



Putting Politics In Your Economics

My economics training started with microeconomics. Yours probably did, too, perhaps after a survey introductory economics course. Then I moved on to macroeconomics. You probably did, too, perhaps alongside a statistics course. These were the building blocks of the curriculum, the stuff you had to know before you could study the stuff that mattered: econometrics and political economics (also sometimes called institutional economics).

Or, as my favorite undergraduate economics professor, Grinnell College's Cliff Reid liked to say, "*You first must learn how the world should work before you can learn how it does work.*" As both a renaissance black man and a stickler for detail, Cliff also loved to counsel that "*repetition is good for the soul, even if you already have soul.*" He was right on both scores!

Which is why, perhaps, I re-read Keynes' **General Theory** on a regular basis: Keynes was both a master of economics as a mathematical discipline and as a springboard for political debate. And unlike many of my economic professors, and even more of my present economist peers, Keynes did not view the politicalization of economics to be the bastardization of economics.

Textbook economics, beginning notably with microeconomics, starts with the presumption that the invisible hand of markets is always and everywhere not just invisible but also unfettered. As a pedagogical matter, this makes sense, similar to beginning the study of human romance with an introductory course in the reproductive exigencies of birds and bees. You gotta start somewhere!

And Adam Smith's invisible hand is a great place to start, because his hand is founded on the proposition that buyers and sellers of goods and services are acting in their own best interest, willingly entering into exchange, without any coercion. Accordingly, microeconomics starts with the presumption that markets work best when directed

by the enlightened self-interest of market participants, unfettered by interference from government. Hard to argue with that, right?

No, it is easy to argue with that, actually. For, you see, free market microeconomics starts with the presumption of the sanctity of private property rights. Without property rights, the invisible hand of markets would always be a hand in dispute, subject to arbitrary and capricious forearms. Thus, even though the study of microeconomics is putatively either apolitical or nonpolitical, all economics has political roots: private property defended by the fist of the rule of law and public property claimed by the fist of government.

Political economics is about relationships between markets and peoples, within countries and between sovereign countries. In contrast, economics without politics is simply a matter of sex.

Speaking of Beer and Oil

As a philosophical matter, economists hate cartels (except for the ones that demand a PhD to be considered for certain jobs and the tenure system!). Cartels are bad, we are taught, because they lead to lower output and higher prices than otherwise would be the case. For example, the cartel that runs the beer and hot dog business at a major league sports event clearly sells fewer brews and fewer dogs, and at much higher prices, than would be the case in a world of competition. Why, then, do cartels exist? Why can't government outlaw them?

In the matter of suds and wieners, the answer is easy: the government, otherwise known as the owner of the stadium, runs the cartel! And the government can, because (in most cases!), it owns the stadium, financing it at municipal bond rates and leasing it to the private sector. Thus, the government has the right – the property right! – to decide who can and can't provide refreshments for America's game.

Theoretically, we the people could object to this cartel, demanding that local governments bring competition to the provision of a warm beer and a cold hot dog. But we don't, for reasons that I don't fully understand. We just don't. My hunch, and it is only a hunch, is that we the people intuitively understand that 'tis better that beer be expensive at the ball park, as a prophylactic against the externality of drunk driving on the way home from the game.

But that's just a hunch; and, in any event, 'tis hardly a matter of great national or international economic importance. Not so, of course, in the matter of oil, which is similarly controlled by a cartel, called OPEC. The fact of the matter is that the low cost producer, Saudi Arabia, is the marginal producer, also sometimes known as the swing producer.¹ This is not the way it is supposed to be, at least according to textbook microeconomics, which teaches that the supply curve for a commodity is upward sloping, with the highest cost producer serving as the marginal producer. Why doesn't this hold in the matter of oil?

Very simple: Saudi Arabia is a sovereign country, blessed by the divinity with huge pools of oil, easier to get out of the ground than water. And Saudi Arabia exercises its sovereignty by limiting production, even though it could handily under price other producers of oil who have higher production costs. Thus, the economics of oil is inherently political economics: it is impossible, literally impossible, to forecast oil prices without making an assumption about how Saudi Arabia will exercise its sovereign property right in the oil below its surface. And, I hasten to add, how other sovereign nations will or won't respect Saudi Arabia's sovereignty. It's called political economics.

