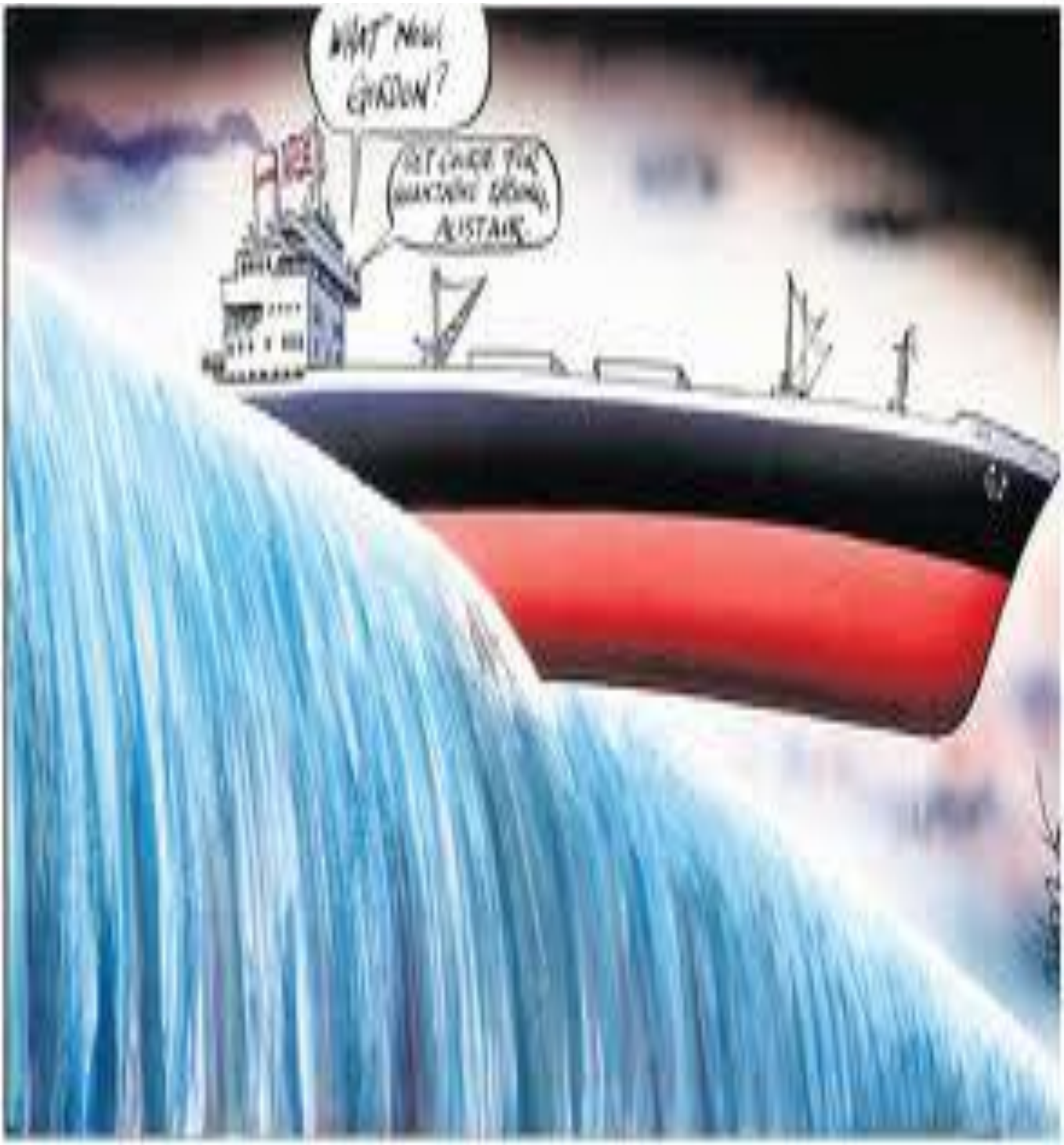
MOVING BEYOND ENDLESS QE'S & THE LIQUIDITY TRAP



Global risk aversion has diminished the risk taking ability of market participants. The relentless & synchronous austerity measures adopted simultaneously by most Western economies is being touted as a panacea for the debt binge (consistent misallocation of capital and insistent misuse of debt) of the last decade. However if everybody deleverages at the same time, the consequences are not very difficult to gauge. We are truly in a downward spiral, and coordinated monetary easing is not resulting in money going into the real economy because no one wants to borrow since each and everyone is already deleveraging(liquidity trap at the lower bound of interest rates is contributing in this pessimism here as well). Banking assets that have turned bad must be quarantined into a Bad Bank that is placed directly under the respective Banking supervisor. It is important that there is a clear demarcation of bad assets into the single "Bad Bank" which will have separate recovery targets and capitalization. The rest of the "good banks" could only then function better with better credit targeting and allocation without the haunting fear of the ghosts of the past which irrationally constrains credit even to deserving candidates.

In an era where every private entity is deleveraging, the State cannot also simultaneously deleverage. To rationalize take a simple case: In a closed economy, where there are only two agents, you and me, my spending is your earning and your spending is my earning. The entire world is a closed economy. If everybody is deleveraging, if unemployment is high, wherefrom economic growth will come? Hence the State has to spend by borrowing, no matter if it is already neck deep in debt. So, are we talking like the two K's: Keynes and Krugman? And what about the lessons from Reagan, Thatcher & the highly acclaimed Chicago clique? Surely Reaganomics and Thatcherism taught us that there is a lot that Keynesian thinking missed out upon. Sure. And that is follows:

After forceful public spending lifts the economy from the depression, the private sector develops the 'animal spirits' to restart investment, borrowing and hiring picks up. In this stronger phase of economic growth the private sector is more efficient than the public sector. Now here is where Keynes writings did not resolve issues because he wasn't around to witness the decadence of public enterprise in the 1970's in the US/UK, and indeed in much of the globe including the USSR. However it was getting very obvious that in the 1970's, the size of the public sector was inefficient, gigantic and it was trying to borrow money from the same public resulting in crowding out of the more efficient private sector. The need of the hour then, was to cut down the size of the government and restrict the role of the state to only those areas where no other actor could qualitatively contribute. That's where Reagan and Thatcher came in, in the 1980's.

But this is 2012. The situation is different. We are entering a global depression.

The only way out for a global recovery to gain ground is that Governments globally borrow massively * and invest directly in the productive sectors of the economy. Roosevelt's "New Deal" needs to get replicated and for that to happen we need to really ignore traditional thinktanks like the IMF that had messed up in Latin America in the 80's and S.E. Asia in the late 90's and are now looking to repeat the same errors in the Western world.

Those who hold Reagan and Thatcher in great esteem can come in later, say in 2016, if by that time the global economy has been safely pulled out of the woods, and the private sector is getting back its mojo. By all means then, dismantle the government and cut down upon activities that the private sector can do better. There will be lethargy on either ends of the economic cycle. Functioning democracies can tackle this type of lethargy and rent seeking on either ends of the cycle provided institutions are allowed to function the way they ought to.

*The only way out is for Governments globally to *ignore the rating agencies in the* defacto Force Majuere situation we find ourselves in and borrow massively a la Marshall Plan and invest directly in the productive sectors of the economy.

Strategy

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