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Getting There: where is Greed when it is needed?

Perhaps the biggest surprise of the first 100 days is the contrast between the President's popular appeal and a clear delineation of Government economic policy going forward. There is an abundance of the former and scant trace of the latter. There's a lot of faith out there sustaining current economic hopes. How long can that continue? At the end of the day, economic activity has to improve and improve markedly or Obama's public support will wither. Until the electorate's patience wears thin, the message is the medium. Let's hope that the academic scribbler behind all of this is not defunct! Keynes closing remarks in the **General Theory** bear repeating[1]

A. To know where you're going, you have to know where you began. We began with a massive downward shift in the risk appetites of savers, domestically and internationally. Abnormal fear replaced rational assessment in the world's credit markets. This shift interrupted and strikingly reduced most traditional forms of business and household credit in the U.S. Consumers altered their consumption pattern, saving out of fear, with a corresponding, sharp decrease in personal spending, particularly automobiles. Increased saving is going into riskless assets, largely Government securities or deposits insured by the Government. Our Shadow Banking system is now stilled as our major financial institutions try to regain their footing by reducing leverage. Credit is available to those who need it least. It is hard to price credit to those who are desperate for it. If you doubt that, go to Detroit!

B. In place of private commercial and household credit, the Government (FDIC, Fed and Treasury) has intervened into significant segments of our disabled credit system and inserted itself into the ownership of the automotive, financial and home mortgage sectors of the economy. Some minimal functioning of these sectors has resumed, but the broad contours of credit creation and access to credit have been drastically shrunk. Without adequate credit, the economy cannot grow and it shows in the GDP data as inventories and receivables are liquidated.

C. With the shift in risk tolerance, former channels of credit and their attendant evaluation and extension procedures, (the so-called Shadow Banking system), has virtually shut down. Securitization has been halted. In its place the Government is making essential credit decisions, and choosing who will live and who will die. Unless we have entered into a permanent state of Government intervention in the economy, it is unclear who will make the decisions formerly made in the credit market over terms and conditions. Until some semblance of a functional credit system re-emerges, self-sustaining economic growth cannot be restored.

How does the Government withdraw and let markets function once again? That is the essence of the "exit" problem which has hardly been addressed. In fact, it has been postponed. The recently concluded stress tests conducted by the Fed suggest that further re-capitalization of several banks will be required and hopes for a rapid return of TARP funds by some financial institutions has been tabled. Exit is perhaps further removed than we thought at the end of 2008.

The process of Government intervention that began in 2007 was initially thought to be remedying a liquidity problem. After the collapse of Lehman, the authorities realized they were dealing with a solvency problem. As solvency issues emerged, risk appetites plummeted world wide and the world's credit system foundered. It is bad in the U.S., but probably worse in Europe because transparency in European financials is significantly lower than in the U.S. What now seems clear is that we are very far from the end of this road because significant Government participation in U.S. finance and industry is just beginning. Nearly every Government official claims that the Government wishes to stay out of this thicket and return to market-based decision making, all the while plunging further into the forest The rules are not only unclear, they are unknown. What rules there were, change virtually at the drop of the next Government program. It is impossible to determine exit conditions when we don't even know what road we traveling upon.

Today, the budget resolution passed the Congress, but that only leads us to a more impenetrable miasma. Multi trillion dollar deficits stretch out in front of us as more of the Obama programs for health care, education, carbon limits are thrust onto the stage. For those who fear inflation, the increasing amount of apparent economic slack (the output gap in today's nomenclature) suppresses current price rises. If the economy doesn't grow, inflation threats will be cured by the loss of output and enlarging capacity, but that is a Pyrrhic victory.

Recently, some market skepticism that the Fed can keep the long end of the yield curve under control is emerging, despite today's Fed statement that reiterated its intention purchase substantial amounts of mortgage paper. Yields on Govies rose at the long end! The battle has been joined: risk aversion versus fear of future inflation.

100 days have elapsed. The Congress and the Executive now belong to a single party with manifold interests, led by a President with a gift for media communication. The Obama White House has cleverly pilloried Detroit, Wall Street, executive compensation and the absence of credit expansion to the wider voting population. The voters applaud, but the essential issue is whether the economy will recover fast enough to outrun the inevitable decline in future popularity.

Financial companies who supped at the TARP table are being poisoned by their indulgence. Their best personnel want to leave for less constrained compensation environments but the Fed is now chained by fears of invidious comparison. Those who depart TARP will leave the market with a very negative view of those remaining and their credit will evaporate. It is adverse selection run amok! That leaves the mega and investment banks in a perilous condition. To rebuild their capital structures they need earnings now and the possibility of even larger future earnings. If they lose their most talented, can they create those desperately needed earnings? If they don't pay their talent, why will the talent stay? It is also a dilemma for the Feds because to the extent mega banks don't earn, the Feds will be forced to inject even more funds. And, we have all been told that the majors are too big to fail. How much more will it take? Only the Shadow knows!

The Obama plan was also hitched to an enormous fiscal stimulus plan. If it works, it will be the dray horse of the recovery. There are plenty of economists who believe that the relevant fiscal multipliers are significantly less than one, maybe closer to zero. The faithful believe in multipliers of 1.5 or more. They both can't be right! If the multipliers are less than one, the Fed has to come up with more tricks to remove bad assets from bank balance sheets. The plan du jour was Ppip. We think that it is an exercise in Crony Capitalism and a rather futile effort to have the private sector lift the toxic waste from Augean Stables of Wall Street. In fact, the only way the Ppip can work is that somehow the taxpayer is foist with paying too much for not enough and the resulting weight lifted from bank balance sheets opens the credit floodgates. The taxpayer will be saddled with the difference but that is long after Obama's first term ends.

Obama has created a great deal of hope in 100 days. What he needs is a tidal wave of credit expansion. It could happen if savers around the world get tired of low returns. Better hope for a return of Greed. Obama will need it and so will we.

[1] It is useful to quote the entirety of J.M. Keynes's classic lines about quote about being slaves to some "defunct economist."

> Practical men, who believe themselves to be quite exempt from any intellectual influences, are usually the slaves of some defunct economist. Madmen in authority, who hear voices in the air, are distilling their frenzy from some academic scribbler of a few years back. I am sure that the power of vested interests is vastly exaggerated compared with the gradual encroachment of ideas. Not, indeed, immediately, but after a certain interval; for in the field of economic and political philosophy there are not many who are influenced by new theories after they are twenty-five or thirty years of age, so that the ideas which civil servants are not likely to be the newest. But, soon or late, it is ideas, not vested interests, which are dangerous for good or evil. **J.M. Keynes, <u>The General Theory of Employment, Interest and Money</u>**