



Global economic recovery has been hindered by a massive game of Old Maid. Who will be forced to bear the losses generated during the downturn? Only when the losses are put behind us will the world be able to focus on creating new wealth.

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The world's economic problem is best summarized by the fact that while, for the past 20 years, Germany, Italy and Japan have been among the worst developed world governments in terms of providing a healthy environment for economic growth, today, Germany is by far the best in this regard – even though it is no better than it was 20 years ago. The problem is that Italy and Japan have gotten far worse, as have the United States and the United Kingdom. Germany is the best, not because of its achievements, but rather because of the degradation of its competitors.

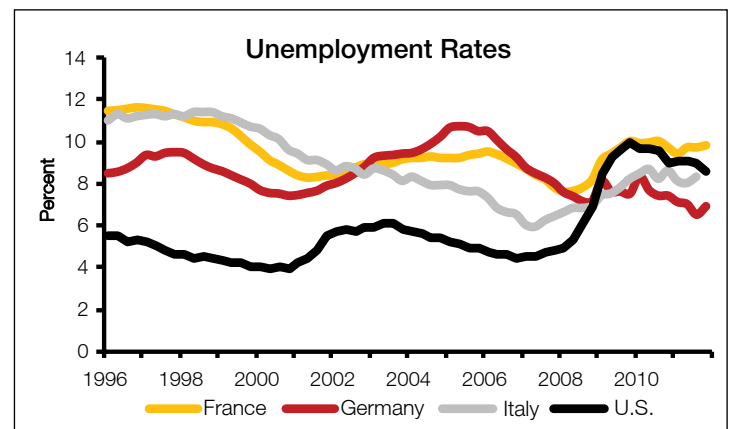
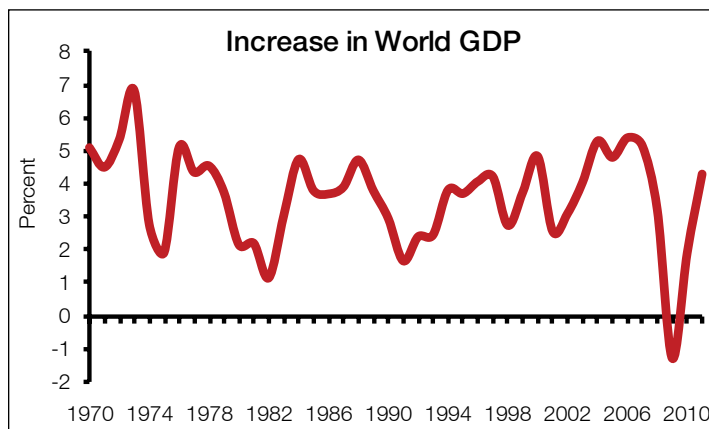
Europe. Historians will one day find it hard to believe that the ill-fated European experiment with a common currency ended because of the excessive spending and lies of tiny Greece. In many ways it is similar to the assassination of Archduke Ferdinand in Serbia leading to the slaughter of World War I. The truth is that the Euro was dead upon inception, with the only question being precisely how and when it would die.

Bad money always drives out good money. Hence, poor PIGIS fundamentals have debased the Euro. The Euro was never popular with Europeans. It was always driven by the political elites who desired to tie their fates to those of Germany and France. While reducing trade barriers was essential to the economic growth of Europe, a common currency was — and remains — superfluous. This is underscored by the fact that the United Kingdom, Switzerland and Norway are none the worse for having remained outside of the Euro.

Absent the free movement of labor across Euro members, and with capital movements highly restricted (particularly in the financial services sector where national heroes are sheltered from competition), there are insufficient adjustment mechanisms to maintain a single currency. Add to this that there is no common fiscal policy and no sovereign backing, and its fate becomes transparent.

To address the lack of a common fiscal policy, the founders established a treaty requiring member country annual budget deficits not exceed 3% of GDP. This treaty was intended to rein in runaway government spending (think of Greece). This 3% rule was quickly abandoned as countries, big and small (including Germany and France), regularly ignored the treaty with impunity, while Greece (and other countries) simply lied to seemingly satisfy the criteria. In fact, over the last three years almost no member satisfied the 3% budget threshold. Nor will they in the near future. Thus, while the founders of the Euro clearly understood the need for fiscal restraint when establishing a de facto fixed exchange rate system, they forgot that history shows that European treaties are made to be broken. It is hardly surprising that when Greek sovereign debt was priced the same as Germany's, in spite of a massively weaker ability to support this debt, they borrowed to the breaking point.

