It's 3:00 AM. Do You Know Where Your Economy Is?

by Howard H. Newman

PINE BROOK

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Last year, I concluded our Annual Meeting with a presentation called "The Other Side of Midnight."

That talk discussed the role which excess leverage played in creating the boom and bust which culminated in the Great Recession.

One of our principal points was that regulators allowed the excessive growth of assets which financed speculation and consumption instead of productive assets – the activity which Minsky called Ponzi Finance.

The returns on these Ponzi Assets were then supercharged with leverage. The resulting high nominal returns on financial assets drew funds away from investment in plant and equipment.

This is a case where the private and public returns on investing activity were very different. Put directly, capital market returns to savers were high, even though returns to the real economy were low. The result was an over-leveraged economy that could not meet its obligations.

At the end of last year's presentation, we sketched out a blueprint for getting to "The Other Side of Midnight."

Our program was based upon an investment led recovery based on low interest rates and called for four actions: (1) increased - and equalized - capital requirements for all lenders; (2) a regulatory framework which required action when system wide leverage increased; (3) a coordinated move to encourage surplus countries to become less dependent on export led growth; and (4) a shift in tax and other policies from favoring consumption over investment.

Well, it's now 3 A.M., and how have we done?

Report Card

SUBJECT	GRADE
Increase & Equalize Capital Requirements For Lenders	Inc
Recognize Need to Monitor System-wide Leverage	A
Implement Process to Monitor System-wide Leverage	F
Address Global Imbalances	C+
Encourage Investment vs. Consumption/Asset Speculation	F

A	Excellent
B	Good
C	Satisfactory

D	Poor
F	Fail
Inc	Incomplete

We have made decent progress on capital requirements, though the implementation has been stretched out over the next 8 years. The focus has been on how much capital counts in the denominator; what goes into the numerator is still open. Unfortunately, it was abuses in the numerator-extensions of credit which weren't counted for capital adequacy, such a back up lines of credit- which was the root cause of the bubble.

Let's award an Incomplete

System wide leverage has become a policy variable, but the responsibility for monitoring it was vested in the Treasury, not the monetary authorities.

Let's award a split grade: A for recognition/ and an F for implementation

Third, much attention has been given to increasing consumption in China and the other high growth economies, and today, this seems to be the topic of most interest. Some movement has been made on exchange rates. But there is a long way to go, especially in getting the developing countries to be less dependent on exports.

Grade: C+

Finally, on the most important part of the program –making the financing of productive investments more attractive than financing consumption and asset speculation, nothing has happened.

Another F

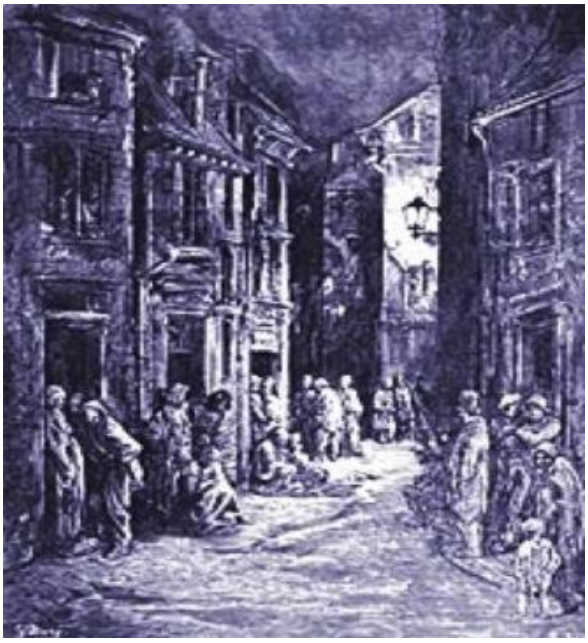
Today, we are going to discuss the reasons why we feel that the last of these four actions-a tilt toward investment-is the most important part of the program, and why its neglect is ultimately behind many of the economic issues we face today.

The Importance of Investment

Early in the industrial revolution, one of the most pressing questions was whether workers would ever earn more than a subsistence wage.

The squalor of 18th century Europe lent weight to this question, and it surfaced in the writings of both English and the Continental scholars, and became known as the "Iron law of wages."

Squalor of 18th Century Europe: "The Iron Law of Wages"



The argument in favor of this bleak outlook for workers was a belief that the supply of labor was a function of the real wage.

