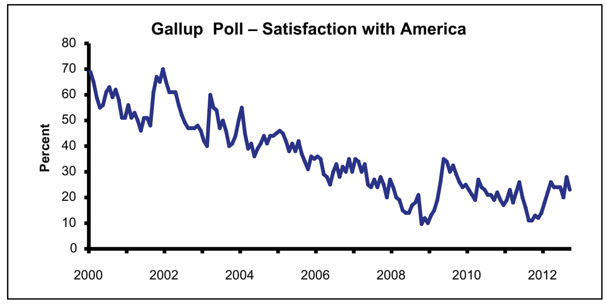
THE LINNEMAN LETTER

This is an excerpt from the Fall 2012 issue of *The Linneman Letter*.

Volume 12 Issue 3

Flawed Theories And No Leadership

By Dr. Peter Linneman, PhD
Chief Economist, NAI Global
Principal, Linneman Associates



Rationalizing with flawed interpretation of Keynesian economic theory, the Obama administration implemented unprecedented spending in the hope that it would stimulate a robust recovery. At the same time, the Fed introduced near zero interest rates and massive quantitative easing of the money supply in an effort to stimulate the economy. The evidence now overwhelmingly demonstrates that these efforts reduced, rather than spurred growth, as actual growth has been far short of that predicted by the models used by spending proponents. In fact, countries that tried greater stimulus have had weaker recoveries due to wasteful spending. These efforts failed (for the most part) not because they were mal-intended (though politically driven) but rather because they were based on seriously flawed macroeconomic models. These models (think back to your macro textbooks) blindly assume that government spends as efficiently as the private sector, and that it does not matter how government spends (it is all just "G"). They further assume that the rules of the economic system are stable and well understood by decision makers, and that risk takers are rewarded, not punished. Yet it is absurd to think that $1 trillion spent invading Canada could generate the same growth as $1 trillion spent on a weenie roast for Ms. Pelosi's constituents, as could $1 trillion spent curing cancer. None of these critical (and unstated) assumptions are true, rendering these models irrelevant.

We are often asked why President Obama did not embrace some variation of the Simpson-Bowles plan for reducing the deficit. Simple: President Obama is a true believer that government spending generates growth and that redistribution does not reduce growth. He believes that economic growth and risk taking "just occur," so that redistribution efforts have little, if any, impact on growth. This view is contrary to empirical evidence, including research generated by members of his economic staff. The failure of this "growth-just-happens" view of the world is amply demonstrated by the dismal economic recovery we have experienced during the Obama administration. The simple economic truth is that risk must be rewarded and the rules of the game must be known if robust growth is to occur. Until the Obama administration grasps these facts, they will continue

Table of Contents

to pursue more government spending as the path to growth. Thus, until they are replaced or have an (unlikely) epiphany, growth will remain stunted.

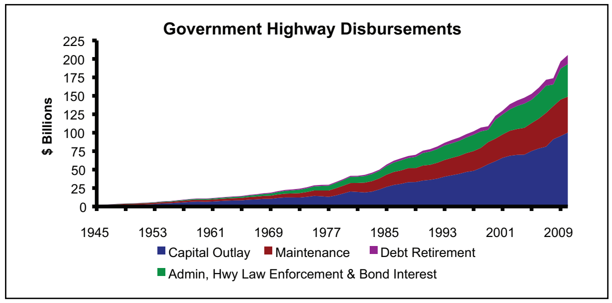
Imagine a great business with a huge franchise and many highly profitable brands that has had poor leadership for 13 years. The company could generate substantial profits due to its enormous brand values, even as it struggles under successive ineffectual CEOs. If a CEO could not revive this company after more than three years, a modern board would be showing that CEO the door, particularly if things had substantially worsened during his watch. In short, the board would be searching for a new CEO capable of re-energizing the brands, much as what occurred at Disney when Michael Eisner was replaced by Bob Iger. This is the situation of the U.S. today. We have an enormous economic franchise with great assets, but have had ineffectual leadership since the last two years of the Clinton administration (when the Lewinsky affair crippled the government). Sadly, the hope that President Obama would be a unifying leader has proven empty, as he has neither led nor unified. In fact, the nation is more fractured than ever due to his failed leadership.

Less, not more, government spending and intervention are needed in order to stimulate the economy. Certainty about “the rules of the game” fosters growth, as does rewarding risk – not some abstract concept of “government spending” by an Omniscient and Omnipotent Deity. The Obama administration is not omnipotent and can no longer blame the Bush administration (which was also an economic disaster) for today’s mess. No better examples exist than these: that for the third time in three years, we still do not know what our taxes will be; and that risk takers are being pilloried as thieves.

Twenty-seven years of democracy (not Democrats) have gutted the massive overhaul of the tax system undertaken by the Reagan administration in 1985, with lobbyists subsequently rifling the code with loopholes. It is high time for a major tax reform to eliminate the mounds of loopholes created by special interests over the past 27 years.

As another example, ObamaCare was a wasted political effort, in which the President created a com-plex, unpopular and expensive (equally flawed) health care system, rather than employing his political capital on more important matters. This stands in stark contrast to the leadership of Lyndon Johnson on the Civil Rights Act, or Reagan’s tax reform, or Clinton’s welfare reform. These were political efforts that required leadership on important matters of the day and fundamentally changed society.