A common trade area does not require a unified currency. For example, the U.S. and Canada share a trade zone, but not a common currency. Similarly, Switzerland, Norway and the United Kingdom are all part of the European trade



zone but function very nicely outside of the Euro. The impossibility of maintaining the Euro is underscored by the fact that the member nations have fought centuries of wars, do not speak the same language, have very different cultures, possess very different tax systems, have huge variations in the extent to which they have underground economies and utilize different social retirement systems. Reaching an agreement is hard enough in the U.S., where everyone basically speaks the same language, there is the same basic tax and legal system, we have rarely been at war with one another, there is a minimal underground economy and we share a common social retirement system. Reaching agreement in Europe is far more difficult than in the U.S., and it is apparently impossible here!

Some say with no trace of irony that since the Euro treaty does not allow countries to withdraw, the Euro will survive. And why does this aspect of the treaty matter any more than those broken every day? After all, the 3% rule was completely ignored by Euro members and European history is awash with an endless number of broken military treaties. In this light, withdrawing from the Euro is a relatively trivial treaty breach.

There is simply not enough European bank capital to cover the losses associated with Greece and any defaults by Spain, Portugal or Italy. European regulators are hesitant to force banks to bring in new capital lest current bank shareholders be diluted. But new capital is critical if sovereign losses are to be recognized. Whether this capital comes from governments or private investors is a political (not economic) choice. We suspect that in France and Germany the capital will primarily come from government rather than private investors.

Germany and France must decide how long they want to prop up the inevitable Euro collapse. And, as we have previously mentioned, the power of a determined

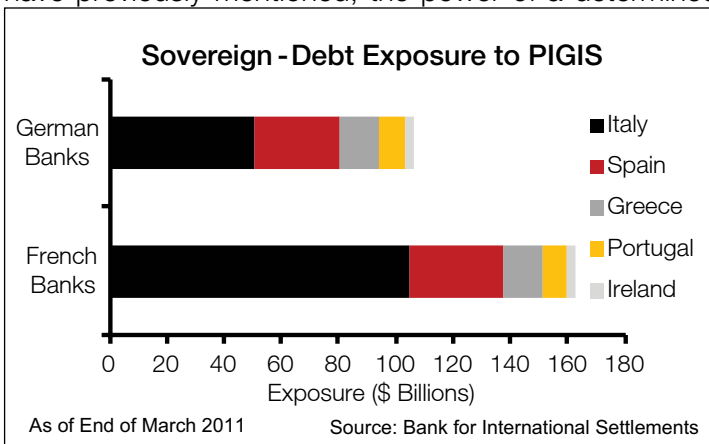
sovereign is an awesome thing. Hence, although the Euro should be long dead, we suspect that it will limp along for several more years via handouts from the French and German governments. The tough decision is whether they hand the money to the Greeks (or Italians) in hope that the Greeks give it back to the French and German banks, or simply refuse to hand it to the Greeks for fear that they will not give it back, and then directly bail out French and German bank losses. In the meantime, the uncertainty about who will bear these losses is part of the global game of Old Maid which is crippling the global economy.

Asia. China and India are perpetual motion economies on steroids. Every year these economies urbanize 15-20 million people each. This not only allows the arbitrage between subsistence farming and a quality of urban economic life à la Spain, but also triggers an enormous need for housing and urban infrastructure (both public and private). As long as this urbanization continues, huge employment opportunities and enormous profits from construction activities exist. For example, 18 million urbanizing Chinese means roughly six million new housing units are required annually for these migrants. And another six million the next year, etc. Building this stock requires millions of jobs, as does the construction of the requisite roads, sewers and attendant infrastructure. As long as these migrants are successfully absorbed, the perpetual motion machine and rapid economic growth continue.

The risk is that if, for any reason, this perpetual motion process stops, it will turn ugly rapidly as new homes will remain unsold, construction will cease, employment opportunities will plummet creating less reason to urbanize causing government revenues from land sales to plunge and social discontent to rise. All this is to say, the larger the scale of the economic perpetual motion machine, the harder it is to stop; but once stopped, the harder it will be to restart.

China is light years ahead of India in terms of valuable economic infrastructure. Offsetting this advantage is the fact that India possesses a mastery of English - the global language. India is also aided by the presence of a democratically elected government, which eventually should provide greater social and economic stability.

China and India have been the rising stars within the global economy for the last few years, with 2010 estimates of real GDP growth rates at 10.3% and 10.4%, respectively. They are the world's two most populous nations,



accounting for nearly 37% of the world's inhabitants. Yet, despite these similarities, China is much further along in its economic development than is India.

As expected, GDP per capita has risen dramatically over the last four decades in both countries. Poverty ratios have decreased, capital investment has soared and internet and motor vehicle usage have increased. While both countries have made significant progress with respect to each of these metrics, China is well ahead of India in nearly every case. A highly urbanized population percentage is the hallmark of developed nations, and from 1981 to 2009, China's urban population grew from 20% to 44% of its total population, while India's rose from 23% to 30%.

