Growth STRATEGIES

Trend Analysis That Builds Business Decisions

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1 – UNDERSTANDING HOW AND WHY WE ARE IN THIS ECONOMIC HOLE

According to Lacy Hunt of Hoisington Asset Management, there are three competing theories for economic contractions: 1) the Keynesian, 2) the Friedmanite, and 3) the Fisherian. The Keynesian view is that normal economic contractions are caused by an insufficiency of aggregate demand (or total spending). This problem is to be solved by deficit spending. The Friedmanite view, one shared by our current Federal Reserve Chairman, is that protracted economic slumps are also caused by an insufficiency of aggregate demand, but are preventable or ameliorated by increasing the money stock. Both economic theories are consistent with the widely-held view that the economy experiences three to seven years of growth, followed by one to two years of decline. The slumps are worrisome, but not too daunting since two years lapse fairly quickly and then the economy is off to the races again. This normal business cycle framework has been the standard since World War II until now.

The Fisherian theory is that an excessive buildup of debt relative to GDP is the key factor in causing major contractions, as opposed to the typical business cycle slumps. Only a time consuming and difficult process of deleveraging corrects this economic circumstance. Symptoms of the excessive indebtedness are: weakness in aggregate demand; slow money growth; falling velocity; sustained underperformance of the labor markets; low levels of confidence; and possibly even a decline in the birth rate and household formation. In other words, the normal business cycle models of the Keynesian and Friedmanite theories are overwhelmed in such extreme, overindebted situations.

Significantly, by 2011, Fisher's seven decade-old ideas have been supported by thorough, comprehensive and robust econometric and empirical analysis. It is now evident that the actions of monetary and fiscal authorities since 2008 have made economic conditions worse, just as Fisher suggested. In other words, we are painfully re-learning a lesson that a truly great economist gave us a road map to avoid.

POLICY FAILURES

Unprecedented monetary and fiscal policies have been ineffective. Importantly, the massive advance in the deficit was primarily due to a surge in outlays that was more than double the fall in revenues. In the current three years, spending was an astounding $2.2 trillion more than in the three years ending 2008. Yet the fiscal and monetary actions combined have had no meaningful impact on improving the standard of living of the average American family.

Rather than lacking the knowledge to improve the economic situation, there may not be the political will to deal with the problems because of their enormity and the huge numbers of Americans who would be required to share in the sacrifices.

THE DEBT BOMB

By 2015, according to the CBO, debt held by the public will jump to more than 75% of GDP, while gross debt will exceed 104% of GDP. The CBO figures may be too optimistic. The IMF estimates that gross debt will amount to 110% of GDP by 2015, and others have even higher numbers.

The gross debt ratio, however, does not capture the magnitude of the approaching problem. By modern private sector accounting standards, gross federal debt is already 500% of GDP.

FEDERAL DEBT – THE END GAME

The formula where all future liabilities must equal future surpluses must always hold. At the point that investors lose confidence in the dollar stream of future surpluses, the interest rate, or discount rate on that stream, will soar in order to keep the present value equation in balance. The surge in the discount rate is likely to result in a severe crisis like those that occurred in the past and that currently exist in Europe. In such a crisis the US will be forced to make extremely difficult decisions in a very short period of time, possibly without much input from the political will of American citizens. Japan has avoided this day of reckoning for two decades. The US may also be able to avoid this, but not if the deficits and debt problem are not corrected.

MONETARY POLICY'S NUMEROUS MISADVENTURES

Fed policy has aggravated, rather than ameliorated our basic problems because it has encouraged an unwise and debilitating buildup of debt, while also pursuing short term policies that have increased inflation, weakened economic growth, and decreased the standard of living. No objective evidence exists that quantitative easing has improved economic conditions.

SUMMARY AND OUTLOOK

In the broadest sense, concludes Hunt, monetary and fiscal policies have failed because government financial transactions are not the key to prosperity. Instead, the economic well-being of a country is determined by the creativity, inventiveness and hard work of its households and individuals.

A meaningful risk exists that the economy could turn down prior to the general election in 2012, even though this would be highly unusual for presidential election years. The econometric studies that indicate the government expenditure multiplier is zero are evidenced by the prevailing, dismal business conditions. In essence, the massive federal budget deficits have not produced economic gain, but have left the country with a massively inflated level of debt and the prospect of higher interest expense for decades to come. This will be the case even if interest rates remain extremely low for the foreseeable future. The flow of state and local tax revenues will be unreliable in an environment of weak labor markets that will produce little opportunity for full time employment. Thus, state and local governments will continue to constrain the pace of economic expansion.

Unemployment will remain unacceptably high and further increases should not be ruled out. The weak labor markets could in turn force home prices lower, another problematic development in current circumstances. Inflationary forces should turn tranquil, thereby contributing to an elongated period of low bond yields. The Fed may resort to another round of quantitative easing, or some other untested gimmick with a new name. Such undertakings will be no more successful than previous efforts that increased over-indebtedness or raised transitory inflation, which in turn weakened the economy by directly, or indirectly, intensifying financial pressures on households of modest and moderate means.

