

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

Edward H. Ladd, CFA, Chairman Emeritus  
Standish Mellon Asset Management Company LLC

April 2012

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### Executive Summary

Ted Ladd has been monitoring and investing in the bond markets for Standish clients for 50 years. That experience makes him better suited than many to put the current recovery phase of global economies and financial markets into perspective. In 2010 Ted shared a broad range of what he believed were distortions and misperceptions about the causes of the financial crisis, suggested solutions to restore economic stability and growth, and the nature of capital markets and investing itself. Amid another year of macro uncertainty and market volatility, Ted has expanded his list of “egregious myths” about markets and economies in an effort to clarify thinking and facilitate effective policy action.

### Introduction

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. 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 opinion 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).

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### **Myth #1 - The U.S. Residential Housing Bubble 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 housing bubble. My conviction is that the causes of the financial markets crisis went well beyond housing, and included enormous complacency and mispricing of risk across virtually all asset classes. These included the huge premiums on corporate leveraged buy-outs; dizzyingly high levels of leverage in hedge funds and investment banks; and covenant-lite commercial loans. The European crisis illustrates that overleveraging was not purely a U.S. phenomenon. I believe risk was wildly mispriced in the run-up to the crisis, 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. There are many 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 performance.

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

Former European Central Bank President Jean-Claude Trichet explicitly said it was wrong to think that fiscal austerity was a threat to growth and job creation.<sup>1</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 many developed countries are still quite deficient, many aging workers are ill-prepared for retirement, 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. Greece is a leading test case of how austerity depresses economic activity and tax receipts, thus exacerbating the levels of deficits and debt relative to GDP.

### **Myth #4 - Cutting Governmental Deficits Automatically Enhances Long-Term Economic Growth**

Of course deficits may be pernicious and may crowd out private investment (no current evidence of this, with ten-year U.S. Treasuries yielding about 2%). All other things being equal, most would agree it would be better to have surpluses than deficits. However, today there seems to me to be vast confusion around "deficits" vs. "investment." For example, in my view deficit reductions requiring the elimination of kindergarten or the shortening of school days exacerbates the long-term educational challenges we face. Given chronic illnesses that are enormously costly over time, expenditure cuts for preventive health care (almost one-third of children in the U.S. are on Medicaid!);<sup>2</sup> will

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<sup>1</sup> *The Wall Street Journal*, July 27, 2010.

<sup>2</sup> "The Uninsured: A Primer," Kaiser Family Foundation, October 2011.

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be very detrimental to health-care costs in the long term. Infrastructure is critical to facilitate economic growth, but reduced investment on bridges, highways, public transit will surely be short-sighted. My belief is that discussions of deficit reduction should not be confused with critical investments that provide superior societal long-term returns.

#### **Myth #5 - A Balanced Budget Constitutional Amendment Will Help Long-Term Economic Growth**

I understand the need for long-term fiscal discipline and expense control but a balanced budget requirement is a fiscal straight jacket that ignores the cyclical nature of revenues and expenses as recessions diminish tax receipts, while stabilizers such as unemployment insurance or Medicaid increase expenses. The best example of the poor functionality of rigid balanced budget requirements is the situation in all states (except Vermont) that do, in principle, require balanced budgets. However, the recent downturn has produced large state deficits requiring either tax increases in recession and/or draconian expense reductions. These state governments have responded by imposing budget tightening but also by drawing on additional subsidies from the federal government (the availability of which would be vastly more restricted if there were a federal balanced budget constitutional requirement). It seems to me that "creative accounting" and ignoring the ticking time bomb of immutable future liabilities have also been part of state governments' tactics to "balance" their budgets, preparing the ground for larger crises ahead.

#### **Myth #6 - Government Budgets Are Comprehensive and Accurate**

There is a vast difference between government financial statements and corporate financials. To start with, government budgets are cash budgets. Government budgets do reflect debt service (including principal and interest) but not depreciation. Most importantly, there is a serious attempt in the corporate sector to recognize future pension liabilities, but not in the government sector. As I point out in myth #15, I estimate U.S. government out-year liabilities at \$60-70 trillion or four times U.S. GDP. In Massachusetts alone, 10 cities face a combined \$4.5 billion in unfunded healthcare benefits for public retirees.<sup>3</sup> Take the prescription drug program approved by a conservative Congress and President, which created in the stroke of a pen an estimated \$8 trillion future liability.<sup>4</sup> Lastly, and less important in the long run, governments on cash budgets do have the occasional practice of simply not paying their bills in the latter part of a fiscal year, letting the payable slide till next year. My advice: beware the accuracy of government budgets!

#### **Myth #7 - Deflation Risk Is Tied to Current Core CPI**

Central banks have been 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. While actual reported inflation may be low and diminish further with a large output gap, 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 over 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.

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<sup>3</sup> "Mass Cities Face \$4.5 Bln Unfunded Healthcare Costs," *PlanSponsor*, January 13, 2012.

<sup>4</sup> "George Bush's Legacy," *The Economist*, January 15, 2009.

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### **Myth #8 - 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.

### **Myth #9 - 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 was catastrophic. While central banks have mobilized all weapons at their disposal, economies and private credit demands are still at best sluggish, 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.”

