Part One

The Economy

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Larry Lindsey

No matter what state the markets are in, there are a handful of economic and strategist ''go-to'' people I always rely on. Larry Lindsey, CEO of the economic advisory firm The Lindsey Group, is one of them. What makes Larry stand out from the hundreds of other economists out there is that he not only cares about the topics he discusses but can break them down in such a way that makes them understandable and interesting to those watching and listening (which, believe it or not, is hard to do when it comes to a television interview). We want the guests on my show to offer our viewers actionable information. Lengthy discourse, although occasionally colorful, is not all that useful; and Larry gets that. I have known Larry for years. I've found him to be always candid, and his global economic contacts are some of the best.

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Before his latest private venture, Larry was a man of the beltway. He served as director of the National Economic Council from 2001 to 2002, and was the assistant to the president on economic policy for U.S. President George W. Bush. In fact, Larry was one of the leaders crafting President Bush's $1.35 trillion tax cut plan, calling it an ''insurance policy'' against an economic downturn. Back in 1996—while acting as a governor of the Federal Reserve Board—Lindsey made headlines for spotting the appearance of the late 1990s U.S. stock market bubble.

Today, as CEO of The Lindsey Group, Larry examines global macroeconomic trends and events that can significantly influence his firm's financial markets and economic performance. Larry breaks down today's navigation of the economic crisis into a formula of three different qualities of leadership that one must have to thrive in the new economy and details how he uses them to grow his company and counsel clients.

Three decades serving in a variety of positions in government, academia, and the private sector have convinced me that one of our society's greatest weaknesses, when dealing with crises, is that managerial and rhetorical leadership qualities have crowded out simple analytics. The reason for this is the confusion that exists between leadership and followership. Most institutions prefer managers who will serve the needs of an existing institution—that is, who will follow the wishes of the various constituencies within the institution—rather than managers who will lead the institution to a new place.

Our political process is dominated by leaders who tell us what they think we want to hear, thereby effectively following the polls and the media and not necessarily leading the country. Worse, our government has created institutional barriers around our leaders that actually prevent them from hearing a variety of analytic points of view in the name of minimizing the influence of "special interests." Similarly, they discourage those who have actually been analytically successful outside of government from entering public service by the current vetting process. For example, the usual connotation of leadership is wrapped up in the presence of followers. After all, one can hardly call oneself a "leader" if no one is following behind. This is true of the lieutenant who inspires the troops into battle and is also the case for a political leader who, after all, doesn't *become* a leader unless he or she has more followers than the opponent on Election Day. But that type of leadership by itself can actually be a handicap for a society dealing with a financial or economic catastrophe. To be precise, financial crises throughout history have developed when excesses went unchecked. Like the over-leveraging of risk in our capital system. All these manias, panics, and bubbles have the same characteristic: the absence of real leadership that takes a contrarian perspective. None of this is a criticism of the actions of political and financial leaders in this or any other crisis; the problem seems to be structural. Societies create institutions that have built-in biases and constraints, and these leaders have very little choice but to carry out the institutional imperative. Indeed, that is their job as leaders of institutions.

One of the most unfortunate examples of this flawed model of leadership was a comment made by Citigroup CEO Chuck Prince in July 2007, when he said of the bank he was supposedly leading: "As long as the music plays, you've got to get up and dance. We're still dancing." This quote shows that despite his personal skepticism about the ability of the market to continue with its excesses, the institutional demands of his firm required him, as a leader, to override his personal cautionary views—and forced his firm to continue on with the practices that ultimately led to disaster in the first place.

In fact, as much as we and they like to deny it now, both politicians and market participants actually *demanded* that firms continued to ‘‘dance’’—and that the band keep playing during the run up to the current crisis. Leverage was encouraged—not discouraged—by market players, including most notably many self-described ‘‘shareholder activists,’’ who acted in the name of creating ‘‘shareholder value.’’ The markets rewarded earnings growth and ruthlessly punished firms that balanced the pursuit of profit with a healthy respect for risk. Members of both political parties pushed for ever-higher degrees of homeownership and demanded that lenders and mortgage securitizers give ever-increasing amounts of loans to less qualified borrowers. Leaders who did not dance to this tune faced condemnation in the press, challenges to their positions by irate shareholders, and withering criticism from members of Congress.

