

INVESTMENT POLICY MEMO

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CAPITALISM HAS THE LAST LAUGH (AGAIN)

There can no longer be any doubt that the U.S. and global economies came out of the tunnel of the Great Recession into the light of an economic recovery in the middle of this year. The trouble is that most people don't see the light at the start of an economic recovery. Unemployment always continues to rise, sometimes up to two years after the recovery begins, and this has become more pronounced over time. Worriers, having been proved right in the immediate past, continue to worry. Some people make a living from worrying – selling newsletters or gold coins and other alternatives to money, stocks and bonds. Others, with a dislike of the adverse moral and environmental consequences of capitalism, hope that the crisis will re-emerge and worsen thus undermining the very existence of capitalism.

The most reasonable argument that this is not a real recovery starts by observing that most of the economic growth in the world is a direct result of the stimulus measures undertaken by governments all over the world. The argument continues that the damage done to the ability of households and businesses to pay their debts will depress consumer spending and business investment for many years to come. This second point is reasonable but by no means indisputable. Consumers, especially in America, have repeatedly surprised everyone by bouncing back after economic contractions with new levels of spending and borrowing beyond previous peaks. Unfortunately, these worriers conclude, the spending stimulus packages generally only last for another year or two, as with the Obama stimulus which will essentially be over by the end of September next year, and the monetary stimulus measures have stopped growing and in some cases are already being cut back.

This last point, that the world's economies will start to collapse as soon as the current stimulus plans are finished, is equivalent to contending that illiteracy in America is about to skyrocket as most school budgets extend only through the coming year. The reason we have had such a quick recovery is that virtually every country in the world produced stimulus plans that were not only more multilateral than ever before but also more timely and bigger than ever before. In most cases monetary stimulus is already in its third year and fiscal stimulus is in its second year. Policy makers everywhere know about the Japanese mistake of cutting back on stimulus too soon in the Lost Decade and the American mistake in cutting back too soon during the Great Depression, each after five years of recovery. Given their unprecedented actions to date and their lavish attention to these historical mistakes it seems extremely unlikely that they will reverse the most successful stimulus ever, even faster than these previous misguided reversals.

If you want to be foreboding, just because it suits you or you hope to attract readers to your blog, here is something to worry about that you can also be angry about. As there can be no doubt that we are in a recovery, there can be even less doubt that the steps taken to get us here

have been overwhelmingly crafted to benefit the rich and powerful. The public has been correct in its perception that the banks were bailed out along with other corporations which had been very badly managed, while workers, homeowners and most everybody else got a few crumbs from the bankers' feast. In a recent New Yorker profile of the wise five who provide daily briefings on the economy to President Obama, the usually careful New Yorker got suckered into presenting the Administration's defense of its economic policies as if it were reporting just the straight forward facts.

A long list of reasons is given for not "nationalizing" the banks – where nationalizing is employed as a frightening synonym for making shareholders take the first losses, as they are supposed to do, and controlling the employment and pay of those who had created the worst economic crisis in the world since the Great Depression. All of the reasons are specious: after all, a large number of financial firms actually have been nationalized with the federal government investing more than the existing equity, guaranteeing vast amounts of debt and settling for owning only a fraction of the company. But the decisive argument apparently is due to an "insight" of the brilliant if emotionally volatile Larry Summers: when investors buy something with a lot of borrowed money, a decline in its price can lead to further declines as the investors are forced to keep selling to pay off their debts. At least the New Yorker did not call this an original discovery.

So the Geithner Plan was based on this insight. The banks were not insolvent. Their toxic assets were not toxic, just depressed by everybody's rush to pay off excessive borrowing. Never mind that these non-toxic toxins were securities backed by subprime mortgages that were experiencing predictable large levels of defaults; or that they had been sliced and diced into mortgage backed securities that had been wildly overrated by the corrupted rating agencies, that were understood by almost nobody and that were structured in a way which made it virtually impossible for anyone to renegotiate the underlying loans as lenders would normally do in such circumstances. If it weren't for forced liquidation to pay off the debts of banks and hedge funds, these securities would be worth much more. This was an idea Bush's Secretary of the Treasury, Hank Paulson, had clung to in 2007 and 2008; but he had not been able to make any use of it despite numerous attempts.