If wages were above the subsistence level, people would breed until they fell back to poverty wages. Any "surplus" created by increasing productivity would be captured by the industrialists, much as the surplus of the medieval peasant was captured by his lord. Subsistence farming was sure to be replaced by subsistence labor markets.

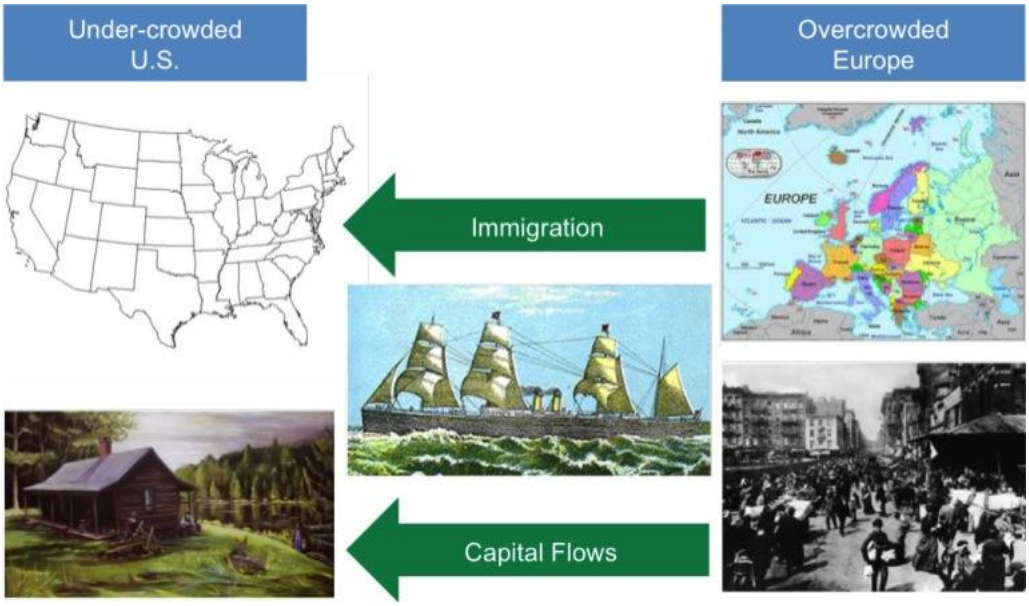
A number of things, however, happened to prevent this gloomy result. And perhaps the most important of them was the discovery of the New World.

From the very beginning, America was a place where land, not labor, was in excess supply. As a result, wages in America were almost instantly established at rates which reflected the productivity of labor, not its overabundance.

U.S. Wages Reflected Productivity and Scarcity

Workers from the poorer - read more populated - parts of Europe flocked to the US, responding to the promise of higher wages. Capital flowed equally easily from abroad, as returns were high despite the high share captured by labor. The land, after all, was quite rich, and there was plenty of surplus to distribute.

An Empty Land Needed People and Capital



There are two important points to glean from this story.

The first point is that increases in productivity do not necessarily accrue to labor. Merely because you give a worker better tools-such as a power loom instead of a spinning wheel-does not mean that she will share in the benefits of increased productivity.

Why so? While the industrialist's own self-interest will enable him to increase wages and add more workers-even at a higher cost-if those wages are below the marginal productivity of that worker, that self interest will also encourage him to hold wages down so that he can capture a higher share of that productivity as rent or profits.

The second point is that labor's ability to capture the benefits of increased productivity lies in its being "Relatively Scarce."

So long as labor can go elsewhere and/or do something else, it can capture a wage which is close to its marginal productivity. Otherwise, the excess profits - what economists call rents- gets captured by land or capital.

Overall, if you look at the history of the US, you come to the conclusion that labor has always been the factor of production which was "Relatively Scarce".

There are three facts to support this conclusion.

The first, of course, is our history of immigration. Labor continues to be needed and come to the US from countries where it is in excess supply. We need labor and we import it from countries which have too much of it.

The second is that US real wages have increased over time at a rate which is roughly equal to the rate of growth in productivity.

The third is that, over long periods of time, the aggregate return on real investment in the US has been roughly constant.

Taken together, these three facts indicate that labor has been scarce enough to capture a wage that reflects its productivity. Indeed, almost all of the "excess" profit in the system has been captured by increased compensation and, as a consequence, higher living standards. Return on capital has been constant; all the excess has been captured by labor.

"Better Living Through Technology" as the old GE slogan put it, certainly was the result!

Unfortunately, this state of affairs may no longer be the case for large sectors of the US economy.

