US suffers as Bush’s gamble fails

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After his 1964 landslide election, President Lyndon Johnson gambled that the US economy could support a war and his Great Society programme. He lost. The expenditures exceeded economic capacity. Shortages occurred, prices rose, and a 15-year inflationary spiral began. Within two years, the Federal Reserve had to intervene by raising interest rates. Economic growth stopped and harsh economic conditions brought an end to Johnson’s dreams.

Forty years later, another president from Texas made another wager: betting the US could fight a war, reduce taxes and avoid conserving energy. He also lost. Over the next two years, President George W. Bush will see inflation return and the Federal Reserve Board act to offset his profligate energy and fiscal policies.

Johnson’s hope that the US economy could sustain the Vietnam war and domestic economic expansion ended when US industry failed to meet military and civilian demands. Unfinished aeroplanes sat waiting for galleys and other gear needed to complete them. Homes stood unfinished as builders waited for lumber, plumbing and other finishings. Prices rose. The Federal Reserve took matters into its own hands when Congress refused to reduce the growing deficit. In 1969, as they made way for the incoming Nixon administration, Johnson’s departing economic advisers noted ruefully: “In the absence of a full measure of timely fiscal restraint, an undue share of the burden of dampening the excessive expansion fell on monetary policy.”

Today, President Bush is in a similar situation. He and his advisers also gambled, although in a different game. Johnson tried to provide guns and butter without raising taxes. George Bush tried to serve up large tax cuts without reducing spending or addressing the nation’s rapacious thirst for motor fuels, particularly gasoline.

The Bush wager failed when Hurricanes Katrina and Rita destroyed a large part of the US Gulf coast. The storm put additional strain on an economy operating near capacity, while simultaneously closing part of the nation’s petroleum refining and natural gas industries. The extensive damage has forced the government to enact large spending increases to rebuild communities and support displaced individuals.

This is a classic Keynesian stimulus package. Given the state of the business cycle, inflation can be expected to rise even without offsetting reductions in government outlays. The huge rebuilding requirements will send prices up and create shortages for materials, capital equipment and critical labour resources. Home builders already report a wide scarcity of plywood.

The loss of natural gas supplies adds to inflationary pressures. Katrina and Rita destroyed perhaps 5 per cent of the nation’s natural gas supply, causing large price increases. Heating bills could double this winter. Furthermore, the cost of goods manufactured using natural gas, such as PVC pipe, will climb sharply even before rebuilding efforts boost demand.

The economic stimulus will also put pressure on petroleum markets. The economic spurt from reconstruction will heighten gasoline and diesel demand. But the increase cannot be met because of storm damage to US refineries. Thus, Katrina and Rita will leave a legacy of much higher gasoline and diesel prices in 2006. These price hikes could have been avoided had we pursued a programme to limit increases in motor fuel consumption.

Here, too, George Bush made a bet. Efforts to tighten fuel economy standards for new vehicles were rejected when his energy programme was introduced and Congress refused to change it. The president declined to push a gasoline tax following 9/11. He wagered that an already stretched refining industry could meet mounting gasoline demand, which is largely linked to American affinity for large SUVs and trucks. The president and his advisers understood that the higher demand would require US refineries to operate at maximum capacity. They knew no new refineries were being built. They also knew no new offshore facilities capable of meeting EPA standards had been constructed. Not until this summer, after months of the industry operating flat out, did they realise new capacity was necessary.

The president lost this gamble as well when the two hurricanes hit the Gulf coast, taking a severe toll on the refining industry. It may take a year or more to bring it back to its pre-Katrina state. Until then, supply will be lower and prices much higher. Although the calculations are hard to believe, econometric models suggest retail gasoline prices might need to double by next summer to maintain market balance. The price rise will add to inflation.

There is only one end to this scenario: higher interest rates. A vigilant Federal Reserve Board will have to boost rates to suppress demand, just as during the Johnson administration. The pressure for higher rates will be even greater given the forthcoming retirement of Alan Greenspan as Fed chairman. His replacement will need to convince financial markets that the Board remains determined to keep inflation in check. The consequences will be a slowdown or worse.

As the rebuilding effort slows, high interest rates and high gasoline prices may pull the economy into recession. Like President Johnson, President Bush took a chance and lost.

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