### **Myth #10 - 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 has determined 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 #11 - Health Care Inflation Is Inexorable**

Health-care costs have been rising persistently but as American economist Herb Stein said: “If something cannot go on forever, it will stop.” At the risk of making a very early and incorrect call, I believe U.S. health-care inflation is about to slow dramatically and that health expenditures will no longer rise steeply relative to GDP. No one is quite clear why, but consumer utilization of health care services is leveling out. We don’t know

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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.”

<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* 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.”

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whether the cause is the weak economy, higher co-pays, postponement of discretionary procedures, and/or a fear of too many MRIs and CAT scans. Reimbursement increases from both private insurers and government programs such as Medicare and Medicaid are slowing dramatically. Price competition is increasing as pressure grows on “accountable care organizations” to deliver appropriate care where the best value can be found. Risk contracting is also rising, whereby providers are incented to do less or be penalized in the event of poorer medical outcomes. Lastly and maybe most contentiously, the U.S. has huge disparities of income, with the cumulative income of the top 1% of earners roughly equivalent to the combined income of the lower 25% of income recipients. When one calculates GDP, these incomes are aggregated. However, when one delivers a quasi public good service such as health care, there are, in my example, 25 times more “customers” in the lower income brackets where co-pays and out-of-pocket costs are vastly more economically painful. While outstanding health-care liabilities are still huge, there is a good chance that health-care inflation will slow dramatically and aggregate health-care costs will no longer be rising significantly relative to GDP.

#### **Myth #12 - Low Interest Rates Are an Unmitigated Blessing**

We all appreciate why the Federal Reserve is targeting low interest rates to stimulate the economy, but very low yields are a mixed blessing. The household sector is a net creditor and, over time, low yields on assets will depress income and be more detrimental on balance than reduced interest payments on liabilities (especially for retirees). Corporate and government pension funds will have larger unfunded liabilities. Insurance companies will have more difficulty meeting fixed liability costs, unless their assets and liabilities are very well matched. Low interest rates may encourage both desirable risk-taking and undesirable speculation, the latter a source of future financial vulnerability. In the long term, the U.S. needs to increase savings and reduce leverage, but very low yields encourage borrowing and discourage savings. Thus low yields may be beneficial to revive economic activity, but also have undesirable short-term and long-term impacts.

#### **Myth #13 - The U.S. Dollar Will No Longer Serve as the World's Reserve Currency**

I will not argue that the U.S. is without serious flaws. There are major questions of unsustainable deficits, large future liabilities, political will in imposing fiscal constraint, etc. However, the reality is the U.S. remains the world's largest economy and its most open capital market, with strong (admittedly imperfect) rule of law. What about the competition? Will the euro hold together given the major strains within the eurozone as well as disparities in income, competitiveness, and discipline among the euro nations, all with a common monetary policy and currency? How about the yen, with huge Japanese gross government debt, deteriorating demographics, and 20 years of poor economic performance? What about the rising power of the Chinese RMB which, despite its alleged undervaluation, does not yet offer capital account convertibility? There may be other currencies that have stronger merits, but their economies and financial markets are too small to serve for their currencies to serve as a reserve currency. My belief is that the U.S. dollar will remain by far the most important reserve currency for as far out as one can reasonably foresee.

#### **Myth #14 - 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 over \$15 trillion in US GDP. Would anyone (other than perhaps leveraged buy-out firms looking for a quick flip) look at a corporate income statement and ignore depreciation and the replacement

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

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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 #15), 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.

#### **Myth #15 - 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 original European Growth and Stability Pact required 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 debt risk. Peter Peterson citing Congressional Budget Office projections contends that current US policies will result in a public debt of 500% of GDP in 50 years as future liabilities become actual debt. In the US, 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 US. Estimated unfunded state and local pension liabilities may be \$3-4 trillion. 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 #16 - 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 US during 2009 amounted to \$47 trillion,<sup>8</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 it's 250%.<sup>9</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 #17 - 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*.

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<sup>8</sup> *The Economist*, July 10, 2010.

<sup>9</sup> Interview with Jack Bogle by Dr. Mark Skousen, May 3, 2010.



### **Edward H. Ladd**

Edward H. Ladd is Chairman Emeritus of Standish Mellon Asset Management Company LLC (“Standish”). Ted’s distinguished career began at Standish, Ayer & Wood — one of Standish Mellon’s predecessor firms — in 1962 and he became Chairman in 1989. He became Chairman of Standish Mellon in 2001 and Chairman Emeritus in 2004.

He is a Director of the A Better City, Conservation Law Foundation, Land Trust Alliance, and The Trustees of Reservations. Ted is Vice Chair of the Board of Directors of Beth Israel Deaconess Medical Center and an Honorary Trustee of Wheelock College. Ted is also Chairman of the Boston Committee on Foreign Relations, a member of the WGBH Board of Overseers, and a Trustee of the Massachusetts Taxpayers Foundation. He is a former Director of Citizens Financial Group, Harvard Management Company, and the Federal Reserve Bank of Boston. Ted has an M.B.A. from Harvard Business School and a B.A. from Yale University, holds the CFA® designation, and has 50 years of investment experience.

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