

Economic Commentary



Central Plains Advisors, Inc. • 100 N. Broadway St., Ste. 130 Wichita, KS 67202 • Economic Consulting & Investment Management

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No Quick End to the Greenspan Mayhem

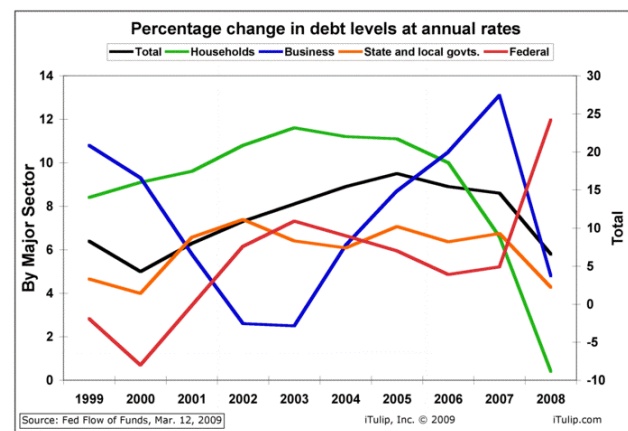
Economic Outlook

Some hopeful signs have appeared over the last month that have ignited a powerful stock market rally. Many believe this is the start of a new bull market signaling the commencement of a recovery in economic activity. Many fund managers are anxious to get on board believing that they may be left behind in the game of relative performance competition. We certainly agree that things appear to be leveling off from the last seven months of precipitous decline in all economic indicators. Such things as housing starts, durable goods orders, and even retail sales have ticked upward. The Chicago Fed's monthly real GDP proxy, comprised of 85 indicators, improved from a negative -4 to a negative -3. The latter, however, is nothing to write home about, remaining typical of a severe recession. We find all this somewhat encouraging, but believe it is very premature to suggest that either a recovery or a new bull market in common stocks is underway. Our recommendation is that one should use the strength in common stocks merely to reduce one's position in them. We would be surprised if this current recession is anymore than halfway over in terms of time. Even when the recovery begins, we doubt it will have much strength. Debt liquidation is a long and arduous process which entails bankruptcies, defaults, lawsuits, and negotiations involving swapping debt for common stocks, as well as other fits and starts. The economy remains extremely weak and devoid of sustainable turnaround conditions.

Debt Conditions

Please note the following chart which appeared on our Web Buzz of 3/30/2009. All economic sectors except the federal government are in a payback mode. This is a necessary condition

under the economic model that prevails today. Doug Noland of the Prudent Bear website, who we believe has the best handle on the financial side of the economy, believes that we must create something on the order of \$2 trillion per year in additional debt just to keep the economy from imploding on the downside. For all of 2008 the total new borrowing amounted to \$2,885.4 billion compared to \$4,270.7 billion in 2007, a decrease of \$1,385.3 billion (or 32%). Of the \$1,845.1 billion of domestic non-financial debt borrowing \$1,239.2 (or 67%) was done by the federal government. All other non-financial economic sectors i.e. households, business, and state and local governments drastically reduced their borrowing. The financial sector also reduced their borrowing by 41% and most of that was guaranteed by the federal government. The federal government has really become the borrower of last resort. We have some (and the em-



phasis should be on some) appreciation for the use of Treasury and Federal Reserve money to keep the banking system afloat. We would, however, do it by completely wiping out the common stockholders. Also we would haircut the bondholders by making them the new common stockholders, along with the F.D.I.C., which would be paid back and taken out at a later

date. Top management and the board of directors should be fired. In our mind those who caused the problem should go. The only more inadequate group to manage the banks would be the Washington politicians. We need to find a way to lock up these people and make them go away.

All of this entire mess was the doing, first, of the Federal Reserve and their totally irresponsible conduct of monetary policy and second, of the tight relationship between Wall Street and Washington DC. We would suggest that the best way to keep this from happening again would be to abolish the Federal Reserve, or at least drastically reduce its mandate, and to get the government out of the various financial quasi-ownership businesses such as Fannie Mae and Freddie Mac. The private sector will always make some mistakes, but the Wall Street-Washington alliance is toxic and the Federal Reserve has created the greatest moral hazard of all time.

The bailout of others beside the financial institutions is wrong and should not be done. It is a complete waste of taxpayer money and unfair to Main Street. Once the reform of the Fed and the Wall Street-Washington alliance is broken up, no one should ever be bailed out again. NO ONE! Creative destruction is what makes capitalism the best business model in history.

