

August 23, 2010: Two of My Favorite Myths

I'm sure many of you enjoy urban legends and myths. I can't seem to get enough of them. This week I'll share two of my favorites.

Fact: George Stigler was one of the greatest economists of the past 50 years. He died about ten years ago, which probably adds to his legend. Stigler was one of the University of Chicago economists who put that school at the top of the world's rankings. He was John F. Kennedy's chief economist and won a Nobel Prize in economics. But perhaps he was best known as being one of the few people of earth substantially smarter than his colleague Milton Friedman. After a year or two of getting thrashed in intellectual skirmishes, Friedman decided to befriend Stigler rather than continue to go head-to-head against him.

There's an urban legend at Chicago regarding Stigler's classes. One did not sign-up for a Stigler course in the traditional way; rather, certain students were invited to attend...sort of the economics equivalent of joining Augusta National. The lucky 8-10 students were themselves expected to contend for a Nobel Prize at some point. Now for the myth.

At the first class meeting, Stigler walked into the room late and stared down the students for what seemed like hours. Finally he announced: "My grading system is simple: "A" is for God; "B" is for Stigler; and "C" and below is for all others." He let that little bomb sit there...for what seemed like an eternity. Eventually, a smart-alecky student in the back row of the classroom (where trouble always starts) said in a voice that was much too loud: "It looks like only God is going to have a scholarship to this place!" Of course, everyone in the small room heard the comment. After what seemed like another hour of silence, Stigler said: "Thank you for that comment, Mr. Slee. It appears that you're well on your way to becoming an "Other".

I hear you - some things never change.

Now let's move to a more recent myth. For the past six months we have been bombarded by pundits who proclaim that American corporations are sitting on mountains of unused cash...just waiting for the right moment to spend, spend, and spend. At some point a magical signal will be given by Immelt or one of the other titans, and a tidal wave of cash will wash over all of us and immediately end the Great Recession. Giving credence to this story is the normally reliable Fareed Zakaria, who reported that top companies "have accumulated an astonishing \$1.8 trillion of cash," leaving them in the best shape, by some measures, "in almost half a century."

Hmmm...something about this didn't sound quite right to me. In fact, very little of what I hear coming out of Washington these days sounds right to me. So I decided to investigate this assertion to determine if it was fact or fiction.

Fact: According to the Federal Reserve, nonfinancial firms borrowed another \$289 billion in the first quarter, taking their total domestic debts to \$7.2 trillion, the highest

level ever. That's up by \$1.1 trillion since the first quarter of 2007; it's twice the level seen in the late 1990s. The debt repayments made during the financial crisis were brief and minimal: tiny amounts, totaling about \$100 billion, in the second and fourth quarters of 2009.

Note that we're talking about nonfinancial firms here. I've already discussed in prior Notes that financial firms (banks) as a whole are technically insolvent. I had much higher hopes for the non-banks.

Central bank and Commerce Department data reveal that gross domestic debts of nonfinancial corporations now amount to 50% of GDP. That's a postwar record. In 1945, it was just 20%. Even at the credit-bubble peaks in the late 1980s and 2005-06, it was only around 45%.

The Fed data "underline the poor state of the U.S. private sector's balance sheets," reports financial analyst Andrew Smithers, who's also the author of "Wall Street Revalued: Imperfect Markets and Inept Central Bankers."

"While this is generally recognized for households," he said, "it is often denied with regard to corporations. These denials are without merit and depend on looking at cash assets and ignoring liabilities. Cash assets have risen recently, in response to the fall in inventories, but nonfinancials' corporate debt, whether measured gross or after netting off bank deposits and other interest-bearing assets, is at peak levels."

By Smithers' analysis, net leverage is nearly 50% of corporate net worth, a modern record (which is not a good record to have, btw).

Aren't we all having a difficult time differentiating fact from fiction in the economy? One of the few things I think I know is that the small percentage of people/institutions that play in the global sandbox will continue to do well; whereas, everyone else will continue to wonder what hit them. Worldview really matters.

Oh yes - I just conveniently remembered the main myth surrounding the Stigler course. According to the legend, in 1981 someone actually received an "A". Or did they?

-Rob

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