The Shape Of The Future

By Peter L. Bernstein

Three months ago, we wrote, "[T]he economic malaise will not be brief, even though its depth is uncertain. The process is going to be like water torture - drip by drip by drip over an extended period of time until all these excesses are squeezed out of the system and new and happier horizons can open up." This metaphor should now form the basis for all decisions, strategies, and analysis. Recessions matter, but the important features of the problems faced by the American economy are not in the short run. The crucial issue is the nature of the new longer-run environment that we are convinced is now a reality. This environment is still in its infancy, but its principal features are already identifiable.

Too few people are thinking along these terms. The short run always tends to dominate mass thinking in any case, but in an odd way the short run is irrelevant to the current situation. The short run is a creature of the immediate past. The longer run will be a profound break from the past. Indeed, the longer run in this instance is going to evolve as it is going to evolve whether we have a perceptible recession in 2008 or whether we squeeze by with a minimum of negative numbers.

Why are we so emphatic about this viewpoint? As Goldilocks shreds, we have to start thinking about what kind of long-term environment is going to replace it. Shifts to new environments are always attenuated. They are also rare across time, which means most of us have limited experience with this phenomenon. New environments often tend to sneak up on us and do not announce themselves with a fanfare. Most of us are unaware of what has happened until enough time passes to provide good perspective.

Imagine, for example, what would have happened if investors had been willing to think through the powerful positive implications of the disinflationary forces that set in during the early 1980s after Paul Volcker had turned the tide of inflation. Instead, backward-focused investors in fear of renewed outbreaks of inflation ignored the way these new trends would lead to a radical improvement in economic stability and opportunity. The record of long-term interest rates in those years is eloquent testimony to the bias toward the past: although yields on ten-year Treasuries broke briefly below 8% in the wake of the oil price break in 1986, they were back up over 8% in 1987 and averaged over 8% for the next two years. Meanwhile, inflation averaged only 4.3%. Clearly, nobody was willing even to think about what the victory over inflation could produce. Yet it would lead to Goldilocks - a remarkable change in the nature of the whole world - would miraculously emerge from the disinflationary environment.

The discussion that follows begins with a few generalities about when and why old environments fade away and begin to yield to new environments. We analyzed this matter some time ago, but recent events provide a better perspective to our line of argument. We go on to explore how much of the old environment has disappeared, which then leads us to some speculation about how the new régime is likely to develop.

The dynamic process: Familiar facts in a new setting

Economic environments do not have a specified life cycle, like the business cycle. As I have argued elsewhere, economic régimes tend to persist as long as people are still trying to figure out what is actually going on. This effort strengthens the underlying characteristics of the environment and extends its life expectancy. Change, therefore, is unlikely until people finally arrive at the belief they understand what it is all about. Such a process has no definable rhythm. The arrival of understanding could come sooner or later, depending on the circumstances. Furthermore, this process applies to all environments, both prosperous and depressed, to the 1920s as well as to the 1930s, to the years from 1949 to 1969 as well as to the devastating decade that followed.

The 1920s were doomed at the moment when the New Era became a common phrase and Irving Fisher explained that prosperity would last forever. The Great Depression continued until unremitting deflation and waves of bank failures convinced a new administration that the tie to gold at $20.67 an ounce was stifling the economy. In addition, a total reversal of tax-raising fiscal policy and restrictive monetary policy was both essential and urgent. The postwar prosperity of 1949-1969 lasted for over twenty years because it was grounded in doubt as everybody kept waiting for an inflation that failed to show up. Inflation remained low, to general surprise, even though output growth was high. Once people got the idea that high output would not automatically cause inflation, the sense grew that now nothing could go wrong - and so we entered another régime marked by the aggressiveness of monetary policy and war finance in the 1970s**. T**he resulting inflation would rage for ten years before people recognized that a profound transformation of the conduct and targets of monetary policy was essential. The outcome, as mentioned above, was the transition decade of declining inflation in the 1980s, leading in turn to Goldilocks after about 1989.

The Goldilocks environment was so benign it appeared to be a long sequence of happy surprises. Goldilocks was aptly named**:** low volatility in capital markets and in the real economy, low inflation, central banks in firm control, a healthy appetite for risk-taking in the business world that led to revolutionary technological change, the transformation of the "emerging" economies into "developing" economies, and the resulting boom in globalization.

