Economics Symposium
University of Detroit Mercy
February 7, 2009

BAD THEORY, BAD POLICY
(The failure of economic policies over the past fifteen years)

ENERGY, ENERGY, ENERGY

The failure of the Justice Department and the Federal Trade Commission to effectively enforce the antitrust laws resulted in the re-cartelization of the American Oil Industry in the 1990s. Thirteen of the larger oil companies merged into six, including Exxon merging with Mobil.

Re-consolidation of the US oil industry (mergers of the last ten years)

1997--Ashland Oil combines most assets with Marathon Oil

1998--- British Petroleum (BP) acquires Amoco

1998--- Pennzoil merges with Quaker State Oil

1999--- Exxon and Mobil join to form Exxon Mobil

2000--- British Petroleum (BP) acquires ARCO (Atlantic Richfield)

2001--- Chevron acquires Texaco to form Chevron Texaco

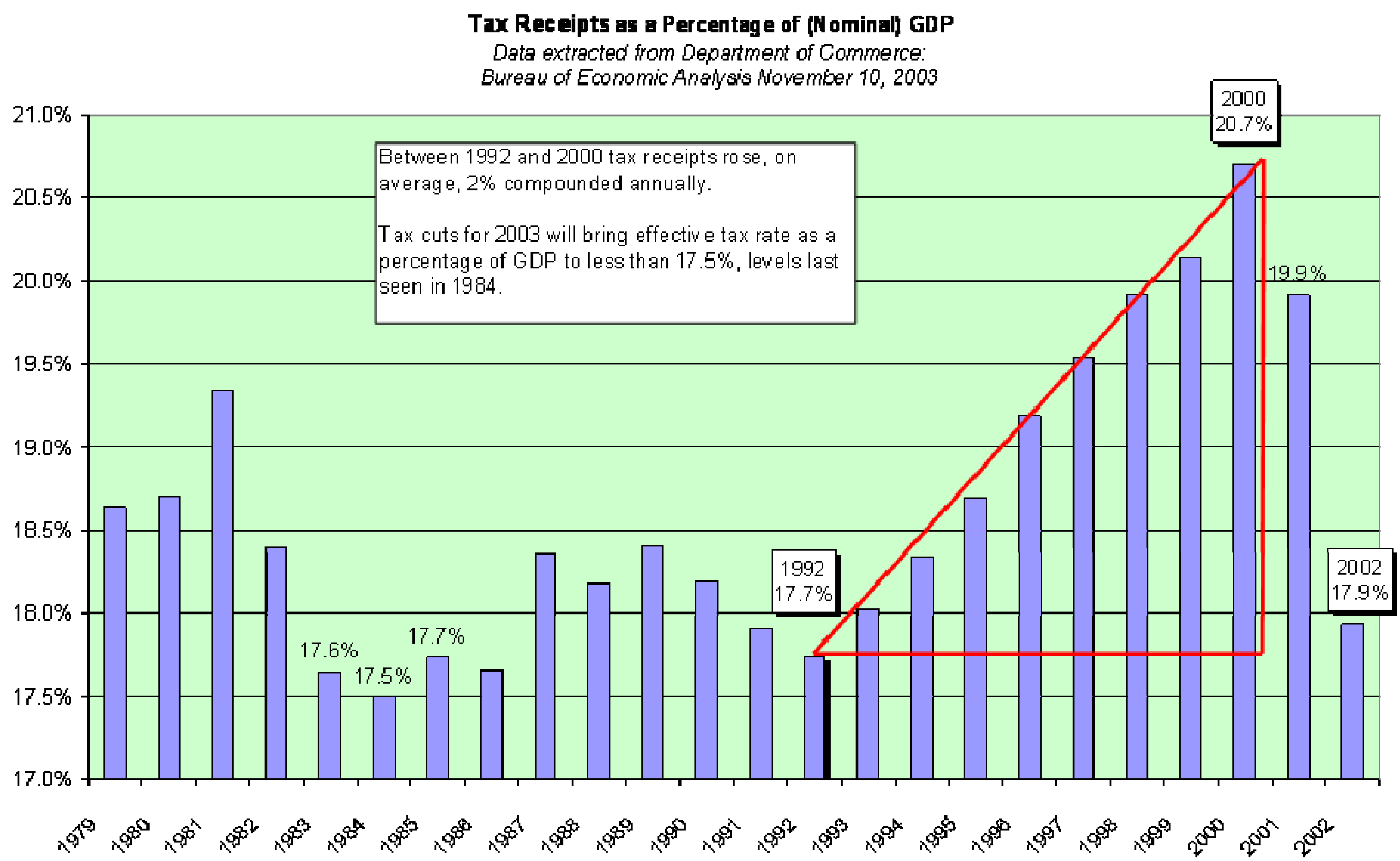
2002--- Conoco merges with Phillips

2002--- Royal Dutch Shell acquires Pennzoil-Quaker State

http://byrned.faculty.udmercy.edu/2005%20Volume,%20Issue%202/2005%20Volume%20Issue%202.htm
(Volume 2005: Issue 2) May 31, 2005)
(The Energy Challenge: U.S. Oil Industry (Merger-Mania) and the FED Conundrum Continues)

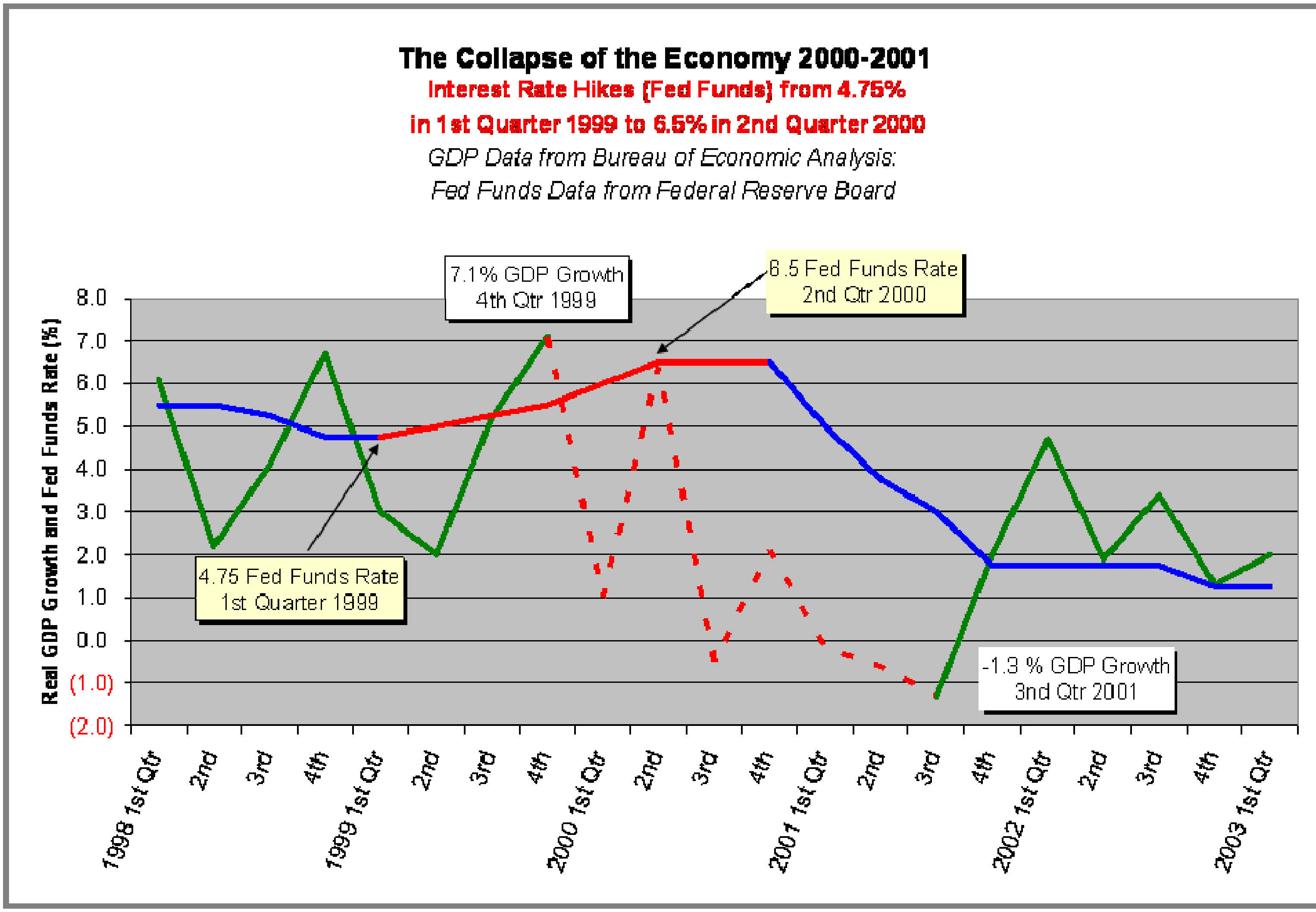
The failure of fiscal policy – or Rubinomics in the 1990s caused the federal budget stimulus to change from stimulus to restraint as tax rate increases slowly helped choke the economy and the federal budget went from a deficit to a sizeable surplus by 1998. The economy collapsed in 2000 not 2001. Note that real GDP went from a positive 7.3% in the fourth quarter of 1999 to a negative real GDP of –0.5% in the third quarter of 2000.

