THE FEDERAL RESERVE SYSTEM

In recent years, the Fed has almost reached the cult status: Inflation slayer, recession causer, neither or both…will the real Fed show itself?

Changes in the Discount Rate have similarly taken on an aura that can at times cause a furor on Wall Street but at other times, it causes hardly a stir. Names like William McChesney Martin, Arthur Burns, Paul Volcker, and Allan Greenspan have approached near celebrity status, at least in the communities of economics and finance.

This issue of the Newsletter will examine the Fed from many angles and from an historical perspective. Can it really do what many say it can? How does it attempt to impact the financial system and the economy? How has its modus operandi changed over time? Has it out lived its usefulness? These questions have been asked before and continue to be asked.

WHO IS THE FED?

The two major components of the Fed as an organization are the Board of Governors and the 12 Federal Reserve District Banks. The most important group within the Fed is the Federal Open Market Committee (FOMC).

The FOMC voting contingent consists of the seven Governors of the Federal Reserve Board:

1. Alan Greenspan, Chairman
2. Roger W. Ferguson, Jr., Vice Chairman
3. Edward M. Gramlich
4. Susan Schmidt Bies
5. Mark W. Olson
6. Ben S. Bernanke
7. Donald L. Kohn

…and five of the Presidents of the twelve Federal Reserve District Banks (four of the five rotate on regular basis):
Cathy E. Minehan, Federal Reserve Bank of Boston

Timothy F. Geithner, New York (Vice Chairman: FOMC) – NY has a permanent, voting position on the open market committee

Anthony M. Santomero, Philadelphia

Sandra Pianalto, Cleveland

J. Alfred Broaddus, Jr., Richmond

Jack Guynn, Atlanta

Michael H. Moskow, Chicago

William Poole, St. Louis

Gary H. Stern, Minneapolis

Thomas M. Hoenig, Kansas City

Robert D. McTeer, Jr., Dallas

Robert T. Parry, San Francisco

(from the Board of Governors Federal Reserve System – December 12, 2003)

See the following link for an explanation of the Fed’s function… In Plain English - St. Louis Fed).

The Governors are nominated by the Present and confirmed by the Senate. One of the Governors is appointed as Chairman of the Federal Reserve Board of Governors for a 4 year term that begins in the mid term of the Presidential term an and ends at mid term of a president 4 years later. The Governors are nominated by the President and confirmed by the Senate for 14-year terms or to fill out a term of an exiting Governor. If appointed to a full term, that Governor cannot be re-appointed for another consecutive term. If filling out a term of a former Governor, then that appointee can serve for another 14-year term.

A tri-partite group representing the financial, and business communities, and the public elect the District Bank Presidents at large. They are neither appointed by the President of the United States nor confirmed by the Senate. These nineteen people (twelve voting) make up the Federal Open Market Committee that meets about every six weeks throughout the year.

While much of what the Fed does is fairly mundane, such as supervision and regulation, keeping the currency money of the system in a useable condition by destroying the portion that wears out and reissuing new replacements, acting as the fiscal agent of the United States Government, its most prominent role to the press and the public is its role as the monetary authority. This is the role on which we shall focus.

The Fed is mandated by a significant number of laws to achieve a number of economic and financial outcomes. Among these are high employment, price stability, orderly markets, etc. It is up to the Fed to prioritize them at various times. For example, in the 1970s in order to keep unemployment relatively low, it pretty much ignored the fight against inflation and then in the spring of 1980, reversed field and fought inflation which was approaching 20% at an annual rate and crushed the economy with a very restrictive policy actions that saw the unemployment approach 10% as a result. When the market
infrequently suffers a severe collapse, the Fed will typically focus on establishing order once again before resuming a policy they had been pursuing. Since the policy/goals mandated through congressional legislation over a period of several decades are often at odds with one another, the achievement of one goal (such as fighting inflation) often results in the inability to achieve other goals. The Fed, via the FOMC, chooses from the various menu of goals.

**How does the Fed influence the economy?**

Very indirectly is the answer, much more so that the public even realizes. With the exception of the Discount Rate, the Fed does NOT administratively set interest rates. They do, however, influence them through impacting the supply and demand for credit. Their influence is primarily in the short-term end of the maturity spectrum and wanes considerably as the maturity grows…more of this later.

