

Friday, May 2, 2014



Global Macro Themes - The Identity Crisis (Part 1)

The first steps to overcoming any crisis involve acknowledging the existence of a problem and identifying its underlying source. While global policymakers have clearly acknowledged that the world economy remains problematic, unfortunately its source has been, and

continues to be, misunderstood. Not until this identification error is corrected, and appropriate macroeconomic policies implemented, can we conclude that we are, finally, on the road to recovery. In this article we not only illustrate why global policymakers have failed to deliver the long-promised sustained economic upswing, but we will prove theoretically that the current policies are not only doomed to fail but are actually exacerbating the underlying problem. In Part Two of this research note, we will outline the macroeconomic policies that are required to resolve this crisis; policies that will dramatically alter the global financial landscape.

Denial – Not Just A River In Egypt¹

For many of us, global policymakers have been completely behind the curve on every single aspect of the global economic/financial crisis, which started to manifest itself in 2007. What initially was described as a “contained” problem in US sub-prime real estate lending², then metamorphosed into a “liquidity” crisis; only to become a “solvency” crisis when central banks realized that the abundant amounts of cash they were injecting into the global financial system failed to have the desired stimulative results.

Episodes of disorderly deleveraging of the type witnessed in 2008/9 are relatively rare. As a result, there were only a few historic examples that economists and investors could refer to and analyse and many financial market participants (including your present author) expended a good deal of time back then digging out information on the Great Depression and Japan’s lost decade as the parallels between these two previous episodes and what has become known as the Great Recession (or GFC if you are Australian) seemed all too clear. The

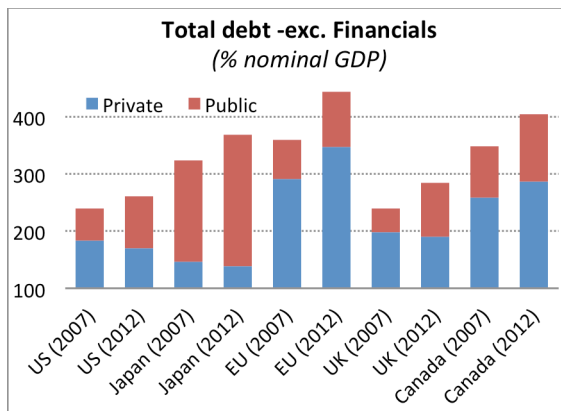
¹ Yes we know, not the best joke ever!

² This is one of the quotes that Bernanke will be forever associated with but would most certainly like to forget and is consistent with the denial phase seen in the first stage of any crisis - economic, financial or personal. It is on a par with President Hoover’s famous assertion made in June 1930 and we quote: “Gentlemen, you have come too late. The depression is over”. It just goes to highlight that despite all we have supposedly learned about macroeconomic analysis over the past seventy years, policymakers continue to make the same basic errors. Unfortunately, these errors have very dire outcomes for the rest of us mere mortals.

common thread between the three episodes was the private sector's desire to reduce its debt load. Unchecked, this debt deleveraging would generate strong deflationary undertows in the economy because in a fractional reserve banking fiat system money is backed by debt³. Given that deflation raises the real cost of existing debt (most debt tends to take the form of nominal commitments) this serves to exacerbate further the problem⁴ encouraging the private sector to shed even more debt generating yet more deflationary pressures.

The Great Debt Switch

Based on the experiences of the Great Depression and Japan's lost decade, global policymakers deemed the appropriate policy response to be a combination of ultra-easy monetary policy - in the form of sharp reductions in interest rates and increased provision of liquidity via either loans or, eventually, asset purchases - and deficit-financed fiscal stimulus. At the macro level, the effect of such policy action is the public sector assumes the liabilities of the private sector, either directly or indirectly. By maintaining - or as can be seen in the chart below almost always increasing - the aggregate level of debt in an economy, this policy-mix short-circuits the disorderly deleveraging process and thereby removes the deflation tail-risk.



With these policies in place by the end of Q1-2009, many financial market participants appeared satisfied that the underlying source of the problem (excessive private sector debt) had been correctly identified and that the appropriate policy response had been found.

This provided a strong boost to investor confidence from levels that were - by any historic comparison - very depressed. Improved private sector expectations about economic growth (both real but especially nominal given the perceived removal of the deflation tail-risk) provided the fuel for a strong rally in global asset markets. For those investors, like ourselves, who have a more sceptical bent this was like "sucking on the end of the reflationary hosepipe"⁵.

