

# My Nominations for the Most Egregious Economic and Financial Myths of Our Time

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While it will likely take years before the definitive history of the recent financial crisis is written — John Kenneth Galbraith's *Great Crash of 1929* was published in 1954 — I believe there are already a number of myths about the crisis and beyond that economists and investment managers would do well to puncture. It is difficult enough to understand accurately the past and try to forecast the future; persistent myths only further cloud our vision.<sup>1</sup> Economists and investors need to define what they truly know and, more importantly, what they don't know. I believe that exercise should include debunking myths that are repeated so often they become a kind of conventional wisdom that casts more heat than light on the pressing questions of our time. In that spirit, I have drawn on my 50 years of investment experience (and ample opportunities to demonstrate what I don't know) to offer my personal baker's dozen of what I believe to be the most egregious myths about the crisis that keep us from understanding what went wrong in the first place; myths about what it will take to restore economic stability and growth; myths about the lessons to be learned so that we can keep from repeating the same mistakes in the future; and perhaps most importantly, persistent myths that must be addressed lest they become the source of future crises. Angry letters welcome to [ELadd@standish.com](mailto:ELadd@standish.com).

## Myths About the Crisis That Keep Us from Correctly Understanding What Went Wrong in the First Place

### **Myth #1 - Subprime Mortgages Caused the Global Financial Crisis**

Given the severity of the crisis, it is important to get the source of the problem right. Many recent, excellent books highlight the deterioration of subprime lending standards and the role of Fannie Mae and Freddie Mac in facilitating that lending.<sup>2</sup> My conviction is that the causes of the financial markets crisis went well beyond subprime lending, and included enormous complacency and mispricing of risk across virtually all asset classes. Focusing solely on the subprime segment of the mortgage market ignores other highly leveraged vehicles that added to the market meltdown. These include

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<sup>1</sup> Professor Galbraith was said to define two classes of forecasters: those who don't know and those who know they don't know. I would add a third: those who assess the false assertions of others who think they know.

<sup>2</sup> See, for example, Michael Lewis's *The Big Short* and Roger Lowenstein's *The End of Wall Street*.

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Alt-A, no-document loans (the delinquency rate for jumbo mortgages is running higher than the overall delinquency rate<sup>3</sup>); the huge premiums on corporate leveraged buy-outs; dizzyingly high levels of leverage in hedge funds and investment banks; and covenant-lite commercial loans. I believe risk was wildly mispriced, as evidenced by phenomenally tight spreads among lower grade bonds, exceedingly low levels of imputed volatility in equity markets, improbable expectations of continued double-digit housing price appreciation, and mega acquisitions of commercial real estate with low cap rates. Many of these problems were, in my opinion, aided and abetted by aggressively easy monetary policy.

#### **Myth #2 - Markets Are Efficient**

While the academic debate on this continues, I think the easier fundamental question is: "Are investors rational?" If they are not rational, then it is hard to argue that markets are efficient. The most recent bubble confirms previous indications that investors are often not rational, chasing performance, buying high and selling low. Studies show that even in periods of high long-term returns from common stock, equity mutual funds with transaction costs and fees underperformed equity indices; and actual shareholder dollar-weighted returns substantially underperformed mutual funds as herd-like investors either chased recent success or fled equity sectors in an untimely fashion due to recent underperformance.

### **Myths About What It Will Take to Restore Economic Stability and Growth**

#### **Myth #3 - Fiscal Austerity and Recovery Will Always Co-Exist Harmoniously**

European Central Bank President Jean-Claude Trichet has explicitly said it is wrong to think that fiscal austerity is a threat to growth and job creation.<sup>4</sup> However, economic recovery amid deficit reductions in the past typically coincided either with sharply declining interest rates (the 1980s), tapping large reservoirs of excess household savings (the U.S. in 1945), or currency depreciation against trading partners. Today, interest rates are already extremely low, household savings in developed countries are still quite deficient, and virtually all major trading partners are pursuing fiscal retrenchment simultaneously. Because the world has no natural offsets to fiscal austerity, I believe reining in government spending dramatically at this time would threaten economic recovery.