2 – WHAT COULD BE DONE TO GET OUT OF IT

How to get out of our current situation? As a futurist trained and steeped in history, I offer three quotations. The first is from Henry Morgenthau, US Secretary of the Treasury during the administration of Franklin Roosevelt. He said:

"We have tried spending money. We are spend-

ing more than we have ever spent before and it does not work. … I want to see this country prosperous. I want to see people get a job. I want to see people get enough to eat. … We want to see private business expand. … We believe that one of the most important ways of achieving these ends at this time is to continue progress toward a balance of the federal budget. … We have never made good on our promises. … I say after eight years of this Administration we have just as much unemployment as when we started, and an enormous debt to boot."

What else might be necessary besides stopping spending and balancing budgets? Well, as painful as it might be, the market for distressed assets has to find a bottom and clear. The troubled asset relief program – TARP – was supposed to help but only bailed out big banks and other financial institutions. So I offer the second quotation; it is from Andrew Mellon, also a Secretary of the Teasury. He said:

"Liquidate labor, liquidate stocks, liquidate the farmers, liquidate real estate… It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people."

Sound too harsh? Don't worry: it will never happen. More likely is the Japan scenario: years of slow/no growth, high underemployment, low dynamism, zombie institutions, limited prospects. Lastly I refer you to Calvin Collidge, President of the United States, who, in an admittedly different (but relevant) context, said the following:

"They hired the money, didn't they?"

(Ironically, he was talking about First World War debts owed the US by the French and British governments – debts that were never repaid. Unpayable debts, by definition, never are repaid; see "Is There Really A Debt Crisis?" in *Growth Strategies* #1039, July 2010.)

3 – POLITICAL RAMIFICATIONS

According to Richard Miniter, writing on Forbes.com, the Democratic Party is doomed. His reasoning is as follows:

The fight over raising the federal debt limit exposes a key weakness in the warfare-welfare state that has bestowed power onto the Democratic Party: Without an ever-growing share of the economy, it dies. Every vital element of the Democrats' coalition – unions, government workers, government contractors, "entitlement" consumers – requires constant increases in payments, grants and consulting contracts. Without those payments, they don't sign checks to re-elect Democrats. And every one of these pillars is crumbling.

The Democrats are a coalition, forged in the New Deal, of diverse interests that do not get along well. The only major element of the Democratic base that doesn't receive government payments is the professional class (lawyers, engineers, stock brokers and so on). These high-earners amount to less than 5% of the population and are not reliable Democrat donors.

On the other hand, the Republicans are a consensus party. Activists and leaders fight like hell – leading Democrats to periodically predict the Republicans' demise – only to settle on some principle that is then adopted by the majority. Tax cuts and preemptive invasions were once battlegrounds, now they are cornerstones. Significantly, very few of its supporters receive government payments. Yes, defense firms, farmers and small-business owners get contracts, subsidies or loans. Yet the overwhelming majority of Republicans pay more than they receive. They want to pay less, not get more.

The exception is retirees, who want their Social Security and Medicare while sometimes voting Republican. Since this group is large and reliably votes in large numbers, its entitlements will never be severely trimmed in the foreseeable future. But that fact actually spells trouble for the Democrats. The only way to pay retirees is to 1) raise taxes, 2) borrow more or 3) cut funding to other members of the entitlement class. Options one and two are essentially off the table. Option three is a nightmare for Democrats and, if not today then very soon, a political reality.

This crisis comes at a very bad time for Democrats. Their coalition is either dying off or going broke.

Unions. Private sector union membership has declined from 52% of the American workforce in the 1950s to 7% today. There is no likely scenario in which private-sector unions grow by significant amount. As for government-worker unions, they too are declining.

Federal workers. The civilian government workforce numbers some 2.3 million. More than 750,000 federal workers are eligible to retire in the next three years. Given the federal government's $14.5 trillion debt and the failing economy it is unlikely that federal government will be able to replace more than 10% of those workers.

Media. While media is not a real source of money or votes, it is a major source of influence. That, too, is declining. The media market is fragmenting, as bloggers, talk radio and free weeklies gain mind share.

Professors. New state universities and community colleges provided thousands of jobs to baby-boomer scholars in the 1960s and 1970s. Now, expansion plans have been put on hold and new state-run colleges are a rarity. The working professoriate will continue to shrink.

Teachers. Like other unions, teachers unions see flat or declining membership rolls. Budget cuts and changing demographics mean that their numbers will probably decline, not rise.

Trial Lawyers. A major source of campaign funds for Democrats, these would-be social engineers are losing too. Texas and other states have enacted tort reforms that make it much harder for them to win windfalls. Federal tort reform would doom them.

Environmentalists. The economy has sharply reduced public support for environmental groups, and public giving to green groups has declined with the economy.

State Governments. Debt service crowds out more and more of state-government budgets. Democrat-dominated cities and counties are no better off. Overall, high-tax states are losing high-income taxpayers while public housing, unemployment payments and other state aid discourages the jobless from finding work in other states. This downward spiral of falling tax revenue and climbing entitlements forces lawmakers to make painful cuts. That, too, will shrink the Democratic Party voting base.

The Population. Those who fondly remember FDR are largely disappearing. The Great Society crowd, now entering retirement, is next. Meanwhile, the Reagan youth is entering its 40s, when most American adults become politically active.

With its traditional funding drying up and its core constituencies fading away, concludes Miniter, the Democrat Party of 2020 will look very different. It will either be smaller or much more centrist. Without federal money to spread, the Democrat Party will have to reinvent itself. It will. The world's oldest political party knows how to survive. And it will look back at 2011 as its high point, the year before the tide ran out.