MACROECONOMICS

Austrians vs. Keynesians

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Kenneth E. Long

Austrian Economics Press

Macroeconomics - Austrians vs. Keynesians

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Kenneth E. Long

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To my wife Kay and my son Peter who have both spent countless hours editing the manuscript, and to Steven Macon for his help and publishing expertise.

I dedicate this book to the millennial generation.

Freedom is not strong and enduring but weak and fragile.

ACKNOWLEDGMENTS

I would like to thank my wife, Kay, who has been supportive in my endeavor to write this book over the years. She has been my best critic, which I appreciate. To my son, Peter, with a degree in technical writing, who was a great asset with his editing skills. To my friend, Steven Macon, whose expertise and experience in editing and publishing has been most helpful.

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This book has its roots in a macroeconomics textbook I wrote for D. Van Nostrand published many years ago. The staff in the Word Processing Center retyped the whole book from the hard copy so that I could work with the soft version. So a great many kudos to Betty Gordon, Shirley Mann, and Letitia Fox who continue to spend hours helping me with the manuscript, and without whom I could have never completed this project.

Without my students, I would have had no reason to write this book. There are too many to mention by name, but the feedback, both positive and negative have been invaluable. I have copied several comments from the Rate My Professor web site below. Even the negative feedback has been beneficial.

In particular, I would like to thank Jaeo Han, who has been invaluable to me as an intern during the later stages of the book. Without his helpful comments, suggestions, and general input this book would be lacking. Also Tina Hosey and Jonathan Migan for their constructive inputs.

Preface

The Austrian School derives its name from its founders who were citizens of the Austrian Empire in the mid-1800s, including Carl Manger, Ludwig von Mises, and Friedrich Hayek. Austrian economists believe that the free market, not the federal government, can best allocate resources.

Keynesians get their name from John Maynard Keynes (1883-1946), who had a book published in 1936 called *The General Theory of Employment, Interest, and Money*. Keynes made the argument that if we can manage demand, we can manage the economy.

The principles of economics do not change and so Austrians and Keynesians speak the same language, but these two schools of thought differ on how to apply the principles to economic events. This book presents the principles of economics as a debate between two opposing economic philosophies.

I highlight and discuss forty books; many of them have been on bestseller lists. I have found these books to be educational, enlightening, entertaining, thought provoking, and challenging. However, most of them are preaching to the choir. How many sophomores in college will read lofty books on economic thought? My hope is that students will gain an interest in economics and the world around them. If some students become active participants in our political and economic system, the book will have accomplished its purpose.

Student engagement should be the ultimate goal for any textbook. If the younger generation does not engage themselves in the affairs of this country and the world, our democratic republic will suffer. One comment I receive repeatedly from students is that current events have come alive for them upon reading the book.

There are student-learning materials at http://www.austrianeconomicspress.us. For each chapter there are PowerPoint slides and PowerPoint tutorials, and a list of internet videos corresponding to each chapter.

The book also comes with a test bank of more than 2,400 true/false and multiple-choice questions. If you are a professor and you wish to preview the test bank, email Austrian Economics Press at auseconpress@gmail.com (please use your college email) and you will receive the test bank as a Respondus File. Respondus is a powerful tool for creating and managing exams that you can print to paper or published directly to Blackboard, ANGEL, Desire2Learn, Pearson eCollege, Canvas, Moodle, and other learning systems.

Friedrich Hayek

Friedrich Hayek (1899-1992) was an economist whose ideas greatly influenced the Austrian school of economics. He favored free market capitalism and opposed socialism. Having been born in Vienna Austria, Hayek witnessed the horrors of Adolph Hitler and his Master Plan. Hayek wrote two books, *The Road to Serfdom*, 1944, and *The Fatal Conceit* in 1988. In *Fatal Conceit* Hayek states, t*he curious task of economics is to demonstrate to men how little they really know about what they imagine they can design.* Hayek makes the case against central planning in *The Road to Serfdom*. He recognized that planners often have a noble purpose, but in order for the plan to work, the plan needs the full cooperation of everyone. Each government intervention in the workings of a free society leads to problems that give rise to more interventions as politicians try to deal with messes they have caused. Artificially low interest rates ultimately lead to malinvestments and economic decline. Ultimately, these interventions lead to centralized authority. At this point, the road to serfdom is complete. Hayek worried that thinking of economics as a science might fuel what he called *the pretense of knowledge* – the idea that anyone could know enough to engineer society successfully. He believed that a powerful government would serve powerful interests.

John Maynard Keynes

John Maynard Keynes (1883-1946) was a British economist whose ideas have fundamentally affected the theory and practice of macroeconomics. Keynes wrote his core beliefs in his book *The General Theory of Employment, Interest, and Money*, published in 1936. His ideas propelled Keynesian economics. Keynes argued that aggregate demand (total demand) determined the overall level of economic activity, and that inadequate aggregate demand could lead to prolonged periods of high unemployment. According to Keynesian economics, government intervention is necessary to moderate the booms and busts of the business cycle. In *The General Theory,* he states *the ideas of economists and political philosophers both when they are right and when they are wrong are more powerful than is commonly understood, indeed the world is ruled by little else. Practical men who believe themselves to be quite exempt from any intellectual influence are usually the slaves of some defunct economist.*

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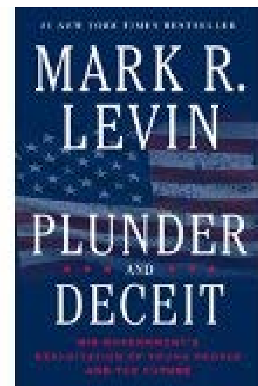
INTRODUCTION: MACROECONOMIC PRINCIPLES

Economic freedom is the freedom to choose without intervention from a government or economic authority. It is the freedom to choose how to produce, sell, and use your own resources, while respecting others' rights to do the same. The foundation of economic freedom is sound money, the rule of law, secure property rights, and open and free markets. The rule of law embodies the principle that all people and institutions are subject to and accountable to law that is fairly applied and enforced – the principle of government by law.

America was once the standard-bearer of economic freedom. Excessive borrowing, anti-growth policies by way of excessive regulations and taxes, human and capital flight, the refusal of politicians to address the failure of many entitlement programs, and a federal government where ideology often trumps rationality have diminished the freedom to choose.



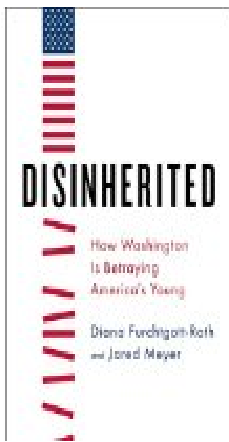
Plunder and Deceit: Big Government's Exploitation of Young People and the Future
by Mark R. Levin
Threshhold Editions, 2015
Image from Amazon.com

According to the World Bank's Doing Business survey, the United States is 33rd in the ease of obtaining construction permits, 49th in the ease of starting a business and 53rd in paying taxes. The U.S. is sliding closer to third world politics than many Americans would like to admit.

Plunder and Deceit, by Mark Levin, is a great read on the subject of how America's youth, the millennial generation, will have to pay for the actions of the older generation.

