Inevitable changes and reversion to long term trends

Technological changes do happen, turning past production functions obsolete. Sometimes there is a certain gradualism that enables economic agents and institutions to adjust; sometimes, time is too short for it. The present economic and financial circumstances seem to be of the second case; the first one would be better depicted by the early weakening influence it had on the Ottoman Empire the discovery of America and alternative sea trade routes to the East that made it an owner of an asset – a virtual logistic monopoly in east west trade - no longer unique: a written and hopeless destiny to become a reality sooner or later.

Shocks do happen and will always do. The real difference lies in the answers to it. Noticeably, changing development paradigms on every shock has never been profitable in the long term. A realistic paradigm that should continue being in place is one of free market policies, strong institutions with checks and balances and defensive capabilities to protect them. What this one has achieved for the world during the last decades, in terms of globalized growth, has not been seen before. Let us not forget this. These new vigorous structural world growth conditions will persist after these disturbances, and they constitute by themselves into the biggest positive shock we have had in the recent past. Moreover, a lower cost of capital seems to be part of these conditions, a resulting net supply side effect of huge technological improvements that have made possible, until now and on a continuous basis, to have more productive capital units for substantially smaller costs than before. The trick, however, is that a neutral monetary policy viewed under historic interest rate parameters would no longer be so, and indeed would be biased on the restraining side.

However, having such a real development machine does not preclude the existence of shocks, some of them directly associated with the transition to this new set of conditions being gradually internalized by people, firms, countries and institutions. In this sense, what may have been erroneous, with hindsight, was the perception of risk and the concomitant expected return associated to it, under this new scenario. A price adjustment is perhaps required, but once it is done and is consistent with this new structural equilibrium of globalized growth and lower long term interest rates, there is no reason not to re-initiate this faster world development path.

Manias, panics, a US Treasury Secretary vividly recalling 1929 similarities and their like are obviously unwelcome guests into this picture. An unjustified – but nonetheless, real - post September credit crunch is certainly affecting activity in the short term and causing big wealth redistributions among market participants, but it should subside as monetary policies successfully return liquidity to the system and rationality finally prevails.

Contrary to a commonly accepted view, monetary policies were not as expansive as they appeared to be, at least in the US. Indeed, their more restrictive true nature might have detonated a decelerating economic activity at the end of 2007 and in 2008 that got mixed up with an overblown view of massive real estate bubbles – from peak prices in 2006, real estate values have fallen 23% in the US, half that of shares, for example - and overexposed banks – mortgage delinquency rates close to 7% are just 2% over historic levels -. Not an ideal picture, but wrong bets and overleveraged financial institutions, now undercapitalized, are more to blame for getting us all into this surreal financial environment and, worst of all, for being the dragging partners central banks have had in order to inject money into the system to get out of it.

Crucially, once there is a shock and consequent price adjustments, the institutional reactions matter most. In this sense, monetary authorities come first. As for the US Federal Reserve, its unorthodox effort to increase general liquidity by directly buying commercial paper and credit notes - bypassing almost petrified financial intermediaries -, is clearly on the right track. Monetary aggregates such as M1 started to consistently grow over 7% annually after this last September, possibly one year later than required, but at the end of the day, the monetary machine is working again – for more than three years M1 was pegged at annual growth rates below 2% -. Similarly, EU monetary authorities have also been dealing with the same phenomenon, and their M1 aggregates are coming back at rates of growth over 3.5%, which are lower than needed, but gaining strength – they were close to zero by last August -. The rest are

following on the same steps. In other words, monetary aggregates are coming back to life, but their revitalizing effects in real activity are to be perceived from the second half of 2009, if they keep moving upward consistently. What is important to note here is that monetary policies, at least in the US and EU, might have been wrongly interpreted as expansive, just by looking at interest rate policy objectives and overlooking the resulting monetary aggregates, which showed much less responsiveness to supposedly loose central bank policies. It might have then happened that the whole interest rate structure turned out to be less expansive under this new scenario where an effective lower cost of capital, due to technology breakthroughs, did come into life. Time will tell.

Institutional reactions on a secondary fiscal policy level have been decisively poor. Unless these policies improve efficiency conditions in the growth machine, permanently lowering taxes and corresponding central government expenses that the private sector could do better, they are mainly income redistributions among interest and paying groups. No significant aggregate activity effect should be expected out of these expenditure packages with no efficiency conditions attached - David Ricardo redeemed, especially when considering the whole world, a closed economy in itself -. In some sense, the world will be much more benefited from other policies such as the recent European Commission intervention in the now defunct merger proposition between giant miners BHP and Rio Tinto, just on the verge of capturing over 1/3 of world seaborne iron ore market and that along the Brazilian mining company Vale would have reached 75% of it, a menacing prospect in commodity markets. Cartels of the world, beware. The message is quite clear.

And where is our modern battle of Lepanto, that effective and highly symbolic defeat of the Ottoman navy at the hands of the Holy League that checked its advance? That is certainly in the rescued financial market, where autarchic behemoths such as Citigroup and JP Morgan are already fated to be carved up. Time has arrived for flexible, highly specialized and non autarchic firms with a technological edge - following the steps of Google and Amazon -, each one independently offering some financial services where manifest comparative advantages exist at a fraction of the cost of these old entities, and quite interestingly, with less inherent systemic risk apparently associated to the “too big to fail” nature of these financial firms. Uncompetitive practices and old protectionist barriers might last for some time, but after these turbulent days, there is no longer a financial Utopia. They are doomed.

Regrettably, the spirit of the Sultan cannot rest now. His proud Manhattan galleys are not fit for the high seas of our own new world.

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