

Economic Review

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Musings & Amusings: Mark Twain

"It's better to keep your mouth shut and appear stupid than open it and remove all doubt."

"The more I learn about people, the more I like my dog."

The Economy: After re-reading *The Tragedy of Pudd'nhead Wilson* recently, I came to appreciate what a literary genius and wit Mark Twain was. He seems to have a quote for all circumstances, such as, "Cheer up, the worst is yet to come!"

Flocks of "Chicken Littles" have been warning recently that the sky is starting to fall. I doubt they will be right, but even if they are, it will be for the wrong reasons which will lead them to propose the wrong remedies and oppose the right ones. As Twain said, "A well put together unreality is pretty hard to beat."

You may have seen former Congressman Ron Paul's long infomercial where he rants about our soaring debt and exploding money supply. The big one is coming, a financial collapse worse than the 1930s. While there's nothing the government can do, you can prepare by buying a book from the infomercial's sponsors.

I don't question Dr. Paul's integrity, since he's been saying this for decades. Last year, I watched a very similar pitch by the same folks but minus Ron Paul. It was titled something like "The White House Scandal that Will Rock the World." Not surprisingly, the scandal turned out to be all that toxic debt and money supply. The solution: buy the book.

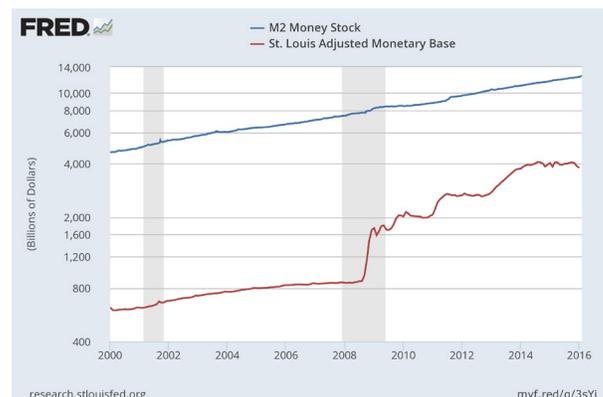
This past Christmas, someone gave me another book, *Aftershock: Protect Yourself from the Next Global Meltdown*. It's a lot like Ron Paul, but with more "economics" as well as plugs for newsletters and services for you to buy.

They claim to have predicted the financial collapse of 2008. Maybe so, but more recently, one of them forecast "50 percent unemployment, a 90 percent stock market drop, and 100 percent annual inflation starting in 2012." No comment.

Again, money supply and debt are the roots of all evil (Twain said, "It is the lack of money that is the root of all evil."). But blaming money growth for the coming gloom is a very serious misunderstanding of monetary economics. When the Fed started buying Treasury bonds and mortgage backed securities for the Quantitative Easing program in 2008, it did NOT pay for them by *printing money* – as is often claimed. Rather, it bought them by crediting *reserves* to the accounts of the banks that sold them.

Reserves only become money when lent out by banks and, thereby, transformed into checking accounts and other deposits. So, those charts purporting to show explosive "money" growth are really depicting *excess reserves*. Banks have not needed to tap them for loans – instead, they are happy to earn the interest the Fed started paying on excess reserves in 2008.

The reason why they – and all the other "inflationphobes" – have been so wrong for so long is because money has simply not exploded. My chart shows money supply (M2,) rising rather steadily, unlike the *monetary base*, which is mostly excess reserves. To quote Twain, "Facts are stubborn things but statistics are pliable."



I'll save the debt discussion for another time. Instead, let's go back to the economy. The Dow Jones stock average is less than 10 percent from last year's highs and bond yields have dropped as the threat of recession grows. I recently read, however, there have been seven episodes where the Dow fell 20 percent without being followed by recession.

The probability of a downturn has been rising: the mid-February *Wall Street Journal* survey now puts it at one-in-five. Nonetheless, they see GDP rising 2.5 percent this year and the Consumer Price Index (CPI) up less than two percent. Recession is still a long shot.

Today's conditions differ from the financial collapse of 2008. Economic weakness is concentrated in energy, with falling oil prices causing bankruptcies among drillers and suppliers. Concern has grown over the profitability of those banks that are heavy lenders into the energy business.

In contrast, by 2008, the subprime mortgage crisis affected much of the economy. Financial institutions that leveraged their balance sheets to load up on very risky securities were teetering on the edge of collapse. The home price plunge made most American families poorer – not just those who lost their homes. Today, lower oil prices have made most Americans better off.

If we had a recession, however, the world's central banks are running low on ammunition. With so little room to cut interest rates, some have turned to *negative interest rates*. They do this by charging banks a fee on idle reserves, encouraging them to lend. I jokingly blogged last year that depositors might have to start giving toasters to banks for accepting their money.

We really don't know how this will work on a large, sustained scale. People might keep a lot more cash on hand to avoid paying penalties. However, there's a good chance the consumers and businesses will also try to spend some rather than hide it under the mattress – which would help the economy.

If the economy falters, then stimulative fiscal policies would be in order. Sure, they would enlarge the federal deficit but so would doing nothing. Today's doomsayers are likely to lead the opposition to expansionary fiscal policy and unconventional monetary actions. Hopefully, we won't have to find out.

Connecticut... Apocalypse No? One of my favorite Mark Twain quotes is, "I've been told that Wagner's music is better than it sounds." This seems appropriate for Connecticut where Twain lived from 1874 to 1891.

Some decent news has gotten lost in the wake of General Electric's (GE) decision to move its headquarters to Boston, as well as growing recognition that the state is in a "permanent state of fiscal crisis." Last year, Connecticut added more than 20,000 jobs. This year, rising submarine production will add 800 well-paid employees.

Job gains have been modest. The state has recovered 90 percent of the jobs lost during the Great Recession, roughly similar to New Jersey (85 percent) and Rhode Island (80 percent). Massachusetts and New York have more than fully recovered, getting back 240 and 250 percent of their jobs respectively. Pennsylvania is at 115 percent.

As long as the nation continues to expand, jobs should rise 15,000 to 20,000 this year. The GE move really doesn't hit until the second half and the number of affected employees is in the hundreds.

Thereafter, the horizon really gets cloudy when the state deficit could hit \$1 billion next year and \$2 billion thereafter. I said recently that the budget process is broken and needs to be fixed immediately. A few suggestions:

Consolidate the legislature into one chamber, like Nebraska. Nationally, the Senate supposedly helps balance the interests of small vs. large states. For Connecticut, there's no need for a Senate when both houses are based on population. A unicameral system would free resources that could be used for a full-time legislature.

Enact legislation to enforce the spending cap that was authorized by a constitutional amendment a quarter century ago. The legislature has never gotten around to this.

Attach sunset provisions to legislation. This would introduce "zero based budgeting" to replace the present "current services" approach that assumes that everything will continue – unless voted otherwise.

Conduct economic impact analysis of major legislation. The independent Office of Fiscal Analysis does some of this now, but we need credible assessments of how tax bills, spending, and regulations will affect the state.

Establish a panel of experts drawn from outside the legislature and special interest groups to make specific recommendations on reforming the process. What I have in mind is a group drawn from experts in political science, business management, finance, and economics.

Let's hope that Mark Twain's most famous quote will be true for Connecticut: "The report of my demise is exaggerated." He uttered this after hearing that his obituary had erroneously appeared in a newspaper.