If you are a member of the millennial generation, born from the early 1980s to the early 2000s, you will bear the greatest burden of this decline in economic freedom, especially if you are in the middle class.

A major roadblock to your economic freedom is excessive debt. The typical college student will graduate from college deep in debt, which is a drag on economic freedom and limits the chances of independence. With student debt topping one trillion dollars, surpassing credit card debt, the millennial generation will face adulthood at a great disadvantage. Cheap loans and an increase in the cost of textbooks add to the cost of college degrees; states have cut funding for colleges and universities and tuition has increased.



Disinherited: How Washington is Betraying America's Young
by Diana Furchtgott-Roth and Jared Meyer
Encounter Books, 2015
Image from Amazon.com

If you are a member of the millennial generation, you should hold the older generation accountable for a record number of your members being unemployed, underemployed (working at a job below your education level and skills), in debt, and facing a lower standard of living than your parents. Thanks to the policies of your elders, you will be responsible for a huge lifetime per capita national debt and the responsibility for funding Social Security, Social Security Disability, Medicare and the Patient Protection and Affordable Care Act that tax the young to subsidize the old.

The complexity of rules, an increase in state and federal regulations, tax laws, a breakdown of the rule of law, and an expansion of licensing requirements are roadblocks to a job and a successful career. Unless you have a family member willing to finance a business, you may never enjoy the rewards of owning your own business.

Past administrations have mortgaged your future by amassing a huge national debt to pay for an increase in retirement benefits and social programs, programs that tend to inhibit economic growth. Therefore, society has dealt you a losing hand. Either you will have to pay higher taxes to fund these programs or you will experience a shrinkage of the economic pie, or a combination of both. Medicare and Social Security, programs that benefit the elderly, make up almost one-half of federal spending. Add to this the unfunded liabilities of state governments, promises made but not funded, and the economic burden that society has put on your shoulders may become unsustainable and unbearable.

As long as your generation fails to take an active role in politics, entitlement reforms will remain in limbo. The older generation is too dependent and accustomed to their generous benefits to change the situation. Because the older generation tends to be more politically active and more aware than millennials, they will continue to vote for generous benefits. Of course, an economic collapse would be a game changer for everyone.

ECONOMIC PRINCIPLES and KEY TERMS

Macroeconomics is the branch of economics that deals with the broad and general aspects of an economy. Macroeconomics examines economy-wide phenomena such as changes in unemployment, national income, the rate of growth, gross domestic product, and inflation. Microeconomics, on the other hand, studies the behavior of individuals, individual firms, or individual markets.

You will have to remember some facts in this course, but most of all, economics is a thought process, a way of thinking. To succeed in economics, you will have to master the vocabulary, learn the basic concepts, and think logically. The following definitions and principles will aid your understanding of the economic way of thinking.

Baltic Dry Index

The Baltic Dry Index (BDI) is an economic indicator issued daily by the London based Baltic Exchange. The index gauges the flow of raw materials by sea; it measures the cargo that ships carry on the high seas, such as coal, iron, and grain.

Gross Domestic Product (GDP)

Gross domestic product (GDP) is the monetary value of all the new and final goods and services produced within a country's borders in a given period, usually a year. GDP is the primary indicator used to measure the health of a nation in terms of growth. For example, if real GDP, GDP adjusted for inflation, increases by 3%, we know that we have grown 3% since last year.

Price, Cost, Revenue, and Profit

Economists define price as the rate at which buyers and sellers exchange money for goods and services, and they define cost as the money businesses pay for their inputs. Economists define revenue as the money gained by selling goods and services, and profit

as the difference between total revenue and total cost. The word "real" in front of a term means that economists have adjusted the value for inflation. If your nominal, or money income, increases by five percent, but inflation is three percent in the same period, your real income has risen by two percent.

Opportunity Cost

Scarcity forces you to make choices, and with every choice, you incur an opportunity cost. Opportunity cost is that which you give up in the best alternative when you make a decision. Opportunity cost can be money you give up in the next best choice or pleasure you forgo in the next best alternative.

When the government changes its policies or the Federal Reserve, our central bank, changes the availability of money, there are opportunity costs. For example, the Federal Reserve may favor low-interest rates to spur economic growth. Low-interest rates, according to their view, will stimulate demand for borrowed money and, therefore, encourage economic activity. However, consider the opportunity costs of such policies. One opportunity cost is the money foregone by savers who are now earning less interest and put more of their money in the stock market. Another opportunity cost is banks' lending less money to consumers. Because of the artificially low-interest rates, banks, like savers, have an incentive to put more money into risky investments instead of lending the money to consumers and small businesses.

Marginal Analysis

Each time you make a decision, you use marginal analysis. The term margin means the last unit or the last increment. Marginal benefit is the benefit from your last decision, and marginal cost is your cost of that last act or the cost of the last unit produced by a firm.

Imagine standing in front of a soft drink machine. Will you purchase a dollar soda? You will buy the first drink if you expect your marginal benefit to be greater than your marginal cost. In other words, if you value the soda more than you value a dollar, you will exchange a dollar for a drink. Will you purchase a second soda? The answer is the same, yes if you expect the value of the second soda to be more than the value you place on a dollar. How many sodas will you buy? You will continue purchasing additional sodas as long as your marginal benefit exceeds your marginal cost.

Leverage

How would you move a thousand-pound rock? You would use leverage by putting a smaller rock near it and placing a long iron pole on the little rock and under the big rock.

Investors use leverage to make it easier to make a profit. For example, investors can borrow money from their stockbroker to buy shares of stock. Economists call this, buying stock on the margin. You can buy $1,000 worth of stock by investing $500 of your money and borrowing the rest. Now when prices increase, you own twice as many shares.

Price Elasticity of Demand

Economists use price elasticity of demand to help them make decisions. The term revenue means the total amount of money entering a business. Price elasticity of demand is a measure used to show the responsiveness, or elasticity, of the effect of a change in price on the quantity demanded. Economists say that the demand is price elastic when an increase in price of a product leads to a decrease in total revenue. If an increase in price leads to an increase in total revenue, economists call the demand curve price inelastic.

Rent-seeking

Suppose you own a business and you have one million dollars to grow your business. If you spend the money on research and development, economists would say that you are investing. However, if you support lobbyists in Washington D.C. to influence legislation that favors your business, economists call this rent-seeking. Rent-seeking occurs when a company, organization or individual uses their resources to obtain an economic gain for themselves, but not necessarily for society. Rent-seeking occurs when business owners lobby Congress for loan subsidies, grants, or tariff protection without giving something beneficial back to society. Rent-seeking benefits politicians and special-interest groups to the detriment of taxpayers. The consequence of rent-seeking is a partnership between big business and politicians.

Moral Hazard

In economic theory, a moral hazard exists when someone has a tendency to invest in something or continue an activity without regard to potential losses. People tend to take more risks when they think that someone else will bear the penalty of a wrong choice. Moral hazard occurs when investors are willing to make risky investments because they believe that someone else will pick up the tab for any losses. Moral hazard leads to ever more risky investments and increases the potential for economic collapse. Some economists believe that the explosion of government regulations in recent years could backfire. Since the financial collapse of 2007-2008, the government has instituted, what it believes, are safeguards that will insulate the economy from another collapse. Moral hazard could be a factor if decision makers are too confident in these safeguards and pursue risky investments thinking that nothing can go wrong because of government oversight.

