade. This floating prison disgorged 400 African men, women and children, to be sold at auction.

These days, Jekyll Island is mostly a state park and nature preserve, with a convention center where, in 2004, George Bush hosted the G-8 Summit. It was an appropriate location for the managers of capital. Jekyll Island was where, a century earlier, the Carnegies, Rockefellers, Pulitzers and others of the superrich of the time liked to disport themselves in seclusion, untroubled by agitators and anarchist assassins. In 1931, the *New York Times* noted in a comment on the death of George F. Baker, one of J.P. Morgan's closest associates, that "Jekyll Island Club has lost one of its most distinguished members. One-sixth of the total wealth of the world was represented by the members of the Jekyll Island Club." Membership was by inheritance only.

Jekyll Island was where the ultimate bankers' plot, the Federal Reserve, was hatched. Almost exactly 98 years before my visit, on the night of November 22, 1910, "a group of newspaper reporters stood disconsolately in the railway station at Hoboken, New Jersey. They had just watched a delegation of the nation's leading financiers leave the station on a secret mission." Thus began the dramatic account by Eustace Mullins, whose book *Secrets of the Federal Reserve*, was commissioned by the poet Ezra Pound in 1948, when he was confined as a political prisoner at St. Elizabeth's Hospital, Washington, D.C. (a federal madhouse) for making broadcasts in favor of Mussolini during the war. Before the war FDR himelf had been a keen admirer of Il Duce, corresponding with him amiably.

Mullins held the foolish belief that the Rothschilds controlled everything, but he

**The conspirators at Jekyll Island ensured that at long last, a central bank would be established in the United States which would give these bankers everything they had always wanted.**

also put together plenty of useful information in a very entertaining way. To his eternal credit, he played a major role in getting Pound released, which he told an interviewer, James Dyer in 2003, was his proudest moment. He told Dyer, that he wrote *Secrets* with George Stimson:

"George was quite a scholar. He was founder of the National Press Club, which did one terrible thing to this country. It created the myth that journalists are serious people. They'd always been known as drunks and fools up to that point, which is what they were. George, because he wasn't a fool or a drunk, created the National Press Club as a place where serious journalists could be taken seriously. But there aren't any. So the NPC became a big office building where a lot of lobbyists and journalists have their offices. Ezra Pound commissioned me to write *Secrets of the Federal Reserve* for $10 a week. When I finished the book, no one would touch it. Devin Garrity said they couldn't print it, and they'd be the only ones that could. We finally found a girl who printed a thousand copies and we sold it immediately. We sold it within a month, they took every book."

Pound-as-prisoner had a galvanizing effect on many visitors, including the poets Olson and Merrill, and L. Ron Hubbard, who worked as an orderly there, watched shrinks prescribing sedatives for inmates like Pound and developed a loathing for psychiatrists and the drug industry. Hubbard went on to found the Church of Scientology.

To return to Mullins' narration of the secret bankers' trip to Jekyll Island:

The delegation had left in a sealed railway car, with blinds drawn, for an undisclosed destination. They were led by Senator Nelson Aldrich, head of the National Monetary Commission. President Theodore Roosevelt had signed into law the bill creating the National Monetary Commission in 1908, after the Panic of 1907 had resulted in a public outcry that the nation's monetary system be stabilized. Accompanying Senator Aldrich at the Hoboken station were Frank Vanderlip, president of the National City Bank of New York, Henry P. Davison, senior partner of J.P. Morgan Company and generally regarded as Morgan's personal emissary; and Charles D. Norton, president of the Morgan-dominated First National Bank of New York. Joining the group just before the train left the station were Benjamin Strong, also known as a lieutenant of J.P. Morgan; and Paul Warburg, a recent immigrant from Germany who had joined the banking house of Kuhn, Loeb.

The Aldrich group had journeyed to Jekyll Island to write in secrecy the banking and currency legislation, which the National Monetary Commission had been ordered to prepare in public. The conspirators at Jekyll Island ensured that, at long last, a central bank would be established in the United States which would give these bankers everything they had always wanted. Paul Warburg did most of the drafting of the plan. Senator Nelson Aldrich was there to see that the completed plan would come out in a form palatable to Congress. The Jekyll Island group remained at the club for nine days, toiling urgently to complete their task, irked by the bossiness of Aldrich and endless technical lectures by Warburg in his grating accent.