After the bursting of the dot.com bubble in 2000, the business sector of the real economy resisted the fever for devil-may-care risk-taking that ultimately infused the financial markets. As a result, Goldilocks had remarkable longevity. Its death-knell would wait until the financial markets finally got the message that high risks were not really high risks in a low-risk economy. Then the fundamental stability and growth momentum of the global economic system created a bulging appetite for risk-taking that led investors around the world to gorge on anything that looked risky. A point came when any trigger would justify ever-greater risk-taking. The actual trigger did not have to be housing, but (with hindsight) we can see housing was a logical candidate. No one seemed to doubt that home prices could ever stop rising. Debt had no ceilings. Just to make everything appear even better, housing requires financing, which was like handing a delicious and multi-layered chocolate cake to the world of finance and financial engineering. Professional investors learned how to clothe high risks in a low-risk format for sale to the Great Unwashed, and to a goodly number of the Washed as well.

In the aftermath of the fervor for risk-taking, Wall Street and the mortgage banks have created many deep-seated problems for themselves. As an unhappy side effect, the business sector, a relatively innocent observer, is going to have to absorb much of the pain of curtailed consumer budgets and fewer exports to foreign nations affected by the turmoil in the U. S.

The aftermath: An introduction

Human nature develops odd biases. In terms of the economy, memories of past environments are more heavily weighted by the disasters than by the positive achievements of the period. These disasters linger long in collective memories, influencing public policy and investment practice for extended periods of time.

Fear of the double-digit unemployment rates of the Great Depression dominated economic policy from the end of the depression in 1933 to the late 1970s. As late as 1978, with inflation raging around 8%, Congress enacted the Humphrey-Hawkins Full Employment Act, providing for "the right of all Americans able, willing, and seeking work to full opportunity for useful paid employment at full rates of compensation." Paul Volcker's great achievement (and courage) were in his conviction he would never defeat inflation as long as he had to tread softly in limiting possible increases in unemployment. That constraint had to change. Volcker saw no alternative if he was to win the battle in which he had been put in command. As he carried out his campaign, the unemployment rate soared from under 5% in 1979 to nearly 11% in 1982, but inflation dropped from a peak of over 14% to less than 6%

over the same period.

Today's central bankers may make interesting observations about influencing inflation expectations, but everyone knows they must ultimately have the courage to see unemployment increase if their policies to contain inflation are to carry credibility and actually influence expectations. The Fed is in an uncomfortable position at this very moment, because the tradeoff has taken on an unusual complexity, with the job market softening while lingering symptoms of inflation are still visible.

As we now move on into the post-Goldilocks environment, which unhappy memories are going to weigh heaviest? Worries about inflation are not about to vanish, but new elements are going to join in. Clearly, everything that led up to the credit crisis and the problems of home ownership will remain a central focus of attention for a long time.

In addition, as we emphasized in our issue of August 15 of last year ("Memory Banks and Economic Policy"), the increased income inequality generated by Goldilocks has become a widespread popular concern, already making vibrations among members of Congress and candidates for higher office. As Bill Gross himself put it in strong words last August, "So when is enough, enough? Now is the time, long overdue in fact, to admit that for the rich, for the mega-rich of this country, that enough is never enough, and it is therefore incumbent upon government to rectify today's imbalances." The rhetoric of the election campaign is full of such talk. This concern will influence tax policy and spending policy for a long time to come.

The aftermath: The particulars

The repercussions in the financial system are our main concern here. Most of the current flood of analyses of the state of the credit markets concentrate on the problems of the present. This kind of information is little help. We need to develop a sense of how this situation is likely to evolve *over time*. To accomplish that goal, our primary task is to discover where the roots of the new régime are being planted.

We now set out our own views along these lines. We begin with a few generalities. These generalities will lay the basis for the particulars that follow.

Credit is always and everywhere a matter of trust. Where there is trust, anything goes, as the recent proliferation of so many structured financial instruments vividly demonstrates. When trust vanishes, the revival of the buoyant credit creation of the past becomes extraordinarily difficult. But without credit creation, economic growth and risk-taking are stifled.

Liquidity is also a matter of trust to some degree. But liquidity has another feature that few people notice. *Liquidity is a function of laziness*. By this I mean that liquidity is an inverse function of the amount of research required to understand the character of a financial instrument. A dollar bill requires no research. A bank draft requires less research than my personal check. Commercial paper issued by JP Morgan requires less research than paper issued by a bank in the boondocks. Buying shares of GE requires less research than buying shares of a start-up high-tech company. A bond without an MBIA (once-upon-a-time anyway) guarantee or a high S&P/Moody's rating requires less research than a bond without a guarantee or lacking a set of letters beginning with "A" from the rating agencies. The less research we are required to perform, the more liquid the instrument - the more rapidly that instrument can change hands and the lower the risk premium in its expected returns.

This emphasis on trust and liquidity in a well-functioning credit market provides useful insights into what is happening. Trust has vanished in many areas where it was taken for granted just a few months back. And when the ratings of S&P and its competitors lost credibility, paper that had traded on sight lost the liquidity it once enjoyed because now it involved far more research than in the past. These words are just an elaborate way of explaining why credit spreads were so narrow just nine months ago and so wide in today's markets.

