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# Quarterly Review and Outlook

Third Quarter 2015

## Economic Realities

Future business activity will reflect two economic realities: 1) the over-indebted state of the U.S. economy and the world; and 2) the inability of the Federal Reserve to initiate policies to promote growth in this environment.

The first reality has been widely acknowledged, as developed and developing countries both have debt-to-GDP ratios sufficiently large to argue for a slowing growth outlook (Chart 1).

U.S. government debt now stands at 103% of GDP. If private debt is included, the ratio climbs to about 370% of GDP. Scholarly studies indicate that real per capita GDP growth should slow by about one-quarter to one-third from the long-run trend when the total debt-to-GDP ratio rises into the range between 250% and 275%. Since surpassing this level in the late 1990s, real per capita GDP has grown just 1% per annum, much less than the 1.9% pace from 1790 to 1999.

These results indicate that the relationship between debt and economic growth is non-linear, or progressively negative, as debt advances to higher levels, a pattern confirmed by academic research (Chart 2). The latest information further supports this relationship. The current expansion began in 2009, and since then real per capita GDP growth has been 1.3%, less than half the 2.7% average growth in all expansions from 1790 to 1999.

The Bank of International Settlements released a report last month stating that total public and private debt relative to GDP for the entire global economy stands at 265%, up from 219% at the peak of the prior credit cycle. Additionally, the global rate of growth is decelerating significantly while debt levels are continuing to rise, indicating an increasing debt drag. Researcher Chris Martenson calculated that

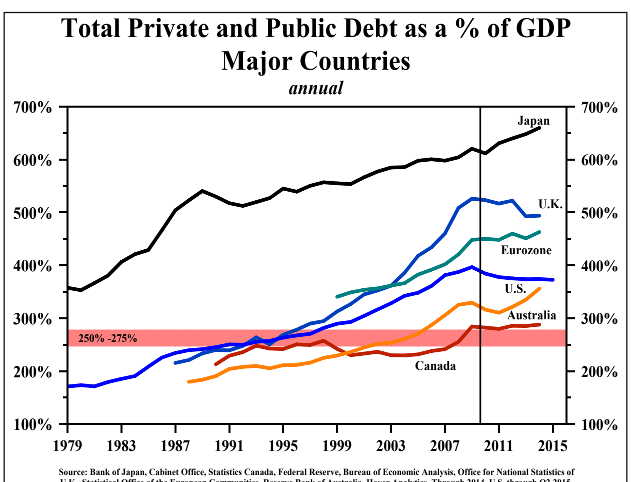


*Chart 1*

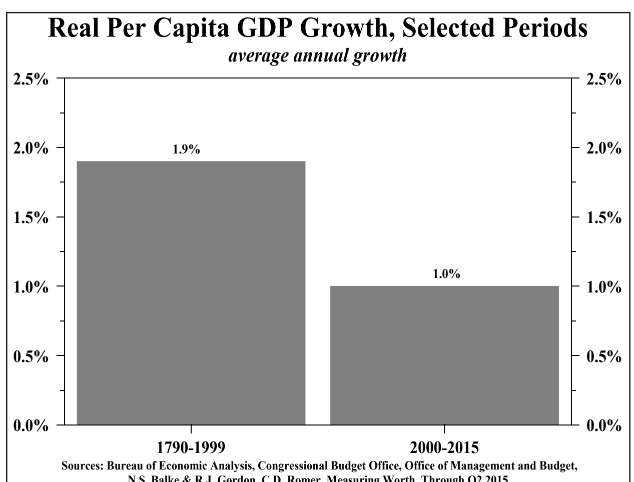


*Chart 2*

since 2008 total public and private debt rose by $60 trillion while GDP gained only $12 trillion.

The second economic reality is the failure of the Federal Reserve to produce economic progress despite years of wide-ranging efforts. The Fed's zero interest rate policy (ZIRP) and quantitative easing (QE) have been ineffectual, if not a net negative, for the economy's growth path.

Short-term interest rates in the U.S. have fallen to near zero, restraining the central bank's ability to lower them further. None of the more powerful channels of monetary policy, including money growth, have been responsive to Fed actions. When the debt overhang is excessive, the Fed and other central banks cannot control money and velocity, real long-term interest rates or the Wicksell Effect. Over the summer, the Wicksell effect has become more adversarial to economic growth in the U.S. as nominal GDP growth has slowed, while the market rate of interest, as measured by the BAA corporate bond yield, has risen. Treasury bond yields, in real terms, have remained stubbornly unchanged since 1990 even though the nominal bond yield has dropped 600 basis points.

