The Great Scare

Some time from now this period will be known in the US as the Great Scare. It will be recognized as a frightening one where an unjustified panic temporarily shut down the economy, specially the financial world, ending with real loses in jobs and wealth creation and giving birth to a huge wealth redistribution from those that had to sell to those that timely invested before the mirage was over. Most possibly, the one actor that will be appreciated is the Federal Reserve with its decisive expansive monetary policy after the credit flow started to freeze. The villains will be over leveraged financial institutions whose bets went wrong and politicians cum economists that almost begged for the arrival of the 1929 Depression, as if it were a case study or a medium to reach power.

It is now almost a consensus that the Federal Reserve with its expansive policies during this decade created the environment for a crisis. Monetary statistics show otherwise: from January 2000 to January 2008, monetary aggregates M1 and M2 increased by 2,5% and 6% respectively per year, while inflation averaged 2,9% and real GDP 2,2% per year. If anything, it was a neutral monetary policy with a downward bias until 2008, nearly covering the demand of money out of a bigger economy with a stable inflation rate. Between January 2008 and January 2009, M1 and M2 grew 15% and 10%, respectively. This growth was sparked in September 2008, but given monetary lags, will have its real impact starting the second half of this year. It is noteworthy that this excess liquidity, as activity gradually returns to normal levels, could be quickly drained so as to return to a neutral monetary policy stance. In short, looking at interest rate policy decisions, instead of looking at its results, ended up misreading the monetary scenario, qualifying it as "too expansive" when it was not.

The relative international value of the country, as reflected in a price adjusted broad US dollar index from the Federal Reserve, is again moving contrary to the consensus story. Between January 2000 and January 2008 it lost 11,5% in value. Since this last month, in the middle of this US based crisis, the index has gained in real terms 12%, being now at a value a little over the average from 1973 until now or equivalent to the January 2000 value. In other words, a "battered country" – and at times, a doomed country- has in fact revalued relative to its competing partners, when the opposite was to be expected. Wrong again.

Real estate values are also a surprising side to this story. They effectively started to grow faster in 2000. But until their peak in June 2006 – using Case Shiller Composite index for the biggest 10 and 20 US metropolitan areas -, they increased by just 9,6% annually in real terms. After falling almost 30% from that peak, by January 2009 their return for the whole period was 2,2% after inflation. In short, here we have a very "particular bubble" by 2006 and none at all by January 2009. The US is now building houses at a rate that hardly covers the needs coming out of its population natural growth. One could argue for bubbles in specific metropolitan areas, but not for the whole country. The story was incidentally quite the opposite.

Delinquency rates? Of course they are up, considering this mess, but again inconsistent with the consensus story. Mortgage Bankers Association recently informed that on the 4th Quarter of 2008 they reached 7,88%. It so happens that they average 4,9% since 1979. In other words, 92,12% of mortgages continue being serviced on time, over real estate values that have fallen from their peaks but are still higher than their 2000 values. And this is the subprime world out of which this crisis was born?

It is really sad to see where we are now and where we should be. The truth is that there was no structural basis for this crisis, and once we got into it, with the great exemption of the Federal Reserve, politicians, treasury secretaries and international financial institutions failed big. They bought a spurious story; their actions and attitudes transformed it into a real one. Reinvention of capitalism? That is scary, indeed, and more so when coming from the same ones that got lost in the first place.

2009 will be a flat year, economically speaking. In the US, activity will resume stronger in the second half and compensate for a lost first one. Employment, a lagging variable, is taking a hit: since January 2008, 5 million jobs have been destroyed, out of 146 million, or 3,4%. Certainly not a rosy figure, but surprisingly different than the 1929 beloved ones.

For the longer term, the growth in federal spending to 28,5% of GDP this year from an average of 20,7% for the last 40 years is worrisome. Consensus opinion is that this increase is needed to ignite growth. It seems to be the case that consensus believes in magic. One thing is to help cover a shortage of income to the people that needs it from the federal government; another thing is to believe that this transfer creates wealth by itself. Think of the country as an apple field that produces 100 units per year. In the past, 20 apples were retained from the federal government for its priorities; now it wants to get 30. Unless it proves that the field will produce more than 100 units because of some externality being corrected, the exercise will only transfer units from one side to the other one, while at the same time decreasing the incentives to producers. It is a redistribution exercise, not a growth exercise. Getting this federal spending impetus undone will be harder. It should be a priority for those who do not believe in magic.

For the short term, the Federal Reserve will correctly continue bypassing banks – which only provide 22% of credit in the US economy - to get liquidity into the system. Overleveraged financial institutions are doomed, and rightly so. The rest of the financial system will regain activity again, but under a much more capitalized scenario, following the rest of the economy that will not trust them that much but their own capital. No authority will overlook, at least for a while, economic debt to equity ratios, including shadowy guarantees that at the end of the day have become real liabilities. And last but not least, the next list of rich people will be quite different. Let us hope that these new ones do not really believe they did anything more than buy cheap a valuable asset; the rest will be automatically done by a silent activity returning to the system.

And the Oscar for best actor goes to … the Federal Reserve. Never to be forgotten, this has not only been about money, but mainly about attitude.

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April 3rd, 2009