Unprecedented Global Government Intervention

In his latest white paper, "Unprecedented Global Government Intervention," NAI Global Chief Economist, Dr. Peter Linneman, discusses the dangers and pitfalls of an unprecedented wave of global government intervention taking place in capital markets. Citing historical examples, he demonstrates intervention only prolongs periods of stagnation and uncertainty. "In all, government activity is now deterring the very investment it was hoping to spur."

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As we enter the third quarter of 2012, we are seeing the pattern of unprecedented government intervention continue. Governments around the world are using the powerful tools at their disposal – spending, regulations, fiscal policy, and taxes – to interfere with the free market in hope of sparking economic recovery. The result is that instead of recovery, we are experiencing further distress as the Euro crisis intensifies and even Brazil and China's economies slow.

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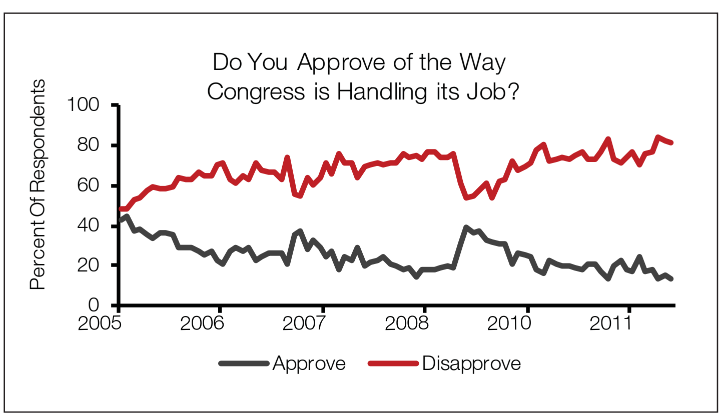
One of the main culprits behind the escalation of government interference is the resurgence of the belief that "government does it better." This sentiment usually focuses on China as the example where government "does it better" than the private sector. These refrains are eerily familiar to those about the Soviet Union, Mao's China, and Japan à la 1980. But China's growth over the past 20 years reflects less on how well they are doing today than on how horribly their government's decisions impoverished China for many decades. From destitute starvation, there is only one direction: up. And even still, the little-known truth is that China's dollar growth in per capita income remains below that achieved in the U.S. For example, in 2010, per capita income in China rose by $770 (at purchasing power parity), versus $1,870 in the U.S. That is, if U.S. living standards in 2010 rose by China's, we would be in an even worse economic situation than we have today.

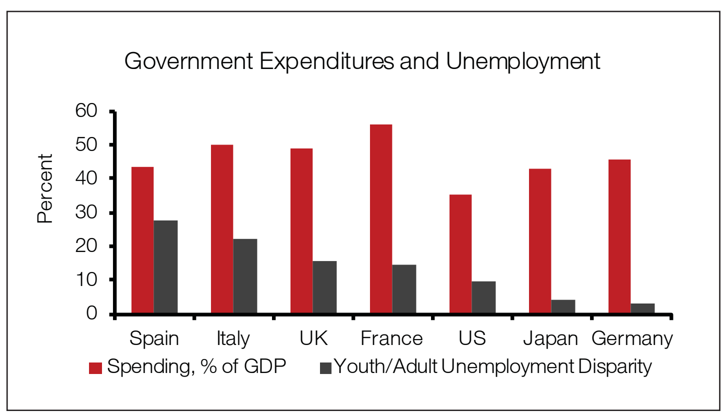
The irony is that the belief in big government is occurring even as trust in the U.S. government (and most other governments) is near an all-time low. Big governments around the world generally result in concentrations of unemployment among the young and immigrants, as these individuals tend not to be voters. In addition, since labor market entrants do not yet have a job, the red tape and regulatory burdens associated with hiring fall disproportionately on them (to the benefit of those with jobs). As of March 2012, unemployment rates among 16 to 24-year-olds stood at 21.9% in the U.K., 35.9% in Italy, 51.1% in Spain, 16.4% in the U.S., and 21.8% in France.

Spending

The rise in belief of big government rests partly on the Keynesian theory that government spending has a multiplier about 1.5. In other words, some believe governments can spend their way to growth. If this was the case, the economies of the world would be experiencing unprecedented booms. Instead, they are stagnating.

