

Is the FED Adjusting Dining Car Temperature in a Free-Falling Train?

I believe the Federal Reserve Bank (FED) enjoyed much more power in the past. Today, they are now trapped because a monetary tightening stance would harm the U.S. economy whereas a loosening stance would harm the dollar and risk a global rejection. The press reports that the FED is cruising along and "fine tuning" interest rate policy to ensure a "Goldilocks Economy" (not too hot and not too cold), and will avoid any "hard landing" from the U.S. housing and auto problems, the priced-to-perfection stock markets, the twin (trade and fiscal) deficits, the bond and dollar overvaluations, a weakening economy, and etc. Unfortunately, the ability today for major Commercial Banks, Credit Agencies, Brokerage firms, and Hedge funds to securitize and pawn debt to greater fools while pocketing lucrative fees has usurped the FED's traditional power. The FED is in a "hold their breath" **support** mode praying the big financial players who NOW HAVE THE POWER will not hang themselves from their past creative financial chicanery. We are now more leveraged in aggregate debt relative to output than ever ⁽¹⁾. To add insult to injury derivative product proliferation under the pretext of providing insurance (Credit Default Swaps) for these ever increasing debt risks is providing false security!

Since we are experiencing the greatest imbalances in the history of the Republic (Trade and budget deficits, asset overvaluations, etc.), here is my "train" analogy...

The U.S. economic train got "off the track" in 1995-2000 when any financial crises (Mexican Peso, Asian, LTC, Russian default, Y2K, etc.) was addressed with easy-money low-interest policies by the FED in concert with the major banking/brokerage/agency/hedge cartel. The train "went off the cliff" when in 2003 the FED and U.S. government orchestrated the most massive liquidity and fiscal ("tax cuts") stimuli in the history of the Republic. The train is now in a hapless "free fall" after having jettisoned the emergency chute via yet additional liquidity injections in support of the wars, aid to our natural disaster victims, etc. Since the credit expansion monster has now taken on a life of its own controlled by the major banking/brokerage/agency/hedge cartel, the FED's power is now equivalent to adjusting the air-conditioning temperature in the dining car on the way down to an inevitable hard landing...!

Why are the magnitudes of these imbalances are so obvious when viewed from an "enginomic" perspective? First, one must experience a paradigm metamorphosis to understand the "Real Economy". Following are 13 transformation steps to enable this mental transformation.

The Steps of the Paradigm change are:

1. Humans ultimately desire Real Wealth within an economic context, which is defined as Goods (Capital, Consumables, and Durables), Delivered Services, and Human Capital (Skill Sets), and Natural Resources. i.e. NOT fiat currency or "paper" assets.
2. Real Wealth can ONLY be produced by **Work** (and natural resources). Note: The inverse is not necessarily true (i.e. Work may not necessarily produce Real Wealth such as digging a hole and filling it back in).
3. Therefore, let's "Follow the Labor" rather than "Follow the Money"!
4. Real Wealth on earth is **finite and will not expand** unless work is performed. That includes the makeup of all businesses in the world. **All work activity can never be recovered.** As an aside; all work activity (and

natural resources) directed to a government purpose is precisely and quantitatively the Real Tax occurring every minute of every day. The noted work activity is a close correlation to Government Spending. Hence, **GOVERNMENT SPENDING IS THE REAL TAX....** In my view any government statement claiming otherwise is fraudulent. The debate then is: Who shoulders the burden of this "real" tax and when? Find out here:

<http://austrianenginomics.com/WhatisaTaxIncreaseB.pdf>

5. The critical measure to focus upon for tracking Real Wealth creation (Real GDP Output) is the Sale Price (willing seller and buyer). I DO NOT ADDRESS VALUE.... That is subjective and satisfies many economic purposes related to motivation and behavior, but is separate from the Real Wealth concept I am trying to convey (e.g. the white elephant party; aggregate value may increase after the party, but Real Wealth does not).
6. The rate of Real Wealth creation in aggregate can only increase as a result of productivity improvements (new products and process changes) assuming employment is neutral.
7. Productivity improvements worldwide in aggregate range within a "tortoise" speed of 1 to 2% historically (per capita).

Historic Data is limited and questionable for most underdeveloped countries. However the International Labor Organization (ILO) assembled "World" scope data for the 10-year period noted below. The extraordinary advances in China and India since 2003 would likely bring this "World" total up to a 1.2-1.3% range recognizing the blistering pace of Asian improvement already in the baseline within the decade noted.

Annual Labor Productivity Growth Rate; Source: International Labor Organization (ILO) ⁽²⁾

- | | <u>World</u> |
|-------------|--|
| • 1993-2003 | 1.0% |
| | Ranging from -0.2% in "Sub Saharan Africa" to an extraordinary 5.8% in "East Asia" |

Another view of productivity, which excludes China and India among others, but offers more historic data, is maintained by the Organization for Economic Cooperation and Development (OECD). The G-7 countries performed very well during the periods shown below. To estimate a logical "World" performance one can compare the G-7 country performance of 2.0% (2000-2005) to the 1.0% "World" performance ILO data (above) during the recent decade, thus concluding the "World" performance during the decades of the 1970's and 1980's might be generally less than 2.0%.

