A quick macro overview

Economic data is pointing towards a global recession deepening in 2009. The scale of the slowdown in economic activity, the damage done to the banking system, the losses accumulated in residential real estate and the impairment of household balance sheets call for extraordinary policy measures. A more or less global though not entirely concerted policy for dealing with the ailing banking system is already underway. It is not working as well as expected or intended. Similarly, monetary policy has become more accommodative globally in an effort to revive rapidly slowing economies. Monetary policy on its own is insufficient as it addresses the ability and not the intention to spend or invest. In a slowing economy, it is individually rational to increase saving at the expense of consumption, and to cut back on investment in capacity, even though it is collectively irrational to do so. Enter government. Governments will have to spend and invest on behalf of households and companies to stabilize economic growth. This approach addresses demand directly but is not without its risks. Developed markets now operating below full potential output, are less at risk of direct crowding out. Inflationary risks are another matter and may raise funding rates to cause de facto crowding out.

There are several ways to fund fiscal reflationary efforts. Taxation is one. Developed world taxation is already high and the scope for increases is limited. It is risky to argue that increased economic activity may result in increased tax receipts. More immediately, cutting taxes may be a necessary element in fiscal deficit spending. Raising taxes on the rich has limited use as the rich are a marginal taxpayer given globalization and the prevalence of tax arbitrage. Another way of financing fiscal deficit spending is of course borrowing through the issuance of public debt. This can create the so called crowding out of private investment. A third way, is

seignorage, which is of course inflationary and historically untenable. This may not be the case today and a range of options may be a more appropriate approach. There is another way, which is enterprise and investment, a technique established in the form of sovereign wealth funds. It is unlikely that deficits will be funded by taxation in the middle of a recession. If so, it might take the form of highly targeted taxation, or cosmetic taxation, such as an increase in marginal taxes on the rich. If anything, marginal tax rates on consumption and lower income earners is likely to be reduced on the rationale that the marginal propensity to consume out of income decreases with increasing income and wealth. This would have a negative impact on tax receipts. Financing deficit spending through the printing of money is directly inflationary but has the advantage of immediately supporting asset prices as well. The cost is in a weaker currency both internally and externally. The inflation cost can be high and depending on the prevailing inflationary conditions might not be viable. The most natural route is financing deficit spending through borrowing, preferably from future generations. This is the most likely approach most nations will take. The impact in the US for example is higher interest rates. Once again, the crowding out effect is unlikely to bite as the US economy is clearly below potential.

A word about inflation ex policy. We have seen the path of the oil price rising from 20 USD per barrel in 2001 to 147 USD per barrel in the summer of 2008 before falling below 50 USD again. Similar patterns are seen in coal, metals, ags, softs, energy. Markets overshoot on both the upside and downside. The equilibrium price ex speculators, that it paid for by people who would like to burn the oil is probably in the 70 – 80 USD range. At these prices, inflation does not decline as much as policy makers would hope. Alternative sources of energy are not commercial once development costs are included. US CPI inflation would probably settle at around 4% while PPI inflation might be slightly higher from 4 – 6%. These levels

are not overly concerning but they are not low by any means. (As an aside, if inflation does increase, the need for pensions and endowments to meet their obligations will likely bring them back into the market for risky assets). All this assumes of course that in the course of fiscal reflation, banking bailouts and other extraordinary measures, governments do not debase their currencies.

If currencies are debased, such as in banking bailouts or where fiscal deficits are funded by printing money, for example, inflation pressures will be exacerbated. The likely candidates where this scenario is likely can be found by an examination of public finances. This is a different analysis from looking at sovereign balance sheets. Developed countries with budget deficits will likely be in this group. They will likely face weakening currencies and inflationary pressures. This could lead to a vicious cycle of rising commodity prices and rising inflation. Currently this is a contrarian view. A little inflation, however, is a good thing. Deflationary recessions maintain and inflate the real value of debt.

Monetary policy across the globe is currently extremely loose, and, given the expected depth of the slowdown, interest rates are likely to be driven further down to zero. This is likely to result in steep yield curves as public debt issuance is increased and inflation expectations are revived. Generally, the market expects little to no inflation and there are even expectations for deflation risk. It is likely that there will be volatility at the long end of the curve. The likely evolution is an early 1980’s yield curve as the expectations oscillate between inflation and recession.

Apart from developed countries where economic dogma eschews the direct allocation of credit by a central planner, developing countries do have the option to lend directly where their banking system may be paralysed. In particular, in Communist countries operating market economies, the banking system can be directed to lend. Without the burden of economic

dogma, certain countries have full freedom to deploy a host of economic tools to revive their economies. They can spend on behalf of consumers, they can put cash in the hands of consumers, they can invest in place of companies, they can print money to finance fiscal deficits, they can borrow to create a normalized yield curve and provide the banking system with a carry trade, they can tax selectively and tactically to synthesize inflation, if it was called for, they can invest in infrastructure, in improving the capital stock, in improving the knowledge base, in human capital. These measures may terrify the free marketer, but ever since the slew of blanket bail outs and ad hoc rescues in the West, criticism is unlikely to arise from those quarters.

A global recession seems unavoidable given the scale of leverage and excess as the global economy drifted into 2007. However, there exist the tools to soften the blow. Most of these tools run counter to the prescriptions of free market economics. The challenge will be the restoration of order and a proper market mechanism once conditions normalize. One of the failings of the system that was at least in part, and possibly in large part responsible for the excesses of the past few years has been the moral hazard created by the US Fed in particular in underwriting the economy and asset markets. More generally, one can extend the critique to the existence of an institution that unilaterally determines the price of money, the central bank, undermining the concept of an efficient money market. Unfortunately, the rescues that are mounted today move us further from a free market and therefore entrench the regulators where in fact the regulators should have their powers diminished. This is likely to create new and greater imbalances and thus sustained uncertainty and volatility in the future. In certain cultures, however, there is the concept that uncertainty is the mother of opportunity.