One thing on which everyone agrees is that Europe and the Euro face great uncertainty, as their social insurance promises and government spending relative to tax revenues place ever greater strains on their economies. Only when European governments (or the European Central Bank) pump $1 trillion into Portugal, Ireland, Greece, Italy, and Spain (PIGIS) does the European economy muddle along. But once such injections are three months old, the weight of the long-term stress reappears. These short-term "fixes" have fixed nothing.





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As the actual economic outcomes have consistently fallen far short of the predictions of Keynesian multiplier models, Keynesian spending proponents simply say, “It would have been even worse absent this spending, so we need even more spending to stimulate the economy.” This is baffling given the presence of a simple alternative explanation: their models are wrong. In fact, sub-par economic growth in the presence of high levels of government spending is exactly the prediction of the microeconomic model that says there is no free lunch. This model argues that increased government spending means less private spending. This is because every fiscal action has an (almost) equal and opposite reaction. Thus, huge deficit spending causes private spending to decline as the private sector realizes that it has a greater future tax liability of equal magnitude. We have witnessed this in the U.S., almost dollar-for-dollar for deficit spending. This phenomenon is known as Ricardian Equivalence; recent experience has confirmed it as more than a theoretical concept, with private debt falling by an almost exactly equal amount as government debt has risen. This means that reduced government spending (and hence deficits) is causing offsetting increases in private spending. And since private spending is more productive than public spending, economic growth declines with increased government spending. Not only does the entire argument that more federal spending is needed to stimulate the economy run counter to common sense and the global experience over the past 50 years; it is absurd at face value. It completely ignores the nature of government spending.

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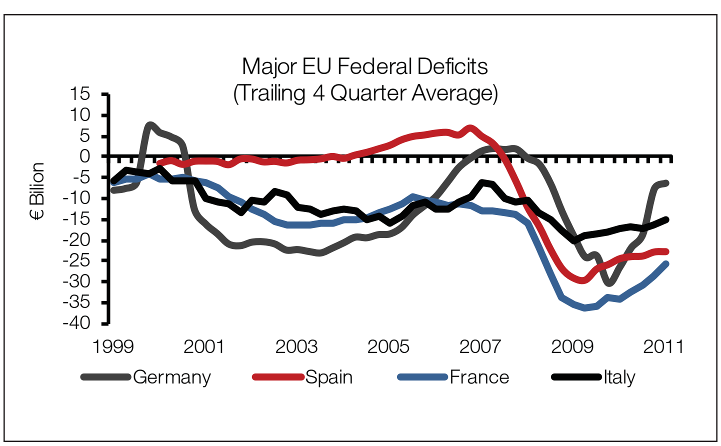

We can turn to China for an example. As was the case in the former Soviet Union and Japan, much of the government-directed output created in China today is of little worth. This is not to say that China has not made enormous progress in terms of improving infrastructure (an important government function), but rather that much of its spending is valued at (but not worth) full cost. That is, the U.S. is not the only country in which governments build bridges from nowhere to nowhere. Notable examples of this are China’s ghost cities, which were built at great cost, yet sit unoccupied. These projects boosted measured GDP as surely as did the endless security spending undertaken in the former Soviet bloc. But such wasteful expenditures add nothing to the nation’s well being.

Furthermore, would you expect enhanced growth if the U.S. government spent \$5 trillion invading Canada? Or if they decided to spend \$15 trillion building a floating bridge to France? Of course not. Such government spending would be destructive and wasteful, and would cause crushing economic declines as the money was redirected from productive private consumption and investment. It is the quality, not quantity, of government spending that matters for growth. Large and rapid increases in government spending are almost always destructive, as there is no way large sums of money can be quickly and prudently deployed “from on high,” particularly if this is the outcome of political horse trading. Thus, any reductions in federal spending would be welcome as commensurately fewer resources will need to be taken away from the private sector.