Growth of GDP per hour worked; Annual Average Growth Rate; Source: OECD (Organization for Economic Cooperation and Development) ⁽³⁾

- | | <u>G-7</u> | <u>OECD21</u> | <u>World (est)</u> |
|-------------|------------|---------------------|--------------------|
| • 1970-1980 | 2.9% | | 1.9% |
| • 1980-1990 | 2.2% | | 1.2% |
| • 1990-2000 | 2.1% | | 1.1% |
| • 2000-2005 | 2.0% | 1.8% (Ref'nce only) | 1.0% (ILO) |

8. If all countries in the world were utilizing a full commodity-backed monetary system (I.e. money that is Real Wealth), then the productivity, employment hours, scarcity (which harms productivity), and substitution (mitigates the scarcity harm) drivers would impact the Real Wealth growth percentage. Under this condition any extraordinary surge in a business(es) or country that would attract incremental investment (Real Wealth money) would at the same time correspondingly force withdrawal of that Real Wealth money from the rest of the world, thus having an aggregate neutralizing impact to market valuations (**assuming the Total Credit Markets remained at pace with aggregate output**). If aggregate Real Wealth grew the 1-2% tortoise speed (again, assuming neutral employment), the aggregate market valuations (and Credit markets) would rise at the same tortoise speed. e.g. 2% more output with the same labor level justifies 2% greater valuation of a company assuming competition keeps aggregate company valuations at historic approx. 14-15 times Real Earnings (which again is Real Wealth).
9. THE PROBLEM begins when fluffy fiat currency enters the scene and humans control its value. Power over currency enables liquidity (money and credit) to grow and shrink in an extraordinary fashion. When the chief money manipulators (Central Banks, Major Commercial Banks, Brokerage firms, Credit Agencies, and Hedge funds) collectively expand liquidity, the perceived (yes, market) valuations of financial assets and Real Estate equity turn into jack rabbit bubbles and DISCONNECT from the Real Wealth tortoise-paced fundamentals discussed above. The "Perfect Storm" scenario that has developed in the world during the past 12 years especially has enabled the extraordinary liquidity expansion to reach the U.S. bond markets and keep their valuations levitated because many foreign trading partners are sterilizing the bond assets they purchase along with U.S. dollar reserves they hold to satisfy their mercantilist motives. As a result, we have generated an unprecedented level of market overvaluations in equities, bonds, and Real Estate at the same time the FED is unbelievably declaring inflation is a paltry 2.x%...!! The influence of low cost imports from China, India, etc. has kept the carefully selective and manipulated inflation calculations low. The stoked liquidity has thus channeled into said financial assets and Real Estate equity.
10. More fiat currency or financial assets do not create Real Wealth. Any monetary expansion injected by government tends to only distort natural market drivers, thus creating malinvestment and harming real productivity improvement.
11. If one can sense the capacity of the world-wide economic engine is realistically capable of a growth range (per capita) of 1-2%, which would justify an aggregate asset valuation increase of the same percentage (plus the employment increase), then why could we not conclude extraordinary liquidity injections would create bubbles? i.e. puffed market valuations relative to the fundamental economic engine capability (current capacity and reasonable growth potential). For example, see my U.S. graphical bubble illustrations here: <http://www.austrianenginomics.com/id10.html>
12. I believe the answers can be found if we pursue "REAL WEALTH" analyses. What creates it, what drives it, what harms it, etc. For example, if we can offer a simple convincing argument that Federal Spending is the REAL TAX, it should at minimum force an enlightened electorate to the polls insisting on a balanced budget... Fraud upon others is viewed with complacency... Fraud upon you encourages an enraged response! With that amendment in place, then why not lay the groundwork for a return to a commodity-backed currency?

13. The relative stability of the Real Wealth growth in the world along with a tight true market-controlled leash on the credit world is more than enough to maintain healthy free market capitalism without fiat currencies. The addition of the fiat currency element, it's influence on the closely linked credit markets, and the absolutely insane derivative markets offering the perceived hedges (insurance) to cover grossly overvalued risks in an historically low risk premium environment today is a recipe for disaster....

Conclusion:

The U.S. economic "train" will experience a spectacular crash landing. There will be a series of sequential crashes, bounces, and busts over years until the imbalances have been diffused. Our global trading partners will suffer the same fate because of the interdependencies. Central Bank easy-money policies caused the imbalances and we will all suffer as a result when they correct. It will be physically impossible for any government organization to hide the illusions of wealth (stock, bond, and real estate overvaluations) when the Boomers begin to leave the workforce in mass all over the world (2008-2010) and attempt cashing in on the illusory assets. The markets will be merciless in their corrections.

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Home Page: www.austrianenginomics.com

References:

1. See: <http://austrianenginomics.com/OurAggregateDebtSealsTheFateofEconomicDepression.pdf>
2. International Labor Organization (ILO) "Global Trends in Employment, Productivity, and Poverty" from "World Employment Report 2004-2005".
3. Organization for Economic Cooperation and Development (OECD) Productivity Database, September 2006.