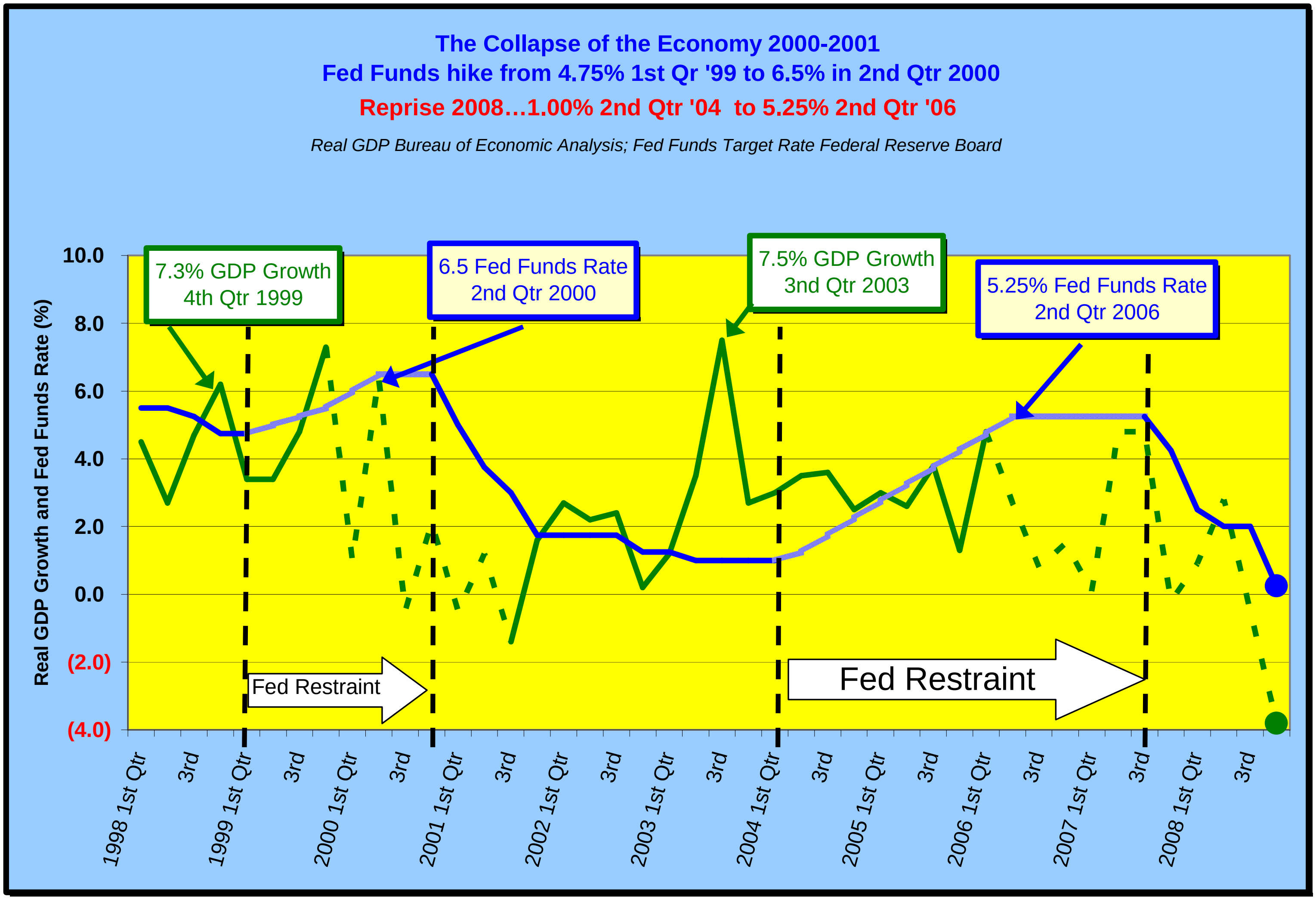
RUBINOMICS – Increased tax rates leads first to raised revenue; second, GDP collapse



The Fed initiated ill-advised policies of restraint in 1998 and again in 2004. By this time, the prescient and paranoid FED had switched from reactive and proactive actions to pre-emptive actions.

Combinations of bad policies resulted in the two collapses in the American Economy, 2000 and 2008. It was not simply problems from within the private sector of the economy that caused these collapses, it was also combinations of ill-advised economic policies by the anti-trust agencies, Congress, and the FED that were the real villains.





These bad policy decisions were due to a failure of these policy making authorities to understand the gradual but profound changes in the landscape of the U.S. economy and its financial system that have been occurring since the Second world War ended over 60 plus years ago. The result of these changes I refer to as the New Paradigm.

The economic instability of the last 10 years was not solely due to the failure of the private sector but heavily due to the failure of economic policy that induced instability in the economic system.

Round One: The Collapse of 2000
Let's look at the first crash, which lasted less than a year, beginning around the first quarter of 2000, not 2001.

1) It began with the onset of what is called Rubinomics, as Congress raised a variety of tax rates steadily in the 1990s. Think of it as Laffer in reverse

(Laffer posited that cutting tax rates would lead to an increased tax base). The increasing tax burden eventually eroded the tax base which is ultimately real GDP. Shades of the early days of FDR in the early 1930s, which aggravated the Depression until those policies were reversed.

2) Add to this the ill advised fiscal policy, the growing international trade deficit, and you have the basis for a severe economic collapse.

3) The third cause of the collapse of 2000 has roots going back to 1980. In an effort to wring out the inflationary overhang of the 1970s when inflation approached 20% at an annualized rate in very late 1979 and 1980, the FED crunched the economy with a 180 degree turn to monetary restraint. This brought down much of the inflationary overhang, and, via the Fisher Effect, nominal interest rates fell as well. However, the inflation fell slightly more than the nominal interest rates fell. Real interest rates ended up relatively high compared to other nation's real risk adjusted interest rates. Of course this was masked to some extent by the collapse of nominal interest rates. This reflected a corporate culture change at the FED as concern for unemployment changed to a paranoid fear of accelerating inflation returning.