The Laffer Curve

The Laffer curve shows that when tax rates are low, the government can raise taxes, and tax revenues will increase. However, an increase in an already high tax rate will cause government revenues to decrease as people find ways to avoid paying taxes that they consider unfair and unreasonable.

Inversions

Stock investors expect companies to make decisions that will profit their bottom line and add value to their stock. Because America has the highest and most complicated corporate tax in the world, some American companies have been purchasing foreign companies. After moving their domicile to that foreign country, they pay less in taxes. Economists call this practice inversion. Inversion is a prime example of the Laffer curve.

Stock vs. Flow

A time-dimensional variable is a flow variable; a stock variable is not. For example, household income is considered a flow variable because families receive it in stages. On the other hand, economists measure wealth at a particular point in time, making it a stock variable. Sometimes the terms long run versus the short run, and static versus dynamic are used. In the short term, there is only one variable and everything else remains the same (sometimes referred to as ceteris paribus); over the long run, everything can change.

The concepts of stock and flow help economists evaluate the effect of a policy change. For example, a tax increase may raise revenue in the short run, but cause a decline in revenue over the long run. In the short run, taxpayers have no choice but to pay the higher taxes. In the long run, they can make adjustments to avoid higher taxes.

Economies and Diseconomies of Scale

When a firm experiences economies of scale, the long run average cost falls as output expands. A larger size often allows for larger, more specialized machines and greater specialization of labor. For example, a farmer who owns a small farm may not purchase an expensive tractor, but a farmer who owns a large farm can justify the cost of an efficient tractor. Typically, as the scale of a firm increases, capital substitutes for labor and sophisticated machines substitute for simpler ones. However, an increase in size beyond a certain point leads to diseconomies of scale, whereby costs begin to increase as the entity expands.

Equilibrium

Economists define equilibrium in several ways. One way to define the term is that an equilibrium is a point toward which the economy tends. For example, the economy may be experiencing an unemployment problem, but it could be tending toward a point of full employment, or, it could be tending toward a point of less than full employment.

Negative Interest Rates

Savers pay the bank interest to hold their money. In some cases, the bank pays borrowers interest on money borrowed.

Bail-out and Bail-in

Bail-outs occur when outside investors, such as the federal government, rescue a borrower, by injecting money into the corporation to prevent an economic collapse. A bail-in occurs when the government forces the company’s creditors to bear some of the company’s losses. For example, a bank confiscates money from depositor's accounts. If the corporation were to bear the weight of its losses, there would be no bail-out or bail-in. There have been some instances in Europe where depositors have lost their money, or at least some of their money in savings, when their banks took the money to pay its debts.

Disparate Impact

Disparate impact holds that government bureaucrats can declare a business practice to be unfair and illegal if the practice has a disproportionate adverse impact on members of a minority group.

Buying shares of stock long and short

When an investor goes long on an investment, it means that he or she has bought a stock believing its price will rise in the future. Conversely, when an investor goes short, he or she is anticipating a decrease in the share price.

Buying shares of stock on the margin

When you use a broker to buy shares of stock, you need an account. The account is either a cash account or a margin account. A cash account requires that you pay for your stock when you make the purchase. When you buy stock on the margin, the broker lends you a portion of the funds at the time of purchase and the stock (security) acts as collateral.

Margin call

You would receive a margin call from a broker if one of the securities you bought (with borrowed money) decreased in value past a certain point. Your broker would force you to either deposit more money in the account or sell off some of your shares.

Marking to Market Accounting

Marking to market accounting is the practice of revaluing an asset according to the price it would fetch if the owner would sell it on the open market, regardless of what the owner actually paid for it. Mark to market accounting can exacerbate an economic downturn because if the purchaser has bought the asset on the margin he or she could be subject to a margin call. A margin call occurs when the account holder must pay additional funds into the margin account in order to maintain the account; otherwise, the account holder must pay the seller money owed.

Derivative

A financial instrument, which derives its value from some underlying asset. When two people make a bet on some future event, they are participating in the derivatives market. The person who wins the bet collects from the losing party. The derivatives market is the largest market in the world at over $600 trillion.

Fiat Currency

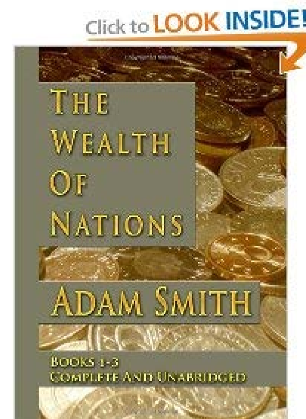
A currency that the government has declared legal tender, but is not backed up by a physical commodity.

Quantitative Easing

Quantitative easy, formerly known as monetizing the debt, is the practice of the Federal Reserve buying government bonds and other assets with newly created money. The Federal Reserve can create money by simply pushing a few keys on its computer.

CHAPTER 1:
THE ECONOMIC PROBLEM

Macroeconomics studies *the economic problem.* The economic problem tries to answer the question of *how society satisfies unlimited wants and needs in a world of scarce resources*. Economists define *good* as anything tangible that satisfies wants and needs. Service is anything intangible that satisfies wants and needs. A capital good is a good that business people use to produce goods. A good or service is scarce when there is not enough for everyone who wants it free.



The Wealth of Nations
by Adam Smith
Penguin Classics Pub., 1982, originally published in 1776
Image from Amazon.com

In a free market, when something is scarce, prices determine who gets and who does not get. Persons who get are those who want it the most and who have the money to pay for it. When there is plenty of a good or service for everyone free of charge, economists call it a *free* good or service.

Adam Smith, known as the father of economics, authored *An Inquiry into the Nature and Causes of the Wealth of Nations*, first published in 1776. He explained how *the invisible hand* of *self-interest* in free markets directs the flow of resources and how the profit motive, or the producer's self-interest, works to satisfy consumer wants.

> *It is not due to the benevolence of the butcher, the brewer, or the baker, that we expect our dinner, but from regard to their self-interest. We address ourselves, not to their humanity but to their self-love, and never talk to them of our necessities but their advantages.*[1]

THE PRICE MECHANISM

The price mechanism conveys information from the consumer to the producer, provides producer incentives, and rewards the producer with money to invest in new plants and equipment. Capital is plants and equipment used to satisfy consumer wants; financial capital is the money used to purchase capital.

Producers determine the initial price of their product, but the market will determine the market price. Producers make an educated guess as to what is the best price for a new product. What happens if they charge too low a price? In this case, consumers will bid up the price to determine who gets the product. Excessive inventory results if the business charges too high a price. Inventory are goods produced but not sold. All businesses need inventory, but when inventory becomes excessive, suppliers will cut back production and lay off workers. If excessive inventories continue, suppliers will consider lowering their prices.

POSITIVE and NORMATIVE ECONOMICS

A positive economic statement is an assertion about an economic reality that facts either support or reject. Positive statements explain cause and effect. Positive statements do not have to be true, but they do have to be testable and verifiable. A positive statement would be if said that unemployment results when the government mandates a minimum wage above the equilibrium wage.

