An Economic Newsletter for the New Millennium

Produced by the ***New Economic Paradigm Associates***

(Volume 2003: Issue 1) August 6, 2003

INTRODUCTION:

WHY ANOTHER NEWSLETTER?

There are two primary reasons for the production of this economics newsletter - The first is to bring to the readers the growing relevance of what some like to call the New Paradigm in Economics. By the end of the Second World War, the American economy became burdened with a bias to both inflationary and recessionary episodes. It appeared that episodes of both were becoming more frequent and more severe in terms of both depth and duration. These biases have seemed to weaken as the economy evolved to the present time. 'What has happened to the business cycle" and "where has the power of firms to control prices gone", and again, "are we entering a deflationary period"?

The attempt to make economic sense of these changes constitutes the body of economic analysis increasingly termed, The New Paradigm. The century leading up to the Second World War saw pretty much, a continuous decline in competition in product and resource markets, including labor markets. As has been shown in the book, *THE NEW PARADIGM, ECONOMIC UNDERSTANDING FOR THE 21ST CENTURY*, (Donald R. Byrne, 2003), a landscape change began to slowly evolve in the U.S. microeconomy that was to lessen the economy's biases toward frequent and severe episodes of inflation and recession. The U.S economy was gradually being transformed from one better characterized as cartelistic free market capitalism to one more consistent with competitive free market capitalism. Monopoly power over prices including wages had increasingly spread throughout the economy as we approached World War 2. Following WWII, that same power was on the wane and gradually began disappearing from an increasing number of markets.

Globalization, deregulation, privatization and commoditization of goods and services and productive resource markets have changed economic behavior. An increasing number of firms in an increasing number of markets have had to seek relief from declining profits by cutting costs and not by raising prices, as was the old remedy. In labor markets, rising union compensation for labor has resulted in growing structural unemployment.

As this occurs along with the diminishing frequency and diminishing severity of recessions, structural unemployment has replaced cyclical unemployment as a major concern. Many economists and most policy makers have failed to understand these changes…recent monetary and fiscal policies have proved failures and gave us the 2001 recession that should have never occurred. See the major article, "WHAT RECESSION" in this first issue for a discussion of this policy failure.

Many good things are coming from this economic evolution toward more competitive markets. The income distribution is becoming more equal as market power disappears gradually. The efficiency of resources such as labor increases more rapidly than before as a consequence of restructuring. The changes gradually occurring (and continue to pervade the economy) will help explain and illustrate the various topics discussed in this newsletter.

The second reason for this newsletter is to avoid as far as possible, ideologically driven arguments. For this reason, only officially published data will be used…such as the National Income and Product Accounts from the Bureau of Economic Analysis, the Flow of Funds Accounts from the Board of Governors of the Federal Reserve System, the Census Bureau data, etc. Hyperlinks to that data will be an integral part of this newsletter. This data will be readily accessible to the reader – only a mouse click away.

Feedback via e-mail is encouraged and appreciated, and will be incorporated in the newsletter as space permits.

Current Newsletter

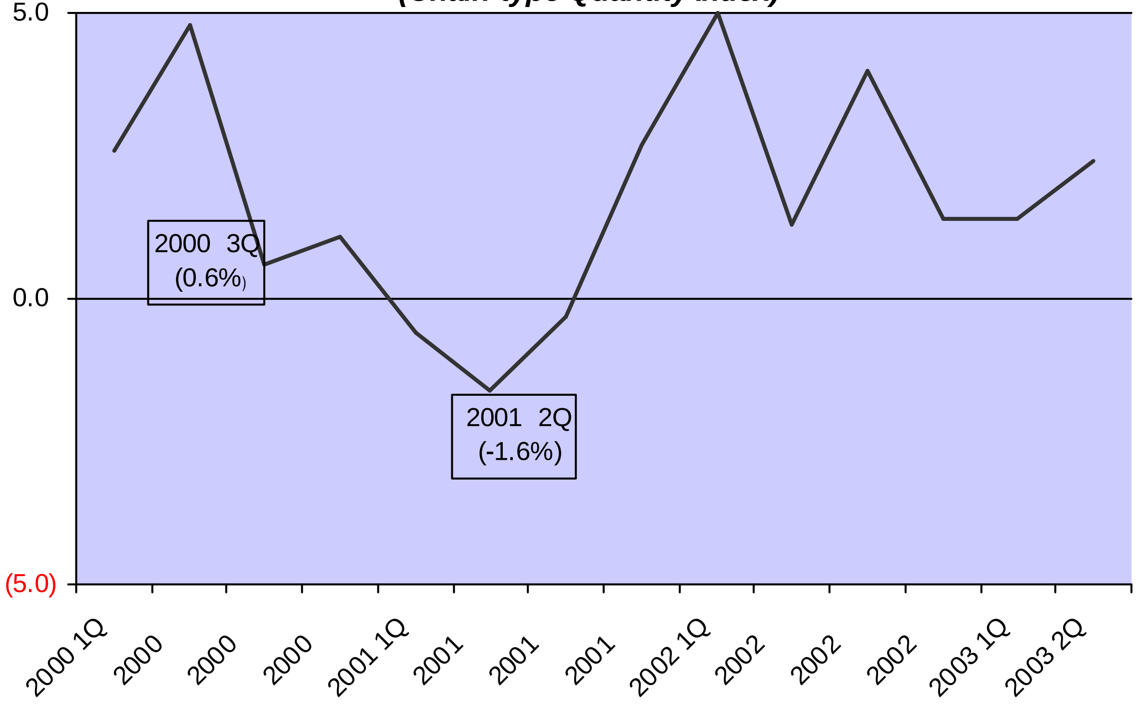
(Volume 2003: Issue 1) August 6, 2003

What Recession?

