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Courage Must Trump Popularity in the New Normal



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PIMCO's "New Normal" view of the US economy is coming to fruition. Yet policymakers have tough but potentially productive options to address the structural problems now confronting our economy.

Six months ago, PIMCO's concerns about sub-par growth and above average volatility were at odds with the views of most investment managers, economists, Wall Street firms and even policy makers. Today, both the current performance of the US economy and the consensus for future economic growth are faltering, with market valuations following.

Despite a record cyclical policy response to the recession of 2008, the nascent recovery in US final demand (gross domestic product less inventories) has been the weakest in post WWII history, and the concomitant recovery in US household income (excluding government transfers) has been equally and utterly un-inspiring for consumer confidence. Housing, a typically leading and interest rate sensitive sector of the economy, has languished despite significant monetary and fiscal attempts at revival. Net investment in the US economy remains critically in a recession.

The core characteristics of the New Normal view we described a year ago remain firmly in play today: The economy continues to de-lever, policymakers continue to re-regulate, and both the financial and non-financial sectors of the US economy continue to face increasing political and economic pressure to de-globalise.

We believe this process will take a long time to complete. Meanwhile, US economic growth will be painfully slow and probably more volatile than many expect. If history is any guide, the process of de-levering, re-regulation, and de-globalisation following a period of significant economic imbalances will take about seven years to complete from the point of recognition. Depending on your point of view, we are in year two or three.

In the near term, in line with our view of above average economic volatility during the journey to a New Normal, the risk of another US recession is increasing. While the economy de-levers, private credit demand is anaemic. Without net increases in private investment, the recovery in household income needed to close the gap between cyclically stimulated consumption and structurally low employment will prove elusive. The lack of income growth will put pressure on public sector budgets, which in turn will force the economy to turn toward fiscal austerity just as underlying economic growth begins to stagnate again.

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Teen Drama Economy

In the face of this growing risk of a second recession, we believe the public debate between further stimulus and a turn to austerity is starkly incomplete: The debate should not be about whether fiscal and monetary policy stimulus is needed again. Instead, the debate should be about how fiscal and monetary policy can be re-tuned toward making medium-term structural changes in the US economy rather than addressing short-term cyclical demand. Much in the same way that every high school teacher - or for that matter every parent of a teenager in high school - is eventually confronted with the difficult choice between courage and popularity in dealing with difficult situations, US policymakers are now confronted with a difficult choice between making structural changes and addressing cyclical demand.

In our view, structural courage must trump cyclical popularity in the search for sustainable US economic growth. But the question remains whether policymakers possess the courage necessary to make difficult structural changes. A necessary first step would be to acknowledge the structural problems that are weighing on the US economy. Specifically, five structural problems in the US economy need urgent attention.

First, the US economy is dangerously out of balance between over-reliance on consumption and under-reliance on investment as a driver of growth. Consumption's share of gross domestic product has continued to rise even as employment has sagged, and investment has been ignored.

Second, the process of creative-destruction in the US continues to slow. In the financial sector, for example, lending is frozen because ex-ante economic capital is still insufficient, and the "too big to fail" problem is very much alive. In the non-financial sectors of the economy, the wasteful focus of monetary and fiscal policy on a housing revival has drawn valuable resources away from the non-housing sectors of the economy, which may be able to pull the US economy out of the New Normal.

Third, the effects of a waning US demographic are being ignored. Labour force participation is near a cyclical low, under-employment is near a cyclical high, the median duration of unemployment continues to increase, and the US is falling behind in the race to attract the best and the brightest from around the world. The long-term health of the US economy depends on an expanding tax base, and counter-acting waning demographics is critical to this goal.

Fourth, US intellectual property rights are being violated and these violations are being tolerated. Take, for example, the experience of the entertainment industry or Internet services industry in developing nations recently. If the economy is expected to continue on its historical path of technological evolution and secular productivity growth, it is imperative that US intellectual property be guarded with the same ferocity that US physical property is guarded.

And fifth, the cyclically adjusted US energy deficit continues to grow, placing pressure on the productive resources of the economy.