What the public wanted in 1908 was legislation to prevent the recurrence of artificially induced money panics. Monetary reform now seemed inevitable. The Jekyll Island group had gathered to head off reform and fix matters to the permanent advantage of the bankers, by establishing their "Central Bank," chastely designated as "the Federal Reserve System." It was Warburg who came up with a scheme, designed to allay entirely correct popular suspicions of a plot by New York bankers, to espouse the "regional reserve bank" model, somehow implying this was a nationwide network and not an Eastern camarilla of bankers. He also successfully counseled against any bothersome intrusion of public participation in the selection of the Fed's officers. Though B.C. Forbes, founder of *Forbes*

**"I do not feel it is any exaggeration to speak of our secret expedition to Jekyll Island as the occasion of the actual conception of what eventually became the Federal Reserve System."**

magazine, did get hold of the story in dim outline in 1916, charges of this bankers' conspiracy were successfully derided for many years. Warburg finally agreed to the request of a biographer of Aldrich, Nathaniel Wright Stephenson, to prepare in 1930 the "Warburg Memorandum," where Warburg conceded, "The matter of a uniform discount rate was discussed and settled at Jekyll Island."

Amid the Depression, interest in the origin of the Federal Reserve, charged with being guilty of prompting the Crash by its policies, was high. In the *Saturday Evening Post*, on February 9, 1935, Frank Vanderlip, former president of the National City Bank of New York, wrote as part of his memoir *From Farmboy to Financier*: "Despite my views about the value to society of greater publicity for the affairs of corporations, there was an occasion near the close of 1910, when I was as secretive, indeed, as furtive, as any conspirator. … Since it would have been fatal to Senator Aldrich's plan to have it known that he was calling on anybody from Wall Street to help him in preparing his bill, precautions were taken that would have delighted the heart of James Stillman (a colorful and secretive banker who was President of the National City Bank during the Spanish-American War, and who was thought to have been involved in getting us into that war) … I do not feel it is any exaggeration to speak of our secret expedition to Jekyll Island as the occasion of the actual conception of what eventually became the Federal Reserve System. The essential points of the Aldrich Plan were all contained in the Federal Reserve Act as it was passed."

National City Bank was the Rockefellers' bank, ultimately mutating into Citigroup. The morning after the tour around Jekyll Island, I switched on the TV and there, as a prime adviser to newly elected Barack Obama, was Robert Rubin of Citicgroup, one of the three or four Wall Street figures most identified with the deregulatory policies of the Clinton and Bush years which prompted the 2008 meltdown. A week before our visit to Jekyll Island, Obama had nominated Tim Geithner, head of the New York Fed, as his Treasury secretary, scheduled – if confirmed – to protect the interests of J.P. Morgan and Citi.

The next day, I headed over the causeway again and headed southwest to Florida, stricken by the housing crash in the land and housing and boom, just as it was in the mid-1920s, after that great boom blew up. Drive most places through America's landscapes, and you find such continuities.

**CP**

---

**ROBERTS** CONT. FROM PAGE 1 COL. 1

an activity, capital is not supplied to that activity. This ensures that capital is not wasted in low value uses. Whenever capital earns a higher than normal return, it is a sign that it is employed in a high value use. The excess profits will lead to an expansion of investment in that use until profits are reduced to normal.

Without price and profit signals, there is no way of knowing how to efficiently use resources to produce the highest valued output. The Soviet economy failed because the system's gross output indicators, the main signal of managerial and plan success, could not tell if inputs were more valuable than outputs.

The study of the price system is known as microeconomics. It is the soundest field of economics. "Free prices" simply means the freedom of prices to change with supply and demand. It does not mean laissez faire or no rules and regulations. The "free market" means the freedom of prices to change as conditions change.

Economists concluded from the Great Depression that a price system could function without ensuring full employment. This conclusion led to the rise of macroeconomics, the study of the factors leading to the overall level of prices and employment.

John Maynard Keynes was the first macroeconomist. With his 1936 book, *The General Theory of Employment, Interest and Money*, he spawned the Keynesian economics, of which the American economist Paul Samuelson is doyen. Keynesian macroeconomists concluded that employment and the price level depend on the level of total spending. If consumers saved more than investors invested, it would result in a leakage from the spending stream and a shortage of aggregate demand (the total demand for resources from consumption and investment). The shortfall in spending would cause a decline in employment and prices.

On the other hand, if somehow there was an excess of spending, the demand on resources would drive up prices and the economy would experience inflation.

