STREET FIGHT

There are, broadly, two schools of thought on managing the economy. They are fostered by three groups of people. The conclusion I have reached is that the people involved have come to a gun fight armed with knives and no longer can tell what the issues are or what tools to use and are figuratively slashing at ghosts.

The schools of thought are Monetarism and Keynesians being, respectively, those who believe that managing the supply of money can control the economy and those who believe that government spending (or not) can control the economy. At the highest, so named macro level, this simplistic statement accounts for virtually all of what passes for macro-economic theory today. Both schools can be, at times, in agreement, effective and well applied. Both are now also out of touch with reality and, in fact, dangerously so. Their cure is now worse than the disease they claim to fight.

Three groups, politicians, academics and practitioners, espouse one or the other school, and often both. Politicians will back the school de jure, so long as it keeps them in office; academicians adopt one school or the other, tie their tenure to it and defend it – regardless. The practitioners, the analysts, advisory firms, businessmen and working economists take the more practical route of trying to analyze which works best for them or the client at the moment.

There are, to be thorough, many “branches” of thought off the primary two, but they tend to be more focused on micro economics – detail. Price theory, marginal utility, the behavioral schools – all seem to me to be measuring the downstream effect of macro decisions. The point is that virtually all involved see the two macro schools as established and substantially inviolate – sort of a “given” – and look no further – myself, to date, included.

Imagine a man in a small sailboat crossing the Pacific from, say, the Panama Canal to Tahiti. He trims, steers, calculates location and direction, fights winds and calms, but successfully completes his journey. Unbeknownst to him, he has, in fact, been carried west in one of the many equatorial ocean currents that flow east to west. In his recounting of his trip, however, he notes the accuracy of his GPS system, the advantage of his new light-weight spinnaker and his overall acumen at mastering the ocean in a small sailboat. Accordingly, future sailors study his methods, his tools and his virtual life so as to duplicate his feat in other places. Sometimes they fail, sometimes they succeed. No one ever really figures out the sailor’s success was the current, the allegorical wind at his back, not anything he did save trimming to avoid obvious temporary disasters.

So it is today, where nations practice variations of the two schools of thought – believing they have a valid macro-economic theory in force and its rules and outcomes are known and predictable, because they’ve seen them “work”.

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It is my view that these old macro-economic schools worked for one reason only: they were carried by an ever-expanding growth in credit, out of the control of either school, which provided an overall "wind at our backs" to economic success. The schools themselves worked to solve only specific minor problems: high inflation, recessions, the business cycle. Each of these were transient, had occurred before and were known to end, in time. The economic schools were, in fact, doing no more than trimming sails.

It is estimated, for example, that consumer credit <u>alone</u> has added 1 ½% to 1 ¾% to overall growth in our nation's total output – GDP. When one sets that against historic GDP growth of about 3% average, the message is clear: we grow far slower than we thought. In 1936, the total consumer debt load was 166% of GDP, it fell to about 40% in 1944, which figures, and it is today 176% . . . how's that for a wind?

This same consumer is now aware not so much what his or her serious current financial problems are, but that their children and their children's children face "game over" – unaffordable medical and pension liabilities now baked into the budget in Washington. There is no longer an underlying credit wind to offset these trillions.

High unemployment, compounded by a sharp decline in one of our nation's great strengths, job mobility,* has no underlying credit wind to offset it. Ever more promises of higher social security – both the monetary version and the broader social version, came as political payback to various voter blocs, and there is no longer an underlying credit wind to offset their costs. The government credit cards are maxed out, consumer cards are maxed out psychologically and practically and all banks are being, well, banks.

Need I say anything about pension benefits agreed to by businesses and local leaders to buy labor peace? We have now taken out a second and third mortgage on our future and are forced to listen to our leaders describe solutions that no longer work – old school economics.

