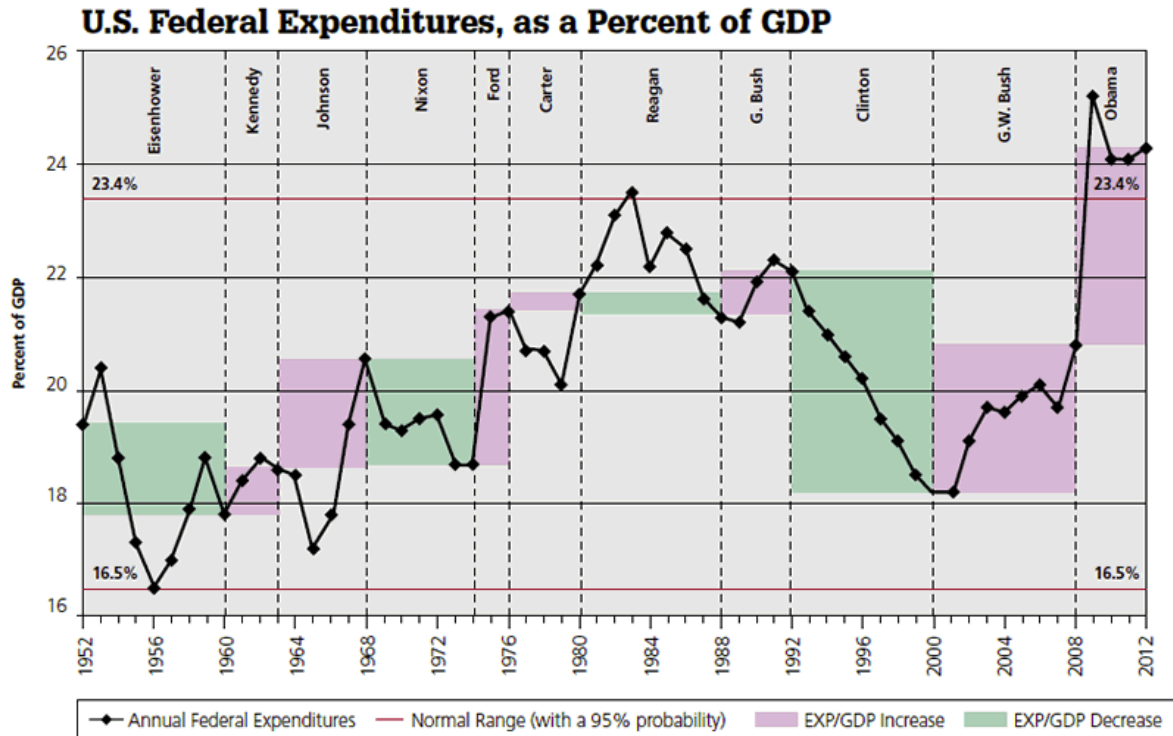




Age Of Illusionists, Focus on Government Spending and Money Supply

By Steve H. Hanke – 11/27/12

Watching Barack Obama and Mitt Romney duel in the presidential campaign should have convinced the spectators that we live in an age of illusionists. Few of the assertions and conjectures thrown around have been subjected to what the political chattering classes deem to be the indignity of factual verification.



Sources: White House Office of Management and Budget and Author's Calculations.

Note: The value for 2012 is an estimate made by the Office of Management and Budget. The normal range is calculated by finding the values that are 2 standard deviations away from the mean (over the period from 1953-2008). This gives you a range where 95% of the sample points are expected to fall.

As a point of departure from illusion to factual reality, I present the accompanying chart, which traces the evolution of federal government expenditures, as a percent of GDP, since 1952. Based on the data, from 1952 until 2008 – when President Obama was first elected – we would expect, with an assurance of 95%, that the relative size of the federal government would fall in a range of 16.5% to 23.4% (see the accompanying chart). Since President Obama's election, in 2008,

the federal government has been in uncharted territory. Today, for example, federal government expenditures, as a percent of GDP, register at 24.3%. This is nine tenths of a percentage point higher than the high end (23.4%) of the so-called 95% historical range. For many people and businesses, this unusually elevated level of government spending is a source of uncertainty and anxiety.

