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11 December 2008 www.bbh.com/fx

What if the Credit Crunch is a Symptom?

Rare is a consensus among economists, the practioners of the dismal science. Yet there seems to be nearly universal agreement about the nature of the current crisis and the parallels with the Great Depression. The paralysis of the capital markets and the inability and/or unwillingness of banks to lend derailed the real economy. By word and by deed, officials and investors seem to concur, but what if they are wrong? What if the credit crunch itself is not so much a cause as a symptom of a larger, structural problem?

Since Milton Friedman and Anna Schwartz's 1963 *Monetary History of the United States* there has been a rough consensus among economists that the tightening of credit conditions triggered the Great Depression. Speaking as a Governor of the Federal Reserve Board, Bernanke offered these pearls at Friedman's birthday party in 2002 according to press reports: "I would like to say to Milton and Anna, regarding the Great Depression, you were right. We did it. We're very sorry. But thanks to you, we won't do it again."

In an editorial in the Wall Street Journal (18 October 2008), Schwartz identified tightening of credit conditions as the critical similarity between that crisis and the present one. The opinion-editorial pages of the leading newspapers and magazines are replete with similar arguments with only slightly variations on the theme.

The policy prescription is clear. Classical, neo-classical and supply-side economic theories agree: Resolve the credit crisis. Provide ample liquidity through financial triage and lender of last resort. This will renew incentives to financial disintermediaries to lend money to business, who in turn will invest, boosting plant and equipment spending, and in so doing create jobs, increase incomes and boost consumption. Re-opening the capital markets will return the economy to its growth path.

Shift in National Income Shares

While this seems like a compelling narrative, it seems to share the vulnerabilities that have signaled the death knell of other great theories: the historical record.

An alternative explanation begins with the recognition that the Great Depression and current crisis are linked by macro-economic similarities beyond the dramatic deterioration of credit conditions. The economic expansions that preceded both the 1929 crash and the more recent one shared the common feature of being driven by consumption, especially of durable consumer goods, rather than investment. And in both cases, the increase in effective demand was fueled not by higher real wages and salaries but by increased consumer credit.

Net private investment (net of depreciation) declined even as manufacturing capacity, labor productivity and industrial output increased. While it is often recognized that investment in plant and equipment is labor saving, most observers do not appreciate that it is capital saving as well.

This means the depreciation allowances for capital equipment can fund replacement of existing stock and it is this replacement that carries technological advances. Of course this has not always been true in the United States. Starting in the 1920s, this atrophy of new net investment became evident and then WWII and its aftermath reversed it temporarily.

These forces, and policy actions, produced a significant shift in national income shares away from wages and salaries and toward profits and dividends. Modern day Puritans harp on the fact that consumption in the US outstripped income (wages and salaries) claiming it is immoral. Few are willing to consider that for most Americans, the problem is not high consumption, it is low income.

Until the early 1970s, there was a social pact between that linked wages and salaries to productivity gains. However, various forces, including the decline of organized labor, have dissolved the pact. Since then real wages have largely stagnated while productivity has risen dramatically. To help blunt the impact of this, transfer payments—these take the form of "entitlement" and other social spending schemes.

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Consumption Key Not Investment

A shift in income shares also preceded the Great Depression. Work cited American historian James Livingston (Rutgers) found that 90% of American taxpayers had less disposable income in 1929 then they did in 1922, while corporate profits were up by nearly 2/3 and dividends doubled. The top 1% of tax payers experienced more than a 60% increase in disposable income.

This combination of a shift in national income shares and a decline in net new investment gave capital few outlets, including conspicuous consumption. It produced a speculative bubble of historic proportions. In the 1920s it was equities. This time it was mainly real estate and derivatives, but also commodities, emerging markets, and other asset classes. These forces finally choked off the household's access to credit and, therefore, effective demand for consumer durable goods.

New net private investment did not lead the recovery in the 1930s and it most likely won't lead this recovery either. The capital stock per worker was actually lower in 1939 than 1929, though national output and income had regained pre-Great Depression peaks by 1937. The historical record is clear: the recovery 1933-1937 was fueled by the rising demand for consumer goods. Rising consumer demand was a result of a shift in income shares from profits and toward wages. This was paid for by government spending, and re-enforced by a re-invigorated labor movement.

Economic upswings since have also been fueled by the demand for consumer goods not investment goods. The famous Reagan tax cuts in 1981 aimed at fueling investment didn't. The top 50 corporate beneficiaries actually reduced capital expenditures in 1982 and 1983. Net new investment trended lower throughout the 1980s. Nor has President Bush's tax cuts stimulated new net investment; something many astute observers have recognized.

Policy and Investment Implications

This alternative narrative has significant policy and investment implications. The imbalance that policy makers should address is the imbalance in the shares of national income. In a rising tide, by all means, help the people with the boats, but it is the consumer that has the boats.

Consumption accounts for more than 2/3 of the US economy and government spending accounts for the vast majority of the remainder. Contrary to the inherited wisdom, there appears to be no correlation between lower corporate taxes, increased net investment and economic growth. Indeed growth has consistently been recorded even as net investment has fallen.

Whereas the conventional view claims the underlying problem is one of a shortage of liquidity and credit, this alternative suggests that to the contrary the problem is one of surplus capital. Like the proverbial dead atheist that is all dressed up with no place to go, the economy is a victim of its own success. Businesses have been very successful in accumulating wealth, with the help, of course, of favorable tax and regulatory policies, but at the same time, the extensive deployment of capital-saving technology prevented the emergence of new profitable investment opportunities. This drove capital deployment to balance sheet engineering, speculation and ultimately its destruction in historic proportions. .

If the credit crunch is indeed a symptom of deeper structural forces, then the solution now, like the 1930s, is to promote consumption through fiscal policy (tax incentives to purchases of consumer durables, a cut in payroll taxes), higher and longer unemployment compensation and massive public investment. Re-linking wages and salaries to productivity growth is not simply a function of fairness, but an issue of economic necessity.

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