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Economic Ideas that Influence Policy Makers

Monetarism and its diminishing Relevance in the American Economy

Early in 2003, the President of the Federal Reserve Bank of Cleveland, Jerry Jordan, retired after over a decade in that position. Over a quarter of a century before that he became a well-known monetarist and wrote profusely on the topic as a senior research economist at the Federal Reserve Bank of St. Louis. Even better known as the high priest of Monetarism, is Milton Friedman (and Anna Schwartz Federal Reserve Bank of Minneapolis-The Region-Anna Schwartz on Milton Friedman (September 1998)), a long time Economics professor at the University of Chicago. While Monetarism comes in many variants, it argues that at least the excessive growth in money is a necessary condition for inflation but to many of this persuasion, it is a necessary and sufficient condition in causing inflation.

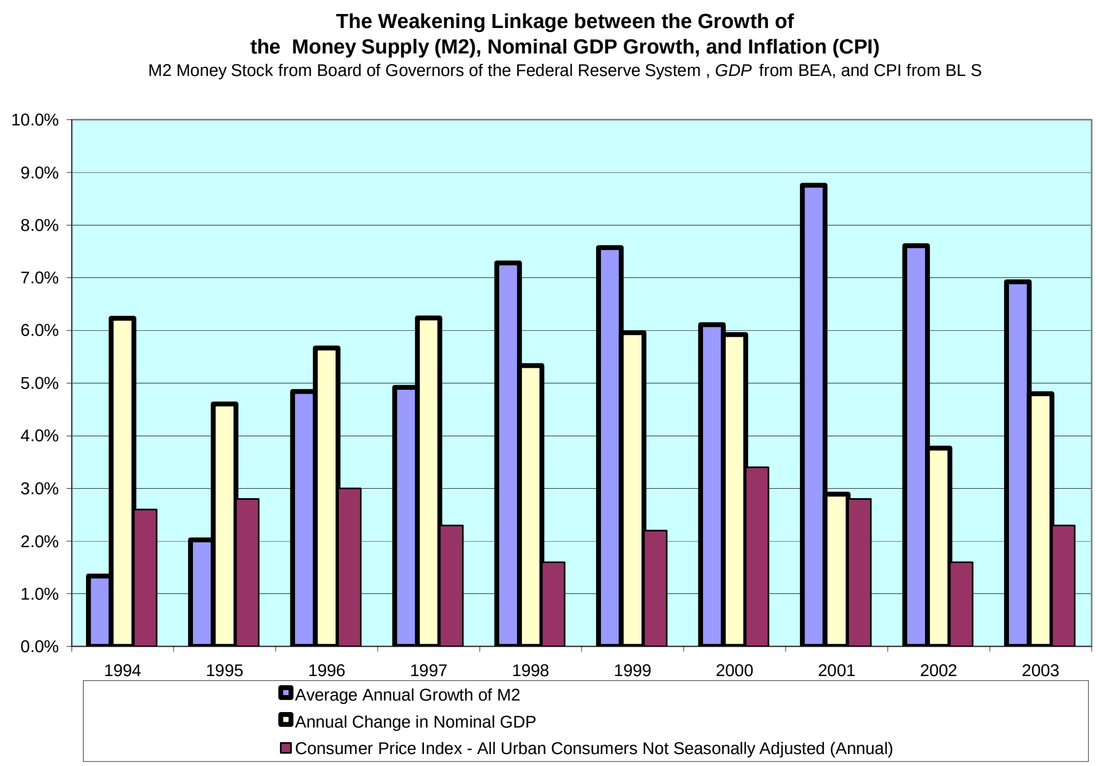
The roots of monetarism go back to the early quantity theory. As it evolved it took on more sophisticated forms, but the excessive growth of money was at the core of inflation. *Essays on Inflation*, written by Thomas M. Humphrey, was one of the best treatments of this evolution. The Federal Reserve Bank of Richmond published it in many editions in 1980s and is available through their website at http://www.rich.frb.org/pubs/index.cfm/0.

Monetarism is a line of reasoning emanating from the Quantity Theory. In a very early version (reference to David Hume http://www.econlib.org/library/enc/bios/hume.html), often called the crude quantity theory, prices on the average grew proportionally to the growth rate of money: Money times it Velocity equals Total Spending. Real output times it prices is the current dollar value of total output, today referred to as GDP. Since there are more than one definition of money and these definitions have changed over the years, a rough approximation of what money meant in this context would be what is called M-2 or thereabouts. The link between spending and money is referred to as the velocity of money. For example, if nominal or current dollar GDP for a year is 100 and the average quantity of money during that period is 50; the velocity of money is 2.

Note: money is a **stock** (measured at any given point in time) and GDP a **flow** (measured over a period of time) so that we use the average stock of money for the year in which GDP is measured.

United States – (Jan-Dec 2003)		
Nominal GDP	**$10,984**	**[Billions of dollars]**
Average M2 Money Stock	**$6,010**	**[Not Seasonally Adjusted]**
Velocity	**1.8**	

For this to be so, the velocity of money must be stable. Real output must be at capacity or full employment levels. When money increases, total spending increases, and if output is constant at full employment capacity, prices will have to rise. In some form or another, the stability of velocity of money is critical to the relevance of the quantity theory of price levels. As a policy guide, the very least is that if the velocity is not stable, its path can be predictable. At its height of popularity in the 1970s and early eighties, even if the secular trend in velocity was rising, as long as it was predictably rising it could be compensated for with a lower rate of increase in money. In the late 1980s and 1990s, the velocity of money such as M-1 and M-2 lost this quality. Part of the g rowing instability of M-1, M-2 and the other monetary aggregates was due to the rapid innovations in practices such as swept balances and part was due to the rapid growth of new and more widespread financial claims often called near money, such as overnight and term repos and Eurodollars.



The editors of this Newsletter would argue that the increasingly competitive structure of the American economy was gradually eliminating price power of firms and labor. The downward price rigidity was giving way to downward flexibility of prices as increasing competition eliminated the price power of firms in many industries. The bias toward inflation was gradually disappearing. In increasingly competitive markets (technically, price elasticity of demand at each price was increasing), the ability of price increases to increase a firm's revenues was diminishing. The rational for price increase was disappearing. Control of costs began to replace attempts at price increases. Restructuring was on the rise.

Inflation is the process in which the average of prices is rising. Firms raise prices in order to raise revenue to increase profits (revenues – costs = profits or losses). If price increases no longer increase revenue because the quantity sold decreases so much, price increases no longer give relief to the firm from falling profits due to rising costs, e.g. in the auto industry.

It is the (gradual) emergence of this New Paradigm that has been gradually eliminating the inflationary bias, and the link between money and price level changes. Thus came the declining relevance of monetarism including its declining influence in the determination and conduct of monetary policy.

The Inflationary Gap of Keynes

While never stressed, the acceptance and continued relevance of the so-called Keynesian Revolution that became dominant by the late 1940s, depended upon the cartelism of markets, both product and resources markets like labor. The gradual demise of competition in the late 1800s and Pre-W.W.II period resulted in a large part of the American economy being subject to price power by firms and labor resources. When this occurs, prices become rigid downward. The first reaction by firms with market power when demand weakens is to cut output and not prices. This imparts to the economy an increasing inflationary bias as well as a recessionary bias. Though a powerful figure in Neo-Classical economics, Keynes began to understand this growing problem in market adjustment to falling demand. His mentor, Alfred Marshall pointed this out in Book Five of his very popular PRINCIPLES.

Inflation was not a problem in the 1930s, when Keynes wrote his GENERAL THEORY; nonetheless, his model had an implied theory of inflation as well as recession. If at full employment, total spending as represented by the Aggregate demand line was above the 45-degree line, an inflationary gap existed.

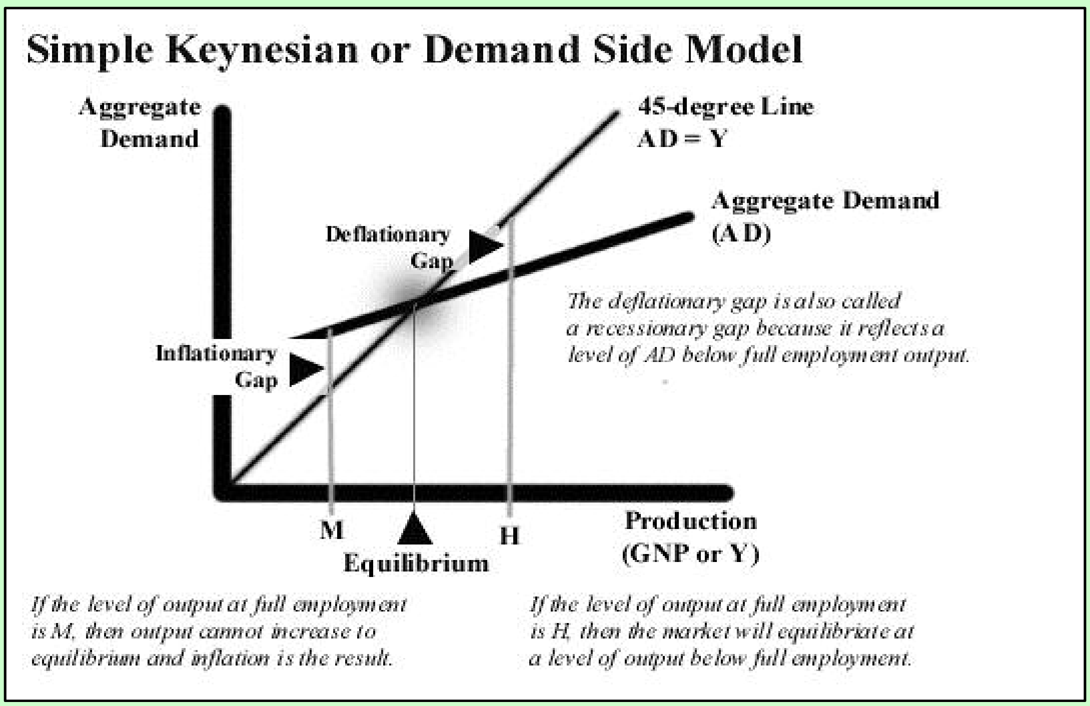
In the Keynesian argument, an economy could be at equilibrium in a 'great depression' or with accelerating inflation. The market would not heal itself as was implied in the neoclassical vision of Say's Law. It was incumbent upon the government through policy intervention such as expansive fiscal policy, to eliminate the recessionary gap. In the late thirties, it was believed that monetary policy was of little value since lowering interest rates, even to negative values, would little help to stimulate investment spending, since there was so much excess capacity. Besides he suggested, the interest rate could not be driven below a minimum level called the Liquidity trap since people would hold money rather than risk investing it. This bias against the efficacy of monetary policy has pretty much disappeared in recent years. From the attention paid to it in FOMC meetings, this seems to be the case.

This necessity of government intervention did not set well with those on the right, nor does it set well today. Fortunately, the need for government intervention is diminishing as increasing competition in markets is eliminating both the recessionary and inflation biases that have so longed plagued the U.S. economy.
The microeconomic assumptions behind the Keynesian Model involve downward price rigidity due to lack of competition in markets – in our current economy; this no longer holds sway.

Keynes – Post World War I – World II:

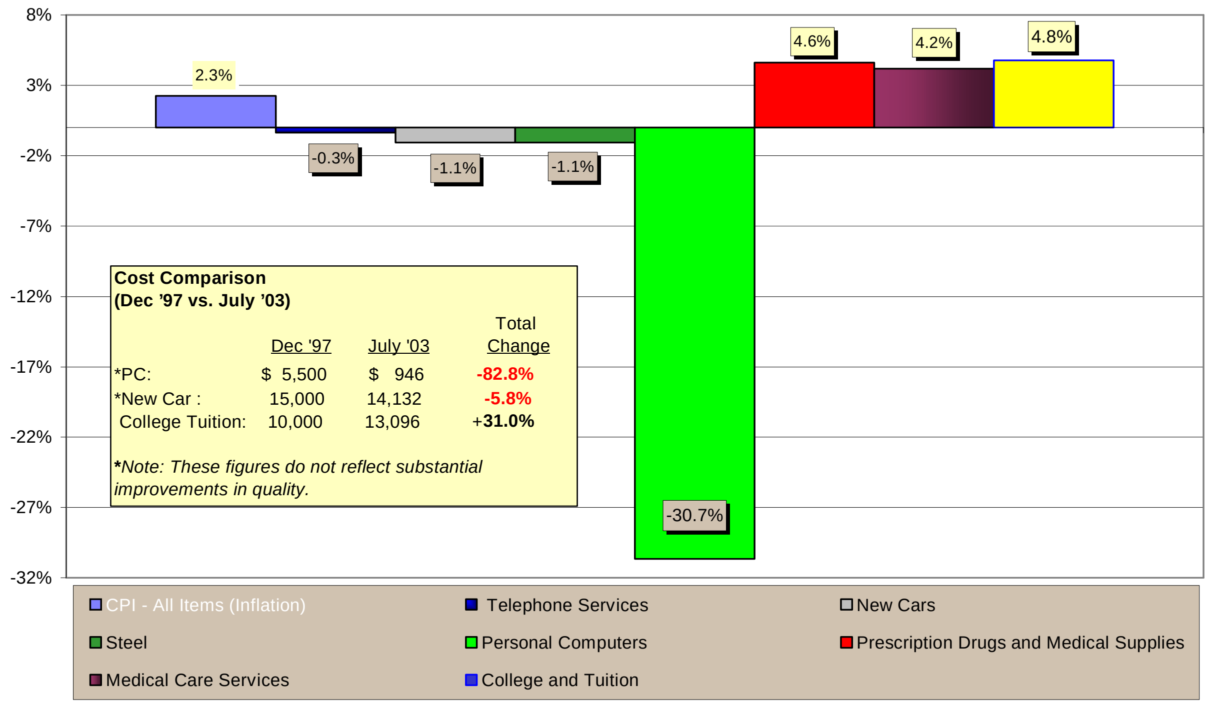
When price rigidity reigned supreme…

Figure 8.6 (from *The New Paradigm in Economics*: *Economic Understanding for the 21st Century Donald R. Byrne, Ph.D.*)



…into the 21st Century:

so much for sticky prices!