The following is taken from Doug Noland's *Credit Bubble Bulletin* article "Revisiting the Global Savings Glut Thesis" posted on PrudentBear.com March 27, 2009:

"The extraordinary risk-management discipline that developed out of the writings of the University of Chicago's Harry Markowitz in the 1950s produced insights that won several Nobel prizes in economics. It was widely embraced not only by academia but also by a large majority of financial professionals and global regulators. But in August 2007, the risk-management structure cracked. All the sophisticated mathematics and computer wizardry essentially rested on one central premise: that the enlightened self-interest of owners and managers of financial institutions would lead them to maintain a suffi-

cient buffer against insolvency by actively monitoring their firms' capital and risk positions." Alan Greenspan, March 27, 2009, Financial Times.

Alan Greenspan remains the master of cleverly obfuscating key facets of some of the most critical analysis of our time. The fact of the matter is that "the sophisticated mathematics and computer wizardry" fundamental to contemporary derivatives and risk management essentially rested on one central premise: that the Federal Reserve (and, more generally speaking, global policymakers) was there to backstop marketplace liquidity in the event of market tumult. More specific to the mushrooming derivatives marketplace, participants came to believe that the Fed had essentially guaranteed liquid and continuous markets. And the Bigger the Credit Bubble inflated the greater the belief that it was Too Big for the Fed To ever let Fail. It was clearly in the "enlightened self-interest" of operators of "Wall Street finance" and throughout the system to fully exploit this market perversion. With unimaginable wealth there for the taking, along with the perception of a Federal Reserve "backstop," why would anyone have kidded themselves that there was incentive to ensure individual institutions "maintained a sufficient buffer against insolvency"? By the end of boom cycle, market incentives had been completely debauched.

The Greenspan Fed pegged the cost of short-term finance (fixing an artificially low cost for speculative borrowings), while repeatedly intervening to avert financial crisis ("coins in the fusebox"). There is absolutely no way that total system Credit would have doubled this decade to almost \$53 TN had the Activist Federal Reserve not so aggressively and repeatedly intervened in the markets. To be sure, the explosion of derivatives and attendant speculative leveraging was central to the historic dimensions of the Credit Bubble.

Mr. Greenspan today made it through yet another article without using the word "Credit." *"Free-market capitalism has emerged from the battle of ideas as the most effective means to maximise material wellbeing, but it has also been periodically derailed by asset-price bubbles..."* "Financial crises are defined

by a sharp discontinuity of asset prices. But that requires that the crisis be largely unanticipated by market participants.” “Once a bubble emerges out of an exceptionally positive economic environment, an inbred propensity of human nature fosters speculative fever that builds on itself...” He might cannily dodge the topic, but Mr. Greenspan recognizes all too well that Credit has and always will be central to the functioning - and misfunctions - of free-market Capitalistic systems.

With respect to the past, present and future analysis, I believe the spotlight should be taken off asset prices. Such focus is misplaced and greatly muddies key issues. Much superior is an analytical framework that examines the underlying Credit excesses that fuel asset inflation and myriad other distortions. Ensure us a stable Credit system and the risk of runaway asset booms and busts disappears. Today’s financial crisis—and financial crises generally—are defined by a sharp discontinuity of the flow of Credit. Major fluctuations in asset markets—on the upside and downside—are typically driven by changes in the quantity and directional flow of Credit. Central bankers should focus on stable finance and resist the powerful temptation to monkey with asset prices and markets. As common sense as this is, today’s flawed conventional thinking leaves most oblivious and poised for Mistakes to Beget Greater Mistakes.

When it comes to flawed conventional thinking, few things get my blood pressure rising more than the “global savings glut” thesis. Two weeks ago from Alan Greenspan, via The Wall Street Journal:

“...The presumptive cause of the world-wide decline in long-term rates was the tectonic shift in the early 1990s by much of the developing world from heavy emphasis on central planning to increasingly dynamic, export-led market competition. The result was a surge in growth in China and a large number of other emerging market economies that led to an excess of global intended savings relative to intended capital investment. That ex ante excess of savings propelled global long-term interest rates progressively lower between early 2000 and 2005. That decline in long-term interest rates across a wide spectrum of countries statistically

explains, and is the most likely major cause of, real-estate capitalization rates that declined and converged across the globe, resulting in the global housing price bubble. By 2006, long-term interest rates and the home mortgage rates driven by them, for all developed and the main developing economies, had declined to single digits -- I believe for the first time ever. I would have thought that the weight of such evidence would lead to wide support for this as a global explanation of the current crisis.”

