
The Idle Speculator™

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It's the Policy Mix, Stupid!

The title of this piece is a riff on Clinton advisor James Carville's memorable campaign slogan from 1992. We believe that, like then, there are some obvious challenges facing the U.S. economy, although almost everyone on the planet would agree with that assessment this time around. Less obvious is how to manage the post-rescue policy environment in a way that allows us to emerge from this crisis with the least amount of harm.

With attention currently focused on details of the financial rescue package being hammered out by Congress and the Administration, we believe it's critical to point out that its ultimate success, and the future performance of the U.S. economy, will depend upon an entirely different set of actions: namely monetary, tax, trade, financial, and regulatory policies. And if policymakers fail to strike an optimal balance between these, then we believe the financial crisis will deepen, asset values will contract further, and the dollar crisis will intensify.

That said, we don't believe that the U.S. economy can escape from this crisis entirely unscathed. Simply put, too much debt was issued, securitized, misrated, acquired, and insured using staggering degrees of leverage. As a result, we face unavoidable tradeoffs between inflation, unemployment, and falling asset prices. Our recommendations won't change that fact, but we believe they will significantly lessen the overall economic damage—inflation and unemployment will not run as high, and asset prices will not fall as far. They are designed, ultimately, to stem the decline in asset prices, reverse the rise in unemployment, and increase the capacity of borrowers to service debt without resorting to inflation.

Anatomy of a Bubble

The numerous causes of this crisis will provide rich ground for research in coming years (bubbles and crises, which tend to occur somewhere on the planet every 3-7 years, always do). The most important factors behind this one include the following:

- Incentives that favor leveraged consumption over saving
- Optimistic economic expectations
- High saving rates outside the U.S.
- Excessively easy (inflationary) monetary policy
- Low risk aversion and complacency
- Tax and policy incentives that favor residential investment

On the credit demand side, we've identified two important factors. First, our tax code and monetary policy have long favored debt financed consumption and discouraged savings. Second, until 2006 or 2007, the expected direction of tax, trade, and regulatory policies in the U.S. inspired optimism regarding future incomes and asset prices. Both of these factors spurred the demand for credit.¹

There were many factors supporting the expansion of credit supply. Plentiful savings from abroad, along with excessively easy Federal Reserve policy from 2001 to 2005, expanded the supply of credit. An extraordinarily low level of risk aversion in credit markets inspired complacency among market participants, regulators, and policymakers.² Public policy explicitly directed credit and investment into residential mortgages and real estate.³ And credit rating agencies conferred overly optimistic ratings on structured finance securities that were much riskier than believed. All of these—especially the actions of the Federal Reserve, in our view—induced a greater supply of credit than the economy could actually support.

Finally, on the policy side, regulatory frameworks in the U.S. and abroad have not kept pace with the deregulation, integration, and evolution of the global financial system. It also should be noted that the theoretical frameworks used by policymakers are as yet unable to capture the true nature of financial markets, which have always been marked by recurrent crises. In addition, an excessive degree of leverage was made possible by the growth of unregulated “dark pools” of capital which created risks that regulators seemed largely oblivious to, or at least powerless to address, until very recently.

These factors combined to obscure overall risk and make more credit available than would otherwise exist.⁴ This spurred an unsustainable rise in investment, asset prices, and

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- 1 Inflationary finance was spurred by the Federal Reserve's excessively easy monetary policy from 2001 to 2005. On balance, tax and trade policies from the 1990s through 2006 inspired a favorable economic outlook, including expectations of rising incomes and asset values, which both tend to raise the demand for credit.
 - 2 Through most of the credit expansion, market prices and indicators implied that few if any debtors were ever expected to default.
 - 3 While ostensibly used to meet social policy objectives, tax and other public incentives distort investment decisions. In this case, residential real estate receives favorable treatment in the tax code and support from government sponsored entities (GSEs) Fannie Mae and Freddie Mac. Even though the GSEs are closely regulated, their financial leverage was extraordinarily high, which seems due to two factors. First were Congressional directives for the institutions to expand their support for the mortgage market, despite the fact that it was becoming increasingly unsustainable. Second was the cozy lobbying relationship between the two firms and their Congressional overseers, which created severe agency risks. Executives who curried favor with politicians were able to pursue strategies to enrich themselves at the expense of the firms' other stakeholders. As a result of these longstanding activities, the CBO found that most of the benefits of the GSEs accrued to executives, lobbyists, politicians, and shareholders (for a time), rather than potential and existing home owners (Congressional Budget Office, 1996).
 - 4 The process, as described by Ronald McKinnon: “The major ongoing and long-run distortion in the world’s financial system is America’s saving deficiency, large fiscal deficits by the Federal Government

consumption--in other words, a bubble.⁵

Anatomy of a Financial Crisis

A credit bubble is inevitably followed by financial crisis, as it gradually becomes apparent to market participants the economy does not have the capacity to support all of the new debt that's been created. The depth and severity of the crisis depends on many factors, not least of which are the policy measures taken to address it.