The First Economic Avalanche

It was clear that it was all going to come crashing down; the question was how. Usually such crashes happen like avalanches; a small change somewhere in the structure finds a critical point of weakness. Relationships and transactions that had held together no longer do. Finally—and what appears on the surface to be suddenly—the whole hill collapses.

The initial weakness here was housing. While serving on the Federal Reserve Board, I was the governor responsible for housing and community affairs issues back in the 1990s during the last housing recession—and it taught me a lot about mortgage markets. We had warned clients—and as the *New York Times* reported, the White House—in late 2005 that a housing bubble was forming and that action should be taken to prevent consequent problems. Housing had not had a catastrophic nationwide collapse since the 1930s; it was generally viewed as an impossibility. By the middle of 2007, there had been a slight deterioration in housing prices, with the Case Shiller index down 5 percent. Housing inventories appeared to have stabilized, and a wide variety of commentators and government officials had concluded that the housing recession had bottomed.

At that point we concluded that far from ending, the avalanche was only about to begin unless something was done. The key was to stop or sharply slow the pace of subprime lending. These mortgages constituted 24 percent of the total dollar volume of mortgages in 2006, an unsustainable number. Some of the mortgage market reforms we had instituted in the 1990s to encourage homeownership had helped create the subprime market. But around the time I left the Fed, it was tightly controlled and constituted only about 3 percent of all mortgages. As the late Herb Stein used to say, ''When a trend is unsustainable, it will stop.'' But this particular trend was the self-perpetuating kind. If subprime mortgages stopped being granted, demand for houses would collapse; this, in turn, would mean fewer buyers and lower prices throughout the market. In July 2007, we estimated that the pace of home sales would drop by at least another 1.5 million—more than twice the drop that had occurred so far. While others were predicting that the bottom had been reached, we saw that there was still a substantial downside risk that the weight of inventories would cause prices to crack and that a self-reinforcing cycle where foreclosures and prices start to interact more directly would begin.

Later that month, while market indices reached double what they had been for the previous four and a half years and were still on their way to a new high, we identified for our clients the likely place where the avalanche would begin. We wrote that ''the biggest risk lies with the intermediaries in the leverage game—the big players in the financial arena—whose top line is driven by fee income from doing the deals and whose balance sheets are crammed full of inventory waiting to be dumped on some buyer.'' We identified the market's faulty logic as this: ''If something goes wrong with the financial system, the world's central banks will have no choice but to open the liquidity spigots and play lender of last resort. Heads you win, tails the system gets bailed out taking you along with it.''

That was 14 months before Lehman Brothers' collapse. The problem with the logic up to that point, as we identified it, was that "the relative prices of assets and goods can only vary so far." Given their pace of divergence, we questioned, "Will these momentums play on asset prices and continue for another year? Probably. Eighteen months? Possibly. Two years? Probably not. Enjoy the party, but also be ready to leave when the hosts start looking worried." The reason for the timing was the parabolic rate at which asset prices were climbing. The music probably had to stop playing for these intermediaries before the end of 2008—and certainly before the middle of 2009.

The Best Offense Is a Good Defense

There is only one way to deal with an impending avalanche: get out of the way! Although our clients' base is quite diverse, whatever their responsibilities, the key for them was to assume a defensive posture. This became clearer as—following the avalanche analogy—other cracks were starting to appear in the financial structure, particularly in the area of consumer finance. In March 2008, I appeared on the show *Squawk Box,* which Lori Ann LaRocco produces for CNBC, with former Treasury Secretary John Snow. I warned that auto finance was the next shoe to drop, and jokingly added that by the end of the year, people would have to go to their local Federal Reserve Bank to get an auto loan. As it turned out, the auto finance companies were the ones going to the Fed; it was still providing the money.

