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Macroeconomics — Five Simple Truths

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You all took a macroeconomics course in college, and some of you (presumably those who also enjoyed "50 Shades of Gray" and the Marquis de Sade) took more than one. You manipulated ISLM (a.k.a. Investment-Saving and Liquidity Preference-Money Supply) curves and simplistic mathematical equations, which elegantly demonstrated how the economy is a well-oiled macro entity. You were also taught that the economy's failings can be easily corrected by the beneficent and perfectly timed actions of benevolent and omnipotent government officials, who know exactly what to do, and when, while mere mortals (including the same people before they became government officials) flounder hopelessly. The amazing thing is that these courses pretend to describe the economy, yet never once mention entrepreneurship, or creating a predictable and stable environment for decision making, or allocating scarce resources from less to more productive players. And you bought it (even though you got poor grades in it). What nonsense!

Here are a few simple truths about the economy that they forgot to teach you. First, temperate risk-taking generates growth by moving resources to enterprises that create future jobs and consumption opportunities. The second truth is that without stable and transparent economic rules that allow and encourage a reasonable return to risk taking, growth will not occur, as even raw entrepreneurs will refuse to take risks. It is intuitively obvious that ever changing rules of the game create uncertainty, which discourage action, while high taxes discourage risk taking. Similarly, low interest rates do not encourage creative risk taking but rather create just more highly leveraged investments in low risk instruments. Hence the leveraged risk taking created by the Fed's low rate policies does not result in productivity. It just distorts temperate risk taking.

The notion that low interest rates stimulate growth is both intellectually and empirically flawed. The theory is that at lower rates, consumers and firms will borrow more, and by doing so will stimulate "aggregate demand," which in turn stimulates the economy. Perhaps you still remember scratching your head the first time that you heard this in a macroeconomics class, thinking, "This makes no sense; if this is true, then why not just have the Fed set rates to zero and have the economy really boom?" By extension, if low prices stimulate "aggregate demand" and spur economic growth, why not have the

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government also lower the prices of oil, medical services, houses, cars, and food to zero? Surely, such price declines would stimulate "aggregate demand," just as the Fed says lowering interest rates would spur "aggregate demand."

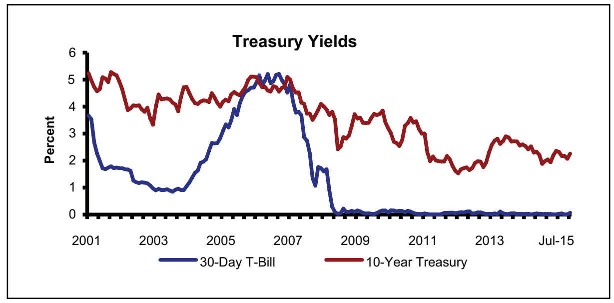
You were probably told by your professor, "Don't be silly. Of course, if the rates were set to zero you would get little growth because no one would provide the money needed to fund growth!" At that point, you thought, "Well, now I am really confused, because they say I am right in the extreme but cannot explain why I am wrong in the small. Plus, why is encouraging people to borrow more a good thing for the economy, especially if the problem was that people already borrowed more than they can repay?"

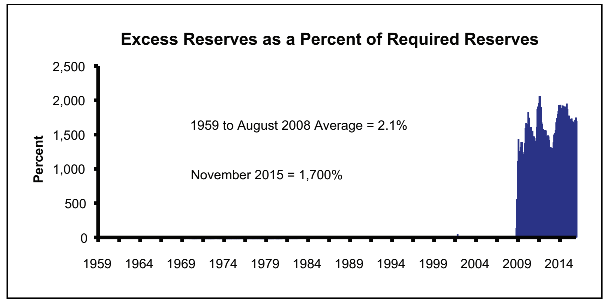
It was at that very moment you grasped the fundamental hollowness of macroeconomic analysis: it fails to recognize that it takes two to tango. Think about what would happen if prices were set near zero by the government. At first, consumers would say, "yippee," but they would quickly discover that the production of these items would grind to a halt, causing millions to lose their jobs. That is, artificially low prices crush growth. And interest rates are simply the price of money. So it is no surprise that growth is low in the presence of artificially low rates. Thus, a third truth is that artificially low interest rates hurt growth just as surely as artificially low prices for corn, oil, medical services, cars or real estate would harm those segments as well.