Key factors at work in the current crisis include:

- Explosive growth in over-the-counter (OTC) derivatives
- Poorly timed changes to financial accounting standards
- Rising uncertainty about the direction of economic policy

One of the most significant financial innovations of the past decade is the credit default swap, or CDS. This is an OTC derivative that allows the holder of a particular issuer's debt to hedge, or insure against, the risk of the issuer defaulting (they also allow speculators to bet on the demise of a debtor). This insurance is "written" by various types of financial institutions, including investment banks, hedge funds, and insurance companies.⁶ Like most innovations, these instruments conferred important benefits on markets but also created new risks (Laing, 2008). Private and public regulation has, quite naturally, lagged the growth of the market, and its settlement procedures are still subject to a good deal of legal uncertainty. More importantly, the size and leverage of the CDS market is staggering, especially relative to the number of participants. This has exposed many large financial institutions to severe liquidity risk. With the performance of some of the insured credits deteriorating, and the implosion of several market participants, fear and uncertainty have gripped the CDS market, which is having a ripple effect on the financial economy.⁷

Accounting standards have also played a role in deepening the crisis. Due to recent

and meager household saving, coupled with a virtually unlimited dollar line of credit on which to borrow from the rest of the world. In addition, over the last two years, U.S. monetary policy has also been too loose with short term interest rates well below the rate of inflation leading to excess consumption—in part by inducing a bubble in housing prices.” (McKinnon, 2005)

5 Without this expansion of consumer credit, U.S. GDP would have been notably lower in this decade, as consumer spending played a large role. It's also interesting to note that housing bubbles occurred in other developed markets as well, such as Spain and the U.K. We haven't analyzed the common factors, but suspect that uneven tax and financial treatment of investment in residential real estate has caused distortions across all of the markets that experienced a housing bubble (for example, O'Reilly, 1999).

6 AIG's demise is attributed to stress in its sizable and unregulated CDS book.

7 According to one study, a primary factor at work in credit market upheaval is counter party risk, or the probability that the institution on the other side of a trade (more aptly in this case, on the other side of millions, billions, or trillions of notional trades) will not be able to fulfill its obligations. The authors claim that this was the main cause of credit stresses around the time of Bear Stearns' collapse (Taylor and Williams, 2008).

changes in standards for valuing financial assets, companies have been required to use “mark to market” accounting methods to value certain financial assets. If those assets don't have a market price, they need to be written down severely, perhaps to zero. This causes additional damage to financial firms' capital base, which forces credit to contract faster and further. Given the amount of illiquid OTC assets created in recent years, and the seizing up of those markets, the timing of this change could not have been worse.

Defenders of mark-to-market standards deny that the changes have contributed to the crisis. But while it's true that mark-to-market valuation is the most preferable form of disclosure regarding balance sheet values, it's a mistake, as economist Reuven Brenner recently pointed out, to impose mark-to-market valuations on assets whose markets are frozen, locked up, or nonexistent (Brenner, 2008). One of the notable features of this crisis has been the prevalence of difficult-to-price assets which supports the idea that the system was over leveraged (Whalen, 2008). But forcing companies to write down (or write off) assets that may still have some economic value, in the midst of a massive financial deleveraging, can only hasten the destruction of wealth.⁸ Reportedly, the International Accounting Standards Board (IASB) is meeting to discuss a modification to the relevant standards, which is an encouraging development (Taub, 2008).

