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STRUCTURAL ISSUES IN THE ECONOMY

"An economic policy, if there had been one in the Bush administration, would have focused on the real economy, not solely on its adjuncts such as interest rates. The administration would have asked why new business starts dried up, killing off the real engine of economic growth, and it would have found the answer in the multiple burdens of ever-rising taxes, environmental costs, and regulatory burdens it heaped on business. It would also have asked why there was so little real effort to curb the congressional propensity to waste money.

Instead, Mr. Brady wanted his fellow finance ministers in Munich to know that the U.S. was leading the way in cutting interest rates. They and the heads of state they serve were not much impressed, for good reason."

George Melloan, Wall Street Journal, July 13, 1992

Mr. Melloan is quite correct in his diagnosis of the failure of the Bush administration's economic policies. This is especially true of the non-policies of Nicholas Brady, arguably the most ineffectual Treasury Secretary in decades. The truth of this assertion does not derive from some ideological position on our part as to whether government per se is good or bad. Rather it stems from a scientific understanding of the critical if unglamorous role of **rational incentive structures** in generating growth in a modern economy confronting truly global competition. The important role of incentives is supported not only by theoretical deductions within the "new" microeconomics of uncertainty and information, but also via empirical analyses of which nations grow fast, which grow slow -- and why.

This much having been said about the longer run, we must now focus on the more immediate outlook for the U.S. economy. We shall review several economic and political developments important to investors. These include (i) the causes of today's shallow recovery, (ii) the myth of "policy coordination" across nations, (iii) the paradox of very slow money growth despite 23 cuts in interest rates during the past three years, and (iv) confusion about protectionism and "industrial policy".

1. The U.S. Recovery

In the United States, a recovery is underway, but it is a shallow one. Looking forward, prospects for more rapid and sustained growth continue to be stymied by a host of structural impediments including:

o **Absence of a classical inventory cycle recovery** -- reflecting not only the role of "just-in-time" technologies in suppressing the classical cycle, but also the self-validating expectations of the business community for a very slow recovery;

o **Ongoing "slimming" of industry** and of the service sector, creating as it has a nearly unprecedented sense of gloom in the labor market not only about short-term employment prospects, but long-term prospects as well;

o **Reluctance of financial intermediaries** either to seek deposits or to book loans given the riskless route to balance sheet recovery by riding today's remarkably steep yield curve;

o **Lack of contra-cyclical fiscal stimulus,** especially, when the distress of state and local governments is taken into account;

o **Desynchronization of the global business cycle,** whereby the economies of Europe and even Japan are weakening just as that of the U.S. strengthens -- a phenomenon which has caused a slowdown in U.S. exports;

o Ongoing **determination of consumers and businesses to repay debt** and improve their balance sheets to the extent possible in difficult times.

Despite the lackluster pace of growth and the lack of optimism in all quarters, a recovery does seem to be under way, and we do not expect another recession soon. The very fact that mean growth is low serves to increase the **perceived** degree of uncertainty about the reality of recovery in a somewhat misleading way. For fluctuations in the values of the various economic indicators around a low growth mean will inevitably give rise to some negative indicators (e.g. a one-month decline in some index). Psychologically, these take a disproportionate toll on the perception that a recovery is really afoot.

All of the foregoing structural impediments to vigorous growth have been analyzed extensively in various publications. There is one, however, that is proving to be particularly salient and thus merits special comment.

"Slimming" and Distress in the Labor Market: We are not as concerned as the market was about the August employment figures, partly because of seasonal factors (e.g., school graduates) for which it is notoriously hard to "adjust". Instead, what is disturbing to us is the extent to which "slimming" of middle management continues to take place notwithstanding the modest upturn in the economy. A continuing rise in official unemployment of non-salaried employees always characterized the early stages of cyclical recovery. But what is currently happening in the ranks of salaried workers has no precedent at all, and in and of itself all but guarantees that the U.S. recovery will continue to be sluggish.

Briefly, two developments in the labor market are particularly noteworthy:

o First, the existence of an extensive network of middle managers went hand in hand with the rather top-heavy and "vertically organized" organizations of yesteryear. But with the advent of the new microeconomics of manufacturing around 1975-1980, everything was to change. Specifically, the advent of the microprocessor, and subsequently of CAD-CAM and digitally

reprogrammable manufacturing equipment made it possible to retool existing products and introduce new ones in a fraction of the time traditionally required to do so.