Despite the unprecedented increase in the Federal Reserve's balance sheet, growth in M2 over the first nine months of this year fell below its average rate of growth over the past 115 years, a time when the growth in the monetary base was stable and quite modest (Chart 3). In addition, velocity of money, which is an equal partner to money in determining nominal GDP, has moved even further outside the Fed's control. The drop in velocity to a six decade low is consistent with a misallocation of capital and an increase in debt used for either unproductive or counterproductive purposes.

The evidence speaks for itself: the Fed cannot print money. The Fed does not have the authority or the mechanism to print money. They have not, they are not and they will not print

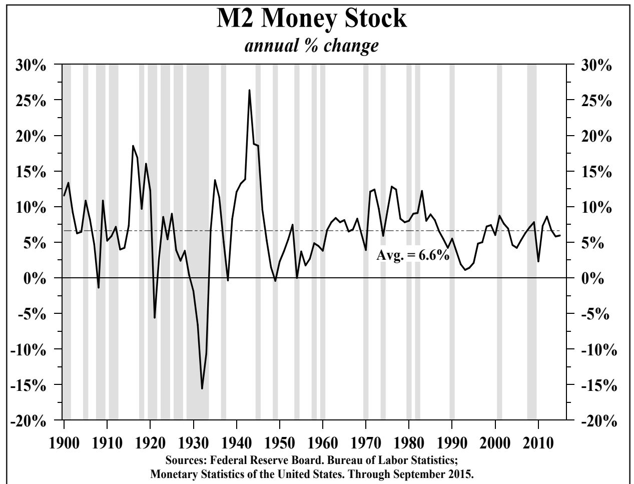


*Chart 3*

money under present laws.

The Fed, of course, has the authority to buy certain assets, including government bonds, in the open market, but that is where their authority starts and stops. They create excess reserves by buying securities in the open market, which are then owned by the depository institutions. However, the Fed does not have the direct capability to move these funds and therefore place them in the hands of households, businesses, and other nonbank sectors. It is this transaction that creates money. Keeping short-term interest rates low for an extended period of time will not change the trajectory of the economic growth path as long as the massive debt overhang persists.

Finally, policy actions have worked at cross-purposes. The current zero interest rate policy has rendered mass distortions in the allocation of capital and mispricing of risk assets. Such repressed interest rates have contributed to more excess capacity that, in turn, has reduced inflation. The ZIRP policy allows low quality borrowers access to debt markets, creating untenable balance sheet exposure when economic activity slows. In the meantime, such actions undoubtedly contributed to the slumping velocity, which means that even if the Fed could have printed money, any impact on the economy would still have been thwarted.

## New Proposals

The evidence is clear that ZIRP and QE have been ineffective and a net negative for economic growth. The Fed appears to have few new policy tools. However, new proposals now make it seem like the Fed could provide a quick solution should a slowdown or recession eventuate.

The problems facing the economy are structural, and cyclical factors are now beginning to interact with longer run forces to create an increasingly delicate economic outlook. If enacted, these new proposals, or "quick fixes", could over time create a set of unintended consequences that might easily produce serious damage to the economy, more than outweighing any short-term gains.

These "quick fixes" include: 1) an implementation of negative overnight and other short-term interest rates; 2) an additional round of QE; 3) a program proponents call monetization of government debt that is really just another round of QE; and 4) a plan to have the Fed print money by directly funding federal tax cuts or spending plans, commonly referred to as a "helicopter drop". The Fed has authority to implement the first two proposals. Option three has already been tried and has failed. Option four would require massive law changes.

## Negative Short-Term Rates

The Fed could achieve negative rates quickly. Currently the Fed is paying the depository institutions 25 basis points for the $2.5 trillion in excess reserves they are holding. The Fed could quit paying this interest and instead charge the banks a safekeeping fee of 25 basis points or some other amount. This would force yields on other short-term rates downward as the banks, businesses and households try to avoid paying for the privilege of holding short-term assets.

No guarantees exist that such an action would be efficacious. Heavily indebted economies are not very responsive to such small changes in short-term interest rates. Many negatives would outweigh any initially positive psychological response. Currency in circulation would rise sharply in this situation, which would depress money growth. The Fed may try to offset such currency drains, but this would only be achievable by further expanding the Fed's already massive balance sheet. If financial markets considered such a policy inflationary over the short-term, the more critically sensitive long-term yields could rise and therefore dampen economic growth.