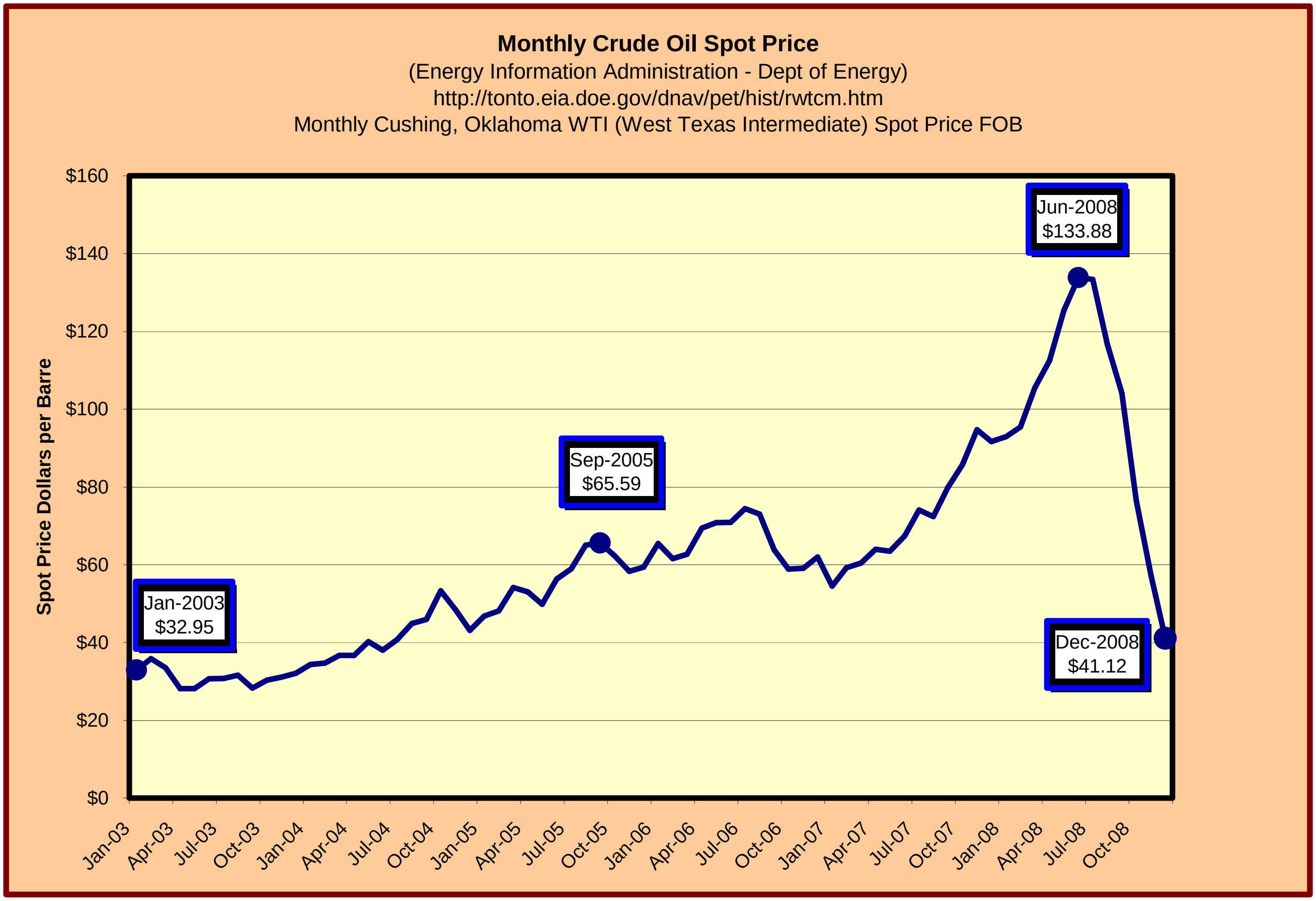
Round Two: the Financial Fiasco of 2008 or FFTTE

In the current economic and financial collapse, fiscal policy restraint was not a problem as Congress, pressured by George Bush, legislated rebates and some reduced taxes.

It would have been better if those cuts were made permanent and the rebates incorporated in to a lower permanent tax structure and not for a limited period of time and with sunset provisions. This is supported by research related to the permanent income hypothesis: temporary fiscal measures whether to stimulate or restrict economic volatility, last only a short period of time as they have little affect upon long run average disposable income. Permanent changes in the tax structure keep their potency for long periods of time.

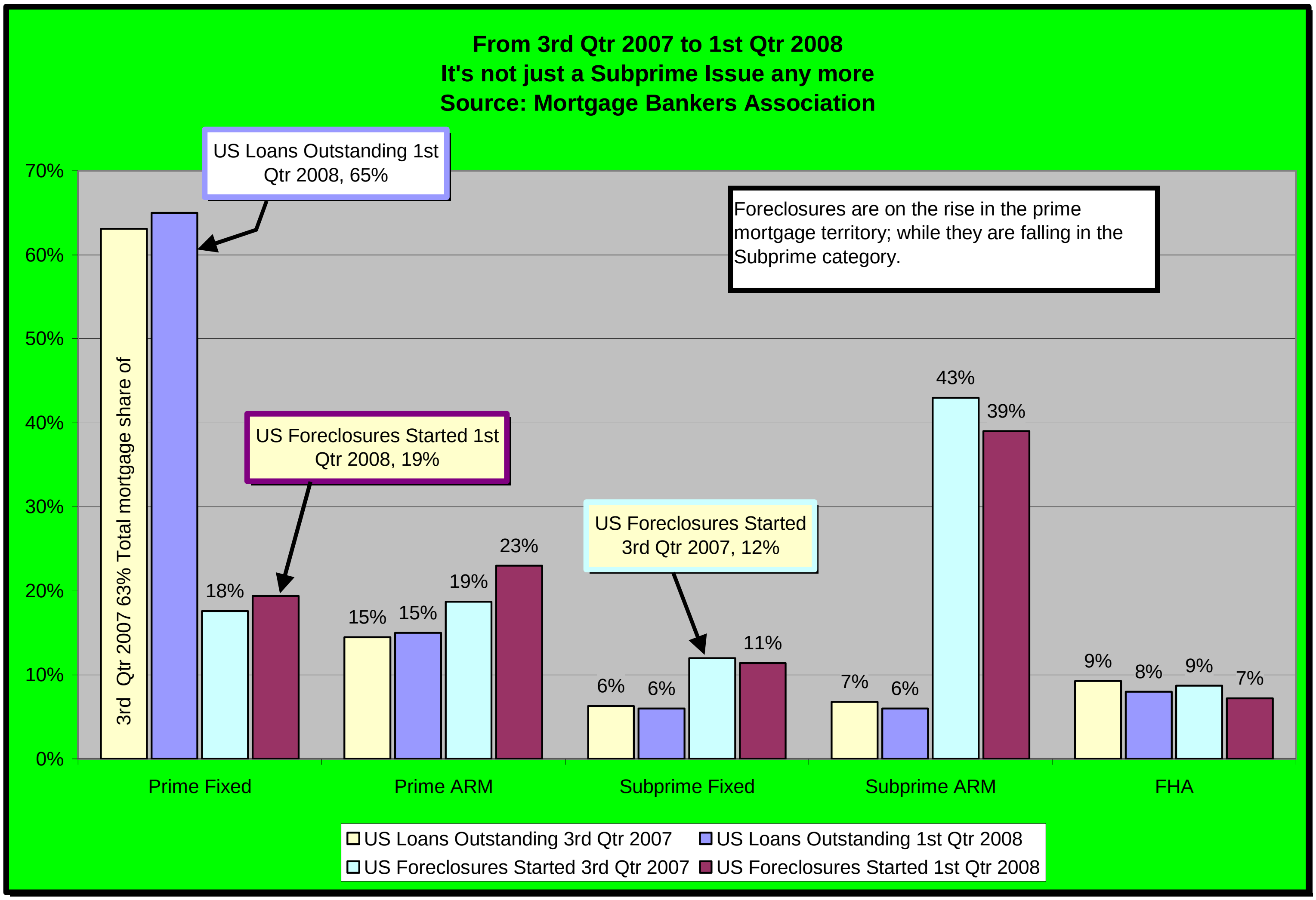
The real igniters of the current collapse problem were two-fold:

First, enter the recartelized oil industry. Discretionary income was absorbed as oil prices rose over a four year period and all of the slack was taken out of the household's budgets, as gasoline prices went above $4.20 per gallon (spot price for crude oil topped $145 per barrel in June 2008).