³ The general public seems to be largely unaware of this fact and perhaps thank goodness they are as it would greatly undermine their trust in the global financial system.

⁴ This mechanism was first described by Irving Fischer back in 1933. See: <http://fraser.stlouisfed.org/docs/meltzer/fisdeb33.pdf> for the original working paper.

⁵ Hat tip: JA for that delightfully descriptive quote of what was, in reality, a very painful process. That policymakers were (and still are) incentivizing investors not to think always struck us as morally and intellectually wrong, albeit financially rewarding (at least in the short-term).

Investment – The Real Test

Despite all the optimism over the “green shoots” of recovery and the rebound in global asset prices, the real test as to whether demand-side policy stimulus would be effective was always going to be determined by the response of business investment; a necessary (albeit not sufficient) condition for self-sustaining recovery in the developed economies. We have already covered this topic in a prior research note⁶ so we will not rehash the arguments here. Rather, we simply reiterate that the hoped for revival of “animal spirits” on Main Street (as opposed to Wall Street), and a reinvigoration of business investment was, and remains, largely absent.

What Went Wrong?

So, despite having done exactly what the economic textbooks prescribed as being the appropriate policy response to a debt-deleveraging crisis, what went wrong? There are basically two schools of thought:

- Global policymakers injected insufficient demand-side stimulus.
- The analysis of the underlying factors that contributed to the economic crisis was flawed, resulting in an inappropriate policy response.

Given the high levels of government debt and bloated central bank balance sheets in the developed economies we find the argument that the demand-side policy response was insufficient to be far from convincing. However, it is hardly surprising that policymakers and ardent Keynesians favour this argument, as acknowledging failure is always intellectually and emotionally difficult.

The alternative hypothesis is, by contrast, much more compelling. Indeed, as we will go on to show, a deeper understanding of the underlying sources of the economic crisis including - crucially – identifying one, so far ignored, factor implies that the demand-side policies enacted were not only theoretically flawed (hence doomed to failure from the very start) but have actually exacerbated the problem. To enable us to do this we need to take a more detailed look at both the monetary and fiscal policy responses to the crisis.

Money, Money, Money

The severity of the economic and financial crisis forced many central banks to introduce non-standard monetary policies after the “standard” monetary policy options were exhausted, namely nominal short-term interest rates hit the zero bound. The most prominent of these non-standard measures is quantitative easing (QE) or in Fed parlance large-scale asset purchase (LSAP) programmes.

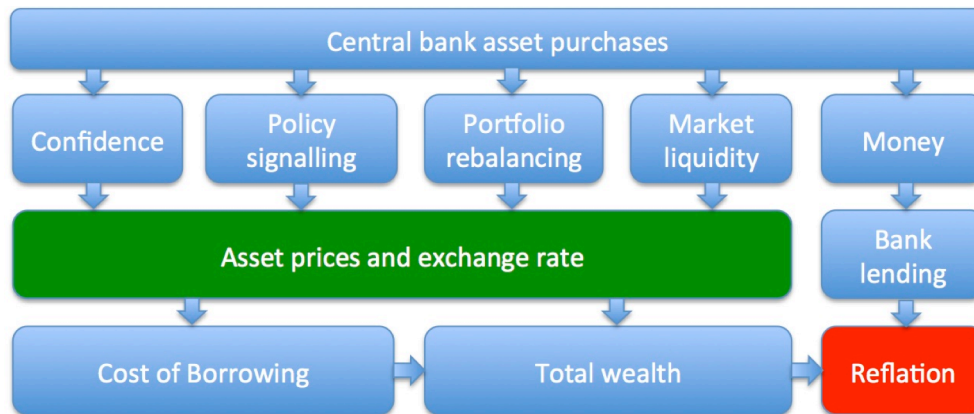
⁶ See “*Global Macro Themes – Keynesian Failure*”, 10 March 2014.

The theoretical foundations for central bank asset purchases are, let us be polite, unclear. Even former Fed Chairman Bernanke acknowledged as much when he quipped that,

“The problem with QE is that it works in practice, but it doesn’t work in theory.”

