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Tuesday 24 – Thursday 26 August 2010 | Sydney

[Markets]
I've been thinking about…

… whether the US has more shocks to come

Dr Horace "Woody" Brock
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Three Critical Developments in the Global Economy 2010-2020

Topic 1: The true import of Greece, the Euro crisis, and Sovereign Debt throughout the Western world.

Topic 2: Four reasons why emerging markets will start to *help* the west rather than compete against it and damage it.

Topic 3: Anatomy of the US recovery, and what to do to fix it.

H. "Woody" Brock, Ph.D.

President

Strategic Economic Decisions, Inc.

Topic 1: The Rise of the East
– How it will *Help* the West –

A Reverse East-West Dependency is Evolving

- **Manufacturing will start coming home (e.g., Catepillar)**
- **Emerging market citizens will soon want *our* goods and services *and* assets more than we want theirs.**
- **Role of branding and consumer snobbism**

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Topic 2: The European Crisis—A Deeper Perspective

- **The Larger Crisis – 2010 is a Pivot Point in History**
- **The Expansion of Public Goods**
- **The Prisoner's Dilemma "Game" of Electoral Politics**
- **Adverse Demography to Boot**
- **Outcome – A forty-year Crisis of Red Ink and Political Paralysis**

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Topic 3: The US Economy: A "Lost Decade"?

- **Sluggish GDP growth—especially given the dual stimuli of very loose fiscal policy *and* very loose monetary policy.**
- **The worst job market "recovery" of the past half-century**
- **Likelihood that GDP growth will remain sluggish, as will employment during the decade 2010-2020**

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Why Such Sluggish GDP Growth?

1. **Growth is *not*, in fact, that sluggish compared to growth in the past 3 recessions—until you take account of huge monetary and fiscal stimulus.**

2. **The Big Story: A "Gestalt" from 35 years of overspending and overborrowing *by everyone* back to more conservative spending 2010–2030.**

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Comparing Economic Recoveries since 1948

Name	Dates of Recession	Average GDP Growth of First 5 Quarters of the Recovery
Recession of 1949	Nov. 1948-Oct.1949	11.2%
Recession of 1953	July 1953-May 1954	7.2%
Recession of 1958	Aug. 1957-April 1958	7.3%
Recession of 1960-61	April 1960-Feb.1961	6.7%
Recession of 1969-70	Dec. 1969-Nov. 1970	5.0%
Recession of 1973-75	Nov. 1973-Mar. 1975	5.4%
Recession of 1980	Jan.-July 1980	2.5%
Early 1980s Recession	July 1981-Nov. 1982	7.6%
Early 1990s Recession	July 1990-Mar. 1991	2.9%
Early 2000s Recession	Mar-Nov.2001	1.9%
The Great Recession	Dec. 2007-Oct. 2009	2.9% (est.)

Sources: BEA, SED

Why Such a Terrible Labor Market?

1. **Uncertainty about future cost of hiring (Obama Care)**

2. **Exceptionally high productivity growth of 5% during recovery**

3. **The Big Problem: Cumulative GDP growth during *recovery* has been much less than negative growth during recession. *It is this ratio that matters to employment during a recovery.***

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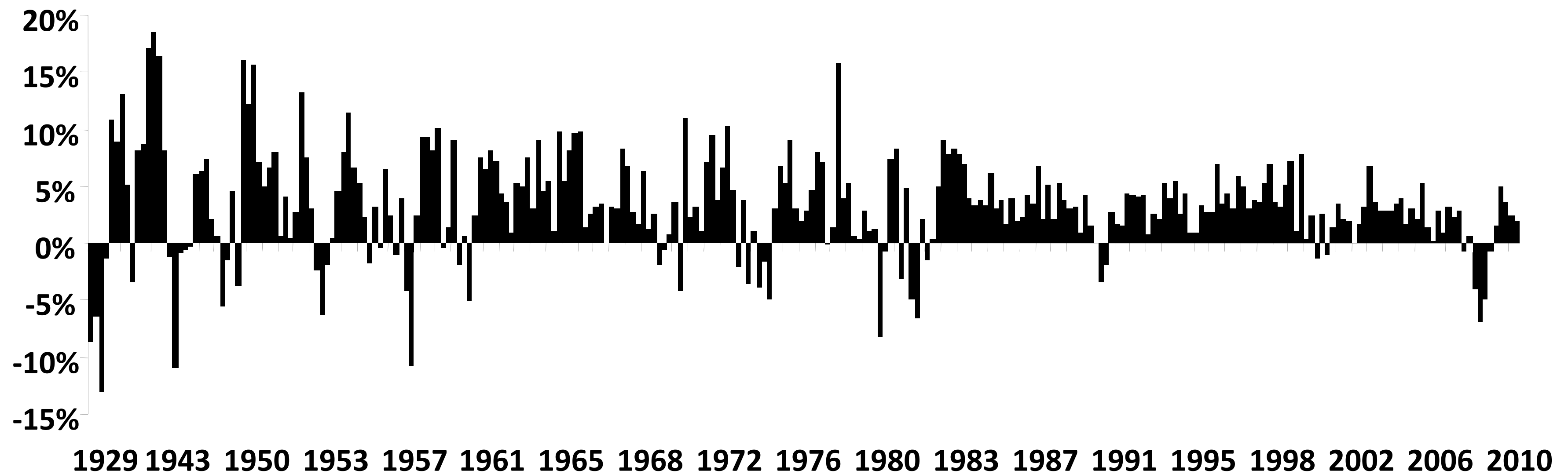
ANNUALIZED GDP CHANGE FROM 1929 TO 2010