A normative statement reflects someone's opinion. Economists have opinions and make value judgments. The federal government should end poverty is a normative statement. Disagreements among economists usually involve normative economics. The disagreements between Austrian and Keynesian economists are normative.

Economic professors tend to have strong beliefs, and they tend to emphasize data that supports their view; that is human nature. Students can perceive a teacher as biased

when he or she is only giving the facts from their perspective. For example, one economist may see an increase in the minimum wage as a benefit to low-income people while another sees it as causing unemployment, both can be right. Some economists believe in free markets while others support big government. Although economists have opposing viewpoints, they do agree on economic principles.

> ***Some economists believe in free markets while others support big government. Although economists have opposing viewpoints, they do agree on economic principles.***

PITFALLS TO AVOID

Whatever their points of view, economists avoid two common pitfalls. The first is what economists call the pitfall of confusing *correlation with causation*. Just because you observe two related events, it does not necessarily mean that the first event caused the second. For example, suppose you grew up on a farm, and a rooster's crowing awakened you every morning, followed shortly by the sunrise. As a child, you assumed that the crowing caused the sun to come up.

The *fallacy of composition* is a second pitfall, what is true for an individual is not necessarily true for everyone. Suppose you are at a football game where the quarterback throws a deep pass, and you stand up to get a better view. You will get a better view if you are the only person who stands up, but if everyone stands up, no one gets a better view.

FACTORS OF PRODUCTION

Land is anything from the earth that helps solve the economic problem, such as fresh water, soil, timber, minerals, oil, and metals. **Labor** occurs when people work to provide a good or service involving market transactions. Labor is cutting your neighbor's grass for money. Cutting your grass is not labor because there is no market transaction. **Capital** consists of buildings, equipment, and machines used to produce other goods. Economists consider a carpenter’s hammer capital because the carpenter uses it to build something that ends in a market transaction. You might have a hammer at home, but if you do not use it in a market transaction, it is not capital. Human capital is the knowledge and skills needed to work with capital.

Entrepreneurship

Entrepreneurship is the fourth factor of production. In a command system, the government would make business decisions, and decide who gets what and how much. In a free market system, the entrepreneur is the driving force. Not everyone wants to be an entrepreneur, not everyone wishes to be wealthy, and jobs can be gratifying and rewarding. Some entrepreneurs do not wish to be rich and do not seek personal freedom. Many entrepreneurs enjoy hard work and relish the challenges of running a business.

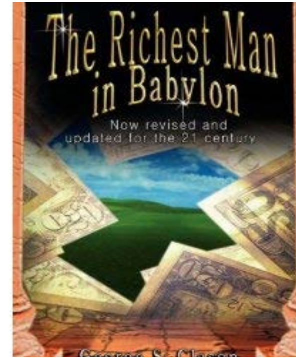
An entrepreneur is a person who organizes and manages an enterprise, especially a business, usually with considerable initiative and personal risk.

Some entrepreneurs, however, want the freedom to do what they want to do when they want to do it, and with whom. They also want to know if they are winning or losing the game. Why does a person who is worth one million dollars want to attain 2 million dollars, and once they get 2 million dollars, why do they want 4 million? Entrepreneurs look at money as a scorecard in a game. If you start the year with one million dollars and end the year with 2 million dollars, you are winning the game. If you end the year with less money, you are losing the game. Winning and losing is what makes the game interesting. Gratification is in the challenge of overcoming obstacles and the satisfaction of beating the odds.

As a student, you are demonstrating many entrepreneurial characteristics. One characteristic you share with an entrepreneur is that you know what you want in the future. You also have a plan and a belief that you can turn your vision into a reality. You have goals; you have learned the lesson of delayed gratification, and you are willing to take risks. John Maynard Keynes called the driving forces of entrepreneurs' *animal spirits*.

Entrepreneurs realize that the more money they have, the more choices they can make. Money is neither bad nor good; money just allows you to make decisions. As a business owner, you would have the potential of higher earnings, more free time, and more security than you would with a job. Why is this? Business as a business owner you can duplicate themselves through other people. Suppose you employ 100 people who work eight-hour days. The money they make in the first seven hours goes to their wages, taxes, rent, insurance, overhead, and health and retirement benefits. Whatever money these 100 workers generate beyond the seventh hour, in the eighth hour, is profit.

As the owner of this business, you have benefitted from working 100 hours in a single 24-hour day! Additionally, you did not have to be present to earn this income. As an entrepreneur, you do not trade hours for dollars, and you do not base your security on your ability to perform. By being able to do what you want to do, when you want to do it, and with whom you want to do it, you gain personal freedom.



The Richest Man in Babylon
by George S. Clason
BN Publishing, 2007
Image from Amazon.com

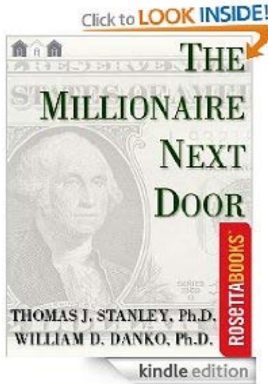
There is another difference between you as an employee and you as an entrepreneur. Your security as an employee is dependent on how important you are to your employer. If you do an excellent job and you would be difficult to replace, you have job security, everything else being equal. However, as an entrepreneur seeking personal freedom, you want a self-sustaining business; you do not wish to be relevant to the enterprise. You have freedom when you own a business that can function without you.

George S. Clason, who wrote *The Richest Man in Babylon*, published in 1926, explains the principle of paying yourself first as the first step to attaining financial freedom. The concept of paying yourself first means that you put a part of your earnings into savings. The optimal word here is *first*. When you receive $100 and save ten dollars off the top, you have paid yourself first. Once you have enough money in savings you can start making investments. Money working for you instead of you working for the money should be your goal as an entrepreneur.

The Richest Man in Babylon tells the story of how a poor scribe in Babylon learns the concept of wealth building. We will pick up the story on page 12 where a wealthy man, Algamish, comes to Arkad, the scribe. Algamish needs some clay tablets carved by the next day. Because this is an enormous task, Arkad makes a deal with Algamish.

> *Algamish, you are a very rich man. Tell me how I may also become rich, and all night I will carve upon the clay, and when the sun rises it shall be completed. . .*
>
> *Mark you well my words, for if you do not you will fail to grasp the truth that I will tell you, and you will think that your night's work has been in vain...*

I found the road to wealth when I decided that a part of all I earned was mine to keep. And so will you.[2]



The Millionaire Next Door
by Thomas Stanley & William Danko
Taylor Trade Publishing, 1996
Image from Amazon.com

Entrepreneurs have attitudes and habits in common. Thomas J. Stanley and William D. Danko researched wealthy people in America over a ten-year period and wrote about their findings in their book *The Millionaire Next Door.* Contrary to popular belief, most entrepreneurs were not born wealthy. So what else did they find?

