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Regime uncertainty posing problem to US economy

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Shortly after the Great Recession started, I wrote a column in December 2008 titled "A Great Depression?" In it, I stressed the findings contained in Robert Higgs' book Depression, War and Cold War: Studies in Political Economy.

Higgs concluded that because of regime uncertainty, investors were afraid to commit funds to new projects during the Depression. They simply didn't know what President Franklin Roosevelt and the New Dealers would do next.

I warned, back in December 2008, that regime uncertainty might pose a problem in the current crisis. As I saw it, the political classes were intent on blaming the markets. They certainly were not going to point their accusatory fingers at themselves, and neither were the world's central bankers.

Well, regime uncertainty still prevails and the United States economy, which is being touted as one of the strongest, isn't so strong.

Nominal final sales to domestic buyers, which is the best proxy for aggregate demand, is still rather anaemic. Its current year-on-year growth is only 3.9 per cent - well below the trend of 5 per cent. So, the US remains mired in a growth recession.

Thanks to continued regime uncertainty and weak monetary growth - broad money is only growing at a 2.5 per cent annual rate - the economy has failed to lift off.

To better understand what has happened since 2008 and where we are going, nothing beats the ability to interpret and understand economic data in terms of patterns, relationships, connections and structures that are likely to prevail in the future.

The relationship between the unemployment rate and the gap between profit and interest is vital to understand.

This important, but neglected, relationship was first analysed by my former professor, Kenneth Boulding.

Boulding reasoned that businesses would tend to hire workers when there was an increasing gap between expected profit and interest.

With an increasing gap, the profit rate associated with a new hire would be increasing, relative to the cost of interest.

Alternatively, if the profit interest gap is decreasing (or negative, as it was during the Depression), a business would have an incentive to reduce its labour force because the cost of interest is rising, relative to the rate of profit.

With the onset of the Depression, the profit-interest gap ratio collapsed, becoming negative in 1932. A dramatic surge in unemployment was associated with it. In 1933, the ratio began to improve, and so did the employment picture.

The general pattern is very clear and consistent with economic theory: changes in the profit-interest gap ratio and the unemployment rate are negatively correlated.

When we move from the Depression to the current recession, it is clear that the same general course is being followed, as was seen from 1929 to 1937.

Understanding that reveals just how narrow the Federal Reserve's room for manoeuvre is. If the Fed increases interest rates too aggressively, the profit-interest gap will fall, and the unemployment rate will rise.

The profit-interest gap ratio and unemployment typically move in opposite directions over time, but they failed to do so in the current crisis. Why? Here's where regime uncertainty comes into the picture.

In a fascinating new book From Crisis to Confidence: Macroeconomics After the Crash, Roger Koppl concluded: "Recent regulatory developments such as the Dodd-Frank Act violate the principle of the rule of law and therefore undermine confidence and increase policy uncertainty."

More importantly, Koppl presented measurements of regime uncertainty in the current crisis and their negative effects on confidence and economic activity.

As long as progressive economic policies are pursued with vigour, we can anticipate more regime uncertainty, subdued confidence, low rates of bank money and credit growth, and weak economic growth.

Not exactly the rosy picture that so many are attempting to paint.