



L. R. Levin Consulting, L.L.C.

# Newsletter

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## Are We About To Have A Double Dip Recession And Run Away Inflation?

Recently the top 100 economist have been making contradictory statements almost daily about whether we are going into a double dip recession, or will see a continuing recovery. They seem equally confused as to whether we will experience high inflation or dangerous deflation. With this level of muddled economic discussion, it is difficult for business to plan what to do over the coming 6 to 18 months.

***Why all the confusion?*** Part of the confusion is caused by how economists define things like “recovery.” To a consensus economist, “recovery” is a statistical term meaning that the GDP is increasing.

There is even the further refinement of whether the GDP is in-

creasing in absolute dollars or inflation adjusted dollars. From a business standpoint, if sales aren’t increasing and opportunities to increase revenues and after tax profits are not there, it does not feel like a “recovery,” no matter what some economist says.

### ***So where is the economy now?***

As the last quarter of 2009 approached, we cut through the economic terminology, and explained in lay terms that the economic data suggested we would hit the bottom of the recession near the end of 2009 or the beginning of 2010. We also explained that it appeared that as the economy hit bottom it would plateau and begin a very slow shallow rise.

From a business planning point of view, this meant if your business was profitable at the bottom, you then had to plan how to thrive at that economic level with an economy moving in a narrow range. We went on to talk about an “H” shaped recovery and what it meant to you.

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That is, in fact, what has happened thus far. The economy has yet to experience any meaningful growth. Businesswise, there were a number of economic factors that contributed to stabilizing the economy.

As with any recession of the type we were having, there comes a point where inventory restocking starts to occur and pent up demand begins to gradually revive sales. That is a critical point in an economic turnaround.

If the proper economic conditions have been put in place, then the recovery will rapidly gain strength and sustained growth will begin. That is why we talk about returning liquidity to the private sector. If the proper economic conditions have *not* been put in place, then the recovery will stagnate and become unstable

In this “recovery,” U.S. business to business sales, not the consumer, lead the stabilization process. Whether the “recovery” remains sustainable under these circumstances is largely dependent on the economic conditions created by the government.

Today, if you ask the question will we have a double dip recession or a recovery like we have had in each

recession since the great depression, there is a simple answer ---- it depends!

*What does it depend on?* It depends on whether the government, including the Fed, create the type of conditions that promote private sector sustained activity and growth or that retard it. This would require returning liquidity to the private sector for job creation, facilitating a stable growing housing market and focusing on middle market small business needs to name a few key factors.

To accomplish this requires a focused coordinated government policy based approach. That is why the 100 top economists are so muddled and contradictory in what they are saying today.

The consensus economists cannot tell which way the government will move. Certain actions would stagnate the economy, while others would, in the long run, return us to meaningful growth.

Had the government taken the appropriate steps over the past 18 months, which economists would have traditionally expected, the conditions for sustained recovery would

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now be in place providing strong growth and job creation.

That has not happened to date. That failure has led to intense confusion over whether we will see a double dip recession and inflation or deflation. ***How should government approach its role in facilitating the right economic environment?*** There are really three ways the government can approach dealing with a recession.

Two are doctrinaire. You can have conservative ideologues who only think in pure strict *non*-government intervention economics. Or you can have liberal ideologues who only think in pure strict government intervention economics. In these approaches, ideology drives the policy.

Or you can have practical based approaches that believe government has a role in creating the kind of environment that let a free market based economy function. Ronald Reagan once said, "Government is not a solution to our problem, government is the problem."

Conservative ideologues think he meant that government should not intervene in the economy at all. Liberal ideologues think, Reagan was

wrong, and government should practice massive intervention and control outcomes, picking winners and losers. Others think Reagan meant it is the quantity and quality of when and how the government acts that matters. Reagan did not think that his predecessor had a balanced perspective in terms of government's role.

Past recessions have benefited from the third alternative approach. Policy driven by practical economists, guided by the laws of economics, who looked for flexible versatile approaches with government working carefully to *foster* conditions that facilitated the private, free market based economy in recovering.

Today, Economists cannot tell which of the three approaches will prevail as government policy. So they cannot tell what the outcome will be over the next 18 months. Moreover, economics is an ever changing art or science, as the case may be.

For example, in the 1920s businesses normally grew and expanded based on invested or retained earnings and capital. If the Fed raised interest rates to control inflation, it restricted business and consumer borrowing, and consequently slowed sales. Since

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companies didn't generally borrow to finance normal operations, higher interest rates did not unduly affect the cost of goods sold.