Despite this recently expressed observation central banks put forward the hypothesis of the portfolio balance channel effect to justify, from a theoretical perspective, their actions and have produced numerous schematic diagrams describing how their asset purchases will feed through the economy to deliver the desired reflationary boost. The figure below, which is based on one from the Bank of England website, clearly shows four of the five proposed channels work via boosting asset prices.

Figure 1: How Quantitative Easing Works



Even though monetary policy decisions are generally not targeted to benefit a specific sector of the economy⁷, what is manifestly clear from the way in which QE impacts, or is supposed to impact, the economy is that it greatly benefits asset owners.

It is undoubtedly true that by helping to stabilise, and ultimately reverse, the downtrend in US house prices QE helped households across the income and wealth spectrum by improving their balance sheets. However, given the huge skew of asset ownership in the US, the greatest positive effects have been felt where they are, arguably, least required.

To highlight this asset ownership skew in the US, the following table is constructed using data from the latest Fed triennial Survey of Consumer Finances⁸.

⁷ With the exception of some of the Fed’s emergency measures which were clearly targeted at some sectors, notably the housing market.

⁸ The data contained in the report refer to 2010.

Figure 2: US Household Wealth by Income

Percentile of income	Before-tax family income	Household Net Worth		Financial Assets	
	Mean (USD thou.)	Mean (USD thou.)	% of total	Mean (USD thou.)	% of total
Less than 20	12.9	116.9	4.7	30.7	3.1
20-39.9	27.9	130.0	5.3	33.8	3.4
40-59.9	46.2	197.1	8.0	69.1	7.0
60-79.9	73.5	292.4	11.8	121.1	12.3
80-89.9	114.5	569.6	11.5	248.3	12.7
90-100	347.8	2,906.6	58.7	1,203.6	61.4

US households in the lowest 20th percentile of the income distribution earn just under USD13,000 per annum before tax. Their net worth equates to just under USD 117,000, of which approximately USD 30,000 is held in financial assets. These holdings represent just 4.7% and 3.1% of the respective economy-wide totals. By contrast, the top income decile has before tax earnings averaging USD 347,000 per annum and net worth and financial assets totalling almost USD 3.0mn and USD 1.2mn respectively (accounting for around 60% of the economy-wide totals).

For the avoidance of doubt we are not closet socialists highlighting the inherent inequality of the capitalist system with this analysis. We are totally in favour of capitalism⁹. What we are simply pointing out here is that quantitative easing (QE) contributed to a further widening in income and wealth inequalities¹⁰. Little wonder that QE has become known as “*monetary policy for the rich*” – an observation not without merit.

This is crucially important to understanding the economic crisis as we will show later in this research note. But, before that, we need to turn to fiscal policy and ask a question, which may at first sight seem to be totally unconnected and is certainly not widely understood.

Where Do Profits Come From?¹¹

Before you all scramble to dig out microeconomic text books and update yourselves on the theory of the firm to come up with MC=MR, what we are

⁹ In its ideal form that is not the bastardised version that we have at the present time where, to borrow language from US film writers, “Failure is not an option”.

¹⁰ This phenomenon is not just apparent in the US, but is also evident in many other countries, especially the UK where the BoE introduced a similar programme. We are just using the US as an example as it has the best data sources.

¹¹ This next section draws on a research paper of the same name by Levy, Farnham, and Rajan (1997). See: www.levyforecast.com/assets/Profits.pdf. The analysis is based on the sector balance approach which we first described in “*Global Macro Themes – Abenomics: One Year On*”, 13 February 2014.

considering here is not the microeconomic foundations of profits but rather the macroeconomic foundations. This is a subject that often gets overlooked in macroeconomic courses and goes a long way to explain why the above question is rarely asked.

The basis for the analysis is the Kalecki profits equation, a Polish economist who first discussed it in the 1930s¹², and is derived from the sector balance approach that we have previously described (see footnote 10). To recap, briefly, the sector balance approach stems from the national accounting identity that domestic saving equals the current account balance. By breaking domestic saving down into the three main sectors – government, household and corporate we can derive the following:

Current Account Balance =
Net Corporate Saving + Net Household Saving + Government Budget Balance

From this identity we can further breakdown net corporate saving into its component parts, namely profit less investment (net of depreciation). With a little rearranging this yields the following:

Corporate Profits =
Business Investment – Net Household Saving - Government Budget Balance + Current Account Balance + Dividends

Plugging in the latest numbers for the US economy we find the following macroeconomic contributions to US corporate profits:

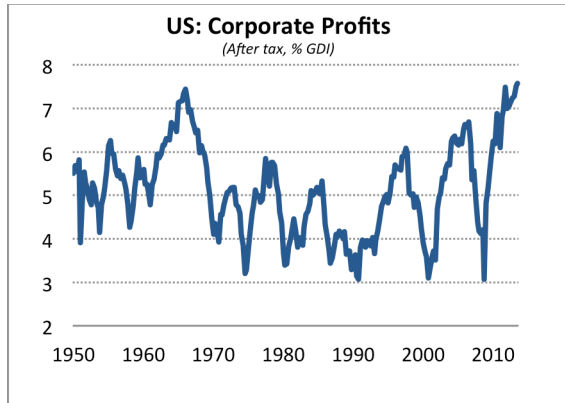
Figure 3: Macro Contributions To US Corporate Profits
(Four quarters ending in Q3 2013)

Source:	(% Nominal GDP)
+ Investment	+3.4%
- Household Saving	-3.8%
- Government Budget	- -6.6%
+ Current Account	-2.5%
+ Dividends	+4.5%
= Corporate Profits	+8.2%

The above table might not, on the face of it, seem to be politically profound, but consider this: the single greatest macro contribution to US corporate profits,

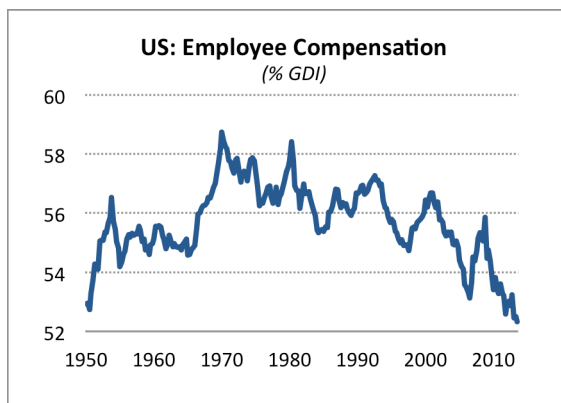
¹² It has also been “discovered” by Levy and Keynes on separate occasions as noted by James Montier in his piece on US Corporate Profits GMO White Paper “What Goes Up Must Come Down!”, March 2012.

which were around 8.0% of nominal US GDP over the preceding four quarters, was the US government deficit; it accounted for almost 80% of the total!



Indeed, if it were not for the deficit-financed fiscal stimulus injected by the US government, US corporate profitability would not have rebounded as sharply as it has done in recent years (see chart). What is also clear from the chart is that US corporate profitability as a share of national output now stands at its highest level in the entire post-war period.

In large part, and certainly in the first stages of the “recovery”, US companies’ boosted profits by very aggressive management of the bottom-line via continued cost-cutting. At the economy-wide level the greatest production cost is labour so not surprisingly the mirror image of the rise in corporate profitability has been a decline in the wage share of national output. It has fallen to its lowest level in the post-war period (see chart).



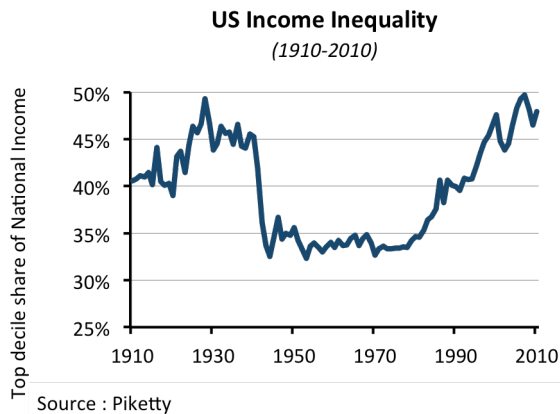
Given that workers are also consumers this loss of purchasing power should have hit corporate profitability hard as the only two other sources of demand for goods and services are either foreign (implying a widening in the US trade balance – something that has not occurred) or via credit creation (something that also has not occurred given deleveraging).

That this outcome was avoided is directly attributable to the US government’s decision to run a much larger fiscal deficit¹³. For the relevance of this research note, however, the key observation is that deficit-financed fiscal stimulus directly feeds into higher corporate profits, income that also accrues to capital owners. Sound familiar? It should.