About two-thirds of us are self-employed, we are compulsive savers and live below our means. We own dull businesses and about 80 percent of us are first-generation affluent. As a group, we are well educated, and most of us work about fifty hours a week.[3]

AUSTRIANS vs. KEYNESIANS

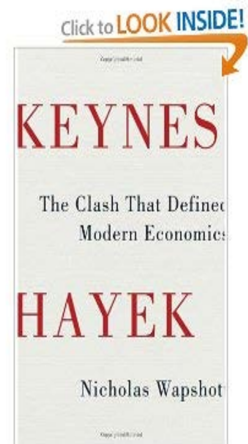
Economists define equilibrium as the point toward which the economy tends. Keynesians favor an active federal government and make use of data and mathematical models to move the economy to a full employment equilibrium if need be.

In economics, Knightian uncertainty is a risk that is immeasurable, not possible to calculate. Knightian uncertainty recognizes that there is a difference between uncertainty and risk; there are certain things that are too uncertain for economists to model. In statistical, econometric equilibrium models, there is no room for uncertainty. Because these Keynesian econometric models cannot consider Knightian uncertainty, Keynesians tend to disregard anything that is uncertain. Often, Keynesians do not know what to do in times of uncertainty.

Austrian economists believe that when society has a strong moral base, when there are reasonable laws and a law-abiding citizenry, markets free from excessive restrictions

and regulations will tend toward full employment equilibrium. The economy may experience unemployment at times, but if we leave it alone, the system will heal itself. Keynes believed that the economy could tend toward a less than full employment equilibrium and, therefore, may need government assistance to move the economy to full employment equilibrium. Keynesians place less reliance on the individual and believe that an active government is necessary for a well-functioning economy. This difference explains why Austrian economists favor a small unobtrusive government and Keynesians favor a large proactive government.

Austrians believe that sustainable growth depends on private savings, exports and private investments devoid of government planning. Hayek's greatest contribution to economics is to show that society is more complex than we realize and therefore government has its limitations when it comes to social engineering. In his book, *The Fatal Deceit*, 1988, Hayek postulated that it is folly to imagine that we can design a fully functional economic system.



Keynes - Hayek The Clash that Defines Modern Economics
by Nicholas Wapshot
W.W. Norton & Co., 2011
Image by Amazon.com

The free and open market ideas contrast with the Keynesian beliefs of demand management economics, greater support of the public sector and trade unions, wealth redistribution policies, and deficit spending. The government runs a deficit when it spends more than it collects in taxes in any given year. Because Keynesians tend to favor big government and planning to achieve preconceived goals, politicians tend to favor Keynesian economics.

FREE MARKETS VS CENTRALIZED PLANNING

Keynesians believe that government planning can rectify injustices, enhance equality, and minimize economic slumps. Keynesians see injustices in free markets, which is why they tend to favor redistribution policies. Austrian economists tend to put more limits on social welfare programs. They believe that slumps are inevitable and are as much a part of a healthy economy as prosperity. They believe that we hinder prosperity when we do not let this natural process run its course. Austrians believe that the government sabotages the economy when it subsidizes too much, taxes too much, and regulates too much. Austrians often site the Constitution to justify limited government.

The Constitution limits the power of government by dividing power among the three branches of government. Following are excerpts from the U.S. Constitution:

> ***Article I***
> *Section 1: All legislative Powers herein granted shall be vested in a Congress of the United States, which shall consist of a Senate and House of Representatives.*
> *Section 2: The House of Representatives shall be composed …*
> *Section 3: The Senate of the United States shall consist of …*
> *Section 4: The times, Places and Manner of holding elections*
> *Section 5: Each House shall be the judge …*
> *Section 6: The Senators and Representatives shall receive a Compensation for their services to be ascertained by law …*
> *Section 7: All bills for raising Revenue shall originate in the House of Representatives, but the Senate may propose …*
> *Section 8: The Congress shall have the power to …*

On 4 January 2011, the House of Representatives passed a rule requiring that members must cite the constitutional authority for every piece of legislation they write. They did this because they feared the ever-encroaching power of the federal government and the abandonment of free market principles.

The fourth unofficial branch of government is a free and knowledgeable media (press). One role of the press should be to investigate and report on government actions and abuse of power. Whenever investigative reporting wanes and the press fails to scrutinize and honestly report on government policies, we stand to lose our freedom.

In the eighteenth century, Alexander Tyler described the following stages of democracy:

> *1) From bondage to spiritual freedom,*
> *2) From spiritual faith to great courage*
> *3) From courage to liberty*
> *4) From liberty to abundance*
> *5) From abundance to complacency*
> *6) From complacency to apathy*
> *7) From Apathy to dependence*
> *8) From dependence to bondage*

Some economists believe that if John M. Keynes were alive today he would not be a Keynesian. Keynes advocated government intervention when the economy was in a less than full employment equilibrium, at other times he supported free market policies. However, once politicians realized that they could justify an ever-larger government through Keynesian type policies, the age of demand management economics flourished.

SUMMARY

The study of macroeconomics revolves around what economists call *the economic problem*. The economic problem is *how do we satisfying unlimited wants and needs in a world of scarce resources*.

Economists define a *good* as anything tangible that satisfies a want or a need. A *service* is anything intangible that satisfies a want or a need. A *capital good* is a good that business people use to produce goods. A good or service is scarce when there is there is not enough for everyone who wants it free. In a free market, when something is scarce, prices determine who gets and who does not get. Persons who get are those who want it the most and who have the money to pay for it. When there is plenty of a good or service free to everyone who wants it, economists call it a *free* good or service. The key to a free market is self-interest. Consumers receive what they want because of the producer's self-interest. Profit motivates producers to give consumers what they want, and competition ensures reasonable prices.

Land, labor, capital, and entrepreneurship are the four factors of production. Land is anything from the earth such as fresh water, soil, timber, minerals, oil, and metals that help solve the economic problem. Labor occurs when people work to provide a good or service involving market transactions. Cutting your neighbor's grass for money is an example of labor, but cutting your grass is not. Capital consists of buildings, equipment, and machines used to produce other goods. For example, economists consider a carpenter's hammer capital because the carpenter uses it as a tool to build something that ends in a market transaction. Human capital is the knowledge and skills needed to work with capital. Entrepreneurs envision a successful business, and they are willing to take risks. Entrepreneurs delay gratification to attain their goals.

Prices convey information from the consumer to the producer. Once the producer sets the price of a new product, the market will raise or lower the price in accordance to demand and supply. The price will increase if consumers bid against one another for a

popular product and the price will decrease if the product is not popular. This price volatility lets the producer know what consumers want. The higher prices also provide incentives to the producer to produce what consumers want and enables the producer to invest in new plants and equipment.

Keynesians believe that government planning can rectify injustices, enhance equality, and minimize economic slumps. Keynesians see injustices in free markets, which is why they tend to favor redistribution policies. The basic idea behind Keynesian economics is *if we can manage demand, we can manage the economy*.

Austrian economists tend to favor small government and limited social welfare programs. They believe that slumps are inevitable and are as much a part of economics as prosperity. They believe that we hinder prosperity when we do not let this natural process run its course. Austrians are skeptical of big government. They believe that the government sabotages the economy when it subsidizes too much, taxes too much, and regulates too much. Austrians often site the Constitution to justify limited government.