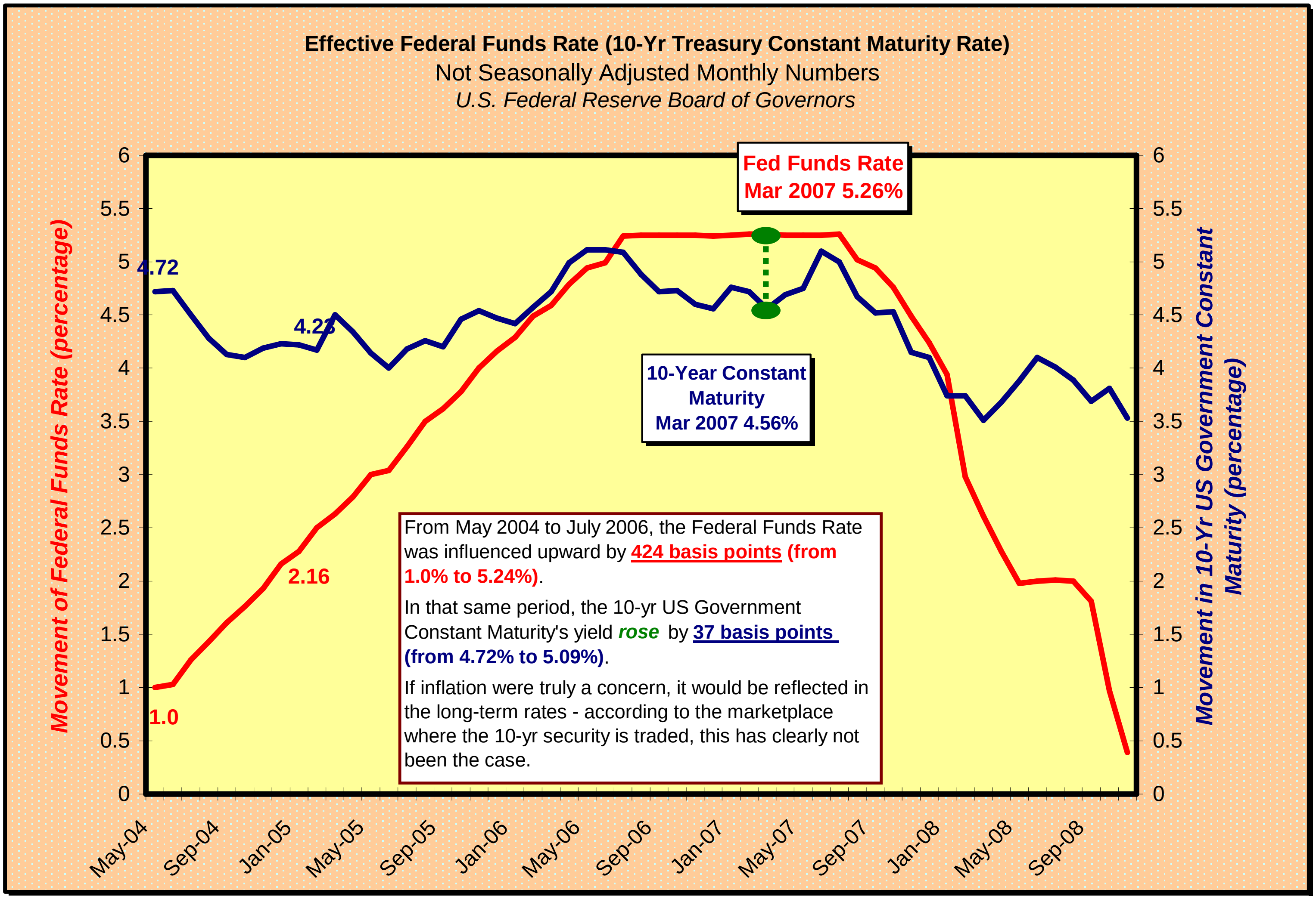


Second, along came the Federal Reserve, applying a massive and prolonged dosage of restrictive monetary policy, beginning in mid-2004 and continuing through Sept 2007. In recent years, the Fed's monetary restraint has been more pronounced at the short-term end of the yield curve and this latest round resulted in seventeen rate increases; the Federal Funds rate rose from 1.00% in June 2004 to 5.25% in June 2006. Again, it remained there until September 2007.

All short-term rates move similarly, in a parallel fashion, including the 1-year LIBOR (London Interbank Offer Rate), the 1-year Constant Maturity Treasury, the COFI (Cost of Funds Index), CODI (Cost of Deposits Index), etc. This led to resetting of adjustable rate mortgages (ARMS) on not only subprime, but also on prime and super prime mortgages. Most of the ARMs are tied to such short term interest rates as the one year LIBOR or the one year Constant Maturity Treasury securities interest rates. As the short term interest rates rose, the ARMs rates were reset upward when the two, three, or five year fixed rate portion of the mortgage expired. The amortization schedule was maintained so the monthly payments began to rise, often nearly doubling as the short term rates kept rising. Having been robbed of discretionary disposable income from higher energy prices, it was inevitable that foreclosures would occur and become widespread. This in turn caused the collapse of the housing prices and the virtual shutdown of new housing construction.



June 6, 2008 – LA Times
http://articles.latimes.com/2008/jun/06/business/fi-foreclosures6
"Although the mortgage crisis began in the sub-prime market, the number of troubled prime loans is on the rise. Of all loans that entered the foreclosure process, 19% were prime mortgages with fixed rates, 23% were prime loans with adjustable rates, 11% were fixed-rate sub-prime mortgages and 39% were adjustable sub-prime loans."