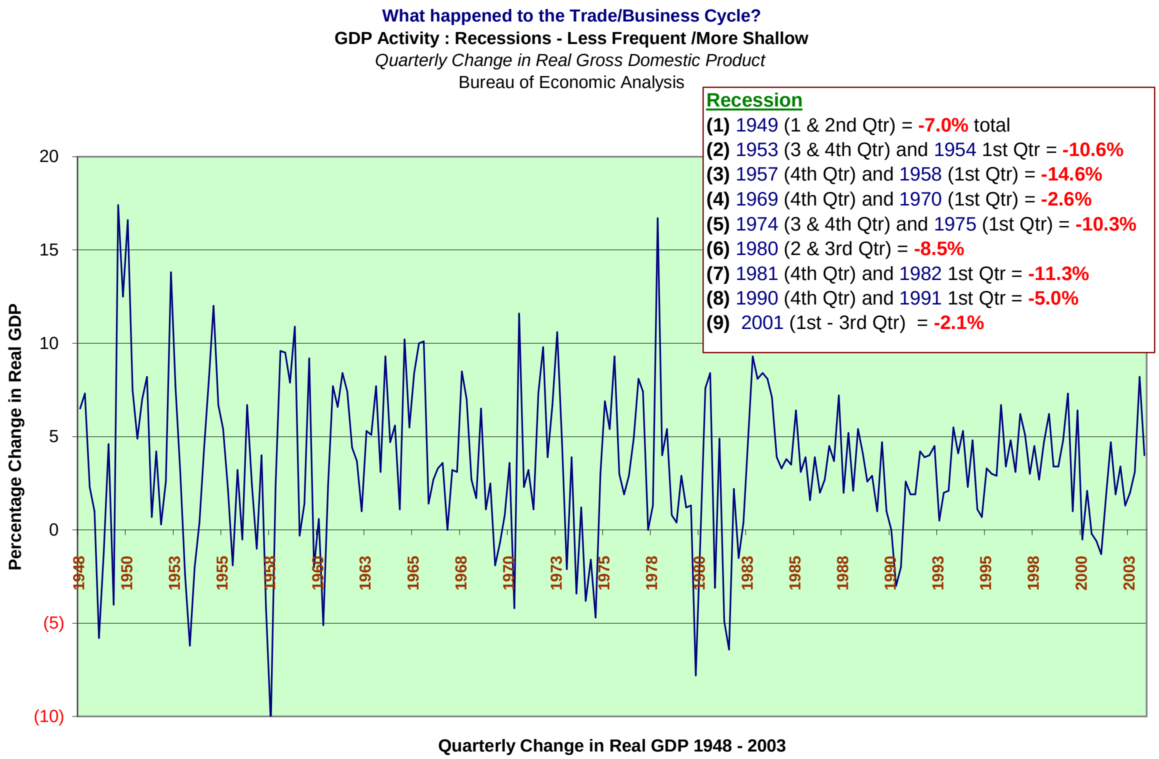
As we will see in futures issues, the same increasing competitive forces cause a less unequal income distribution by elimination of surplus rewards whether it be profits or labor compensation. These are characteristics of the evolving New Economic Paradigm in the American economy.

Austrian Economics

In a very real sense, this is a rambling set of arguments that have been generated over one and one-half centuries. It more or less began with the battle between Bohm-Bawerk and others over Karl Marx's argument that capital was unproductive. Marx asserted that only labor was productive. This is a variation of what has occurred throughout the history of economics. The Physiocrats argued only agriculture produced a surplus. Some argued that services did not produce surpluses, only the goods sectors did that.

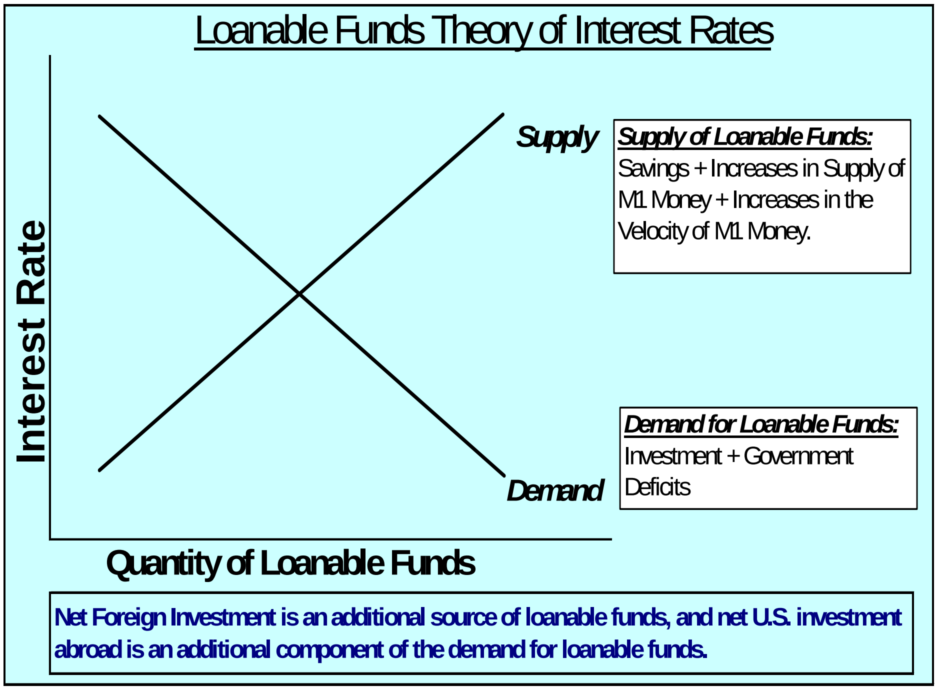
…But the Austrian School stands for much more to it supporters. Probably one of its more important tenets is the Austrian Theory of the Trade Cycle. It is really a first cousin to Knut Wicksell's theory of inflation. In the Wicksell version, banks create money and credit and cause the market rate of interest to fall below the natural rate of interest. The natural rate of interest was that interest rate that equated saving and investment and assured that the natural rate of employment was achieved, that is the labor market was

cleared. By driving down the market rate of interest below the natural rate of interest, Investment exceeded saving, resulting is excess demand and causing inflation.



The Austrian version stresses that once the market rates of interest were driven below the natural rate, the excess investment was called malinvestment. When interest rates rose to their natural levels, the excess investment had to be worked off thus resulting in the contraction part of the trade or business cycle. In a Congressional hearing around 2-years ago, the Fed Chairman used the term 'malinvestment' to describe the economic malaise the United States had entered. Terms like irrational exuberance, while not necessarily Austrian, were also frequently used.

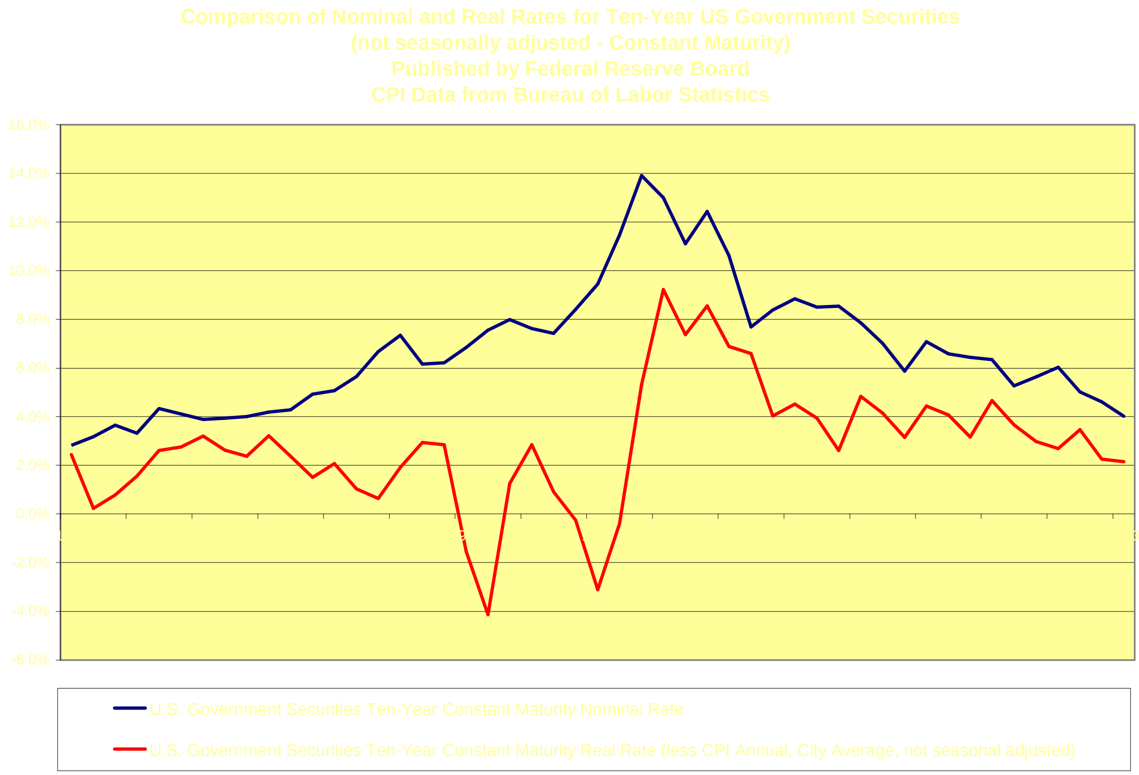
Both the Wicksellian and Austrian arguments rest on the old classical theory of interest rates, where saving and investment determined the natural interest rates. As that theory was amended including contributions of Wicksell, it has evolved into the *Loanable Funds Theory of Interest Rates*. Economic historians such as John Gurley and Edward Shaw recognized that other sources of credit (such as increases in the velocity of money) as contributing to more rapid economic growth by driving down interest rates and accelerating the rate of capital accumulation.



Modern financial theory does not deny that mistakes occur by firms in undertaking some expansion requiring capital, but is more due to errors in forecasting future cash flows rather than artificially low interest rates. If one were to look at real interest rates rather than nominal or market rates…interest rates in the inflation-adjusted sense have changed far less than have nominal or market rates of interest not so adjusted.

Convergence:

Disappearing inflationary bias between nominal and real interest rates – in the face of Rational Expectations…



Did you know…?

A few statistical tidbits that might be of interest

Poverty, Income, and Taxes

There are seventeen definitions of poverty published by the U.S. Census Bureau.

Poverty 2002

Number and Percent of Persons in Poverty, by Definition of Income: 2002
(Poverty Thresholds Based on CPI-U-X1)
Total number of persons was 285,317,000 in 2002

Definition of Income	In Poverty: Number Below Poverty (thousands)	In Poverty: Poverty Rate (per cent)
Income before taxes:		
1. Money income excluding capital gains (current measure).........................	30,685	10.8
1a. Money income less taxes without EIC...	33,430	11.7
1b. Money income less taxes with EIC...	29,050	10.2
2. Definition 1 less government cash transfers..	53,419	18.7
3. Definition 2 plus capital gains..	53,363	18.7
4. Definition 3 plus health insurance supplements to wage or salary income	51,735	18.1
Income after taxes:		
5. Definition 4 less social security payroll taxes.....................................	54,167	19.0
6. Definition 5 less federal income taxes (excluding the EIC)......................	54,418	19.1
7. Definition 6 plus the earned income credit (EIC)..................................	50,245	17.6
8. Definition 7 less State income taxes..	50,566	17.7
9. Definition 8 plus nonmeans-tested government cash transfers.................	30,200	10.6
10. Definition 9 plus the value of medicare..	29,599	10.4
11. Definition 10 plus the value of regular-price school lunches.....................	29,594	10.4
12. Definition 11 plus means-tested government cash transfers.....................	27,487	9.6
13. Definition 12 plus the value of medicaid..	26,232	9.2
14. Definition 13 plus the value of other means-tested government noncash transfers..	23,359	8.2
14a. Definition 13 plus the value of other means-tested government noncash transfers less medical programs..	24,013	8.4
15. Definition 14 plus net imputed return on equity in own home..................	21,517	7.5

Source: U.S. Census Bureau, Current Population Survey, 2003 Annual Social and Economic Supplement.

