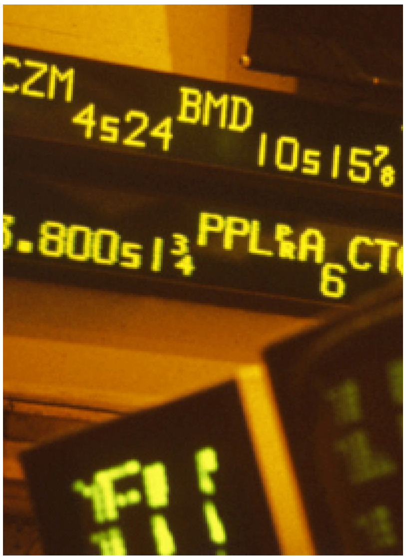
Written by **Bob Adelmann** on August 11, 2010

Fed Confirms Recovery Stalled



When the Federal Open Market Committee announced yesterday that “the pace of economic recovery is likely to be more modest in the near term than had been anticipated,” stocks in Europe lost three percent of their value, interest rates on the U.S. 10-year Treasury note dropped startlingly as investors ran to safety, and the dollar hit the lowest level against the Japanese Yen since 1995.

A Japanese bond dealer said, “Investors were unnerved by the Fed’s statement. It just confirmed that the U.S. economic recovery is slowing.” This resulted in the stocks of Japan’s producers such as Sony and Nissan declining sharply as the stronger Yen against the dollar makes their products less attractive to American consumers. It also penalizes such companies when they exchange their dollars into Yen. Peter Boockvar, an equity strategist at Miller Tabak & Company in New York, said in a note to his clients, “If one of the Fed’s goals in yesterday’s statement was to instill confidence … they accomplished the exact opposite.”

In addition, the U.S. trade deficit widened by a remarkable 19 percent in June, which has caused analysts to revise downward, again, their estimates of GDP for 2010. Estimates of 3 ½ percent growth were cut to 2 ½ percent, and were cut again to 1.3 percent. Even this may be optimistic. Dan Greenhaus, chief economic strategist at Miller Tabak told his clients that second-quarter GDP “is indeed likely to be revised down closer to 1 ½ percent or 1 percent.”

Investors Business Daily confirmed that second-quarter growth was disappointing, and that businesses simply aren’t hiring enough workers even to keep up with the 120,000 new job-seekers entering the job market every month. *IBD* dismissed suggestions by the Fed that they could provide additional support for the economy from its purchase of long-term government securities, saying such moves “won’t work. The Fed has already pumped an estimated $2 trillion into the banking system to encourage lending … but it didn’t boost real economic output.” Such Keynesian “stimulus” simply hasn’t worked. “If anything,” says *IBD*, “the Keynesian medicine prescribed by the president and Congress is making the patient sicker.”

Just how sick the patient is isn’t being addressed by the Fed, or by others commenting on the Fed’s statement. However, the severity of the patient’s illness isn’t being ignored by everyone. Laurence

Kotlikoff, economics professor at Boston University, was refreshingly candid about the real reason for the case of nerves evidenced by tremors in the stock and bond markets: “Let’s get real,” he said. “The U.S. is bankrupt. Neither spending more nor taxing less will help the country pay its bills.” For support, Kotlikoff points to the International Monetary Fund’s annual review which “has effectively pronounced the U.S. bankrupt.” Here’s the language from that report:

> The U.S. fiscal gap associated with today’s federal fiscal policy is huge for plausible discount rates … [and] closing [that gap] requires a permanent annual fiscal adjustment equal to about 14 percent of U.S. GDP.

What the IMF is saying, in other words, according to the professor, is “that closing the U.S. gap [the difference between projected spending and projected revenue in all future years] … requires … an immediate and permanent *doubling* of our personal income, corporate and federal taxes as well as [Social Security].” (Emphasis added.)

Other estimates of the size of that gap have appeared here and have exceeded $100 trillion. However, according to Kotlikoff’s own analysis,

> Based on the CBO’s data, I calculate a fiscal gap of $202 trillion, which is more than 15 times the official debt. This gargantuan discrepancy between our “official” debt and our actual net indebtedness isn’t surprising. It reflects what economists call the labeling problem. Congress has been very careful over the years to label most of its liabilities “unofficial” to keep them off the books and far in the future.

For a college professor teaching at an establishment school, what he says next is remarkable: “This is what happens when you run a massive Ponzi scheme for six decades straight, taking ever larger resources from the young and giving them to the old while promising the young their eventual turn at passing the generational buck.”

Where does the economy go from here? Kotlikoff quotes Herb Stein, President Richard Nixon’s chairman of the Council of Economic Advisors: “Something that can’t go on, will stop.” Kotlikoff says that this “scheme” will stop, but “it will stop too late … and it will stop in a very nasty manner.” He then predicts a combination of draconian cuts in benefits, huge tax increases, and increasing pressure on the Fed to print its way out of the mess.

Far from just a couple of percentage points’ decline in market averages and a gain in bond prices as investors scurry for safety, the Fed’s announcement may be the “outlier” event that finally brings the country’s economic and fiscal reality to everyone’s attention. As *Investors Business Daily* put it, “In the end, what’s left? Only real stimulus … [such as] serious spending cuts, freer trade, and further tax cuts, or least the extension of the Bush tax cuts due to expire at year-end.”

> Such policymakers have learned that when all else has failed, logic requires you to do the one thing you haven’t tried — especially when it has worked before. Is common sense too much to ask?