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Hysteresis And The Conventional Wisdom



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The Less Bad economy propelled a heartening second quarter rally in stocks, credit, commodities and risk assets in general, but the bloom seems to have come off that particular rose in the past three weeks. Less Bad is currently being reconsidered as Not Good, and market pricing is adjusting accordingly: V-shaped markets can't long co-exist with L-shaped (at best) economic performance.

This sort of wrong-footing between financial markets and the real economy is simply the way they relate to each other: markets discount the economic future, and the economy is affected by, but lags, the markets. This sort of hysteresis is a form of frictional inefficiency that is inevitable and unavoidable in so complex a system as the global economy. It's not a simple matter, after all, to organize even a three-car parade.

From that perspective, it is possible to see the results of the G-8 summit meeting in L'Aquila, Italy, as less disappointing than a more immediate interpretation might have it. The chief executives of the world's leading mature economies signed on to the usual pieties regarding responsible public-spirited behavior but were unable to deliver much in the form of measurable commitments. It was agreed that world trade must be re-invigorated – the OECD estimates that real world trade will shrink by 16% this year, far in excess of the 2.2% shrinkage of world GDP in its latest projections – but despite “progress” having been made in negotiations, no finish lines will be crossed until the September G-20 summit in Pittsburgh, if then.

Climate change was another topic piously seen as an urgent problem for all but one on which no binding agreement could be achieved regarding mitigation. A big five of invited emerging market countries (China, Brazil, India, Mexico, and South Africa) served as critical kibitzers around the G-8 table, questioning the developed world's commitment to hard targets for control of carbon emissions while simultaneously expressing reluctance to make any commitments of their own. It was agreed that we're all in this together but a bottom line take-away must be that conditions are going to have to get worse before they can get better.

Just about the time that markets were marking down their take on the 2009-10 economic outlook, the IMF was publishing a less pessimistic set of quarterly projections. Its April numbers had come out just as the Very Bad economy was morphing into Less Bad and now, in what might be seen as another instance of hysteresis (unless it's two instances) – its somewhat better July numbers appear coterminously with renewed market jitters.

The IMF still expects a deep global recession to be followed by a weak recovery. Its own version of Less Bad is based heavily on a sunnier view of East Asian prospects, with significant mark-ups for China, Japan and the ASEAN Five. For which, read China: it's deceleration from smoking to merely quick developmental progress offers hope of a global engine to replace the tapped-out American consumer. George Soros has rejoined his old Quantum Fund co-founder, Jim Rogers, as a table-

pounder on the investment merits of China. "The Chinese, in my opinion," he was quoted by Bloomberg, "are going to gain in power and influence in a way that people currently don't recognize."

That very well might be. After all, they're cash rich, which is a good thing to be at a time of deep recession and stubborn bear markets in risk assets of all types. "Follow the cash" is a time-tested first principle for real estate developers and it should probably apply now to global economic projections. That long-established global locomotive, the American household sector, is heavily indebted relative to its income and the U.S. federal government is going increasingly into hock in its attempt to fill in the gap created by householders' forced saving. It is one of the timeless he-who's that when credit is in bad odor, he who has cash is king.

Soros – and today's conventional wisdom – is probably right that China will grow in power and influence in the years ahead. It seems inevitable, in the long sweep of history, that the United States, with 5% of world's population, won't be able to maintain its nearly 25% share of world GDP or its still larger share of global consumption. Either the "rise of the rest" or the decline of the West is likely to see

to that. But getting the long-term year-to-year, or even decade-to-decade, details right is likely to be as difficult as nailing quarter-to-quarter numbers when projecting out a year or two. China may have plenty of cash but it also has the challenge of ethnic and separatist strife in its western provinces, as Tibetans showed recently and Uighers demonstrated last week. Cash won't always be king.

Financial markets are having trouble figuring out just what is the nature of the cyclical recovery, if any, that lies ahead. It is far from clear that this is a "typical" business cycle and so we must struggle to understand it within a longer and broader sweep of history. Markets don't synchronize with the real economy; they anticipate and lead it. Short-term cycles are not the long-term trend: they vibrate around it, creating it as they go. Economists and others use the freshest data they can get – data that is no longer current by the time they get it – to project inferences into the unknowable future. All of these lags and shifts and cultural perspectives inform policy judgments that must be pushed through a range of governments and bureaucracies in order to influence economies and markets.

Except for all of the above, I think I understand it perfectly. Financial markets, however, have lately indicated some indecision. ■

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