
Wanted: Iconoclasts

By Martin Hutchinson *Wed, Dec 9, 2009*

"Like the 8th-century Byzantine church, the nexus of Washington and Wall Street has grown corrupt," says Hutchinson, who writes the Bear's Lair column at PrudentBear.com, where this article first appeared.

The publicity and vituperation around the book tour of a middling ex-governor of Alaska seems to have nothing to do with Sarah Palin's politics, which judging from her term in office are unexceptional and only center-right. The heat derives from her style, which is that of an iconoclast outsider, and from the establishment's fear that iconoclasm may be the wave of the future. Economically, their fears may be justified, whatever Palin's future career plans.

Historically, iconoclasm was an 8th-century Byzantine movement in opposition to the religious icons central to Orthodox worship. By smashing icons, the iconoclasts hoped to restore the purity of the Church and focus religious belief on the spiritual—they appear to have had similar impulses to those that later inspired Martin Luther to revolt against the decadent Medici papacy. Their opponents, the "iconodules," did not just love images, they were regarded as enslaved to them.

In the economic arena, there would seem to be a good case for iconoclasm. The bipartisan support for the bailout in late 2008 and the lack of action thereafter has left the institutional structure frozen, even a year after the event. Citigroup, AIG, Fannie Mae and Freddie Mac are still in existence, and no plans have been made for their closure or breakup. Wall Street, in the form of Goldman Sachs, is making record profits and will pay even more outrageous bonuses than in the boom year of 2007, yet much of its activity is pure rent-seeking, with no beneficial effect on the outside economy. The U.S. mortgage market is even more hopelessly compromised than it was a year ago, with the combination of the home-buyer tax credit and the Federal Housing Administration's lax requirements for only a 3% down-payment producing a new \$1 trillion pile of mortgages that appear to be toxic.

Other damaging policies that were improvised during the crisis are also still in place, and show no signs of being reversed. Interest rates are still close to zero; indeed bank "window dressing" was reported to have driven interest rates on short-term Treasury bills to below zero. The monetary base was doubled in late 2008, a sharper increase than ever before in the history of the Federal Reserve, yet there is no sign of its decline, while the banking system's excess reserves pile up at over \$1.2 trillion. On the fiscal side, the 2009 budget deficit was \$1.4 trillion and the 2010 deficit promises to be still larger. President Obama has vowed to reduce the deficit, but it has become clear that for this administration the mantra should be "Watch what we do not what we say." In practice, he remains fully committed to a health-care 'reform' proposal that increases both the costs and the budget deficit, by around \$1 trillion over the 2011-2020 period.

As I have discussed previously, continued worship of these icons, whether in the form of the bankrupt financial institutions, the zero-interest-rate policies, or the trillion-dollar deficits, will drive the U.S. economy into a renewed downturn that will achieve new records both in terms of pain and difficulty of exit. Yet the iconodules Bernanke, Geithner and Obama continue their worship, and the congressional

opposition to them seems content only to vary the forms of ceremony, without producing serious proposals that would break the major icons or even chip them.

Like the 8th-century Byzantine church, the nexus of Washington and Wall Street has grown corrupt and its corruption has come to exert increasing costs on society as a whole. Wall Street has become excessively concentrated, trading dominated and rent-seeking, while its rewards, like those of the overblown Byzantine hierarchy, have become completely out of proportion to the increasingly impoverished lives led by the rest of the population. Goldman Sachs chairman Lloyd Blankfein claims that his organization is “doing God’s work;” St. John of Damascus, the leading iconodule would doubtless have claimed the same on behalf of the Byzantine Church. In Washington, eight years in which the ideology that had been sold to the voters in 2000 was replaced with something quite different, there’s a new clerisy even more enthusiastic to expand the power of government without very much regard as to whether that expansion is either cost effective or helpful to the population as a whole.

