April 2012

By Max J. Rudolph, FSA CFA CERA MAAA

How to Fix the Economy

What a preposterous headline. HOW TO FIX THE ECONOMY. Writers use headlines like this to get people to read what they really want to share. Surely no one thinks they actually know so much about the economy, its nuances and unintended consequences that they can solve the world's problems? No, but it is a fun distraction at best to throw out ideas, and even more fun if some of them are later implemented or are shown to improve the economic environment.

Fiduciary Duty

Many of the financial disasters of the past decade would have consequences if the authors had a fiduciary duty to perform. Recently Greg Smith of Goldman Sachs wrote a public letter when he resigned about the disastrous culture that has taken hold of the firm. Buyer beware! From Iceland to Greece, Goldman and other investment firms have offered advice that was not in their clients' long-term interest. Sometimes they appear to have traded against this advice, in particular in the US home mortgage arena. If GS had a fiduciary duty to anyone doing business with them it would make for a more stable world. One way to accomplish this, at least in part, would be to move Goldman back to the partnership model. Today the managers get the upside and the taxpayers get the downside. Not good. Another option would be to disallow proprietary trading of any company eligible for bailouts, increase capital requirements, or force a divestiture. If an investment banker has a good idea, there is a good chance it is at least partially based on insider trading knowledge. This should be strongly discouraged.

Minimum Wage

I'm not aware of any study that says raising the minimum wage creates jobs, so why don't we reduce it? At least for minors, or you could have a gradually increasing scale based on age. Currently the federal minimum rate is $7.25, so below 18 could earn $4 and below 21 could earn $6. My personal preference would be to eliminate it entirely, but that seems unlikely to happen. Rules designed for disabled workers could continue.

Taxes

Taxes should be consistent and transparent. A step in the right direction will come with disclosure of 401(k) fees later this year. We also need to revisit taxation of benefits. Benefits should be taxed and voluntary. You still get the value of the group discount, but why do employees at a company get tax preferenced health care while individuals without a job, or self-employed, do not? This consistency would allow a lower rate overall and be consistent with the current direction of a health care requirement.

Shovel Ready Projects

In 2009 the deficit spending was explained with the term "shovel ready projects", and many roads were rebuilt as part of this initiative. It was also a ruse, with most of the money going elsewhere with no future return. The world's infrastructure is aging, with water pipes, roads and even more recent technological tools nearing the end of their useful life. They need to constantly be maintained to generate their greatest utility. For the United States to continue as a great power we need to focus more on infrastructure and less on income inequality. Yes, many bigwigs are paid too much but this distracts us from the real debate.

The Federal Reserve

The Fed thinks that keeping interest rates low is the only reason we borrow. I disagree. I think that just as much "real" borrowing would occur at 2 or 3% rate, and there is limited value in forcing rates lower. There is also a negative in that the major benefactors of low interest rates are those that leverage up their investments like hedge funds and investment banks. Is this really our goal, to create more leveraged investments and forcing investors to reach for yield while discouraging real growth opportunities? The lack of transparency on bank balance sheets makes them hesitant to do anything.

Inflation

Eventually politicians will realize that the least painful way to deal with the current crisis is to allow inflation to increase. This will make the debt smaller, favor lenders over borrowers, and reduce some of the off balance sheet liabilities like defined pensions. To make this work they will need to adjust the inflation adjustment that automatically occurs for Social Security payments. The other options seem much worse to me, let alone to a politician.

Warning: The information provided in this newsletter is the opinion of Max Rudolph and is provided for general information only. It should not be considered investment advice. Information from a variety of sources should be reviewed and considered before decisions are made by the individual investor. My opinions may have already changed, so you don't want to rely on them. Good luck!