

BEACON INVESTMENT MANAGEMENT

THE FRIDAY BRIEF

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Toll Free 888-621-5885

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Unordinary Behavior

*"Those who cannot remember the past are condemned to repeat it."
George Santayana, in The Life of Reason*

"Common sense is very uncommon." Horace Greeley

There seems to be a sense in Washington in this time of crisis that the rules of ordinary behavior of most any kind simply don't apply. Whether observing economic behavior, spending behavior, fiscal behavior, monetary behavior, political behavior, or what used to be generally acceptable and responsible behavior, it's all up for grabs these days. Didn't we get into this mess by abandoning the ordinary rules of lending and of borrowing and regulating?

If Washington must spend billions in the name of fiscal stimulus, is it too much to ask that it at least stimulate the economy? Why on earth can it not be targeted toward the productive segments of the US economy rather than toward the destructive and leaky segments? The \$787 billion stimulus bill and the \$275 billion housing bill appear to be mostly welfare, non-simulative infrastructure government spending and rewards to those who do not work or to those who make bad financial decisions. The stimulus and housing plans represent 7.5% of the entire US economy last year and are more than twice the largest US budget deficit in history. If the funds were simply doled out rather than filtering through the inefficient government filters it represents \$3,543 for every man, woman, and child in America (citizens, that is).

Here's the problem; fiscal stimulus largely does not work. We are wasting billions of our children's savings on ineffective programs, if history is any guide. The classic example, the New Deal, was much more a welfare program than a stimulus program as some think. It is credited with putting 40% of the US unemployed workforce back to work and feeding a destitute population that might otherwise have starved; but it did little to stimulate growth.

Today, the government provides unemployment insurance, food stamps and Medicaid to aid the under- and unemployed during economic downturns. A boost in support for these and for weakened states would be appropriate, but beyond that, government spending for near-term economic stimulus is mostly wasted.

Thomas Firey of the Cato Institute, a liberal think tank says:

"First, the economic history of the New Deal and the rest of the 20th century raises serious doubts about the effectiveness of discretionary fiscal stimulus packages in reversing an economic downturn. Monetary stimulus has a far better track record ... Second, the helpful welfare benefits of the New Deal are now carried out automatically by other government programs."

Referring to the recession that occurred within the Depression in 1937-38 Firey goes on to say: *Although federal deficit spending did decrease along with the economy, the recession appears to have been largely the product of onerous new banking regulations that weakened the monetary stimulus (a point that today's eager-to-regulate Congress should bear in mind).*

Christina Romer chairman of Obama's own Council of Economic Advisers wrote a paper for the Journal of Economic History titled "What Ended the Great Depression?" It provides empirical evidence that FDR's fiscal policy provided little stimulus during the Great Depression. If not the Republicans in Congress, let's pray the Democrats eventually listen to their own counsel.

What did work very efficiently to reverse the destructive trends of the Great Depression was monetary policy (money). Romer goes on to argue that another FDR policy, doubling the fixed exchange rate for the dollar relative to gold, actually reversed the economy's trend recognizing that the New Dealers seem to have lucked into the result rather than planning for it. The rate change worked as a monetary stimulus, inducing large gold flows into the United States, where they could now buy twice as many dollars. That buttressed bank deposits and increased bank willingness to lend, thereby encouraging investment. The lending resulted in a sharp increase in the money supply, pushing against the Depression's price deflation and encouraging consumption. From the moment the exchange rate changed, the United States began to climb out of the Depression, albeit slowly; more slowly than many other countries.

Firey adds that "Romer's explanation dovetails with Milton Friedman and Anna Schwartz's work on the root cause of the Depression: the Federal Reserve's sharp reduction of the money supply in the late 1920s, in order to moderate the stock market boom and return the United States to the pre-WWI dollar-gold exchange rate. It also dovetails with evidence that other nations' recoveries from the Great Contraction began soon after they abandoned efforts to return their currencies to pre-war gold exchange rates. My reading of the economic literature indicates that the "monetary policy did it" thesis has been generally accepted by economic historians."

We believe the Federal Reserve is using its monetary tools as effectively as the broken banking system allows. We also believe that Treasury Secretary Timothy Geithner and his very intelligent team will eventually embark on a program or programs that will restore health to the US banking system. On these experts rest our hopes for eventual recovery and we feel confident they will succeed.

So, why must Washington spending so much of our children's' future on largely disproven fiscal programs? Romer, Obama's top advisor says "the thing that is striking about this time is that it is not an **ordinary** recession. Here we had one caused . . . by a financial meltdown. And even when the Fed tried to be fairly aggressive, it wasn't enough. That's why the usual rules would not apply." Moreover, she said, the current stimulus is much bigger than anything Roosevelt tried. "It's a completely different animal in terms of size."

We couldn't agree more, it is an "animal" but we worry whether this beast is friend or foe? We also worry when Washington says the "usual rules do not apply." The echoes remain loud and clear from similar choruses such as those following the terrorist attacks of 9-11, or bankers who championed the practice of lending to unqualified borrowers, or the plans of a relatively few who masterminded the sub-prime securitized mortgage investments. Remember the dot.com crash of 2000? In the late 90's investors said the usual rules did not apply. Price earnings multiples of 30, 40, even 100 could be justified because of the skyrocketing productivity and historically low interest rates. *'The Internet changes everything'* they said.

When will we learn that "what has been will be again, what has been done will be done again; there is nothing new under the sun." Ecclesiastes 1:9

Mr. Bernanke and Mr. Geithner, we and our economy need your extraordinary common sense.