In monetary affairs, inflation concerns have taken a toll.⁹ After more than twenty years of disinflation, and even a few years of deflation, inflation pressures began to build in recent years as the Fed pushed real interest rates below zero for the first time in a generation.¹⁰ It has also persisted in its longstanding error of focusing on domestic economic conditions and price levels, rather than global activity and price levels, which have been flashing inflation for most of this decade.¹¹ After a lengthy tightening cycle beginning in 2005, the

8 Some might be tempted to allow a speedy destruction of wealth to unfold. Early in the Great Depression, Treasury Secretary Andrew Mellon famously urged President Hoover (according to Hoover himself) to let the liquidation of labor, stocks, farmers, and real estate to proceed as it was the only way to “purge the rottenness out of the system”. The problem then, which neither Mellon nor Hoover understood, was that forcibly reimposing the gold standard at its 1914 parity, at the same time that trade and tax barriers had lowered expected output and incomes, destroyed massive amounts of wealth unnecessarily (and unjustly) by crushing debtors. Wealth will obviously be destroyed by this crisis, but there's no good reason to allow a poorly designed (or timed) accounting standard to make things worse.

9 The most sensible description of inflation is a loss in the relative value of money, which leads, over time, to an inexorable rise in the overall level of prices. The most sensible explanation for how inflation comes about has to do with interest rates—specifically, when the cost (in %) of a new unit of money is significantly less than the expected marginal return on that money, inflationary finance will occur, and eventually, through quantity constraints in certain goods (and/or asset) markets, inflation pressures result which will feed through the price level over time if no countervailing measures or responses take hold (for example, see Wicksell, 1936 and Batten, 1981).

10 This was caused by the Federal Reserve's attempt to stave off residual deflationary pressures caused by its 'strong dollar' policy of 1996-2002. By going too far in this effort, the Fed pushed the marginal price of a new unit of money below zero for the first time since the 1970s. If Alan Greenspan's swan song had a title, it might be “Too Loose, Too Long, So Long”.

11 To be fair to the FRB, this behavior is required under the “dual mandate” imposed by Congress in the Full Employment and Balanced Growth Act of 1978 (a/k/a Humphrey-Hawkins).

Fed cut its target rate sharply over the past year, intermittently pushing the real funds rate below zero again.¹² Expectations of rising inflation were apparent in the dramatic rise of commodity prices in the first half of 2007, and in social unrest related to food and other shortages in many developing countries.¹³ Although food and other crude goods are not as large a budget item, inflation has pernicious effects in mature economies too, because it destroys the value of saving and investment. In fact, when the combined effect of taxes and inflation are taken into account, most savers will earn low, zero, or even negative returns.

For example, if someone saves from their current income to buy a bond that yields 4% annually, and they pay a combined federal, state, and local income tax rate of 25%, it takes only a 3% rate of inflation to wipe out any real return on that investment. On the other hand, if you borrow money at an interest rate of 5%, and inflation increases at 3% annually, you are really only paying 2% interest. You might be able to write off the interest payments on your taxes, making the net cost even lower. And when the principal comes due, you are actually paying back less money than you borrowed.

As we pointed out at the beginning of this paper, our tax code interacts with inflation in a way that creates strong disincentives to saving, and encourages debt financed consumption. Ironically, many of the politicians who decry our low (and recently negative) personal savings rate are responsible for the very policies that make saving a losing proposition. Furthermore, if inflation expectations come unhinged as a result of federal intervention in the credit crisis, it will have disastrous effects on savers and taxpayers, the very people who are rebelling against the Congressional rescue package.

There's also growing concern about the ability of the federal government to service its debt, especially when long term entitlement obligations are taken into account (Congressional Budget Office, 2007). Earlier this month, Barron's noted that the price of credit default protection on U.S. Treasury securities, although still virtually risk free, had risen as much as ten fold over its long term average, as the Treasury began taking Fannie and Freddie assets and obligations onto its balance sheet (Forsyth, 2008). Earlier this

12 It's not a coincidence that the dramatic run up in commodity prices in 2007 occurred as the Fed began to expand its facilities and methods for providing additional liquidity to the financial system. However, as the Fed released periodic details of its balance sheet, it became clear by mid-summer that those new injections were being sterilized by the Fed's Open Market Committee (FOMC); in other words, the Fed defended its interest rate target by sterilizing its targeted injections of liquidity as necessary (Federal Reserve, 2008). However, recent Fed activity has expanded the monetary base by a significant percentage, and the fed funds rate fell below target as this process unfolded; by our calculations, roughly 70% of this expansion was in short term repos, but that still means a significant and possibly permanent expansion at an annualized rate of 362%; if that trend continues, we expect a significant inflationary impact.