I am constantly amazed by students and the public at large when they ask about the recession we are in. Of course as the data from the Bureau of Economic Analysis shows in Figure 1, we are not in a recession and have not been for over one and one-half years. As you can see in Figure 1, the recovery began in the fourth quarter of 2001 and has continued through the first quarter of 2003. All indications are that when the data of the third quarter of 2003 comes out, it will show that this last quarter was a continuance of the recovery /expansion.

(Parenthetically, after over one and one half years of recovery, the exalted National Bureau of Economic Research declared that the recovery had begun in November of 2001. There is nothing like timeliness to add credibility to an organization's pronouncements.)

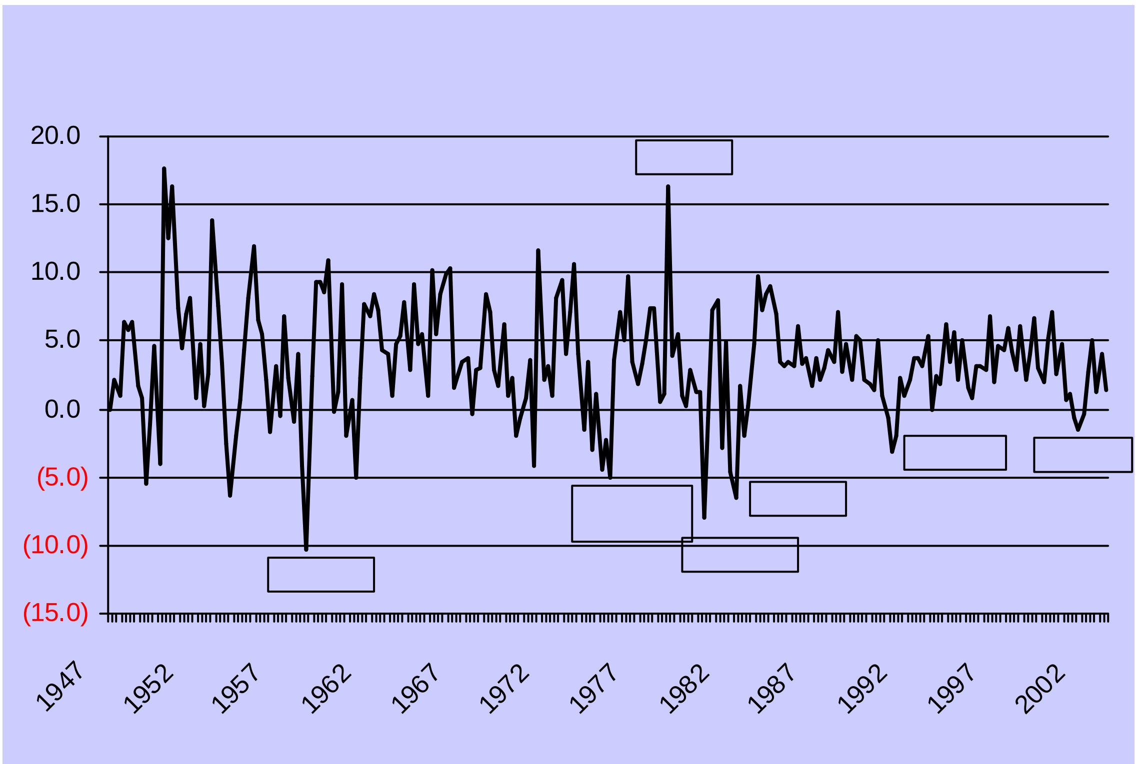
Figure 1
Qrterly GDP Change 2000 - 2002
(Chain-type Quantity Index)



When I tell my students that and show them the data, they invariably wag their fingers at the unemployment figures. I then distinguish between the cyclical unemployment, of which there is very little, and structural unemployment, of which there is a significant amount. Structural unemployment is the flip side of rapid increases in labor productivity that result from restructuring. The old jobs are gone and will not come back with expansion; new jobs must therefore be created.

To a great extent, these increases in productivity are a result of restructuring. This increases the competitive ability of firms. It tends to lower their unit labor costs. Unfortunately for society, the productivity dividend to the public at large does not occur until the structurally unemployed are re-deployed into new jobs, sectors, etc., producing additional goods and services. None of this was possible before the restructuring occurred since the redundant labor was buried in the cost of the given product.

We need a stimulus, not to recover from a recession, but to reap the productivity dividend by re-employing the structurally unemployed in newly created jobs. As the New Paradigm argues, we can experience a faster real rate of economic growth without serious inflation re-emerging. Let us hope that the FOMC has learned a lesson from the ill advised policies of 1999-2000. The greatest defense against inflation is significant competition in the market place.



THE NEW PARADIGM

In my public presentations, going back a few years and in my classroom lectures, I began to find the existing macroeconomic analysis of increasing irrelevance. That analysis is usually referred to as Keynesian demand side macro. I had similar misgivings about monetarism and its explanation of inflationary episodes. It seemed that the economic landscape had been gradually evolving and a new perspective was needed. As I argued several years ago, and has become increasingly apparent of late, the gradual increase in the strength and pervasiveness of competition has been causing profound changes in product and resource markets. It appeared that firms in a growing number of industries were losing their price power. Resources such as labor were experiencing declining job security. Terms such as globalization, privatization, deregulation and commoditization were seen more and more in the literature of business.

As economic analysis has always argued, the presence of increasing competition reduces the ability of business to raise revenue by raising price. As Alfred Marshall pointed out many years ago, that when firms face little competition and thus have monopoly power (when demand weakens), they do not cut price, they cut output. When John Maynard Keynes developed his new paradigm, published as his *GENERAL THEORY* (1937), its centerpiece was the downward inflexibility of prices, caused by declining competition in markets. As I point out in Chapter 12 of my text, *THE NEW PARADIGM IN ECONOMICS*, downward price rigidity in markets due to lack of significant competition causes a bias toward frequent and severe episodes of inflation and recession. Prices will rise but rarely fall in markets with little competition; an inflationary bias results. The U.S. was experiencing the growth of cartelistic capitalism from the late 1800s through the Second World War, in both product and resources markets such as labor. The auto, steel, telecommunications, and lumbering industries all experienced the rise of "big labor" in the form of the UAW, USW, CWA, etc.