Before proceeding, another inconvenient little fact must be mentioned. The economic cost of a dollar's worth of government expenditures is more than a dollar, because taxes must be imposed to finance government expenditures. These taxes impose distortions (costs) on the economy, and these distortions cut the economy's potential and reduce economic productivity. The costs created by taxes are referred to as the "excess burden" of taxation.

Since 1992, even the White House Office of Management and Budget (OMB) has recognized the existence of the excess burden. For purposes of evaluating federal projects, the OMB requires that an excess burden of 20% be employed. A wide range of scholarly research indicates that the average excess burden of the federal tax system is actually closer to 35%. Accordingly, the real economic cost of a dollar's worth of federal spending is \$1.35, not \$1.00. To put this fact into context requires us to expand the level of government expenditures by 35%. After we do that, federal government expenditures, as a percent of GDP (including the excess burden of taxes), rise from their current level of 24.3% to a whopping 32.8%. By adding this little inconvenient fact into the mix, the "big" versus "small" government debate comes into sharper relief.

Percentage Point Changes in U.S. Federal Expenditures, as a Percent of GDP

President	Years	% Point Change in Total EXP/GDP	% Point Change in Non-Defense EXP/GDP	% Point Change in Defense EXP/GDP
Eisenhower	1953-1960 (8 years)	-1.6	2.3	-3.9
Kennedy	1961-1963 (~3 years)	0.8	1.2	-0.4
Johnson	1964-1968 (~5 years)	1.9	1.4	0.5
Nixon	1969-1974 (~6 years)	-1.8	2.1	-3.9
Ford	1975-1976 (~2 years)	2.7	3	-0.3
Carter	1977-1980 (4 years)	0.3	0.6	-0.3
Reagan	1981-1988 (8 years)	-0.4	-1.3	0.9
G. Bush	1989-1992 (4 years)	0.8	1.9	-1
Clinton	1993-2000 (8 years)	-3.9	-2.2	-1.8
G.W. Bush	2001-2008 (8 years)	2.6	1.3	1.3
Obama	2009-Present (4 years)	3.5	3.2	0.3

Sources: White House Office of Management and Budget and Author's Calculations.

Note: The values in the table represent percentage point changes in U.S. government expenditures, as a percentage of GDP (in constant 2005 U.S. dollars), calculated from the last year of the preceding president's term, to the last year of each president's term.

Green cells represent a decrease in expenditures. Red cells represent an increase in expenditures. Yellow cells represent the expenditure category that drives the change in total expenditures. The sum of the % point change in non-defense EXP/GDP and % point change in defense EXP/GDP may not add up to the total % point change in EXP/GDP due to rounding error.

The accompanying table allows for a more precise look at the fiscal record of U.S. Presidents. Let us begin with President Bill Clinton. The Clinton presidency was marked by the most dramatic decline in the federal government's share of the U.S. economy since Harry Truman left office. The Clinton administration reduced the relative size of government by 3.9 percentage points. Since 1952, no other president has even come close. At the end of his second term, President Clinton's big squeeze left the size of government, as a percent of GDP, at 18.2%.

What is noteworthy is that the squeeze was not only in defense spending, but also in non-defense expenditures. Indeed, the non-defense squeeze accounted for 2.2 percentage points of President Clinton's 3.9 total percentage point reduction in the relative size of the federal government. Since 1952, the only other President who has been able to reduce non-defense expenditures was Ronald Reagan.

The Clinton squeeze didn't last long, however. By President George W. Bush's second year in office, the federal government's expenditures (both defense and

non-defense) were exploding. By the time he left office, his administration had added a whopping 2.6 percentage points (equally split between defense and non-defense expenditures) to the federal government's share of the economy.