The result: a dramatic foreshortening of the "distance" between the producer and his suppliers on the one hand, and the producer and his customers on the other. **In this new environment, with its premium on fast turnaround, the necessity to flatten the organization's structure and thus to slim middle management was a foregone conclusion.**

o Second, the reality of these structural and non-cyclical developments in the labor market has dramatically altered the **expectational context** in which microeconomic decisions of every kind are made -- ranging from decisions about hiring to decisions about purchases of consumer durables. The growing realization that many job losses are permanent creates a self-validating set of expectations that ripple through the economy.

In this context, the new research into the phenomenon of unemployment by John Roberts of Stanford University becomes highly important. Roberts uses advanced game theory to demonstrate that Keynes may well have been right and Adam Smith/Arrow/Debreu wrong concerning one of the most fundamental issues in all of micro and macro-economics: the logical possibility of an **involuntary** unemployment equilibrium.

In such a state, no equilibrium set of wage rates exists which clears the labor markets **despite an absence** of the usual "rigidities" that create unemployment, such as imperfect competition (e.g., labor unions), an absence of "contingent markets" to cope with uncertainty about the future, etc. Keynes argued but did not formally demonstrate, that certain pathological cycles of self-validating expectations could result in involuntary unemployment of this kind. Arrow and Debreu proved formally that this could not happen in the absence of classical rigidities.

By generalizing the Arrow-Debreu model, Roberts showed that this need not be the case. His work is not merely of theoretical interest. For the circumstances which can generate an involuntary unemployment equilibrium in his model mirror precisely those we witness today, and stem from self-validating expectations of inadequate aggregate demand. This is indeed sobering food for thought.

2. The Myth of "Policy Coordination" - and Today's Dollar

During the early and mid 1980s, and culminating with the celebrated "Plaza Accord" of September 1985, it became widely believed that G-7 governments would increasingly coordinate their macroeconomic policies in the future. This somewhat fuzzy concept was soon extended to a prediction that interest rate levels in Japan, Europe and the U.S. would increasingly move in sync.

However, monetary policy and interest rates in general are variables that continue to be determined by largely **domestic** conditions. In addition, with the desynchronization of the global business cycle, domestic economic conditions are proving to be neutrally correlated. As a result, monetary policies and interest rate levels would go their own way. Conversely, volatile currency movements will continue to bear the brunt of the adjustment process in a world where monetary policies are not coordinated.

Events during the past three years certainly substantiate the above reasoning. The economies of Europe, Japan, and the U.S. have been very much out of sync, and these domestic economic realities have precipitated completely uncoordinated monetary policies driven solely by domestic concerns. Currency movements continue to bear the brunt of the underlying adjustment process accompanying divergent monetary policies. In particular, the recent steep drop of the dollar should be understood almost solely as a result of German rates repeatedly being driven higher than expected, and U.S. rates being driven lower than expected. **Understanding these dynamics of adjustment is highly important for investment managers given their increasingly global orientation.**

There is of course one context where policy coordination is alive and well, and this is **within** a given currency bloc, in particular the European Monetary System. We are currently watching a number of European nations seriously impairing their own economies by adopting coordinated monetary policies aimed at maintaining fixed exchange rates. Time will tell whether such policies will continue. We are skeptical that they will or should given the fundamental differences between several European nations; Germany and Italy in particular.

3. Paradox of Slow Money Growth

The U.S. Federal Reserve Board has eased interest rates 23 consecutive times since 1989. Yet, especially recently, the monetary aggregates have grown at rates well below target. How can this be the case, and what does it mean? An answer to these questions presupposes an understanding that money growth is a variable which must be interpreted in a proper supply/demand setting. After all, what exactly is the "growth of M2?" It is nothing other than the rate of change over time of the point of intersection -- projected onto the "quantity axis" -- of two price/quantity relationships: the demand curve for money, and the supply curve. Here then is an analysis of today's paradoxical situation which results from adopting this perspective.

Demand for Money: M2 has been growing well below 2.5%, the lower end of the Fed's target range of 2.5% - 6.5%. Slow money growth certainly indicates that consumers and businesses have decided that they do not want to hold significant cash (or otherwise highly liquid) balances. Why might this be the case, and what do these reasons protend for the economy? Three stories can be told in this context.