(*see U.S. Census Bureau* Poverty 2002)

You may be surprised that poverty levels are considerably lower, or higher, than you may have thought. Bear in mind that the measures are relative (within the scope of the Census Bureau's definitions as well as beyond…this is solely within the context of the United States).

We will be discussing income distribution in upcoming newsletters. Again, you may be surprised to learn how little difference there actually is between the various levels of income.

From U.S. Census Bureau *: **Table IE-4***
Household Income Limits by Percentile Income Limits by Percentile (e.g., if two earners in a household earn $75,500 each, then that household is within the top 5% of income earners).

Year 2001	
10th (Lowest Income)	**$ 10,686**
20th	**17,970**
50th	**42,100**
80th	**83,500**
90th	**113,628**
95th (Highest Income)	**$ 150,499**

Another topic near and dear to most readers is taxes – how much, or how little we pay…

The first thing that jumps out at the reader (or should) is the fact that the overwhelming burden of (Federal Personal Income) taxes are ***borne by only half of the taxpayers…96% in 1999****.*

Who Pays the Taxes…

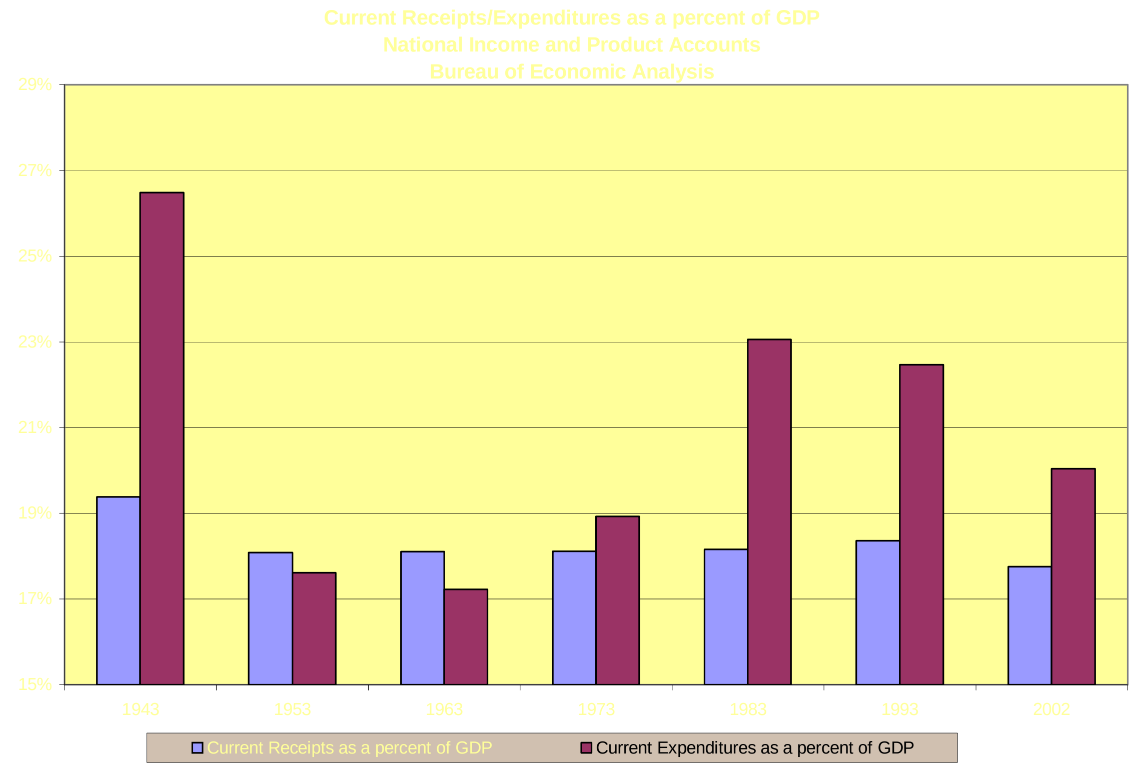
In 1999 Percentiles* Total Share of AGI % of Federal Personal Income Tax

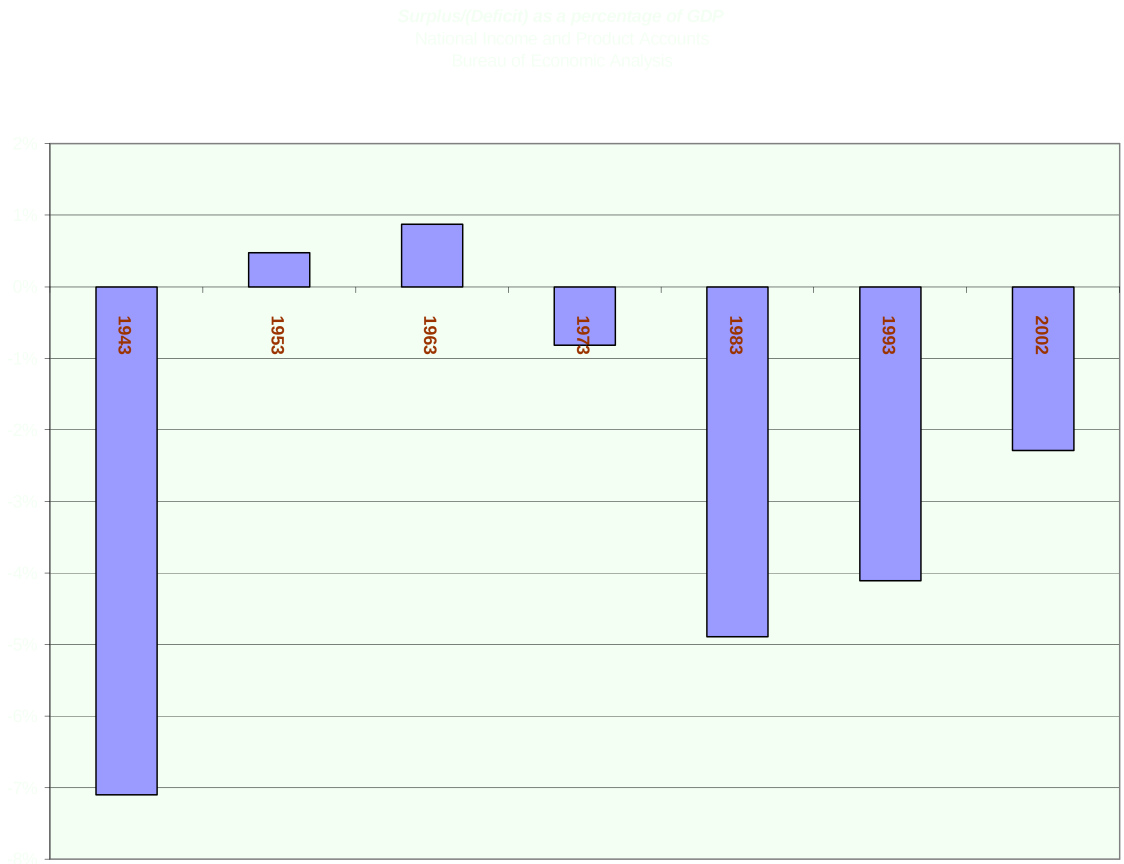
	Income Earners	Income Earned	Taxes Paid
Top	1%	20%	36%
Top	5%	34%	56%
Top	10%	45%	67%
Top	25%	67%	84%
Top	50%	87%	96%
Bottom	50%	13%	4%

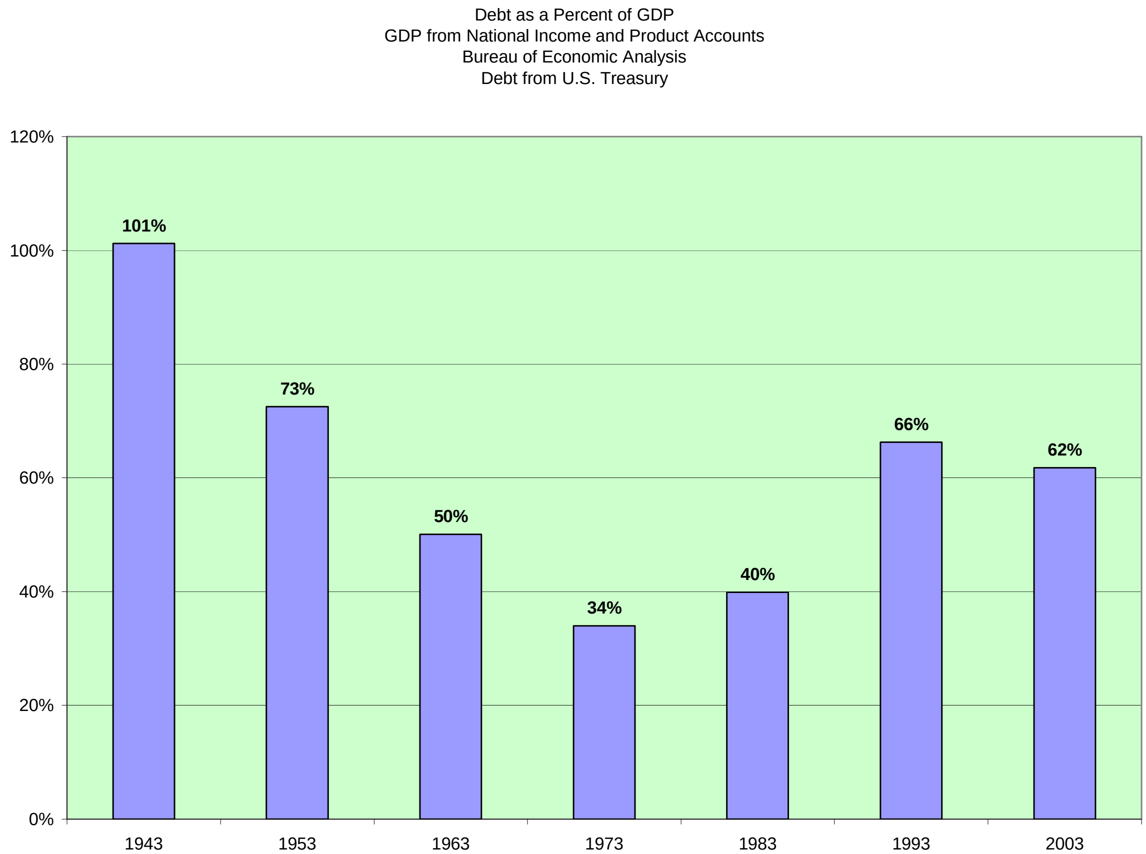
Source: IRS
*Ranked by adjusted gross income (AGI

Of (Federal) Deficits, Debt and Taxes…are we over the brink?

The following graphs depict a number of issues in relation to the GDP. We opted to go as far back as the data was available to show how we stack up today…

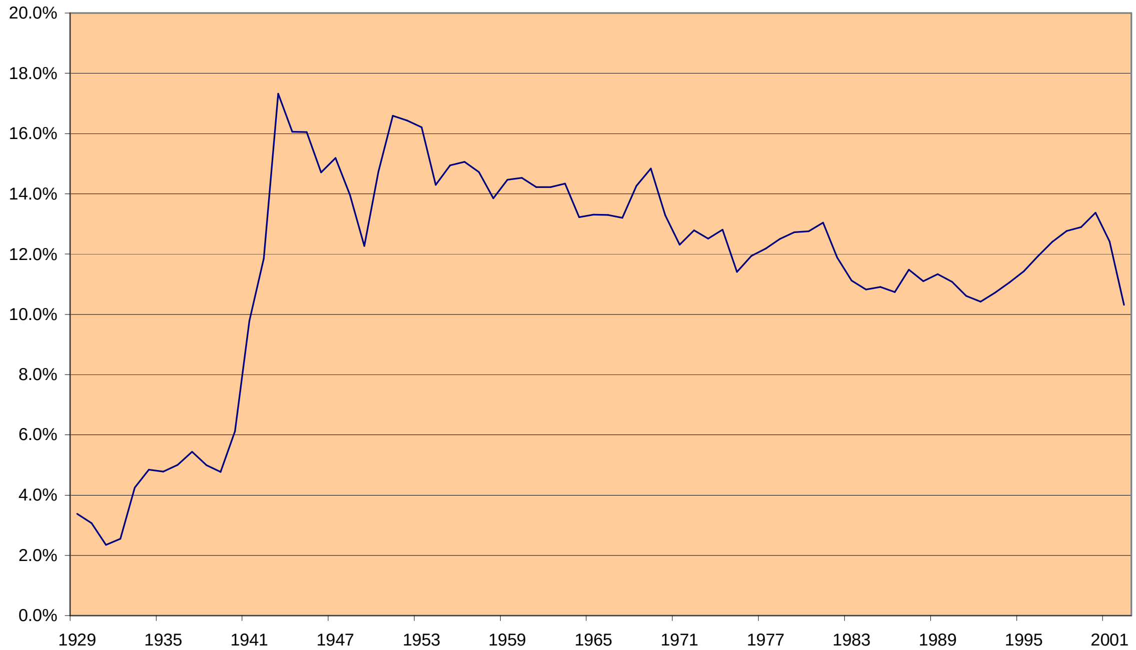

Current Receipts/Expenditures as a percent of GDP
National Income and Product Accounts
Bureau of Economic Analysis
29%
27%
25%
23%
21%
19%
17%
15%
1943
1953
1963
1973
1983
1993
2002
Current Receipts as a percent of GDP
Current Expenditures as a percent of GDP


Surplus/(Deficit) as a percentage of GDP
National Income and Product Accounts
Bureau of Economic Analysis
2%
1%
0%
-1%
-2%
-3%
-4%
-5%
-6%
-7%
-8%
1943
1953
1963
1973
1983
1993
2002



How much have federal taxes really gone down? The tax (as a percent of GDP) reached their recent high watermark in 2000.

