The Washington Times June 12, 2012

Wrong Tools for the Job

by Richard W. Rahn

CENTRAL BANKS CAN CREATE MONEY, BUT ONLY PRIVATE SECTOR CREATES WEALTH

Assume you are a skilled heart surgeon and your patient needs a new heart valve, but you were given a spoon rather than a scalpel to cut open a chest. Relying on the Federal Reserve and the European Central Bank (ECB) to cure the lack of job growth is going to be no more effective than giving a heart surgeon a spoon.

Central banks, such as the Fed and ECB, can cause major economic problems by printing too much or too little money. They do not cause fiscal problems - too much taxing and spending - nor can they cure them. Last week, Fed Chairman Ben S. Bernanke came close to acknowledging what many already know - that the Fed can do little at this point: "To the fullest extent possible, federal tax and spending policies should increase incentives to work and save, encourage investments in workforce skills, stimulate private capital formation, promote research and development, and provide necessary public infrastructure," he said. ECB Chairman Mario Draghi has basically said the same thing to the political leaders of the eurozone countries.

The political class, to cover its own irresponsibility, is trying to dump the economic crisis on the central banks. The job of the central bank is to maintain price stability. When central banks are also asked to ensure economic growth, full employment and even consumer protection, they will fail - because they have the wrong tools.

When the euro was established, the member countries agreed not to run deficits exceeding 3 percent of their gross domestic product (GDP). It was clearly understood that high and persistent deficits would cause debt-to-GDP ratios to rise to levels where deficits could not be financed. All of the major European economies are now running deficits higher than their rates of economic growth, which means that their debt-to-GDP ratios continue to rise. The ECB cannot stop this. Only those who control the fiscal levers of the individual governments can stop these deficits, and the political forces seem unable to reach the necessary level of self-control.

On Saturday, the European finance ministers agreed to lend Spain 100 billion euros (about $125.4 billion) to bail out the Spanish banks. The money will be wasted unless the Spanish and the other Europeans get on a high-growth track. To achieve high growth, they will have to greatly reduce entitlement spending, rigid labor policies and counterproductive regulations. How likely is that? France, rather than increasing the retirement age, which is necessary for fiscal sanity, just reduced it last week. Shorter working lives means less output and economic growth and, over the long run, less tax revenue. Yet, the French, along with the other European national banks, are going to lend money they do not have to cover loans made by Spanish banks for unproductive seaside villas.

President Obama and his allies are now claiming that the reason U.S. job growth has lagged is that not enough new "public sector" (i.e., government) jobs have been created. Which creates wealth - the government hiring another bureaucrat to produce more paperwork for a gas-drilling company to fill out, or the gas company hiring another worker to produce more gas? The Fed can print more money, and Congress can increase taxes in order to hire more government workers, but if their "work" increases the costs on business as a result of more regulations or other impediments, businesses will be hiring fewer workers. If the new government workers are not doing anything that actually increases people's standard of living, they are merely a dead weight on the economy, which decreases the money individuals and businesses have to create real wealth.

A schoolteacher in the classroom who teaches kids to read is creating real long-term wealth. An education bureaucrat demanding more paperwork from teachers, thus reducing the classroom teacher's time spent with students, is a wealth destroyer. Most of the increase in education spending has gone to create wealth destroyers, not wealth creators. Cutting government employment by getting rid of the wealth destroyers will be more than offset by the creation of productive jobs in the private sector.

The Keynesians love to talk about the jobs "multiplier" effect from more government spending. This multiplier only exists in the minds of those (such as New York Times columnist Paul Krugman) who are blind to reality and the empirical evidence - and have no understanding of how the public and private sectors actually operate. Mr. Obama's famous trillion-dollar stimulus - like previous big-spending programs - did not produce the jobs that its advocates claimed it would.

The law of supply and demand has not been repealed. If the cost of labor and capital is reduced, more people will be hired. The government can reduce the cost of labor and capital by reducing taxes and destructive regulations. Demand can be increased by allowing people to keep more of their own product. Central banks have the tools to create money - but not wealth - by reducing the value of private savings, which are diminished by inflation and low or negative real interest rates. Most government activities destroy wealth, and most private-sector activities increase wealth.

Richard W. Rahn is a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth.

http://www.washingtontimes.com/news/2012/jun/11/wrong-tools-for-the-job/