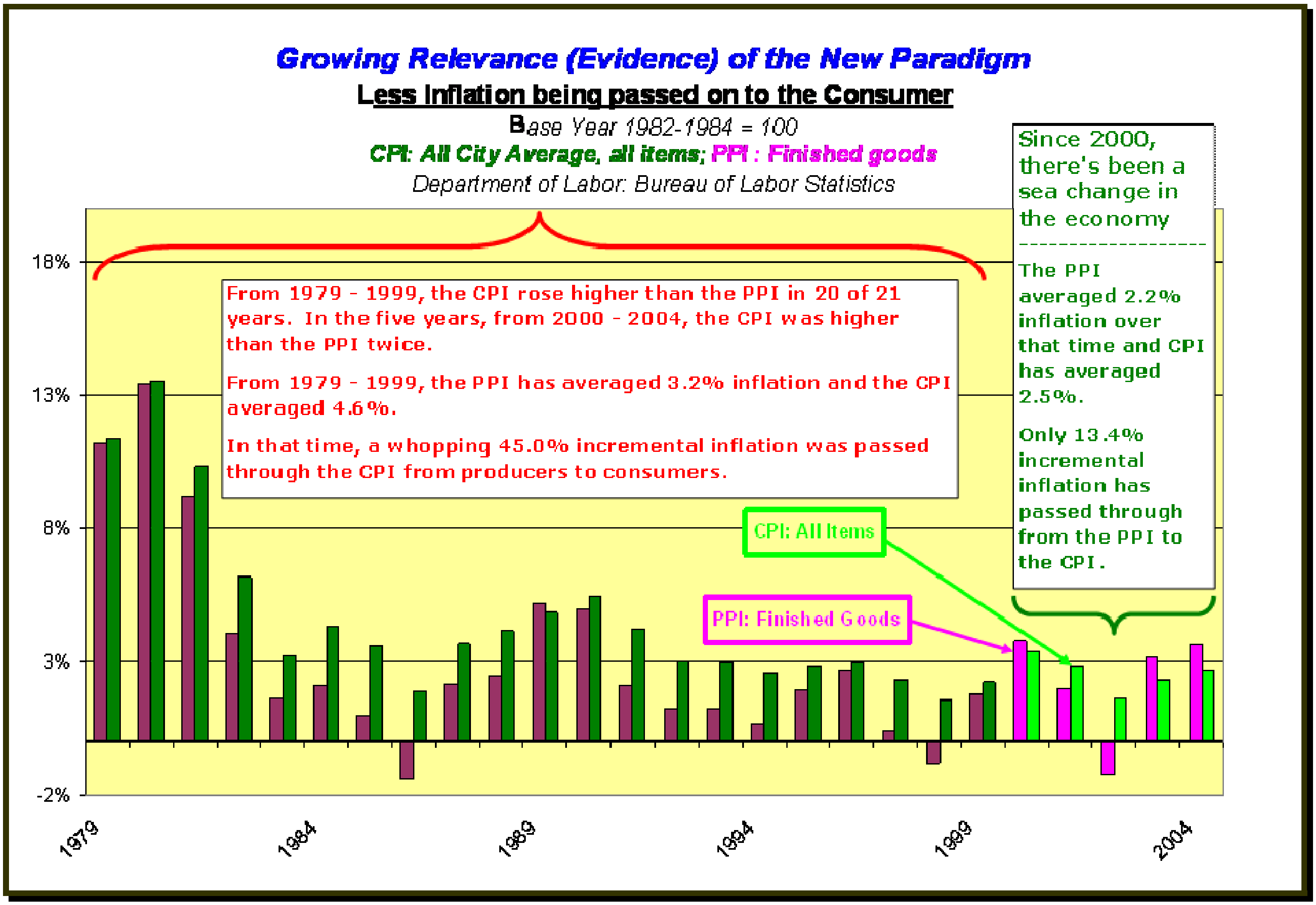


Note that long-term rates did not respond to the FED's upward pressure on short term interest rates…the now famous Greenspan CONUNDRUM (he's still scratching his head).

The expectations of the market, as explained in the Expectations Theory of the Term Structure of Interest Rates, did not reflect the belief that short-term rates would continue to rise in the future, and hence long-term rates not only DID NOT rise significantly but began to fall giving rise to the much ballyhooed inverted yield curve. According to the Expectations theory of the term structure of interest rates (its graphical representation is called the yield curve) current longer term interest rates are the geometric averages of the expected short term interest rates.

Why did the Fed initiate this restrictive policy in 2004?

Continued reliance on the old paradigm, where there is a strong inflationary bias, resulting from the lack of competition in the markets. The old paradigm prescribed monetary intervention through restrictive policy to preempt what they viewed was the inevitable return of inflation. If you look at the actual figures, the CPI no longer follows the PPI. Price changes at the consumer level were relatively less than the price changes at the producer level. The reason: increased competitiveness in the market for final goods, such as personal consumption expenditures – for example Autos.



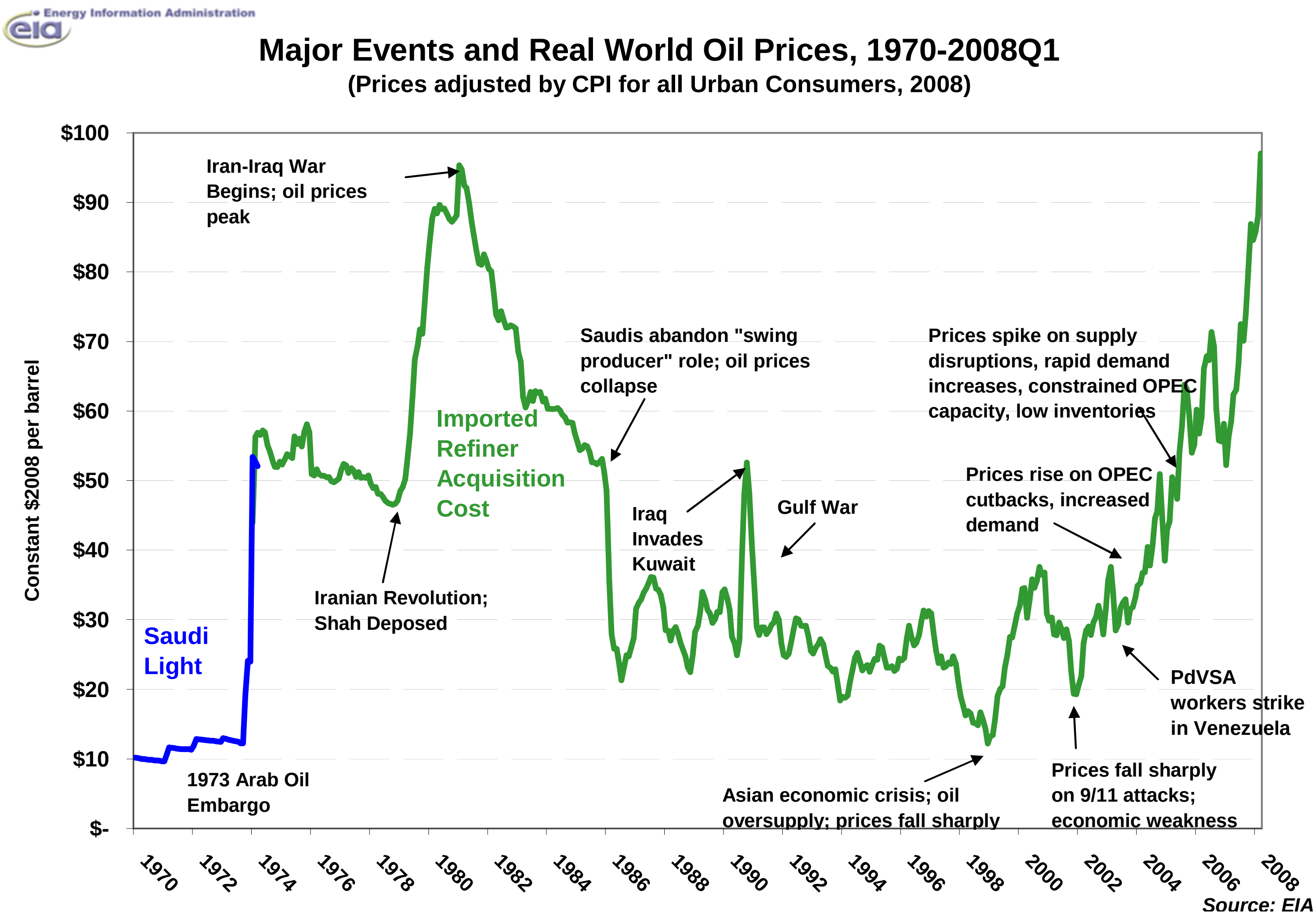
"For the past five years, as contrasted with previous data, the Consumer Price Index CPI no longer reflects the Producer Price Index pressures. The CPI has been rising less than the PPI in three of the last five years. Remember also, that the CPI includes services at the retail level have in previous years, been the main source of inflation. Even with these included,

the CPI is reflecting less inflation than the PPI. This is in stark contrast to what has typically been the case in the past."

http://byrned.faculty.udmercy.edu/2005%20Volume,%20Issue%201/2005%20Volume%20Issue%201.htm

The second reason for the Fed's ill-advised policy was the change in the collective culture of the Fed, resulting in their failure to stem the inflation, especially in the late 1970s, as OPEC caused two major supply side shocks to the American economy. This prompted a 180 degree turn in the Fed's policy in 1980 from one of concern over unemployment and disregard for inflation, to a new corporate culture with disregard for unemployment and a paranoid fear of inflation.

