



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

Newsletter

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Can The Fed Boost The Economy?

There are increasing signs, acknowledged by many observers, that the Fed intends to try and boost the economy. Fed Chair Bernanke has expressed dissatisfaction with the rate at which the economy is improving.

In his speech at the annual Jackson Hole, Wyoming, conference, Fed Chair Bernanke said that the Fed would intervene, if the economy failed to improve fast enough. He explained that the Fed had four (4) options it could use to boost the economy.

Many economists now believe, the government failed to take the appropriate steps during the past 20 month to create the conditions that would allow a robust recovery. ***Can the Fed make a positive difference by acting now?***

The national debt over the past 20 months has grown to more than \$13,560,000,000,000 or 92% of the

GDP to date this year. Moreover this represents more than 94% of 2009 GDP. Unemployment is at over 9.6%. Substantial tax increases even before 2011 are further reducing buying power.

What are the four (4) options the Fed is thinking about and would they help or hurt? The most prominently mentioned option is a program of long term security purchases, such as buying government debt, to keep long term interest rates low and put liquidity into the economy.

Given where we are in this economic cycle, this does not appear to be a beneficial choice. Normally, the Fed considers purchasing long term debt when there is a lack of liquidity in the ***banking system*** preventing banks from meeting a need for financing based on qualified business and consumer demand.

The Fed's prior purchases of long term securities (still on its balance sheet), the slow U.S. recovery, the Euro Zone crisis, and the strength

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of the dollar have already brought the long term treasury rate to an abnormally low level. It has been there for too long, and this artificially low long term rate is beginning to hurt the recovery.

By keeping the long term security rates artificially low the Fed has made it very difficult for retirees to find any class of moderate risk securities that pay a good return. This reduces older American's purchasing power (economic liquidity) at a time when non voluntary purchases such as medical care and food are inflating.

U.S. demographics show that this is a growing portion of the population. Similarly, preventing the long term unemployed from having a safe, accessible asset class available to use for their savings, while they look for work, means that they are exhausting their savings that much more quickly.

At this stage in the current economic cycle, artificially low long term rates only helps the government finance growing debt, not the economy. Increasing federal debt merely takes more liquidity out of the economy. The current economic data does not indicate that there is a lack of available money in the banking sys-

tem to finance business growth. Rather business is suffering from inadequate demand for goods and services to make expansion reasonable.

Continuing lower long term rates won't put money in the hands of private sector consumers. Presently, businesses are investing to improve efficiency and lower costs not to meet substantially increased demand. We only have a 72% utilization rate for our manufacturing infrastructure.

Reality based economics teaches that at this stage in the cycle, artificially lower long term rates won't increase demand, it will reduce income and in turn reduce demand. By competing with the private sector for capital to finance deficits and increasing taxes, government is only making it that much harder for the private sector to expand. By buying long term debt the Fed will only push down the value of the dollar and contribute to inflationary pressure as the cycle progresses.

The *second* option that Fed Chair Bernanke has suggested is to lower the bank deposit interest rates that banks get for reserves they keep with the Fed. Of course, the bank deposit interest rates are already artifi-

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cially low. That alone suggests that making it even lower won't accomplish much.

The concept is that a lower deposit rate will encourage banks to make more loans. There is no question that any bank could today get a substantially better return on a private sector loan than on a Fed deposit. The problem is that under current federal loan risk profiles, there aren't private sector loan opportunities for using the deposit funds, otherwise they wouldn't be deposited with the Fed.

Even worse the current low rate is contributing to small regional bank failures. Lowering the rate would do no good and will do harm. What is needed is increased manufacturing and retail sales to create the conditions that will facilitate more profitable lending opportunities.

The *third* option that Fed Chair Bernanke has suggested is extending the Fed's promise to keep the short term rate at which banks borrow from the Fed low for a longer period than currently expected. Like the discussion of long term rates, short term rates already have been artificially low for too long.

In fact, the low short term Fed rate is, in turn, preventing consumers from having a safe place with a decent return to put their short term funds. This just reduces buying power. The problem is not that the banking system has no liquidity, as occurred in late 2008, but rather that consumers' lack purchasing power and, therefore, the economy is experiencing a lack of demand.

Without increased private sector sales to provide a return on investment, continuing the artificially low short term rates at which banks borrow from the Fed doesn't do much for the economy.