With President Obama, the size and scope of the federal government has expanded at an accelerating rate. In his first four years, President Obama has operated in the twilight zone, with government expenditures, as a percent of GDP, exceeding the top of the 95% historical range in each year of his first term. In just four years, President Obama's administration has added a record 3.5 percentage points to the federal government's share of the economy. It took George W. Bush eight years to reach what was then a near-record increase (2.6 percentage points). The astounding thing about this brief account of the evolution of the relative size of the federal government is President Clinton's change of mind. During his presidency, Clinton squeezed and squeezed hard, and his rhetoric matched his actions. Recall that in his 1996 State of the Union address, he declared that "the era of big government is over."

By contrast, the champion of "big government" – in both rhetoric and deeds – is President Obama. And who was a champion of the President's reelection? None other than President Clinton – the illusionist?

This brings us to the sharp pencil people in the Obama administration, specifically the OMB. They claim to know what the relative size of the federal government will be in 2016, at the end of President Obama's term. According to the OMB's plans, the federal government, as a percent of GDP should be 22.5%. That's a 1.8 percentage point drop from the current level. Given that President Obama's first term recorded a record growth in the relative size of the federal government, and that the President campaigned on a platform of more big government, it is doubtful that he will come close to meeting his own OMB forecasts, in his second term. Yes, the illusionists, not the President's sharp pencil people, will probably carry the day.

What will make the President's task even more onerous is money – as in the money supply. It turns out that the Obama administration, led by U.S. Treasury Secretary Timothy Geithner, has embraced the imposition of more stringent capital requirements on banks. And, the Obama administration isn't alone. All the major powers have backed the use of Basel III bank capital requirements. These elevated bank capitalization mandates, when applied in the middle of a slump, are misguided and dangerous.

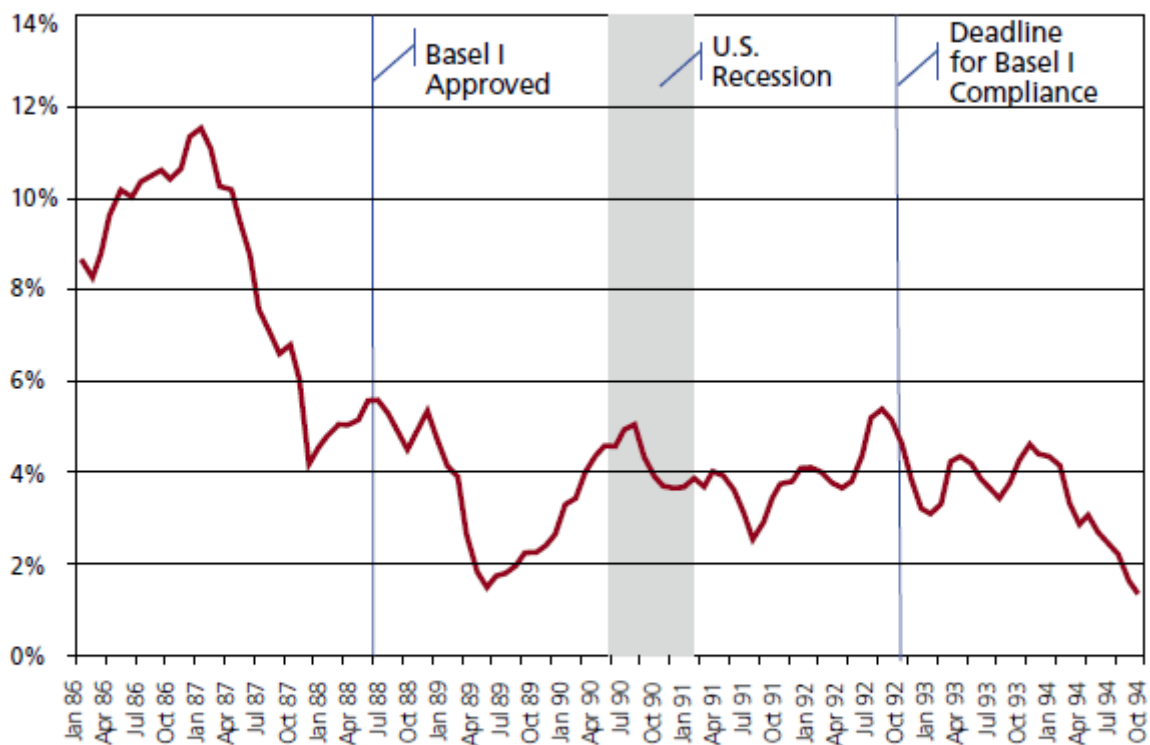
They have forced banks to deleverage on a massive scale. In consequence, bank money (the portion of the money supply created by the banking system) has contracted in most countries. And, since this portion of the money supply is so much larger than that accounted for by state money (the portion of the money supply produced by central banks), the net result has been a tight monetary reality in most countries – with a few exceptions, such as Canada, Germany, and