Regulation

Every economic bust creates calls for more extensive government regulation, in order to impede future financial fluctuations. The Obama administration continues to add more regulatory measures in the mistaken belief that it can regulate excessive behavior out of existence. However, most regulations are poorly conceived and hinder economic growth, while yielding no behavioral improvement. History shows that regulatory overload holds market forces hostage, leaving investors in regulatory purgatory. Increases in regulation induce prolonged flats in the stock market, reflecting an inconsistent environment that is not conducive to economic growth. The stock market flats of the 1970s, and since 1998, partially reflect regulatory activity under both the Bush and Obama administrations. The 1970s were defined by the policies of Presidents Nixon and Carter, who added a myriad of regulatory bodies to the government, such as the Environmental Protection Agency (EPA) and the Consumer Product Safety Commission (CPSC). The effects were clear, with the Dow Jones Industrial Average and the S&P 500 decreasing by 22% and 26%, respectively.

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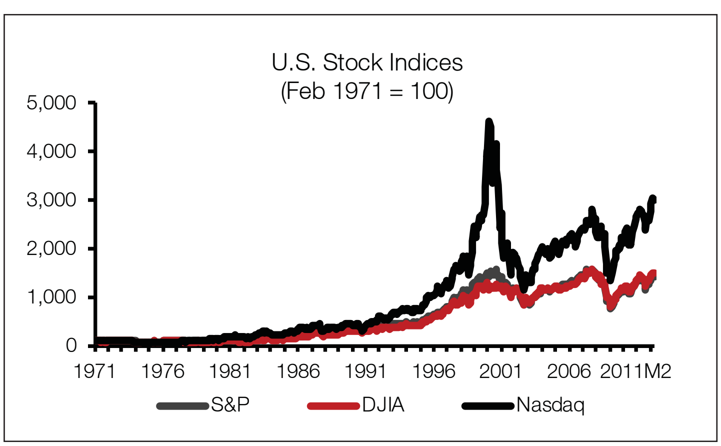
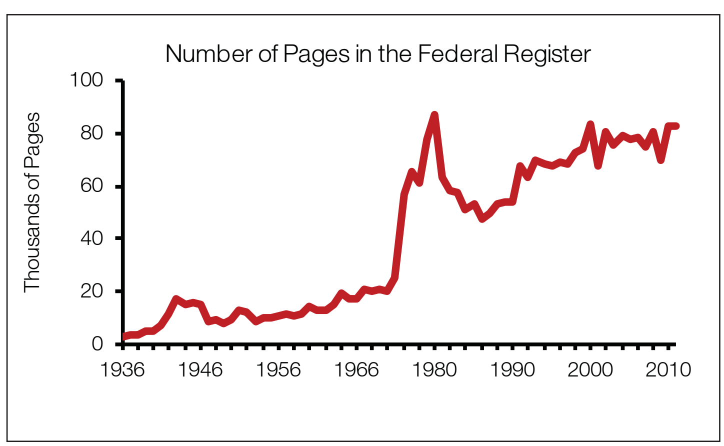
A study of the market reveals the same pattern of regulatory growth and economic stagnation. From 2001 through today, the Dow and the S&P 500 have only seen gains of 15% and 6%, respectively, compared with the 380% growth seen over the same time span beginning in the 1980s. From the peak in 2007 to the lows of early 2009, the Dow, the S&P 500, and the NASDAQ indices all declined by about 50% in response to unprecedented government tinkering. As of mid-June 2012, the Dow and the S&P 500 are still 11% and 16% below their respective 2007 highs, while only NASDAQ has managed to surpass the previous high, by 0.3%. Recent measures such as Dodd-Frank, SOX, and the hotly contested Patient Protection and Affordable Care Act (Obamacare) do little but add to the bureaucratic mess that is American government.

A look at the number of pages in the Federal Register reveals that the current state of affairs is starting to follow a trend last seen in the late 1970s. As of 2011, the number of pages in the Register stood at over 82,000, the highest level since 2000 and the third highest level ever recorded. The new regulatory efforts continue to undermine the business sector and discourage growth in a fragile economy.