Geithner (and presumably Larry Summers, his former boss in the Clinton Treasury and virtual boss in the Obama economic policy regime) came up with the solution. If banks and hedge funds wouldn't lend each other the money to buy these questionable assets, the United States Treasury would do the job, lending "qualified" investors ten times as much money as they themselves invested to purchase packages of floundering mortgages. If financial risk addicts had run out of leverage, the government would be the drug supplier of last resort. Oh, and by the way, just in case nobody else thought these securities were worth as much as Larry Summers did, the government (i.e. we the taxpayers) also guaranteed these qualified (i.e. rich, powerful and experienced in high financial skullduggery) investors against losing even the small part of the investment that they paid for in purchasing these really not toxic assets. Is it any wonder that the depressed prices of distressed assets went up under this policy, which effectively bailed out banks and hedge funds at a cost yet to be known, but did little for the defrauded or unemployed homeowner who could not pay her mortgage? Yet, the New Yorker story implies, oblivious to all of these decisions, that the rebound in toxic asset prices verifies Summers' insight, when in fact it merely shows that the United States government is more credit worthy than Citibank or a sub-prime borrower.

The Federal Reserve and the U.S. government, mostly without any explicit authorization from Congress, have lavished trillions of dollars on buying stocks, bonds and toxic assets, guaranteeing debts and investments and effectively paying off Goldman Sachs and others for unregulated private contracts (read “bets”) they had made with AIG, Lehman and Bear Stearns. All of these efforts and some of the tax cuts in the stimulus package are bailouts for the rich and reckless. Not only are they of questionable morality, they also are very inefficient measures for inducing an economic recovery. As a result Wall Street is on its way to an all time record breaking year for revenues and bonuses, while Main Street is left holding the bag with unemployment approaching and likely soon to exceed 10% and houses and stock portfolios worth about 30% less than two or three years ago.

This is because financial bailouts were about \$3.5 *trillion* dollars, while spending on job creation and homeowner assistance was about \$500 billion dollars. If another \$700 billion dollars, or 20% of that \$3.5 trillion bailout, had gone into more direct support for Main Street, unemployment today and a year from today would be much lower. As former International Monetary Fund chief economist, Simon Johnson, has been saying all year, the United States now closely resembles the banana republics it once derided for being governed by oligarchs and bankers.

In the 1950’s William McChesney Martin, the very conservative Chairman of the Federal Reserve, summed up the Fed’s responsibility as taking away the punch bowl when the party got going. Since then the policy mantra has been steadily transformed so that it can now be expressed as bringing out a fresh punch bowl when the first one is empty and the guests are in danger of sobering up. Although the collapse of leverage is the proximate cause of our problem, the resurrection of leverage -- which will inevitably collapse again -- is proffered as the solution. So here is the answer to the worrier’s prayer; but only the far sighted worrier, as we must first have the rebuilding of the tower of leverage and the celebration of yet another new golden age before we can get to the collapse of that tower. There will be another crisis, perhaps as bad or worse than this one; but not for at least another seven or eight years.

Meanwhile, it is nearly certain that developed countries will continue at least a modest recovery for a number of years while most emerging economies resume quite rapid growth. Generally most stocks in the world are still reasonably priced given this positive economic outlook, while the protection that bonds offer against a deflation now seems unnecessary. Accordingly we are close to fully invested in common stocks given the guidelines in different portfolios. A number of specific areas are attractive, including exposure to improving consumption in the developed world and accelerating consumption in emerging markets; new technologies, especially Internet based, that are gaining market share; renewable energy; health care, especially outside of the United States or with high exposure to the consequences of an aging global population; and financial companies that will benefit from an economic recovery or the growth of emerging market consumption not to mention the policies we have excoriated above.

-- Robert Zevin