13 Incredibly, some experts and economists advocate inflation to support the value of real estate. Not only are the dynamics highly questionable (how exactly would authorities manage to achieve this without causing immense collateral damage?), and how can any intelligent person ignore the unintended consequences

week, Reuters reported that the cost of credit protection on 10-year Treasuries reached 29.2 basis points, almost fifteen times greater than its long term average (Sithole-Matarise, 2008).¹⁴ Those pressures serve to reinforce long-term inflation fears, as the U.S. government may seek to inflate away some or most of its future debt obligations, should the burden eventually outweigh taxpayers' willingness to bear it.¹⁵

Finally--and this should be more widely noted in our opinion--widespread uncertainty about the future direction and mix of economic policies took hold of our economy with a vengeance at the beginning of 2007, and we believe this was an important catalyst for both the financial crisis and the incipient downturn in the real economy.¹⁶ As we asserted in the first section of this paper, optimism about the direction of taxes, trade, regulation, and income helped contribute to the credit expansion. However, since the start of the 110th Congress, uncertainty and pessimism regarding future policy has been rising.¹⁷ The 2003 tax cuts now look almost certain to expire, which is a 180 degree turn from the expectations that prevailed from 2003 to 2006. Trade agreements have become far more difficult to craft and pass, and political campaign rhetoric has included threats to renegotiate *existing* trade agreements. Regulatory burdens appear likely to rise on many fronts, including very costly changes to energy, environmental, and health care policies.¹⁸ "Re-regulation" has become a frequent mantra during the financial crisis.¹⁹

14 The overall stress in credit and CDS markets could be at work too. While we haven't done any back of the envelope calculations, it's important to note that CDS spreads on Treasury paper are still far lower than the CDS spreads that existed on the privately issued paper that the Treasury recently acquired or guaranteed. This reinforces the idea that the federal government, thanks to size of the U.S. economy and productivity of U.S. taxpayers, remains the strongest risk taker in the economy by far. Policymakers must be careful to preserve that capacity over the long run. Current CDS spreads on Treasuries are signaling that they should proceed with caution.

15 As noted elsewhere in this paper, the existence of a competing issuer of a global reserve currency (the ECB and the Euro) changes the game. It is likely to become far more risky and difficult to inflate away the U.S. debt burden.

16 As economist Axel Leijenhofvud has noted, "it is the decline of investment expectations and the consequent contraction of output that prompts deleveraging." (Leijenhofvud, 2008)

17 Of course, some constituents, especially those who feel they've gotten a raw deal under Republicans from 2000 through 2006, may expect these policy directions to be beneficial to them, and some polls bear this out. However, the overall, net impact of these policy directions is likely to be negative, and financial market action since 2007 seems to support this assertion (although admittedly, it's difficult to tease out the impact of policy direction from the much larger market impact of the financial crisis; it's also difficult, perhaps impossible, to analyze the impact of policy direction on the financial crisis itself).

18 While it seems easy to blame Democrats for these developments, Republicans bear much of the responsibility. Sunset provisions were included in 2001 and 2003 tax legislation at the behest of Senate Republicans. The Democrats' success in the 2006 Congressional elections was a response to the disastrous management of the Iraq war, and evidence of corruption (and even blatant moral hypocrisy) among Congressional Republicans. Finally, the party has been largely oblivious to (sometimes even brutally dismissive of) some well grounded complaints from many stakeholders in our political economy regarding stagnant and falling living standards. We think this has been an important source of support for the resurgence of union rhetoric and legislative activity since the fall of 2006.

19 It's disconcerting that in recent years, heavy handed measures are dressed up in the dress of 'free market'

However, increasingly complex and heavy handed regulation, a rising tax burden, and restrictive trade policies are the last thing that a slowing or contracting economy needs (for example, see Romer and Romer, 2007).²⁰

Damage Assessment and Estimates

Damage from a financial crisis is a function of credit losses and leverage. Current estimates of total expected credit losses range, roughly, from \$1T to \$3 (they could go higher). While commercial banks were subject to traditional leverage ratios in the neighborhood of 10:1, Wall Street investment banks carried leverage of well over 30:1, Fannie Mae and Freddie Mac were leveraged more than 40:1, some European banks reportedly carried leverage of up to 60:1 (Gros and Micossi, 2008), and the total leverage among hedge funds and other significant 'dark pools' of capital is unknown, and assumed to be quite high. Suffice to say, total leverage in the system was at a historic level, which means that the financial system was priced for nothing less than economic perfection (and perhaps more). This left the system extremely vulnerable to the policy uncertainties that took hold in 2007.