Speaking of Currencies

A similar political dynamic holds true in forecasting the price of the dollar, as measured in units of non-dollar currencies. Yes, I know that Treasury Secretary Snow preaches that currency values should be set in free and open markets, as all good students of microeconomics are taught to believe and preach. In the real global world of fiat currency regimes, however, the notion of a free and open market in currencies is an oxymoron. Sovereigns, everywhere, have the power, granted or taken from

their peoples, to declare what is and isn't legal tender for the payment of debts. This is an awesome power: monopoly power over money creation.

Accordingly, the notion of free and open markets in currencies is but a veil over reality. Yes, in real time, countries with convertible currencies and no capital controls ostensibly let the markets determine the value of their currencies in terms of other currencies. But at the end of the day, sovereigns retain control over the supply of their currencies, otherwise known as the size of their central banks' balance sheets (or their ministry of finances' balance sheets, which are but one step removed from their central banks' balance sheets). This is reality!

Thus, economists steeped in the textbook microeconomics doctrine of purchasing power parity, also known as the "law" of one global price, are constantly frustrated in forecasting currencies. In the textbook, global arbitrage is presumed to bring currencies into such an alignment that prices for goods and services denominated in various currencies are all roughly equal. In the real world, currencies deviate so far from presumed purchasing power parity values as to make a mockery of the concept. Why?

Very simple: there is no free and open global market in citizenship. Sovereign countries retain the power to print passports and visas. In turn, sovereign governments – especially democratically-elected governments, but also governments with democratic tendencies – must be responsive to their citizens' needs and wants, not global citizens' needs and wants. Thus, sovereign countries should and do have the ability to print their currencies in sufficient volume to keep them undervalued on purchasing power parity terms. It's called mercantilism. And all developing countries practice it, to some degree, so as to bootstrap themselves to prosperity by exporting goods to developed countries, while importing their superior know how, institutions and political stability.²

This is neither good nor bad, just the way it is: developing countries acting in their own perceived best interest, undervaluing their currencies through the power of sovereign-owned printing

presses for money. Developed countries do the same thing, just in a different way, overvaluing their passports by restricting their production via sovereign-owned printing presses. This is neither good nor bad, just the way it is. Thus, it is impossible to forecast future currency values without starting with an assumption as to how developing countries will run their printing presses for money and developed countries their printing presses for passports. It's called political economics!

Speaking of Social Security

So, too, the matter of nations taking care of their elderly. In textbook microeconomic terms, rational individuals should prepare for their own retirement years, deferring consumption while they are working so as to be able to continue to consume when no longer working. But individuals don't always have either the ability or the smarts to do that. In which case, textbook microeconomics would suggest a Darwinian solution, otherwise known as a destitute old age.

In contrast, civilized societies reject the notion that you can eat only what you kill, or have saved from that which you have killed. Civilized societies, particularly democratic ones, start with the notion that parents have legal obligations to their children when they are young and grown children have legal obligations to their parents when they are old. Obligations to children are actually easier for we the people to enforce than obligations to parents. We all understand that children can't take care of themselves.

All of us don't, however, buy into the notion of taking care of our parents. And many that do don't have the resources to do so. Accordingly, we as a society consider care of the old to be a public good, defined as something we all want, but do not have the individual incentive to buy. And as the case with all public goods (think the military), we tax ourselves to pay for society's commitment to prevent its elderly from suffering a destitute journey into the good night.

Different countries manage this intergenerational commitment in different ways, but at the end of the day, all such schemes involve a transfer of real resources **in real time** between workers and retired

workers. Put differently, the financial architecture surrounding retirement schemes is but a veil over reality: retired workers eat because active workers toil in the soil.

Yes, an individual can "fund" her retirement, saving out of current income to provide a financial nest egg to buy goods and services in the retirement years. But a society of individuals cannot do this: future supply of goods and services will be provided by workers at that future time. Accordingly, the invisible hand of markets must play second fiddle to the visible fist of governments in engineering resource transfer payments from workers to retirees.

Yes, individual retirees may have "earned" those transfers by living frugally during their working years. But for the society of individuals, it is impossible to "save" for retirement. The only thing society can do is invest in its capital stock, making it more productive, so that workers and retirees in the future will have a bigger pie of goods and services to share.

Fed Chairman Greenspan has, of course, been making precisely this point in recent weeks, thumping the table again and again that America needs to save more so that it can invest more. He's right about the need to invest more, but is wrong in the matter of savings being a necessary condition for investing more.

