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A government spending boom won't set us free

From Mr Daniel J. Aronoff.

Sir, Martin Wolf implicitly describes the economies of the US, Europe and Japan as being in a liquidity trap, where desired saving exceeds desired investment at a zero risk-free real rate of interest and the system is forced to contract until actual savings and investment are equal ("We still have that sinking feeling", July 11).

He identifies a dramatic increase in private sector saving as the root cause of the imbalance and argues that continued government deficit spending is the only plausible means to counter the contraction.

I agree with his diagnosis of the predicament, but I think his conception of policy choices is too limited, the option he advocates is too dangerous and he leaves out an important underlying cause of the crisis that must ultimately be dealt with.

Private sector spending can be increased if banks will lend and banks will lend if their leverage is dramatically reduced.

Private spending will also increase if banks reduce the principle owed on mortgage debt, which can be done with lenders retaining an interest in future value appreciation in homes. Governments have the authority to effectuate both policies if they want to.

The problem with continuing to run large government budget deficits is that, no matter how low the borrowing rate, the principal must be repaid and debt levels are already dangerously high. Government risks insolvency the moment the bond market reaches a tipping point at which investors lose confidence, which could occur at any time.

The underlying cause of the excess savings in the US and peripheral Europe is the large current account deficits that they have been running for the past decade and a half, which flooded their economies with additional savings.

In the early 2000s a boom in housing investment maintained the savings investment balance at full employment, but since the crash balance has been achieved by a combination of unemployment and government spending.

What Mr Wolf advocates, in effect, is a government spending boom to replace the housing boom, which risks generating a government debt crisis to rival the housing debt crisis.

We will not extricate ourselves from the roller-coaster of boom and liquidity trap unless and until we cure the curse of chronic trade imbalances.

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