The most overwhelmingly important tool the Fed employs currently is the open market operation function, where they buy and sell securities in the open market through a couple of dozen independent dealers. Open market activities are centered at the Federal Reserve Bank of New York. This influences the supply of credit, particularly in the short-term end of the financial markets. The role of open market operations has gradually replaced the use of the Discount rate because the Fed controls the legal reserves of depository institutions. More remotely, the monetary base which includes these legal reserves (plus currency in circulation), through open market operations as opposed to days of yore where the legal reserves of depository institutions (formerly only commercial banks) by lending the legal reserve to depository institutions. Over the years the role of the discount window facility has shrunk and been replaced by a growing reliance on open market operations to control the monetary base and the quantity of legal reserves.

The Fed controls money and a good deal of credit creation by controlling the legal reserves of depository institutions and their minimal relationship to checkable deposits (and credit created by these institutions). This minimal relationship between legal reserves and the money and credit depository institutions can create is called the legal reserve ratio. Like the discount window facility, it was used more frequently in past years but in recent times has been left fairly dormant as the Fed rarely changes these ratios anymore. Similarly, the use of the discount window has been relegated to supplying legal reserves for seasonal demand and, if a run on a depository appears to be occurring, to supply it with reserves it has lost, if the Fed deems it good for the system. This has relegated changes in the discount rate to a symbolic importance having virtually no operational impact on the system. This is the case since such a small portion of total legal reserves flow to the depository institution system through the discount window as compared open market operations.
Factors Affecting Reserve Balances of Depository Institutions
(Data for week ended December 10, 2003)
Total Factors Supplying Reserve Funds = $779,885

Open Market Operations activity is by far the most important function of the Fed in directing Monetary Policy.
Discount Window activity is currently insignificant (this has not always been the case).
Other Federal Reserve operations are fairly static.

Includes U.S T-Bills, Notes & Bonds (nominal and inflation indexed), Inflation Compensation, Federal Agencies, and Repo Agreements Controlled by Federal Reserve Open Market Committee (FOMC) 88.65%

Primary, Secondary, Seasonal, and Adjustment credit Controlled via Discount Window (Rate) 0.005%

Other Federal Reserve assets (includes Other Fed Assets, Gold Stock, drawing rights, currency outstanding) 11.34%

$691,381 Million
$88,467 Million
$37 Million

BASIC UNDERSTANDING OF MONEY AND CREDIT CREATION

Nearly a decade ago, Prof. Byrne designed picture of how money is related to wealth. It has appeared in his text, FINANCIAL ECONOMICS, for several years. It is reproduced here for the reader. Money has two general meanings. First, its broad meaning is that money is a set of assets the store wealth in a very liquid manner. Its second meaning is that money is anything generally acceptable as...
a medium of exchange. These are the most liquid assets of all. In this nation, the Fed defines the two types of measure. M-1 has traditionally meant the medium of exchange. M-2, M-3, L or liquidity, M-4, M-5, M-1a, M-1b have been some of the designations given money especially as a liquid store of value. The composition changes over time. At one time years ago, gold coins and gold certificates were included but have not for many years now.

The current designation for money as a medium of exchange is M-1. It is composed of three elements: currency, checkable deposits, and non-bank travelers’ checks. The last of the three is so small, it is often ignored. Nearly 99% of M-1 is either currency or checkable deposits. If we divide the economy into the underground economy (in pursuit of indictable activities including tax evasion) and the above ground economy or legitimate economy, which money as a medium of exchange is dominant, if radically different? While currency is roughly one-third of M-1 money and checkable deposits about two thirds, nearly 100% of the transactions in the underground or illegitimate economy is facilitated by currency while the corresponding figure in the legitimate or above ground is nearly 5%. A major part of the currency component of M-1 serves as the preferred currency in places like Cuba, Russia, etc., where local currencies evoke little faith in their ability to hold value.

Currency consists of coins and paper money, nearly all of which are Federal Reserve Bank notes. While the coins are heavy, they are swamped in dollar value by the Federal Reserve notes. Checkable deposits consist of demand deposit, negotiable orders of withdrawal (NOW accounts), share drafts at credit unions and ATS or automatic transfer accounts (zero balance checking accounts attached to a savings account. Just below is a breakdown of the components of M-1 along with those of M-2 and M-3. Until a short while ago, L or liquidity was also published but has been discontinued.