If we take a conservative estimate of system leverage as 15:1, and assume \$2T of credit losses, the hit to global net worth would be in the neighborhood of \$30T, an amount that represents—these are very rough approximations—30% of U.S. public and private net worth, 28% of global financial assets, and 10-15% of global net worth²¹ (Boston Consulting Group, 2008; Federal Reserve, 2008b; Office of Management and Budget, 2002). Thanks to economic and financial integration, much of the resulting damage has been, and will continue to be, shared by the rest of the world—clearly an argument for financial integration.²² If these losses had to be borne by North Americans alone, they could nearly wipe out their estimated financial wealth of \$39T at the end of 2007 (Boston Consulting Group, 2008).

Some forecasters expect a roughly 30% decline in median U.S. home prices from their peak, and a similar decline in the S&P 500 from its peak would put it somewhere in the neighborhood of 1,000 to 1,100. Factors that could take it lower include a recession that's deeper or longer than expected, poor economic policies and performance (both relative and absolute), currency and inflation effects, and rising risk aversion; factors that could provide a lift include a short lived or nonexistent recession, an improved growth outlook, and renewed confidence in the USD. All of these favorable factors depend on

rhetoric.

20 David Romer is reportedly an economic advisor to Senator Obama. We can only hope that his research is being given full consideration.

21 Using a subjective probability weighted matrix, we forecast a decline in global net worth of up to \$30-\$40T.

22 Autarkic economies were the hallmark of the Great Depression, and policymakers must be careful not to push the world in that direction. For example, if the U.S. commits a series of major policy errors, the rest of the world may become increasingly unwilling to share financial risk with us. That's a critically important lesson for Congress and the next President.

improvement (and at this point, outright reversal) in the direction of Congressional and Federal Reserve policies. All of the negative factors result from higher taxes, heavier regulation, contracting trade, and inflationary monetary policy. To avoid a more negative outcome, U.S. policymakers must commit themselves to an *optimal policy mix* of lower taxes, expanded trade, more efficient regulation, and a stronger (and ultimately stable) dollar.

What is the Optimal Policy Mix?

The concept of an “optimal policy mix” was developed by Nobel economist Robert Mundell while working at the International Monetary Fund in the early 1960s. At that time, the U.S. was struggling with an economic slowdown and growing concerns about inflation. The optimal policy mix, he argued, was tighter money to control inflation, and lower taxes to spur growth (Mundell, 1999).

That idea became embedded in President Kennedy's economic recovery plan that was passed posthumously (and despite its success, utterly abandoned by later U.S. administrations). It was also at work in the 'tax revolt' legislation crafted by Congressmen Jack Kemp and Bill Roth in 1978, and in subsequent legislation signed into law by President Reagan, which, in concert with the excessive hawkishness of Fed Chairman Paul Volcker, brought the stagflationary malaise of the 1970s to an end. When the Clinton Treasury's strong dollar policy was combined with Congressional Republicans' tax cutting initiatives, it ushered in the impressive growth of the late 1990s.²³ Today, with confidence in the dollar severely shaken, inflation fears on the rise, expectations of falling incomes and declining economic activity, and the potentially toxic combination of an easy Fed and a burdensome Congress, the optimal policy mix of lower taxes and tighter money is precisely what the domestic economy needs.²⁴

Why is the optimal policy mix composed of lower taxes and tighter money? The idea certainly runs counter to some prevailing tenets of macroeconomic policy.²⁵ Mundell pointed out in 1961 that the U.S. economy's struggles were being caused by a stubborn tenet of prevailing economic policy—the idea that monetary policy and fiscal policy

23 Its champions' claims notwithstanding, Clinton's first tax plan, which hiked marginal rates on high income earners, did little more than help hand control of Congress to the GOP in 1994, an event that the boom years of the 1990s did not precede.

24 We've seen plenty of calls for a stronger dollar, and plenty of calls for lower taxes; however, we've heard little to nothing about the importance of coordinating the two. This is disconcerting to us, especially if a strong dollar policy is pursued without accompanying action on the tax front. We're resistant to frequent comparisons to the Great Depression, but such an approach would be reminiscent of 1930-32.