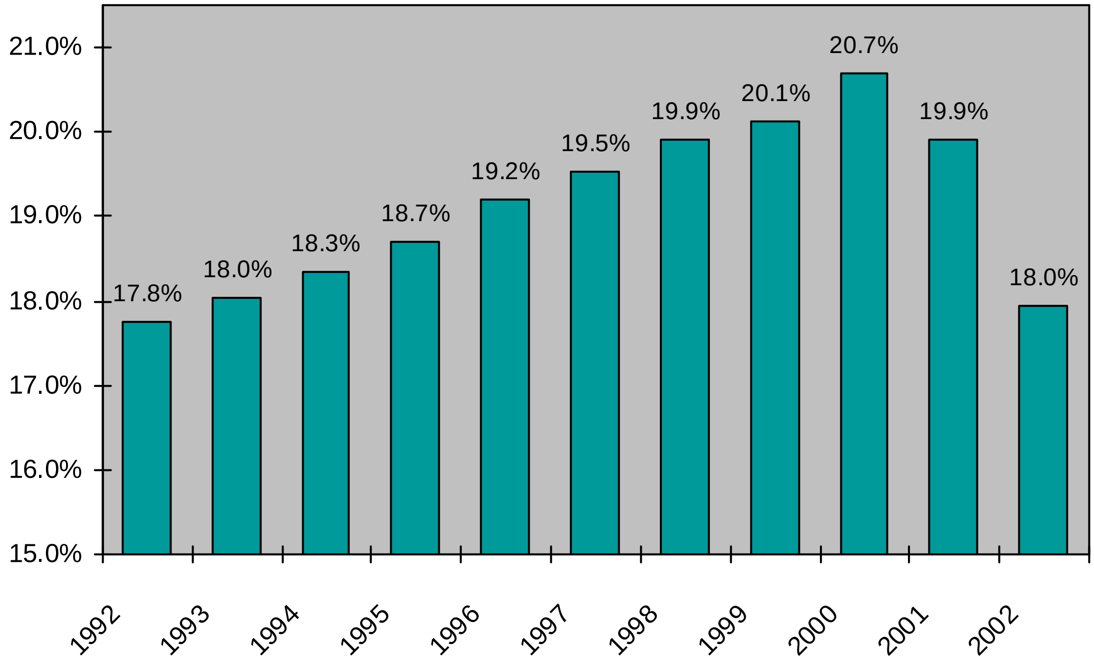
The markets no longer worked as argued in the neo-classical economic tradition. The late 1920s and much of the 1930s proved that prosperity was not just around the corner. Keynes' writings were really geared toward explaining the Macroeconomics of cartel-laced free market capitalism. Incidentally, that era of cartelism began to decline after the Second World War. Re-globalization or world trade was reborn with GATT and the IMF fixed exchange rate system. Deregulation began and continues today. The Hot, Cold, and Space Wars caused rapid technological change, undermining any efforts to control many markets. Privatization continues to bring competition into areas such divergent services as garbage collection and education, all formerly the domain of government ownership.

We are increasingly experiencing an evolution toward competitive free market capitalism. Growing competition reduces market power of both firms and the resources they employ. As costs rise and profits decline, the old remedy of raising prices to increase revenue becomes less and less effective in raising revenue and restoring profits. Economic theory tells us that as competition increases, price elasticity of demand at each price increases. The rationality of price increases in terms of maximizing profits declines. When competition increases, prices become more flexible downward as firms lose their control over pricing. As prices become less rigid downward and firms have less power to raise prices, the inflationary bias weakens. As firms lose their power to protect price by reducing output, and output cuts are moderated by falling prices, the recessionary bias is lessened.

This means that episodes of inflation and recession become less frequent and when they do occur, they are less severe in terms of duration and depth. This moderation of the business cycle also logically means that past patterns of significant and prolonged periods of accelerating inflation like the 1970s are much less likely to occur. The fears of inflation re-igniting in 1998-2000 were unjustified in the light of the New Paradigm. Increased competition in many formerly cartelistic markets did not bring about the demand pull inflation characteristic of years back when the economy was experiencing strong and sustained growth. A recent Ford Motors Economics Staff presentation at a DABE meeting showed that auto prices adjusted for content, have been drifting downward for many years, especially the last five years. This is a far cry from the sticker shock years of the past, when two price increases per year were common. Given the huge increase in market share of the transplants, and the corresponding increase in competitive pressures, the reason for the loss of price power by firms in that industry is apparent.

Since the FED engineered recession of 1980-82, we have experienced only two mild recessions. Bear in mind that FED policies in the 1970s were designed to allow adjustments for two massive oil price shocks, in the hope of avoiding devastating effects on employment. Unfortunately this led to an inflation rate in 1979 of nearly 15 percent and an annualized inflation of greater that 20 percent in the last two months of that year. The FED, under Paul Volcker, then made a one hundred and eighty-degree policy turn, and made eliminating inflation their number one policy goal. Twenty years ago, the economy was less competitive than it is now. Fighting inflation when prices were more rigid downward resulted in a deep and relatively long recession. Since then, more extensive deregulation, privatization, globalization, and commoditization have reduced a good amount of that downward price rigidity as competition has since become more extensive and significant in markets. The reduced severity of the two recessions since then can be seen in the BEA data. The most recent recession, in the first three-quarters of 2001, was swamped by the recovery in the fourth quarter of that year, and positive growth for the 2001 calendar year over all.