Economic professors tend to have strong beliefs, and they emphasize data that supports their belief system; that is human nature. Sometimes students can perceive a professor as biased when he is only giving the facts as he sees them. For example, one economist may see an increase in the minimum wage as a benefit to low-income people while another sees it as causing unemployment. Some economists believe in free markets while others support government intervention. Although economists do frequently have opposing viewpoints, they do agree on the principles of economics.

KEY CONCEPTS

- The economic problem is how do we satisfying unlimited wants and needs in a world of scarce resources.

- Economists define good as anything tangible that satisfies a want or a need.

- A service is anything intangible that satisfies a want or a need.

- A capital good is a good that business people use to produce goods.

- A good is scarce when there is not enough of it for everyone wants it free.

- The price mechanism in a free market convey information from the consumer to the producer, give incentives to the producer to satisfy consumer wants, and reward the producer with money to invest in plants and equipment.

- Just because you observe two related events, it does not necessarily mean that the first event caused the second one.

- What is true for an individual is not necessarily true for everyone.

- Land is anything from the earth that helps solve the economic problem.

- Labor occurs when people work to provide a good or service involving market transactions.

- Capital consists of buildings, equipment, and machines used to produce other goods.

- An entrepreneur is a person who organizes and manages an enterprise, especially a business, usually with considerable initiative and personal risk.

- Land, labor, capital, and entrepreneurship are the four factors of production.

- Austrian economists believe that the free market, not the federal government, can best allocate resources.

- Keynesians get their name from John Maynard Keynes (1883-1946), who had a book published in 1936 called *The General Theory of Employment, Interest, and Money*. Keynes made the argument that if we can manage demand, we can manage the economy.

- Economists define equilibrium as the point toward which the economy tends.

- The government runs a deficit when it spends more than it collects in taxes in any given year.

- The government runs a surplus when it spends less than it collects in a year.

- Keynesians believe that government planning can rectify injustices, enhance equality, and minimize economic slumps.

- Austrians often refer to the Constitution to justify limited government.
- Austrians believe that the economy will tend toward a full employment equilibrium, providing society has a strong moral base.
- Keynesians do not take for granted that society has a strong moral base, they believe that the economy could tend toward a less than full employment equilibrium.

FOOD FOR THOUGHT

✓ Adam Smith explained how a free market system produces the goods and services that consumers want and provide these things at reasonable prices. He explained how this is possible by what he called *the invisible hand*. What is the invisible hand of the free market and how did this help solve the economic problem?

✓ Consider a situation where people are poor and do not have enough food or even shoes to wear. In the same neighborhood, there are several food and shoe stores. Instead of this merchandise sitting in the stores, we could help people by giving these things to them. Explain why this would or would not be a good idea.

✓ When prices increase, consumer's buying power diminishes. This inflation is causing a great deal of harm to the majority of the population. If the government were to pass a law putting a price freeze on all consumer goods and services, we could raise the standard of living for people who subsist on a relatively fixed income. In light of the price mechanism in a free market, why or why not would this be a good idea?

✓ Assuming you desire to have personal freedom to do what you want to do, when you want to do it, and with whom, what is the only way you can achieve this?

✓ When you have a job and you are in a position where you are trading hours for dollars, what is your limitation in terms of building wealth?

✓ George S. Clason, who wrote *The Richest Man in Babylon*, published in 1926, explains the key to building wealth. Assuming you want to live a life of personal freedom, according to Clason, what is the first step to building wealth? Explain how you would incorporate this idea into your habits.

- ✓ Assuming you are in college because you want more money and more free time in the future. What two things are you giving up by attending college?

- ✓ In the old Soviet Union, the government controlled all prices. Therefore, it set the prices of many consumer goods very low. By so doing, the government prevented the price mechanism to function normally. Explain how the price mechanism still worked, it just looked different.

- ✓ If the federal government had enough authority, it could eliminate the business cycle whereby we could have stable prices and perpetual prosperity for almost everyone. Do you think this is possible? Why or why not.

- ✓ What is the biggest threat to our personal freedom?

- ✓ The U.S. Constitution helps preserve our freedom. Explain.

- ✓ What are the basic differences between Keynesian an Austrian economists? Do you consider yourself an Austrian or a Keynesian? Why and why not?

- ✓ What is Knightian uncertainty? Do you believe that econometric equilibrium models can correctly access reality?

- ✓ Do you believe that society has a strong moral base? Do you support the Austrian point of view of free markets devoid of government planning? Do you support the demand management beliefs of Keynesian economists?

CHAPTER 2:

CHOICES

AS a college student, what should you declare as a major subject? What occupation should you pursue? What are the advantages and disadvantages of a college degree? Should you vote? Moreover, if you do, should you vote Democrat, Republican or Libertarian? Should you apply for a job or should you aspire to be self-employed? Should you marry or stay single? Should the federal government mandate the use of ethanol in gasoline? Should the market or the Federal Reserve determine interest rates? Should we continue to use coal or seek alternative energy sources? What authority should the federal government have over states' rights? Ah, so many choices, it makes the head spin!

ABSOLUTE AND COMPARATIVE ADVANTAGE

Absolute advantage refers to the ability of a party (an individual, firm, or country) to produce a greater number of a good or service than others, using the same amount of resources.

You will make better decisions when you understand the principles of absolute and comparative advantage. Absolute advantage occurs when you can do something using fewer resources than other people do. Comparative advantage occurs when you can do something with lower opportunity costs than other people. You will maximize your welfare when you make decisions based on comparative advantage and not absolute advantage.

Let us suppose your bedroom needs painting. Should you paint the room yourself or hire someone? Now assume that you can make $50 an hour as a lawyer. Assume that you have a choice of working at your profession or spending the time painting the room. In this case, for every hour you spend painting the room, you are giving up $50. Fifty dollars is your opportunity cost of painting the room. Assume you could hire someone to paint the room for $20 an hour. Therefore, if you hire someone, you get the room painted, and you gain $30 an hour. Though you may have an absolute advantage in painting the room, you could do the job better than other people can, you do not have a comparative advantage because of your high opportunity costs.

The benefit or advantage of an economy to be able to produce a commodity at a lessor opportunity cost than other entities economists refer to as comparative advantage.

Now assume that you can make only $15 an hour at your job. In this case, you will lose $5 an hour if you hire someone to paint the room for $20 an hour. Therefore, you should paint the room yourself. You have a comparative advantage in painting the room because of your low opportunity cost; you are giving up only $15 an hour to paint the room. You will maximize your welfare when you make choices based on comparative advantage and not absolute advantage.

Suppose you charge $25.00 per hour as an automobile mechanic. You work eight hours a day, five days a week. Therefore, each hour you spend cleaning the shop, you incur an opportunity cost of $25.00. One day, Ed, a high school student, comes by looking for work. If you hire Ed for $10 an hour and spend the time repairing cars, you are better off by $15 an hour. You might have an absolute advantage in cleaning the garage because you will do a better job than Ed will, but Ed has the comparative advantage in cleaning the garage because of his low opportunity cost.

ECONOMIC DECISION MAKERS

Consumers, businesses, foreigners, and government make choices. The interaction among these groups determines how society grows and distributes its resources. The roles that each play depends on the economic system, but systems have common characteristics.

