AIMS Commentary

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Who's Irrationally Exuberant Now:

Debt-shy consumers or pump-priming politicians?

Harry Koza – Fellow in Financial Markets
Atlantic Institute for Market Studies

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Today, January 26th, is Chinese New Year - the day before the federal budget – heralding the Year of the Ox, or Yi Chou. Last year was the aptly named Year of the Rat, or Wu Zi. There were plenty of rats scurrying for cover when the lights came on in the market in 2008 and everybody suddenly discovered that maybe all that leverage wasn't such a great idea after all, and indeed, most investors were certainly woozy by the end of the year. The Ox, in Chinese astrology, is the symbol of fortitude and hard work, which will be necessary attributes for getting through what promises to be another tough year in the markets.

On the other hand, the Year of the Ox has barely gotten out of the barn and already there's been plenty of bovine thinking out there.

First, there are all those optimists on the StockPorn Channel, saying that now is a good time to buy stocks/mutual funds/bonds/whatever because the Government is going to ride to the rescue and spend us all back to prosperity. Sure, like that'll happen. Oh, I don't mean the spending part – we'll get that in spades. It's the prosperity part that seems a little irrationally exuberant (as Mr. Greenspan might say).

A few weeks back, I saw Pimco's Bill Gross (The King of Bonds) being interviewed on BNN-TV. I don't mean to accuse the erudite Mr. Gross of bovine thinking, but something he said threw me for a loop. Aside from his voice sounding alarmingly like that of Michael Jackson – which made me fervently hope that Mr. Gross never records a cover version of "Billie Jean" – the thing that struck me was his comment that the US government and the US banking system now have a relationship that is like a "club partnership." I'm not sure what that is, probably some kind of golf term, but I think the new relationship between the US government and the US banking system – and those of Euro-zone governments and their banking systems – would be better described as thralldom.

The trouble is, it's awfully hard to tell which side of that relationship is the thrall, and which is the master. Does the government now own Citi and Goldman, or do Goldman and Citi now own the government? Time will tell.

That's not an entirely facetious question. So far in the Great Unwind of the credit bubble, governments have pumped trillions into the global banking system, to the point where now most developed countries – except Canada, and don't rule us out if Jack Layton ever becomes Prime Minister – have, either effectively or outright, nationalized their entire banking systems. Even the US government now owns over 20 per cent (and rising) of all American bank capital, not to mention now being the largest mortgage lender and biggest insurer in the U.S.

This is widely viewed as a good thing, since all those entities were too big to fail. Why, forcing overleveraged banks and dealers to eat their losses, to write them down and absorb them, or go bankrupt and have their remains scavenged by the hyenas of Schumpeter's creative destruction, could bring the entire creaking edifice of the global financial system crashing down.

OK then, Ben and Hank and the Plunge Protection team to the rescue. I've lost track of the acronym soup of their various plans (TARP, TSLF, etc), but the US government, between the Fed, FDIC, the Treasury, and some of its other minions, has made financial commitments to the tune of well over US$8 trillion. Meanwhile, in Europe, it's been much the same thing, with governments firing up the printing presses and plowing cash into the financial system.

How's that all working so far, you might well ask? Well, the good news is, the system hasn't collapsed yet. The bad news is, the whole thing is a complete shuck. The Great Unwind hasn't been an unwind at all: it's been a giant transfer of all that bad credit, all that dodgy paper, all those sweaty assets and all that excess risk from the private sector to the public sector, from the books of the banks to the backs of the taxpayers.

Instead of banks and investment dealers having to either eat their losses or go out of business, governments are obligingly eating their losses for them and will, over time, pass them on to the taxpayers through the pernicious stealth taxes of inflation and currency debasement. It was ever thus.

Failure to act, after all, could lead to a credit deflation. Central banks the world over are so afraid of deflation that they are throwing everything including the kitchen sink into their bold efforts to create enough inflation to stave off the D-monster – to the tune of over eight trillion dollars and counting in the U.S. alone, and that's even before President Obama starts creating his promised three million jobs.

Yet, while central banks, treasury secretaries and even Canadian finance ministers are in a tizzy over deflation, they are simultaneously exhorting the public to get out there and spend and borrow, and haranguing the banks to lend more. This strikes me as completely insane. The solution to a debt problem isn't taking on more debt.

Even worse, while governments and their minions are busily panicking about the threat of a global credit deflation, they insist that you don't even think about it. It's not allowed. No, you are expected to do your part by continuing to borrow and spend. Don't worry, be happy, and why don't you go down to the mall, where they're having a big half-price sale on Soylent Green? Jeez Louise, politicians are starting to sound like they come from Orwell City. Debt is wealth. Saving is bad. Consumers have no savings and debt up to their ears, but their political masters want them to go out and dig themselves in even deeper. The solution to the debt bubble is more debt. Yeah, borrowing and spending our way to prosperity – that'll work.