As I will show in a few minutes, this failure to see the gradual elimination of the inflationary bias at the consumer price level has resulted in an obsessive fear of a reprise of the late 1970s and very early 1980, when inflation approached 20% on an annual rate.



Source: US Department of Energy, Energy Information Administration
http://www.eia.doe.gov/emeu/cabs/AOMC/Overview.html

Why have we experienced these policy failures?

The answer is clear. Since the Second World War, the American economy, on average has become increasingly competitive in the product and resource markets. An example in the product market is the increasingly competitive automotive and telecommunications markets. In the resource markets, labor in particular, union labor has fallen from over 30% to less than 15%.

According to the U.S. Department of Labor (Bureau of Labor Statistics), nearly half of them are government employees who earn on the average 28% more in compensation than workers in the private sector.

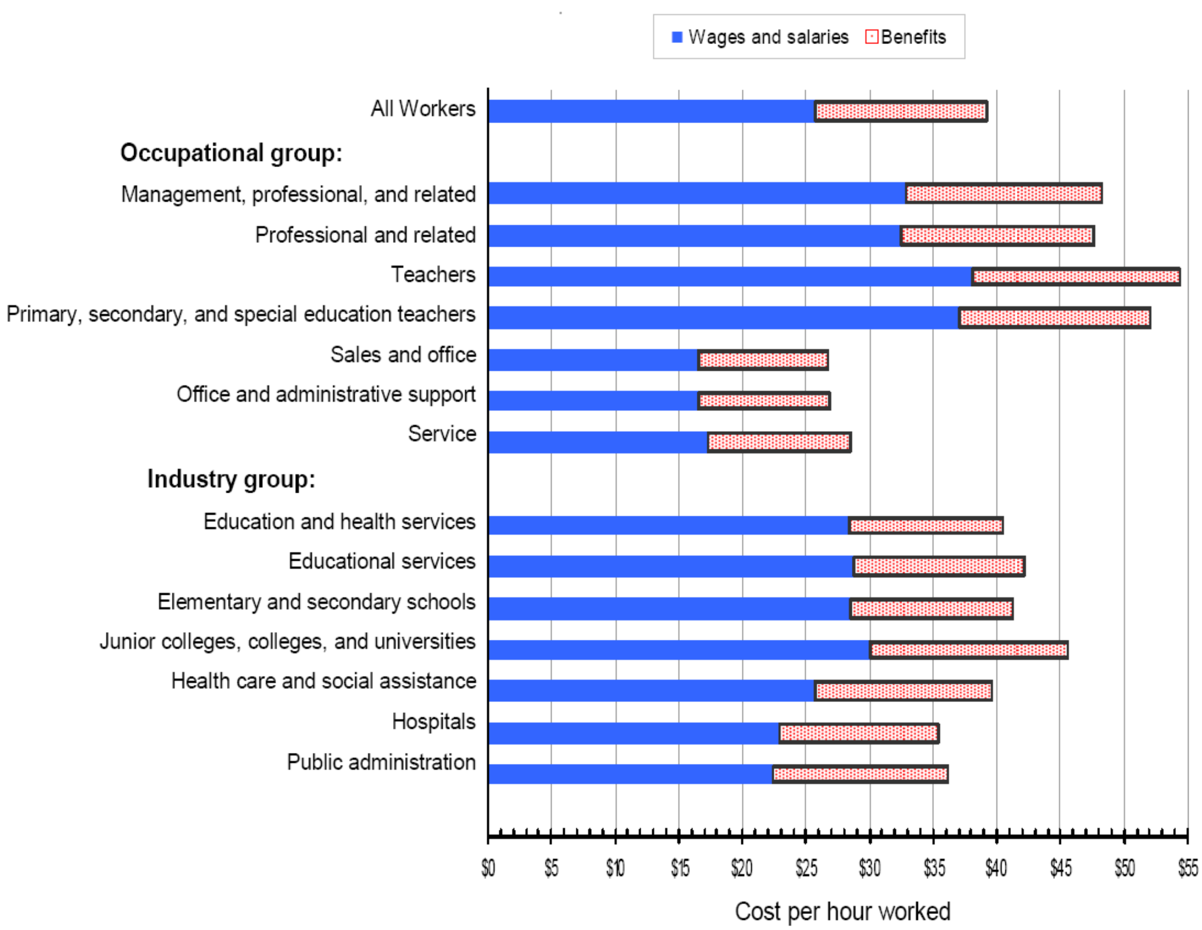
http://www.bls.gov/news.release/pdf/union2.pdf

In 2008, among full-time wage and salary workers, union members had median usual weekly earnings of $886 while those who were not represented by unions had median weekly earnings of $691 (earnings=28.2% higher in union v. nonunion).

The union membership rate for public sector workers (36.8 percent) was substantially higher than the rate for private industry workers (7.6 percent). Within the public sector, local government workers had the highest union membership rate, 42.2 percent. This group includes many workers in several heavily unionized occupations, such as teachers, police officers, and fire fighters.

http://www.bls.gov/news.release/pdf/ecec.pdf

Chart B. Employer costs for employee compensation, State and local government, September 2008



Terms such as globalization, deregulation, privatization and commoditization reflect an overall growth of competition in the American Economy.

There have been a few exceptions to this trend, such as the recartelization of the oil industry. As a result of this increasing competition, a gradual – but PROFOUND change has occurred in the economic landscape in the United States.

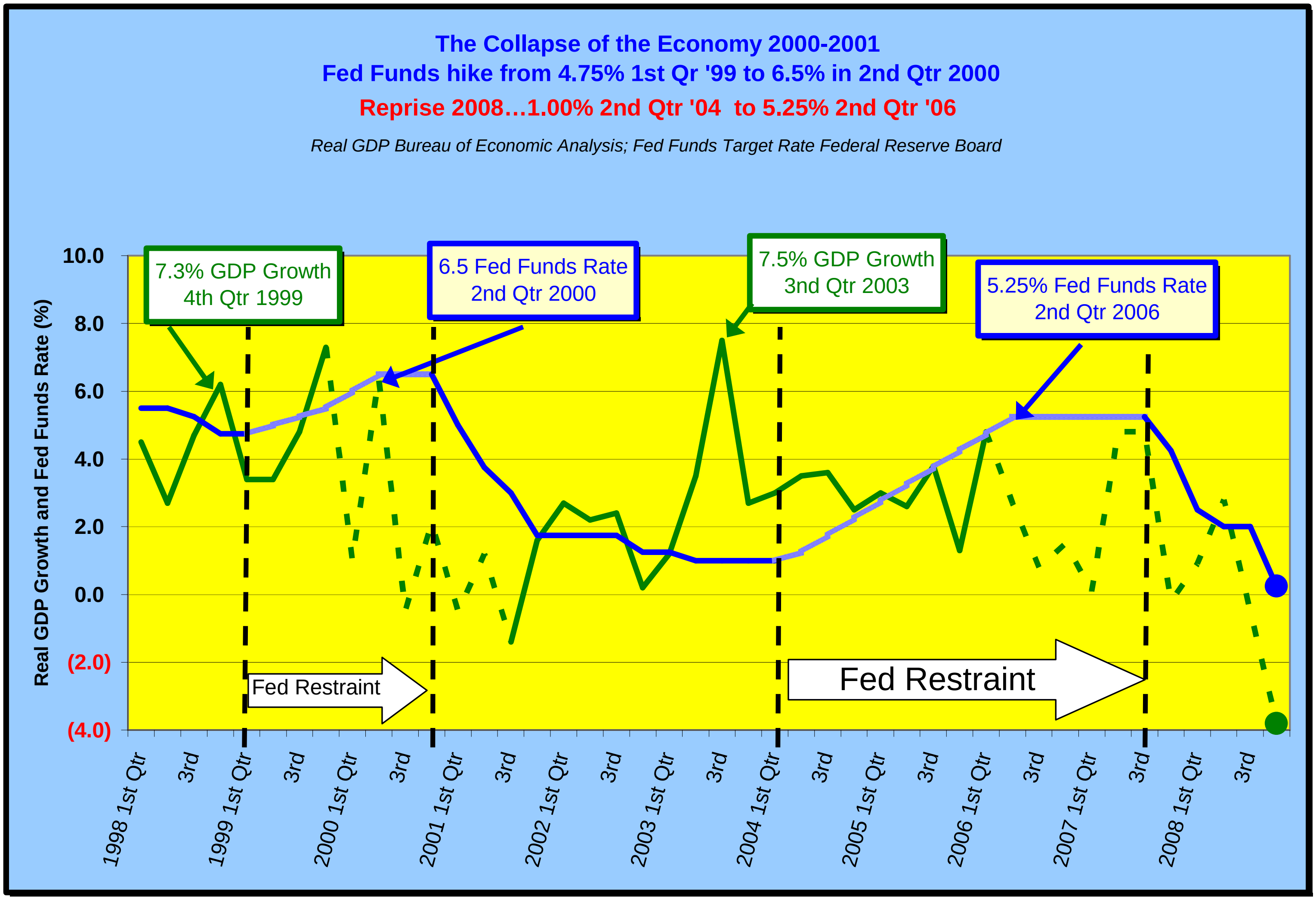
(Volume 2008: Issue 2) May 13, 2008)
(Oil & Autos: Cartelistic v. Competitive Free Market Capitalism)
http://byrned.faculty.udmercy.edu/2008%20Volume,%20Issue%202/2008%20Volume%20Issue%202.htm