At this point, the financial system was doing its best to paper over the cracks in the ice sheet. On July 14 we noted that although Freddie Mac had reported that it had $16 billion in stockholder's equity in a supplement to their GAAP (Generally Accepted Accounting Principle) numbers, the firm had also reported that they had a net asset value of negative $5 billion under Fair Value Accounting. We noted that a similar exposure existed at Fannie Mae and that the amount of leverage both companies had to home prices meant that things could deteriorate very quickly. Both stocks rallied that week on the seeming "good news" in their quarterly report. However, it was to be short lived.

Two months later, Lehman Brothers collapsed, and a panicked Washington rushed to fill the breech. We wrote to our clients, "For all the observations by policy makers that the market had six months to prepare for Lehman, [these] policy makers themselves had not been fully prepared for this further deterioration in markets. During this time, many of the activities in Washington were designed for publicity but had little developed policy behind it." The shocker about Lehman Brothers—and particularly, the rescue of AIG—was that policy makers were essentially making up the rules as they went along. That point was crucial. In the same note to clients, we predicted that the Troubled Asset Relief Program (TARP) designed to purchase distressed assets in an attempt to fortify the financial sector would not work; and indeed, after many false starts, it didn't.

Our focus shifted from the inevitable market meltdown to the government's efforts to repair the damage. In a piece on March 11, we laid out the details of what was likely to work and what was not likely to work. This remains very much a work in progress and is the center of our attention and the attention of my company.

Thriving Criteria

To put it mildly, we are an unusual firm. I doubt very much that my high school guidance counselor had anything like my current job in his great catalog of "things you can do when you grow up." We believe that analytic leadership is in short supply and that it is our job to provide it. But given the shortage of road maps in this regard, we have had to make up our own guideposts and have settled on three: independence, objectivity, and candor. Although these are great words, implementing them can be challenging—because none of them represents a path to popularity.

Independence requires we not be tied to any existing institution. Chuck Prince's private analysis—and given the e-mail trails that are now being revealed, probably those of many other corporate leaders—was that the financial system was on an unsustainable path. But the needs of the institutions they led demanded that they stay on it. Moreover, a variety of in-house analytic shops in the financial sector had encountered some difficulty in recent years as their forecasts became suspect. Markets wondered whether these in-house shops could keep their independence or whether the interest of the institution that was paying their salaries would influence their decision. Even if the individuals involved did their best to preserve their autonomy, they would still face market skepticism. So we concluded that the only way to preserve independence is to actually *be* independent. We are unaffiliated with any organization, and we make sure that our cash flow is not dependent on any single client.

Ahead of the Crisis

We were very early in warning about the likelihood of a housing market crash. We had begun to caution our clients in late 2005 about potential trouble ahead. One of our clients, a national firm, had significant exposure to that segment of the economy. Our analysis was hotly debated within the firm because, if we were right, it would require a significant change in their corporate strategy to prepare for the tough times ahead. The firm lightened up on debt financing and expansion plans, which, at the time, was an extremely unpopular decision in the markets. With leverage and expansion held down, profit growth stagnated; and with it, so did the share price. This was in the midst of a rising stock market and ever-increasing leverage. The decision contributed to calls for the resignation of the CEO. Housing inventory began to stabilize in the middle of 2006, and the consensus was that the "housing cycle had bottomed." This implied that the CEO had made the wrong call, which was a contributing factor in his departure.

Although some believed housing had bottomed at that point, we continued conveying to our clients a decidedly downbeat long-term housing and economic forecast. In mid-2007, we warned them that "a collapse of subprime lending back to its historical pace could take $1.5 million off annual home sales in the aggregate." Worse, we extended our forecast for the housing downturn, writing that "our assumption has been that 2008 would be the bottom of the housing market. But it is not clear how the inventory overhang will correct itself by then." We went on to warn that "there is still a substantial downside risk that the weight of inventories will finally cause home prices to crack." At that time, the Case Shiller index had house prices down only 5 percent, while most forecasts were indicating that housing had bottomed.

