

A VISIT WITH AL

WEB BUZZ 2009.06.24

The following is a quarterly piece done by an old (older than Don) friend—Dr. Albert M. Wojnilower. Al and Don became friends in the 1970s when Al was the chief economist for First Boston Corp. Al is Keynesian oriented, but Don has “graciously ignored that fault” due to his superior economic analytical insights, plus the fact that he is just a really good man.

“Recovery”

Dr. Albert M. Wojnilower

June 12, 2009

The financial system has been discharged from intensive care. . . what a relief! But the relief we feel at a patient’s survival usually gives way quickly to new worries. How fast and completely will the patient’s damaged body parts (banks, auto companies, homebuilders) heal? To the extent the patient is unable to regain his former self, how will he be different? And since, in this instance, the injuries were mostly self-inflicted (through the financial equivalent of excessive alcohol, tobacco, and narcotics), can the “recovered” patient be deterred from resuming these suicidal activities?

Apparently financial markets care little about such concerns. All that matters, they seem to be saying, is that the numbers for the quarterly GDP changes turn positive, which would entitle them to view the recession as over and to rationalize the bull market in stocks. (Never mind that changes in GDP, which are due for another multi-year overhaul in late July, are an unreliable thermometer of economic health.) Over the preceding two quarters, GDP fell at an annual rate of 6% (actually closer to 8% if we exclude sales to government and nonprofits), but many Wall Street professionals look for significant gains soon.

However, even if such gains materialize (which I consider unlikely till late 2010 or beyond), economic conditions will remain depressing for a long time. For the typical (nonfinancial) firm, rising GDP would imply a modest profit recovery, but probably only to levels well short of the previous peaks. For the employed, real incomes would barely hold their own, as wage growth stumbles and the prices and taxes that maintain transport, education, sanitation, and other essential services escalate. In addition, fuel prices will remain at chronic risk to ignite, due to speculation induced by low short-term interest rates. As for the unemployed, their ranks can be expected to swell for at least another year.

All the same, the tone of business has clearly improved. While this partly reflects the financial “rescue,” the main reason is a mundane rebound from rapid inventory liquidation. All recessions and recoveries are amplified by inventory swings that, in hindsight, appear overdone. Most inventories are manufactured products, many imported, especially so in the U.S. That is why output in the rest of the world will probably benefit more from the inventory turn than in the U.S. The shift from inventory liquidation to stockpiling may be breath-taking, but it is also self-limiting, especially when sales and credit are scarce.

The underlying problems of the American economy are longer-lasting. The oversupply of new houses is rooted in place and will take years to absorb. Major reductions (and bankruptcies) impend in nonresidential construction, as the shopping centers and other facilities being built alongside the empty new homes are completed. Auto sales may rebound modestly, but imported vehicles and parts for transplants will increase their market share. Most burdensome, however, is the excess capacity that has been spawned by over-optimism and reckless credit, which inhibits private capital spending across the board.

Unfortunately, those economic sectors that do require expansion – such as public health, transport and energy, children’s education, environmental and climate control – depend critically on governmental and therefore politically controversial

participation. As a result, the resources allotted thus far are grossly inadequate, whether in relation to the stated objectives or for reviving job growth. How this logjam is to be broken is unclear.

With unemployment high, short-term interest rates in the U.S. and/or Japan are likely to hover near zero for a long time. The major central banks want to keep the eventual rate increases gradual and the markets warned well in advance, as current academic wisdom preaches. (But do keep in mind that if we have a new Fed chairman next year, he might be less able to restrain the hawks who, as in the 1930s, will want to tighten prematurely.) Now that money-market credit is flowing again, the opportunity has returned for “carry trades” in which speculators borrow at minimal short rates and play wherever they sense price momentum, be it in currencies, commodities, or securities. Bubble psychology is reviving. When the cat’s away – when the liquidity of counterparties is guaranteed and regulation indifferent – the mice will play.

Although the rise in Treasury borrowing has been huge, the shrinkage of private borrowing has been even more enormous. Long-term interest rates should fall. The outlook is obfuscated, however, by internal contradictions in the Fed’s operations. The Fed buys large quantities of longer Treasuries to keep rates low – but it also tries to buy them as cheaply as possible. No market manipulator trying to raise the price of a security would deliberately provoke the accumulation of distress inventory, yet that is what the Fed does. Prices may rally when the Fed announces its intention to buy and dealers assemble inventory to sell to them. But then the Fed buys through auctions, which are bound to leave some disappointed dealers with rejected inventory, and depress prices. Over time, the low short rates and the carry trade are likely to prevail in bringing Treasury long rates down, but upward volatility will remain fierce.

Descriptions of saving and investment often draw on homespun farming wisdom, which recalls how people saved by clearing fields, planting trees, and storing

victuals and seeds for winter and difficult times. But today, most of us can save only financial claims rather than physical capital. These claims, moreover, are not on our family or tribe, but on entities run by strangers for their own advantage. Such institutions are restrained from theft and corruption principally by law enforcement and their managers' sense of shame, but these appear to be eroding. Indeed, management and control of many businesses has become short-lived. As individual life spans and financial planning needs lengthen, managerial horizons have shortened. This bodes serious problems.