25 If you listen to policymakers, economists, or market pundits talk about monetary policy, they will almost always advocate loosening of monetary policy to address weakness in the economy, rather than to maintain global monetary stability. We've been able to get away with this false assumption for decades, because the relative size and health of the U.S. economy after WWI and WWII made us the world's central banker by default. Eventually, we're going to learn how wrong our prevailing approach to monetary policy is. We may not learn that lesson until it's too late, but we will eventually learn it.

could be used interchangeably to influence economic performance (Mundell, 1999). This may be true for a closed economy²⁶, and when Keynes wrote his *General Theory*, most of the world's economies were in fact closed, or autarkic. International trade and finance had essentially collapsed from 1929 through the Great Depression. In that world, domestic policymakers were indeed able to use monetary and fiscal policies interchangeably.²⁷ However, following the conclusion of World War II, the global economy began to reintegrate, moving towards the more optimistic and highly integrated world that existed in the latter decades of the 19th century, and away from the pessimistic, autarkic world that Keynes had modeled and that his successors continue to (mistakenly) assume.²⁸ As Mundell put it,

Keynes' *General Theory* was written in the 1930s. Its premises reflect the uncertainties of that decade. Keynes assumed rigid wages, no growth, [and] a closed economy...The Keynesian model is a *short run* model of a *closed* economy, dominated by *pessimistic* expectations and *rigid* wages. This model is not relevant to modern economies. (Mundell, 1971).

Monetary Policy in an Open Economy

In a global economy, the issuer of the global reserve currency—which since World War I has been the United States, through the quasi-public Federal Reserve—sets the marginal price of a new unit of money. Ideally, they do so at a level that will produce neither inflation nor deflation. But that depends upon conditions in the *global* economy. If monetary policy is used to manage employment and output in the *domestic* economy instead—which Humphrey-Hawkins legislation in the U.S. explicitly requires—then the reserve currency's value and reliability become suspect, and global price stability becomes more elusive. The Bank of England, the previous issuer of a global reserve currency, understood and accepted that its role was to keep the value of the pound stable in order to support global price stability, even on those occasions when the English economy fell into recession. Today, the European Central Bank (ECB) understands this role and is playing it diligently, despite the current slowdown in the eurozone.

The Federal Reserve, however, has never really seemed to understand or embrace this role, and at times, this has been a source of severe economic damage and political consternation around the world. And from the standpoint of managing the domestic

26 A closed economy is one that contains all economic agents and activities. In the interwar period, many economies and regions could be considered closed, as they engaged in limited or no external trade or finance. Today, as in the 19th century, it's fair to say that the only closed economy is the global economy.

27 That may sound like a good thing, but a central tenet of economics is the existence of tradeoffs. While autarkic economies might have made life easier for policymakers, it lowered the overall standard of living in the world. To the extent that WWII can be attributed to the economic policy errors that caused the Great Depression, the net costs of autarky are truly staggering and incalculable.

28 This isn't exactly true. Prevailing economic theories (esp Keynesian and Monetarist) assume that floating exchange rates allow monetary policymakers to pursue strictly domestic objectives. Historical and empirical evidence does not bear out this assertion, in our view.

economy, the problem with using monetary policy is that because of trade and financial integration, the desired effects of monetary easing are more likely to unfold in faster growing economies abroad, while any resulting inflationary pressures will eventually feed back into the U.S. price level.²⁹

For example, in the 1960s and 1970s, Japan, Germany, and several developing economies, including Scandinavian countries, were faster growing economies that attracted most of the investment that easy Fed policy was trying to stimulate in the U.S. As inflationary finance fueled international demand for many goods and commodities beyond existing capacity, price pressures began to feed through the global economy, eventually impacting the the price level and inflation expectations in the U.S.³⁰ This occurred against a backdrop of domestic recessions and unemployment. High unemployment and intense political pressure made the Fed reluctant to raise rates, and thus intensified the rise in inflation and inflation expectations.³¹

Today, we can substitute China, India, Brazil, emerging Europe, and many other parts of the world for Germany, Japan, and the rest. And the current dynamic is similar to that earlier one: a combination of bad tax, trade, and regulatory policies are driving down the expected rate of return in the U.S. economy, and the Federal Reserve has reacted by lowering its interest rate target; but the Fed's actions can do little more than fuel eurodollar or petrodollar financed growth and inflation in faster growing countries, which eventually contributes to stagflation at home. In other words, by trying to induce growth in the U.S. economy, the Fed unintentionally engages in inflationary finance outside our borders.³² The only way around this is to improve the competitiveness of the real economy through better tax, trade, and regulatory policies. Admittedly, these have improved since the 1970s, but what matters most is not the absolute level of taxes, tariffs, and regulations, but rather their relative level and direction compared to the rest of the

29 The inverse situation can also occur. For example, from 1996 to 2002, the Fed tried to use monetary policy to slow growth in the U.S., but the brunt of the impact fell on emerging economies that were more highly leveraged and growing more slowly at the time.