The downside of the global economy is that labor is a global market as well. For certain jobs, labor is no longer "Relatively Scarce." US workers who perform jobs that can be performed elsewhere are now in competition with workers in countries where labor is in excess supply.

Are conditions precedent for the iron law of wages to reasserting itself? Is the US doomed to see the end of its fabled middle class as the bargaining power of labor- no matter how enabled-gets eroded by competition from abroad?

As usual, the answer is, "It all depends".

Certainly, jobs which can be done either here or abroad are at risk. Or more accurately, the wages in those jobs where products can be made abroad and then transported back to the US are at risk if the labor –and the productivity of that labor- are the same here as abroad.

After all, wages are not the issue. Unit Labor Costs are the issue. And Unit Labor Costs are determined by productivity. So if the productivity of the US labor can be enhanced, then there is no reason why both the jobs and the income cannot be protected.

Take a step back and consider a job- almost any job. You do it this year; you do the same job again next year. If nothing else changes, the output of that job is the same, and the pay should be the same. There is, after all, nothing which guarantees that a worker should earn more next year than this year for the same output. Indeed, this is why jobs disappear every year; if productivity is not enhanced, those workers can be bid away to other jobs or industries-or other countries- where productivity is higher.

Fortunately, productivity is not that hard to enhance. It merely takes investment. That investment can be in infrastructure, new machines, IT, training, venture capital, -a whole host of things which, to simplify this talk, I will call tools.

Give a worker more tools, and he can become more productive. If he is more productive, he can compete with foreign workers who have fewer tools.

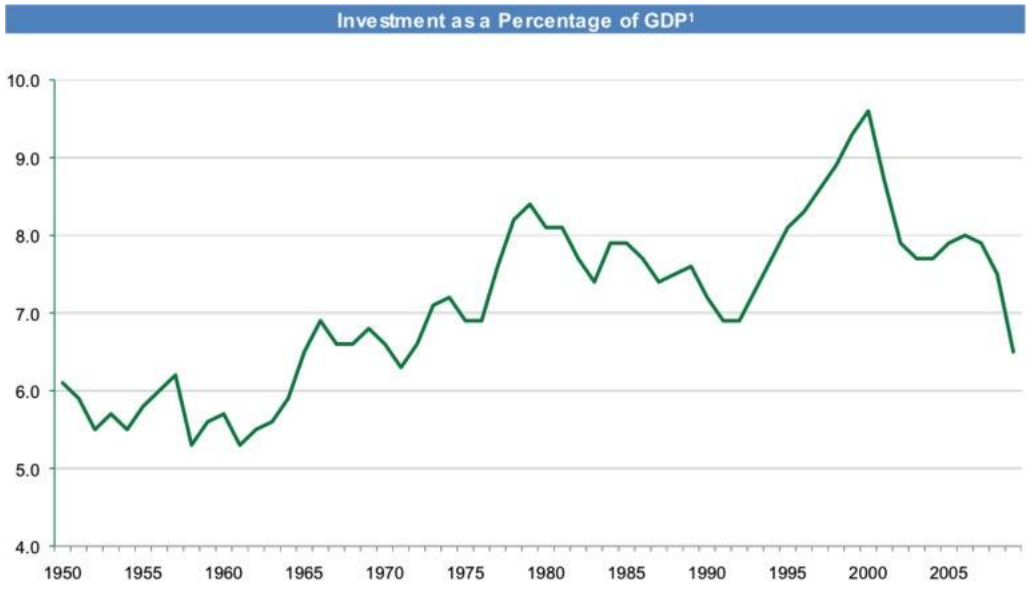
Tools, Tools and More Tools

There is another benefit to giving our workers more tools. It makes them economically different from labor abroad. Workers with different tools, training or technology at their disposal are not interchangeable. These differences create the "Relative Scarcity" needed for labor to capture a fair share of the gains which come from productivity. Simply put, more tools means higher incomes.

The key is figure out how to get our labor more tools. How do we increase investment?

As we know, however, the US has been shirking its investment in tools for some period of time now.

Tools Drive Productivity



1) Source: Bureau of Economic Analysis.