Current Personal Taxes/GDP
National Income and Product Accounts
Bureau of Economic Analysis



One last note on Unemployment (for now that is)…

There is an ongoing debate over the two methodologies employed in measuring the levels of unemployment (employment)…Namely, the Household Survey and the Payroll Survey (Establishment).

There are critics of both, but please read the following to at least have a reasonable understanding of both (their limitations and purposes).

Excerpts from:
Statement of Kathleen P. Utgoff Commissioner Bureau of Labor Statistics Friday, February 6, 2004:

From the Household Survey
*"Turning now to our survey of households, the unemployment rate was little changed in January at 5.6 percent. Civilian **employment rose by 496,000** (after accounting for an adjustment to the population estimates), and the employment-population ratio edged up to 62.4 percent."*

From the Payroll Survey
*"Nonfarm payroll **employment increased by 112,000** in January and has risen by 366,000 since August 2003. In January, there were job gains in construction and several service-providing industries. While manufacturing employment*

continued to trend down, the rate of job loss has slowed considerably in recent months. The unemployment rate, at 5.6 percent, was little changed over the month but is down from its recent peak of 6.3 percent in June 2003."

…more from Bureau of Labor Statistics 10/8/2001

Coverage, definitions, and differences between surveys

Household survey

The sample is selected to reflect the entire civilian noninstitutional population. Based on responses to a series of questions on work and job search activities, each person 16 years and over in a sample household is classified as employed, unemployed, or not in the labor force.

People are classified as employed if they did any work at all as paid employees during the reference week; worked in their own business, profession, or on their own farm; or worked without pay at least 15 hours in a family business or farm. People are also counted as employed if they were temporarily absent from their jobs because of illness, bad weather, vacation, labor-management disputes, or personal reasons.

People are classified as unemployed if they meet all of the following criteria:
They had no employment during the reference week; they were available for work at that time; and they made specific efforts to find employment sometime during the 4-week period ending with the reference week. Persons laid-off from a job and expecting recall need not be looking for work to be counted as unemployed. The unemployment data derived from the household survey in no way depend upon the eligibility for or receipt of unemployment insurance benefits.

The civilian labor force is the sum of employed and unemployed persons. Those not classified as employed or unemployed are not in the labor force. The unemployment rate is the number unemployed as a percent of the labor force. The labor force participation rate is the labor force as a percent of the population, and the employment-population ratio is the employed as a percent of the population.

Establishment survey

The sample establishments are drawn from private nonfarm businesses such as factories, offices, and stores, as well as Federal, State, and local government entities. Employees on nonfarm payrolls are those who received pay for any part of the reference pay period, including persons on paid leave. Persons are counted in each job they hold. Hours and earnings data are for private businesses and relate only to production workers in the goods-producing sector and nonsupervisory workers in the service-producing sector.

Differences in employment estimates. The numerous conceptual and methodological differences between the household and establishment surveys result in important distinctions in the employment estimates derived from the surveys. Among these are:

--The household survey includes agricultural workers, the self-employed, unpaid family workers, and private household workers among the employed.
These groups are excluded from the establishment survey.

--The household survey includes people on unpaid leave among the employed. The establishment survey does not.

--The household survey is limited to workers 16 years of age and older. The establishment survey is not limited by age.

--The household survey has no duplication of individuals, because individuals are counted only once, even if they hold more than one job. In the establishment survey, employees working at more than one job and thus appearing on more than one payroll would be counted separately for each appearance.

Other differences between the two surveys are described in "Comparing Employment Estimates from Household and Payroll Surveys," which may be obtained from BLS upon request.

Volume 2004: Issue 1
Current Statistics (02-02-2004)

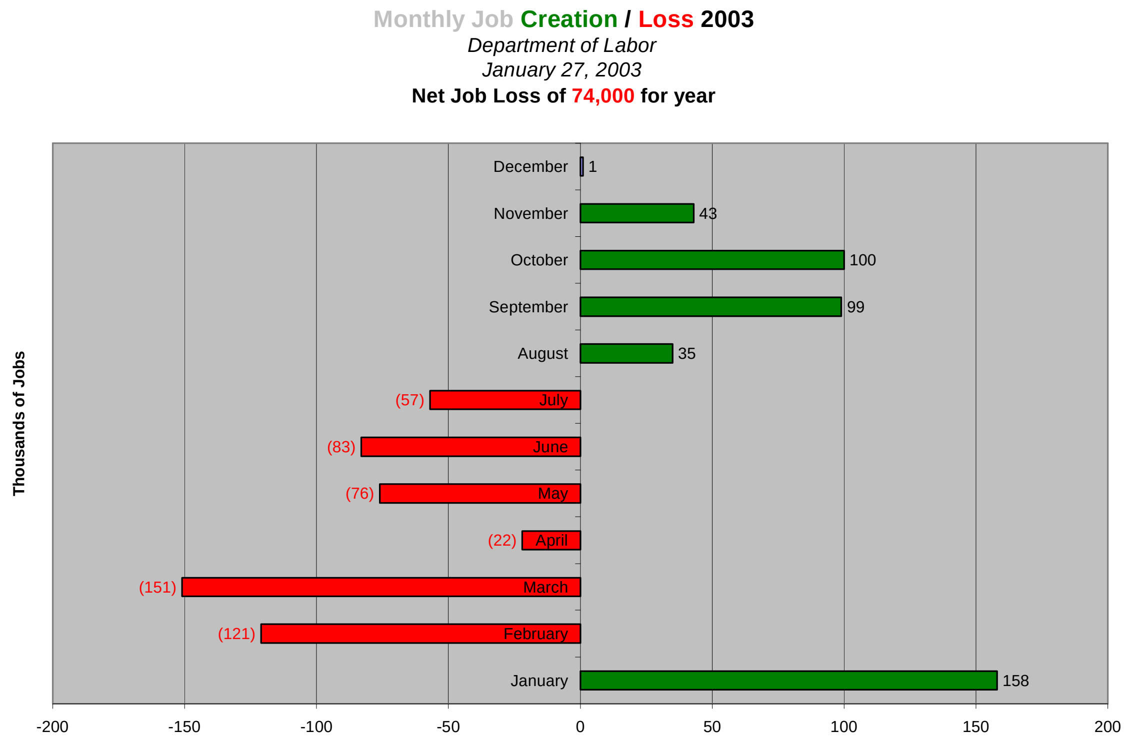
The Employment Picture

Unemployment Rate **({6.0% Oct }…{5.9% Nov })…**{5.7% Dec}

The December Unemployment Rate came in at 5.7%. According to the Bureau of Labor Statistics, unemployment dropped from 6.4% in June to 5.7% (*Seasonal adjusted* measure) of the labor force in December, constituting a significant and continued brightening in the employment picture.

When looking at the numbers based on Job Creation, the performance of the economy has been less than bright: October was adjusted down from 137,000 to 100,000; November from 57,000 to 43,000; and December coming in at a paltry 1,000 jobs. This leaves the net Jobs Creation/Loss at –74,000 for 2003.

While the unemployment rate dropped 0.2% in December, the lack of job creation has left many to wonder what is going on. The answer to that is likely to lie more in the increased numbers of people either retiring or re-retiring (as the stock market has rebounded), rather than any significant increase in job seekers giving up on hope of employment (we are well past the discouraged worker effect phenomenon at this stage of the recovery/expansion). In addition, the Department of Labor instituted information gathering and reporting changes around June 2003. In implementing those changes, and tying out year-end numbers, the December numbers appeared to be skewed badly; the changes had ripple effects going back several years.



Speaking to structural unemployment…

> **In his teleconference speech before the HM Treasury Enterprise Conference, London, England on January 26, 2004, Chairman Greenspan noted, *"We can thus be confident that new jobs will displace old ones as they always have, but not without a high degree of pain for those caught in the job-losing segment of America's massive job-turnover process."***

FRB: Speech, Greenspan--Economic flexibility--January 26, 2004 for entire transcript of address

link address:
http://www.federalreserve.gov/BoardDocs/speeches/2004/20040126/default.htm

Jobless Claims
(4-wk rolling avg: 347,750 Jan-15, to 345,250 Jan-22, to 346,000 Jan-29)

The new Jobless Claims data came in at a 342,000 for the week ending January 29, 2004 a decrease in claims of 1,000 from the previous week's

343,000. The much-watched four-week average increased slightly for the week ending January 29, 2004.

According to Labor, "The advance number of actual initial claims under state programs, unadjusted, totaled 386,263 in the week ending Jan. 24, a decrease of 104,269 from the previous week. There were 434,888 initial claims in the comparable week in 2003."

GDP (4th Quarter 2003 Real GDP: 4.0% - Preliminary)

The preliminary numbers for the fourth quarter of 2003 showed continued positive growth in real GDP. The Commerce Dept. reported a 4.0% growth rate for the 4th Quarter 2003 (on an annualized basis). It marked the 9th consecutive quarter of economic expansion. The 4th Quarter 4.0% rate is a respectable number, given the 8.2% growth in the preceding quarter. Again, the GDP growth was spread across the board, but Personal Consumption Expenditures (PCE) off, going from a 6.9% growth in the third quarter to a 2.6% increase in the fourth. Likewise, durable goods purchases rose 0.9% in the fourth quarter versus a 28.0% growth in the third. Much of the changes in fourth quarter were attributable to the expenditures on autos (down in terms PCE) and automotive investment (up in the area durable goods – motor vehicle inventory investment). Updated 4th Quarter GDP numbers will be released in February 2004.

<u>What Recession?</u>

Nine (9) quarters of economic growth and counting!

(3rd Qtr 2003 **8.2** - the best performance since 1st Qtr 1984)

Bureau of Economic Analysis

Table 1.1.1. Percent Change From Preceding Period in Real Gross Domestic Product

[Percent] Seasonally adjusted at annual rates

Today is: 1/30/04 Last Revised on January 30, 2004 Next Release Date February 27, 2004

	2000				2001				2002				2003			
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV
Gross domestic product:																
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**	**4.0**

Leading Indicators (4.7%+ annual rate December 2003)

According to figures released by the Conference Board on January 22, "The leading index increased by 0.2 percent in December. This index increased 0.2% in November and 0.5% in October. "The leading index has now increased at a 4.7 percent annual rate from its most recent low in March, and this pickup has continued to be widespread."

Construction (put in place)

The most recent data from the Census Bureau shows continued strong levels of construction put in place. The December figure of $933.2 billion annualized, shows an increase of 0.4% above the November numbers. Additionally, the 2003 data is 4.3% above that of 2002. This amounts to an annual amount of $898.2 billion for construction in 2003. This sector continues to perform strongly through the current expansion.

New Housing Starts

The most recent U.S. Census Bureau data available shows continued near record levels of new housing starts. The December figures are running at a seasonally adjusted annual rate of 2.088 million units, 1.7 percent higher than the 2.054 million-unit revised rate reported for November. An estimated 1.848 million units were started in 2003. This is 8.4% higher than December 2002 figure of 1.705 million units.

New Residential Sales

According to the Census Bureau, sales of new homes dropped from November's numbers of 1.117 million units, to 1.060 million units (on a seasonally adjusted annualized basis) in December, representing a fall-off of 5.1%. This rate exceeds the December 2002 figure of 1.052 million units by 0.8%.

Durable Goods

The most recent report from the Commerce Department shows that **New Orders** for Manufactured durable goods decreased 0.2% in December (excluding defense) to $181.4 billion. Excluding defense, new orders decreased 2.9% (excluding transportation, new orders were down 0.7%). For year 2003, new orders were 2.8% above 2002.

Shipments increased at a 0.6% rate or $1.2 billion. This followed a 0.3% increase for November. For the year 2003, shipments were 0.8% above 2002.

Unfilled orders increased 0.4%, or $2.0 billion, with transportation leading the way at 0.8%. This followed an increase of 0.7% in November.

Meanwhile, **Inventories** increased 0.2% in December, reversing the November decrease of 0.3%.