Figure 3
Federal Receipts as Percentage of Nominal GDP (1992 - 2002)



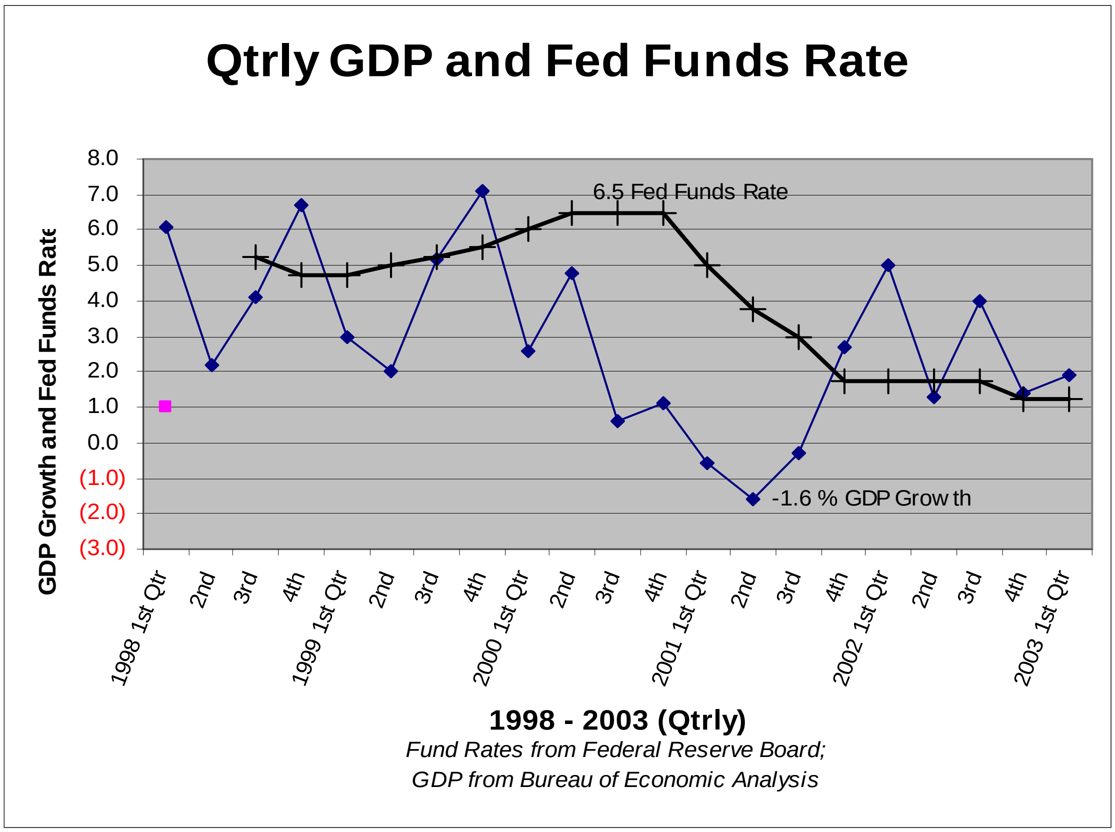
Data from Bureau of Economic Analysis, National Income and Product Accounts (U.S. Dept. of Commerce)

WRONGFUL ECONOMIC POLICIES AND THE RECESSION THAT SHOULD HAVE NEVER BEEN

This last recession, short and shallow though it was, should have never occurred. There are two smoking guns, so to speak, that caused it.

The first was the steady rise in the effective tax rate from 1993 through 2000 as can be seen in the chart (Figure 3). In an Internal Revenue Service report in 2002, the IRS shows that effective tax rates, Federal Income Taxes as a percent of both Adjusted Gross Income and Taxable Income had risen each year from 1977 through 2000. They go on to say that in the seven years prior to and including 2000, six of those years showed a similar rise in the effective tax rate. Old Paradigm or New Paradigm, taxes depress the economy by reducing Disposable Personal Income.

In 1998 and throughout 2000, the FED through its spokesman, Alan Greenspan, kept saying that the growth rate being experienced could not be sustained without a significant re-igniting of significant inflation. Furthermore, Greenspan cited irrational exuberance as causing an excessive growth rate in personal consumption. A major culprit he cited was the Wealth Effect. And in turn, a major cause of this the wealth effect was the suspicious growth rate in the stock market. This should have warned all stockholders, institutional or individuals that stock prices had to suffer. The inflation indices, especially the core rates did not really support such dire comments.



As the tax burden continued to rise, The FED (FOMC) began a policy of severe monetary constraint in 1999 continued it through 2000. Give this two pronged constraint of fiscal and monetary policy, the economy began a collapse in mid-2000 and then turned negative in the first quarter of 2001 and stayed negative through the third quarter. The Fed more or less said it was a pre-emptive action.

The lesson of the New Paradigm has apparently escaped the understanding of the fiscal and monetary authorities. The threat of inflation is much reduced as competition became more pervasive and significant in many markets. To make things worse, the power of monetary policy re revive an economy that it has caused it to fall into a recession, is indisputable. That power is somewhat lessened in an economy where prices have become much less rigid downward. The problem is that the FED's power to revive an economy is much weaker than it is to slow it down. Primarily through open market operations, it controls the capacity of depository institutions such as commercial banks to create money and credit. Restrictive policies cause the capacity to create money and credit to grow more slowly than the demand for money and credit by the public. This increasing scarcity of money and credit is what causes interest rates to rise. But the FED cannot conversely force demand for money and credit to rise in a weak economy even when they attempt to flood the system with excess reserves. Unless profitability in credit creation is there, monetary stimulus fails. The power of the FED's monetary policy is asymmetrical. This is why the long string of the FED actions aimed at lowering interest rates has done little to bring us back to a more robust economy. Heavy tax rates also reduce the demand for credit. Until more robust growth is achieved, the productivity dividend from restructuring is aborted.

