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US needs to end tax incentive for leverage: William Poole

We do not see signs as yet that the federal government is coming to grips with the fiscal situation

Latha Venkatesh / CNBC-TV18

William Poole is a senior fellow at the Cato Institute, a think tank based in Washington, DC, and a former president of the Federal Reserve Bank of St Louis. He was very intimately involved with how the Fed responded to the financial crisis. Edited excerpts of an interview:

Strategic shift: William Poole, former president of the Federal Reserve Bank of St Louis, says the US needs an investment-oriented economy. Dennis Brack/Bloomberg

Would you say that the way the US economy evolved from the crisis after the huge amounts of fiscal help will at least ensure we will not go back to another recession? That it maybe a weak recovery but it will not be a recession?

I don't think we will have a double-dip recession, as some people put it. It does look like we are going to have a slow recovery. What worries me most about this recovery is the failure of the government to provide incentives to business investment. We had an economy that is too consumption-oriented, and we need to have an economy which is more business investment-oriented to drive the economy forward.

Do you see it coming? Do you think the Obama administration is fixing it at all?

I don't see anything in the works that would provide the incentives for this.

Every time you see one of the sovereign governments on the verge of default, there is a movement towards US dollar assets, especially treasurys. Do you think that this safe haven status which the dollar still enjoys will be able to help the US government spend its way out of this problem?

The appetite is there but if the federal government in the US doesn't get the state of the fisc under control, then the US would lose that advantage and countries and private firms will start to go to other currencies that are stronger. So the US has a very serious fiscal situation ahead of it.

It certainly does but do you think the dollar is really under threat at all as a reserve currency? It may have its problems but it doesn't seem to have competition.

Not yet, and the market has confidence that the US will fix the fiscal problem and I think I have confidence. But I think we do not see signs as yet that the federal government is coming to grips with the fiscal situation.

How do you think the Chinese central bank policies may evolve?

I have no special knowledge about what China is planning. There seems to be widespread agreement that it's not in China's interest to continue this policy indefinitely. I understand China has some very substantial problems. It's still a country with a low per capita income and yet it's a waste for China to accumulate dollar reserves indefinitely with a very low rate of return.

One of the more fashionable jargon that has come up is the term 'new normal', but yet it's certainly something that we should understand. How do you see the 'new normal' in the global economy? Would it be a long period of developed markets or developed economies growing rather slowly?

Unfortunately, the "new normal" at this point is not well defined. What worries me most about the situation in the US, and it would also apply to western Europe as well, is the assumption in the markets that any large banking firm or a large financial firm that gets into trouble will be bailed out. That is not a sustainable situation in the long run. So we need to change that situation because it's a source of instability; it cannot be a "new normal" that we have this indefinite period where firms can be bailed out by the government.

Do you think it's becoming so much of an expectation that they will be bailed out?

Absolutely, the large financial enterprises can raise funds more cheaply than their smaller competitors, and, as a consequence, the market assumes that the risks are less because the government will bail them out. That means that the large enterprises have a substantial advantage over the smaller enterprises. They only grow larger and we will have a banking system that collapses into fewer and fewer, larger and larger firms that is not a source of strength for the US, it's a source of vulnerability.

In that context, you would support the Volcker-Obama proposition that banks should be made smaller in the US?

I am not sure I would, and the reason is that I believe at the end of the day trying to draw up a list of permissible activities will produce a game between the regulators who try to define permissible activities and the accountants, lawyers and consultants who try to go around the rules, and I don't think that is a stable situation.

So what should the administration be doing? They seem to be getting their intentions right but you think that their methods won't work?

I would emphasize two things that are to be done. One, we need to have much more vigorous capital requirements than we have today and they are to be specified in the law. They should not be subject through the regulatory discretion.

The second thing is we need to end the tax incentive for leverage. We have an incentive for leverage, which makes no sense. Why do we encourage companies to become more leveraged, to take on debt, and households too? We could change the incentives for leverage by phasing out the deductibility of interest on all tax returns and reducing the statutory tax rates so it’s not a method of raising more revenue. We have a subsidy for leverage; it makes no sense.

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