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Getting a Handle on the Ingredients for Recovery

We have been comparatively silent recently, mostly due to the complexity of the current economic environment. In part, this is because this RECESSION is DIFFERENT just as the BOOM that came before was different. However, Boom-Bust is not a totally unknown scenario, and it is well to re-emphasize some of the salient points of a Boom-Bust sequence.

1. Booms invariably involve artificially low **real interest rates** that stimulate huge amounts of **capital investment**. It takes a long time to work off the excessive capital stock that results from the Boom, and if you plug up the "exits," it can take forever (consider Japan). "Capital Exit" is the ***sine qua non*** for recovery, but how the 'exit' is created has a great deal to do with the quality of the subsequent recovery and the duration of poor economic performance after the bust.

2. The causes of a Boom are manifold. Sometimes excessive consumer spending triggers a Boom. Sometimes Governments, who never seem to learn the lesson of Guns and Butter (especially when elections are near at hand), create excess demand. Sometimes (as it was this time), the Boom comes from the seemingly unparalleled investment opportunity that beckons capital resources from every nook and cranny, with investors standing in line to pick a seemingly bountiful harvest. The 'unparalleled investment opportunity' could itself be the result of a technology breakthrough, but it also could be a 'perceptual' event, as in the case of those who thought Japanese corporate managers in the 1980's had discovered the secret of permanently enhanced productivity and profit growth. (Other examples: South Sea Bubble, American Railroads, Argentine agriculture, the 1920's Radio Bubble, etc., come to mind, each with a different contour).

3. What really defines a Bubble is the behavior of **asset prices** (prices for capital assets), as opposed to the **prices of final goods and services**. In the Boom, capital asset prices rise dramatically but the prices of other goods and services seem relatively stable. This divergence is critical since in a typical inflationary expansion, the general level of prices rises, nearly always in response to a huge, unforeseen monetary stimulus, while assets prices may even fall! In the latter case, invariably the Central Bank will begin to tighten. A Boom reverses that sequence and capital asset prices seem to behave as if they are playing in a 'league of their own.' Given conventional Central Bank (CB) norms, the CB nearly always fails to 'act early enough' to quench the fire, because the CB's primary indicator (general price indices) are not showing the excess demands that accompany the Boom. Second, it is a hard political choice for any Central Bank to be blamed for causing a capital market Bust!

4. If **asset price inflation is the key**, then recovery involves reversing to some extent asset price growth and it may even require asset price declines. This etiology suggests Booms will be different in different countries depending upon their institutional arrangements, but it also suggests that Greenspan will not

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955 Mt. Moro Road, Villanova, PA 19085. tel (610) 527 5368 fax (610) 527 5068

Website www.ecomentary.com. Contact: munkb@ecomentary.com

escape criticism for allowing the Bubble to rise as much as it did.[1] The continuing comparison to Japan suggests that some Market Players think that the Japanese experience is universal and will catch up with us. We think this is a very inappropriate analogy, although Japan's response offers excellent insights for policy makers and for market participants. Unfortunately, critics have focused largely on the extent and duration of the Japanese post Bubble hangover, but insufficiently on the terms and conditions of Capital Exit that are required to effect a cure.

5. The next question is how long does it take to get out of the soup followed by identifying which policy works best to get the economy moving again? Keynes gave an answer that later generations of economists have largely rejected. Let the government spend its way out of the Depression! Greenspan and Bush have provided different answers. Be very easy on monetary policy and try to eliminate taxes so as to raise personal incomes. Both policies work to extend durable goods purchases by consumers and help to compensate for the lack of flow-through investment demand. If the Fed or its fiscal counterparts could stimulate exports, they would, but they can't do it very easily (by intervening with regard to other countries' currencies). Broadly speaking Greenspan would like to have the dollar decline…albeit slowly, provided it worked to stimulate more U.S. exports rather than signal foreign investors to suddenly liquidate and flee! How to do that by policy measures is akin to magic.

6. When the recovery depends on the consumer to the extent that we are now trying in this economy, skeptics come to worry that the consumer will run out of spending power before growth returns. But, observers need to be very careful with this household debt burden argument or the fatuous argument on corporate cost reductions, recently printed in the New York Times (The writer, Louis Uchitelle, attributes the argument to Goldman Sachs' "Paradox of Corporate Thrift" but he commits so many logical errors that that it nearly doesn't pay to spend time giving his version of the "paradox" serious consideration). In the first case, it is a case of flows. How much can be borrowed by households and how much can and will be repaid? (We skip the more subtle issue of whether we will have a Fannie Mae moral hazard problem). Right now, the "burden" does not seem so high that consumers cannot continue to buy.