#### **Myth #4 - Deflation Risk Is Tied to Current Core CPI**

Once again, markets and central banks are spooked by deflation. The fear is that with zero-bound interest rates, deflation would prompt an involuntary rise in real interest rates and that the servicing cost of past nominal debt would spiral in a world of declining nominal income. Given current economic slack, it is not surprising that inflation is receding, with the most recent 12 months' core Consumer Price Index and Personal Consumption Expenditures in the U.S. at 0.9% and 1.3%, respectively.

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<sup>3</sup> Michael David White, "Accelerating Jumbo Mortgage Delinquencies Will Hurt High-End Property Values," *Seeking Alpha*, June 21, 2010.

<sup>4</sup> *The Wall Street Journal*, July 27, 2010.

While inflation has decelerated, I believe the driving force is not retrospective price trends but rather the impact of inflation *expectations* upon future investment and economic behavior. Given the implied inflation rate in ten-year TIPs of almost 2% or the surveys of long-term inflation expectations of close to 3%, deflation fears are not supported by the numbers. I believe it is future expectations rather than historical inflation that influence economic behavior and should influence monetary policy.

#### **Myth #5 - Allowing the Bush Tax Cuts to Expire Will Bring Disaster**

The tax change effects, especially for allegedly “sophisticated” high income investors, have already been highly publicized. The default forecast should be expiration of the tax cuts. As such, it seems logical to me that the anticipated event has already been heavily discounted so that the effect of the actual event will be relatively small.

#### **Myth #6 - Chinese Currency Appreciation Will Materially Help the U.S. Economy**

Over the years, the Chinese have been under intense pressure from the U.S. Treasury and Congress to stop “manipulating” the renminbi (RMB) and let their currency appreciate, thereby reducing the U.S. trade deficit with China and spurring U.S. job creation. But I believe RMB revaluation is not nearly all it is cracked up to be: China is to a significant degree a processing economy that imports raw materials and exports finished products. A revaluation of the RMB against the currencies of China’s trading partners might dampen export demand for Chinese goods but also reduce China’s import costs, thus having relatively little impact on the Chinese trade surplus. To the degree that China becomes a higher-cost country, more of the low-cost U.S. imports will emanate from China’s lower-cost competitors such as Bangladesh, Cambodia, or Vietnam. Most importantly, the U.S. has a bilateral trade deficit with China, but also needs to import multilateral foreign capital to offset domestic investment and governmental deficits in excess of domestic savings. That foreign capital import will persist as long as the imbalance between U.S. domestic savings and investment continues, regardless of trade with China.

### **Myths About the Lessons to Be Learned So That We Don’t Repeat the Same Mistakes in the Future**

#### **Myth #7 - Bubbles Needn’t Be Pricked; Central Banks Can Pick up the Pieces Later**

One thing we do know for sure about bubbles is they are an unresolved issue for central banks. Former Fed Chairman Alan Greenspan is on record as saying that burst bubbles are scarcely benign, but the consequences need not be “catastrophic” for the economy.<sup>5</sup> However, we know that the bursting of the recent US housing bubble and resulting global credit crisis were catastrophic. While central banks have mobilized all weapons at their disposal, economies are still weak, private credit is still contracting, and the creditworthiness of many banks and sovereign governments is still in question. It is by no means clear that central banks know how “to pick up the pieces later.”

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<sup>5</sup> Statement by Greenspan before the Joint Economic Committee of the U.S. Congress, June 17, 1999. In the same statement, Greenspan says: “Bubbles generally are perceptible only after the fact.” Three years later, on August 30, 2002, Greenspan said: “The idea that the collapse of a bubble can be softened by pricking it in advance is almost surely an illusion.”

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While I don't necessarily aspire to Bhutan's gross national happiness index, I do think we need more broadly defined measurements of economic health and growth.