several Asian countries. This explains why we are witnessing so many credit crunches at the same time central banks are pouring out liquidity.

The Obama administration (and the Bernanke-led Federal Reserve) isn't the first to be caught wrong-footed by the embrace of more stringent bank capital requirements. In 1988, Basel I was approved. It had been supported by President George H.W. Bush and then-chairman of the Fed Alan Greenspan. As the accompanying chart shows, the money supply growth rate slowed sharply in anticipation of the more stringent capital requirements, as banks reined in loan growth.

Divisia M4, Excluding Treasuries (DM4-)

Year-Over-Year Percentage Growth Rates



Sources: Center for Financial Stability and Author's Calculations.

For methodology on Divisia see: Barnett, W.A., Liu, J., Mattson, R.S., and van den Noort, J. (forthcoming) "The New CFS Divisia Monetary Aggregates: Design, Construction, and Data Sources." *Open Economies Review*.

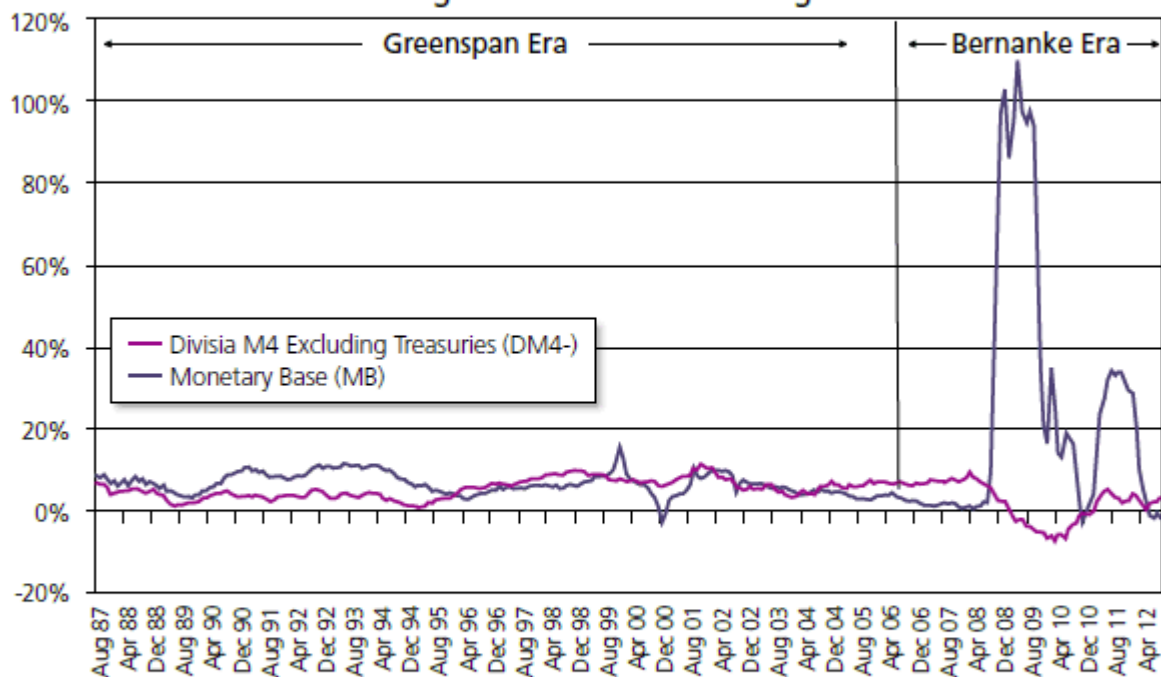
The result was a mild recession; one that cost H.W. Bush a second term. In the case of both Basel I and Basel III, the illusion of "safer banks" ultimately weakened the economy and made the banks less safe.