Fortunately, the new CEO of the client firm was convinced by our analysis, and the firm continued to reduce its exposure to a still-potential and prospective housing decline. In retrospect, it was our independence that had been crucial to this outcome. Had we been physically housed in corporate headquarters or had we been members of the board, our ability to be self-regulating would have been compromised. At a minimum, we would likely have been perceived as taking sides in office politics, with the possibility that our own position within the firm would have been jeopardized. Indeed, it was our independence that most likely provided the credibility to our forecast that tipped the scales within the firm.

The Next Shoe to Drop

Another quality needed to thrive in times of crisis is objectivity. Although sometimes confused with independence, this attribute is actually far harder to achieve. Whereas, independence is a physical trait—at least on an organizational chart—objectivity is a state of mind. It requires that you do not get caught up in the moment. And even the best of us is influenced by what is happening around us. Momentum trading is an extreme view of this, which implicitly assumes that Newton's law that "an object in motion will stay in motion" applies here as well, at least until some outside force affects it. Moreover, we all have a tendency to talk our book—and an even deeper psychological need to be right. This tends to keep us in our positions longer than we should be. On the other hand, there is also an inclination to overcompensate for this, which turns us into nervous Nellies and changes our view with each piece of data that happens to go the other way.

Objectivity requires perspective. It requires knowing what data are important and what are not and knowing when there is a critical mass of contrary evidence to force one to change one's view. By far, the most useful tools in acquiring a perspective is a knowledge and sense of history. History, by definition, takes you out of the moment. By far the biggest trap that caused many to lose objectivity in the months leading up to the current crisis was the widespread view in the economics profession and in financial markets that we were in the midst of a "Great Moderation."* However, the Great Moderation was actually a historical moment lasting 25 years, not a permanent development.

As we saw the crisis unfolding in June 2007, we sent our clients a message titled "The Next Shoe to Drop: Credit Spreads." We noted that too much confidence can depress returns to risk and lead to capital being diverted into projects that will, on average, lose money. Financial assets had risen in value, which raised wealth-to-income ratios and therefore consumption-to-income ratios, thereby depressing new savings. We predicted that spreads would rise and that ironically, this would take a good deal of pressure off the yield curve in the riskless market, leading to a rally in government bonds and a lower Fed funds rate. On September 12, we predicted that the Fed would begin a series of rate cuts at their Tuesday meeting, with an initial 50 basis point cut, but noted that even this cut would be unlikely to unfreeze credit markets; we

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* *Author's note:* The "Great Moderation" is a phrase used to describe the post-Reagan period from roughly 1981 to 2007, during which interest rates and credit spreads dropped and equity premiums rose sharply.

further predicted a series of cuts in Fed funds to at least 3.5 percent. More than 90 percent of analysts surveyed had predicted just a 25 basis point cut. At its October meeting, the Fed cut only a quarter point and declared the risks to be "balanced." We warned our clients that although this might be the case, the risks had not gone away—and that the Federal Open Market Committee (FOMC) would soon change its views.

Law of Unintended Consequences

One of history's great lessons is that policy makers, in both the public and private sectors, tend to underestimate the costs involved when they contemplate the actions necessary to address some adverse change in circumstances. Although this is due in part to long periods of conditioning to the relationships and magnitudes that existed before the crisis, an equally important cause of the underestimation is the Law of Unintended Consequences. Even the most carefully designed policy responses involve unforeseen results, and in a crisis, there is not the time for as careful a consideration of the consequences of policy as might be ideal.

