Economic Viewpoint

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Global Economy in the Grip of Regime Uncertainty

Key messages:

- A key factor weighing on global economic prospects is "Regime Uncertainty".
- As originally pioneered by Robert Higgs, this concept applied to taxation and regulatory uncertainty under the Roosevelt Administration, and was applied to explaining the failure of sustained economic recovery to take root.
- In the modern context the concept should be broadened out to include monetary regime uncertainty (in US and Europe and China)
- There is little prospect of regime uncertainty diminishing this Autumn. It is much more likely to increase.
- In particular, it is increasingly plausible that EMU can be saved only by a tactical retreat. But there is little prospect of Merkel and Sarkozy leading this.

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SPECULATING ON EMU, BERNANKE-ISM/OBAMA-ISM, AND CHINA

In a recent Cato Institute blog (23.8) (under the title of "In the Grip of Regime Uncertainty Again"), Professor Steve Hanke draws attention to the analysis of Robert Higgs as to why the Great Depression lasted so long.

Higgs puts much weight on "regime uncertainty" and its severely negative impact on the propensity of business to invest. What Higgs had in mind was "pervasive uncertainty about the property-rights regime", explaining why the New Deal policies embraced by President Roosevelt generated regime uncertainty and "why the Great Depression lasted so long and was transformed into the Great Duration".

The author of *Economic Viewpoint* has not read the Higgs thesis, but the concept of Regime Uncertainty as presented in the summaries appears unnecessarily restrictive. Should regime uncertainty in the period of the Great Duration not have embraced the monetary order (Roosevelt's massive devaluation of the dollar, his ending of the gold standard in the US, the generation of huge uncertainty about future monetary stability, stark questions about the monetary future in Europe, and perhaps most of all the future of peace with war clouds gathering from the mid-1930s onwards?

In this broader concept there can be no doubt that today's global economy, not just the US, is in the grip of regime uncertainty. Let's list the main constituents.

First, there is the huge uncertainty about how the Obama Administration's spending programs will be financed in the long-run amidst considerable suspicion that ultimately the tax burden will land on capital (Yes, Warren Buffett may have handed the Obama Administration a brief publicity coup by signing up to a billionaire's and it seems a millionaire's tax hike, but by now the sceptical public can put this in the immediate context of the subsequent Bank of America deal and the gearing of its success to how the Administration will rule on various related matters, including those to be reviewed by the Justice Department).

Yes, there is the possibility that the Obama Administration will be swept from office in November 2012, but prediction markets (for example Intrade) are putting just less than 50% probability on that outcome and they are putting only around 60% probability on the Republicans gaining control of the Senate (and that would be far short of a filibuster-blocking majority). And so there is a real prospect that by end-2012, US business-owners/entrepreneurs/risk-takers will be staring at the certainty of vast new programs (including most saliently Obama care) and existing unreformed entitlement programs being financed by "share the wealth" taxation.

Second, there is the monetary chaos induced by Bernanke-ism and its twin monetary explosion organized by the People's Bank of China through 2009-10. Bernanke-ism with its features of deflation phobia and monetary authoritarianism has induced huge uncertainty in the minds of investors in the US and globally about the monetary future and about the whole intricate valuation process in financial markets. Bernanke-ism and the PBC's monetary explosion produced a commodity price bubble and also generated a huge froth of current income in the emerging market countries. This froth has been reflected in all valuations relevant to the emerging market universe (including the equities in multinationals heavily engaged there). But the underlying monetary uncertainty (and the knowledge that financial booms are followed by busts) has stood in the way of any decline in equity risk premiums and has so contributed to the process of global mal-investment (under-investment in the advanced economies, especially the US, and over-investment in the frothy areas of emerging markets and commodity extraction).

Of course Professor Bernanke totally denies that there has been any monetary chaos. In his Jackson Hole conference speech he gave an account of US economic developments over recent years and into the future that totally expunges any role for monetary disequilibrium (or the proverbial monetary monkey-wrench of J.S. Mill getting into all the other machinery of the economy) in the sequence of economic troubles. Future historians might argue that as a great American and great scholar Professor Bernanke would have announced last Friday his resignation and intention to dedicate the rest of his academic life to analysing and chronicling what went wrong with his flawed monetary doctrines. That did not happen. Instead we have the theatre of the absurd, with every financial cable TV program filling up its air-time with speculations on what the Bernanke-ite triumvirate will do next. Of course they will bring out a few tricks but these have no chance of economic success and little chance beyond a few days in influencing financial markets.

The biggest US monetary question out there now is whether or not Professor Ben Bernanke will still be in office 18 months from now (President Perry would presumably dismiss him) – and so political regime uncertainty blends into monetary regime uncertainty. In the interim, a subsidiary question is whether the Republicans in the Senate can successfully block all Obama appointments to the Fed so as to keep some empty seats there – and of course there is the looming theatre of the Alan Krueger nomination hearings (to CEA Chair) including a review of his role in the Obama stimulus programs (authoring the cash for clunkers scheme, for example) and his relationship to three other Princeton Professors – Ben Bernanke, Alan Blinder, and Paul Krugman.

The third global area of regime uncertainty is the future of European monetary union. The salvaging of broad monetary union including all present members is already widely seen as mission impossible. If monetary union is to survive then there has to be a tactical retreat. Scarce bail-out resources, with future additions limited by German political realities, must be concentrated on the job of re-capitalizing weak banking systems in the core countries where present lack of market confidence would not allow public debt issuance for that purpose, not squandered in Greece. ECB Bad Bank expansion if it occurs any further should be limited to a role in absorbing government bonds (at market prices) out of the Italian banking system, so as to reduce the correlation between banking risks and government bond market risks there.

A tactical retreat as described can be ordered only by Chancellor Merkel and President Sarkozy in combination, with the plan hatched in secret. Is this a possibility for Autumn 2011? It would be bold to say not at all, but there is absolutely no evidence as yet that the European tide is moving in that direction. In the meantime global investors cannot be faulted for being highly concerned and uncertain about monetary developments in Europe and their potential to bring about a global recession.

And the fourth area of regime uncertainty is China. The PBC's monetary explosions have ended. The extent of subsequent monetary restriction is dubious, but financial history suggests that the rampant asset price inflations turn into asset price deflation even without significant policy tightening. The Australian dollar, still in the high atmosphere, suggests that global markets are not yet homing in on the China regime dangers.

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