Macroeconomists concluded that the way to manage the economy was for the government to manage demand. If there was insufficient spending to maintain full employment, the government would fill in the gap by running a deficit in its budget. That is, the government would spend more than it received in tax revenues, thus adding to aggregate demand.

If there was too much spending, the government would reduce the amount by running a budget surplus. In other words, the government would collect more in tax revenues than it would spend, thus contracting the spending stream.

The Keynesians were on to something, but the only economist (a physical chemist actually) who got it right was Michael Polanyi in his 1945 book, *Full Employment and Free Trade* (Cambridge University Press). Polanyi correctly interpreted Keynes' theory to mean that widespread unemployment meant that there was *a dearth of money*. What the government needed to do was to expand the monetary circulation. It could do this, Polanyi noted, simply by printing money to pay its bills.

Polanyi was on to more important deductions than the Keynesians. He said that it was pointless and expensive for the government to borrow money, on which it had to pay interest, in order to spend, when it could far more cheaply provide the missing purchasing power by printing the money to cover its budget deficit. Polanyi saw fiscal policy as a way to expand the money supply when reluctance or impaired ability to borrow and lend prevented the central bank from expanding the supply of money.

At that time, Polanyi's conclusions were over the head of the economics profession. But two decades later, in the 1960s, Milton Friedman and Anna Schwartz made it clear that the depression in the U.S. during the 1930s was caused by Federal Reserve mistakes that resulted in one-third shrinkage in the supply of money. The depression in the UK following World War I resulted from the decision by the British government to go back on the gold standard at the prewar parity of the British pound sterling and gold. As the money supply had expanded so much, the return to gold at prewar parity required shrinkage in the money supply, a shrinkage that collapsed employment and prices.

Thus, the Keynesians, who had the right idea, initially did not understand that full employment was a monetary phenomenon. If government spent more by borrowing to finance its deficit, its borrowing reduced spending on consumption and investment just as taxation did. A budget deficit could boost consumer demand only if the central bank accommodated the deficit by expanding the money supply.

The Keynesians' second mistake came from their failure to understand the impact of fiscal policy on supply. To maintain full employment, the Keynesians came to rely on monetary expansion. Keynesian demand management kept money and credit abundant to ensure sufficient spending. To restrain inflation, Keynesians relied on high tax rates to withdraw from the population spending power that the easy monetary policy provided. The Keynesian economists believed that high taxes served to reduce consumer demand to noninflationary levels. In fact, high tax rates reduced the supply of labor and the supply of goods and services, while easy money pushed up consumer demand. Consequently, prices rose more than real output.

The Keynesian demand management policy came unglued during the Carter administration in the late 1970s, when worsening trade-offs between inflation and unemployment left macroeconomists with no policy solution except wage and price controls. In other words, the failure of macroeconomics meant that the price system would not be allowed to allocate resources.

Congress had recently had an experience with fixing one price – the price of oil – and it had been a disaster. Congress was in no mood to fix all prices. Congress preferred to listen to new voices, the

**The Keynesians were on to something, but the only economist (a physical chemist actually) who got it right was Michael Polanyi in his 1945 book, *Full Employment and Free Trade*.**

voices of "supply-side economists" (in contrast to Keynesian "demand-side economists"). Supply-side economists were new macroeconomists who had both blades of the scissors. They pointed out that, in Keynesian macroeconomics, fiscal policy (changes in tax rates or changes in government spending) only affect aggregate demand: higher taxes reduce consumer purchasing power and total spending declines; lower taxes increase consumer purchasing power and aggregate demand rises. Supply-side economists said that, in fact, changes in marginal tax rates (the rate of tax on additions to income) *change aggregate supply.*

Supply-side economics is a correction to Keynesian demand management. It has nothing to do with "trickle-down economics" or with a claim that tax cuts pay for themselves. Supply-side economics says that some fiscal policies shift the aggregate supply curve, not the aggregate demand curve. Specifically, if marginal tax rates are raised, there will be fewer goods and services supplied at every price. If marginal tax rates are lowered, there will be more goods and services available at every price.

Today, this conclusion is no longer controversial. But in the 1970s it was a new thought. Initially, Keynesians resisted it, but in the mid-1980s Paul Samuelson came to terms with supply-side economics in the twelfth edition of his economics textbook.

By bringing relative prices that affect individual behavior into macroeconomics, supply-side economists integrated micro with macroeconomics, a long-standing goal that economics had not achieved. Supply-side economists showed that a shift in marginal tax rates changes relative prices and affects individual decisions whether to save more or to consume more, and whether to work more or to enjoy more leisure. The allocation of income between saving (investment) and consumption and the allocation of time between work and leisure affect the growth rate of the economy. (See Paul Craig Roberts, *The Supply-Side Revolution*, Harvard University Press, 1984.)