H.6 Money Stock Measures

(M-1)
- Consists of (1) currency outside the U.S. Treasury, Federal Reserve Banks, and the vaults of depository institutions; (2) travelers checks of nonbank issuers; (3) demand deposits at all commercial banks other than those due to depository institutions, the U.S. government, and foreign banks and official institutions, less cash items in the process of collection and Federal Reserve float; and (4) other checkable deposits (OCDs), consisting of negotiable order of withdrawal (NOW accounts), automatic transfer service (ATS) accounts at depository institutions, credit union share draft accounts and demand deposits at thrift institutions. Seasonally adjusted M1 is calculated by summing currency, travelers’ checks, demand deposits, and OCDs, each seasonally adjusted separately.

(M-2)
- Consists of M1 plus savings deposits (including money market deposit accounts), small-denomination time deposits (time deposits-including retail RPs-in amounts of less than $100,000), and balances in retail money market mutual funds. Excludes
individual retirement account (IRA) and Keogh balances at depository institutions and money market funds. Seasonally adjusted M2 is computed by summing savings deposits, small denomination time deposits, and retail money fund balances, each seasonally adjusted separately, and adding this result to seasonally adjusted M1.

(M-3)

- Consists of M2 plus large-denomination time deposits (in amounts of $100,000 or more), balances in institutional money funds, RP liabilities (overnight and term) issued by all depository institutions, and Eurodollars (overnight and term) held by U.S. residents at foreign branches of U.S. banks worldwide and at all banking offices in the United Kingdom and Canada. Excludes amounts held by depository institutions, the U.S. government, money funds, and foreign banks and official institutions. Seasonally adjusted M3 is calculated by summing large time deposits, institutional money fund balances, RP liabilities, and Eurodollars, each adjusted separately, and adding this result to seasonally adjusted M2.

(from the Board of Governors Federal Reserve System – December 12, 2003)

It is critical to understand the overwhelmingly dominant role that checkable deposits play in the legitimate economy. It is also critical to understand those checkable deposits, your checking accounts, are short-term liabilities of depository institutions, commercial banks, savings banks, savings and loan associations, and credit unions.

What most people do not understand is that checkable deposits are created by depository institutions when they create credit. Since the dominant form of M-1 money consists of checkable deposits, it means that the private sector creates M-1 money for the legitimate part of the economy and the Federal Government. The checkable deposit money is created by private sector depository institutions in the process of creating credit. That is, the private sector depository institutions create a liability on themselves, swapping it for the financial claims the borrowers’ offer, usually some for of note payable which to the depository such as a bank is a note receivable. The borrower and the depository swap debt and M-1 money in the form of checkable deposits is created as well as credit being created.

MONETARY THEORY AND ITS INFLUENCE ON MONETARY POLICY

When the Federal Open Market Committee makes decisions about monetary policy, it is not done in an intellectual vacuum. The nineteen members of the FOMC come from a variety of backgrounds and are often bearers of economic orientations that in various ways are inconsistent with one another. Some are monetarists, a few reflect the Austrian tradition, and some are of the Keynesian tradition. Many analysts are eclectic. Lord Keynes in his General Theory back in the middle 1930s spoke of contemporary politicians basing their policies and arguments on theorems of long-dead economists.

In the bottom of the economic decline that began in 1999, at least two members of the FOMC suggested even tighter monetary constraint to avoid inflation that would occur
since the monetary aggregates were growing too rapidly. This is the argument of monetarists. One member of the FOMC spoke of malinvestment, a term very much related to the Austrian theory of the business cycle.

In the next issue of this newsletter, we will devote a portion of that newsletter to a survey of the “schools of thought” for want of a better term, that influence the decisions of the policy makers. We will scrutinize these arguments in the light of the New Paradigm, which increasingly makes these arguments, though very relevant in past times, increasingly irrelevant to the evolving economic landscape.