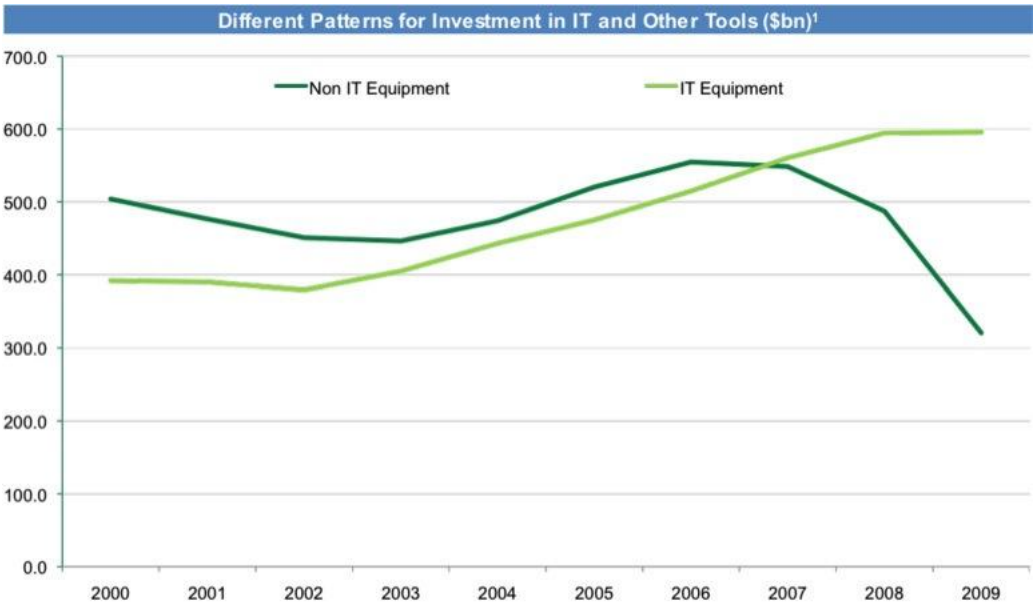
From 1950 until about 2000, investment in Tools gradually increased from 5.5% of GDP to over 9%. Real incomes went up dramatically in this period.

Since then, it has declined steadily and is now under 7%.

The composition of that investment has also changed dramatically.

In recent years, real private investment in equipment other than for IT has been constant, while IT spending is up considerably. There has been no increase in the non-IT tools provided to our workers! Is it so hard to understand why real incomes, which grew so steadily for everybody for so long, have been flat in so many jobs for the past 10 years? Could it be economics, and not politics, which is responsible for this sad state of affairs?

Tools Drive Productivity and Real Wages



1) Source: Bureau of Economic Analysis.

Macroeconomic Issues

It is now time to move from the micro discussion to the macro side.

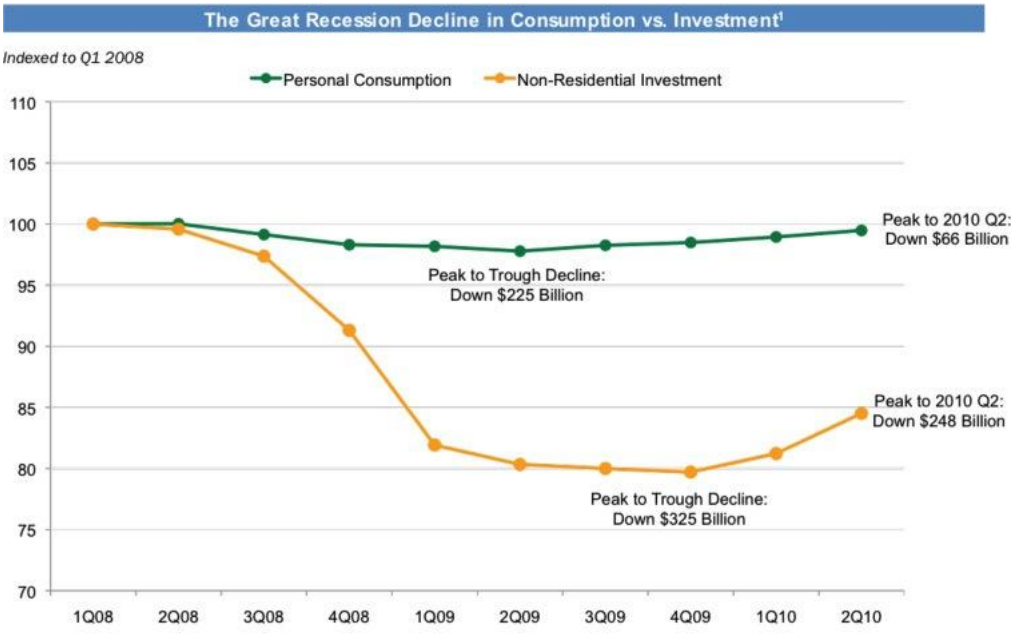
We are facing two major problems domestically: inadequate aggregate demand and an excessively leveraged economy.