Proof that public spending is popular on both sides of Congressional aisles was recently provided by the $120 billion appropriation bill for highway spending. This bill achieved bipartisan support of 74-19 in



Government Spending and Economic Recovery

Country	Real GDP (2011, $ millions)	Govt. Spending as % of GDP (Avg. 2008-11)	Total Real GDP Growth (2008-11)
United States	$15,255,222	41.5%	1.1%
Japan	$4,512,228	40.6%	-2.1%
Germany	$3,257,687	46.5%	1.8%
United Kingdom	$2,371,347	49.6%	-1.5%
France	$2,247,715	55.8%	0.1%
Italy	$1,894,942	50.2%	-3.4%
Korea	$1,579,295	30.9%	10.5%
Spain	$1,433,613	44.2%	-3.7%
Canada	$1,418,722	42.9%	2.8%
Australia	$958,235	35.5%	6.3%
Poland	$795,788	44.2%	10.1%
Netherlands	$713,764	49.8%	-1.1%
Belgium	$420,067	52.4%	1.4%
Sweden	$381,645	52.6%	4.8%
Switzerland	$359,565	33.7%	3.2%
Austria	$350,487	51.4%	0.8%
Greece	$293,742	51.2%	-13.1%
Czech Republic	$291,157	43.4%	-0.5%
Norway	$268,003	44.2%	0.4%
Portugal	$261,047	48.7%	-3.2%
GDP Growth-to-Government Spending Correlation			-0.49

Source: OECD, Linneman Associates

Pre-Recession vs. Today

	Real GDP Index*		Industrial Production Index		Unemployment Rate	
	2007	2012	2005	2012	2005	2012
Brazil	100	145	100	107	9.5	6.5
China	100	207	100	247	4.2	4.1
France	100	99	100	92	9.1	10.0
Germany	100	103	100	115	11.7	6.8
India	100	144	100	162	8.4	3.8
Italy	100	93	100	82	7.8	10.8
Japan	100	100	100	92	4.3	4.3
Spain	100	96	100	75	9.3	24.6
U.K.	100	97	100	84	4.8	8.0
U.S.	100	103	100	106	5.0	8.3

Source: Trading Economics, OECD, Linneman Associates

** Real GDP index based on 2005 purchasing power parity in USD.*

2012 GDP levels calculated from 2011YE actual and estimated 2012 growth.

the Senate and 373-52 in the House, because there were enough local goodies to buy off almost everyone in the run-up to the election. And how will we pay for these goodies? Following the lead of ObamaCare, it is done by the magic of funding 27 months of spending with 10 years of future highway tax revenues and "yet to be named spending cuts." Didn't the guys from Enron go to prison for this kind of accounting?

Despite what President Obama believes, empirical evidence indicates that less government spending leads to greater economic growth. According to data collected by the Organisation for Economic Co-Operation and Development (OECD), a very clear inverse relationship exists between government spending levels and the rate of economic recovery since 2008. In fact, for the largest 20 economies that the OECD tracks, the correlation factor between economic growth and government spending as a percentage of GDP is an astounding -0.49. That is, for every 100 bps that the government spending-to-GDP ratio increases, economic growth decreases by 49 basis points. Further, the quickest recoveries have occurred in South Korea, Poland, and Australia, where government spending comprises 30.9%, 44.2%, and 35.5% of GDP, respectively. The countries left behind in the recovery have been Greece, Spain, and Italy, where government spending comprises 51.2%, 44.2%, and 50.2% of GDP, respectively.

We further examined a select set of countries to determine how each is faring in the economic recovery. We specifically looked at GDP, industrial production levels, and unemployment rates for each country before the recession and today. For real GDP, we set the 2007 values for each country to an index level of 100. Of the developed nations, only Germany, Japan, and the U.S. are expected to surpass their previous GDP peaks by year-end 2012. In contrast, it will take significantly more time for France, Italy, Spain, and the U.K. to achieve their respective previous GDP peaks. Developing nations, including Brazil, China, and India have had consistently positive growth during the global recession, but at declining rates.

Industrial production tells a similar story. We compared industrial production levels in mid-2005 to mid-2012. The U.S. has already surpassed the pre-recession level, as has Germany. But in June 2012, Spain's industrial production was only 75% of what it was in 2005, while Japan and France (both 92%) also lagged. Production in China and India has grown at impressive rates over the last decade (though India has shown some slowing in 2012), while Brazil's industrial production growth has been on par with the U.S. over the past seven years.

While it is difficult to make comparisons between unemployment rates across countries due to varying definitions, it is clear that labor markets in all of the developed nations in our sample (except

Germany) are extremely weak. U.S. unemployment is still more than 300 bps above where it was in 2005, despite a 170-bp improvement from the peak. Spain's unemployment rate skyrocketed from 9.3% in mid-2005 to 24.6% in June of 2012. In contrast, Germany's unemployment rate dropped from 11.7% to 6.9% during the same period, as it refused to undertake "stimulus spending".

True leadership is getting people to focus on what they can do rather than on what they will not do. This is where Presidents Reagan and Clinton (during his first six years) excelled, as do many business executives. It turns out that Barack Obama in 2008 was our "mirror": we each saw what we wanted to see rather than what was really there. The fact is that President Obama is a promoter, not a leader. He was not a leader in 2008, nor has he grown into one.

Should Obama become a two-term President (in light of Romney's recent political blunders), is there any hope for a stronger economic recovery? Perhaps. The Baby Boom flooded into the recessionary economy of the early 1980s, spurring growth with their youth, creativity, and energy. They overcame the disarray of Nixon, Ford, and Carter, ultimately generating massive growth. Will the Baby Echo, which is even larger than the Boom, spur a similar growth explosion, or is this generation too entitled to roll up its sleeves and power the economy forward? Only time will tell. But one thing that is clear is that absent clear ground rules and rewarding risk, growth will remain far below its potential.

Follow us on Twitter:
@P_Linneman
@NAIGlobal