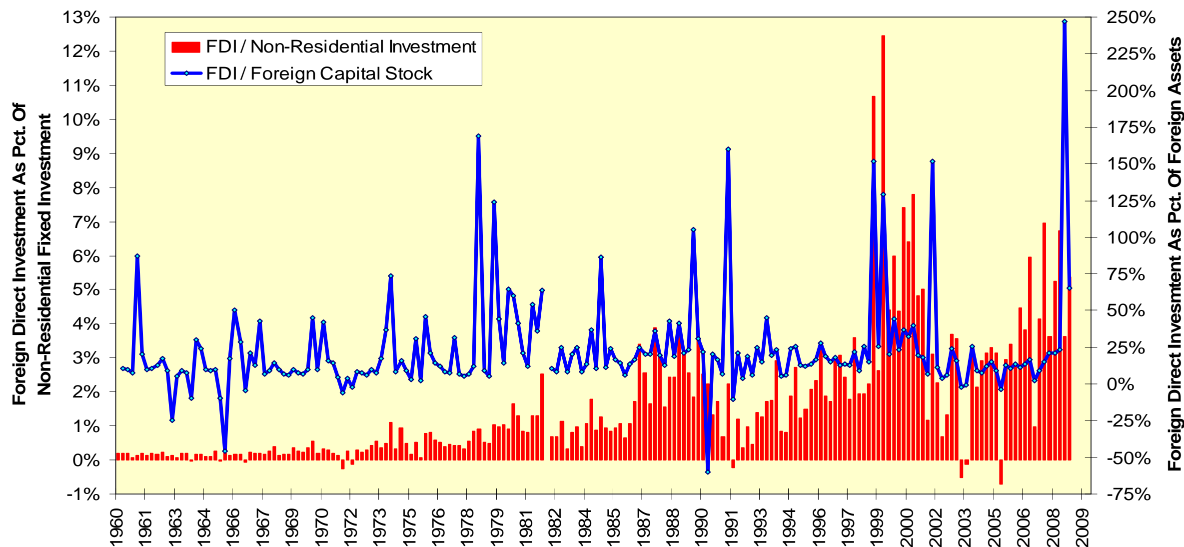
Capitalism Requires Capital

Let's say, just for the sake of argument, you are a certain export-dependent East Asian country with $1.95 trillion in foreign exchange. Your largest customer and the largest debtor to you is a certain North American country whom you suspect is counterfeiting the world's reserve currency and whose combined current account and federal budget deficits could swallow your reserves in one gulp.

You have to run a capital account deficit in order to maintain your current account surplus. Otherwise, all of those unattached young men – you have a 1.23 : 1 male-to-female ratio amongst your young people - who migrated into your cities from the countryside will either start rioting or be faced with the prospect of migrating back to the farms where they would face a lifetime of chasing water buffalo.

Given this choice, a rational investor would rather buy plant and equipment than portfolio investments. Of course, if you are China and saw your efforts to acquire Unocal stymied by the Bush administration or watched how Congress stuffed Dubai Ports' efforts to buy into U.S. port infrastructure and have seen how both Congress and the last two presidential administrations have run roughshod over property rights when it suits their short-term political needs, you might think twice about direct investments. The U.S. is the big loser here; while portfolio investments can come and go with the click of a mouse, direct investments can create real jobs without resorting to multi-trillion dollar federal pork projects.

But we digress. The U.S. foreign direct investment picture is negative. As a percentage of total non-residential fixed investment, the 5.4% total is actually 1.1 standard deviations greater than the post-1986 average; 1986 was chosen as the starting point here as this is when the U.S. engaged in direct intervention against its own currency. However, as percentage of foreign-owned assets at the end of the previous quarter it will be negative as foreign assets owned fell to -$7.61 billion at the end of 2008.