The market structures have, on the average, shifted from more – to less concentrated markets. In the world of market concentration, the chief economic problem is what is termed as DOWNWARD PRICE RIGIDITY – prices can rise, but don't fall as easily. This imparts two biases to the MACROECONOMY, an inflationary bias and a recessionary bias. The latter resulting from output reductions, replacing price reductions when demand weakens. Harm also occurs to the MICROECONOMY. The theoretical economics welfare ideals of equity and efficiency are violated.

The violation of equity results in a much greater inequality in the income distribution. And even though a few benefit from it, the average standard of living is less than what it need be. As competition returns through such things as international trade and deregulation, industries that were never really very competitive become more competitive, good things happen to the American economy. In the MACROECONOMY, the biases toward recession and inflation are gradually reduced. Episodes of inflation and recession become less frequent and less severe when they occur. In the MICROECONOMY, the inequality in the income distribution is lessened and the per capita income increases.

This lessens the need for intervention by government on LOGICAL, not IDEOLOGICAL grounds. It increases the possibility, however, that the failure to detect and understand these changes in the economic landscape can lead to ill-advised policies, such as those we've seen over the past fifteen years.

As I pointed out earlier, it was bad economic policy that caused the collapse in the first three quarters of 2000. Bad policy also caused the current financial fiasco as the FED, for the second time in six years, pursued a policy of monetary constraint which helped cause the current collapse of the housing markets and the overall economy as well.

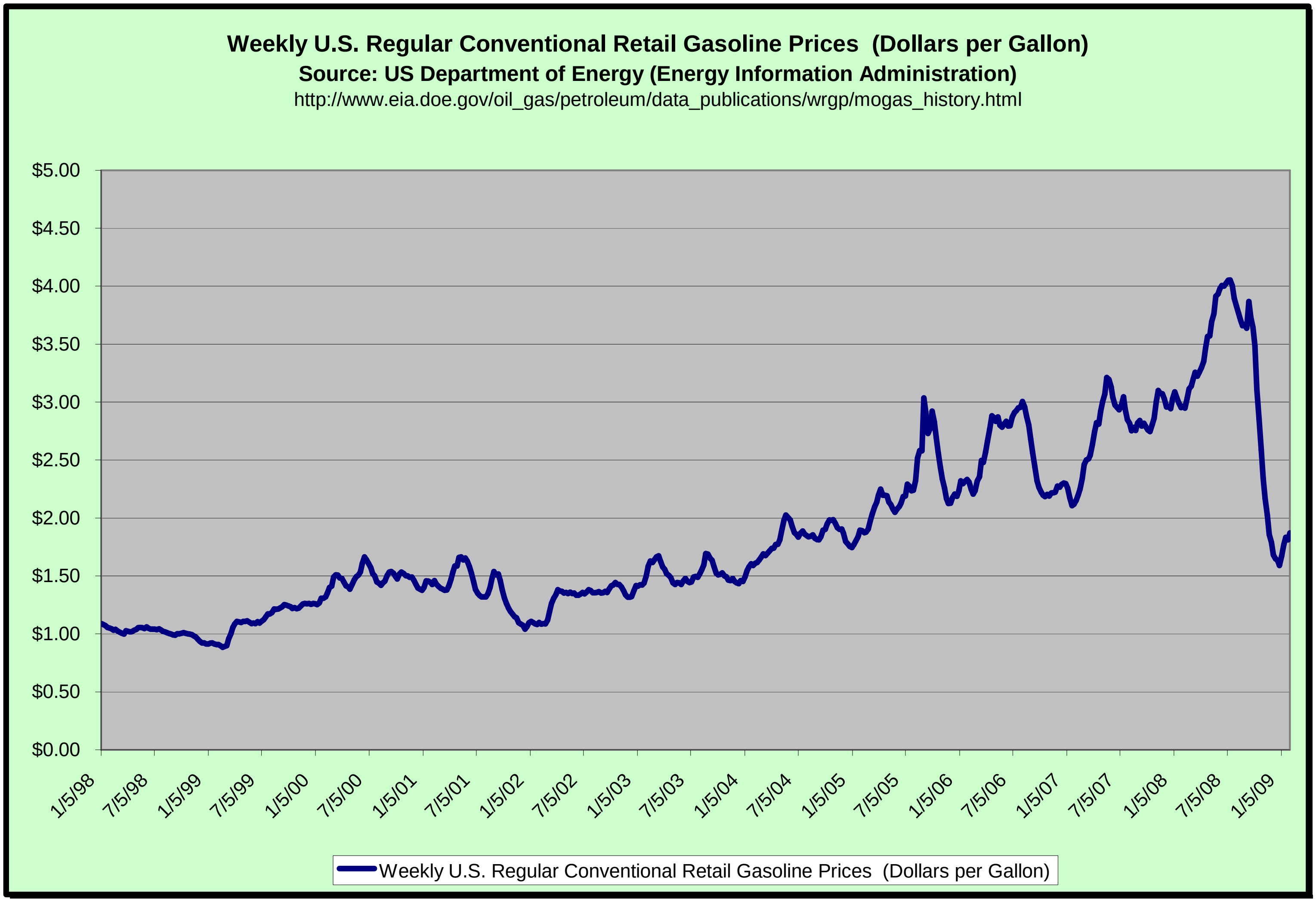


The Financial Fiasco of 2008

This leads us to the financial fiasco of 2008, which I refer to as the gang rape of the taxpayer. This orgy continues under the guise of the fiscal stimulus package, which has little to do with the solving of the underlying problems.