There have been claims and counter claims that the Fed mistakenly caused the economic downturn that ended with the recession of 2001. In the very first issue of this newsletter, the editors argued that the economic downturn which began in 1999 and culminated in the recession of 2001 was primarily the result of several years of a rising ratios of federal taxes (receipts) to GDP, a very large trade deficit resulting from an overvalued dollar and also beginning in 1999, a monetary policy change that brought to the economy, monetary restraint. All three contributed to bringing an economy that was growing at a real growth rate of over 7% in 1999, to a trough of a negative 1.3% annual rate in 2001. The large trade deficits began in the early 1980s, the increasing tax burden in the early 1990s while the monetary restraint occurred in 1999–2000.
There is plenty of blame to go around. A former Treasury official takes the credit for influencing upward federal taxes as the cause of declining inflation but does not seem to connect that reasoning to the economic collapse beginning in 1999. No credit for eliminating inflation is given to increasing competition, which is the most fundamental cause of the elimination of the inflationary bias. The trade deficit is rarely mentioned as an eventual co-cause of the economic slowdown. Now criticism of the Fed’s role is receiving more press.
Federal tax cuts, a depreciating dollar in foreign exchange markets (is easing the trade deficit), and the FOMC - now assuming an accommodative stance (brushing aside fears of inflation as the economy begins to expand at very high real rates), are all contributing to the current vigorous economic expansion. Productivity gains have been great and large numbers of highly skilled and experienced laborers are ready to be called back to new jobs after becoming structurally unemployed. Structurally unemployed individuals represent a rising percentage of total unemployed – even though the unemployment rate is falling. This reinforces the assertion that a fall in the unemployment rate is a lagging indicator of economic recovery/expansion.

...a bit more on the Deficits and Unemployment

With 2003 winding to a close, the concerns over the economy have switched from whether or not this recovery is for real, to whether or not the price paid for this recovery and expansion are too great. In this issue of the newsletter we have had three “Letters to the Editor” all basically asking if this is in fact not the case.

We have purposely avoided delving into the arena of political economy, choosing instead to address issues from an objective viewpoint. Rather than opine, we instead draw data from easily identified and verifiable basic sources, encouraging the reader to digest this information and draw their own conclusions. While we strive to explain in a straightforward manner, economics tends to be a complicated discipline, requiring patience and an open mind to formulate informed analysis. It’s easily discerned and readily understood that many people, rather than explore these areas difficult to
understand, would prefer instead to politicize issues, labeling all-comers as either liberal or conservative. The problem, of course, is that while this seems to satisfy some irrational longing to oversimplify and obviate, it does nothing toward shedding light on very complicated, yet absolutely essential aspect of our every day lives.

**Fiscal Deficit**

We’ve indicated that the fiscal deficit is likely to surpass $400 billion for 2003, and will likely reach higher levels in 2004 and 2005. We’ve stated unequivocally in previous issues that high levels of government receipts (a.k.a., taxes), coupled with reduced government spending contributed significantly to government surpluses. The downside was that the increase in government receipts put a great deal of stress on the economy and we believe contributed greatly to thrusting the U.S. into recession in 2001 (with the downturn beginning much earlier on – even as early as 1999).

Given that we have now embarked on a fiscal policy targeting tax reductions and higher government spending to wage war on terrorism, among other agenda items, what are the prospects for actually reigning in the expanding deficit? How long until we turn the corner and once again experience lower deficits, or even surpluses?

**What will happen to the projected fiscal deficit of $450 Billion in 2004 if…?**

- Real GDP grows 5.5% annually on average over the next ten years.
- Government spending increases 3% annually on average over the next ten years.
- By the end of 2013, the fiscal deficit should be nearly zero…
- Continuing at the same rates, by the end of 2023, the surplus should be in the range of $1 Trillion.

With the Current Account Deficit likely to be at around $530 Billion for 2003 (the trade deficit will probably come in at $450 - $480 Billion), there is ample reason for concern. On a good note, the dollar has depreciated by nearly 15% since the beginning of 2003. In spite of the locomotive effect (increased imports) associated with an expanding economy, it’s likely that the Current Account Deficit will shrink to under $450 Billion for 2004, and drop even further as exports continue to pick up and a depreciating dollar will cause imports to become more costly.
The dollar has depreciated nearly 15% (on an annual basis) since the beginning of 2003. This depreciation should serve to increase exports and lower imports in the year ahead.

**Unemployment**

Further good news on the unemployment front for 2004… 2003 has been a year where productivity has sky rocketed to levels not seen in twenty years, corporate profits are up and the need for an infusion of labor will encourage employers to once again begin hiring to meet increasing demand. Structural unemployment issues, brought on by persistent cost pressures have forced employers to be more cautious in hiring back workers, but rational decision making should net gains in the employment picture, bringing the unemployment roles down well below the current 5.9% rate.