This abrupt shift in viewpoints has caused snarls in many areas of the credit markets. Over the longer-run, the most serious of these blockages is the disruption in the process of securitization. Securitization works only in an atmosphere of trust and where the paper involves a minimum of research. *Without securitization, and without the lively derivatives markets that developed around the securitization process, the entire credit system loses an immense source of capacity, hindering deserving borrowers in search of financing and, as a result, the pace of economic growth.*

Until the system can restore trust and the related willingness to buy instruments on the basis of limited research (or even no research), the credit markets are going function below optimal levels. But restoring trust and liquidity is no simple matter. Securitization broke the old personal relationship between lender and borrower, greatly expanding the market for credit in the process. The old-fashioned way - when lender and borrower were essentially on a face-to-face relationship - was slower, more cumbersome, and, most important, far more limited in terms of capacity.

In my days as a commercial banker, back in the late 1940s, the president of my bank said to me, "Remember this. I much prefer the customer to be angry at you because you denied him credit than for you to be angry at him because he failed to repay when due." That attitude sounds quaint today, but it was very much in the spirit of a time where jokes about bankers' glass eyes were legion. As the market for glass eyes revives - and it is reviving as we speak -

new credit creation will inevitably slow down. As Woody Brock recently emphasized, "the combination of diminished bank capital and tighter lending standards could prove fatal to credit creation."

Now, it would be naïve to project this set of conditions into the indefinite future. Trust will regenerate over time, and the burdens of research will lighten. The pace of change in that direction, however, will be slow, a matter of years rather than months. An entire structure has crumbled and has to be rebuilt, brick-by-brick. Nor will that process necessarily be smooth. The impact of unforeseen but inevitable credit problems will loom large, detouring and delaying the pace and patterns of recovery on each occasion.

There could be bright spots as well. Our whole argument rests on the proposition that the demand for credit is going to exceed the supply, which is blocked by lack of trust and an increased burden of research. But a case where supply fails to respond to an excess of demand is rare in our system. People in finance have extraordinary energy for innovation in new products, new concepts, new paths to ultimate objectives. For example, hedge funds and sovereign wealth funds are already functioning as sources of credit, although a bump along the way might turn them off as well.

These widespread and complex problems originated from an unanticipated sequence of shocks involving banking institutions believed to be impervious to losses in the billions and major impairments of equity capital. As we emphasized above, new régimes are colored by the unhappy memories of the preceding régime, and those memories linger on for extended periods of time. The plight of Citicorp and Merrill Lynch reaching for massive help from foreign government investment funds was an event nobody could have foreseen - but few will forget. How the mighty had fallen!

The critical ingredient in the state of distress

The sequence of events that caused the economy to lose its forward momentum over the course of 2007 was unique. This fact is central to our entire argument here. The cause was not too much inventory, not overexpansion in industrial capacity, not a sustained burst of inflation requiring a determined move to tight money and higher rates at the Fed.

The root of today's problems in the financial markets and in the economy as a whole is the household sector. The point needs no elaboration, but its significance cannot be minimized. As we have argued on more than one occasion, the shrinkage in the personal savings rate is not the result of consumer profligacy, as other commentators persist in describing it. Rather, the savings rate has been suppressed by a slowdown in the growth of household incomes. The shortfall between income and outlay has been met by borrowing, and in particular by borrowing against the family real estate. Now the opportunity to borrow has shrunk dramatically, an outcome that will profoundly change the household's spending power and spending patterns. But the impact is not just on the household. A slowdown in the growth of consumer spending has ominous implications for the entire global economy - and, along the way, the U. S. federal deficit, soon to be overburdened by spiraling benefit obligations. This predicament is not a short-run matter, unless home prices abruptly reverse themselves and head back into the stratosphere - which is hardly likely.

The bottom line

The central message of our analysis is not that the origin of today's difficulties is uniquely in the household sector or that the residue of these difficulties has scrambled the whole credit structure in the financial markets. Everybody knows about these troubles.

On the other hand, too few observes have noted how the consequences of these developments are going to require an extended period of time before the blockages they impose have been eliminated. But that is not all they have missed. *This extended period of difficulty is going to bring about a new economic régime, different in many aspects from the experience of most people alive today.* Along the way, we will have to pass through a transition period that harks back to an unfamiliar past in both the financial system and in the household sector.

But this, too, shall pass. Yes, glassy-eyed bankers, prudent consumers, and a reformulated globalization can keep a lid on economic activity around the world for quite a while. What develops from that transition, however, should resemble what took place over the course of the 1980s. Without anyone realizing it, the errors of the past, drip by drip by drip, were buried and a new and better system took their place.