The last or *fourth* option that Fed Chair Bernanke has suggested is for the Fed to raise its inflation target above 2%. The current target is a range of 1.5 to 2%. Even Fed Chair Bernanke understood how poorly this would work. At Jackson Hole he appeared to rule this out. ***Could he be forced to rethink this one also?***

One concern is that the new Federal Reserve board members being appointed since the beginning of 2009, have substantially changed the policy approach to inflation. They may want to extricate the U.S. from

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its unsustainable deficits by monetizing the debt!

The Fed could monetize the debt by keeping interest rates low and printing money which it would use to purchase long term federal debt obligations. This sounds a lot like options 1-3 above: 1) the Fed prints money and uses it to buy long term government debt, 2) the Fed reduces what it pays on bank deposits forcing banks, absent permitted private sector loans, to buy government debt, and 3) the Fed keeps short term rates artificially low making it attractive for banks to borrow freshly printed money from the fed and buy slightly higher rate long term federal debt.

The result of flooding the economy with dollars, not backed by increases in GDP, as would be the case at this stage of the cycle, could be tremendous inflationary pressure – Option 4. The consequences of uncontrolled long term Stagflation are enormous.

In a recent interview, Chicago Fed member, Charles Evans suggested that by buying long term Federal debt the Fed could drive inflation above their current target. He saw this as a positive because it would

keep long term interest rates low, which, when adjusted for inflation, would even further depress the real return on government debt. (Real return is defined as the face interest rate less the rate of inflation.)

Fed member Evans' reasoning is that if large investors cannot make any real return in interest bearing investments, they will be forced to invest in expanding businesses. He further reasons, that if average individuals cannot make any real return in interest bearing investments at a time of increasing inflation, they will be forced to spend their money rather than save it.

As Evans summed it up, "It seems to me if we could somehow get lower real interest rates so that the amount of excess savings that is taking place relative to investment needs is lowered, that would be one channel for stimulating the economy." This entire approach ignores the fact that business isn't making an adequate return on investment now.

Without increased sales, investors aren't going to take the risk of expanding their businesses, especially if the government increases the tax on profits. Nor will forcing people to

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spend rather than save, build long term liquidity or buying power. Isn't that how got here in the first place?

Hopefully, Fed Chair Bernanke will take a pass on this one. No nation has ever inflated its way to prosperity.

The good news is that, if the Fed is cautious and does not over-react, the economy is beginning to recover on its own. Both business to business and consumer sales are slowly gaining.

With the rate of rise of new orders outpacing the rate of rise of inventories, manufacturing should see an increase in demand as we head toward Christmas. It appears the recovery will continue, although at a slower pace over the next three quarters. The recovery is the government's to lose!

In Case You Didn't Notice, The Recession Ended In June 2009

The Business Cycle Dating Committee of the National Bureau of Economic Research has now declared the Great Recession ended 15 months

ago in June 2009! As we explained in the *Managing for Success* article on "H" shaped recoveries, this is a "haves and have not recovery." ([Click Here To Read the article on An "H" Shaped Recovery and What It Means For You.](#))

What does the National Bureau finding show? The National Bureau has now confirmed that a modest statistical uptick from a dramatic low, does not mean your business outlook has recovered. We are a long way from putting people back to work and creating growing prosperity and opportunity.

A 21% drop in retail sales followed by a modest 2 or 3% increase doesn't change the fact that we have suffered a major dislocation. The "recovery" is just semantics. A more than 20% drop in peoples' net worth is not a plateau that results in a healthy economy.

Statistically our "recovery" is continuing, but at what price? The U.S. needs to return to a major manufacturing economy and restore employment. We need not only to restore employment, but do it with self sustaining, well paying private sector

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jobs. With respect to these goals we are still headed in the wrong direction.

What is the practical significance of the finding that the recession ended in June 2009? The most significant aspect of the finding is that the **recession's downward pressure ended before the stimulus had any impact!** The recession ending in June 2009, confirms what our strategic partner, the Institute For Trend Research said at the time.

What does this tell us about the government's policies and why we have an "H" shaped recovery? The underlying economy had recuperative elements at the time that the Lehman misstep and the political rhetoric caused a steady decline in economic activity to turn into a precipitous fall and severe recession. Left to the normal adjustments of a free market economy, we could absorb the dislocation and enter a new economic cycle, which we did in June 2009.

The finding also teaches that it was the government's policies that eliminated the normal recovery that should have followed hitting bottom in June 2009. In plain English, a policy of raising taxes, poorly focused spending, unproductive deficits, in-

creased complex regulations, misguided rescues, and the like, blunted the recovery.