Capital Goods Industries:
Defense, new orders increased 0.1% to $9.2 billion; shipments increased $0.2 billion or 2.9% to $7.7 billion; unfilled orders increased $1.5 billion or 1.1% to $138.2 billion; inventories increased by $0.3 billion or 0.2% to $105.2 billion.
Nondefense new orders increased by $0.1 billion or 0.2% to $58.1 billion; shipments decreased by $0.1 billion or 0.2% to $58.7 billion; unfilled orders decreased by $0.6 billion or 0.3% to $220.6 billion; and inventories fell by $0.2 billion or 0.2% to 105.2 billion.

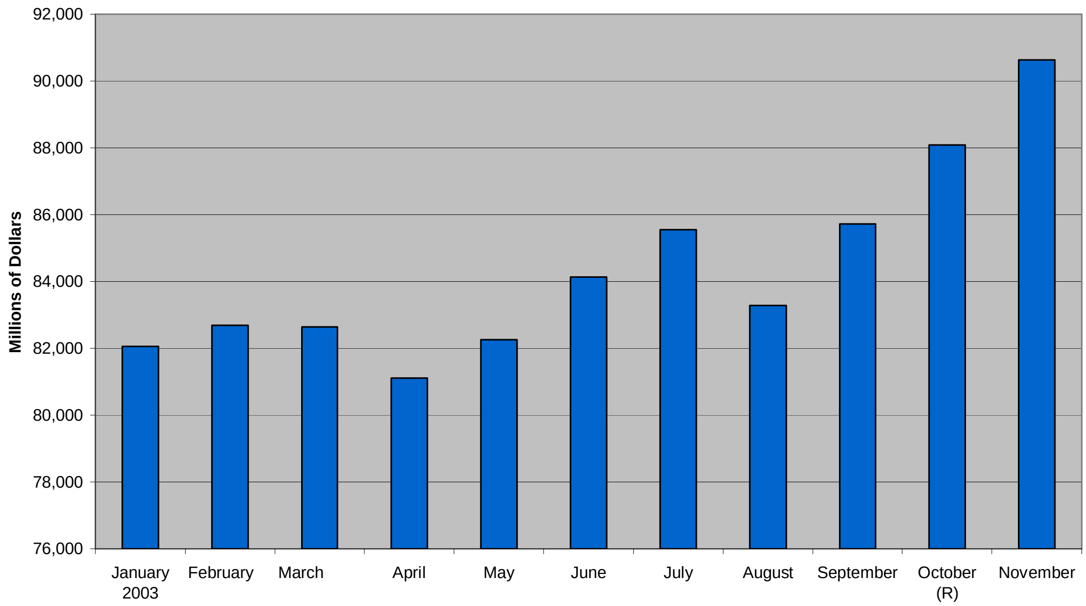
The durable goods measure continues to be a volatile indicator and will likely continue in this manner.

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.

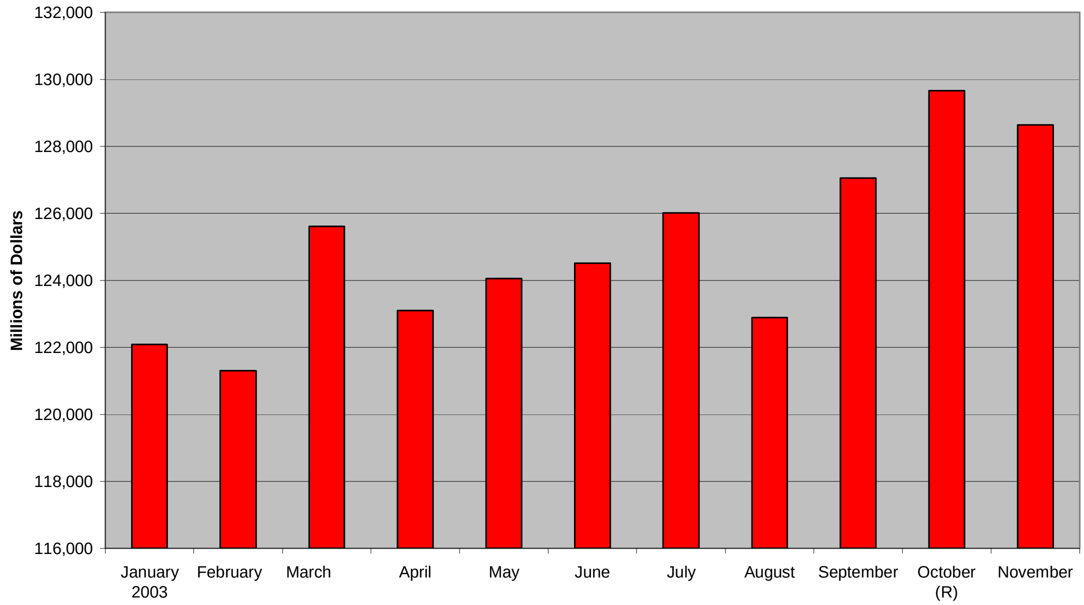
As reported by the Commerce Department on January 14, 2004, the trade deficit in November 2003 stood at $38.0 billion, shrinking by (8.7%) $3.6 billion from the $41.6 billion (revised) reported for October 2003. November exports were at $90.6 billion up by $2.5 billion from $88.1 billion revised figure for October. Imports were at $128.6 billion, down $1.0 billion (rounding) from the revised $129.7 billion reported for October.

The Good **(Exports 2003)**
Extracted from Department of Commerce
January 14, 2004 (R) = Revised



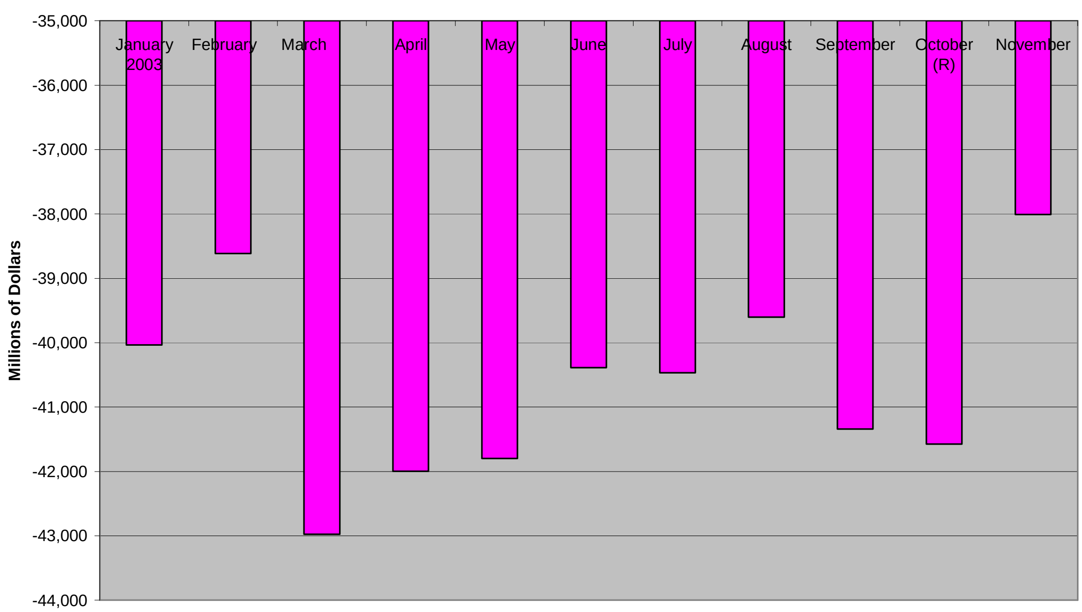
On a good note, exports have improved from October, growing by 2.8%.

The Bad **(Imports 2003)**
Extracted from Department of Commerce
January 14, 2004 (R) = Revised



Imports, improved from last month, dropping 0.8% from October.

The Ugly **(Trade Balance 2003)**
Extracted from Department of Commerce
January 14, 2004 (R) = Revised

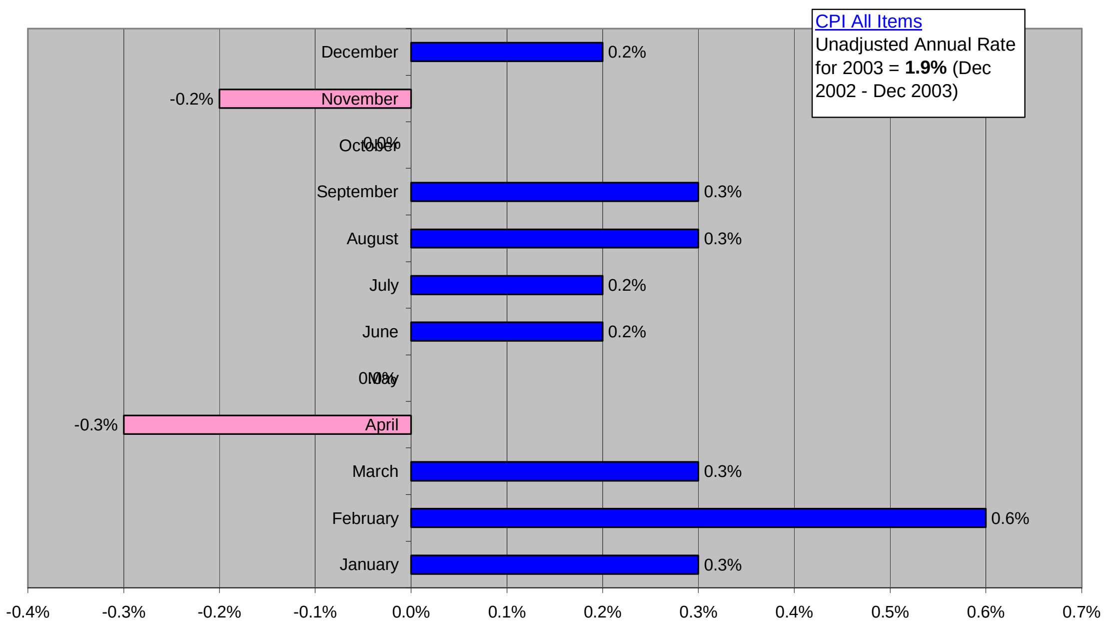


The "better" part of the ugly news is that while the trade balance continues to remain in deficit territory, it improved significantly, dropping 8.7% in November (attributable more to increasing exports, than to diminishing imports).

CPI 0.2% / PPI 0.3% (Seasonally adjusted)

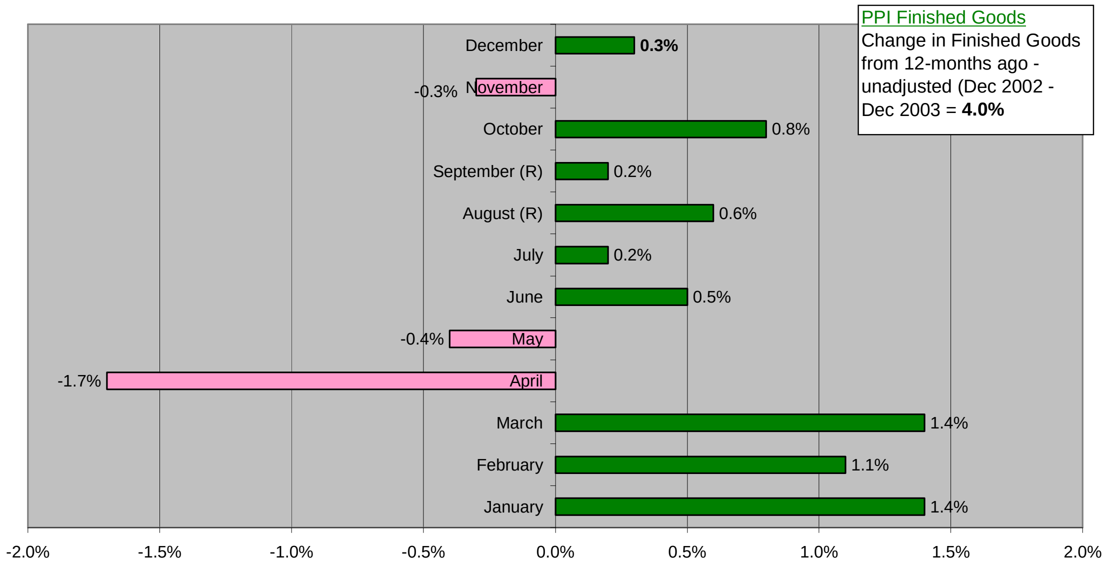
CPI – On a seasonally adjusted basis, the CPI-U (all urban consumers), which had declined 0.2% in November, rose 0.2 percent in December. Much of the increase in costs for the month and the year were in the areas of energy, food (beef) and medical care.

CPI 2003 (All Items)
U.S. city average Seasonally Adjusted (Base 1982-1984 = 100)
Department of Labor: Bureau of La bor Statistics
(Extracted January 15, 2004)



PPI – On a seasonally adjusted basis, the Producer Price Index for Finished Goods increased 0.3 percent in December. This increase culminated in a year-end 2003 unadjusted number of 4.0% (Finished Goods). Finished Consumer Food rose a 7.7% for the year, while Finished Energy Goods rose 11.5% (Dec 2002 – Dec 2003).