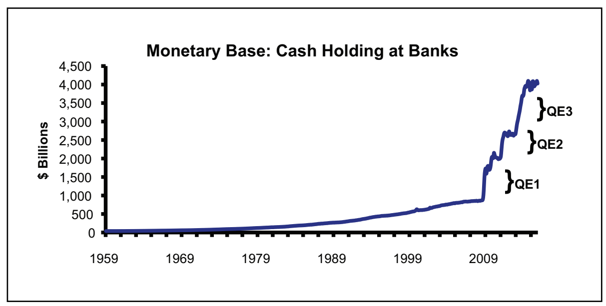
This is a basic failing of Keynesian analysis, which says that government spending stimulates the economy by supposedly stimulating "aggregate demand." After all, if the government is spending more, won't the private sector spend less, as the government's profligacy will need to be repaid? Yes, low rates create an increased incentive to borrow, but it also creates a reduced incentive to lend. Yes, there is more demand from a wildly spending government, but there is less spent by the more productive private sector. And in the end you have less growth as money flows from higher productivity users in the private sector, to lower productivity government spending. Plus, the distortions and uncertainty further reduce growth.

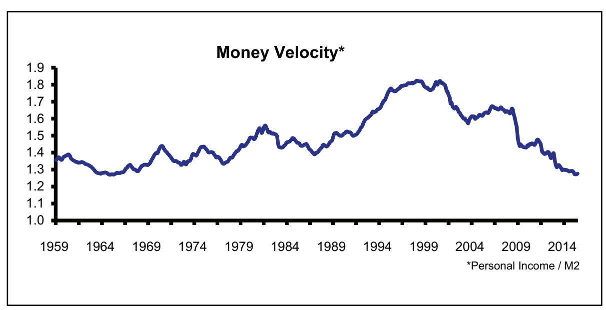
The simple truth is that there is no such thing as "aggregate demand" to stimulate. There are simply millions of micro markets for millions of items. And to thrive, each of these markets requires a price which relatively efficiently matches supply and demand. If the price is too high, suppliers are frustrated by the lack of demand, and if prices are too low, consumers are frustrated by the lack of supply. The economy's growth is simply the sum of these millions of markets. The economy is like a complicated eco-structure, with millions of tiny organisms, and disturbing this eco-structure, even in a small way, can damage the whole.

A further basic truth about economic growth is that if the Fed gives lots of money to lenders, but promises (à la non-transparent "stress









tests") that they will decapitate lenders if they lose money, banks will not lend. Instead, as we have seen, they will simply pile up that money at the Fed.

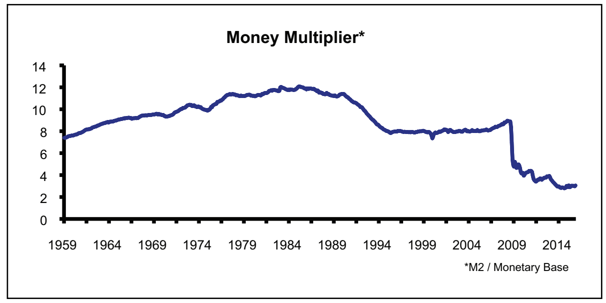
The final, and perhaps most basic truth of economic growth is that it occurs when labor and capital move from low productivity, to high productivity users. Decide for yourself whether moving about 45% of GDP over the past 7 years from the private sector to the government resulted in more productive use of those funds. Our vote is no.

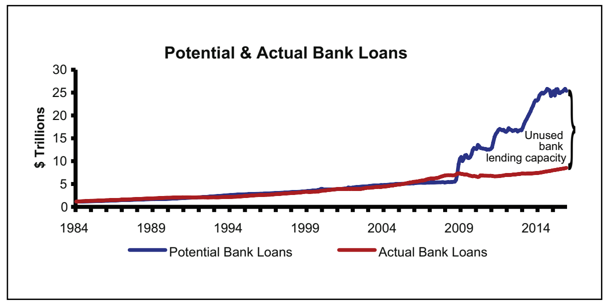
Over the past 5 years, the government sector has been allocated \$4.7 trillion (62%) of the \$7.6 trillion increase in credit. If the government is just 100 bps less productive in its use of this capital than the private sector, this allocation has created a negative productivity arbitrage of \$470 billion. This is 2.8% of GDP. If this negative productivity arbitrage is spread out over 5 years, it amounts to a loss of 56 bps of GDP annually. Perhaps not coincidentally, this is about the amount by which GDP growth has been below its long-term growth rate.