In the most recent issue of the newsletter, I point out that a number of developments, both past and present, have turned the American financial system into a powder keg ready to explode. You can read the newsletter for the 14 points I have listed that contributed to the powder keg's construction. Explosions require an ignition source (igniter, blasting cap, etc.) and there were two of them that blew this system wide open. As I pointed out before,

the first was the failure of the antitrust authorities to prevent the oil industry from recartelizing in the 1990s. It literally robbed households of their discretionary disposable income, leaving them with no slack to cope with any other financial bumps in the road. Recall when the fill up of your SUV went from $30 per week to over $100 per week.



The second igniter, which helped decimate the American economy, was the **Fed's** initiation of the economic **policy of restraint** that it launched in 2004. This caused record foreclosure rates on housing as ARMs (adjustable rate mortgages) of the subprime, prime and superprime variety were reset with monthly payments that frequently resulted in doubling of these payments. Robbed by the oil cartel of discretionary income, households could not meet the recurring and rising shock to their budgets.

With OPEC (Organization of Petroleum Exporting Countries) alone, these surges in oil prices generally lasted only a year or two at the most, with it's partner – **OPIC** (Organization of Petroleum Importing Countries) – the US oil industry, this last series of price hikes lasted over 4 years, culminating in $145+ per barrel, gasoline prices above $4.20 per gallon…not to mention the price of energy for heating and cooling your home. If want to see an example of market power, just look at the rate of return on equity for the likes of EXXON Mobil --- they have hovered around 35% for the past few years. The Mafia would be thrilled with results like this.

Having seen the results of the IGNITION OF THE two blasting caps destroying the financial system, let me run the risk of boring you, by enumerating a couple of the many points that were explained in detail in the most recent issue of our newsletter regarding the powder keg construction whose explosion resulted in the financial fiasco of 2008.

LEVERAGE and the DEMISE OF THE COMMERCIAL LOAN DOCTRINE

Financial services firms in general and depository institutions such as commercial banks specifically, employ a high degree of financial or debt leverage. Rarely does the ratio of owner's equity to assets reach above 10% and is usually closer to 8%. This means than a little more than 90% of their assets are financed by creditors showing up on the bank's balance sheet as liabilities. For most banks, a fall in net assets of less than 10% will cause insolvency. Therefore these institutions must avoid any serious degree of risk from any source. In the case of depository institutions such as commercial banks, these liabilities are also very short term or liquid deposits, a good portion are checkable or payable on demand. Every such institution is under the threat of a run which it cannot meet without outside help such as the central bank.

To cope with these problems, depositories such as banks followed the management philosophy called the Commercial Loan Doctrine. Lend only on a short term and self liquidating basis. Preferable, working capital loans to business. Banks moved away from this philosophy to others sanctioning longer term and riskier loans. Such change was justified by the industry as resulting from changes in the market place easing the need from such a limited philosophy as the Commercial Loan Doctrine. (See the most recent issue of our newsletter for a more thorough explanation of all this). The most recent management philosophy is called Asset Liability Management or ALM. To use an old phrase, something was lost in the switch. Some financial institutions have behaved like steamboat gamblers, chasing risk for yield. Well brothers and sisters, than risk has materialized.

GREED FACTOR

Over the very long haul, the average rate of return on owner's equity that is well diversified is around 10% according to creditable authorities such as Ibbotson Associates. Yet management of large firms are expected to achieve 20, 25, and 30% ROE or return on owners' equity. This is the basis for such huge "excess management compensation" in the millions of dollars. Yet such rates of return on equity can only be reached by market power as in the case of the recently cartelized oil industry where ExxonMobil has average in the mid thirties for the past few years, or chasing risk for high yields. The latter has resulting in very large financial services such as Citigroup and Lehman Brothers going bankrupt and begging for bailouts as the risk they chased materialized.

TIME TO CHANGE THE INVESTMENT BANKING INDUSTRY

That exclusive club of investment banking firms has to be radically reorganized. In the four years priors to their recent bailout (2004 – 2007), they distributed nearly **$115 billion**, not million, in bonuses, primarily to a handful of their elite salespeople. The ability to do this came from the fees and commissions from mergers and acquisitions activity and the selling of such products as the now infamous mortgage backed securities.

New York City Securities Industry Bonuses

	Wall St Bonuses ($bil)	Change (percent)	Avg. Wall St Bonuses ($000)	Change (percent)
1985	1.9	44.8%	13.970	33.1%
1986	2.2	15.7%	14.120	1.1%
1987	2.6	18.9%	15.610	10.6%
1988	2.0	-21.3%	13.290	-14.9%
1989	1.9	-5.5%	13.260	-0.2%
1990	2.1	9.9%	15.540	17.2%
1991	4.1	95.7%	31.100	100.1%
1992	4.9	18.1%	36.200	16.4%
1993	5.8	18.1%	39.660	9.6%
1994	4.9	-15.7%	32.190	-18.8%
1995	6.2	26.8%	41.410	28.6%
1996	9.8	59.3%	63.870	54.2%
1997	11.2	14.5%	67.800	6.2%
1998	9.1	-18.8%	53.040	-21.8%
1999	13.5	48.5%	75.010	41.4%
2000	19.5	44.3%	100.530	34.0%
2001	13.0	-33.2%	74.140	-26.3%
2002	9.8	-25.0%	60.900	-17.9%
2003	15.8	61.3%	99.930	64.1%
2004	18.6	17.7%	113.450	13.5%
2005	25.7	38.2%	150.160	32.4%
2006	34.1	33.0%	190.600	26.9%
2007	32.9	-3.6%	177.010	-7.1%
2008	18.4	-44.0%	112.020	-36.7%

Notes:
1. Wall Street bonuses are for the securities industry (NAICS 523)
2. 2007 and 2008 bonus estimates are forecasts and subject to revision

Data Sources:
1. Historical bonuses are OSDC estimates drawn from the NYS Dept of Labor's insured employment series.
2. 2008 estimate was derived by OSDC from personal income tax withholding collections and industry revenue and expense data.

Prepared by the Office of the State Deputy Comptroller, January 28, 2009

New York State Comptroller's Office (Thomas DiNapoli) – Wall Street Bonuses http://osc.state.ny.us/press/releases/jan09/012809.htm
"DiNapoli also estimated that the traditional broker/dealer operations of the member firms of the New York Stock Exchange lost more than $35 billion in 2008—more than three times the record loss in 2007. Industry losses were actually much greater when other business services, such as mergers and acquisitions, were factored in."

Of course mergers and acquisitions as occurred in the 1990s in the U.S. oil industry reduce competition in markets, and, in the macroeconomy increase the biases toward inflation and recession. In the microeconomy this causes a more unequal income distribution we call a violation of equity. It also lowers the per capita real GDP which is termed a violation of efficiency.

Hooray for the few and to hell with the many!

The other profitable products such as mortgage backed securities often haunt the buyers for years after. Most recently, they were a primary cause of the failure of many financial institutions here and abroad.

As underwriters, the investment bankers dominate the market where new securities are first sold to or placed directly with investors. In the secondary markets such as those for bonds and stocks, the law requires that investment bankers must "touch" most transactions for which they charge fees and commissions. This continues despite the information technology revolution we have experienced. Their grip on the financial markets must be broken.

OTHER FACTORS

There are at least a dozen other causes for the current malaise in our financial system. This is all laid out in the current issue of our newsletter. Read it and weep.

You are going to be handed the bill for all of it, very shortly.

Had the two igniters not detonated, the powder keg would remain, but we would not have had the fiasco. If the Fed had not initiated this ill-advised policy of monetary restraint in 2004, we would probably have skirted most of the problems. But the two together, the Fed and the recartelization, were too much for the economy to absorb. Since that powder keg blew, but nothing has been done to redress the core issues, that powder keg will be quickly refilled and will blow again in the near future. Just as we have not addressed the real problem of the American portion of the Big Three auto industry; that portion will continue to implode as well. Jobs will continue to migrate to the Southeastern U.S.

A belated Happy New Year to all!