Note: Data is annual from 1929 to 1946 and quarterly from 1947 to the second quarter of 2010.

Sources: BEA, SED

Mr. President: These Are Your Choices

1. **Focus primarily on deficit reduction and accept the high unemployment tradeoff just sketched. This may make the bond market happy, and citizens miserable.**

2. **Ignore the deficit, leave it *unchanged* as you did this current year, stimulate GDP growth by doing so, and say "to hell" with the bond market vigilantes.**

3. **"Muddle Through" with a compromise of reducing the deficit by only 4% of GDP down to about 6.5% of GDP. Via the previous analysis, this will permit GDP growth itself to be stronger—even though it will still be far too weak to make much of a dent in the job market.**

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Solution: Having Your Cake and Eating it Too

Mr. President: Between the time when I gave you the bad news last January (summarized above) and June 2010, I had an epiphany. I realized that my analysis was incomplete, and as a result, wrong.

FUNDAMENTAL PROPOSITION: It is possible during this ostensibly "lost decade" for the US *both* to radically reduce its deficit *and* to achieve full employment *and* to significantly raise productivity and GDP growth. In short, you can have your cake and eat it too. All of it. How??

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The Structure of What Follows

First, we summarize the extremely important work of Kenneth Arrow and Mordecai Kurz in 1970. They generalized and unified the three different branches of macroeconomics. [*Public Investment, The Rate of Return and Optimal Fiscal Policy*]

Second, we set forth our proposed solution to today's US economic crisis. The required policies are inspired by this surprisingly little-known Arrow-Kurz analysis.

NOTE: The policy solution we arrive at required us to fundamentally *redefine* two terms: "deficits" and "private versus public investment." This approach to problem solving is often utilized in pure mathematics and in the natural sciences.

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The Disarray in Macroeconomics Prior to 1970