An extended period of negative interest rates would lead to many adverse unintended consequences just as with QE and ZIRP. The initial and knockoff effects of negative interest rates would impair bank earnings. Income to households and small businesses that hold the vast majority of their assets with these institutions would also be reduced. As time passed a substantial disintermediation of funds from the depository institutions and the money market mutual funds into currency would arise. The insurance companies would also be severely challenged, although not as quickly. Liabilities of pension funds would soar, causing them to be vastly underfunded. The implications on corporate capital expenditures and employment can simply not be calculated. The negative interest might also boost speculation and reallocation of funds into risk assets, resulting in a further misallocation of capital during a time of greatly increased corporate balance sheet and income statement deterioration.

Hypothetically, due to the severe currency disintermediation during prolonged negative short-term interest rates, the U.S. government would probably need to call in all currency in circulation, which currently totals about $1.3 trillion. The banks would then hold these additional excess reserves and would have to pay a safekeeping fee. Many of the general public would view such a move as highly suspicious, if not confiscatory. In such an environment, legislation would have to be passed and the rules and regulations of a pure bank deposit system would need to be established. If such a regime could be enacted, which is highly debatable, the process might take many years.

**QE4**

In spite of all the problems and lack of empirical support for the efficacy of earlier QE programs, some still promote another round. The boost to risk markets from QE4 would be much more short-lived than in earlier QEs because today the initial conditions are far worse. In the earlier cases the economy was either just coming off or close to a deep 2008-09 recession. When inventories are depleted and pent-up demand is high, the economy is like a coiled spring ready to snap back. That is not the current situation. Today's unprecedentedly weak expansion has passed the six-year mark, which is old by historical standards.

Other differences exist. QE1 and QE2 did lower the dollar, and the resultant gains in U.S. manufacturing came at the expense of manufacturing elsewhere in the world. As this became apparent, the dollar started moving higher before QE1 and QE2 ended. It is unlikely that QE4 would result in any significant short-run decline in the dollar since the effect of QE3 on the dollar was almost nil due to the learning curve. Weak economic conditions in major trading partners suggest that another round of QE might evoke a much faster retaliation, particularly by the Chinese who have already taken small steps to stimulate their economy through currency depreciation. This might risk a round of currency moves like those that resulted in a "race to the bottom" from the mid-1920s until World War II.

To the extent that risk assets receive a short-term boost, this would further worsen the income and wealth divide, which has been a negative outcome of earlier QE programs. Without any improvement in economic activity, QE4 would aggravate the misallocation of capital caused by previous efforts, resulting in more excess capacity and additional downward pressure on inflation, which is already subdued.

**Called Monetization**

Due to recognition that three QE rounds in the United States and many more in Japan have produced neutral, if not negative results, some recommend expanding QE but with new wrinkles. One of these QE variants would combine even larger central bank bond purchases with "wise" Federal spending or lower taxes. The idea is that Congress and the President would pass bills to spend $1 trillion for infrastructure projects or tax cuts. The Federal Reserve would purchase the federal debt created to fund the $1 trillion dollar project through the open market.

This policy is typically referred to as monetizing federal expenditures. These proposals recognize that the Congress and the administration first have to enact the expenditure and tax changes, and then the President has to sign them into law. However, they assume that this can be done because of a promise from the Fed to purchase all of the new debt caused by the tax cut or the higher infrastructure spending.

This program, which is merely open-ended QE, has already been tried unsuccessfully. Without fanfare, during QE 3, the Federal Reserve expanded its balance sheet by $1.6 trillion by buying U.S. Treasury and federal agency securities while the U.S. budget deficit was a considerably lesser $1.2 trillion. Japan has often funded tax cuts and expenditure programs with purchases of debt from the Bank of Japan. Growth, however, has continued to stagnate.

Aside from being ineffective, huge political obstacles exist since Congress and the President would have to increase the gross federal debt by the amount of the proposed change in taxes or spending. This is not a small matter; it has proved extremely difficult to fund even ongoing activities for the current year. Then the Fed would have to agree to buy additional government securities in the face of evidence indicating no economic benefit.

History, economic studies and practicality of politics suggest this is just another red herring trying to solve over-indebtedness with more debt. This is not monetization of debt but just another QE program. January 2017 would be the first time this could happen, and it would depend on the 2016 election results. Of course, nothing guarantees that the fiscal policy process will be more viable then than now.