Risks in Believing in Solely on History

However, just as knowledge of history provides a tremendous advantage in trying to be objective, there are huge risks in believing too literally that history repeats itself. This is most apparent today in a widespread view that we are in for another Great Depression. Our company has never been in that camp. Our forecast at the end of 2007 called for a peak unemployment rate of about 10.5 percent before it would begin to decline in the middle of 2010. That is, of course, a tough recession; but it is not a repeat of the 1930s. Policy decisions do, however, have their effects. For example, in early February 2009, we predicted a "Second Quarter Bounce" long before any green shoots began to be discussed, much less appeared. The reason was the size of the fiscal stimulus plan that had been passed. But because of its inefficient design, we also warned our clients that this might induce a bond market sell-off and that the lack of efficient design would mean that any near-term bounce would likely not lead to a sustained recovery. Thus, the role of history in helping maintain objectivity in any industry is a complicated one.

The way we approach this challenge is to imagine ourselves as future historians writing about the events of the present. This causes us to contemplate an outcome, which we as future historians have the advantage of knowing with 20/20 hindsight, and then work back to establish a chain of events that led to that outcome. When you do that, you have to visualize how something is going to happen and decide whether or not your vision is realistic. If it is not realistic, you reject it. Thus, only a small fraction of the speculative "future histories" one considers actually make it into the range of plausible scenarios. For example, if one imagines a future history of rapid economic expansion in 2010—as the administration and many in the economics profession believe—one has to imagine a sharp decline in the personal saving rate. There is no way to stand in December 2010 with a rapidly growing economy without having had consumers resist raising their savings and choosing to spend instead. Is this plausible? It is certainly possible, but given the widespread wealth destruction and high degree of unemployment-induced economic uncertainty, it is a much less plausible scenario than assuming a further increase in the saving rate. So we tend to differ with most forecasters regarding the speed and timing of the recovery.

This future-history approach doesn't guarantee that you will have picked the right future, but it does facilitate objectivity. Once present-day events occurred that differed from what you imagined, that is, once the world ended up somewhere other than where you thought it was going to end up, you would know that, objectively, you were wrong.

Candor Is Key

It is so important in business to remember that you are not just dealing with economic data and trends; you are also dealing with people. You must be honest with your clients, no matter how unpleasant the news is. Candor requires that you state your objective and independent opinion to someone who may not want to hear it. Your analysis may, in fact, implicitly be telling someone, ''You're wrong.'' What makes candor particularly challenging in the consulting world is that the person to whom you are being candid is paying you.

There are, of course, some obvious pointers on how to deliver the candid but undesirable message. One should always be polite, strive to listen carefully, and remain objective and analytic. Try not to defend your message simply because it is yours, but instead because the facts warrant it. No one should believe that candor is easy. It really depends on the client, and what you may conclude is that your product or service is really not for everyone. One obvious place where candor gets tough is the discussion of politics.

Politics entail risks to our clients; thus, they should receive our best judgment on what the numbers say the outcome of an election is—and what that outcome is likely to mean for policy. Predicting the outcome of an election is very much like economic forecasting; it is data-intensive and requires both independence and objectivity to do it right. We called both the 2004 and 2008 election results almost precisely correctly, erring on the popular vote margin both times by only a few tenths of a percent. In 2008, we missed by a single electoral vote—the first district of Nebraska, which voted for Obama, although the state voted for McCain (we had not broken down the outcome to the congressional district level).

But delivering that result was not easy. Our Democratic clients were none too pleased with our yearlong predictions of the 2004 race, given their distaste for Bush; and our Republican clients were not happy with our view that Obama was going to win easily. There were times during both elections when the polls of the moment were calling the reverse result. But again, future history suggested that looking back from the perspective of after Election Day and trying to chart a path to that outcome made that contrary result implausible.

The Next Phase

The next phase of the economic crisis was the financing phase. Although the economy overall did not deleverage, some leverage was moved from the private sector to the public sector. The lost private sector leverage represented a general recognition of lower asset values—and an offsetting, public sector-financed reduction in liabilities. As a result, the private sector was not made fundamentally better off, in that its net worth did not increase. Instead, the hole that had emerged in its balance sheet was recognized, or partially recognized, and the institutions that faced insolvency issues as a result were rescued by a debt-financed injection of capital from the government. From the point of view of the national balance sheet, the country is therefore poorer.

