SPECIAL FX

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Amor Fati: Moving toward Our Maximum Regret

The risks are asymmetrical. Many of the world's national economies, in various stages of recovery, are still highly dependent on government support. While it is possible that the combination of aggressive fiscal and monetary policy responses have put the economies on a strong growth path, there remains a much greater risk that as the stimulus is removed the economies stagnate or worse.

Aborted recoveries are rare. They are the exception that proves the rule. Despite the gallons of ink spilled on prognostications of a "double dip" or a "W" shaped bottom, there have only been two in the U.S.—the Great Depression and the early-1980s Reagan-Volcker recession. They seem to be products of a policy error, like removing a splint too early from a broken bone.

Because fiscal and monetary policy options seemed largely exhausted addressing the recent crisis, to be hit with another one now would be particularly ominous and ruinous.

History Doesn't Repeat but Sometimes Rhymes

If the first rule for policy makers is to do no harm, the second is to minimize the maximum regret. Everyone wants to avoid the downward spiral of world trade, for example. Many, if not most, countries, contrary to their pledges, have ventured a bit down the economic nationalist path. However, the biggest disruption to trade was not so much a function of policy, but of the disruption to the capital markets in general, and trade finance in particular.

In addition, the very globalization that characterizes modernity combines two key elements that magnify the impact of a drop in a nation's output. First, it further develops and extends the division of labor that Adam Smith explored in The Wealth of Nations in a tour of a pin factory.

Second, by exploiting a number of technological improvements in transportation and communication, the different functions or elements of that extensive division of labor can be strewn across the world where it makes political and/or economic sense. Milton Friedman illustrated this by recounting how a pencil is made in Free to Choose. Few products are made wholly in a single country. A decline in demand is felt through the extensive global supply chain.

The point is that the world experienced a downward spiral in trade but not as a result of a Smoot-Hawley type of trade war. Most of the protectionist actions adopted recently appeared well after the downward spiral in trade began.

It is Political Economy

If the disruption of trade this time was not so much a product of human agency, the same cannot be said for the pressure to remove the fiscal and monetary scaffolding of the economy.

To be fair, there were some libertarians and economists from the Austrian School who were opposed to the scaffolding in the first place. But no responsible policy makers in any country advocated such a do-nothing course. By and large the fiscal and monetary efforts were seen as an issue of necessity, and in most countries they found support from the center-right to the center-left.

There does not seem to be much public outcry to rein in fiscal policy now; quite the contrary. Labor markets throughout the industrialized and developing world seem to have plenty of slack. Unemployment rates may not have peaked. What recoveries have taken place appear anemic by a range of metrics compared with past recoveries. There was a tremendous amount of apparent wealth destroyed and a major dose of economic insecurity injected.

If anything, there seems to be clamor for the various governments to do more, especially in terms of providing economic security and helping to create jobs. Nevertheless, there appears to be increasing pressure on policy makers to rein in fiscal policy.

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Bond Vigilantes vs. Democracy

The pressure appears to be coming from what used to be called bond vigilantes. The phrase is attributed to the Wall Street economist Ed Yardeni who is said to have coined the phrase in 1984 to describe fixed income investors who protest the (expansionary) monetary or/and fiscal policies of a government.

There is a tremendous supply of sovereign bonds that will be brought to market this year—several trillions of dollars worth. Countries are competing with each other to secure funding for their budget deficits, as well as the private sector, which still have access to only limited-functioning financial disintermediaries (banks and other financial institutions) and have been forced to raise funds in the capital markets directly.

There is a limited, though still large, pool of savings that the debt managers compete for. The managers of those savings, Yardeni's bond vigilantes, were collectively and broadly chastised for mispricing risk in the run-up to the crisis. They are being more discriminating now and this has forced interest rates higher, and dramatically so for some weaker sovereign credits.

In the post-crisis financially scarred world, the managers of savings have the ambrosia that is in much demand. As the over-subscribed reception to the recent Greek and Spanish bond auctions demonstrate, the vigilantes have not declared a capital strike, but they have demanded a greater risk premium (not just from these two countries but from the weaker credits generally).

In recent weeks, numerous countries appear to be almost tripping over themselves to appease the vigilantes, by reducing their budget deficits. However, there could be profound consequences if the braces are removed before the economic foundation is in place.

Life Blood

Nearly all policy makers share two key interests: lay the foundations for a sustainable economic recovery and unwind the emergency facilities and spending. There appeared to have been a consensus, giving more weight to the former than the latter this year. The bond vigilantes have instigated a disruption of that consensus much to the chagrin of the popular will. Indeed, those countries that capitulate the most to the vigilantes are likely to experience the most social push back. Stay tuned.

Ironically, the effect of the bond vigilantes and the social resistance may be similar insofar as the economic impact is negative. Ultimately what is at stake is the how the costs (broadly understood) of the bailouts and stimulus are going to be distributed, not just in terms of classes, but also sectors, industries and countries.

This is taking place along another potent but yet somewhat less personal of a force. Like a victim in a trendy vampire show, the life blood of the two largest economic regions, the US and Europe, is being sucked out.

Money supply, measured by the ECB's M3 has collapsed. In January 2009 it was growing at a 6% year-over-year pace. By the end of the year it was contracting at a 0.2% pace. It was contracting in both November and December. The next report is due January 25th and even if one is not a monetarist, the situation is worrisome.

It has been lost in the light of the preliminary 5.7% Q1 US GDP, but in the Fed's statement there appeared what seems like the first official recognition of the ongoing contraction in bank credit. The FOMC implies that this is being offset by improved financial market conditions. We thought so too.

But the capital markets are fickle and given the surge in volatility and the general deterioration of market conditions (should it persist), the risk is that it no longer is sufficient to offset the contraction in bank credit. Even if this is just a normal market correction, it could stall the economies at a crucial time.

The real tragedy is not what is happening in Athens, as painful as the adjustment promises to be. Rather the real Greek tragedy is that we are running quickly, even if not irrevocably yet, into precisely that which we wanted to avoid the most.

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