30 It's believed by many economists that the overall price level can only rise significantly if a "wage spiral" occurs. Because union strength has declined markedly since the 1970s, they hold that significant U.S. inflation is unlikely. However, we have several objections to that thinking: (1) wages have been spiralling upwards in many parts of the global economy; (2) due to tax code distortions, employer benefits have become a more important component of compensation since the 1970s; the high rate of medical care inflation should not be overlooked; and (3) unions are enjoying a resurgence in the U.S., and the current Boeing negotiations demonstrate that they are still able to put upward pressure on domestic wages.

31 Much is made of the fact that Fed Chairman Ben Bernanke is an expert on the Great Depression. If we were in the midst of a deflationary contraction, that would be a good thing. However, in a stagflationary crisis, the 1970s are a more relevant period to study.

32 Foreign authorities can enact measures designed to dampen this process, but given the size of the U.S. economy, it's difficult and costly to control. It also imposes involuntary costs on other countries—sometimes rather large ones--which doesn't engender goodwill towards the U.S.

world. That's an area where we truly have lost our leadership.³³ And of course, our competitive situation is made worse by the implosion of a massive domestic credit bubble.

An optimal policy mix would take us in a very different direction. As the U.S. economy enters a slow or no growth period, the Fed would focus on keeping the value of the USD stable throughout the global economy. If nothing else were done, recession would be likely, although the overall cost of living would remain stable thanks to low inflation.³⁴ But if policymakers wanted to improve the economic climate, what could be done?

The answer should be obvious: as long as there's a tax, trade, or regulatory burden of any significance on the domestic economy, growth expectations can be raised by lowering barriers to productive investment and activity. This narrows (or even closes) the 'growth gap' between the U.S. and the rest of the world. It also makes the Fed's monetary discipline less painful. In fact, if growth expectations shift far enough, it could even render the Fed's monetary policy completely painless. This is the essence of Mundell's optimal policy mix³⁵—foster growth through competitive fiscal, trade, and regulatory policies, and use monetary policy to keep the value of the dollar stable and prevent inflation.³⁶

33 Small, open economies have become the leaders in growth oriented policies. Examples include emerging European countries, Ireland, the Asian Tigers, etc. But we're even falling behind large economies (Japan being the noteworthy exception). For example, while “the mean corporate income tax rate in the EU was 38% in 1990, it dropped to 33% in 2000 (Gorter en De Mooij, 2001)” (as cited in deMooij and Ederveen, 2001). Meanwhile, U.S. statutory tax rates on corporate income are essentially unchanged over this period, other than a slight steepening in 1992 (Taylor, 2002), while recent empirical research has found that corporate taxes fall disproportionately (perhaps entirely over the long run) on employees (Mintz, 2007; Romer and Romer, 2007). For all the campaign talk of helping “workers” and the “middle class”, there's been pitifully little attention paid to one of the biggest levers available to actually help them.

34 This is the situation that eurozone economies currently find themselves in.

35 This is how Mundell described the policy mix experience of the 1960s: “...In the fall of 1961, I was asked to look into the theoretical aspects of the monetary-fiscal policy mix. The main problem...was sluggish growth and subpar employment in the United States in contrast to Europe and Japan...and a now worrisome balance of payments deficit...In my analysis, I showed that none of the [proposed] policies would work, and would lead the economy away from equilibrium. The correct policy mix was to lower taxes to spur employment, and tighten monetary policy to protect the balance of payments...It gradually came to be realized that the [existing] policies of the Kennedy administration were not working: the wrong policy mix had produced increasingly disequilibrating effects: a steel strike, a stock market crash, and stagnation. At the end of 1962, Kennedy announced a reversal of the policy mix, with tax cuts to spur the economy and interest rates to protect the balance of payments. Legislative delays meant that the tax cut had to wait until the summer of 1964 but its anticipation positioned the economy for the great expansion of the 1960's” (Mundell, 1999). As pointed out earlier, similar scenarios played out in 1978-1987 and 1994-2000 as a result of getting the policy mix right—lower taxes, tighter money.

36 There are two important benefits from monetary stability. The most obvious one is that it removes the inflation tax on savings. Less obvious is that it ensures that monetary policy does not favor the interests of debtors over creditors', and vice versa. The importance of this may not be obvious at first glance, but in any financial economy--where investment and economic activity is financed by matching debtors and

Important Caveats Regarding Conventional Wisdom

There are some critically important points to keep in mind as we move through this crisis, and as policymakers take action to address it.

