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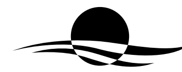
Trend Analysis That Builds Business Decisions



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1 – STIMULUS AN UNNECESSARY DANGER

Comparing our current situation with the Depression is wrong. In fact, the current downturn may be all but over, and doing too much, not too little, is the real danger. So writes Clark Judge, chairman of the Pacific Research Institute.

Ours is a crisis of monetary aggregates, Judge explains. In mid-2007, a large class of securities – first thought to be packages of mortgages, later understood to include all so-called derivatives – was found to be fundamentally flawed. As the value of these instruments started to fall, the reserves of institutions heavily invested in them fell too. Those institutions included banks, but also firms and funds functioning as banks though not covered by the banking laws. The result was a suddenly much smaller quantity of base money.

When reserves shrank, so did all lending. Commercial paper and other derivative-driven markets seized up. Banks wouldn't do business with each other. The structured-finance markets (major drivers of US lending) ceased functioning.

But in 2008 the Treasury and the Federal Reserve attacked the problem at its source. The Fed added more than $1.1 trillion in new facilities to its balance sheet. Each facility was designed to restart the markets for one or another of the troubled classes of assets, strengthening the balance sheets of institutions holding those assets. To supplement these efforts and to augment bank reserves directly through preferred stock purchases, the Treasury received authority to commit up to $1.5 trillion – about a quarter of which had been deployed when the new administration took office. Non-banks acting as banks were brought under the banking laws where legal authority existed to shore them up too. Currency, bank reserves, assets underpinning bank reserves: every component of base money was addressed.

It is very likely that enough has already been added to the monetary base to restore economic activity, Judge believes. The severe downturn of the last three months of 2008 almost certainly originated in the monetary events of January through May when, among other things, the structured finance markets went dead and Bear Stearns folded. By the same rule, following the massive actions the Treasury and Fed took between September and December last year, the economy should rebound between May and September this year.

What could go wrong? In contrast to what the Obama administration is arguing, having done enough, the government could now do too much. Working with Congress, it could mandate trade protection, increase tax rates, divert resources from productive private investment to uneconomical government-sponsored activities, intrude in the management of major industries, or prosecute business people to make populist political points. The stimulus package takes major steps in several of these directions.

The irony here is that, if it keeps such errors to a minimum, the Obama administration is well positioned to take the bows for the Bush administration's response to the crisis. All it needs is a few months of restraint.

2 – UNEMPLOYMENT AND STIMULUS

There is absolutely no long-term economic evidence that higher government spending creates jobs, writes Brian Wesbury, chief economist for First Trust Portfolios, L.P.

Comparing the unemployment rate with federal government spending as a share of GDP over the past 50 years shows clearly that more government spending does not create jobs. In fact, it is exactly the opposite. More government spending is correlated with higher levels of unemployment. In 1965, federal government spending was 17.2% of GDP and the unemployment rate was 4%. By 1982, spending had increased to 23.1% of GDP and unemployment had climbed to almost 11%.

Government spending then fell from its early-1980s peak back to a new low of 18.4% of GDP in 2000, and the unemployment rate fell back to a low of 3.8% in 2000. Lately, due mostly to the profligate spending of the Bush Administration, government spending has increased to 20.7% of GDP. And guess what, the unemployment rate is up, not down. In fact, for the first time in over 25 years, the unemployment rate is higher today than it was at its peak during the last recession.

The reality is that every dollar the federal government spends must be borrowed or taxed from the private sector. And the more resources the government usurps from the private sector, the less job creation occurs.

It is also true that most government spending is less efficient than private sector spending. While there may be a few areas that government spending makes sense – say, defense or some R&D – the vast majority of government spending has nothing to do with creating new wealth. It often competes against the private sector – the postal service and Amtrak – and much of it is pure re-distribution.

Why is the government trying the same old spending stimulus that the evidence clearly shows does not work? With nearly $1 trillion dollars to spend, the government could do some astounding and positive things. The US could rewrite its tax code and move to a flat tax that would make the US much more competitive in the global economy. Or, we could rethink and rework the entire entitlement system, so that it wouldn't eat our budget and economy alive in the next few decades.

We can see the problems that the welfare state is causing in just about every other major industrial country around the world that is ahead of the US on the demographic aging scale. Why not change our course right now and implement true change so that we don't end up like Japan or much of Western Europe? It's a shame, concludes Wesbury, that the US is not thinking along these lines.

3 – THE GREAT DEPRESSION? NO, THE GREAT REPRESSION

Governments cling to the delusion that a crisis of excess debt can be solved by creating more debt. The general assumption seems to be that practically any kind of government expenditure would be beneficial – and the bigger the better. Harvard University Professor Niall Ferguson calls this delusion "The Great Repression."

There is something desperate, he writes, about the way economists are clinging to their dogeared copies of Keynes' "General Theory." Uneasily aware that their discipline almost entirely failed to anticipate the current crisis, they seem to be regressing to macroeconomic childhood, clutching the Keynesian "multiplier effect" – which

holds that a dollar spent by the government begets more than a dollar's worth of additional economic output – like an old teddy bear.