Consumption Sector

The consumption sector is the largest sector of GDP. It is also the most stable sector because consumers tend to make choices based on their perceived long-term income, not their present income. Consider a family whose income declines by $30,000 a year. Will the family's spending habits adapt to the lower income immediately? No, because human nature pulls us toward the familiar. In other words, the family will continue to dine out, attend athletic events, and buy a new car every three years. The family will maintain their lifestyle by dissaving. Dissaving is the act of taking money out of savings. Eventually, they will take money out of their real savings, such as selling shares of stock and the boat they rarely use. After this, they will borrow other people's savings. Eventually, only after a time lapse, will they adjust their spending downward to match their new lower income.

The consumption sector is the largest and most stable of the four sectors.

Investment Sector

Sole proprietorships, partnerships, and corporations make up the investment sector. A sole proprietorship has a single owner who has the right to all proceeds and who bears unlimited liability for the company's debts. Most business owners choose sole proprietorships because of its simplicity. A partnership is a contractual agreement between two or more people in a business. All participants in a partnership are one hundred percent liable for any debt.

Corporations are large companies that have the rights and duties of an individual. People may choose to form a corporation because of capitalization and the avoidance of personal liability. Corporations can raise financial capital by selling shares of stock and can utilize capital because of their large size. The corporation shields private property from any business losses because the law recognizes the business as a legal person.

The investment sector is the most volatile of the four sectors. Investors base much of their choices on their expectations of future events.

The investment sector is unstable because entrepreneurs make choices based on their expectations of future events, and so many unforeseen things can affect their expectations. Investors have to believe that their expected rate of return is going to be greater than the cost of the investment when they make an investment.

Foreign Sector

The foreign sector can be large or small depending on the country. If the balance of payments is positive, GDP increases, if there is a payments deficit, GDP decreases.

People will choose to export products when they have a comparative advantage. They will import goods when other countries have a comparative advantage.

The foreign sector can be an addition to or subtraction from GDP. If a country exports more than it imports, GDP will rise as more money enters the nation than leaves. If imports are greater than exports, GDP will shrink as more money leaves than enters. The foreign sector can be a stabilizing force if it moderates the highs and lows of the business cycle. Domestic demand can decrease, but if exports remain high, it acts as a buffer to a declining economy. The foreign sector can be destabilizing if a country depends on exports and exports decline.

Government Sector

The government sector is large in totalitarian countries and smaller in democratic republics.

The government sector is almost as big as the consumption sector. The government sector has grown because voters have chosen to support an ever-larger welfare state. By government, economists mean federal, state, and local.

The United States Constitution established a federalist form of government, which grants each level of government sovereignty in certain areas. When Benjamin Franklin exited the Constitutional Convention, a woman asked him w*hat have you given us.* His response was, a *republic, Ma'am, if you can keep it.* Notice that he did not say *we have given you a democracy*.

DEMOCRACY AND REPUBLIC

What is the difference between a democracy and a republic? In a pure democracy, the majority rules. The majority can vote and take everything away from the minority. A republic is a political system based on the law. In a democracy, the law protects the minority from the majority. Our form of government is a republic tempered by democracy.

A threat to any republic comes when society chooses to tip the scales too far in either direction. Too much republic leads to oligarchy, which is a political system ruled by a few. Too much democracy hinders the minority.

The Founders of America feared that a lack of safeguards would bring about a situation whereby the majority of citizens would choose to raid the nation's treasury. In the beginning, only white male property owners (about 10 to 16 percent of the population) could vote. Because all voters had *skin in the game*, there was less chance that the majority would choose to raid the treasury. During the early 1800s, states gradually dropped these property requirements, and eventually other groups gained the right to vote.

The United States is a democracy in a republic. The majority voters rule a democracy and a republic is a system based on the rule of law.

A blow to our republic was Senate Majority Leader Harry Reid's decision in 2012 to undo 200 years of precedent that required a supermajority to change Senate rules. Previously it took 60 votes out of 100 to change Senate rules, and now it takes only 51 votes to change some rules. If a simple majority can change laws at a whim, the Republic is on the road to lawlessness.

James Madison, known as the father of the Constitution, warned us against making poor choices:

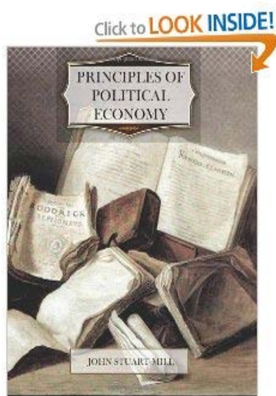
> *Democracies have ever been spectacles of turbulence and contention; democracies have ever been found incompatible with personal security and rights of property, and have in general been as short in their lives as they have been violent in their deaths.*[4]

Alexander Hamilton was a Founding Father, soldier, economist, political philosopher, one of America's first constitutional lawyers and the first United States Secretary of the Treasury. Samuel Adams was an American diplomat, political philosopher, one of the Founding Fathers of the United States and a signer of the Declaration of Independence.

> Alexander Hamilton: *We are a republican form of government. We will never achieve real liberty in despotism or extremes of democracy.*

> Samuel Adams: *Democracy never lasts long. It soon wastes, exhausts and murders itself.* [5]

WHAT KIND OF ECONOMIC SYSTEM?



Principles of Political Economy
by John Stuart Mill
D. Appleton & Co., 1885
Image by Amazon.com

All societies have to answer the three basic questions of what, how, and for whom to produce. In almost all situations, both the government and the free market influence the allocation of society's scarce resources. Capitalism is a system whereby private individuals own and operate the means of production and free markets determine supply and demand.

Prices play three roles in a free market. A change in the price of a good or service conveys information from the consumer to the producer. Everything else being equal, an increase in the price lets the producer know consumers want more, and a decrease in the price tells the producer consumers want less. Therefore, a change in the price allows the producer to make informed choices.

If consumers bid the price up, producers can make more money and, therefore, have an incentive to produce more. If consumers do not buy very much, prices will decline as will the producers' incentive to produce. Thirdly, the price mechanism gives the producer the financial ability to give consumers what consumers want as profits increase with a rise in the price level, everything else being equal.

John Stuart Mill, a philosopher and economist who lived in the 1800s, recognized that the market system was about the production of goods and services, not necessarily about distribution. In his famous book, *Principles of Political Economy,* published in 1848, Mill states:

> *The things once there, humankind individually or collectively, can do with them as they please. They can place them at the disposal of whomever they please, and on whatever terms. . . . Even what a person has produced by his individual toil, unaided by anyone, he cannot keep, unless by the permission of society. . . . The distribution of wealth, therefore, depends on the laws and customs of society.*

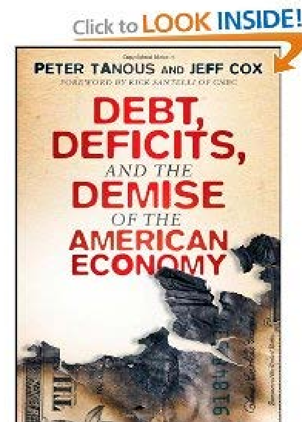
Consider the following quote by Robert Heilbroner, economist, and author:

> *Society could tax and subsidize, it could expropriate and redistribute. It could give all its wealth to a king, or run a gigantic charity ward; it could give due heed to incentives, or it could—at its own risk—ignore them. But whatever it did, there was no correct distribution—at least none that economics had any claim to fathom.*[6]

Yes, we can choose to redistribute goods and services, but at what point will this redistribution lead to inefficiencies? At what time does redistribution impede growth and impair productivity? If the government interferes with the price mechanism too much, price signals blur and the economy shrinks, as decision makers cannot get a clear picture of economic events.

