

Quarterly Critique

March 2009

As I write some of my collected thoughts the markets are rebounding strongly. Despite, and undoubtedly, owing to, quite widespread scepticism, the rally has powered along, almost without pause. As usual people who cling to the notion that markets are somehow efficient would have us believe that the “cause” or reason for the rally is the latest in a series of bailout plans, combined with the dubious proposals from the G20 summit.

It seems ludicrous that after an almost continuous series of bubbles in world finance that the Efficient Market Hypothesis has any adherents. Intellectual fashions are slow to change it seems, even in the face of extraordinarily unfavourable contrary evidence.

Of particular concern to me are the policies being adopted by authorities worldwide, although parts of Europe are displaying some notable restraint. It is hard to believe that the so called intelligentsia misconstrue the nature of the problem. After decades of credit growth significantly exceeding GDP growth in Anglo Saxon countries in particular, leading to inflated house prices, external deficits and so forth, the authorities seem to believe the problems are essentially a result of subprime problems impacting liquidity across a wide range of financial assets. They do not view sub prime as a *symptom* of excessive credit growth which caused enormous imbalances in the world as China basically vendor financed excessive Western consumerism. Although Alan Greenspan’s easy money legacy is somewhat tarnished, his

successors appear to have the same mind set. Fiscal measures and extraordinarily low borrowing costs are directed towards getting the banks to lend more (because we don’t have enough credit!), and trying to revive consumer spending (because we have so many unfilled needs).

So, in simple terms, most Western economies are addicted to the dangerous drug of easy credit, accompanied by low levels of saving (and low investment – the Chinese can do that) and high levels of consumption. It is breathtaking that the prescribed remedy is more drugs. It would be comical if it were not so disconcerting.

Australia has thus far been less affected by the financial crisis than most. Nevertheless, the Rudd government has seen fit to take on significant amounts of unnecessary debt to give handouts to consumers who as a group are already “maxed out” on credit. Rudd seems to think that if consumers are so obstructive as not to borrow any more, we’ll do it for them! In doing so we can also help Chinese producers of plasma televisions, and perhaps get some of the money back through gambling taxes.

We also seem intent on fostering our own little subprime bubble here. The generous first home owners grant is typical of government policy fostering unintended consequences. The grant was intended to improve housing affordability for first home buyers and to provide a boost to the ailing home building sector. Any improvement in home building conditions is hard to discern in the midst of a major building downturn,

particularly in the once booming states of Queensland and WA. In terms of affordability, the improvement has mainly come through lower interest rates. Indeed, prices have often risen in the housing segments within reach of most first home buyers, with vendors capturing the benefits of the grant rather than buyers. Given house prices are still at very inflated levels relative to incomes in Australia, it hardly seems a desirable outcome to have lower end house values increasing – temporarily, no doubt – as a result of government policy. Where the grant has helped first time buyers is in providing them with a deposit for a loan. CBA's Ralph Norris has highlighted that people with little or no savings history are now more able to get a mortgage. Hopefully they don't lose their jobs - historical evidence would point to the young new homeowner demographic being more at risk than most. Does that not sound reminiscent of subprime loans in the US? A populist government is more likely to extend the grant than pay heed to the warnings of a seasoned banker like Norris.

I have only partly explored my theme of the dangers of authorities relying upon flawed intellectual foundations (I cannot use the words "accepted wisdom"). Milton Friedman and Ben Bernanke's view of the Great Depression appears to be accepted as gospel. I am not an expert, but it seems to me that people believe the Fed failed to act after the crash, and that the US government failed to spend on big projects until the *New Deal* came along.

This view is patently false. The Fed dropped rates 2 days after the initial crash, again a couple of weeks later, and a year after the crash the rate had dropped from 6% to 1.5%. It may be fair to say, however, that the Fed could have done more to prevent bank runs of non-member banks. As to fiscal programmes, Hoover was a big exponent of public works such as the Hoover dam. When bank failures began in earnest in September 1931, Hoover created the National Credit Corporation, and when that proved inadequate, the Reconstruction Finance Corporation - the TARP equivalent of the 1930s.