To reflect this unfortunate reality, a new term has been coined, Duppies. It stands for Depressed Urban Professionals. Several former students of mine are among this involuntary cohort. In an article by Haggin Geary, a CNN/Money staff writer, appearing on June 17, 2003 examples of the hundreds of thousands of former high-income individuals, once earning upwards of $200,000, are now lucky to earn $20 per hour ($42,000). Many remain unemployed or have turned to entrepreneurial endeavors.

Current Statistics (8-04-2003)

Unemployment Rate

The recent report from the Bureau of Labor Statistics showed the unemployment rising to 6.2% of the labor force. Yet GDP growth has continued at a positive rate 2.4% (2nd qtr 2003 – annualized rate). What has occurred is a phenomenon called the ENCOURAGED WORKER EFFECT. In a traditional business cycle, after the recession has set in, some workers eventually stop looking for work and are removed from the unemployment statistics. This mutes to some extent the severity of a recession when looking at employment statistics. After the recovery begins those formerly discouraged workers begin to search for employment as they are encouraged by positive signs in the economy. Now they are back in the labor force and until they find a jobs are once again classified as unemployed. This ENCOURAGED WORKER EFFECT mutes, to some degree, the strength of the recovery as indicated by employment statistics. A second reason for the rising unemployment rate is the continuing restructuring of firms and new structurally unemployed workers as a result. As the economy becomes increasingly competitive, dismal profits cannot be improved by raising price; rather, it takes concerted efforts to lower costs. This is the lesson implied in the New Paradigm in economics. This has also resulted in deflationary pressures replacing a long standing inflationary bias in the American economy.

For more detail on unemployment double click on following link…to return to Current Statistics left click back browser

The Changing Meaning and Significance of Unemployment
(Hyperlink: Included in following sections)

Jobless Claims

In the recent report released by The Department of Labor, the number of new jobless claims fell from a forecasted 415,000 to 386,000 in the week of July 26, 2003 (This is the second straight week that the jobless claims have fallen below 400,000 – the numbers had been more than 400,000 for the twenty-two previous weeks). Given the large amount of structurally unemployed workers, this is heartening news. Unless the structurally unemployed workers are re-employed/redeployed, the productivity dividend for society as a whole is aborted. While it has the positive the affect of lowering unit costs to the firm restructuring, the potential increase in goods and services (sales) from such changes will not be realized until these workers are reemployed.

Leading Indicators

The most recent report indicated a one tenth of one percent increase in the leading indicators. While not exciting, it does indicate the recovery that began in the fourth quarter of 2001 is continuing at a reasonable and consistent pace. Again, a stronger recovery is needed to re-employ the large number of structurally unemployed dominating the ranks of the jobless.

New Housing Starts

The most recent data shows near record levels of new housing starts. They rose 3.7% since the last report. This amounts to an annualized rate of 1.6 million units. This sector has continued strong through the current expansion but through much of the last mild recession in 2001. This is one area where low interest rates have helped buoy household spending.

Durable Goods

The most recent report from the Commerce Department shows a 2.1 % increase in long-lasting durable goods and 3.9 % in durable goods orders in the Transportation sector. Tax cuts on such business spending appear to be having the expected effect. Relatively low levels of such business spending in the recent past (significant drops in fact) argue for this as another reason for the continued expansion of the economy.

Second Quarter, 2003 Real GDP
The second quarter of 2003 showed a continued positive growth in real GDP – The Commerce Dept reported a 2.4% growth rate for the 2nd Quarter 2003 (on an annualized basis). It marked the 7 consecutive quarter of economic expansion, allying fears of a double dip recession. At this rate, indicators argue for the 3rd Quarter of 2003 to confirm continued economic expansion. To reduce unemployment, most of which is structural, an even high rate of expansion will be needed. The third quarter figures will be released at the end of July.

Price Indices

There are two types of indices that attempt to measure inflation…

One type uses a fixed basket of goods (and services, in the case of the Consumer Price Index). A representative basket of goods and services is selected for the base year whose market value is pre-determined. That market price of the same basket is measured in successive periods and the difference is related to the base period. A percentage change is calculated. It is usually seasonally adjusted and annualized. This type of index ignores the substitution effect and is quality blind. The **Consumer Price Index, or CPI, and the Producer Price Index, or PPI,** are of this type. Some attempts have been made to adjust for quality changes, but such adjustments are widely criticized. In an effort to capture the substitution effect, chain link indices have been developed. There is still a residual error of overstatement of inflation. This problem arises because buyers will substitute goods whose prices have risen less than have the substitutes in the basket.

The other type of basket, the **GDP Implicit Price Deflator**, is one that changes with buyers changes in spending patterns. Theoretically, the price changes are determined by retroactively pricing the current more relevant basket which reflects changing buyer preferences. It is interesting to note that according to Implicit Price Deflator numbers, there was NO RECESSION in 2001!

Bureau of Economic Analysis
Table 8.1. Percent Change From Preceding Period in Selected Series
[Percent] Seasonally adjusted at annual rates
Today is: 7/24/03 Last Revised on June 26, 2003 Next Release Date July 31, 2003

	2000 I	2000 II	2000 III	2000 IV	2001 I	2001 II	2001 III	2001 IV	2002 I	2002 II	2002 III	2002 IV	2003 I
Gross domestic product:													
Current dollars	5.7	7.3	2.2	3.2	3	0.9	1.9	2.2	6.5	2.5	5.1	3.2	3.8
Chain-type quantity index	2.6	4.8	0.6	1.1	-0.6	-1.6	-0.3	2.7	5	1.3	4	1.4	1.4
Chain-type price index	3.1	2.3	1.6	2.1	3.7	2.5	2.2	-0.5	1.3	1.2	1	1.8	2.4
Implicit price deflator	3.1	2.3	1.6	2.1	3.7	2.5	2.2	-0.5	1.3	1.2	1	1.8	2.4

10-year U.S. Government Bond Rate

While falling to nearly 3% a short time ago, this interest rate risen rapidly to nearly 4.5% before falling back to 4.28% on August 4, 2003.