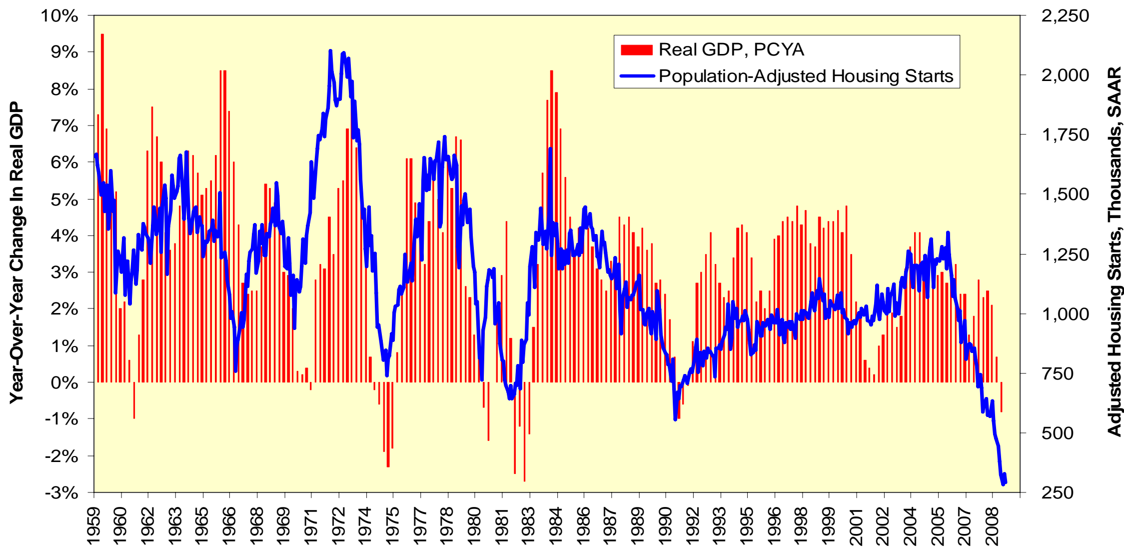


Residential Investment

A critical point of understanding about the recent unpleasantness has been the money was lost not during the credit crunch and concomitant collapse but rather during the misallocation of investment capital to residential investment as opposed to non-residential investment during the housing bubble. This is why I have maintained the various Treasury and Federal Reserve programs are doomed to fail in the long run; lost amidst the banging of cowbells and blaring of klaxon horns is the stark reality you cannot hop in a time machine and redress that loss. You can only avoid compounding the errors by not throwing good money after bad, but it is probably too late for that, too.

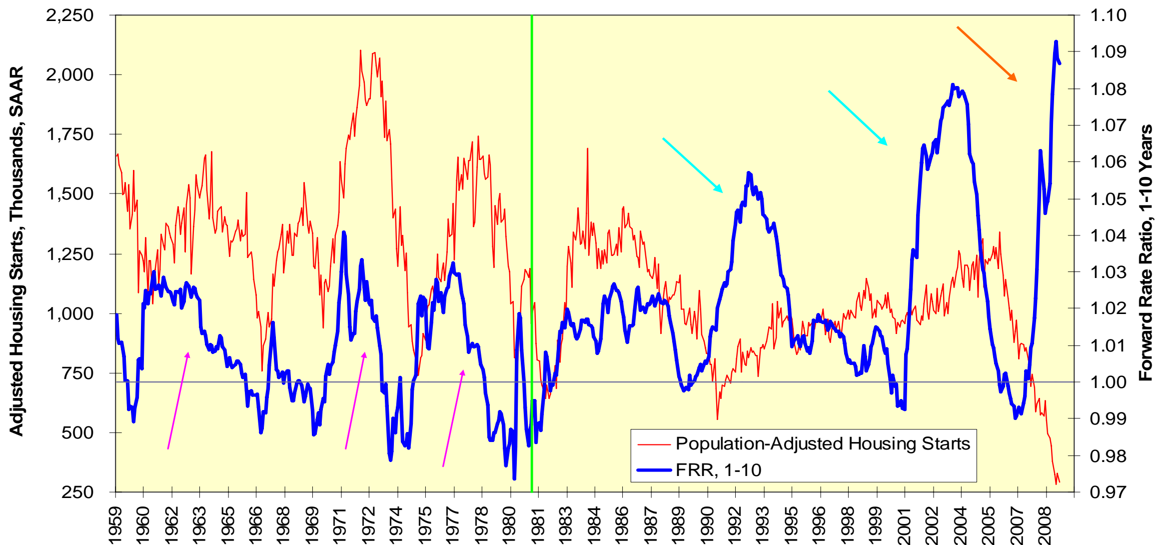
The decline in housing starts adjusted for changes in population certainly contributed to the recession. Non-residential fixed investment would have had to have increased to offset the decline in residential fixed investment, and then some; all major changes in investment patterns involve frictional costs as the economy heads off in a new direction.