This reduction in wealth necessitates a slowing of economic activity. It should happen primarily in the consumption spending of the household sector, because this more than any other sector saw a reduction in wealth that was not offset by government. In particular, we anticipate saving rates to continue to increase as households seek to rebuild their balance sheets. By contrast, official forecasts anticipate that the saving rate will fall again and return to the levels seen in the middle of the decade. If those official forecasts turn out to be analytically wrong, then economic growth will face a tremendous headwind going forward—and we should see a subpar economic performance at least through 2010 and possibly longer. So the analytic point for markets should be to determine whether household savings will fall in the face of deteriorating balance sheets and high unemployment, as the administration and most official forecasts presume, or whether it will rise. If officials are wrong and their budgetary and economic projections turn out to be too rosy, the second analytic challenge will be to determine how economic leaders will respond.

Our view is that the household saving rate will ultimately rise to 8 to 10 percent and the unemployment rate will rise to double-digit levels. If this is correct, how then will the administration and other public sector decision makers respond? How will markets react? We anticipate that leaders will use more rhetoric and political management. Of course, as a future historian looking back on the path that produces this outcome, one must remain alert to possible changes that would signal a different outcome.

One such change would be an actual sharp decline in the personal saving rate that many now have built into their forecasts. That would mean more robust economic growth over the near term. Although it would produce real long-term challenges to the country, the temporary relief provided by a lower saving rate would likely take some of the pressure off the political developments described previously. A second such change would be a shift in the balance of decision-making power within the administration away from rhetoriticians and political managers and toward analytic experts.

If history is any guide, there will be a series of major personnel shake-ups over the next couple of years. It will be interesting to see which leadership types gain ground and which lose ground.

Grappling with the Crisis

One of the advantages that our firm offers is that all of the principals at The Lindsey Group have spent time working for different political leaders as well as being involved in financial markets. And with increasing power flowing to Washington, this should prove crucial. Our experience develops a deeply seated sense of realism about leadership. In particular, it emphasizes the point that nobody is perfect. There are two corollaries to this observation about leadership: First, it means that leaders will tend to perform well at some tasks and not so well at others. In general, successful leaders tend to use the skills they have in abundance to compensate for their shortcomings. Second, the universality of imperfection means that when one has a leader who thinks he or she is perfect—or almost perfect—or if there is a media perception that this is the case, mistakes are likely to be made and expectations are almost certain to be disappointed. This is not a disparagement of any particular individual; rather, it is an independent, objective, and candid view of the difficulties leaders are going to have in grappling with the current crisis.

One should start the analysis with leadership style. Of the three types of leadership described here—managerial, rhetorical, and analytic—the current administration appears to have the first two in abundance. The rhetorical powers of President Obama are second to none. He exceeds those of Bill Clinton, and at least rivals those of Ronald Reagan. Many analysts of leadership skills that are required of a President put this rhetorical power as first in importance. After all, President Barak Obama must convince members of Congress and the public at large of the importance of his agenda. There is no doubt that President Obama has done this, given the size of his mandate in November; his ability to produce electoral coattails, which gave his party a very comfortable majority in Congress; and his propensity since the inauguration to turn that majority into legislation.

Indeed, the ability to move legislation through quickly is another reminder of the skills the administration has in political management. Although the president does not appear to manage per se, and instead devotes his time to maximizing the use of his rhetorical skills, he has hired a tremendously successful team of political managers in the likes of Rahm Emanuel, Valerie Jarrett, and David Axelrod. These three were instrumental in his upset victory over Hillary Clinton in the contest for the Democratic presidential nomination, and they ran a virtually flawless general election contest against John McCain. They are people who know how to move the political process to deliver on the rhetorical leadership that is President Obama's strong suit. In addition, they collectively enforce a degree of message discipline over administration personnel that is far greater and more successful than that developed by the Bill Clinton or George W. Bush White Houses (and neither Clinton nor Bush were particularly slackers in this regard).