They need to grow up and face the harsh reality: The Western world is suffering a crisis of excessive indebtedness. Governments, corporations and households are groaning under unprecedented debt burdens. Average household debt has reached 141% of disposable income in the United States and 177% in Britain. Worst of all are the banks. Some of the best-known names in American and European finance have liabilities 40, 60 or even 100 times the amount of their capital.

The delusion that a crisis of excess debt can be solved by creating more debt is at the heart of the Great Repression. Yet that is precisely what most governments propose to do.

The born-again Keynesians seem to have forgotten that their prescription stood the best chance of working in a more or less closed economy. But this is a globalized world, where uncoordinated profligacy by national governments is more likely to generate bond-market and currency-market volatility than a return to growth.

There is a better way to go, writes Ferguson: in the opposite direction. The aim must be not to increase debt but to reduce it. Only a Great Restructuring, he believes, can end the Great Repression.

4 – LET INNOVATION STIMULATE THE ECONOMY

The economy is in terrible shape. But rather than a time for panicked reactions, writes Shikha Dalmia of the Reason Foundation, this is the time to fully understand a lesson of history: The rubble of every recession contains the seeds of its own regeneration. Physical and human capital of dying economic sectors doesn't vanish with them. These assets – equipment, property, workers – are re-released into the economy, where entrepreneurs, unless thwarted by taxes and regulations, scoop them up and inevitably find more productive uses for them. In the process, new companies are born and new jobs created – offering, over time, far better returns and wages than before.

This is not idle, theoretical speculation, writes Dalmia. Consider the experience of the US steel industry in the 20th century and the tech sector at the start of the 21st century. Both went through brutal downsizings that eventually strengthened the American economy and led to generally higher living standards.

About a quarter of American steel producers went bankrupt between 1974 and 1987. The industry's global market share shrank to 11% and employment dropped from 2.5 million in 1974 to 1 million in 1997. But this fight for survival, spanning decades and several recessions, eventually restored the overall industry to profitability.

An arguably more stunning comeback involves the dot-com industry. After the 2000 stock market crash, hundreds of Silicon Valley startups collapsed, throwing thousands of highly paid computer professionals out of work. However, within a few short years the industry began to recover, reabsorbing many of the laid-off workers.

One reason for the industry's quick recovery, according to Todd Zywicki, an economist at the George Mason University, was that it was able to rapidly redeploy its resources away from failing enterprises toward more promising ones. Unlike traditional industries, much of the dot-com sector was financed not by debt from bond holders but venture capitalists with equity stakes. This meant that when these companies started showing signs of trouble, their financiers were able to cut their losses and seed other ventures without getting bogged down in time-consuming bankruptcy proceedings.

These are tough economic times and it is impossible to know in advance where the next telegraphic or broadband revolution will come from to drive us out of recession. But the American economy has demonstrated awesome powers of self-correction when its entrepreneurs are left alone to blaze new trails – without a panicked Washington pushing them off course.

5 – NOT THE FAILURE OR END OF CAPITALISM

Carl Schramm and Robert Litan of the Kaufman Foundation write of the causes and effects of the current economic crisis:

Reasonable people might disagree about the specific causes of the current crisis. But there can be no doubt that the housing credit markets were at the root – and the complex securities backed by subprime mortgages the most important branch. The meltdown of those markets provide a perverse lesson in the ability of financial entrepreneurs to make risk so opaque that even the most intelligent, most sophisticated, and most experienced financial minds could so badly misjudge matters of professional life and death. As a result, institutions built on trust have vanished overnight. Surely, much of the blame belongs with those who created these instruments, and with those who misjudged them.

But much more lies with government.

It was politicians, after all, who were determined to raise the home ownership rate from an already robust 64% – the highest in the developed world – to 69% or more (in retrospect, we probably would have been safe at 67%, given the current income distribution, but that extra 2% sent us over the proverbial edge). And it was government that pushed financial institutions to keep lending to ever riskier borrowers in order to achieve that goal.

But what about the steps taken to contain the crisis? For instance: the steady expansion of the Federal Reserve's lending to new "customers" (investment banks, insurance companies, and the commercial paper market); the federal rescue of Fannie Mae and Freddie Mac; the inducements for mortgage lenders to modify delinquent mortgages to avoid foreclosing them; and the $700 billion elephant in the room, Treasury's TARP (Troubled Asset Relief Program), which conceivably could be expanded.

We are cautiously optimistic that once this crisis passes, the government not only will be able to extricate itself from its ownership stakes in the companies it is now rescuing, but market discipline to a large degree will be restored. After all, the United States had plenty of market discipline after the Reconstruction Finance Corporation, created during the Depression to prop up ailing banks and other firms, went out of business in the early 1950s.

Furthermore, the current crisis should be seen as the financial equivalent of a 1-in-100 year flood that is unlikely to be repeated any time soon. With the exception of massive regulatory forbearance granted to insolvent thrift institutions and government aid provided to Chrysler during the 1980–82 recession, the federal government has not injected federal monies into financially threatened firms in past recessions. It therefore would be imprudent for even our largest firms to expect federal rescues in future recessions. And even if future rescues take place, shareholders are likely to take heavy hits first, while executives either will be ousted or have their pay constrained, as has happened during this crisis. In short, the various "bailouts" should not undermine market discipline – a core feature of capitalism however one defines it – going forward.