For further discussion on interest rates click on the following link… to return to Current Statistics left click back browser...

Interest Rates

Why the fall over much of the last year and its recent return to the levels of one year ago (although still low in terms of the last 30 years or so)? I approach the analysis of interest rates in a rather unique fashion. I isolate the pure interest rate, from the market rates you see. The market rates of interest you observe are impacted by changes in the price level (Fisher Effect) and differences in credit risk and tax treatment. As I mentioned earlier, I have included in the hard copy form of my presentation, 4 chapters on interest rates from my text, *Financial Economics*.

Pure Interest Rate

- If there were **no changes in the price** level and no expectations of any such changes.

- If there was **no credit risk**, that is perfect certainty.

- If the tax code was perfectly neutral.

- There would be one and only one interest rate on all obligations and that rate, the pure interest rate, would be between one and two percent.

What you see in the real world of financial markets are tens of thousands of interest rates reflecting varying price level change expectations, varying degrees of credit risk, the distorting affects of the tax code, etc.

My discussion will center primarily on the pure interest rate determined by supply and demand for credit and the expectations of changes in the price level. These are powerful tools in analyzing overall interest rate movements.

Let us use the 10-year U.S. Government bond rate. This has replaced its 30-year counterpart as the benchmark rate because of the Treasury Department's decision to retire the long-term end of the Federal Debt. I disagree with this decision and last year I explained to you my view that it will make interest risk management less efficient and hence more expensive to holders of long term debt such as insurance companies and pension funds. **As usual, they ignored me.**

The factors of supply and demand that determine the pure interest rate are such things as:

- The savings rate

- Increases in the quantity and velocity of M-1 or medium of exchange money.

- The amount of net foreign lending to the U. S. as measured by our current account balance.

- The deficit or surplus in the federal, state and local government budgets.

- The demand for capital goods.

Some of these are offsetting. Changes in these factors occur all the time and many of them are offsetting. You might get another 100 basis point increase in the 10-year government bond rate, though I would not bet on it.

You have already had about a 125 basis point rise in the last few months from its low near 3%. Absent any surge in inflation, I would not expect any further appreciable rise much beyond 5 percent in this rate. A good deal of new corporate debt issues has already occurred to take advantage of the low market rates. Much of the refinancing of the housing stock has already occurred. Given the difficulty of reducing the unemployment, which is primarily due to restructuring and hard to reduce, the Fed will probably prevent, if needed, any significant rise in interest rates.

Over the past several years, I have tried to explain that the landscape of the American economy had gradually undergone a major change since the Second World War. Increasing competition had gradually reached the point where firms, as certainly experienced in the auto industry had lost the control of price in a significant portion of this economy.

The high interest rates that began in the later 1960s and exploded in the 1970s were due to the accelerating inflation of that period. At an annualized rate, the CPI was near 20 percent in late 1979. 30 year fixed rate mortgages rate flirted with 20%. But with an inflation rate averaging near 15% for the year, the real or inflation adjusted 30 year mortgage rate was around 5%, where it is now.

Inflation is pretty much dead as a dodo bird. Price power only appears where government has allowed monopoly power to exist or re-occur. Professional sports, the oil industry, and tariffs on imported steel are a few of the examples. Price increases are non-existent in autos, computers, etc. As inflationary bias disappears, episodes of inflation become less frequent and declining in severity. In fact, the probability of deflation occurring is increasing.

The major cause of large swings in interest rates is due to price level changes and not supply and demand factors. This is unlike the pure interest rate fluctuations reflecting federal deficits and debt, or a flight back to equity, as has been seen in the stock market for the last several months. Another hundred basis point rise in the ten-year government bond rate from such factors is possible but not highly probable. But the likelihood of a significant inflation premium being tacked on to market rates of interest, as we saw throughout the 1970s, is close to zero.

You have to understand that the possibility of a return of significant inflation is near zero. Regulators are still concerned with the last disaster of the roaring inflation of the 1970s. That is typical of regulators. Back then, variable interest rates were the rare exception. Securitization had just started to become popular. If serious inflation should return (about as likely as hell freezing over), we have the tools to control damage from interest rate risk. Shocking balance sheets by a 300 basis point increases may be required by regulators, but in the long run, they are about as useful as the thousands of bunkers and berms Saddam had in place during the First Gulf War. You also have in place higher capital ratios to absorb the damage should interest rates rise appreciably, but that presupposes significant rises in interest rates which presupposes significant rises in inflation rates.

The Changing Meaning and Significance of Unemployment

The American economy seems to be showing signs of a split personality. On the one hand, in terms of real or price level adjusted GDP, the economy is now in it seventh quarter of recovery and expansion after the very mild and short-lived recession of the first three quarters of 2001. Of course the slowdown occurred in the middle of 2000 when we went from nearly 5% real growth to zero growth by the end of 2000.

Despite the current expansion we are in, the unemployment rate is not only not falling; it is rising and now above 6%. How can this be? We must distinguish between the categories of unemployment and patterns of unemployment over a business cycle. The categories of unemployment are *frictional*, *seasonal*, *structural*, and *cyclical*. The most widely accepted and modern definition of full employment is that when no cyclical unemployment exists. Even with an unemployment rate of 10%, in the presence of no cyclical unemployment, full employment still exists. So, if the sum of frictional, seasonal, and structural unemployment equals 10% of the labor force, then, that is the full employment, unemployment rate.

Even if structural unemployment rises by 2 percent of the labor force, so that the sum of frictional, seasonal, and structural unemployment rises to 12%; as long as there is no cyclical unemployment, full employment exists and the full employment rate of unemployment is 12%.