Just like QE, deficit-financed fiscal stimulus directly benefits the owners of capital¹⁴, which as we have already shown, is overwhelming skewed towards the wealthiest segment of the population in the US and most other economies.

¹³ Even though they may not realise it given all the negative press about Obamacare etc, US corporates have a lot to thank the President and his economic advisors for.

¹⁴ In the earlier section on QE we referred to the benefits to asset owner. For clarity we use the term capital owner and asset owner synonymously in this research note.

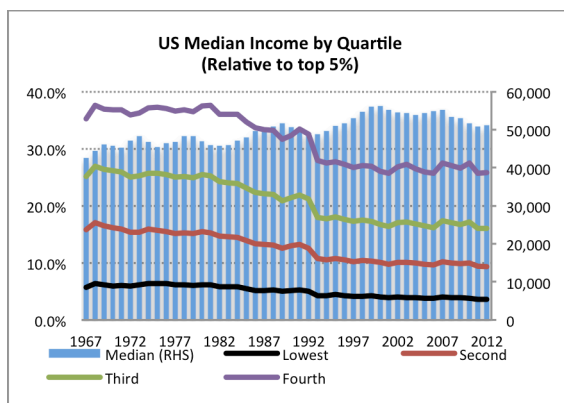


In short, the combination of demand-side monetary and fiscal stimulus, is increasing not decreasing income/wealth inequalities in the US economy¹⁵. This turns out to be a crucial observation because as we will now argue rising inequality was a significant underlying – but largely ignored - source of the economic crisis.

What Caused The Debt Bubble?

As mentioned at the outset, the general perception amongst financial market participants is that the economic crisis was the result of the private sector becoming overextended and then striving to shed what was, *ex post*, considered to be an excessive debt load. This is the end of the thought process as far as many financial market participants are concerned, especially given the correct policies were/are assumed (incorrectly) to be in place. We, in contrast, are naturally more inquisitive and this led us to wonder what was the reason for the private sector becoming overly indebted.

In our previous research note we argued that many factors contributed to the US debt bubble, such as China's mercantilist policies over the past two decades and the Fed's benign neglect of US external trends in deference to its price stability mandate. Strong asset price gains resulting from these policies encouraged US households to borrow, especially in the real estate sector as this is always the easiest asset class for households to gain leveraged exposure to. Due to improving household net worth, reflective of higher asset prices, banks and other credit providers were only too happy to provide the loans, contributing to the debt bubble. But these were not the only driving forces.



Keeping Up With The Joneses

Providing further impetus to the surge in household debt was the fact that US median wage growth was barely positive in real terms over the preceding 40-year period, rising at an annual rate of just 0.4% per annum since 1967.

¹⁵ Admittedly it requires a bit of visual effort, but squinting at the far right hand side of the top chart the last data point shows an uptick consistent with an widening in inequality.

Making matters worse, not only did the US middle class witness very modest increases in their real incomes over an extended period of time, they also experienced a significant decline in their real incomes relative to the wealthiest section of the population. By gaining leverage exposure to rising asset prices, US middle-and low income households were able to maintain strong consumer spending – and hence the mirage of improved living standards¹⁶ - even in the face of tepid real wage growth.

While it is impossible (even *ex post*) to disentangle the relative importance of the various factors that contributed to the debt bubble in the US many studies of behavioural finance conclude that it is not just absolute income that is relevant for consumer utility (or sense of well-being in plain English) but also relative income. As such, the relative decline in living standards for a significant percentage of US households almost certainly provided a strong psychological drive to leverage up their balance sheets in order to “enjoy” the benefits of rising asset prices.

If, as we argue, income/wealth inequality was one of the key contributing factors to the US debt bubble (hence one of the underlying sources for the economic crisis); and, as we have just demonstrated theoretically, demand-side Keynesian policies are exacerbating income/wealth inequality, then logic implies that the macroeconomic policies implemented to tackle the economic crisis are, necessarily, doomed to failure.

Real Solutions

We have never been satisfied with just pointing out a problem and not providing possible solutions. Thankfully, such solutions exist, although their impact upon the global financial landscape will be very dramatic. Identifying the policy “end game” is going to be a major challenge to all global asset managers; and potentially very profitable. This is something we will discuss in the second part of this research note.

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¹⁶ It was a mirage in the sense that the support for increased consumer spending from wealth was based on asset price gains that were not supported by underlying economic fundamentals and hence, ultimately, unsustainable.