PPI 2003 (Finished Goods)
Seasonally Adjusted
Department of Labor: Bureau of Labor Statistics
(Extracted January 14 2004
(R) = Revised



While low inflation continues to be the rule rather than the exception, it will be interesting to see if upward pressure from the Producer Price end will manifest itself in the CPI in 2004:

{PPI (Finished Goods) 2001 – 2002 = 1.2%; 2002 – 2003 = 4.0%}

{CPI (All Urban Consumers) 2001 – 2002 = 2.4%; 2002 – 2003 = 1.9%}

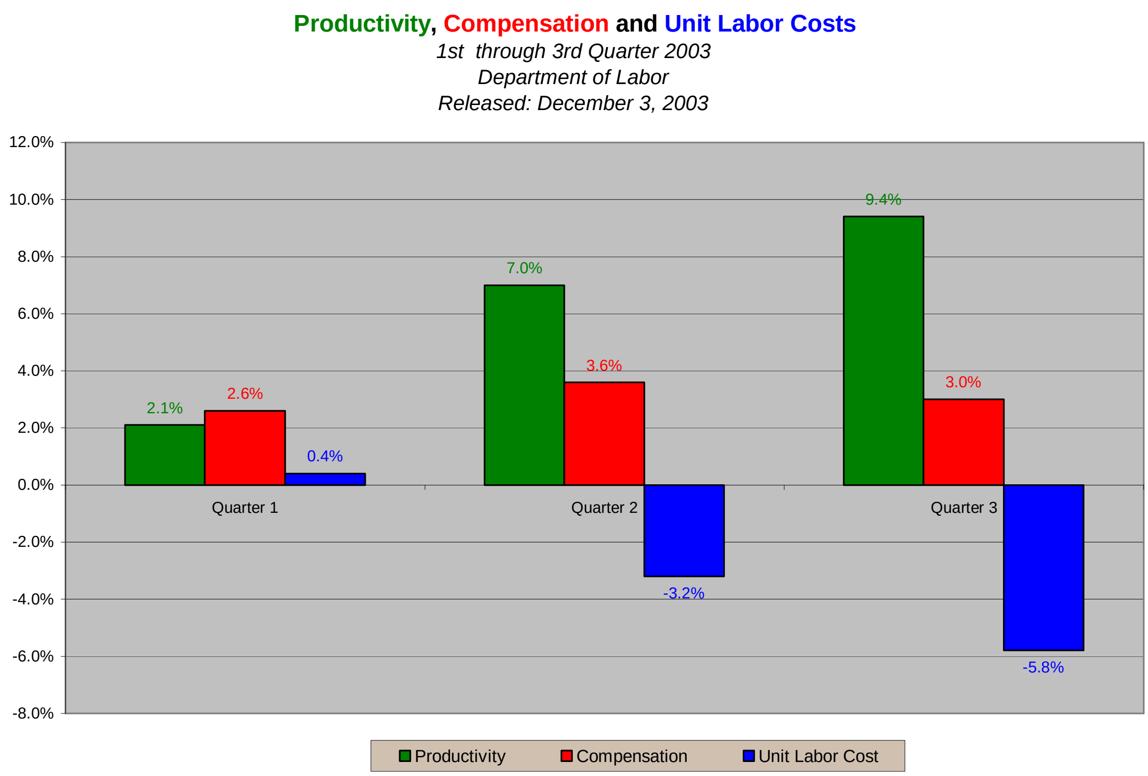
Until now, this inability for producers to pass on price increases to the consumer is further evidence of New Paradigm in action.

Productivity, Unit Labor Cost and Compensation (Seasonally Adjusted)

No change in this indicator from last month, but it's worth a replay…

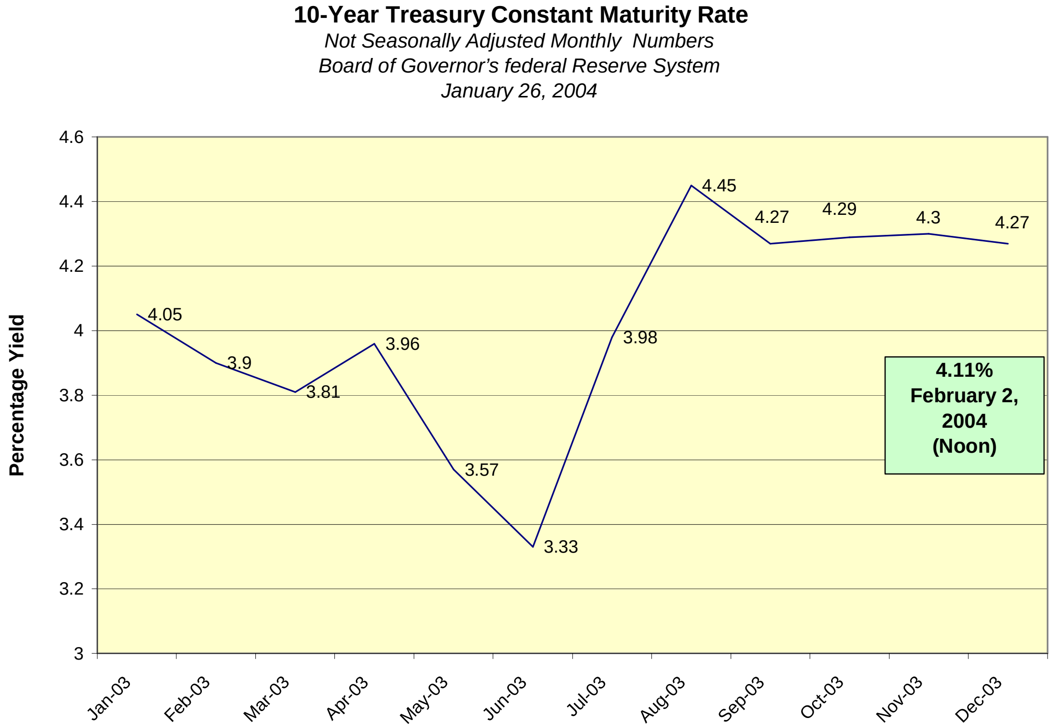
According to a Department of Labor report, published on December 3, 2003 **Productivity** gains amounted to 9.4% for the 3rd Quarter 2003. This was revised from the November estimates of 8.1%, adding to the 7 percent gain from the second quarter. **Unit Labor Cost** was revised downward from -4.6% to 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. For the month of December 2003, the yield averaged 4.27 percent.



The 10-year rate continues to remain at low yield levels, trading in the low 4.0 – 4.5% range.

Letters to the Editor

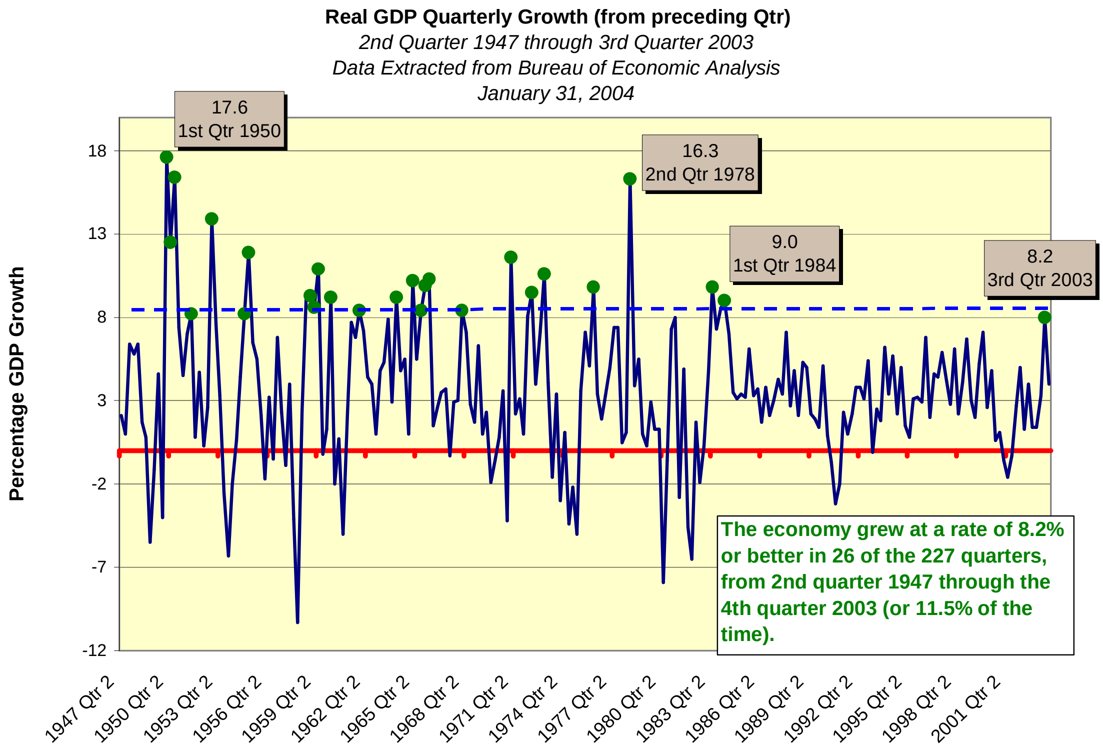
Two rather lengthy exchanges with John, in Great State of California…

Part 1 from John…

In reference to (commentary in the 5th Issue, Volume 2003 of the Newsletter) I am still concerned with regard to unemployment. Also, your model of 5% growth for 10 years (noted also in the 5th Issue, Volume 2003) is unsustainable. A 3% average would seem more realistic.

Unemployment is a concern for us as well - it's an ongoing issue that we will continue to monitor.

We take your point regarding the 5% growth issue, but my question is, why not 5%? What causes you to think that it is unsustainable? We threw the number out there and while at first blush it appears rather high, we suspect that so long as we keep taxes low, we should be closer to 5% than to 3%. Not really a point of argument…perhaps just a point of departure. The real GDP growth rate has averaged in the 3.5% range for the last three decades,



but for tax (receipt) purposes we still use nominal GDP, which includes an inflation premium of about 1-2% (currently)...that would get us up in the 5% range.

On a further note, there is much more to the unemployment statistics than meets the eye. If you've ever been involved with silly finance exercises at year-end (with moving accruals, tying numbers into year-end, etc.), you'd know how squirrelly year-end numbers get. In addition, the Department of Labor made some big changes mid year.

Part Two from John…

I agree that the economy has grown. However, this is apparently dissimilar to other recoveries in that hiring seems to be recovering more slowly. Moreover, many employers are transferring jobs off shore. This is +/- since it keeps down prices but it can create areas of depression in *regions that previously flourished. I believe Michigan has seen some of this because of changes in automobile manufacturing. However, it is also happening in computer software design with a vengeance.*

I watched a bit of the post, State of the Union discussion. A number of people interviewed were very skeptical regarding the recovery. Here, we are still on the bubble but the restaurants look like they have increasing clientele. We will see.

From your chart (sent as a previous attachment and included above), there are not many periods where the growth rate can be sustained at this pace.

John,
You hit the nail on the head. In the past, at this point in a recovery, employers hired like crazy, driving up labor costs, etc. (often precluding significant sustained GDP growth), but the structural nature of the change has inhibited significant re-hiring and has forced companies to continue to press the productivity frontiers. This has much to do with prices remaining sticky (or even falling) and has forced corporations to continue cost-cutting measures to remain competitive and eke out profits (much of the cost cutting has translated into lower prices at the consumer end - again competition).

There are positives and negatives to the entire scenario, but since all people are consumers, the positive effect of keeping the lid on prices is that most everyone shares in the net gain in purchasing power (consumer surplus). This is not the case in the presence of inflation: there are winners who can pass price increases on to consumers. This was the case with the auto industry many moons ago (no longer the case, obviously). It appears that Volkswagen has been attempting to refrain from any pricing strategies (rebates)...the net result being that they experienced something on the order of 10% loss in market share this past year.