It is difficult these days for me to accept that Greenspan, Bernanke and others are sticking to this misplaced view that a glut of global saving was predominantly responsible for the proliferation of U.S. and global Bubbles. The failure of our policymakers to understand and accept responsibility for the Bubble must not sit well internationally. Long-time readers might recall that I pilloried this analysis from day one. The issue was never some glut of “savings” but a historic glut of Credit and the resulting “global pool of speculative finance.” In today’s post-Bubble period, it should be indisputable that the acute financial and economic fragility exposed around the globe has been the result of egregious lending, financial leveraging, and speculation. True savings would have worked to lessen fragility – instead of being the root cause of it.

Unfortunately, there is somewhat of a chicken or the egg issue that bedevils the debate. Greenspan and Bernanke have posited that China and others saved too much. This dynamic is said to have stoked excess demand for U.S. financial assets, pushing U.S. and global interest rates to artificially low levels. This, they expound, was the root cause of asset Bubbles at home and abroad. I take a quite opposing view, believing it unequivocal that U.S. Credit excess and resulting over-consumption, trade deficits, and massive current account deficits were the underlying source of so-called global “savings.” Again, if it had been “savings” driving the process, underlying system dynamics wouldn’t have been so highly unstable and the end result would not have been unprecedented systemic fragility. Instead, the seemingly endless liquidity—so distorting of markets and economies round the world—was in large part created through the process of unfettered speculative

leveraging of securities and real estate.

As is so often the case, we can look directly to the Fed's Z.1 "flow of funds" report for Credit Bubble clarification. Total (non-financial and financial) system Credit expanded \$1.735 TN in 2000. As one would expect from aggressive monetary easing, total Credit growth accelerated to \$2.016 TN in 2001, then to \$2.385 TN in 2002, \$2.786 TN in 2003, \$3.126 TN in 2004, \$3.553 TN in 2005, \$4.025 TN in 2006 and finally to \$4.395 TN during 2007. Recall that the Greenspan Fed had cut rates to an unprecedented 1.0% by mid-2003 (in the face of double-digit mortgage Credit growth and the rapid expansion of securitizations, hedge funds, and derivatives), where they remained until mid-2004. Fed funds didn't rise above 2% until December of 2004. Mr. Greenspan refers to Fed "tightening" in 2004, but Credit and financial conditions remained incredibly loose until the 2007 eruption of the Credit crisis.

It is worth noting that our Current Account Deficit averaged about \$120bn annually during the nineties. By 2003, it had surged more than four-fold to an unprecedented \$523bn. Following the path of underlying Credit growth (and attendant home price inflation and consumption!), the Current Account Deficit inflated to \$625bn in 2004, \$729bn in 2005, \$788bn in 2006, and \$731bn in 2007. And examining the "Rest of World" (ROW) page from the Z.1 report, we see that ROW expanded U.S. financial asset holdings by \$1.400 TN in 2004, \$1.076 TN in 2005, \$1.831 TN in 2006 and \$1.686 TN in 2007. It is worth noting that ROW "net acquisition of financial assets" averaged \$370bn during the nineties, or less than a quarter the level from the fateful years 2006 and 2007.

The Z.1 details, on the one hand, the unprecedented underlying U.S. Credit growth behind our massive Current Account Deficits. ROW data, in particular, diagnoses the flooding of dollar balances to the rest of the world – and the "recycling" of these flows back to dollar instruments. This unmatched flow of finance devalued our currency, and in the process inflated

commodities, foreign debt, equity and assets markets, and global Credit systems more generally. In somewhat simplistic terms, ultra-loose monetary conditions fed U.S. Credit excess, excessive financial leveraging and speculating, asset inflation, over-consumption, and enormous Current Account Deficits. And this unrelenting flow of dollar balances to the world inflated the value of many things priced in devalued dollars, thus exacerbating both global Credit and speculative excess. The path from the U.S. Credit Bubble to the Global Credit Bubble is even more evident in hindsight.

Back in November of 2007, Mr. Greenspan made a particularly outrageous statement. *"So long as the dollar weakness does not create inflation, which is a major concern around the globe for everyone who watches the exchange rate, then I think it's a market phenomenon, which aside from those who travel the world, has no real fundamental economic consequences."*

Of particular interest to us in the above excerpt from Doug Noland's recent comments regarding the role of the Federal Reserve in the worldwide credit bubble is the paragraph that comments, "Unfortunately this is somewhat of a chicken and egg issue . . ." This is the crux of the debate between the Keynesian and Austrian economic models. What comes first, supply or demand? The Austrian model tells us that supply must come first—without supply there can be no demand. The Keynesians believe demand creates supply. Both are correct depending upon where one is in the economic cycle. When the Fed supplies free money and lots of it, the Keynesian model takes over. That is without a doubt what created the savings for suppliers (i.e. China & India). Had the Fed not acted first, there would be no savings. Not only that, but no speculative blow off and resulting depression.



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