It is not hard to see that there is a common solution to these challenges, and that solution is the same as to the problem of falling real incomes for our workers.

Let's start with inadequate aggregate demand.

The recession saw real personal consumption expenditures drop by $225b, or 2.4% from peak to trough. At the same time, non-residential fixed investment fell $325 billion, or 20%. More telling, consumption began to recover in the third quarter of 2009, and is now only $66 billion –or .7% below its peak, while investment is still $248 billion, or 15%, below its high. While the decline in personal consumption expenditures is what made this recession so severe, it is not hard to see that the issue with the recovery is on the investment side.

From the Peak, Investment Is Down $248 Billion and Consumption Is Down $66 Billion



1) Source: Bureau of Economic Analysis.

Instead of addressing this economic fact, we have a silly squabble about the stimulus.

Stop. You're Both Right!

Of course the economy needs stimulus.

We have underemployed resources; they need to be employed. The Keynesian "solution" is to consume these idle resources, and this solution is assumed to have no cost because investment is already at its maximum. We would only be consuming idle savings.

But we are also in the liquidity trap. Animal spirits have been tamed, in part because of a natural uncertainty about demand, in part because of the continued weakness in the financial system, in part because of the hostile rhetoric in Washington, and in part because of a concern as to the future consequences of additional government debt. The Rational Expectations critique of Keynes is also valid; concerns over the consequences of the deficit are also hindering investment.

The answer is to find a stimulus package which deals with the shortfall in investment, not one which merely finances consumption or relies on transfer payments to convert "the idle savings of the rich" into the needed consumption of the poor and middle class.

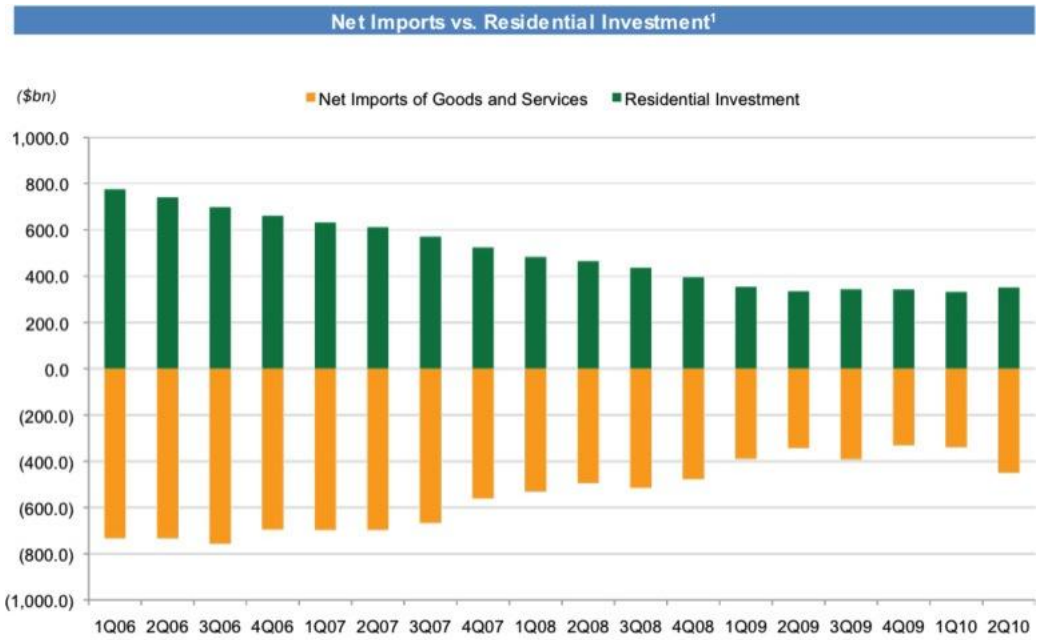
In order to be effective in both the long and the short term, stimulus must be self financing and create the income to repay it.

The ideal stimulus is an addition to investment, not consumption. In this sense, both Keynes and the Rational Expectations positions are correct. Economics is, after all, about both supply and demand, and the debate today has each side forgetting this simple fact.

Let's return to the National Income statistics to provide a bridge to the second problem, namely excess leverage. The culprit often cited for this recession was the popping of the real estate bubble. But here are some inconvenient truths.

