

Dow Jones Reprints: This copy is for your personal, non-commercial use only. To order presentation-ready copies for distribution to your colleagues, clients or customers, use the Order Reprints tool at the bottom of any article or visit [www.djreprints.com](http://www.djreprints.com)

[See a sample reprint in PDF format.](#)

[Order a reprint of this article now](#)

**THE WALL STREET JOURNAL.**

WSJ.com

OPINION | JANUARY 13, 2009, 8:31 A.M. ET

## We're All Keynesians Again

*Nobody can accuse the government and the Fed of inaction.*

By **GEORGE MELLOAN**

In 1935, six years after the 1929 Crash, the U.S. remained mired in the Great Depression -- as it would be for five years more. At a congressional hearing, then Federal Reserve Chairman Marriner Eccles told Rep. Thomas Alan Goldsborough (D., Md.) that there was very little the Fed could do beyond what it was already doing to pull the country out of the doldrums.

"You mean you cannot push on a string," said the congressman.

"That is a very good way to put it," replied Mr. Eccles. "One cannot push on a string. We are in the depths of a Depression and beyond creating an easy money situation through reduction of discount rates, there is very little, if anything, that the reserve organization can do to bring about recovery."

The Fed is in that position once again. With a federal-funds interest-rate target near zero, the Fed has pumped tons of newly created dollars into the economy over the last four months. This has doubled the monetary base (bank reserves and currency), a phenomenal increase that has shocked market watchers and raised fears of inflation. But all economic indicators are flashing recession.

Last week brought the dispiriting news that the U.S. suffered a net loss of 2.6 million jobs in 2008, the most since 1945. Now 7.2% of the work force is idle. New factory orders, housing construction and retail sales have shriveled. Mortgage foreclosures are rising.

Last year's crash was caused primarily by the deflation of a real-estate bubble that those two government-sponsored behemoths, Fannie Mae and Freddie Mac, had a large role in inflating. As the Japanese demonstrated in 1990, real-estate crashes cause far more collateral damage than mere stock-market slumps. It's amazing that the U.S. policy makers chose to ignore the danger, despite repeated warnings from these pages.

Between 2002 and the fall of 2007, funds raised in U.S. credit markets nearly doubled. Talk about a credit explosion! Easy money, much beloved by politicians

and Wall Street, is a sure recipe for an asset bubble.

So the Fed is again in the position of "pushing on a string" and finding that nothing happens. Some economists describe this as a "liquidity trap." Money creation loses its stimulative power -- vastly overrated even in ordinary times -- because public demand for loans is weak. Americans are too strapped financially, too short on investment opportunities, or too concerned about the future to borrow. They prefer to save instead.

Some economists argue that "trap" is an inappropriate description. The new money the Fed has pumped into the economy to replace the financial-sector liquidity wiped out by the collapse of the bubble *has to go somewhere*, they point out. It has to end up in someone's bank account and banks have to quickly convert deposits (liabilities) into investments or go broke even faster than some have by loading up on polluted, mortgage-backed securities. Maybe "liquidity malfunction" is a better term than "trap."

With 30-year mortgage rates now hovering near 5%, banks are spending a lot more of their time and resources responding to householder demands for refinancing at the lower rates. That doesn't do much for bank profits, but it does improve household balance sheets, cushioning to some degree the impact of the recession.

But what the Fed has mainly been doing since Black September has been transferring economic resources to government from the private sector on a massive scale. There is one thing the banks can do with their deposits if they can't find willing and qualified borrowers -- the word "qualified" was rather neglected when Fannie and Freddie stood ready to buy any cats and dogs offered. They can put those deposits into U.S. Treasury securities.

Banks and investors around the world fleeing for safety have been doing just that, holding down federal borrowing costs, at least temporarily. The global flight for the presumed safety of Treasuries has also shored up the U.S. dollar in foreign-exchange markets, sending crude oil prices plunging. Because of the Treasury mania, 30-year Treasury bonds were yielding only 3.06% and the popular 10-year bond 2.39%.

So the Treasury has a good deal. The Fed pumps money into the economy by buying Treasuries with checks written on thin air. The Treasury quickly spends those dollars on the huge ongoing expenses of a government running a trillion-dollar deficit. Recipients of its spending put the money into bank accounts and, presto, the money comes right back to the Treasury to finance yet more government spending.

The government is thus the main beneficiary of the phenomenal rise in the

monetary base. The base remained relatively stable through the ups and downs of Fed interest-rate policies in this decade, until it went on its fourth-quarter skyrocket trip. For what it's worth, Fed Chairman Ben Bernanke, a student of the 1929 crash, has at least made sure that no one in the future will be able to accuse him of starving the economy into a Depression, as conventional wisdom has held that the Fed did 80 years ago.

Keynesians were banished in the 1980s by Reaganomics but made a comeback years ago and again control U.S. levers of power. They argue that massive deficit spending by the federal government is the right policy for these times. Paul Krugman of the New York Times has asserted that the Great Depression lasted 10 years because the New Deal didn't spend *enough*. Japan tried to spend its way out of its postbubble malaise in the 1990s but ended up with a mountain of debt and a "lost decade" of little or no economic growth. Nevertheless, the incoming Obama administration is promising close to a trillion dollars in fiscal stimulus, and the Bernanke Fed seems to believe the way to deal with a collapsed bubble is to reflate it. That of course takes no account of how we got the bubble in the first place.

Well, there's a lot of high-powered money out there in the huge monetary base the Fed has created. It's at the Treasury's disposal. All that can be said to the Keynesians is, "better luck than last time."

**Mr. Melloan is a former deputy editor of the Journal's editorial page.**

Please add your comments to the [Opinion Journal forum](#).

Copyright 2008 Dow Jones & Company, Inc. All Rights Reserved  
This copy is for your personal, non-commercial use only. Distribution and use of this material are governed by our [Subscriber Agreement](#) and by copyright law. For non-personal use or to order multiple copies, please contact Dow Jones Reprints at 1-800-843-0008 or visit [www.djreprints.com](http://www.djreprints.com)