First, the classical monetarist explanation of the choice to hold fewer liquid assets would be that people simply don't plan to increase their spending anytime soon, and thus decide to accumulate assets of a non-cash variety. Yet recent and highly interesting empirical research by Benjamin Friedman and others suggests that in today's environment, neither money aggregates (such as M2) nor credit aggregates (such as private debt outstanding) contain meaningful information about the future course of the real economy. This is particularly true when the turnover or "velocity" of money is changing as it now is, for reasons not fully understood. Accordingly, this first explanation of low money growth is problematic; the second and third stories are more persuasive.

Second, the extraordinary slope of the yield curve has caused people to shift funds out of low-yielding liquid assets, and to lengthen their maturities, shift into stocks, or whatever. This indeed is true. Evidence abounds that people have been shocked by below 3% returns on cash

deposits, and have altered the composition of their assets as a result. Note that this second explanation contains no information about prospective economic growth.

Third, the steep yield curve has caused people to alter the **liability** side of their balance sheet as well as to redeploy their assets. Specifically, with longer-term rates remaining high, the temptation to pay off debt has rarely been greater, and evidence abounds that people who can afford to do so are paying down debt. This third explanation may portend slow real growth to the extent people use income (rather than existing liquid deposits) to retire debt.

Supply for Money: The Fed has certainly done its part, especially over the past year, but what about the banking system? This is the supply-side question, and it underlies the debate about the existence of a credit crunch. The evidence suggests that banks have not done their part. Rather, they have chosen to exploit today's steep yield curve and redress their balance sheets in two ways entailing minimum risk.

First, they have not increased the interest rates they will pay on deposits, thus indicating that they do not want to increase the liability side of their balance sheet.

Second, they are booking extremely safe assets, either in the form of purchases of government securities, or else loans to established, credit-worthy borrowers.

Taken together, these "shifts" in both the supply and demand curves in the money market explain the performance of the monetary aggregates.

4. Postscript on Protectionism and "Industrial Policy"

Just as the problematic concept of "policy coordination" became fashionable in the 1980s, so did that of the prospective advent of Fortress Europe, Fortress Japan, and Fortress North America in the 1990s. Regional protectionist policies are certainly an ominous possibility as the end of the millennium draws near. But here we have another example of a concept which **sounds** compelling on the surface, but which may not make sense when scrutinized from a bottom-up microeconomic perspective.

To understand this, consider developments in the increasingly important memory chip industry. It turns out that for microeconomic reasons utterly unbeknownst to government planners, production of the next generation 256 megabyte chip will require a staggering $1.25 billion investment up-front. Daunted by this figure, IBM, Siemens, and Toshiba deemed it micro-economically rational to team up and go it together.

In a parallel deal announced two weeks later, Advanced Micro Devices and Japan's Fujitsu announced a "strategic alliance" to develop so-called "flash" chips. Should this be any surprise? No, not when appraised from the light of microeconomic logic. McKinsey and Co. and other consultancies have reported for years on the rising significance of strategic alliances of just this form.

Here in the States, people blind-sided by these recent developments and at a loss as to what they portend include Harvard's Robert Reich -- an architect of the Clinton economic program. Reich and others are not business oriented, do not understand microeconomic logic, and are

busy promulgating top-down "industrial policies" designed to bolster U.S. performance in the coming era of protectionist blocs.

Yet what Reich and others like him fail to realize is that businesses both small and large are becoming increasingly impervious not only to national frontiers such as those within the European Community, but also to the artificial barriers erected by economists and policy makers around supposed continental trading blocs. In such an integrated global context, any industrial policy aimed at improving U.S. competitiveness should assume a microeconomic, bottom-up form. The aim should be to reduce regulatory, tax and other impediments to investment, innovation and growth, instead of attempting to promote growth through the protection and subsidization of industries selected by government agencies.

FED POLICY

Commentary: Several paradoxes arise in the context of monetary policy during the present business cycle. First and foremost is the paradox of why an unusually strong dosage of Fed easing has failed to kick-start the economy. The reasons lie in the peculiar role of structural impediments to strong growth which easier Fed policy has not been able to offset. The second paradox concerns why money growth has remained so slow despite aggressively easier monetary policy. A meaningful answer to this conundrum requires an understanding of behavior on both the demand and the supply side of the money market.

Looking forward, we believe that the Fed will most probably maintain the current Fed funds rate of 3.25% until after the election. If there is any further adjustment between now and then, it will be a **downward** move to 3.0%. The drop in consumer confidence recently announced increases the likelihood of this. Yet by winter 1993, we expect economic growth to be well enough established for the Fed to raise rates back to around 3.5%. This being the case, and with the election behind them, the Fed will most probably begin to turn its attention to the dollar. In this regard, it is often forgotten nowadays that the dollar remains the world's reserve currency, and as such needs some tender loving care once in a while. Additionally, there are the potential inflationary implications of a record low dollar. It is for these reasons that we anticipate a slight tightening at the beginning of the new year.