Suddenly, in a move so bizarre it's as if mullets and painter pants and platform shoes were suddenly en vogue again, Keynesianism is back. Stimulus, goes the cry, that's the ticket. We need fiscal stimulus, and plenty of it. Every politician in the country has added the phrase "shovel ready" to their vocabulary, and overused it to the point where whenever I hear it, I want to take a shovel upside a few heads. (Usually, when I feel that sort of urge, I put on my goalie mask and go out to the driveway and rev up my chainsaw, which, while it does scare the hell out of my neighbours, does help me feel much calmer).

Anyway, so politicians are vying to come up with bigger and better stimulus packages, and the newspapers are filling whatever space is left after their exhaustive coverage of the Obama inauguration with suggestions from everyone and his dog about what form the stimulus package should take and how big it should be, all too many of them containing the phrase "shovel ready."

I've written in the past about how one of the reasons we are in this financial mess in the first place is because we've been pumping stimulus into our economies for years now, to the point where they are more stimulated than a grade three class on Ritalin. Oddly enough, no one is actually questioning whether we in fact need fiscal stimulus, or whether it is an appropriate response to the current malaise. No, the notion of fiscal stimulus was wholeheartedly accepted both by governments and the rentiers that look to make out like bandits once it starts. The only question for the political and chattering classes is how big they can make it.

Here in Canada we also have the odd case of the opposition parties simultaneously castigating the Harper government both for allowing the nation's books to fall into deficit and for not running a big enough deficit. Talk about having your political cake and eating it too.

Damned if it does and damned if it doesn't, the Harper government will likely deliver a budget stuffed to the gunwales with fiscal stimulus.

There are two main kinds of stimulus, of course: tax cuts and spending on such things as infrastructure. Infrastructure is a good thing, after all, and we've been neglecting it for years, so naturally it's at the top of everyone's wish-list.

Of course, past infrastructure plans, such as that memorable $6 billion Chretien-era program, have included such essential infrastructure "investments" as putting a roof over every bocce court in the Greater Toronto area, so don't be too eager to see them come up with a new plan to spend two or three per cent of GDP on similar schemes. Most infrastructure, things like sewer and water pipes, are boring and don't provide many ribbon-cutting photo ops for politicians, so if past performance is any guide, expect to see lots of social spending and outright pork barreling labeled as infrastructure.

The empirical evidence, meanwhile, strongly suggests that permanent tax cuts would be the most efficacious form of stimulus. A dollar of tax cuts, according to recent studies, can generate three dollars of GDP, while a dollar of fiscal spending at best generates one dollar of GDP, and often less[1].

Any guesses as to which kind of stimulus we are most likely to get?

There are already plenty of shovel-ready opinion pieces clogging up the nation's op-ed pages, detailing why tax cuts are bad stimulus. If you cut taxes, they say, people might act rationally and save their extra after-tax income for a rainy day, or pay down their debts, instead of spending it. Better that government, in its infinite wisdom, spends it on our behalf. It really raises my spleen when I hear that one.

If I have more money left after paying my taxes, and I put it into a savings account in my bank, it is not dead money. Far from it. It is then available for the bank to lend to my neighbour in a mortgage, or to a local business to expand its operations, thereby creating jobs, or to a student to help her pursue higher education. And for every dollar I save, my bank can lend 10 dollars or more. Or I can invest that money in the market, to provide for myself in my old age.

But that would be bad, apparently. How stupid is that? Ohmigosh, consumers are starting to spend less and save their money and pay off their debts, and generally just waking up and smelling the coffee and starting to do prudent things, things like saving for a rainy day and deferring the purchase of that Cineplex-sized plasma screen until they can afford it and cutting up their 10 credit cards and paying down their debts. That's only rational economic behaviour when you're up to your ears in debt, have no savings and, with the economy in a deepening recession, might even lose your job.

[1] According to Christina D. Romer and David H. Romer, then economists at the University of California, Berkeley, a dollar of tax cuts raises G.D.P. by about $3. The Romers argue that, "tax cuts have very large and persistent positive output effects." They find that permanent tax cuts have a multiplier of 3x.

How does that stack up against government "stimulus" spending? In fact in practice the multiplier for government spending is not very large. The best evidence comes from a recent study by Valerie A. Ramey, an economist at the University of California, San Diego. Based on the United States' historical record, Professor Ramey estimates that each dollar of government spending increases the G.D.P. by only 1.4 dollars. So, by doing the math, we find that when the G.D.P. expands, less than a third of the increase takes the form of private consumption and investment. Put another way, according to the Romers, the multiplier for tax cuts is more than twice what Professor Ramey finds for spending increases.

Other references:

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But no, citizens of the world, your governments don't want you to be rational. They want you to spend more, consume more and borrow more. They want you to be irrational. Encouraging irrational behaviour may seem like a very odd thing to do, but it makes perfect sense in the Orwellian world of politics. Of course they want you to be irrational. How else would they ever get your vote?

AIMS' Fellow in Financial Markets, Harry Koza, is Senior Analyst for Canadian markets at Thomsonreuters' IFR Markets. He is also a former bond market columnist for the Globe and Mail.

Atlantic Institute for Market Studies

2000 Barrington St., Ste. 1302 Cogswell Tower,
Halifax NS B3J 3K1
phone: (902) 429-1143 fax: (902) 425-1393
E-Mail: aims@aims.ca http://www.aims.ca