What would have created the environment for a "V" shaped recovery? From January 2009 until now, our national debt has grown by more than \$2,500,000,000,000. Imagine if even half of that had been devoted to a two year across the board tax cut. That would have added \$1,250,000,000,000 of buying power to the economy in 2009 through 2010.

As history confirms (1921, 1960, 1980, 2001, etc.) that added buying power would have supported existing private sector productive infrastructure. That would have reduced layoffs, and supported a "V" shaped turn around. By now we would be experiencing increased tax revenues, and be able to start funding repayment of the increased government debt.

Imagine if, in addition to the across the board tax cuts, we controlled increases in the size of government and kept non-tax cut spending at 2008 levels. That would have cut more than a trillion dollars off the current deficit.

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By doing this and borrowing more than a trillion dollars less, capital would have been freed up to support a non-inflationary expansion where government does not compete with the private sector for investment capital.

The National Bureau's findings merely reinforce what the economic data indicates. We need to change our policies if we are to restore our economy. To do this would require more pain in the short run in order to provide long term prosperity. *Is our nation ready to do this?* If we do not return to a reality based economic policy soon, we may be headed toward the perfect storm.

Is The Real Employment Picture Still Deteriorating?

While the Labor Department essentially summarized the unemployment situation as "unchanged," September saw the situation further deteriorate. Real unemployment rose in September to 26.8 million Americans for an actual 17.38% unemployment rate.

Private sector employment rose by only 64,000 jobs, far less than the 150,000 to 200,000 jobs need just to offset the new young people entering the work force for the first time and unable to find jobs.

Of the 64,000 new private sector jobs, 44% were temporary service jobs, not permanent employment. Manufacturing jobs have been essentially flat since last May, and continue to show no improvement.

Manufacturing work week hours actually decreased by 0.1% in September. The slow growth of the economy has left manufacturing flat.

The number of employees in September forced to accept part time work because they could not find full time work, increased by more than 612,000 to 9.5 million people.

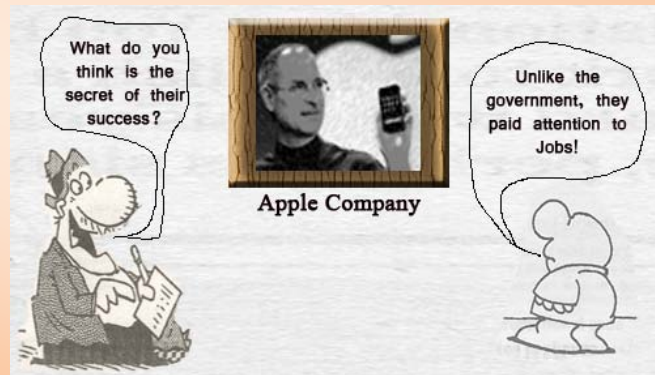
The continued jobless "H" shaped recovery is beginning to signal serious dislocations ahead absent a major course correction for government policy. If government stops interfering with the normal functioning of our economy and lets the entrepreneurs and business leaders get off the sidelines, 2011 and 2012 will look much better.

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THE WISE OLD OWL

The economic data suggests that the economy will continue to improve over the next 12 months, but at a very modest pace. At this pace, it could take as much as 6 more years for employment to return to 2007 levels. The current trend suggests inflation is beginning to build. This, plus the weaker dollar and the Fed continuing to dilute the dollar's value, suggest raw materials will cost more over the next 6 to 18 months, while slowly growing demand will continue to depress margins.



Rising oil prices will make it hard to control inflation over time. This combined with low interest rates could create further unintended consequences. The heavy concentration of employment growth in temporary service jobs is what we would expect to see right after a recession hits bottom when the cycle is about to have renewed growth, not 15 months after the recession ends. Thus, the data is telling us that because there are so many countervailing economic forces in play, the economy will be quite erratic and sector driven in the near term.

You need to plan for how this will affect your business as the next 12 months unfold. There are many crossroads that will be reached in the next 6 months. This is a time when focused branding, new revenue streams, and training, coupled with quick reaction time to changing circumstances will be critical to success over the next 12 months.

The consequences of not planning could be very unpleasant. Do you know if your marketing plan will increase your brand penetration and is backed up with all the resources to take advantage of the future? [Give us a call, we can help.](#)

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