Typically at year-end, employers are unwilling to bring on new workers as their primary goal is to protect their profits. This year, however, has seen new jobless claims drop significantly and steadily, even in late December. While a bit early to say definitively, this increased activity in the labor markets should carry well into 2004.

According to the Conference Board, the index of Help Wanted Advertising ticked up to 39 in November 2003 moving from a rather anemic 37, where it had been since August 2003.

The Employment Picture

Unemployment Rate (6.1% Sep) ... (6.0% Oct) ... (5.9% Nov)

The November Unemployment Rate came in at 5.9%. According to the Bureau of Labor Statistics unemployment dropped from 6.4% in June to 5.9% (Seasonally adjusted measure) of the labor force in November, constituting a significant and continued brightening in the employment picture. The data becomes even clearer when using the Not Seasonally adjusted numbers: June 2003 >> 6.5%, and November 2003 >> 5.6%!

Monthly Job Creation / Loss 2003
Department of Labor
December 23, 2003

... for this recovery to really continue in 2004, we will have to see job creation numbers on the order of 200,000 per month as we move through the first quarter.

Jobless Claims
(4-wk rolling avg: 364,000 Dec-6, to 362,000 Dec-13, to 361,750 Dec-20)

The new Jobless Claims data came in at a 353,000 for the week ending December 20, 2003 an decrease in claims of 1,000 from the previous week’s 354,000. The crucial four-week average dropped to 361,750 for the week ending December 20. Department of Labor data indicate that there have now
been twelve consecutive weeks of claims below the 400,000 mark, generally viewed as the level required for economic expansion.

\[ \text{GDP} \quad (3\text{rd Quarter 2003 Real GDP: } 8.2\% - \text{ Final}) \]

The third quarter of 2003 showed continued positive growth in real GDP. The Commerce Dept. reported an 8.2% growth rate for the 3rd Quarter 2003 (on an annualized basis). It marked the 8\text{th} consecutive quarter of economic expansion, completely dismissing any notion that this recovery was a flash in the pan. The 3\text{rd} Quarter 8.2% rate is the fastest the country has expanded in twenty years (9.0% in 1\text{st} Quarter 1984). Again, the GDP growth was spread across the board, and is most markedly reflected in durable goods purchases rising some 28.0% and exports rising 9.9% (while imports rose only 0.8%).

\textbf{What Recession?} \\
\textbf{Eight (8) quarters of economic growth and counting!} \\
(3\text{rd Qtr 2003 } 8.2 \text{ - the best performance since 1\text{st} Qtr 1984})

\begin{center}
\begin{tabular}{|c|c|c|c|c|c|c|c|c|c|c|c|c|c|c|}
\hline
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\text{Gross domestic product:} & \\
Previous Real GDP & 2.6 & 4.8 & 0.6 & 1.1 & (0.6) & (1.6) & (0.3) & 2.7 & 5.0 & 1.3 & 4.0 & 1.4 & 1.4 & 3.3 & 7.2 \\
Revised Real GDP & 1.0 & 6.4 & (0.5) & 2.1 & (0.2) & (0.6) & (1.3) & 2.0 & 4.7 & 1.9 & 3.4 & 1.3 & 2.0 & 3.1 & 8.2 \\
\hline
\end{tabular}
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This is the third upward revision in Third Quarter GDP in as many months. Also, it is interesting to note that the Bureau of Economic Analysis made significant revisions to previous periods. Note that 3\text{rd} Quarter 2000 GDP was actually negative.

\[ \text{Leading Indicators} \quad (5.7\% + \text{ annual rate November 30, 2003}) \]

According to figures released by the Conference Board on November 30, “The leading index increased by 0.4 percent in October. September’s originally reported 0.2 percent decline was revised up to a 0.0 percent change. The leading index has now increased at a 5.7 percent annual rate over the last six months and this increase has been extremely widespread.”
Construction

The most recent data shows continued strong levels of construction put in place. The October figures show an increase of 0.9% above the September numbers. Additionally, the October data is 7.0% above that of October 2002. This amounts to an annualized rate of $922 Billion. This sector continues to perform strongly through the current expansion.