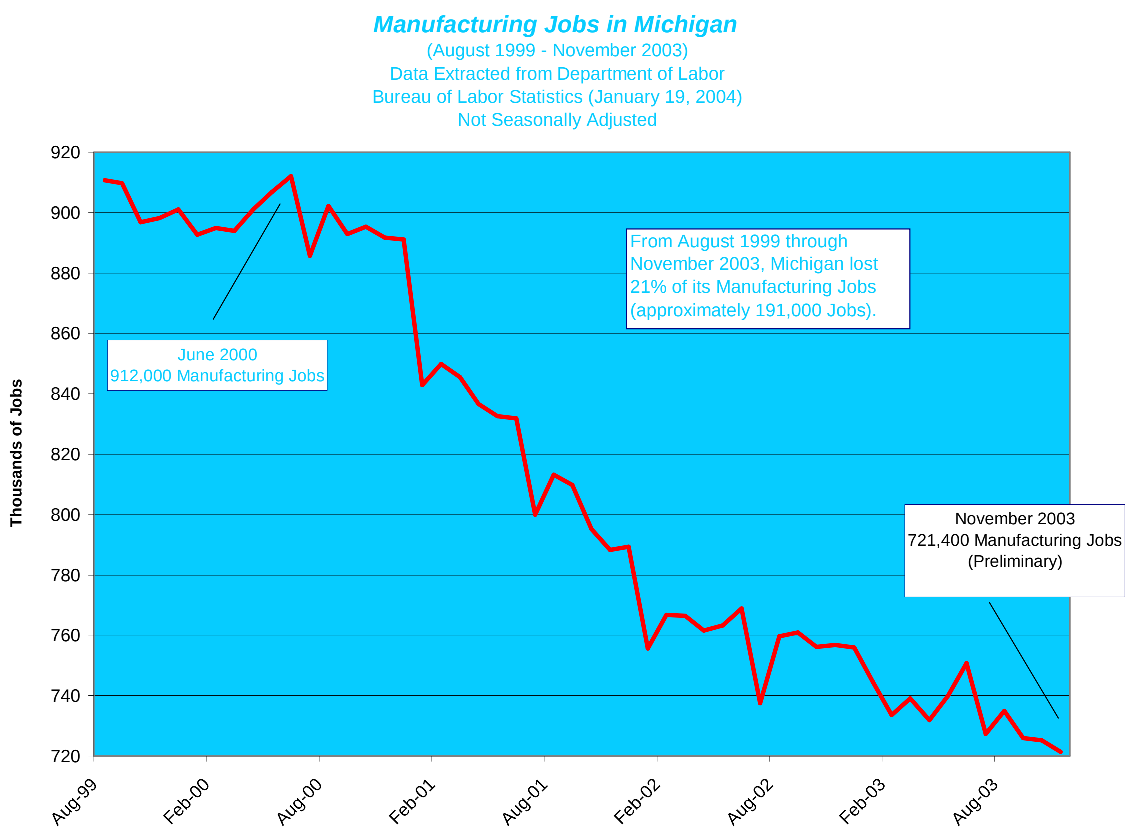
We tend to agree that real GDP growth will not continue in the 8% category (as was seen in the 3rd Quarter 2003…and now at 4.0 for the 4th Quarter - preliminary), but there is no reason why we won't see it above 4.5, and perhaps even 5% in the years to come.

The thing on the job front is that the high wage manufacturing jobs will continue to erode so long as those manufacturers operate in a competitive environment.

Alan Greenspan, Chairman of the Federal Reserve Board, in a speech on January 26, 2004 to the HM Treasury Enterprise Conference, London, England:

"Flexibility in labor policies, for example, appears in some contexts to be the antithesis of job security. Yet, in our roles as consumers, we seem to insist on the low product prices and high quality that are the most prominent features of our current frenetic economic structure. If a producer can offer quality at a lower price than the competition, retailers are pressed to respond because the consumer will otherwise choose a shopkeeper who does."

The following is a graph of the (manufacturing) job situation in Michigan. Lesson: the consumer is loath to pay premiums for goods produced by higher priced union labor.



Granted, the depreciating dollar will help all sectors, and the productivity gains will also help on the export fronts. Increased demand will reduce unemployment, but the structural nature of it (the unemployment) will force those employees to be redeployed in other segments of the economy.

This is certainly not the first time that economic realities in the demand for labor has forced people to make hard decisions concerning relocation and lifestyle changes.

Another thing to note is that many of the jobs that have moved offshore make a great deal of sense in terms of the bottom line and on good note, it has freed up many people to re-create themselves and find more "creative" and fulfilling endeavors. There are many in this category, and, while it is less than pleasant, the reality is that there is hope and most will be the better for it in the end. On a further note, the abundance of IT jobs (for example) that were created in the 90s were temporary, awaiting only the build up in infrastructure in places with lower wages like India, China, etc.

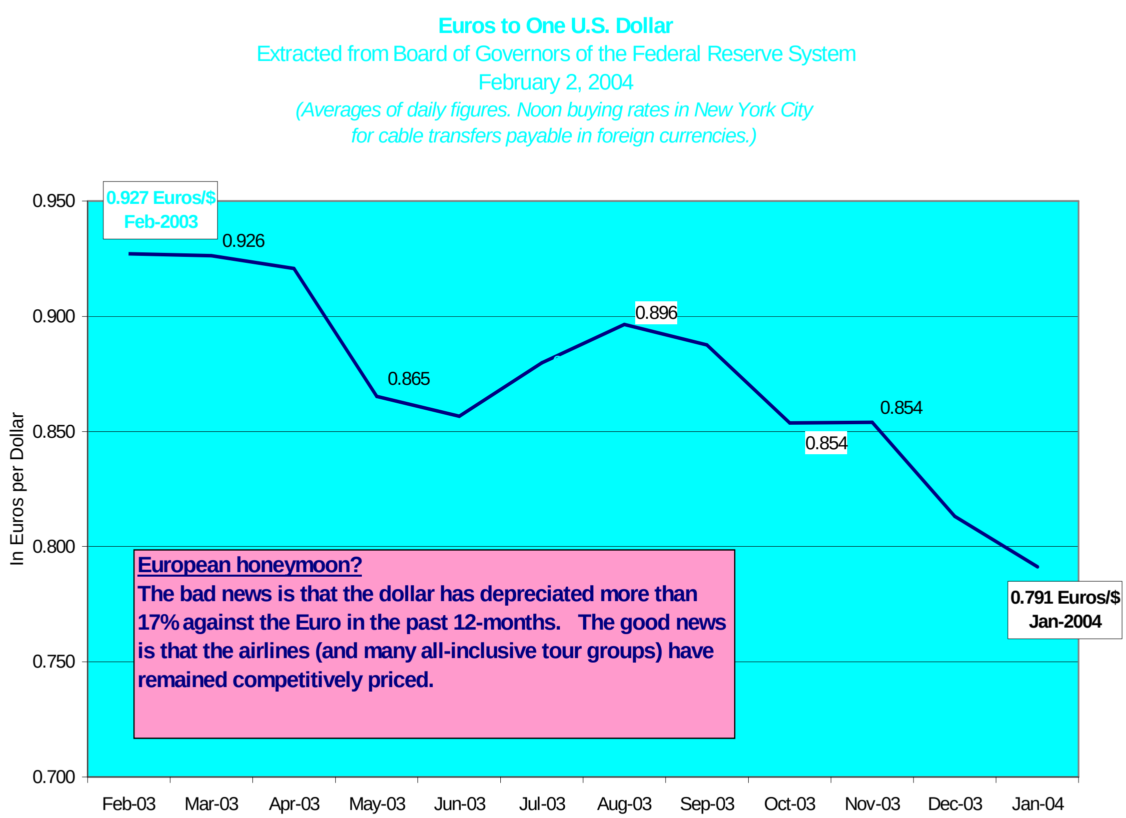
We do see things continuing to improve and the job situation will certainly do so as well. Employers are making rational decisions in rehiring, recognizing the immediate impact to the bottom-line and are scrutinizing as never before.

Like yourself, we remain guardedly optimistic, but it certainly hasn't been easy.

From Chris, also in California …

My fiancee and I were planning a honeymoon in Europe, but have concerns over the value of the Dollar vs. the Euro. What do you see happening in the foreign exchange markets in the upcoming months? On a less self-serving note, since commodity prices are determined by the world (in aggregate), then doesn't it follow that prices will rise in the U.S. as the dollar depreciates?

In response to your first question:



I guess the graph speaks for itself. It's unlikely that the dollar will rise in value in the ensuing months. Buy early and look for a good deal (the latest exchange rate – February 2, 2004, the exchange rate was at 0.80 euros per dollar).

Concerning the second part of your question…
Prices in commodities will certainly rise in the U.S. as the dollar depreciates (witness the 4.0% increase in PPI (finished goods) for year in 2003). Having said that, it appears that the increase in prices would also manifest themselves in terms of imported goods. This clearly has not been the case… In addition, it should be noted that as prices rise for oil (for example), then more U.S. producers become involved. This is the case in nearly all segments of the economy concerning commodities (raw goods in particular). After rising significantly as the dollar showed signs of depreciating, gold, once well into the $420+ range, it has dropped to under $400 an ounce. As further evidence, the price of U.S. imports rose only 1.9% in total for 2003 (Department of Labor / Bureau of Labor Statistics: U.S. Import and Export Price Indexes December 2003 – Released January 14, 2004), with nearly half of the increase in Petroleum Imports.

Thanks for the question(s) and enjoy your honeymoon!

From Tom in Lansing, Michigan…

Dear Doctor Byrne,

I had the distinct pleasure of attending your speaking engagement in Novi, Michigan, January 22, 2004. I found your speech extremely enlightening – ***grow out of deficits, not tax your way out****. From what I could gauge from the audience, I was not the only one who found your presentation intriguing. Would it be possible to get another copy of your speech (the outline you passed out)? By the way, I suspect that quite a few people (readers) would be interested in having a copy as well.*

Tom,

You're too kind! Thank you for your words of appreciation.

The speech follows…

Presented at the Novi Expo on January 22, 2004

Donald R. Byrne, Ph.D.
Professor of Economics
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Editor/Founder: Economic Newsletter for the New Millennium
http://www.udmercy.edu/faculty/byrned/

Bush Tax Cuts as Viewed Through the Lens of the New Economic Paradigm

I would like to begin with some history. When FDR was campaigning against Herbert Hoover, he argued more vigorously for tax increases than did Hoover. For what purpose was he proposing these tax increases? To lower the deficit in the Federal budget brought on by the beginning of the Great Depression. Of course, once elected, Roosevelt ignored those election arguments…in the great American tradition where a politician will often say anything to be elected.

From the Cato Institute – March 24, 2003
By Veronique de Rugy

*On the campaign trail in 1932, Roosevelt noted**: "For over two years our federal government has experienced unprecedented deficits, in spite of increased taxes."** Yet, much like Gov. Davis today, Roosevelt decided to increase taxes more. He found out that a tripling of tax revenues did not balance the budget because the deficit soared from $2.2 billion in 1932 to $2.9 billion in 1940.*

…by the way, since this was published, Davis has been terminated by the current Governator of the great state of Kalifornia.

The cause of the deficit was not low tax rates but the collapse of the tax base due to the onset of the Depression.

…fast forward to the 21st Century

We currently hear similar cries from naysayers that the taxes should be raised and not lowered. They argue that the Bush tax cuts already legislated must be repealed; and that the federal deficit poses the most serious problem.

In February 2003, Alan Greenspan, Chairman of the Federal Reserve Board of Governors stated to lawmakers at a hearing of the Senate Committee on Banking, Housing and Urban Affairs:

"I am not one of those who is convinced that stimulus is desirable policy at this point."

Again, in early 2003 (February), economists (several Nobel Laureates) from the Economic Policy Institute signed a document critical of the tax cut, stating the following:

…and from February 23, 2001, a quote from an interview with Robert Rubin, former Secretary of the Treasury on the Jim Lehrer Newshour (PBS):

History is replete with examples that economic growth is the way to eliminate deficits in the Federal budget. You grow out of deficits and not tax your way out of them. As economic growth occurs, the tax base grows. Taxes grow at a faster rate than government spending for any given fiscal structure. In past years, this more rapid rise in taxes was referred to as the fiscal drag.

In the days of Eisenhower and Kennedy, economic advisors warned of growing stagnation unless the tax rates were cut and the fiscal drag reduced. Those of more liberal persuasion would have preferred large increases in government spending, especially of the transfer payment variety. Congress usually agreed and cut the tax rates to promote faster economic growth.