Economic orthodoxy – or at least entrenched economic beliefs of policymakers and authorities – relies on modern interpretations of Keynesian theories. It is not at all clear to me why there is such widespread and unquestioning acceptance of a theory. Dr Steven Kates of RMIT writes a very interesting perspective on fiscal stimulus and deficit spending in the March 2009 issue of *Quadrant*. Titled "The Dangerous Return to Keynesian Economics", Dr Kates explores the idea of inadequate aggregate demand and the Keynesian prescription that the government should step in to make up for the deficiency. But, as he notes, "no one explains the present economic downturn... in terms of deficient aggregate demand. It would be an absurdity to suggest the problems being experienced have been caused by consumers no longer wishing to buy more than they have...". The article is well worth reading and I urge you to do so. Amongst other things, Kates suggests that Australia and the UK, which believed in balancing their fiscal budgets, emerged from the Great Depression earlier than the US which amassed a heavy debt burden for questionable or nugatory benefit.

Japan's recent experiment with huge deficit spending instills scant confidence in current actions of the authorities, with massive public spending announcements and increased indebtedness. As Peter Costello notes in *The Sydney Morning Herald*, 18 March 2009, over Japan's 'lost decade' beginning in 1990, Japan had at least 10 stimulus plans amounting in total to about 30 trillion yen, but the country suffered several recessions while the rest of the world grew, feasting on easy credit. The US government, notably Larry Summers and Tim Geithner in the Clinton administration, urged this fiscal largesse. Geithner is the current US Treasury Secretary, and his tenure has been controversial so far. Japan's stuttering economic performance is clear for all to see, as is its huge government debt.

Henry Morgenthau Jr, US treasury secretary under Roosevelt, testified as follows before the House Ways and Means Committee in May 1939: "We are spending more money than we have ever spent before and it does not work. I want to see this country prosperous. I want to see people get jobs. We have never made good on our promises. I say after eight years of this administration we have just as much unemployment as when we started and an enormous debt to boot." I believe this says it all.

In my opening salvo, I criticised some of the proposals of the G20 summit as "dubious".

There was disagreement on proposals for co-ordinated fiscal stimulus, chiefly from France. Perhaps Nicholas Sarkozy has studied economic history. One of the most troubling things to come out of the summit is the removal of mark to market accounting. Investors need greater clarity and transparency when looking at financial stocks, not less. Although this has been taken as a positive, it beggars belief that the banking lobby group has succeeded in removing this rule, a change that should actually undermine confidence in the banking system. Will we now be told of great profits, unimpeded by huge losses were assets to be valued at realisable value? Will asset market liquidity dry up further as banks become unwilling to sell assets because that would crystallise a loss that they can otherwise pretend does not exist? I remind you of a comment in my March 2008 critique deriding the hypocrisy of those who in the 1990s criticised Japan for not letting banks fail and for allowing banks not mark assets to market.

Also emerging from the G20 summit are agreements reflecting the groundswell of opinion against high executive compensation. I am not a keen supporter of government intervention, but the market has clearly failed here. Institutional shareholders have largely failed to oppose extraordinary executive packages, which have usually been "justified" to me by companies by referencing independent remuneration consultants and the need to attract talent. This is a wonderful argument as it does not mean pay levels are correct, simply that the people deciding such pay levels, and benefiting from them, are almost all in agreement that very high levels are good. The gap between executive pay and the pay of average workers is extreme by historical standards, and it should be no surprise that the mood has swung against executives. To quote my prediction in the Cannae March 2008 critique: "In the developed world, people forced out of their homes and losing their jobs will have little sympathy for investment bankers who have been rescued by the Fed having received jaw dropping bonuses during the good times. It would not surprise me to see the yawning gap in executive compensation which has developed begin to narrow again".

**Hugh Giddy,
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