First, unlike 1961, 1978, and 1994, the Fed enters this crisis facing a serious competitor in the ECB, which is not only staunchly committed to managing a sound global reserve currency, but is also less prone to political pressure from lawmakers who would prefer to have the central bank do the heavy economic policy lifting for them. The presence of the ECB is a true game changer, and it requires us to implement the right policy mix more expediently and more persistently than we have in the past. If the USD loses its global reserve status, the impact on this country would be devastating. Like England in the 20th century, our standard of living would fall, and our capacity to deal with future crises would be severely impaired.

Second, there's been a resurgence of interest in public works and other government spending as a means to address the economic downturn. This country certainly has the capacity to make smart public investments and provide reasonable economic protections to its citizens.³⁷ However, to believe that increased government spending is the best route for resolving a financial crisis or reversing an economic downturn is to ignore the experience of Japan since 1989, and the experience of the U.S. in the 1930s.³⁸ The federal government's unmatched ability to assume risk can be put to good use in a crisis, but putting the cart of government before the horse of the private sector will only prolong and deepen this downturn.³⁹

Third, coincident with public works spending coming back into vogue, the federal government has become increasingly fond of “stimulus packages” that “put money in people's pockets”. This is a poor way to encourage anything other than visiting the bank to cash or deposit a check. Yes, there are multiplier effects if the money is spent, and yes, some people will use it to save or pay down debt, but these are one off occurrences. Even if subsequent “stimulus” is issued by the government, it will do little or nothing to foster investment, productivity, and wage growth. It also has little or no net effect on long term economic performance. It simply borrows from future tax revenues to finance current

creditors—that balance is critically important.

37 The federal government's unrivaled capacity to assume risk, mentioned earlier, could play a productive role (and to some extent already does under existing programs) in insuring against extreme risks, e.g., involuntary unemployment, catastrophic illness, severe disability, and even life insurance and longevity risk.

38 The only pro-growth measure enacted by FDR was his revaluation of the USD against gold (which many mistakenly think of as a devaluation), bringing it closer to its non-deflationary 1918-1929 parity. Almost all of the other measures he enacted tended to delay the recovery of the private sector.

39 Except for a couple of brief respites, one in the 1990s, and one in this decade, Japan has followed the very path that our policymakers seemed determined to lead us down—high burdens on productive investment, and low interest rates. Japan has been in a prolonged downturn since 1989, and carries a public debt that is several times larger than its domestic economy. That is not something to shoot for.

consumption, and that's exactly the kind of behavior that got us into this mess.

Fourth, the conventional wisdom behind plans to “unlock” frozen credit markets is that credit needs to flow in order for consumption to pick up. While it is clearly important to ensure the orderly functioning of credit markets, is renewed consumption really the best objective for an over-leveraged economy? Why not saving, investment, and employment? Short-term GDP and “consumer demand” are too often seen as the end-all-and-be-all of economic performance. The primary objective at this point should be to rebuild households' balance sheets, prevent further deterioration in the Treasury's balance sheet, and neutralize the perverse incentives that favor debt and consumption over saving and investment. These are especially critical objectives if we are to deal with the looming entitlement crises of Social Security and Medicare.

Would an Optimal Policy Mix Solve the Financial Crisis?

In a word, no. As we've pointed out, what's been done, via inflationary finance and a credit bubble, is done. We will have to endure some combination of recession, inflation, and falling asset values. But an optimal policy mix would do a great deal to minimize the overall damage.

One of the overarching problems in this crisis is the inability of many debtors to make good on their debts. The only way debtors can recover from such an impasse is to delever and repair their balance sheets, and the only way household balance sheets can be repaired is by paying down debt, or declaring bankruptcy--and only one of those is a net positive for the economy. And given the state of household balance sheets, there is no way that one, two, three, or thirty three “stimulus packages” will resolve this problem. Only expectations of steady and rising future incomes will support the delevering process. The federal government cannot employ enough of the population to make this happen.

By pursuing an optimal policy mix of lower taxes, more efficient regulation, and expanded trade and financial openness, policymakers will expand incentives to invest and employ resources in the domestic economy, which in turn will produce rising incomes. And rising incomes are the only thing that will allow effective debt service and balance sheet repair require. It is also the only way to get through this crisis with a tolerable amount of economic damage. It will dramatically improve our competitive position in the world, the long term trajectory of our economy, and our capacity to manage both expected and unexpected crises in the future. In fact, getting the policy mix right is at least as important as intervening in credit markets, if not moreso.

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