New Housing Starts

The most recent data available shows continued near record levels of new housing starts. The November figures are running at a seasonally adjusted annual rate of 2.07 million units, 4.5 percent higher than the 1.98 million-unit revised rate reported for October. This is 17.6% higher than November 2002 figure of 1.76 million units.

New Residential Sales

According to the Census Bureau, sales of new homes dropped slightly from October’s numbers of 1.109 million units, to 1.082 million units (on a seasonally adjusted annualized basis) in October, representing a fall-off of 2.4%. This rate exceeds the November 2002 figure of 1.022 million units by 5.9%.

Durable Goods

The most recent report from the Commerce Department shows that New Orders for Manufactured durable goods decreased 3.1% in November to $180.1 billion. Excluding defense, new orders decreased 2.9%. This represents the largest decline in new orders since September 2002. Year-to-date, new orders for 2003 were 2.0% above the same period for 2002.

Shipments increased at a 0.1% rate or $0.1 billion. This followed a 0.9% increase for October. Year-to-date, shipments were 0.1% above the same period for 2002.

Unfilled orders increased 0.4%, or $2.2 billion, with machinery leading the way at 1.5%. This followed an increase of 1.6% in October.
Meanwhile, **Inventories** dropped 0.1% in November, reversing the October increase of 0.3%.

**Capital Goods Industries:**

**Defense**, new orders decreased $0.4 billion or 4.7% to $8.8 billion; shipments decreased $0.4 billion or 4.8% to $7.5 billion; unfilled orders increased $1.3 billion or 1.0% to $136.2 billion; inventories decreased by $0.6 billion or 0.6% to $105.1 billion.

**Nondefense** new orders decreased by $4.0 billion or 6.4% to $57.8 billion; shipments increased by $0.2 billion or 0.4% to $58.9 billion; unfilled orders decreased by $1.1 billion or 0.5% to $221.0 billion; and inventories fell by $0.6 billion or 0.6% to 105.1 billion.

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**Current Account Balance (Trade Balance)**

The Current Account Balance consists of the Trade Balance (Net Exports (Exports less Imports) of Goods and Services), the Income Balance (Income Receipts and Income Payments), and net Unilateral Current Transfers. The Department of Commerce publishes the Current Account Balance data on quarterly basis.

As reported by the Commerce Department on November 12, 2003, the trade deficit in October 2003 stood at $41.8 billion, growing by 1.2% from the $41.3 billion reported for September 2003. Exports were at $88.0 billion up by more than $2.2 billion from $85.7 billion revised figure for September. Imports were at $129.7 billion, up by nearly $2.7 billion from the revised $127.1 billion reported for September.
On a good note, exports have improved significantly from September, growing by 2.7%.

Imports, on the other hand, grew at a 2.0% rate from September.
The bad news is that the trade balance continues to worsen – again, this is due to the Locomotion Effect (rising imports during economic expansion). This trend, however, should begin to reverse in the next few months (due to continued deterioration in the dollar and improvements in exports).

CPI (-0.2%) / PPI (-0.3%) (Seasonally adjusted)

CPI – On a seasonally adjusted basis, the CPI-U, which was unchanged in October, declined 0.2 percent in November. Energy costs declined 3.0 percent, following a 3.9 percent drop in October.
PPI – On a seasonally adjusted Producer Price Index for Finished Goods declined 0.3 percent in November. This decrease followed five consecutive increases -- including a 0.8-percent rise in October and a 0.3-percent increase in September.
Low inflation continues to be the rallying cry of this recovery. *The New Paradigm* reveals the continued deterioration of pricing power market-wide.

Productivity, Unit Labor Cost and Compensation (Seasonally Adjusted)

According to a Department of Labor report, published on December 3, 2003 Productivity gains amounted to 9.4% for the 3rd Quarter 2003. This was revised from the November estimates of 8.1%, adding to the 7 percent gain from the second quarter. Unit Labor Cost was revised downward from -4.6% to an incredible -5.8%, versus a 3.2 percent drop in the second quarter. Lastly, Compensation was revised down from a 3.1% in the third quarter to 3.0%, down from 3.6 in the second quarter.