Think about it this way. The cost of current consumption is the foregone future income from saving and investment. Income is an after-tax phenomenon. The higher the tax rate on income, the less current consumption costs in terms of foregone future income or, in other words, the less future income is given up by today's consumption. The lower the tax rate, the larger the amount of future income that is lost by consuming instead of investing.

For example, consider the 98 per cent tax rate on investment income that was the rule in England prior to Prime Minister Margaret Thatcher. Suppose a person has 100,000 pounds. Shall he invest it or purchase a Rolls Royce? If he invests the money at, say, 10 per cent, he would earn 10,000 pounds before tax. But after-tax, his earnings would be reduced to 200 pounds. Thus, the opportunity cost of the Rolls Royce is a measly 200 pounds a year in foregone income. The high tax rate on investment income makes current consumption extremely inexpensive in terms of foregone income.

If the tax rate on investment income is 15 per cent, the cost of the Rolls Royce in terms of foregone income would be 8,500 pounds per year, or 42.5 times as much annually. The 98 per cent tax rate on investment income makes the Rolls Royce essentially a free good. The 15 per cent tax rate makes the car purchase expensive.

Similarly, the cost of leisure is the income given up by not working. The higher the tax rate, the less the after-tax income lost by using time for leisure instead of work. The lower the tax rate, the more expensive is leisure in terms of foregone income. The marginal tax rate on earned income thus affects the supply of labor.

Supply-side economics also corrected a mistake in capital theory. Economists taught that the interest rate determines the cost of capital. If the interest rate is high, capital is costly and investment small. If the interest rate is low, capital is cheap and investment flourishes. At one time this theory made sense, and that time was prior to the income tax. Capital theory originated prior to the income tax, and until supply-side economists came along, no adjustment was made for the impact of taxation on the cost of capital. When there is an income tax, profits or the earnings of capital are an after-tax phenomenon. The higher the tax rates, the higher the cost of capital, and the less is investment and the growth of the economy. (See Paul Craig Roberts, Aldona Robbins, and Gary Robbins, "The Relative Impact of Taxation and Interest Rates on the Cost of Capital," in *Technology and Economic Policy*, edited by Ralph Landau and Dale Jorgenson, 1986.)

Supply-side economists added supply to the macroeconomic scissors. Prior to supply-side economics in the 1970s, macroeconomics was stuck in the pre-Marshallian past. The stagflation that destroyed Jimmy Carter's presidency was induced by policy. Demand-side Keynesians pumped up consumer demand with easy money, while they restrained output with high tax rates. The result was stagflation.

People unfamiliar with facts claim that it was Federal Reserve chairman Paul Volcker's tight monetary policy that cured stagflation. This erroneous claim ignores that prior to the Reagan administration's supply-side policy, tight monetary policy had had no effect on stagflation. Indeed, all Volcker's tight money did was to drive interest rates on money market funds to 17 per cent, thus providing plenty of consumer spending power to drive inflation higher while high tax rates suppressed investment.

Today, Keynesian economics has been reconciled with monetarism and with supply-side economics, making macroeconomics a coherent whole.

However, today macroeconomic policy faces new challenges. In the 21st century, the U.S. economy has been kept going by an expansion in consumer debt, not by rises in consumers' real incomes. Consumers are up to their eyeballs in credit card and mortgage debt. They are no longer in a position to borrow more in order to spend more. Interest rates are very low, and the government's budget deficit is very large; yet, the economy is sinking.

**Monetary and fiscal policy cannot help when the problem is that American jobs have been relocated offshore. Because of offshore production, stimulating demand stimulates production in China and other offshore sites.**

Monetary and fiscal policy cannot help when the problem is that American jobs have been relocated offshore. Because of offshore production, stimulating demand stimulates production in China and other offshore sites. As high-productivity jobs have been offshored, American incomes, except for the super- rich, have ceased to grow. Thus, there is no effective way to boost consumer spending short of printing money and giving it to the population, or handing out tax rebates accommodated by monetary expansion.

Prior to the collapse of world socialism and the rise of the high-speed Internet, it was not possible to offshore jobs or production for U.S. markets to any significant extent. In those prior times, American incomes rose with productivity. If a glitch in employment occurred, an expansionary demand-side or supply-side policy would boost employment and GNP. Today, the jobs have been moved abroad. They are no longer here waiting on an expansionary policy to call Americans back to work.