Residential investment actually peaked in 2006-two years before the recession began. At roughly the same time, the US trade balance began to improve. Interestingly, the decline in housing ($281 billion) was roughly offset by the decline in net imports ($248 billion). The housing bubble was financed abroad by the recycling of our trade deficit! All that debt and no income to service it!

Financing the Housing Bubble



1) Source: Bureau of Economic Analysis.

An economy is over levered when the amount of its financial obligations get too large relative to the income needed to service those obligations. In financial terms, the ratio of debt to national income grows. And grows. And grows……

There are three ways to restore the balance: eliminate the obligations, inflate them away, or increase national income and service them.

Clearly, I prefer the last of these three solutions. And that means more tools.

Returning to our conclusion from last year, the crux of the financial crises was a regulatory environment which discouraged investment in tools, not directly, but by supporting alternatives that appeared to be higher yielding. Regulators permitted-and often encouraged!- Ponzi investing. (Recall that Ponzi securities are those which are dependent, when issued, on refinancing to meet debt service.) Simply put, the returns to holding Ponzi securities exceeded those available from investing in the real economy. Why earn 10% by financing a new plant when you could earn 25% by owning the equity tranche at the bottom of a securitization of consumer debt?

Sadly, the reforms enacted during the past year did not adequately address this point. The overarching theme of reform has been that the problems behind the financial meltdown were all liquidity issues, not real economy issues. Thus, the solutions passed have been designed to enhance liquidity-or, more accurately, make the occurrence of market illiquidity less likely. (And to punish those who

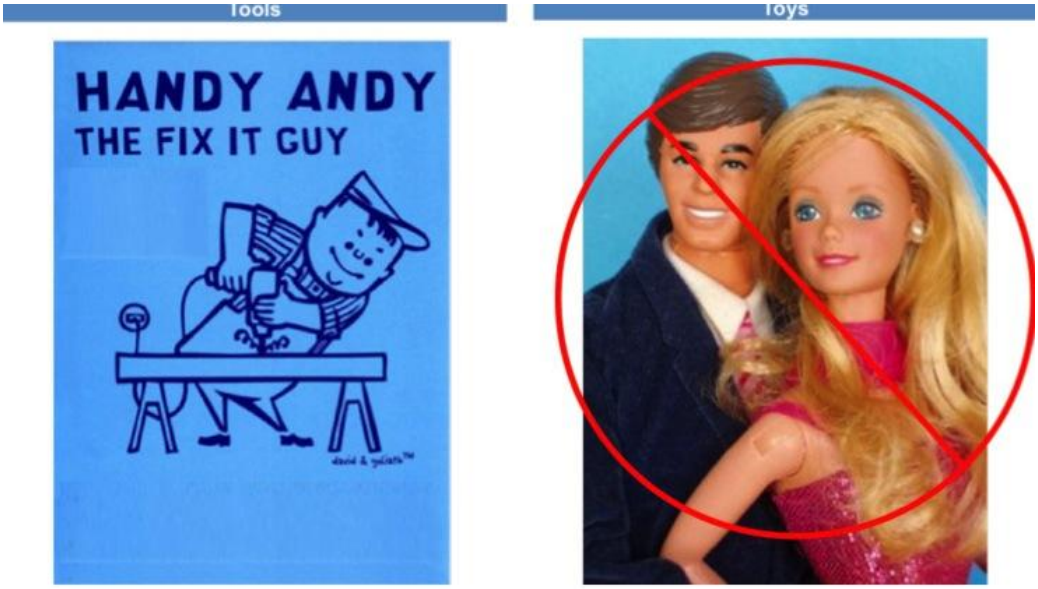
were politically unpopular-but that is another set of issues we can discuss over cocktails.)

Unfortunately, these solutions are not designed to address the more fundamental problem that it is easier to make money with leverage than by investing in tools.

So let's see what we have discussed today: declining real wages for US workers; threats from globalization, the great recession; and financial reform.

We have pointed to more investment-what we economists call capital deepening-as the solution to these issues. Can we make it happen? This is the challenge we face.

Tools – Not Toys!



The way from 3 am to dawn, is clear. We are in a wonderful place. Capital is available in unprecedented amounts. But it has to be used to produce tools-not toys. This decision, ultimately, is a political one. Perhaps the anger we see today will lead to recreating a consensus that recognizes the needs of both growth and fairness-investment and consumption-in the future. Time will tell.