China's infrastructure spending continues to outpace India's, with China spending about 9% of its GDP on infrastructure, or almost \$530 billion a year. On the other hand, India's plan for 2007-2012 called for \$500 billion in infrastructure spending over five years, with estimates for the 2012-2017 plan calling for another \$1 trillion. China's total capital investments, which amounted to \$1.8 trillion in 2008, were about 4.5 times greater than India's.

Both countries are plagued by a lack of transparency and extensive corruption, which needlessly raise risk premiums for dealing in these countries. In addition, India suffers from a "Hindu culture" acceptance of one's lot in life, relative to China's unbridled passion for profits and advancement.

China's centralized, consensus decision making works well – as long as good decisions are made. After all, benevolent and omnipotent dictators are tough to beat

as a form of government. However, history has repeatedly revealed that dictatorships are never omnipotent, and very rarely benevolent. The risk is that eventually they will make bad decisions. In fact, history suggests they will eventually make very bad decisions (like China's "ghost cities"). And large, centralized, consensus decision making is ill-suited to resolving mistakes, as inertia and lack of a consensus make the needed changes nearly impossible. This has been the case in Japan for over two decades (and the U.S. for almost four years).

The U.S. Meanwhile, the U.S. is three years into the most anemic recovery in post-WWII history, and the

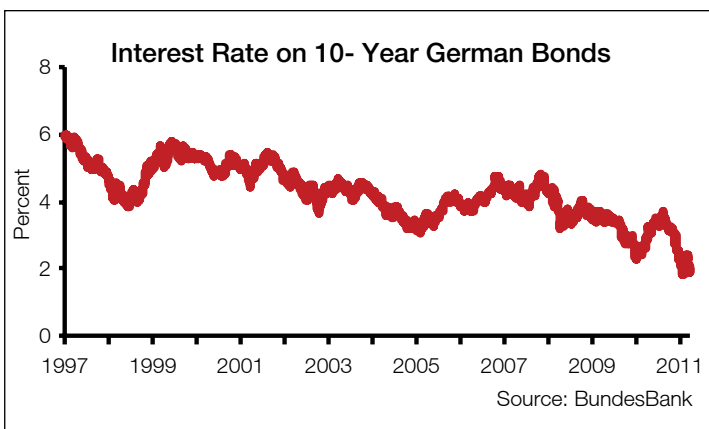
recovery will further weaken if Europe does not muddle through its mess. Everyone, including bearish forecasters, has been shocked by the weakness of the recovery to date. After a burst of growth surrounding the November 2010 elections, weakness returned as the fundamental collapse of stable and predictable rules for the economy resumed. It became clear within a few months after the

November 2010 elections that politicians of both parties were more interested in rhetoric than predictability. As government shutdowns and defaults were threatened by leaders of both parties, unpredictability soared. Meanwhile, the Obama administration issued new regulations and interventions in the belief that bureaucrats, not entrepreneurs, create growth.

The Obama administration has created economic chaos, reminiscent of the pre-Thatcher governments in the United Kingdom or any Italian or Japanese government of the past 20 years. Historically the impact of the federal government on real estate was second order of magnitude relative to business fundamentals. Today it is everything, because absent a legitimate and predictable government we have slipped into the abyss which has long punished countries such as Japan and Italy. As a result, the primary source of U.S. growth is population growth. So we grow slowly while Italy and Japan flat-line with their zero population growth.

The economic prominence of the federal government today is underscored by the disproportionate performance of the so-called Lobbying Index in recent years. That is, the stock prices of companies which spend heavily on lobbying have far outperformed the rest of the firms in

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the economy, a notable change from the past. In a world where rules change daily and there is an explosion of new rules, rule makers are more relevant than ever. And, as we recently discovered, many of our legislators have utilized this information to invest far more profitably than the electorate. Rules rarely change in baseball, football, Scrabble, Monopoly, chess or checkers, as absent clear and predictable rules, it is all about currying the favor of rule makers rather than effectively playing the game. The “rules explosion” changes the emphasis of the economic game from the players to the officials, to the detriment of the economy.

In spite of endless governmental activity and posturing, we are no closer to knowing who will ultimately bear the burden of the trillions of dollars of wealth lost when the housing bubble burst. This contrasts with the immediacy with which it was known who bore the wealth losses suffered when the Dot-com bubble burst. In the case of the Dot-com collapse, the losses were quickly realized by the equity investors and lenders who “bought the dream”. With the burden of these losses quickly established, we moved on to creating new wealth free from the fear that the losses would be redistributed. This decidedly has not been the case this time. Instead the bulk of the loss was shifted to the federal government via a series of breathtaking interventions (dare we say bail outs) by the Treasury and Fed.