## Helicopter Drop

An extremely controversial line of reasoning is that a total rework of monetary policy will energize economic activity, cause inflation to surge, bond prices and the dollar to plummet and stocks and commodities to soar. The basic plan is to have the Federal Reserve write checks to pay directly for increased government spending, tax cuts and/or cancel the federal debt. Some of these proposals call for $1 trillion or more of either infrastructure spending or tax cuts. The objective here is to take fiscal actions without adding to excessively high debt levels.

Prominent economists such as Milton Friedman, Ben Bernanke and others have discussed such proposals. However, these ideas are theoretical and do not take into consideration three formidable problems. First, the Fed does not have this authority under present law. Second, federal debt still goes up and parties with rights would be harmed and have potential avenues of redress. Third, numerous unintended consequences would arise even if new legislation were enacted to resolve the first two issues.

**Legal Obstacles.** The original idea of the Reconstruction Finance Corporation (RFC), which was created by FDR in the Great Depression in 1932 and lasted until 1957, was for the Fed to fund various infrastructure projects by writing checks on itself just as it does when it buys government or agency securities. This was determined to be illegal since the Fed, with its open market powers, can only purchase certain “market-tested” securities. The Fed can buy government paper but only after it has been sold in the market place and a fair price is determined. After the funding scheme for the RFC was not permitted, the Treasury issued debt and the RFC was funded.

Every Federal Reserve Chairman from William McChesney Martin through Ben Bernanke, with the exception of G. William Miller who served only briefly, has been requested to directly fund some type of federal activity. Each of these requests has been refused. The most recent proposal occured in 2013 (the 'Platinum Coin') which was rejected by the Treasury and the Federal Reserve.

**Debt still rises, parties harmed.** In a scheme where the Fed directly writes checks, government debt still rises; however, assets of the Fed would not rise at the same time. Therefore, capital requirements of the Federal Reserve banks would be impaired in contradiction with the terms of the Federal Reserve Act. The legally required dual entry accounting system would be violated. This is not a technicality since the private depository institutions that contributed two-thirds of the capital of the Federal Reserve banks would be harmed. In all likelihood the banks would take various actions to protect their position, which includes a legally mandated 6% dividend on their contributed capital.

**Unintended Consequences.** Forming a comprehensive list of legal changes needed and anticipating unforeseen economic consequences is impossible. For example, this transaction would run afoul of the extremely broad and comprehensive Federal Debt Limit Statutes. Hiding federal debt on the books of the Federal Reserve would not change the fact that a Federal Reserve IOU is a U.S. government IOU. Another form of a helicopter drop is to have the U.S. Treasury issue its own currency, as in the U.S. Civil War, which the Fed would fund by balance sheet expansion. This proposal would encounter all the same legal difficulties. The Federal Debt Statutes would require that this U.S. currency be classified as debt, or essentially something equivalent to tax anticipation notes issued by state and local governments. The Fed could not buy this currency since it would not be market-tested.

Serious problems would emerge for the depository institutions. They would be left with the IOU on the Fed, a zero maturity asset they are only permitted by law to trade amongst themselves. How would the U.S. find a way to retain a central bank based on a fractional reserve requirement banking system? What mechanism would determine how the banks would be paid for these zero maturity assets?

Another unknown is how this system would work when inflation became a problem. If this new system were put into place and the drop effectuated, the central bank would not have the tools to contain future inflation. The money created under this proposal would be "wild" in the sense of being held by untold numbers of economic participants. How would they be retrievable by the Fed when its marketable assets do not equal its liabilities? The Fed would have an insufficiency of assets to sell in order to be able to reverse the helicopter drop. At the point that inflation became a problem, the Federal Reserve would have to transfer its debt back to the U.S. Treasury, and possibly even need to reverse complicated law and constitutional changes enacted, to carry out the helicopter drop.

The lessons of history strongly suggest that the helicopter drop will fail in the long run, as do all regimes that try to use inflation to promote real economic growth. Time and again in the countries that have tried such approaches, inflation has ultimately outpaced nominal GDP, resulting in a reversal in any initial gains in real GDP. The standard of living has contracted and, like in previous periods of rampant inflation, households of modest means fell further behind those with higher income.

All of these new proposals are reflective of the recognition that the U.S. economy has a slowing growth path. Global conditions are similar, so goods prices are in a decreasing trend and inflation is waning. These new proposals all have serious flaws and will do nothing to ameliorate the over-indebtedness of the nation or address the structural problems of future claims on our federal and state budget revenues. History suggests that such a condition engenders a long period of low inflation and thus low long-term interest rates. Therefore a position in long-term government bonds continues to be our investment stance.

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