In such an atmosphere, with unemployment above 10% and rising, and U.S. living standards descending inexorably towards those of the Third World, it is not surprising that the public beyond the Washington Beltway is in an iconoclastic mood. Its iconoclasm is rational, economically speaking. The tight oligopoly of Wall Street is profiting excessively from its 2008 bailout by taxpayers, with the payments to Goldman Sachs and others on the AIG credit default swaps coming to seem increasingly misguided and possibly corrupt, given Goldman Sachs’s close connection with the Treasury Secretary Hank Paulson who disbursed taxpayers’ money in such an unproductive manner. AIG and Citigroup remain in business, with even AIG Financial Products, the cause of much of 2008’s pain, still in operation. Fannie Mae and Freddie Mac remain dispensing their guarantees to the housing market, noticed by the media only at the end of each quarter as they tote up their losses and demand further billions of the taxpayers’ money. The economically damaging subsidies to home purchase, diverting as they do scarce U.S. capital towards yet more unproductive housing, have just been extended both in time, for a further six months and in scope, to existing homeowners. The economic recovery, such as it is, appears to producing almost no jobs but only an ever-widening spiral in commodity prices, affecting the costs of everything the public consumes and eroding the value of its meager savings.

It’s not surprising given the new public taste for iconoclasm that the iconodules of both political parties have reacted with fear and alarm to Palin, who is no ideologue but through her background and style represents the strongest possible iconoclastic sentiment, opposed to Wall Street, Washington and all their doings. Her own political future is uncertain, as is her capability to take advantage of the new movement. But if she plays her hand cleverly, combining iconoclasm with political centrism, attracting good advisors while maintaining her anti-Washington following, her chances of a major political future at a national level would appear good.

With or without Ms. Palin, the iconoclast movement has substantial momentum. The current political-economic system is simply unsustainable; no economy can afford to pay for four giant zombie financial institutions, two substantial military adventures, a zombie-driven housing market, an exploding health-care bill and Goldman Sachs partners’ lifestyle aspirations. While the iconodules remain in charge, U.S. economic performance will consist of anemic growth punctuated by deep, grinding recessions, with new

and small business starved of capital, which is instead sucked inexorably into the triple money pits of housing, the federal and state budget deficits and the investment-banking trading fraternity. In such circumstances, mere reform at the edges will not be enough; icons will have to be broken to liberate the U.S. economy from its excessive costs and allow new private sector growth sectors to emerge.

An icon-smashing president is probably likely to arrive before an icon-smashing Congress, given the electoral advantages to congressional incumbency. The U.S. economy must thus probably suffer at least another three years with the icons in place. Even a sharp 2010 congressional change would probably produce only legislative gridlock, although a belated conversion to iconoclasm by the Obama administration might produce change sooner. By 2013, the case for iconoclasm will be obvious to all. The current period of low interest rates and bubble creation will have met its inevitable sticky end, and the economic costs of unproductive icons will be fully apparent. The economy will be locked in an inflationary version of 1990s Japan, in which necessary reforms have not been taken and the detritus of old problems clogs up the streams of capital formation. At the same time, the costs of health-care reform will be looming close, and the tax increases necessary to move even partially towards balancing the federal budget will be hurting both taxpayers and the economy.

It will thus have become obvious that the housing market needs to be restored to a fully private market state, in which government subsidies are confined to the truly indigent. Zombie banks must be closed down, while the beneficiaries of “too big to fail” must be forced to slim down and divest operations until they are of a size where failure is conceivable. Commercial banks will simply become regional entities, whose failure would damage a regional economy but not the entire financial system. The trading behemoths will be broken into several competitors, whose market share will be too small for them to profit from “insider information” about market flows—a modest transactions tax will also reduce trading’s dominance. Home mortgages will once again be granted locally, with derivatives and securitization technology used only to prevent cost squeezes in high-growth areas. The obvious cost reductions in health care, eliminating the current system’s cross-subsidizations, will be legislated to reduce the sector’s oppressive cost growth. Public expenditure generally will be put on a strict diet, with expansionist foreign policy ended, both in its belligerent and its globalist forms. Finally, monetary policy will set interest rates at a level that rewards savers properly and prevents bubbles.

Iconodule vested interests will oppose such a program with all their strength. But in the end, the iconoclasts will win—the United States cannot economically afford for them to lose.

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