Back to Basel III and President Obama's money supply woes. As the accompanying chart shows, the Fed has dramatically increased the supply of

state money (Monetary Base) since the fall of 2008, when Lehman Brothers collapsed.

Divisia M4, Excluding Treasuries (DM4-) and Monetary Base

Year-Over-Year Percentage Growth Rates since August 1987



Sources: Center for Financial Stability, Federal Reserve Economic Database and Author's Calculations.

For methodology on Divisia see: Barnett, W.A., Liu, J., Mattson, R.S., and van den Noort, J. (forthcoming) "The New CFS Divisia Monetary Aggregates: Design, Construction, and Data Sources." *Open Economies Review*.

But, state money only makes up roughly 15% of the total U.S. money supply. Bank money is the elephant in the room, and due to the anticipation of more stringent capital requirements (Basel III), bank money has been contracting. In consequence, the total money supply (Divisia M4, excluding treasuries) has slumped.

Since money dominates, the economy has failed to ever recover to its trend rate of growth. A U.S. growth recession – growth, but below the trend rate – at best, will make it very difficult to push government expenditures, as a percent of GDP, down into the normal range, let alone reach the fanciful OMB target of 22.5% by 2016. It would seem that the President's promises of future cuts are nothing more than an election-year illusion.

Thanks to Basel III, the U.S. money supply isn't the only one creating growth headwinds. Europe faces significant money supply deficiencies (see the accompanying table).

Eurozone Money Supply Gaps

Country	Money Supply Gap	% Needed to Close Gap
Eurozone	543	6.01%
Austria	17	6.09%
Belgium	18	4.15%
Cyprus	9	18.66%
Estonia	0.3	2.89%
Finland	3	2.31%
France	80	4.40%
Germany	-71	-3.04%
Greece	77	50.23%
Ireland	62	35.99%
Italy	62	4.63%
Luxembourg	22	8.40%
Malta	2	16.78%
Netherlands	-1	-0.15%
Portugal	25	17.23%
Slovakia	10	30.05%
Slovenia	4	19.81%
Spain	244	23.66%

Sources: Bundesbank, European Central Bank, and Author's Calculations.

Note: The money supply gap = (total money supply) - (the trend level calculated from January 2003 to present.). All values represent M3, in billions of euros, as of September 2012. Red-shaded cells signify a money-supply deficiency. Green-shaded cells signify a money-supply surplus.

It's no surprise that the Eurozone has just fallen into a recession. When it comes to the money supply, just about the only bright spots are in Asia (see the accompanying table).

Money Supply Gaps - Selected Countries

Country	Money Supply Gap	% Needed to Close Gap	Monetary Aggregate
Canada	-13.8 Billion CAD	-0.88%	M3
China	-10.0 Trillion RMB	-10.85%	M2
Hong Kong	-0.3 Trillion HKD	-3.54%	M3
Indonesia	-311.0 Trillion IDR	-10.18%	M2
Japan	-26.1 Trillion JPY	-2.32%	M3
Singapore	-6.7 Billion SGD	-1.43%	M3
Taiwan	0 TWD	0.00%	M2
UK	275.7 Million GBP	12.07%	M3
US	1.0 Trillion USD	6.76%	M3

Sources: Bank Indonesia, Bank of England, Bank of Japan, Central Bank of the Republic of China (Taiwan), Federal Reserve Bank of St. Louis, Hong Kong Monetary Authority, International Monetary Fund, Monetary Authority of Singapore, Shadow Government Statistics, and Author's Calculations.

Note: The money supply gap = (total money supply) - (the trend level calculated from January 2003 to latest available data point). Red-shaded cells signify a money-supply deficiency. Green-shaded cells signify a money-supply surplus.

Will Asia continue to be the world's locomotive? We will have to wait and see. At present, though, one thing is certain – an age of illusionists has arrived.