Frictional unemployment occurs when a worker quits in search of a job more in line with his or her talents. For example, you complete your MBA and your firm fails to recognize it with a raise in pay. You depart and begin looking for an employer more appreciative of you newly acquired credential. Research seems to show that job search under this condition is more efficient if you quit rather than continue working while you are looking.

Seasonal unemployment occurs when golf course employees or farm hands are laid off when winter weather sets in. The Canadian economy is saturated with this type of unemployment.

Structural unemployment occurs when a job is eliminated. As restructuring occurs in the American economy, this type of unemployment dominates the statistics. Many of the structurally unemployed are on the higher end of the compensation structure and had been earning six figures. They will not be called back; the job is gone. This is the major reason why in the current recovery and expansion, the unemployment rate is rising.

The last category of unemployment is **cyclical**. As the economy weakens, workers are laid off. When the recovery occurs, they are called back. For the last several years in the auto industry, an increasing amount of layoffs is structural and not cyclical.

There is a typical pattern of unemployment over a business cycle. As business cycles become shallower and shorter, some of these patters will become less discernable. The first sign of recession setting in is a fall in labor productivity. This occurs because, as production and sales fall, firms are reluctant to lay off workers until they are certain the slow down is going to continue; thus labor productivity falls. A note of caution: one must be careful in this regard. There are reasons other than recessions and recovery to explain falling and rising labor productivity.

As recession persists, firms begin to layoff workers. In a lengthy recession, some of the laid off workers become discouraged and no longer look for work. When laid off workers stop looking, they are said to have become discouraged and are no longer in the labor force and hence are no longer unemployed. The so-called **discouraged worker effect** mutes the severity of the recession by reducing the unemployment.

When the recovery starts, the first sign is a rise in labor productivity. Firms are reluctant to call back labor until they are sure the recovery is actually occurring and under way. Again, this could be misleading because there are other causes for an increase in labor productivity aside from economic recovery.

As the recovery continues, the discouraged workers become encouraged and begin to look for jobs. This is called the **encouraged worker effect**. It raises the unemployment and mutes the strength of the recovery. The last report on unemployment indicating a jump in the rate was due partly to an encouraged worker effect, but also due to a continued rise in (new) structural unemployment.

Letters/Commentary from our Readers

…From John in Los Altos, California

1. Productivity appears to be still on the increase. What will be the impact on the US and world economies?

Increased productivity is good thing in general, wouldn't you say? The question you ask is how shall this productivity increase be felt in the economy?

The answer is simply this, if productivity translates into lower overall prices then the consumer surplus will rise and result will be that consumers will be able to purchase more goods. In a competitive industry this is readily apparent as we are now experiencing considerable amounts of deflation in various sectors. The net result is that the consumer wins.

The following is an excerpt from Dr. Byrne's book, The New Paradigm in Economic - it illustrates and expands upon my answer above…
When markets are very competitive, the conditions of economic efficiency and economic equity are closely approximated. Competition has put downward pressure on prices and the ideal conditions of maximum consumer surplus and no economic rent to the productive resources are close to occurring. As consumer surplus rises and economic rent falls, the share of total output going to the consumer increases relative to the productive resources. Everyone is a consumer. With the surplus going to the consumer, the poor can benefit where they could not if it went to resources in the form of economic rent. Further, as the productivity raises total real output, most of the increase goes to the consumer in the form of consumer surplus, whether the consumer is poor or rich. It occurs through downward pressure on prices.

When markets are not competitive, much of the dividend goes to productive resources in the form of economic rent. In this case, the poor receive little of the productivity dividend of society. This is the broad view of the income distribution where the concentration is on who benefits from the production of goods and services. A narrower and more traditional view of the income distribution is to array the deciles by income medians or thresholds and to use cumulative figures as the share of each decile or quintile. This can be somewhat misleading.

As shown in the analysis above, when markets are not competitive, resource rewards in the form of profits, compensation to employees, and managerial or entrepreneurial income can include varying amounts of economic rent. This means that rewards to productive resources exceed the resources' opportunity cost. This is a result of power and the true value of the contribution of the resource to the production process. In effect, by the use of power to restrict supply and raise the price, the firm expropriates part of the consumer surplus that in term can be expropriated by labor and entrepreneurs from the surplus profits.

In this manner, the surplus expropriated from the consumers is usually shared by all the resources in the form of surplus compensation to employees, excess managerial compensation, as well as surplus profits.

In recent years, with the rise in the importance of human capital, the increased number of two working spouse households, and the increased average number of hours per week worked by each individual, concentration of income in the upper 20% of households is less and less a result of expropriated consumer surplus and more and more a result of greater opportunity costs, or employed resources. As increasingly competitive markets reduce the power of firms to reduce output, raise output, and increase revenue, economic surplus is decreasing. The income distribution by deciles or quintiles is more and more reflecting opportunity costs and less and less economic rent.

At the end of this chapter, Census Bureau data is shown indicating that as educational attainment increases, income increases for every age bracket. Also, unemployment rates fall as educational attainment increases. The greater rewards result from increased human capital, not merely expropriated consumer surplus.

2. The computer/web industry has been a major source of increase in value for the US market for the last 15 years. Has the ability of the computer industry to create value declined? If so, is there another industry or a facet of the computer industry that is likely to be a major driver for US economic recovery?

Actually, the computer/techy areas of the economy have been fighting a very difficult battle since the Fed put the clamps on the economy a few years back. Since that time, they have had to weather through a very difficult stretch, but it appears that the stronger components of the industry have managed to come through very well. Since the beginning of the year, the hi-tech sector has done extremely well, John. The truth is that the computer/web industry is at the heart of productivity gains and shall continue to be the point of the spear for years to come. In short, I only see good things for the computer/web industry in the foreseeable future.