In keeping with the New Paradigm, this is the best quarterly productivity increase in more than twenty years (2nd Quarter 1983).
10-year U.S. Government Bond Rate

The 10-year Maturity U.S. Government Security continues to remain trading at a relatively low rate. On December 26, 2003 the yield stood at 4.15 percent. In the absence of inflation, and coupled with the quality of U.S. Government debt, there is no reason for it to rise to a significantly higher rate in the near future.
Letters to the Editors

From John in Los Altos…

Excerpts from John’s letter, dated December 1, 2003 (John’s questions/comments are underlined)

*See Nov 8 Economist for a discussion of the Bush Financial Strategy - or lack thereof. They were heavily critical of the mess it will create…Much less complacent than your letter.*

Let’s see, since November 8th, the Real GDP has been revised upward, we have the lowest number of new jobless claims since January 2001, most all of the positive indicators are on the rise, and the negatives on the wane. No doubt they (*The Economist*) point to concerns over deficits and trade balance issues - well, the truth of the matter is that we can and will grow out of our short-term deficits and the trade deficit is already showing signs of diminishing. More to the point, with the expanding economy, healthy, nominal GDP growth will bring in more tax dollars. Trade balance issues are complex in that there are numerous reasons why they continue: protecting our national interest (China, G7…now G8 with
Russia), the still robust dollar (it is depreciating), and wholesale intervention by other nations who use our imports/their exports as a means to conduct domestic policy.

_The unemployment situation is very serious here. It is not turning around. I hope that it will but there are people leaving for jobs elsewhere. Two of my kids are unemployed (Seattle and Boston) and say there are pretty limited opportunities. Our raises are going to be on the order of 2% for most people this year. I do not see this as a rosy economy yet._

Rises first - why should raises be any more than 2% if inflation is basically zero (it is generally accepted that the CPI overstates inflation by between 1 and 2 percent)? Besides, increased compensation translates into higher product costs - the consumer won't pay for it because there are substitutes (competition - the heart and soul of the New Paradigm). Besides, a 2% increase goes much further when it is basically a REAL 2%.

Unemployment: Again, The New Paradigm speaks to structural unemployment, that is unemployment not cyclical in nature - jobs go away period, and new jobs have to be created...this last part takes time, much more than in the past. For the months of September and October the economy grew 250k jobs. This may not seem like much, but it is better than had taken place for the two years previous. The numbers have been less than encouraging, but there is improvement, as I noted above.

_Nationally we have an increasing debt to service, increased cost of war, increased farm subsidies, the baby boomers getting ready to retire, and increased medical costs born by the government. In addition, a lot of people have borrowed heavily during the low inflation/interest. Who is going to pay for all this and when?_  

Who do you think pays for this stuff, John? Those that pay taxes pay for all of this stuff. Sorry, don't mean to sound trite, but it is true.
As indicated in the graph below, the debt service is not as big a problem as you might think (bear in mind that lower interest rates also reduce cash flow and debt service concerns, allowing the public to again retain more for their money). Also, debt service ratios have actually eased a bit since 4th Quarter 2001.

The cost of caring for the Baby boomers will be borne by subsequent generations, as has been the case for previous generations. The real issue that will arise and will continue to be raised is transfer of wealth to the next and subsequent generations.

One of the major issues the editors of this newsletter have been discussing is what is the best course of action the government should take, in a fiscal sense to address the concerns of a burgeoning deficit. The biggest problem we noted from the nineties was that fiscal policy was basically geared to tax increases to run surpluses. The problem with that was that excessive taxes depress, making it increasingly difficult for the economy to maintain substantial growth. Instead, it is our assertion that it is far better to allow the economy to expand at a faster rate with lower tax rates and allow the tax base to increase more quickly (no matter how you look at it, taxes depress - whether in the Keynesian Model or in this New Paradigm).
Your newsletter should offer options for solutions, not just discourse.
Interesting comment, John. We are very confident that we have in fact done just that, by defining what the issues are and going from there. We certainly have discussed and to that end make no apology, but so far as offering solutions, we have laid out options and paths that we believe should be followed.

It is apparent from your comment that we have much work to do toward that end.

Tina from Canton…

After reading an article by Alan Framm of the Associated Press, Analysts: Future Budget Outlook Gloomy, I couldn’t help but feel a measure of discomfort at the prospect of ballooning and persistent budget deficits. How are we going to cope with these seemingly problematic deficits?