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### **Myth #8 - Inflation Targeting Should Be a Major Foundation of Monetary Policy**

Notwithstanding the failures of monetary policy to address bubbles and their aftermath, the U.S. Federal Reserve in particular still clings to the notion that inflation targeting is desirable.<sup>6</sup> A new school of thought calls for the Fed to adopt a still higher (implicit) inflation target to try to spur consumption and investment and avoid the perceived problems of deflation. In my opinion, beyond the failure of the Fed to deal with the consequences of its previous, excessively easy policy, there are still profound uncertainties about inflation targeting. One key question is what measure of inflation should be used for targeting. Core prices? Headline inflation? Asset prices? Different inflation metrics can yield wildly varying data. What time period should "anchor" inflation expectations? Should the central bank extrapolate from past inflation or attempt to predict future inflation? What happens if investor expectations diverge from central bank expectations? I acknowledge that conducting monetary policy is exceedingly difficult and growing ever more complex. At the very least, however, I believe the Fed should not ignore asset price inflation as it did in the recent bubble when asset risk was severely underpriced.

### **Myth #9 - GDP Is the Best Measure of Economic Health**

Virtually everyone relies on GDP as the single best measure of activity and economic health. In addition to the usual anomalies that plague all economic statistics, I believe there are serious fundamental problems with GDP. It measures *gross* rather than *net* activity, excluding depreciation,<sup>7</sup> which represents almost \$2 trillion of \$14 trillion in U.S. GDP. Would anyone (other than perhaps leveraged buy-out shops looking for a quick flip) look at a corporate income statement and ignore depreciation and the replacement cost of capital assets? The calculation of growth also suffers from the usual base effect: a weak prior period always makes the subsequent growth look better. The GDP number does not account for excessive debt burdens, poor infrastructure, weak educational systems, or insufficient long-term productivity enhancements. There is also no allowance for out-year liabilities in GDP calculations (see Myth #10), thus potentially understating a country's economic problems by a wide margin. While I don't necessarily aspire to Bhutan's gross national happiness index, I do think we need more broadly defined measurements of economic health and growth.

## Persistent Myths That Must Be Addressed Lest They Become the Source of Future Crises

### **Myth #10 - Current Government Deficit Relative to GDP Accurately Defines Sovereign Debt Risk**

From Greece to Japan, the hand-wringing is about current-year reported fiscal deficits as a percentage of GDP, sometimes even outstanding debt as a percentage of GDP. The European Growth and Stability Pact requires member countries to have annual fiscal deficits of no more than 3% and total debt no more than 60% of GDP. All these figures leave out the present value of future liabilities, stemming predominantly from retirement and healthcare liabilities, which pose a far larger source of sovereign

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<sup>6</sup> Vice Chairman Donald Kohn's speech in Atlanta, January 3, 2010: "Monetary policy generally operates with one instrument - a short-term interest rate - and using it to damp asset price movements implies *more* (author's italics) medium-term variability in output and inflation around their objectives... We do not have good theories or empirical evidence to guide policy makers in their efforts to use short-term interest rates to limit financial speculation."

<sup>7</sup> Technically known as capital consumption allowance.

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debt risk. A recent article by Peter Peterson,<sup>8</sup> citing Congressional Budget Office projections, contends that current U.S. policies will result in a public debt of 500% of GDP in 50 years<sup>9</sup> as future liabilities become actual debt. In the U.S., the out-year liabilities far exceed the explicit public debt. My own calculations suggest out-year liabilities easily add up to \$60-70 trillion in the U.S. Two studies<sup>10</sup> indicate that California's unfunded pension liability may be half a trillion dollars, almost seven times its official debt. Estimated unfunded state and local pension liabilities may be \$3-4 trillion.<sup>11</sup> My guess is that almost all developed countries have future liabilities of 300% to 500% of GDP. We insist on accrual accounting for corporate balance sheets but condone cash accounting for government balance sheets. I believe that never before in the history of civilization have future liabilities accounted for such a high proportion of current economic activity.