3. What is the impact of increased US military involvement and the war on terror on the US economy?

This is a good point. Since the US has embarked on "military adventures," going back to at least WWI, we as a people have benefited from what many refer to as the "peace dividend." Some may scoff at this, citing that there has been very little peace over that period of time, but the fact remains that via projection of US military force, or at least the ability to do so, we have secured a relatively stable economic environment - on our shores and elsewhere.

More recently, the ongoing war on terror is just the last incarnation of US foreign policy, taking the form of military intervention. While some might criticize the methods, the objective of our policy has been and will be to continue to serve to secure our financial system. In the near-term, there will certainly be fluctuations, the result of war news and the like. We've been through this before and our financial markets have weathered the storms. By the way, I've been hearing rumblings about guns and butter - the cry associated with our making choices between the two. Critics cite the Bush Administration for trying to do this terror stuff on the cheap, for running deficits and passing legislation for tax-cuts. The American economy is complex and I would like to refrain from going into this - save it for discussion in the newsletter. We prosecuted a much more costly cold war (relatively speaking) while growing our economy, so I see no problem with us doing the same for the war on terror.

4. What is the impact of the increased shift to third party payers and the potential drug reimbursement programs on the economy?

In short, third party payers never worked. The result has always been decreased efficiency and more costly programs/drugs. The problem is that third party payers have very little control over the pricing mechanism - the further the consumer/payer is from the market, the less control they exercise over prices. We can cite various examples of failed policies from the British National Health Service (NHS) to the Canadian version. Their programs are grossly inefficient, very costly and always on the verge of bankruptcy. Increased taxes remedy the short-term problems but in the long run they only serve to further burden taxpayers and put a drag on their respective economies. This is not a political commentary merely a statement of fact.

5. The US and Europe have subsidized farming in their respective states. This is precluding a meaningful development of farming in the third world. Will the new round of GATT talks change the current subsidy pattern? If not, is there another way to develop economies in poorer countries, particularly Africa?

Subsidies, in whatever form, only serve to increase profits for the recipients and transfer costs to the consumer in the form of higher taxes and higher prices. Farming subsidies, educational subsidies, copyright laws (that are renewed), steel subsidies, etc., only serve to reward winners for no other reason than their ability to exercise political power. What is happening in the context of the ongoing GATT talks is that the various winners are sniping at one another and taking exception to their own respective policies. The beauty of it is that GATT often rescinds/nullifies the tariff/subsidies, thus mitigating their effects.

With regard to the African issue, much of the debate centers on genetically altered crops. This widens and furthers the debate between Europe and the US. Something of note is that I have seen plenty of imported foodstuffs in the form of fruits and vegetables from places I have never seen before. This will only continue and will certainly help the Third World as prices continue to decline.

The greater question of poverty and hunger are ones that will continue to be at the forefront of discussions in the coming years but it is interesting to note that increased competition, productivity and efficiency will lead the way toward solving those problems.

I apologize if this doesn't adequately answer your question, but rest-assured that it will be discussed in greater detail in the newsletter. Dr. Byrne and I will be serializing his publications in the newsletter (al a Charles Dickens) and this subject will be covered.

Biographies

Donald R. Byrne, Ph. D.
Ph. D., Economics, University of Notre Dame
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Publications

THE NEW PARADIGM IN ECONOMICS – 1995 Manuscript (Last revised 2003)

FINANCIAL ECONOMICS – 1990 Manuscript (Last revised 2003)

FINANCIAL MARKETS IN TRANSITION – 1995 Published by Federal Reserve Bank of Chicago (with Paul Ballew, Senior Research Economist, currently Chief Sales Forecaster General Motors Corporation)

Doctor Byrne has been in the classroom for nearly four decades. In that time he has impacted countless numbers of students and professionals. The educator's educator, Doctor Don Byrne has dedicated himself to teach whoever is in front of him. His greatest success lies in his analysis and his ability to convey the theory behind that analysis to his students in a complete, passionate and articulate manner. His objective has always been to train young (and not so young) minds to analyze data so that they can develop a level of competency in a very difficult discipline – Economics.

Doctor Byrne's primary goal in the classroom has always been to encourage students to think for themselves and to approach all things economic with an open mind and always with their analytical tools at the ready. His dogged determination and adherence to the analytical process has brought him to an unmatched level in the field of economic study. Doctor Byrne's New Paradigm in Economics embodies a life's work and is truly ground breaking in its elegance and clarity.

Edward T. Derbin, MA, MBA

MA, Economics, University of Detroit Mercy
MBA, University of Detroit Mercy

Awards/Honors

Beta Gamma Sigma, National Business Honor Society (Top 5% of class)
Alpha Sigma Nu, National Jesuit Honor Society (Top 5% of class)

When Doctor Byrne speaks of the New Paradigm in Economics, the best example is illustrated by what Ed Derbin has undergone over the past few years. A solid financial professional at DaimlerChrysler for more than nine years, Ed was laid off in a cost-cutting effort wherein more than twenty percent of the finance staff was let go. This was an organization that was the proud recipient of the Malcolm Baldridge Award just a few years before. The award was given for having a lean operation, or as Ed put it, they earned the prize by doing a job and a half per employee in the finance area. In an odd twist of fate, he has used this negative experience to his best advantage by more thoroughly immersing himself in the theory behind the phenomenon that caused him to lose his job in the auto industry. Not unlike his mentor, Doctor Byrne, Ed's passion lies in the classroom and in the analysis and theory of economics.

In short, Ed Derbin's role in this endeavor is to support, encourage and bring his significant expertise in terms of financial and management skills to bear in this ongoing project. His long-term objective is to gain mastery of The New Paradigm and Economics and to share the load as Associate Editor of this newsletter in bringing this increasingly relevant view of the American economy to the public.