Prepare for a Keynesian Hangover

- DECEMBER 28, 2009, 8:49 P.M. ET
- Our government's spending orgy will haunt us in 2010.

By BENN STEIL

In 2008, as the U.S. economy teetered under the weight of years of reckless credit expansion, the Bush administration decided against proposals to sweep out the bad debts from the banking system and then fix the regulatory structure—an approach based on tried and tested models from the S&L crisis and other financial crises.

We will pay the price for this decision in 2010. That's because the Obama administration and the Federal Reserve are plowing forward with Plan B: Nationalize credit creation and "stimulate" the private sector by spending in its stead.

Richard Nixon's famous line, "We're all Keynesians now" never seemed more apropos. With the budget deficit at an eye-popping $1.4 trillion, and on track to stay above $1 trillion indefinitely, Berkeley economist Brad DeLong writes breezily in his Nov. 30 blog that "anything that boosts the government's deficit over the next two years passes the benefit-cost test—anything at all."

On the monetary side, the fireworks have been even more spectacular. Since the financial crisis of late 2008, the Fed has flooded the globe with newly conjured dollars in an unprecedented no-holds-barred effort to prod private credit expansion. Watching the booms in the markets for distressed debt, junk-rated corporate bonds and poor-country sovereign bonds since the summer, one might be forgiven for concluding that the Fed had succeeded well beyond its expectations, and that the market's flight to safety had given way to a flight to Vegas. Yet "the truth is that policy should be piling on," Princeton economist and New York Times columnist Paul Krugman writes in his Nov. 25 blog, "not looking for the exit."

Fed Chairman Ben Bernanke wants it both ways. On the one hand, he regularly reminds the market that he's already found the exit: continuously lending out its securities short term in order to soak up cash. The so-called reverse repo market through which this would be done is probably too small for the task of controlling inflation. But such a softly-softly approach is much more attractive politically than actually collapsing the Fed's bloated balance sheet, which would require dumping hundreds of billions of dollars of stockpiled mortgages.

On the other hand, Mr. Bernanke continues to berate the banks for failing to lend while the government continues to do so with heroic abandon.

Former Salvadoran finance minister Manuel Hinds points out in the latest issue of International Finance that banks have indeed been shirking on their day job of transforming increased deposits into increased private-sector credit. But they haven't quit entirely. In fact, they've funneled significant new funds into nonbank financial institutions—which have not lent them on. What's happening is that U.S. banks have been behaving exactly like developing country banks during earlier crises, such as Indonesian banks in the late 1990s—raising lending to their worst borrowers to keep them alive, lest the banks themselves collapse from their borrowers' defaults.

For U.S. banks, these zombie borrowers are their affiliated financial entities set up to manage so-called off-balance-sheet activities—such as the famous SIVs (structured investment vehicles) created by Citigroup and others during the boom. Thus, the massive fiscal and monetary bailouts of the banks have served to worsen the credit misallocation that led to the general economic collapse in 2008.

What is the right solution? The same one that most observers, including the U.S. government, backed until late 2008: Get the bad assets off of the banks' balance sheets. Banks will continue to use accounting gimmicks for window dressing, but as long as they know the truth—that their assets remain seriously impaired—they will continue to starve far too many sound commercial ventures.

Those who insist that the government buying up soured private assets amounts to an unacceptable bailout should be reminded that the market-driven alternative is called bankruptcy. Unfortunately, this option is now considered too politically toxic.

So what we're left with is the type of government-sponsored orgy of spending and money creation that Washington used to condemn with all-knowing righteousness when undertaken south of the border. But the effect of our doing it is far more consequential, since America possesses the exorbitant privilege of minting not only its own but the world's money.

As we move into 2010, no doubt the horns will be blowing for the long-awaited U-shaped recovery. I suspect it won't be long before we realize we've drunk too much, and that the second dip of a W-shaped recession awaits us.

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