The result is a staggering increase in the federal deficit, and four years on, we still do not know how this burden will ultimately be split among the citizenry. Will it be via taxes on everyone, or only the super rich? Via broad

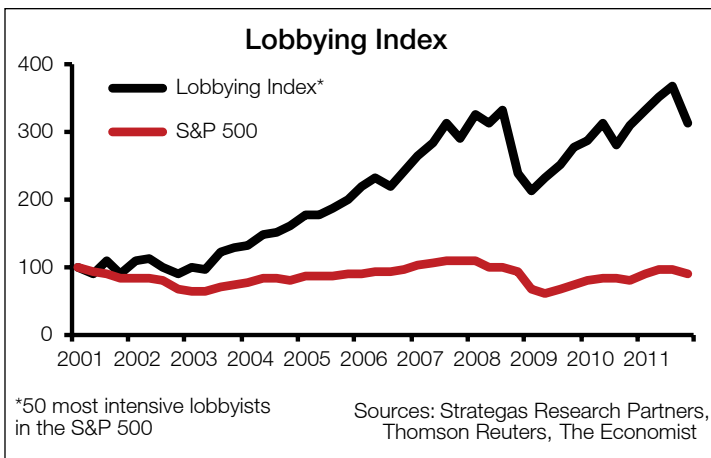
reductions in federal spending or through reductions in defense spending or entitlements? Or will we resort to the tried and true mechanism of inflating it away? Absent clarity on who will bear this burden, everyone assumes the worst, and acts defensively to avoid the loss burden falling on themselves. Instead of focusing on creating new wealth, we have devolved into a variant of Russia, where fighting over existing wealth trumps creating new wealth. It has become a game of “Old Maid” of epic proportion, where no one wants to get stuck with the Old Maid.

Absent leadership in any branch of government (and the recent collapse of the Congressional Super Committee demonstrated there is a complete leadership vacuum in D.C. today), this malaise will continue. We recall that 25 years ago, many in the U.S. wanted to become more like Japan; sadly, we have succeeded and have the anemic economic growth to prove it. In the meantime, our growth is largely dragged forward by increases in population rather than entrepreneurial activity.

Do not kid yourself: our government officials do not know the solution. If they did, they would have solved it three years ago. Instead they continue to do more harm than good, displacing private spending with record setting government spending focused on redistribution rather than wealth creation. This is viewed by Washington as “policy”, but as John Wooden used to tell his players, “do not confuse activity with productivity”.

The so-called Keynesian cry for increased government spending to stimulate the economy is woefully unaware of the foundations unpinning Keynes’ conjecture. His core suggestion was that federal budgets should be balanced over the business cycle, rather than in every budget year. Keynes noted that a year is an arbitrary time period, and theorized that in bad economic times, when consumers fail to purchase, the government should borrow from the future and run a temporary budget deficit in order to offset reduced private consumption. But Keynes was very clear that as soon as the economy returned to growth, the government must run an offsetting surplus to repay this debt, maintaining a balanced budget over the cycle. He agreed that government budgets must be balanced over time; his quibble was merely over the precise time period to achieve balance.

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Since we run large budget deficits in normal times, the Keynesian framework is irrelevant, as such deficits generate unsustainable federal debt levels which impair economic growth. Calls for stimulus spending ring hollow unless these proponents agree on how we achieve the subsequent budget surpluses necessary to offset the deficit periods over the business cycle. And we have heard no deficit proponent suggest surpluses as part of their call for increased government spending. They want larger governments and find Keynesian counter-cyclical spending arguments as convenient rhetoric to hide this expansion.

The real question is whether scarce resources are more efficiently deployed at the margin by the government or by the private sector. If the government more efficiently deploys resources, then increased government spending will increase GDP, though less than 1-to-1 due to the fiscal burden associated with the increased government spending. But if – as we generally believe – private consumption and investment is more efficient than government spending, transferring resources from the private sector to the public sector is a negative economic arbitrage activity which shrinks GDP. While the best research is generally consistent with a negative outcome, at best there is no evidence of any increase in GDP as government expanding increases.

One of the many nonsense statements we hear is that since “the government made money on TARP, TARP was a success.” But the private sector would have made far more if these billions had they been invested by entrepreneurs

rather than bureaucrats. The net result would have been a bigger economic pie, very different winners and losers, and quick settlement of who bears the losses. While the government may (or may not) ultimately make a little money on its investments in GM, Chrysler, AIG and banks, it came at the cost of wiping out long standing rules. It also imposed unforeseen losses on private bondholders who were crammed down by government dictate. And remember that private investors made far more money investing in Ford without any theft from bondholders. Further, if GM and Chrysler had not been bailed out, Ford investors would have fared even better.

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It is not government’s role to decide which firms get capital. That is the job of private investors. Recent efforts by the Energy Department to function as a private equity fund underscore government’s inability to effectively allocate scarce capital. The government’s job is to provide a transparent and fair playing field, not to be an economic player.