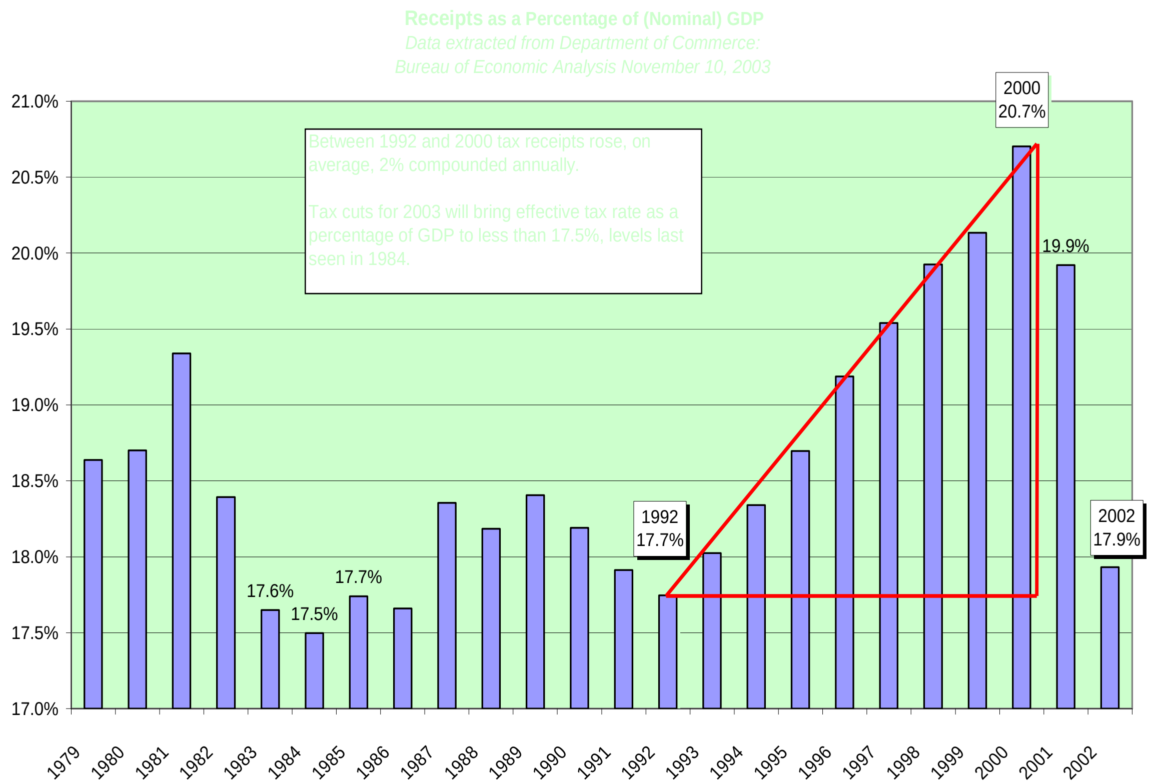
And now from pages of my newsletter…

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.*

Question: Who made the following statement?

"Economic expansion in turn creates a growing tax base, thus increasing revenue and thereby enabling us to meet more readily our public needs, as well as our needs as private individuals."

President Kennedy Appeals to the Congress for a Tax Cut April 20, 1961



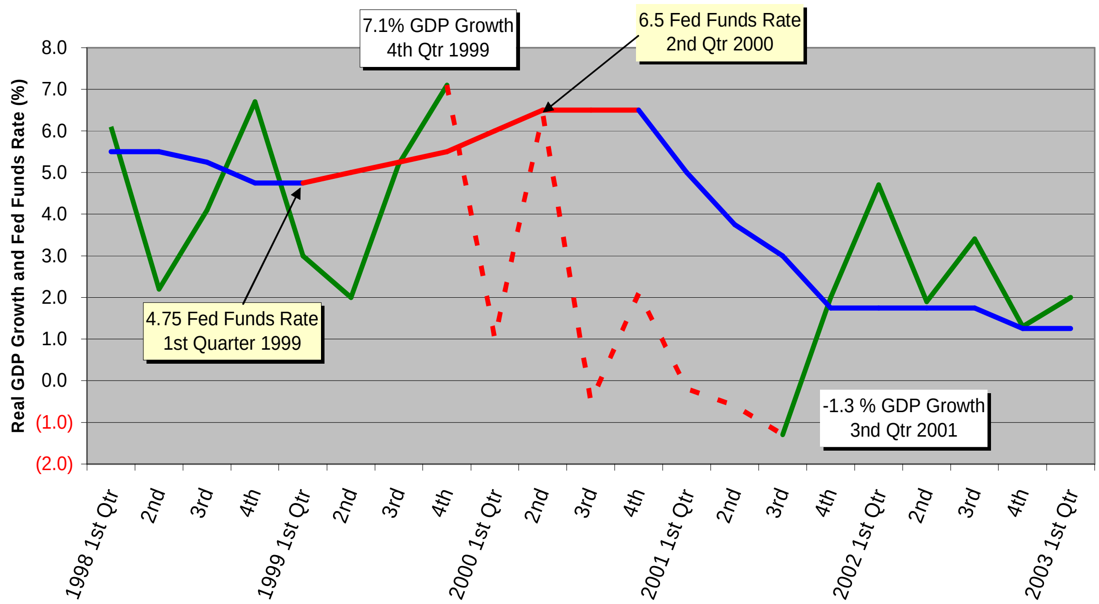
The Collapse of the Economy 1999-2001

Interest Rate Hikes (Fed Funds) from 4.75%

in 1st Quarter 1999 to 6.5% in 2nd Quarter 2000

GDP Data from Bureau of Economic Analysis (Retroactive Adjustments in Dec. 2003)

Fed Funds Data from Federal Reserve Board



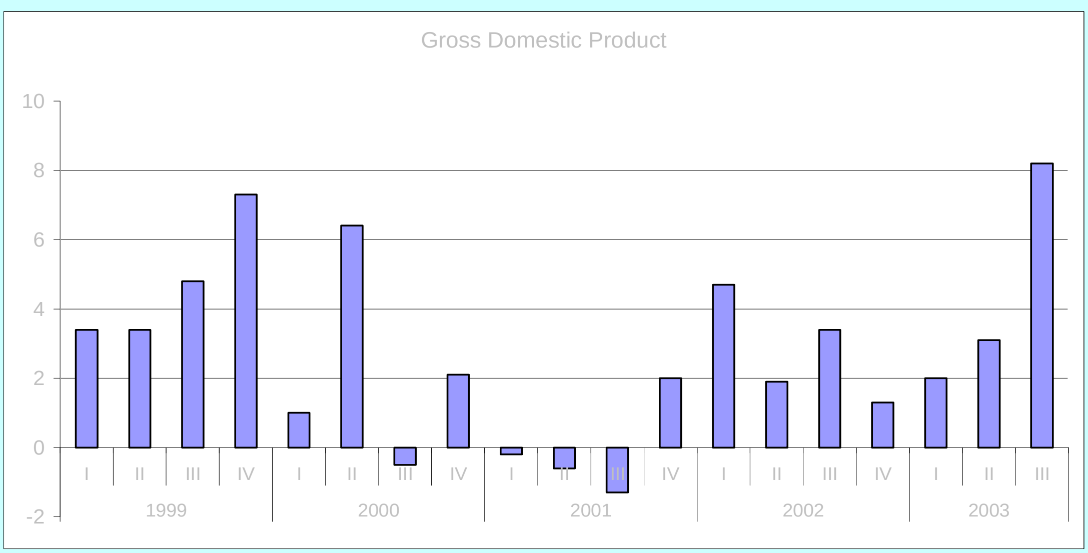
National Income and Product Accounts Table

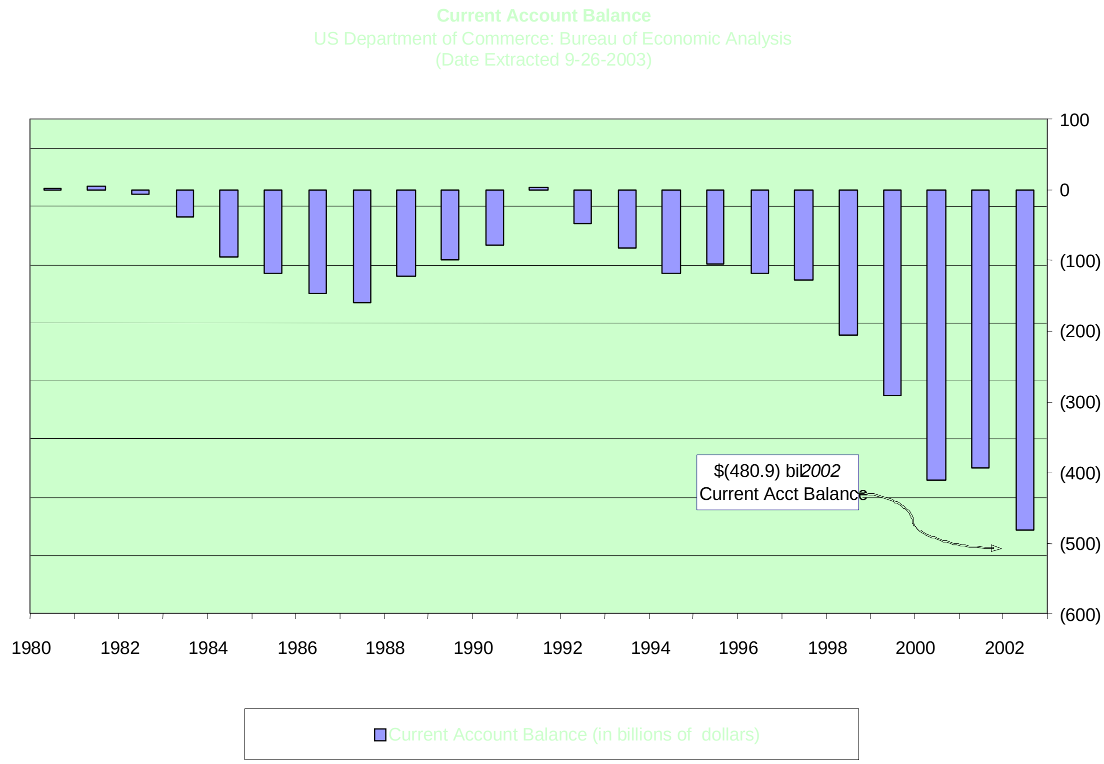
Table 1.1.1. Percent Change From Preceding Period in Real Gross Domestic Product

[Percent] Seasonally adjusted at annual rates

Today is: 1/12/04 Last Revised on December 23, 2003 Next Release Date January 30, 2004

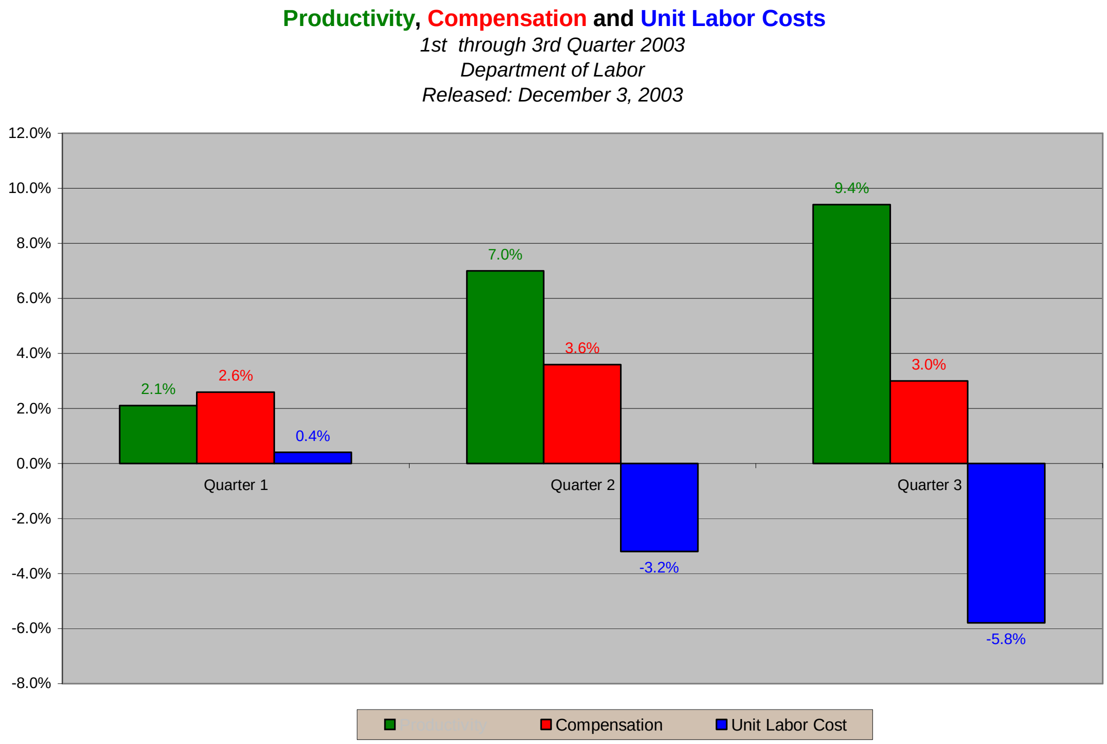
	1999				2000				2001				2002				2003		
	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III	IV	I	II	III
Gross Domestic Product	3.4	3.4	4.8	7.3	1	6.4	-0.5	2.1	-0.2	-0.6	-1.3	2	4.7	1.9	3.4	1.3	2	3.1	8.2





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 few last words on taxes and surpluses…

A tax of and by itself depresses. This is so because the taxpayer earns its income by helping produce goods and services: for that effort a reward called income is received. The income thus earned enables the person to buy the goods and services thus produced. If those persons are taxed when they earn the income or when they spend it, some of the goods produced end up being unconsumed. Unless some form of non-consumption spending occurs such as investment, the goods go unwanted and will soon cease to be produced as inventories pile up.

A federal budgetary surplus means that the Federal Government spends less on collective consumption and investment and transfer payments such as welfare, than it collects in taxes. This surplus results in a net reduction in total demand for goods and services and results in some combination of a fall in real economic activity and employment or deflation. If the economy is fully employed and inflating, this provides some relief. If the economy is struggling to create jobs so that the structurally unemployed can re-enter the workplace, and inflation is not a threat, the impact of federal government surpluses is certainly harmful.