The recent Jumpstart Our Business Startups (JOBS) Act highlights the fundamental flaw of increased regulation. In the name of spurring entrepreneurial activity, the JOBS Act defines how a company should be regulated as it grows larger, allowing smaller firms easier regulatory access to capital. But if lesser regulatory oversight is good for small firms, on what basis is increased regulation justified for larger, more established companies? As regulatory legislation becomes increasingly burdensome, businesses are at the mercy of an unfamiliar and ever changing political landscape. Without certainty of the rules of the game and a stable business environment, companies sit in a regulatory purgatory, unable to raise capital or hire workers. This means they cannot drive the economy forward.

The strongest period of American growth coincided with Ronald Reagan's presidency. As part of Reaganomics, the





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Reagan administration implemented measures to reverse the legislation signed during the Nixon-Carter era. Reagan appointees to the EPA, CPSC, Energy, and other departments pulled in their regulatory talons, and regulatory agencies saw deep real budget cuts and steep reductions in their regulatory power. It was not an accident that by the time Reagan left office, both the Dow and the S&P 500 were up approximately 160%. The country had been pulled out of regulatory purgatory and put on the track for sustained expansion.

Monetary Policy

The "government does it better" mentality also extends to central banks, which have aggressively been using monetary policy with unprecedented interventions in a futile attempt to prop up failing economies. Remember these agencies miserably failed in their job of bank oversight. They are hardly omnipotent! The initial quantitative easing (QE1) was, for the most part, justified in order to ensure that the banking system did not fail (even if it should have, given excessive risk-taking). But the combination of the Fed subsequently keeping interest rates absurdly low and QE2 has only served to distort investment decisions beyond all recognition. The Fed is intentionally forcing you to take on risk by setting the short-term rate at zero and forcing down long-term yields via quantitative easing.

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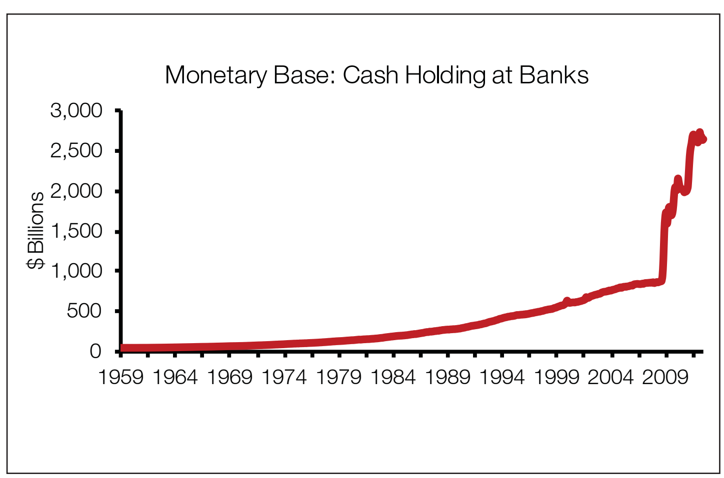
Fundamentally, the Fed is commanding you to "choose your poison:"

- Stay in cash and receive zero return as inflation runs 3-5%.
- Price your investments off of 10-year Treasury yields of 2% and assume that rates do not rise, running the risk of rapid interest rate increases if the federal government is unable to finance its next debt auction.
- Or pursue alternatives that involve greater business risk than you have previously undertaken (for example, buying single-family homes to rent in an attempt to find yield not available via buying traditional garden apartments).

In each case, you take on greater risk than you have at any time in your life. Is it any wonder that you are confused? Welcome to the large and non-exclusive club of confused decision-makers. We are living in an "Alice in Wonderland" world, where sovereign credit downgrades may reduce their debt yields, and the demand for safety is such that negative expected real yields are being paid on U.S. and German government debt. The simple truth is that no one knows the answer to these questions. Even highly informed opinions on these matters are based on some educated guesses, logic, extensions of normal behavior to very abnormal conditions, and occasionally a tiny bit of related history. In fact, not even the Fed knows what the Fed will do in the future, as they too have never experienced such conditions that exist today.

This is not to suggest that Mr. Bernanke and his Fed are evil or mal-intended, but rather that he is overmatched in his job. But then, anyone would be overmatched if assigned the job of fixing the "right" price for any important commodity (like money). Milton Friedman was the master at criticizing the conceit of Fed officials who believe that they can set the "right" interest rate. One of Friedman's great insights was that determining the "right" interest rate is impossible, and the Fed's constant interventions simply lead to unintended adverse consequences; hence his long support of rules of Fed behavior, rather than discretionary Fed interest rate setting.