Thanks for the article. Yes, running significant and consistent deficits is not a good way to go in the long run. The point is that when an economy is on the way to recovery, it is not uncommon to run budget deficits, especially in light of the added cost in the war on Terrorism. The major point to bear in mind is that while we are certainly running deficits, the economy is expanding at a rate much higher than government expenditures are actually expanding…at least this has been the case for the 3rd Quarter 2003:
Comparison between growth in GDP and Government Spending

Department of Commerce: Bureau of Economic Analysis (BEA)
December 23, 2003

Think of a typical situation in business: you are incurring higher levels of debt in order to expand your business, increase your cash flow. The short-term risk of running deficits can, if managed properly, afford long term gains in the form of increased sales/expanding business. There is not much difference at the government level. So long as government expenditures maintain a long run growth level below GDP, we should avoid any long-term problems. Additionally, as government receipts grow, in spite of lower tax rates, we should start seeing a turn around in the deficit picture within about 3-4 years. In fact, within 10 years, we will likely begin to see surpluses. All of this is dependent upon a lot of factors, including sound fiscal and monetary policy...and, most importantly, continued economic growth.

George in Rancho Bernardo, CA…

In an article by Justin Lahart, CNN, “Bill Gross has added his voice to the growing throng of market observers who see inflation on the rise. In his latest monthly missive, the bond manager, who oversees $350 billion in assets for Pimco, said the stage has been set for higher prices and recommended that
investors act accordingly. A fed funds rate at 1 percent, massive current account and budget deficits, high levels of household debt, lower tax rates, a falling dollar, rising commodity prices, costly Medicare reform are all pointing the way to a revival of inflation.”

What’s up with all of this literature of impending doom? The one thing that I’ve learned in my reading is that those portending bad things to come outnumber the good by at least two to one. While I am not a pessimistic person by nature, I am concerned. In the spirit of your New Paradigm, would you care to debunk (address) the possibility of the upcoming ‘inflationary’ period forecasted by Gross?

A few things to remember:

- Henry Ford: 'History is BUNK!
- In 1997, many smart people said DOW 20K in Y2K.
- The BCS system ensures an unambiguous NCAA Division 1 Football National Champ!

The curious thing with Mr. Gross is that if you were to present the current scenario to him: that is the economy growing at an 8% clip; the fed funds rate at 1%; deficits running at around $500 Billion; Current Account Deficit (Trade Balance + Unilateral Transfers) at around the same rate $500 Billion; and a depreciating dollar, this fellow would no doubt tell you that inflation is well into the teens. Guess what, George? We’re running in the 1-2% range, with the most recent data indicating deflation in the CPI. Mr. Gross is suffering from what the Fed has been wringing their hands about for the past several years - where in the hell is inflation? It has become the dog that didn’t bark.

Burned by their last adventure into economy killing rate hikes, the Fed is loathe to raise rates without substantial proof that inflation is rearing its head. The point is that Gross and probably the Fed have a bias toward inflation driven via the money supply (Monetarism), or by fear of an expanding inflationary gap (Keynesian). Remember this comment on inflation, George: firms raising prices cause inflation. The presence of heavy market competition, productivity gains, etc., has precluded any significant increase in prices in the economy to date. In the nineties, Robert Ruben took credit for keeping inflation at bay, citing that high taxes kept consumer spending under control. What was really going on was that competition was becoming more pervasive, keeping inflation at relatively insignificant levels in spite of sustained economic growth...

Yes, he (Gross) indicates that commodities have and will continue to rise as the dollar depreciates - but the flip side to this is that as the dollar depreciates it
becomes more advantageous for domestic producers to crank up their volumes (oil, copper, steel, etc.). His assertion that consumer debt is flat out wrong. As indicated in the newsletter, Volume 2003: Issue 3 and in the graph found in the response to John’s letter, consumer debt is not running out of control.

The question for Gross and others who doubt the realities of this recovery is when will this uptick in inflation occur, and how much inflation are they speaking of?

One last thought...yes, the Fed was speaking of deflation a few months back, primarily because their monetary policy (influencing/coaxing the Fed Funds to the 1% level) was basically irrelevant and impotent. The amusing thing is that what completely befuddles the Fed is that inflation has not already reared its head - again, citing the incredible growth...this is what Gross is banking on. Let's see how it plays out in the months ahead, shall we.