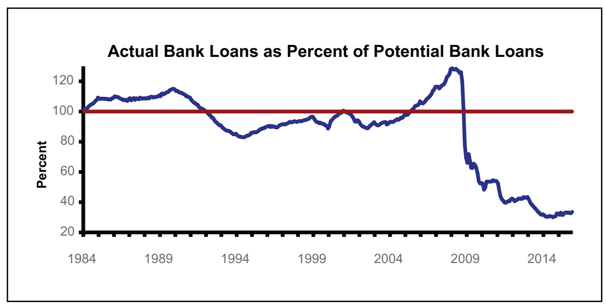
That you have never heard these blindingly obvious truths about economics is both amazing and disgraceful. And it may (or may not) explain why you did so badly in macroeconomics, as deep down, you knew it made no more sense than a class that taught the earth is flat (that's how old we are)!

During the Great Depression, equally omnipotent political decision makers decided that the Depression occurred because "prices were too low." If only prices could be forced upwards by government policies, growth would occur as higher prices would create greater profits and more hiring. So they imposed cartels on the economy which quickly pushed up prices. But the economy shrank, because faced with these artificially high prices, consumers reduced their consumption, which reduced employment. And the Depression ground on, deepened by these ill-conceived policies. The lesson is that markets, while imperfect, generate better growth because they better — not perfectly — allocate resources to higher productivity uses than do artificially high or low prices.

What economists call the velocity of money is at a historic low in the U.S. It is the rate at which money moves from one transaction to another in a given period of time, and is measured as a ratio of GDP (or personal income) to the money supply. The problem is that today's low velocity moves people into cash — an extraordinarily low-productivity use of capital — and out of entrepreneurial risk taking. As such, it is negative productivity arbitrage that reduces growth. Simply stated, in spite of the massive unprecedented liquidity injection into the banking system by the Fed, money is turning over at record low rates. It is this low velocity of money that has "magically" kept consumer price inflation low. This is partially due to regulatory changes, most notably Dodd-Frank and the Fed's "black box" stress tests, which keep these liquidity injections at the Fed,







rather than in the pockets of consumers and businesses. But it is also attributable to sustained low interest rates increasing the demand for money holdings. That is, as interest rates fall, the opportunity cost of holding money falls, and the demand to hold money increases. This phenomenon was once described by our friend Sam Zell as the absence of an urgency to act in the face of little opportunity cost.

Empirical estimates of the elasticity of the demand for money range from -0.4 to -1. This means that a 50% decline in interest rates triggers a 20-50% increase in the demand for money, and a commensurate decline in the velocity of money (as the velocity of money is the exact inverse of the demand to hold money). Thus as the Fed forced down the 10-year Treasury yield from 5% in 2007 to 2% today, these empirical estimates of the demand for money suggest a 25-60% decline in the velocity of money, which is consistent with the 25% drop over this time. That is, the decline in the velocity of money basically behaved "as expected." This means that the Fed's extreme interest rate manipulation, in the misguided attempt to stimulate the economy, largely offset their equally misguided attempts to stimulate the economy via massive liquidity injections. Instead, these interventions only generated massive wealth and income redistributions (the job of Congress, not the Fed) from savers (and industries like housing which benefit from savers) to borrowers (especially money center banks). In short, capital market distortions redirected money from the private sector to a far less productive government sector, resulting in massive uncertainty that has reduced economic growth.

Because of the depressed velocity of money, CPI inflation has remained largely benign. Thus, it is not surprising that when QE ended, nothing happened to economic growth. And when rates rise, it will also do nothing to change CPI inflation. But, these policies have raised prices of Fed-favored assets and reduced the prices of disfavored assets. Yet the Fed (and its counterparts around the globe) continues to find reasons (supposedly rooted in "economic growth") to maintain excessive interventions, even as a cold hard look at the facts fails to show any impact on growth from their policies. The real basis for their policies is rooted in the demand for continued handouts, particularly by the world's largest debtor — the U.S. government — and a failure to believe in markets. Much like a dictator, who does not believe in freedom of expression, can always find reason to continue martial law; so too a Fed comprised of members, who fundamentally do not believe in markets, can find reason to continue economic martial law. And just as extended martial law invariably cripples civil liberty, extended economic martial law undermines the growth dynamics of the U.S. economy.