7. The second issue (downsizing the work force) is essentially an issue of flexible wages and prices. In the extreme, as in Europe, where wages cannot fall for "political reasons," the economy suffers unemployment and poor growth because the policy tools no longer belong to the sovereign states. Ultimately, there are arguments over policy mix that is not easily resolvable under current institutional requirements. If you have a Stability Pact that prevents the national Government to intervene, it will be forced to wait on the ECB whose policy guidelines beat to a different drum. In Japan, the actual policy menu has been to prevent firms from firing workers. The result is that the excess Capital Stock cannot leave the firm or industry and the Bank of Japan is then dragooned into a monetary policy that allows continued commercial loans that cost nothing to "certified borrowers." That keeps the Zombie firms alive and growth stagnant because capital, rather than exiting, is frozen in! Since recovery requires that capital must exit the areas in which it is in excess supply, the sun never rises and the recovery is a protracted slump. In the U.S. we have only just begun with Telcom particularly, but more generally

[1] This piece was originally written prior to Greenspan's speech at the Kansas City Fed's Jackson Hole Conference. (See "Economic Volatility," remarks by Chairman Alan Greenspan, delivered at the conference on August 30,2002. http://www.federalreserve.gov./boarddocs/speeches/2002/20020830/default.htm)

with Tech. We have begun and more will be done over this next year.

8. The contrast between the Old Economy and the New Economy is quite revealing with regard to Capital Exit. Think about the New York Times story on Sunday August 25th about Texas Pacific agreeing to help finance US Air's bankruptcy. The terms of the deal require renegotiation of the labor contracts--and the same will be true of United even if United does not go into bankruptcy. The lesson is clear. If you have flexible wages and prices, you get cost reduction and firms can be restructured, provided there is sufficient borrowing leverage to do the restructuring now, without waiting for the natural forces of **technological obsolescence.** The key is the availability of suitable finance.

9. In the new economy, labor cost restructuring is comparatively easy. Surprisingly, the labor that is dismissed in one tech firm is quite easily transferable to others still in the Tech Space or to Old Economy firms that need workers with good technology backgrounds. But elsewhere, particularly with strong Unions, there is considerable resistance. The capital stock must fall to raise the rate of return on capital. That will require bankruptcy, closure of firms, and a repricing of their fixed capital assets. In the New Economy, firms that had business plans focused on Sales or Markets, and not on profits, will ultimately get starved out---freeing various kinds of skills to work (perhaps at lower wages) in other tech or tech related business.

10. While this process is being worked out, net investment in the private sector will not recover in a striking way. Given limits on export growth, the trade sector has little punch for the overall economy. Thus, the critics of a monetary based recovery spring forth—citing one sector (hamburger) models of the economy to make the charge that corporate cost reduction will lead to a failure of the 'household' sector to stay on a sustainable consumption path. Hence, the presumptive appeal of Double Dip or what will now become the leading argument of skeptics, intolerably slow growth. Here comes Japan again, but the focus is on slow growth, not recession or no growth. From an equity market standpoint, the fear is that without reasonably rapid growth, earnings growth is doomed and therefore neither earnings nor multiples can expand. Under this scenario, the stock market is not suffering a 'disconnect' with the economy. On the contrary, the stock market is an accurate forecaster of a continued down turn. But notice that each of the putative aborted recovery scenarios require that capital fails to exit industries in which it is excessive (in sufficient magnitude). Or, the labor market is not allowed to reprice itself to allow full employment. Finally, one should add, implicit in both scenarios is a kind of blockage to new capital entering to restructure old businesses, often on a leveraged basis.

11. The Bottom Line: If the U.S. economy has insufficient capital exit and if labor markets have a high degree of wage rigidity, it will be hard to raise rates of return to capital and to motivate a resumption in private domestic investment certainly in a reasonable amount of time. The ECB and the Japanese experience are like bright warning lights, flashing yellow and red. What the U.S. economy will require to get out of the current malaise is access to capital by young, growing businesses and an active market in 'takeovers.' Second, restrictions in the labor market to re-pricing labor in various industries can be a huge 'headwind' for recovery. Third, the political response to a sluggish recovery and to the current furor over corporate accounting scandals and corporate governance can lead to another significant impediment to recovery, namely re-regulation or regulation that stifles taking business risk.

12. The right comparison between Europe, Japan and the United States is not the pitfall of poor growth,

but the reasons why their growth experience is so poor are labor market inflexibility, poor financial intermediation and excessive regulation. The major strengths of the U.S. economy have been its labor market flexibility and the soundness of its financial institutions. What looms on the regulation and legislative punishment fronts, however, is poorly thought through efforts to impose a regulatory harness on the economy. Invariably, that will put a serious, long-term damper on U.S. growth.

13. Signals and Signposts: The comparative economics of the three 'global poles' suggest what to look for in terms of signals of repair: A significant downward move in interest rate spreads or credit swap spreads and rather flexible adjustments in contract wages in industries that need restructuring. The airlines may provide a good case history on adaptability in the U.S. economy, but there will be others. Further, one might suppose that credit spreads will come in as the Corporate Governance problem dies back. However, on this score, we may see even more examples of "bad apples." The history of government regulation ---often stimulated by conditions of a Bust---also suggests a signal to worry about. Often, regulation designed to offset some of the worst aspects of a Bust, takes a toll on the speed of recovery, and that is a very big danger when it comes to the Corporate Governance problem. If politicians drag out the resolution in order to make hay before the election, recovery will be delayed. Capital markets like certainty and nothing is more disconcerting than the threat of more regulation.

14. We have left the War Scenarios for another note, but we would be remiss not to mention them and their handmaiden, a putative Oil Shock. Investors can still be shocked, particularly by unforeseen or poor Government policy. So far, consumers have hung together. If the policy mix is right, they will continue to do so until capital investment begins once again. If consumers fail, however, the problem gets a lot worse.

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