Adjusted Housing Starts And GDP Growth

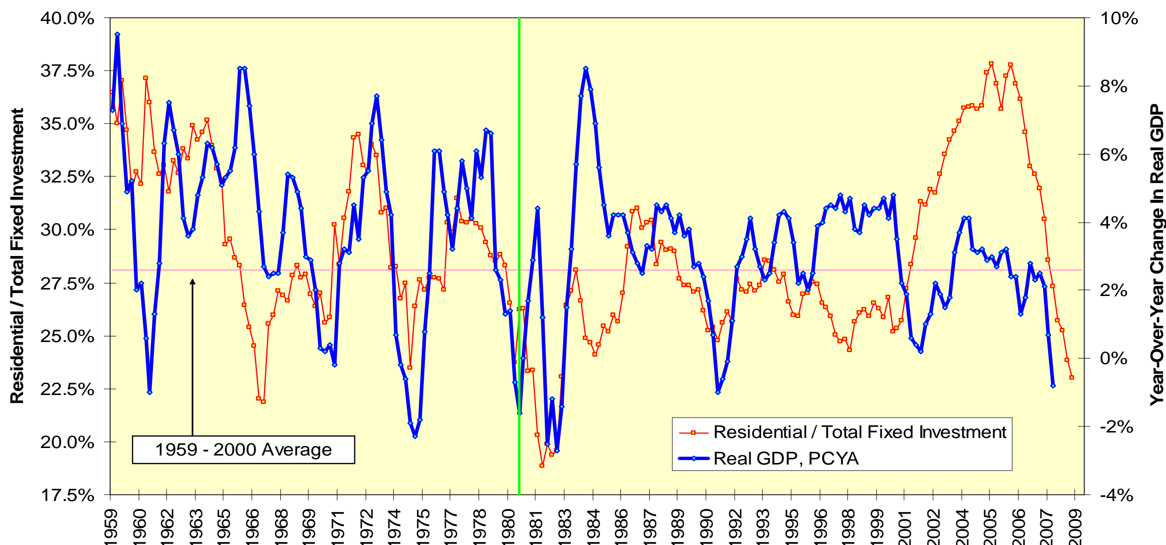


While such an adjustment is required for the long-term health of the American economy – we should know by now the global imbalance of China producing everything we buy and financing everything we consume is not a sustainable economic model – our monetary policies seem determined to re-inflate the 2003-2006 bubble. Here they are failing. If we look at previous credit tightening episodes as measured by the forward rate ratio between one and ten years, the rate at which you could lock in borrowing for nine years starting one year from now, divided by the ten-year rate itself, you would see prior to the elimination of Regulation Q interest rate ceilings in 1980 (green line) a pattern, marked with magenta arrows, of population-adjusted housing starts falling in response. After 1980, loosening of credit, marked with turquoise arrows, led to an increase in population-adjusted housing starts. The current episode, marked with an orange arrow, shows how a massive steepening of the yield curve has been met with a major decline in population-adjusted housing starts.

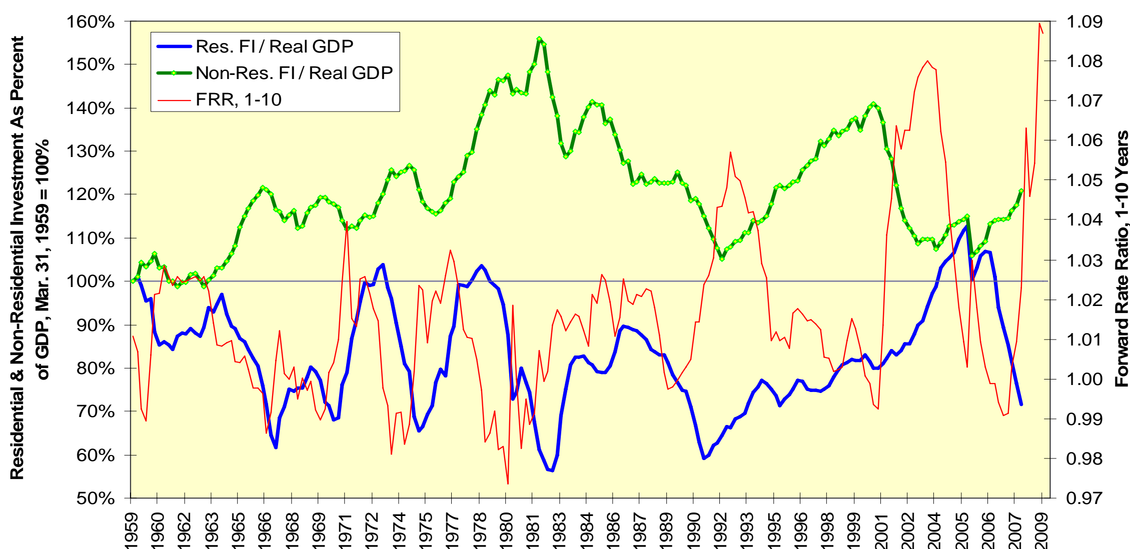
Yield Curve Response To Housing



The 23.0% share of fixed investment claimed by residential construction is the lowest since the third quarter of 1982 and is well below the 1959-2000 average of 28.1%. This share bottomed in the fourth quarter of 1981 at 18.8%; real GDP did not turn higher until the first quarter of 1983, and that was during the very pro-growth Reagan administration. Even if we could repeat that turnaround, unlikely given the circumstances, the first quarter of 2010 would be the earliest when we should expect positive changes in real GDP.



Can we expect non-residential fixed investment to pick up the slack? This measure has been rising as a percentage of real GDP since the first quarter of 2005, but it has been unable to offset the decline in residential fixed investment. And, Federal Reserve *inflationistas* should note this measure is unrelated to monetary stimulus.



Quite simply, why should the next dollar of fixed investment be made in the U.S. as opposed to China? The Chinese Communist party understands the importance of pro-business policies whereas we seem determined to punish those who create value and want to redistribute it before it is created. Shortstops who worry about the double-play before they catch the ball generally see “E-6” on the scoreboard.

The win-win in this situation is simple, and that involves creating an economic, political and legal environment conducive to attracting direct investment from China. That would promote real job growth in the U.S. and a better global balance. Who, besides all the powers that be, would not want that?