What is less clear at this point is whether the administration has developed real analytic powers. There is no doubt that they have extremely talented individuals who possess such powers in both the economic and the foreign policy areas. But the balance of power within the administration and the process of decision making is driven far more by the managerial and rhetorical demands of leadership than the analytic. In the economic area, this tendency for rhetoric to get ahead of analysis showed up in the stimulus bill. To their credit, administration officials contacted a good variety of economic forecasters, including me, on the appropriate size of the stimulus package. I concurred on the size that ultimately was proposed: $800 billion. But the administration's analytic work stopped there. It then turned over the crafting of the details of the stimulus bill to the Congress, and more precisely, to the appropriations committees in Congress. These are the reptilian brains of the political process whose single thought is to spend on the projects the members of the committee and their friends want. The result was an absolute disaster: money appropriated to areas that would have little benefit to the economy or job-creation effect. This conclusion was widespread among budget analysts, including the Congressional Budget Office, which noted that the long time lag on spending made this a particularly inefficient piece of "stimulus."

The inefficiency of the stimulus bill and the other spending that has gone through Congress is producing an unintended consequence that is going to drive the economy, markets, and, indirectly, public policy in the months ahead. This inefficiency produces the combination of a weak recovery—particularly on the jobs front—and sharply rising budget deficits. These higher deficits, in turn, put pressure on interest rates. To attract the necessary funds to finance the deficit, rates must rise in order to attract capital from abroad or crowd out private domestic investment or debt-financed consumption.

Leadership in the Financing Phase

Thus, the economics of the financing phase of this crisis is inextricably linked to the political handling of the crisis. In contemplating the likely actions of the administration, it is worth considering how they view themselves—and how their allies view them. The most common phrase used in Washington and in the mainstream media is that they are "pragmatists," a moniker they've earned because they have shown a willingness to compromise. For example, it became obvious on the Cap-and-Trade scheme that the opposition by current emitters of carbon and their customers would block what was basically a "carbon tax" approach. So the administration gave up on collecting revenue from Cap and Trade and used 85 percent of the supposed proceeds as a give back to the polluters who were objecting to the proposal. This is pragmatic, but it has unintended consequences. The $80 billion per year that was expected to be collected—and that was a key part of the president's long-run budget—has just been given away. This only further weakens the analytic position of the fiscal policy position of the country and the administration.

So, pragmatism is not analytical, and it is quite different from realism. A pragmatist is a rhetorical leader or political manager who has been mugged by reality. An analytic realist might have noted the incompatibility of counting on carbon tax revenue that was crafted in a way that would have ensured its political defeat, while a pragmatist plows forward anyway and compromises when forced to.

Apply this pragmatism to the possibility that the economy does not expand as the administration expects because of a household desire to increase savings. The analyst would have a plan B in place.

A pragmatist waits for reality to hit and then deals with it in a way that seems right at the time. The one thing a pragmatist can't do is admit that he or she was wrong and take back what was proposed to try a new approach. Rhetorical and managerial leaders don't do this. Like Chuck Prince, they will keep dancing as long as the music is playing; and if they have enough power, they will do all they can to make sure that the band keeps playing.

This does not mean that they can't adapt or compromise. One obvious possibility would be to go on offense and say that what was done was right, but too small in magnitude, so what is needed is to do more of the same, that is, to use the formidable rhetorical and political management skills of the administration to pass another stimulus bill. A number of analysts, particularly on the left, have already called for doing so. Although this is a possibility, it is unlikely to be the path of least resistance for the political process or for the markets. The markets pose the most obvious impediment. They are already reacting to the massive financing needs that the first stimulus bill and other pieces of legislation created by driving intermediate and long-term interest rates substantially higher. This is crowding out other economic activities and making particular trouble in the bond market. So it would be questionable, to say the least, on economic and financial grounds to simply do more of the same.