Trade deficits mean that consumers have spent their money on goods produced abroad at the expense of domestic GDP and employment growth. Writing on the *CounterPunch* website (Dec. 11, 2008), economist Peter Morici reports that U.S. GDP is $1.5 trillion smaller as a result of the record trade deficits accumulated over the last 10 years.

A country that gives away its productive capability and becomes dependent on foreign creditors to finance its budget and trade deficits is a country that has problems beyond the reach of monetary and fiscal policies. For example, no country's borrowing ability is unlimited. The U.S. has been financing its trade and budget deficits by turning over the ownership of existing U.S. assets and their income streams to foreigners and by foreigners recycling their trade surplus dollars into the purchase of new U.S. Treasury debt. This dependence on foreign creditors now constrains U.S. monetary and fiscal policy.

Such creditors hold most of their reserves in dollar-denominated assets. The low interest rates and large budget deficits that are the traditional macroeconomic response to recession make America's creditors reluctant to add to their dollar holdings. The question has risen whether the U.S.A. can continue to hemorrhage debt and retain the reserve currency role. If the U.S. dollar is dethroned as reserve currency, the U.S.A. would no longer be able to pay its bills in its own currency. Such a development would complicate America's financing needs. The U.S. is an import-dependent country, dependent on foreigners for energy, manufactured goods, and advanced technology products.

The U.S.A. has been able to consume more than it produces and to borrow more than it saves because the dollar is the reserve currency. Other countries that get into such a situation either go broke and lose all access to credit or accept an International Monetary Fund austerity program that forces them to curtail consumption and to pay down debt. For the U.S., an IMF austerity program would mean a substantial reduction in living standards.

What can be done? As it would be very

difficult for the U.S.A. to get its house in order if it were to lose the reserve currency role, the government should take immediate action to preserve this role. Preserving the dollar as reserve currency requires large reductions in trade and budget deficits, a tall order for the current weak state of the U.S. economy.

The U.S. can reduce the budget deficit by hundreds of billions of dollars by ending its pointless and illegal wars in the Middle East, by closing hundreds of overseas military bases, and by cutting an overstuffed military budget. This would require the U.S. to give up its goal of world hegemony, but now that America's creditors have seen its aggressiveness, they are unlikely to continue financing U.S. militarism. Better to give up an unrealizable goal than to have it yanked away.

In traditional economic analysis, rising domestic unemployment curtails imports as consumers have less income to spend, thus reducing the trade deficit. The U.S.A. needs to do much more. U.S. manufacturing has declined so much that, should its creditors permit, the time is not far off when the U.S. trade deficit becomes as large a share of GDP as its manufacturing output.

Offshored production needs to be brought home. When corporations offshore their production for U.S. markets, they reduce U.S. GDP and increase the trade deficit, dollar for dollar.

The U.S. could, perhaps, bring home its offshored production by abolishing the corporate income tax, instead taxing corporations according to the amount of value added to their products that occurs in the U.S.A. Corporations that produce their products in the U.S. would have a low rate of tax; those that offshore their production would have a high rate of tax.

**The U.S. can reduce the budget deficit by billions of dollars by ending its wars in the Middle East, by closing overseas bases, and by cutting military the budget.**

This change would take time to become effective, and in the near term it could anger creditors, such as China. However, if the policy was seen as credible, the world would see a renewed prospect for the U.S. dollar as reserve currency.

Another helpful reform would be to overthrow performance pay for management, based on short-term profits. Quarterly reporting and the cap on executive pay that is not performance based gives U.S. corporations a very short-time horizon compared to overseas competitors.

These suggestions would have to run the gauntlet of ideologies on both the right and the left. Moreover, the hubris of American the elites might outlast the window of opportunity that exists for the renewal of the U.S. economy. **CP**

**Paul Craig Roberts** has made original contributions to scholarship in the fields of macroeconomics, Slavic studies, economic organization, and medieval economic history. As assistant secretary of the Treasury in the Reagan administration, his policy innovations cured the stagflation that destroyed Jimmy Carter's presidency. He can be reached at PaulCraigRoberts@yahoo.com.

**CounterPunch**
PO Box 228
Petrolia, CA 95558

**Phone 1-800-840-3683 or visit our website to find out about CounterPunch's new books.**

1st Class
Presort
U.S. Postage
PAID
Permit No. 269
Skokie, IL

**First Class**

**return service requested**