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The U.S. has come to resemble the Soviet Union, where attempts to set prices led to cascading unintended market distortions, which reverberated across the economy, greatly reducing economic growth. Current Fed policy is nothing more than raw price manipulation driven by a conceit that the Fed knows better than the market. The Fed's low rate policy has stolen billions of dollars from savers, while creating artificial incentives to take unknown risks. Cutting interest rates in an attempt to stimulate sustained economic activity focuses solely on the incentives facing borrowers, while ignoring the fact that lenders face offsetting disincentives. Specifically, why lend long-term at low rates rather than wait until rates rise?

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The Fed's zero rate policy has been an unmitigated disaster for millions of retirees, who have seen the income derived from their life savings fall to zero, due to near zero interest rates. These people have had to liquidate far more of their life savings than they anticipated, leaving them exposed should they live "too long." Their heightened risk of running out of assets causes them to reduce their spending, even as the government attempts to stimulate consumption. Meanwhile, Baby Boomers are realizing that the inheritance they once thought they would receive from their parents is rapidly being liquidated or devalued, leading to reduced Boomer consumption. As in physics, every action has an equal and opposite reaction.

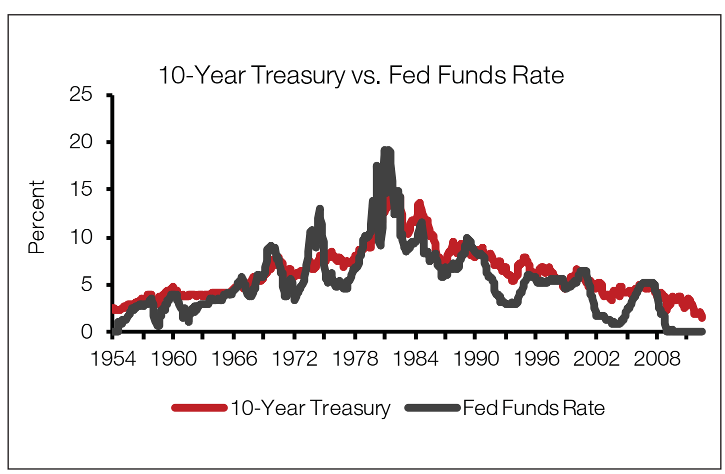
Taxes

There is a great deal of talk about the Fiscal Cliff that promises to unfold in January absent government action. Specifically, taxes are set to rise when the Bush cuts sunset, while mandated federal spending cuts are also scheduled to go into effect at that time. As discussed previously, a reduction in federal spending would actually help the economy, as a decrease in public spending increases private spending according to Ricardian equivalence.

The other part of the Fiscal Cliff relates to increased taxes. This raises a very real risk of reduced economic growth. Research by the former chairperson of President Obama's Council of Economic Advisors, Christine Romer, indicates that a 1% increase in taxes generates almost 3% lower GDP. And a recent survey of numerous economic studies on this topic concludes that every 100-bp increase in taxes reduces GDP growth by 15 bps: that is, a multiplier of 0.85, not the 1.5 multiplier commonly asserted by Keynesian proponents. This is the real Fiscal Cliff danger, which lurks if taxes are increased in January.

Unfamiliar Investment Landscape

These government interventions have distorted the investment landscape beyond recognition. Spending has created unsustainably large deficits around the world, and an uncertain political climate is making it hard to know exactly when and how those deficits will be tamed. The best businesses can do is spend less to account for the almost certain rise in future taxes. Increased and uncertain regulations are further incentivizing investors to wait and see; it makes much more sense to invest when there is stability and confidence that regulations will remain fairly constant for the length of the investment. Moreover, central banks around the world are slashing interest rates to the point where investors are forced to take on more risk than ever before. In all, government activity is now deterring the very investment it was hoping to spur. Governments need to understand that businesses need stability and a degree of freedom to grow and create jobs. When that change in mentality occurs, the economy will be back on the path towards stable growth.



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