#### **Myth #11 - Buying Stocks = Investing**

To me, investing involves the reasonably efficient allocation of capital to contribute to the long-term health, productivity, and sustainability of the economy. Warren Buffett's hero investor Benjamin Graham emphasized the distinction between investing and speculating. Current data suggests more of the latter is occurring: equity market trading in the U.S. during 2009 amounted to \$47 trillion,<sup>12</sup> compared with an overall equity market capitalization of only \$15.1 trillion; the turnover rate was 310% and the average holding period was about four months (the relatively undeveloped Chinese market was a distant second with turnover of *only* about 175%). Vanguard founder Jack Bogle has noted that "in 1950, the turnover of the New York Stock Exchange was 25%; now its 250%."<sup>13</sup> For me, that level of short-term churn amounts to speculation, not investment. It may or may not be profitable, but it bears virtually no relationship to the long-term health of global economies.

#### **Myth #12 - Governments Can Solve Pension Liability Problems by Issuing Bonds**

The State of New York recently considered issuing bonds to generate cash needed to fund pension obligations, i.e., creating a stronger contractual liability versus a somewhat weaker one. In an even more counterintuitive twist, the state wanted to issue the bonds to the state pension funds themselves. The state pension funds have an assumed investment return of 8%, but the tax-exempt bonds would presumably yield only a bit more than 3%, a negative cost of carry of about 5%. The magical thinking is to leverage the pension funds and hope that by holding risk assets on margin, the riskier assets in the fund would recover sufficiently in market value to reduce the unfunded liability before the state-issued bonds mature. This strikes me as myth-making on a grand scale.

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8 Peter G. Peterson, "Tax Aversion Syndrome and Our Deficit Future," *The Wall Street Journal*, July 24, 2010.

9 The most dramatic statement I have seen is the article by Professor John Taylor of Stanford writing in the *Federal Reserve Bank of St Louis Review of May/June 2010*, projecting U.S. federal debt late in this century to be close to 800% of GDP.

10 *The Economist*, June 26, 2010.

11 R. Eden Martin, "Unfunded Public Pensions: the Next Quagmire," *The Wall Street Journal*, August 19, 2010.

12 *The Economist*, July 10, 2010.

13 Interview with Jack Bogle by Dr. Mark Skousen, May 3, 2010.

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So the next time “experts,” who purport to know what they don’t really know, begin expounding on the wonders of companies with no revenues yet skyrocketing stock prices or housing markets that are sure to defy gravity indefinitely, remember: *plus ça change, plus c’est la même chose.*

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Underfunded pensions are a global problem that is becoming more pressing in countries like the U.S., Russia and China where large portions of the population are reaching retirement age. In the U.S. alone, beginning in 2011, four million baby boomers will reach age 65 every year for 18 years. That’s more than 10,000 people turning 65 every day. And we know that some state, local and private pension plans are underfunded to such a degree that only a coordinated and far-reaching array of policy changes and incentives will address the fundamental underlying issues.

**Myth #13 - This Time Is Different**

Perhaps the best debunking of this myth is the recent book by Kenneth Rogoff and Carmen Reinhart of the same title. The authors meticulously dissect “eight centuries of financial folly” to highlight the parallels of financial crises across time and geographies. So the next time “experts,” who purport to know what they don’t really know, begin expounding on the wonders of companies with no revenues yet skyrocketing stock prices or housing markets that are sure to defy gravity indefinitely, remember: *plus ça change, plus c’est la même chose.*<sup>14</sup>

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<sup>14</sup> “The more things change, the more they stay the same.”



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Ted's distinguished career began at Standish, Ayer & Wood in 1962, and he was named Chairman in 1989. He became Chairman of Standish Mellon Asset Management in 2001 and Chairman Emeritus in 2004. He is a Director of the Conservation Law Foundation, Land Trust Alliance, A Better City, The Trustees of Reservations, and The Boston

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