Policy Solutions

These are certainly daunting problems for any policymaker to tackle separately, let alone all at once. Fully recognising that any set of solutions aimed at addressing all these concerns together must be a "first best" recommendation, it is time to shift the

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debate toward attempting to do so. We believe solutions may include tax policy changes, sector-specific fiscal and commercial policy changes, immigration policy changes, and trade policy changes that can help to begin addressing the structural problems discussed here.

To rebalance consumption and investment in the US, a federal value added tax (VAT) on final consumption is necessary. The VAT should exclude intermediate points of sale, but be applied to all final sales of consumer goods across the economy. Energy consumption at the residential level should be taxed progressively based on an energy use per area occupied measure to reduce waste of residential energy across the US, freeing up household incomes for incrementally productive investment. Further, credit standards to consumers and property rights of creditors must be tightened. A significant driver of reliance on debt for overconsumption is the laxity of recourse in consumer credit.

To speed up the process of creative-destruction, corporate tax rates should be lowered on average to globally competitive levels. However, distributions of corporate income via dividends should be taxed at personal income tax rates so as to incentivize the creation and growth of small businesses. Further, companies engaged in financial intermediation should be charged a progressive balance sheet tax to encourage a more diverse ecology of institutions, and both the personal income and corporate income tax code should be made more progressive to pay for lower average corporate tax rates.

US government investment in private sector research and development should also increase substantially. This can be achieved in a sustainable manner by providing zero-cost long-term loans in exchange for equity warrants on high-tech start-ups with reasonable merit.

Finally, barriers to inter-state competition across the financial, insurance, and medical services sectors of the US economy should be substantially lowered to raise efficiencies and lower the costs of these specific services. Returns on capital to finance, insurance and medical care services are much too high and wasteful to the long-term outlook for US productivity.

To combat the effect of a waning US demographic, long-term fiscal spending commitments should transition to a means-tested basis and legislation amended to reflect lower unfunded liabilities.

Meanwhile, the minimum wage should be lowered to better reflect the reality of the economy and to raise the economic tax base. The median US household income has stagnated for nine consecutive years now while the minimum wage has risen, contributing significantly to a lower employment to population ratio, and exacerbating the effects of aging on the economy's potential.

Unemployment benefits should be extended, but with a pre-defined half-life of one year and a final maturity of five years. Taxes should be raised on the consumption of all goods that are deleterious to the life expectancy of the population. This would extend consumption taxes on tobacco to other unhealthy consumption items, like foods high in saturated fats, alcohol and the like.

The US should provide zero-cost, 30-year, education and re-training loans to the unemployed and provide similar credit to entrepreneurs willing to start non-profit

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private education institutions across the country so that the spiralling cost of education can be managed from both a supply and demand perspective. This should be done in tandem with efforts to increase the immigration of the “best and brightest” to the US, which may include eliminating alien worker visa caps, and introducing wider investment-based immigration programs aimed at expanding the economic tax base, reducing the glut of housing, and boosting overall aggregate demand.

To combat the leakage of intellectual property, the US should use every means available to aggressively pursue and prosecute foreign violations of US intellectual property rights under international trade law. This can be addressed via bilateral trade negotiations, bilateral capital negotiations, or if necessary bilateral military negotiations. The US should not ignore this structural problem, as it alone, more than any other, has the ability to reinforce the New Normal view even beyond the length of historical experience outlined here.

Finally, to close the energy deficit, the US should implement a 10-year investment program to nurture the road transportation architecture off gasoline dependence and on to a combination of electricity and natural gas. Large and medium cities should be provided with zero-cost long-term financing for building energy efficient public transportation grids. This will greatly reduce the forward current account deficit of the US, raise the value of domestic assets, and create long-term private sector investment and employment incentives.

Time to Act is Now

The secularly declining investment share of this country’s gross domestic product is a harbinger of trouble ahead, and a function of serial policy focus on cyclical demand management instead of secular supply management. An increasingly inflexible US labour cost regime, the rapid globalisation of goods and services production without adequate globalisation of intellectual property rights, the inefficient management of energy resources, and an overall rise in government regulations and interference to slow creative-destruction processes in the US are all contributing to the New Normal pathway.

To address these fundamental short-comings, reverse the economically and politically painful effects of the New Normal, and return the US economy to its path of high productivity, high returns on capital, and full employment, policymakers must seize their opportunity today to act with courage.

As with all difficult but necessary rehabilitations, courage will trump popularity in the long run.

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