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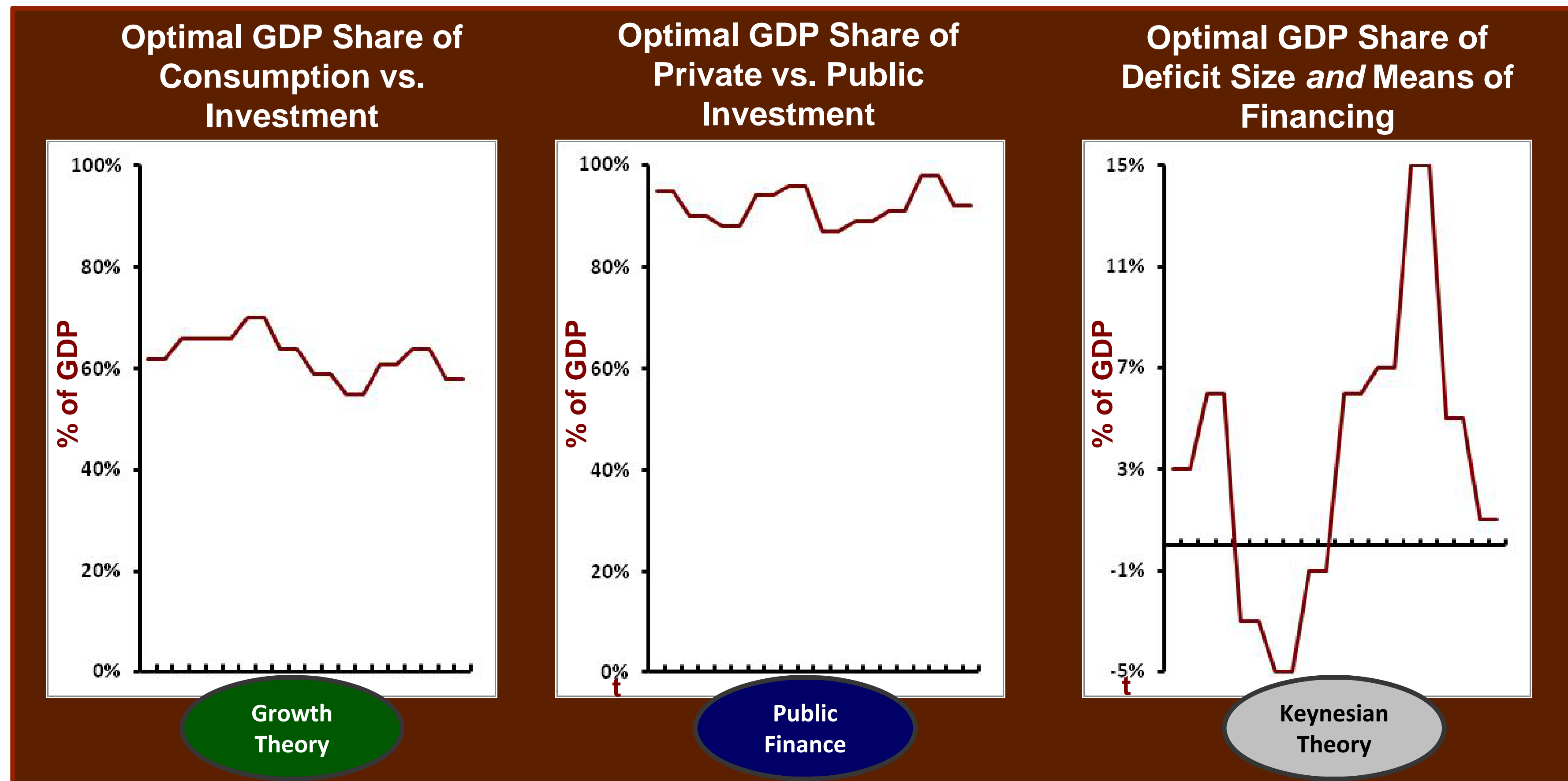
The Arrow-Kurz Generalization and Unification



NOTE: These three optimal "policy functions" are interdependent and thus must be solved for *simultaneously.* Macroeconomics is now unified.

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Mr. President: The Proposed Solution

The solution lies not in reducing the deficit for 15 years, but in fundamentally *reconfiguring the expenditures* that generate it.

Recall that there are three different kinds of government spending that (given government revenues) generate deficits:

1. **Transfer payments for consumption subsidization**
2. **Digging ditches to nowhere (*bad* public investment)**
3. **Digging ditches to somewhere (*good* public investment)**

The bond market only looks favorably upon type 3 spending.

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The Policies Required to Square the Circle

1. **Keep the deficit at 10.5% of GDP for the next 15 years.**
2. **Reconfigure government spending so that 10.5% of GDP each year is "good" *public* investment. No animal spirits needed.**
3. **Recall from the Arrow-Kurz analysis that "good" public investment requires investment in projects with *high* rates of return on capital invested. No boon doggles allowed!**
4. **Extend the Arrow-Kurz analysis via the Macquarie Bank (Australia) model so that a good portion of these projects can eventually be privatized.**
5. **Understand that the bond market will not view deficits resulting from such investments as problematic. Rather, they will see the true deficit as merely the *amortized* portion of the new public investments. Thus, the nominal $1.5 *trillion* deficit becomes a negligible $30 *billion* deficit.**

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An Aside on the Rate of Return on Public vs. Private Investment

Three reasons why greater public infrastructure spending is so attractive to the US (and to the UK) at this moment:

1. **The US has deferred spending on bullet trains, oil refineries, energy grids, basic research, airline terminals, and roadwork—thus *raising* the return from such investments today.**

2. **Only the government *can* carry out such needed investments. For the private sector *cannot* capture in its rate of return estimates the large "externalities" and "spillover effects" associated with projects like the interstate highway system, and the Kennedy space shot.**

3. **The risk premium appropriate for government investment spending is *lower* than that for private sector investment because of government's ability to "pool risks," as proven by Kenneth Arrow and Robert Lind in a classic 1970 article.**

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Additional Benefits of the Proposed Solution

1. **Switching $1.5 trillion of current government spending into investment spending annually will trigger remarkably high accelerator and multiplier effects. This will trigger an accelerating reduction in the unemployment rate which current transfer payment spending cannot.**

2. **The sharply increased investment in much-needed (i.e., high-yielding) projects logically implies a significant rise in productivity. This implies still faster growth of output *and* wealth.**

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