U.S. LONG BOND YIELDS

Uncertainties central to long bond yields include real GDP growth, the trend in core inflation, Federal Reserve Board policy (where we expect a slight tightening after the election or in the winter of 1993), and the magnitude of the "distrust premium" exacted by today's long-term bondholders.

We continue to believe that the best watchword for the bond market remains that which we have used for the past two years: **"sticky"**. By this we mean first, that relatively high long-term rates have been and will remain the order of the day, reflecting the existence of the distrust premium, reduced net foreign capital inflows, a low domestic savings rate, and large net government borrowing. Second, the term reflects the fact that reactions by the bond market to unexpected news will be lesser and shorter-lived than was the case in the past. The events of this past July bear this point out in an informative way. When the arresting June employment

number was released July 3rd, and the Fed concomitantly dropped the discount rate to only 3%, the bond market rallied, much as one would have expected. Yet note the end result: **the yield curve ended up even steeper than before,** as the modest 15 - 20 basis point drop in long-term yields failed to match the 25/50 basis point drop in the Fed funds/discount rates respectively.

This phenomenon is important for two reasons. First, it reinforces the likelihood that long-bond yields will remain sticky. Second, it throws doubt on the classical "expectations theory of the yield curve" whereby the steepness of the yield curve today contains significant information about tomorrow's term structure.

U.S. FISCAL DEFICIT

We expect that the deficit will lie in a $350-$400 billion range during fiscal year 1993. Uncertainties central to the deficit outlook include real GDP growth, the prospects for significant post-election fiscal reform (which we believe are slim), further reductions in defense spending, and further surprises in deposit insurance outlays.

Post-Election Fiscal Reform: The June defeat of the Balanced Budget Amendment has not completely eliminated the prospect of serious fiscal reform. Indeed, the most important legacy of Ross Perot's presidential campaign may be his deficit reduction program - widely acclaimed as the best such program to be set forth in several years. The possibility that either remaining candidate would adopt such a program should not be completely discounted. The beginning of a new term and new Congress would be a promising time for such a dramatic measure. Nonetheless, any paring of the deficit of this magnitude would mobilize every conceivable special interest group to oppose it, and even if the new president were to propose such measures, changes for enactment remain slim.

Defense Cuts: The House has now passed a defense spending bill $25 billion lower than Administration proposals, and legislators such as Senator Sam Nunn have called for far-reaching armed services restructuring to reduce inter-service duplication and reduce costs even more. Nonetheless, despite the appeal of reduced military spending, members of Congress are all too well aware of the economic impact of such cuts on their home districts in a weak economy and may be expected to oppose them regardless of the nation's larger needs for fiscal discipline.

Deposit Insurance Costs: Most of OMB's $70 billion reduction of the estimated fiscal 1992 deficit stems from lower deposit insurance (and associated "bailout") costs. Some $20 billion of this results from the effects of lower interest rates, and another $50 billion from Congress' failure to provide new RTC funding. The latter should **increase** future deposit insurance costs once spending resumes. MHII believes further overruns are likely in 1993 as interest rates rise slowly and many regional real estate markets remain weaker than expected or planned for.

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Emad is the Managing Partner and Chief Executive Officer of Vanderbilt Avenue Asset Management LLC. Vanderbilt's client base includes Multi-national Corporations, Public Funds, Foundations/Endowments, and Taft Hartley accounts.

Previously, Emad was Chairman of Institutional Business at Pioneer Investments. Pioneer investments has more than $300 Billion in assets under management. The parent of Pioneer, UniCredit S.p.A., is the largest bank in Italy and the second largest bank in Europe. Pioneer had purchased Vanderbilt Capital Advisors, of which Emad was the founder and Chief Executive Officer.

Emad has had numerous articles published in professional and academic journals such as The Journal of Forecasting, The American Economist and The Journal of Fixed Income. He is a Board member of The National Investment Company. Emad was a member of the Board of Advisors of the Pacific Institute, The Advisory Committee of Fulcrum Global Partners, The Chief Executive Officers Club and formerly a board member of The Foreign Policy Association. He also served on the Board of Directors of the University of Albany Foundation, NextGen Healthcare Inc., The Park Avenue Bank, AA Bank and The New Providence Fund and Associates LP.

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