Yes, savings and investment equal each other after the fact, but before the fact, investment is not – repeat not! – a function of savings. Rather, investment is a function of prospective returns on current resources deployed in building the tangible capital stock. If those risk-adjusted prospective returns are perceived to be high, capitalists will, as if by an invisible hand, pursue more investment, which will beget higher income, which is the mother's milk of savings.

Let me repeat: investment is not a function of savings; rather, savings is a function of income, which is a function of consumption and investment! Or, in the elegant words of Lord Keynes:

"...the traditional analysis is faulty because it has failed to isolate correctly the independent

variables of the system. Saving and Investment are the determinates of the system, not the determinants. They are the twin results of the system's determinants, namely, the propensity to consume, the schedule of the marginal efficiency for capital and the rate of interest. These determinants are, indeed, themselves complex and each is capable of being affected by prospective changes in the others. But they remain independent in the sense that their values cannot be inferred from one another. The traditional analysis has been aware that saving depends on income but it has overlooked the fact that income depends on investment, in such fashion that, when investment changes, income must necessarily change in just that degree which is necessary to make the change in saving equal to the change in investment."

Bottom Line

Economics as a discipline is neat and the invisible hand of markets is cool. But economics without politics is the analysis of a world that does not exist. In the real world, the invisible hand of markets depends on the visible fists of government to enforce property rights, and is also subject to the visible fists' power to redistribute property, acting in the perceived best interest of sovereign peoples. Political economics is neither an oxymoron nor a contradiction of terms, but a definition of reality.

These real-time exigencies are nowhere more clear than in the analysis of three key issues of our times: prospective global prices for oil, currencies and retirement. To forecast these three prices – which we must if we are to succeed as active investment managers! – we must understand and forecast not just the motives of those with invisible hands but the motives of sovereigns with visible fists.

Here at PIMCO, we will be doing precisely this at our upcoming annual **Secular Forum**, chaired by Bill Gross and featuring some of the world's best experts on the nature of the globe's prevailing oil, currency and retirement regimes. It's gonna be fun!

But time waits for no man or firm. As we write, the invisible hand of global markets is acting in mysterious ways, as market participants increas-

ingly accept that all macroeconomics is, in the end, political macroeconomics. Most important in this regard for fixed income investors is what Fed Chairman Greenspan called the conundrum of low real global long-term interest rates.

We wrote about precisely this issue last month³, one day before Mr. Greenspan uttered the now famous word. Specifically, I said:

"I expect the speculative 'run' on long-duration bonds to exhaust itself, as speculative money flows grow weary of real money not 'showing up' to take them out of their bigger-fool purchases."

Since then, the ten-year U.S. Treasury yield is up almost one-half percentage point, much less of a conundrum, as Uncle Alan noted himself last week. Greenspan speaks and the world listens! For that, we are grateful, I suppose, since we were positioned for a bear steepening of the U.S. yield curve.

That does not, however, mean that "in Mr. Greenspan we trust." He sometimes can get what he wants, but that doesn't necessarily mean the world gets what it needs. As the day rapidly approaches when Mr. Greenspan will ride into the sunset, the global market participants need to rely less and less on what he says, and more and more on good old-fashioned global political economic analysis. Here at PIMCO, we commit to doing precisely this.

Paul A. McCulley
Managing Director
March 16, 2005
mcculley@pimco.com

¹ "Exercising Free Dumb," *Fed Focus*, October 4, 2000

² "A Debtor's Blessing," *Fed Focus*, November 21, 2004

³ "Conditionally Unconditional," *Fed Focus*, February 14, 2005

Past performance is no guarantee of future results. This article contains the current opinions of the author and such opinions are subject to change without notice. This article has been distributed for informational purposes only and is not a recommendation or offer of any particular security, strategy or investment product. Information contained herein has been obtained from sources believed to be reliable, but not guaranteed.

Each sector of the bond market entails risk. Municipals may realize gains and may incur a tax liability from time to time. The guarantee on Treasuries and Government Bonds is to the timely repayment of principal and interest, shares of a portfolio that invest in them are not guaranteed.

No part of this article may be reproduced in any form, or referred to in any other publication, without express written permission of Pacific Investment Management Company LLC. ©2005, PIMCO. FF047-031605

P I M C O

840 Newport Center Drive
Newport Beach, CA 92660
949.720.6000