Based on supply and demand economics, raising interest rates under these normal conditions reduced buying and inflationary pressures. But by the 1970s, the concept of leverage was the prevailing norm. Businesses used borrowed funds for all aspects of their operations.

Inventories of raw materials and finished goods were financed, primarily, out of short term borrowed funds. When the Fed raised rates to 21% in the late 1970s to fight inflation caused by OPEC's dramatic increase in oil prices, they were applying economic concepts proven in the 1920s, not the 1970s.

The Fed's rise in interest rates in the 1970s had the exact opposite effect to what was intended. Raising interest rates had no meaningful effect on OPEC oil prices. The oil inflation still had to work its way through the economy.

Since inventories were financed with borrowed funds the rate hike increased the cost of goods sold at each level of the distribution chain. It add-

ed to raw material costs which were passed on to the next level. The manufacturer added its markup to the passed on interest costs and also added its own higher interest costs to the cost of the finished goods it sold.

The retailer did the same. This meant that the higher interest cost were passed on as a geometric increase to the consumer, since at each level, interest cost were added and the prior costs were increased by the next level's profit margin. Therefore, this approach accelerated the inflation, rather than reducing it.

It was not until the 1980s when interest rate came down dramatically, coupled with across the board tax cuts, that inflation was brought under control and the economy returned to a long period of sustained growth.

This illustrates that the laws of economic are constant, while the circumstances of how business functions in a free market economy change over time. Economists need to adjust their thinking and the application of principals as conditions change to avoid unintended consequences.

There is an old story about one of the world's top economists who returned to his graduate school to re-

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ceive an honorary degree. While there he visited his old economic professor, who showed him his current final exam.

The top economist gasped when he read it. He told his professor “don’t you know this is the same exam you gave when I was a student, and that fraternities and sororities keep copies of old exams to help their members study for the final?” The professors laughed and said, “don’t you understand in economics it’s not the exam questions we change, it’s the answers.”

To date, the government, faced with a great recession, has responded in what we would call an “ideological” manner. We have debates over whether tax cuts should apply to the wealthiest American’s who make over \$250,000 per year. We should be asking what type of tax cuts will return liquidity and restore the economy and create jobs, not how do we prevent some people from getting tax benefits. We need to be practical, not ideological.

Just as changes in how businesses finance their inventory changed how higher interest rates affect the economy, changes in how

businesses pay their taxes, directly or by having their owners report the income on owner’s personal return (“pass through business entities) paying the tax at personal rates, has changed how individual tax increases effect the economy. These changed circumstances need to be taken into account in formulating economic policy.

In 1960, when John F. Kennedy proposed across the board broad tax cuts, he said, “a rising tide lifts all boats.” We should be asking what type of tax cuts will restore the economy and create jobs, not trying to sink some of the boats.

In this recovery, ideology appears to be controlling the decision making process. The result is that the conditions that would facilitate a rebound are not in place, and we have plateaued.

***How will the economy behave over the next 6 to 12 months?*** Where we go from here does “depend” on what the government does next.

It is true that it takes time, often 6 to 8 months for government policy to impact the economy. The current economic data suggests that for the next six months we will see the econ-

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omy continue to move in the current narrow range with modest inflation of about 2.5%. An economist would say the recovery (growth in GDP) will continue, but at a slowing pass from what we have seen.

There are “game changers” on the horizon. In 2011 we are currently scheduled to have at least a trillion dollars in new federal taxes take effect. State and local governments are considering tax and fee increases of at least as much.

Healthcare costs under the recent legislation are going up substantially. The oil spill, new regulations of the financial industry and others will materially increase costs and reduce profits. Government departments whose budgets increased over 25% in the last 18 months look to further increase spending. The deficit is increasing rapidly. These are but a few of the domestic negatives 2011 anticipates.

Each of these will withdraw liquidity from the economy. They will make it hard for business to obtain funds or increase employment. It will hurt housing. Artificially low interest rates will reduce individual income, buying power, and tax revenues.

These examples should be adequate to demonstrate why what the government does about these during the next six (6) months, could have an enormous effect on the next five (5) years.

Our foreign policy has not come to grips with many long term economic issues, including China and currency issues. The effect of a nuclear Iran or war in the Middle East could have a big impact on our economy.

If the government continues its current policies, it is possible that we will have a double dip recession within 12 months. If the government pauses in its approach, we should continue in our current narrow range.

If however, the government changes policy and focuses on helping the broader private sector create jobs and stability, then we could rapidly begin to see a real rebound. Since no one can predict which course the government will take at this crossroads, you can expect to see continued confusion among consensus economist.

For now, you can plan your business based on the economy continuing on its current course for the next 6 to 8 months with modest inflation.

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