I anticipate a sharp rebuttal – primarily from economists with Ph. D.s. Perspective, they will say, keep it in perspective. Why, Greece is but a minor bump; the 20% of Eurozone GDP that Greece, Spain, Portugal and Italy represent can be easily offset if France and Germany simply delay fiscal reform to keep growth going. Right. Listen to yourself. And, better, give ObamaCare a chance. Look at Canada, they say, it works there. Okay, let's look: Canada, 30 million folks. U. S., 300 million. Major issue with Medicare? A massive shortage of supply, not demand, for medical services. Track record of government supply? Post Office, Medicare, Social Security, Fannie Mae, Freddie Mac – all broke. Perspective? Seems pretty clear to me.

In brief, we are too big, too dependent on an overextended government which is indifferent to how we got here – that wind beneath our growth – and that thinks, broadly, that they have economic models that work. And the rest of the globe, save China, <u>sees it the same way.</u>

**can't move – can't sell your house. Good case to never again own a home.*

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So, a fair question is what is the new economic model? I can only offer that it has these few pieces with more to come. We, as a nation, must have

1) recognition of the end-game or, as Einstein put it, insanity is doing the same thing over and over and expecting different results;
2) a purpose to work – to succeed. Art Laffer said it best ". . . people don't work to pay taxes . . ;"
3) equity of treatment which dials down the endless list of regulations supposedly designed to protect various (self) disenfranchised groups;
4) a cost to failure – simple accountability – you screw up, you're out;
5) application of regulation rather than another layer for folks to tweak;
6) a sound currency – and that means not automatically assuming that printing more money or more government spending is always a solution – restraint is due, cuts are overdue;
7) recognition of global interconnectivity: in or out of synch with other economies is old news – we all are tied by the credit crisis and only our arrogance keeps us from seeing, for example, that European banks have financed $1/2 trillion of Asian development (European banks still hold our toxic mortgages – levered);
8) acceptance that monetary and fiscal policies are sail trimming, not engines of growth;
9) leverage, long ignored, must be in all new economics and
10) new economic schools around such ideas as these few will absolutely create periods of both deflation and inflation – the temptation to regress, by all the participants, will be huge.

As an example of #10 above, I expect China to end as a source of deflation; they, too, now face rising wage and material costs and will have to ultimately price accordingly. I give deflation about 6 more months – and we need to think about what to do before it ends.

Something like 2 billion souls world wide are staged to enter the middle class. As this country grows at one-half its former rates, battles inflation, deflation, high unemployment and declining personal income, other parts of the world will discover credit (and all of its vices) and grow. We will sell to them, so some U. S. firms will benefit. We will buy from them, but not as much as before – that will come from their immediate neighbors. (We tend to forget that for 18 of the last 20 centuries, Asia was the economic world, was global GDP; they are just now re-emerging.)

Here, for months to come, I see growing anger at tax hikes, persistent joblessness, still falling home prices, attempts to bust union packages and further firings of state employees, the only segment of government so behaving. The fact that rates are effectively zero means simply that the Fed has no tools to stimulate (monetarism thus fails) and further trillions of debt for fiscal stimulus will put people in the streets (fiscal policy thus fails). There are solutions, but I fear it will take near violence, on both continents, to overturn the mindset of entitlement and general dependency on governments. Only when all suffer does it become palatable, but so far, Main Street, with zero interest rates, is providing some obscene profits to a few, and it is not going

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unnoticed how Washington is encouraging this under the banner of preserving our financial markets. This is not new economics, but the last gasp of the old – and folks are figuring it out.

I find great comfort in the growing awareness of our local issues, disenchantment with all our leadership and especially increased understanding of our permanent financial links to the rest of the globe. I do not believe anyone can step up and say, "I can fix this." American cynicism now runs deep and that's a good thing. My fear is that our anxiety slips into anger and we end up resolving issues, like Greece, in the streets. It is no surprise that the world is skeptical of the European plan to bail out the PIGS or that our stock market is growing more directionless. It is no surprise that talk of a "double dip", another recession very soon, is vehemently rebutted by the current administration, while calling for fiscal reform. It is no surprise that folks are hiding in Treasury instruments and gold. With all that said, this cleansing is a marvelous opportunity for real investing to take hold. Yes, a weak recovery is taking hold, and the operative word is weak with the further implication of no ability to make a dent in our debt.

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