But there is a separate political factor that probably blocks exploring this avenue. Politicians respond to the behavioral characteristic of, "if it feels good, do it." Trouble is, this avenue didn't feel so good. In general, the political feedback has been poor, with voters asking tough questions about the inefficacy of what was passed and the "strings" that were attached. Thus, taking the offensive in fiscal matters seems unlikely; a defensive response seems more so.

Economically and in markets, all of this will come together in a reversal of the Great Moderation. That 25-year historical moment increased private risk taking as the perceived riskiness of public decision making declined. The leverage created by that private risk taking and the asset prices supported by it remain in place, but this leverage is inappropriate for the new era. As more power devolves to Washington, the market risks associated with policy formation increase. This means that risk premiums must rise across the board. Equity risk premiums will rise because more of the volatility of economic performance will come from discrete political decisions rather than more gradual market ones. Credit and term structure risk premiums will also rise as uncertainties about future monetary and fiscal policy increase. All things equal, this could also mean a lower equilibrium level for the foreign exchange value of the dollar.

Prospering in this New Economy

As more power is shifted to Washington, the challenge for investors becomes more difficult. Some are advocating a policy of "invest with the government and you can't go broke." This would lead one to put money in the new partly nationalized sectors of the economy, such as the large money center banks, the auto companies, and probably parts of the health care industry. This does not seem like a good way to initiate the financing phase of an economic crisis. Although these firms are surviving because they get money from Uncle Sam, Uncle Sam himself is running out of borrowing capacity. Even if his new wards in the private sector don't go broke, they won't be allowed to be exceptionally profitable either. Those profits will be appropriated to fill other missions that Washington needs accomplished.

The central issue for America will be to pay its bills—particularly its overseas debt. This will mean that America's exporters will have a very important role to fill. The likely decline in global faith in the dollar will help them along. If one thinks about those things in which America already has a comparative advantage—agriculture, aircraft, entertainment, and technology—the new economy will require them to be even more profitable than in the past.

But a broader and more hands-on government will also mean a rollback in the areas of the economy that have benefited from financial intermediation. Home ownership rates are unlikely to regain their recent peaks. Indeed, in terms of metrics like square feet of living space per person, we have probably seen peaks that may never be attained again, or if so, only after decades of recovery. It is worth keeping in mind that the total stock of housing investment did not keep up with depreciation from 1929 through 1945, despite a growing population.

Finance itself is likely to change and become less intermediated. Institutions that were set up to bring borrower and lender together in an increasingly complex financial arrangement have been significantly discredited, because the real value of their involvement generally was less than the fees they charged. In the new economy, we suspect that private arrangements will become more common as entanglement with highly regulated financial intermediaries becomes less attractive. Moreover, given recent institutional failures, traits such as independence, objectivity, and candor will be valued more than marquee names in the intermediation arena.

The new economy will also be one in which new economic leadership will emerge. Although we do not believe that America's best days are behind us, the confluence of rising political control over economic matters in the midst of this financing phase means that near term, the relative economic power of America will wane. Our relationships as a firm reflect this. We are rapidly developing contacts and doing business in South and East Asia and Arabia. It is worth keeping in mind that financial and economic relationships in these areas tend not to be institutionalized, and only lightly intermediated. Trust—and a long experience with the individuals with whom one does business—is vital. It is particularly interesting that what we would have considered an "underdeveloped" financial marketplace in these areas is actually the kind of model to which we will gradually evolve in this financing phase of the crisis.

The greatest question in these areas is whether a dollar-based global economy will continue or whether the whole concept of a pure fiat-money system will also be a casualty of the recent crisis.

Current talk of a "currency basket" replacing the dollar seems misplaced. The problem the dollar has is that it is thought to be subject to political manipulation in order to meet the near-term economic needs of the United States. Substituting a basket of such currencies, each politically manipulated by its own government, hardly seems like a compelling substitute. The more pressing question is whether one of the newly emerging countries decides that it can offer a real competitor to the dollar by moving away from a fiat-based system toward one that represents a more pure store of value. Some form of specie-based currency may turn out to be a real possibility in our new economic era if global faith in the dollar erodes.