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SED PROFILE

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TODAY'S PERFECT FINANCIAL STORM – The Use of Fiscal and Monetary Policy to Redress It –

By

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***The “Hindenburg Effect”:** In attempting its landing in Lakehurst, New Jersey on May 6, 1937, the great dirigible Hindenburg burst into flames whilst only 160 feet above the ground. What stunned those who had gathered to celebrate this landing was the astonishing speed with which the entire skin of the airship caught fire and devoured it. This speed prevented many passengers and crew located in the ship’s observation deck from escaping, and reduced news commentators to speechlessness.*

What more apposite metaphor is there for today’s global crisis than this? What has shocked everyone the most is the rapidity with which a subprime mortgage crisis in the US morphed into the greatest global financial crisis since World War II. To make matters even worse, this global financial crisis is now morphing into a global recession.

Personal Introductory Note: I can recall only three occasions in my life when I felt quite overwhelmed by external circumstances: *First*, the Cuban missile crisis when I was a youngster at boarding school. *Second*, the 9/11 attacks on New York City where I was living at the time. *Third*, today’s Perfect Financial Storm.

I have deliberately waited to write an in-depth **PROFILE** essay about today’s crisis until its true contours had become clear to me, in particular the causal linkages between Wall Street and Main Street. In this regard, the verdict is now in: Wall Street has brought down Main Street in the US, not the other way around, which is very unusual in today’s post-industrial world of recession-proof economies dominated by highly-stable service sectors. The US contagion has recently been spreading, and now a global recession is at hand. Its magnitude will be determined by the complex interplay of acute deleveraging on the one hand, and the aggressiveness of monetary and policies adopted around the world on the other hand.

The **PROFILE** that I originally drafted was bi-partite and addressed two quite different sets of issues: *First*, the true causes of the crisis, and in particular the Hindenburg Effect whereby a manageable problem within the US morphed into a huge global crisis with arresting rapidity. *Second*, the policies that governments should adopt to redress it. The result was a forty page essay that was frankly, too long and too demanding. As a result, I have split this into two different essays.

First Essay: The present essay focuses on the second issue, namely those policies that government can and should adopt to manage the recession. This is the immediate problem at hand, and I felt it was best to begin with it. While we focus on policies appropriate for the US, the logic set forth is general, and these policies will apply to most any other country.

Why is a special essay needed on fiscal and monetary policy? The reason is as straightforward as it is important: The magnitude of fiscal stimulus that will be needed is virtually unprecedented, with total US Treasury financing needs already projected to exceed \$2 trillion in Fiscal Year 2009, and possibly in FY2010 as well. Because of this magnitude, investors of all stripes will be forced to ask:

- Where will the requisite funds come from?
- What will be the implications for interest rates, for the dollar, and for inflation?
- Can the necessary funds be raised without a disturbing dosage of “deficit monetization”?
- But what exactly does this widely misunderstood term mean, and what will be its consequences?

The essay that follows was written because of the critical importance of these four questions right now, and because of widespread ignorance of the correct answers to them. Widespread ignorance here is readily understandable for two reasons. *First*, the issues are inherently difficult, and often very counter-intuitive (e.g., very large fiscal deficits should not, and in general do not, result in higher inflation). *Second*, the unprecedented magnitude of the financing effort at hand puts us in uncharted territory whose contours are enough to frighten anyone.

Acknowledgement: In firming up my own understanding of these issues, I turned to my old friend Professor Benjamin Friedman of Harvard and posed a dozen questions to him. He answered all of them with the deliberation and clarity of thought for which he is well known. His comments immeasurably improved this essay. Of course, any errors and opacities that remain are solely my fault.

To simplify the exposition and bring the topics alive, I have adopted a “Socratic Dialogue” format. This permits me to pose questions that readers will want answered. The format also keeps me focused, and prevents me from bloviating!

During the next year and beyond, investors will have no choice but to make their own forecasts of the implications of the massive fiscal and monetary stimulus now at hand. It is my hope that readers of this particular Dialogue will gain a significant leg up in doing so. Indeed, I know of no comparable research effort. Finally, my determination to author this Dialogue bespeaks the most fundamental goal of SED's Advisory Service: To permit clients to be less wrong in their forecasts and decisions than their peers are, and thus to outperform them.

Second and Future Essay: In a second follow-on essay, we will assess the kinds of *longer-run* policy reforms (transcending shorter-term fiscal and monetary stimulus) that must be adopted if we are to prevent additional Perfect Financial Storms in the future. But to know exactly which reforms are needed, we must understand at a causal level the true origins of today's credit market crisis, and as a result to *explain* the Hindenburg Effect from first principles. Some readers know my own beliefs in this regard, namely that today's crisis was not due to "fear and greed," "herd mentality," and other forms of allegedly irrational behavior.

Rather, the crisis resulted from the toxic intersection of two developments: (1) A set of conditions implying a very high level of "endogenous risk" (price overshoot), in particular a high degree of Pricing Model Uncertainty characterizing those hard-to-price exotic securities that brought the system down; and (2) Highly excessive degrees of leverage on the part of individual investors and financial institutions alike — degrees of leverage that are demonstrably inconsistent with the magnitude of underlying risks involved, and that should never have been legal.

Because of the highly important research programme at Stanford University with which I have been involved for over a decade, it can now be shown mathematically that the intersection of both of these developments fully accounts for the Hindenburg Effect that is the hallmark of today's distress. Moreover, no assumption of "irrationality" is required to demonstrate this. The situation is akin to what happens in a Prisoner's Dilemma game: What *appears* to be irrational behavior is not, in fact, irrational upon closer inspection. Rather, the problem results from individually rational behavior within a game that is, in fact, pathological. That is, it is the *game* itself that is the problem, not the players in it.

In the present case, an investment game was rendered pathological by the *ability* of, and indeed the *incentive* of, players to leverage up to a degree that brought the system down. "It's the leverage, stupid!" is thus the mantra that must be invoked by policy makers attempting to reform our financial system over the longer run. Regrettably, it is a mantra that is not yet being heard. Instead, we complain about the "greed" of others!

Postscript on Rational Optimism: I am personally optimistic that, after policy makers and investors work their way through the current global recession, long overdue reforms and re-balancing *will* occur, and a lot of good will result from today's painful adjustments. Moreover, very exciting new investment opportunities will soon be emerging as a result of a shift in the composition of US GDP away from consumption towards infrastructure investment. In this vein, forthcoming ***PROFILE*** essays will identify and focus on some of these investments.

– H. Woody Brock

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