Too much government encourages crony capitalism. Crony capitalism is a term describing an economy in which success in business depends on close relationships between large companies and government officials. We experience more *rent-seeking* and *moral hazard* with crony capitalism.

As you might recall from our discussion in the introduction, Rent-seeking occurs when a company, organization, or individual uses its resources to obtain an economic gain from others without reciprocating any benefits back to society. Rent-seeking occurs when a corporation lobbies government for loan subsidies, grants or tariff protection. These activities may not help society because the practice tends to transfer resources from taxpayers to special interest groups. When business people can make choices without fear of loss, rent-seeking leads to moral hazard.



Debt, Deficits, and the Demise of the American Economy
by Peter Tanous and Jeff Cox
Wiley Pub., 2011
Image from Amazon.com

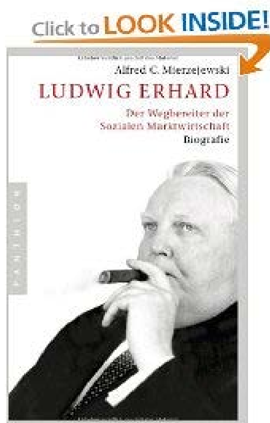
ECONOMIC GOALS

Economists identify eight primary goals: economic growth, full employment, stable prices, efficiency, fair and impartial sharing of goods and services, minimizing negative externalities, economic freedom, and economic security.

Growth

Choosing to grow is a goal. Societies can choose more growth or increase spending on social programs, but they cannot do both at the same time. Society neglects pro-growth policies to its peril. Not replacing plants and equipment causes us to have less with each passing day as goods deteriorate. That well-running car you are driving will eventually deteriorate, as will everything else. Failing to grow will lead to an ever more unequal distribution of wealth, a decline in society's standard of living and possibly civil unrest. Greece and Puerto Rico are good examples of the consequences of making certain choices.

Many of societies' choices depend on a country's per capita living standard. If we stand still but the birth rate declines, society is better off on a per capita basis. Likewise, if we replace what we currently have, but the population increases, then on a per capita basis we are worse off. The world is experiencing lower birth rates, but life expectancies are longer than in earlier years. The longer life expectancies are the main reason the world's population has increased from 3 billion 50 years ago to about 7 billion today. More children today are surviving and living to adulthood and old age; therefore, we have to grow just to stand still on a per capita basis.



Ludwig Erhard
by Alfred C. Mierzejewski
Bertelsmann Verlag Pub., 2006
Image from Amazon.com

The government can make decisions to help pro-growth policies by supporting business and by a tax system that encourages people to save, take risks, and invest. Germany offers a compelling example of pro-growth policies under Gerhard Schröder in recent times and Ludwig Erhard in the 1940s. By 1948, the German people had lived under price controls for twelve years and rationing for nine years. Adolf Hitler had imposed price controls in 1936 so that his administration could buy war materials at artificially low prices. Later, in 1939, the government imposed rationing on the nation. In 1945, the Allied Control Authority, formed by the governments of the United States, Britain, France, and the Soviet Union, agreed to support Hitler's price controls. The artificially low food prices discouraged farmers from bringing their food to market, leading to food shortages and famine.

Opposed to the Social Free Market School was the Social Democratic Party (SDP), which wanted a strong central government. The SDP argued that the currency reform and

decontrolled prices would be unproductive. Agreeing with the SDP were labor unions, the British authorities, most West German manufacturing interests, and American authorities. Ludwig Erhard won this debate in the 1940s and abolished most price controls. The abolishment of price controls allowed consumers to express their wants to sellers, and the higher prices encouraged producers to increase production. Along with currency reform and decontrolled prices, the government also cut taxes, paving the way to a booming economy. The government reestablished money as the preferred medium of exchange in free markets. Output continued to grow after 1948, and by 1958, industrial production was more than four times its previous annual rate. Economists sometimes regard this economic growth a miracle.

Ludwig Erhard understood the harmful effects of inflation on the economy. He illustrated that price controls and high tax rates led to poverty and that free market policies enhance productivity gains and prosperity. Similarly, Gerhard Schröder, who was German chancellor from 1998 to 2005, lowered taxes, revamped unemployment benefits, and streamlined labor laws. Economists have credited Mr. Schröder's shakedown of the welfare state with insulating Germany against the debt problems that would later befall Southern Europe.[7] Mrs. Merkel, the German chancellor in the mid-2000, kept the spirit of the Schröder reforms alive in Germany.

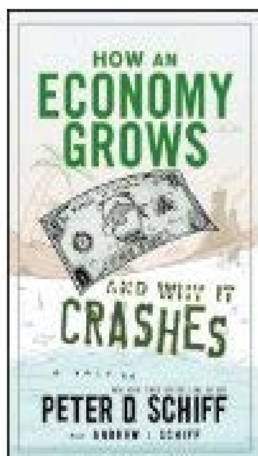
When the federal government is responsible for a large portion of total spending, this is a problem because when funding comes from the government political goals often supersede growth policies.

Beginning in the 1980s Europe chose to adopt high-tax, high spending, extensive regulation and competition restricting policies. Consequently, incentives to hire new workers, to invest in new plants and equipment, and to take risks diminished over time. Since the 1980s, there has been a drop in the number of hours worked, in investments, and the development of new technologies. Restrictions that protect incumbent producers, putting newcomers at a disadvantage, have compounded the problem. For example, France has made free shipping from Amazon illegal to protect French businesses. At the same time, there has been a movement away from private funding of new enterprises to public funding. When funding comes from the government, political goals often supersede free market growth policies.

Growth is the only way out of Europe's debt quagmire. The Keynesian consensus, which has dominated world economic councils, believes *growth* is largely a function of government spending (even if it necessitates a tax hike) and that spending cuts are tantamount to lower growth. This Keynesian emphasis on public expenditure is a top-down approach to problems, whereas Austrian economists tend to favor policies that grow the

economy from the bottom-up. Austrians believe that slumps are inevitable, and, therefore, the ebbs and flows of economic activity are normal.

Austrians tend to choose small government because investors need a predictable future in order to take risks. With a big government, politicians often make decisions for political reasons, making policies unpredictable and confusing. Austrians see a problem when the government often changes the rules because rule changes can leave investors at a disadvantage when the rules change.



How an Economy Grows and Why it Crashes
by Peter Schiff and Andrew J. Schiff
Wiley Pub., 2010
Image from Amazon.com

Austrians believe that targeted and temporary tax cuts and spending is foolhardy and can destabilize the economy. Congress has a poor record of accomplishment when it comes to the timing of government policy.

Despite these shortcomings, Keynesian policies are the norm today, but this philosophy has not always been in vogue. President Ronald Reagan supported Austrian economics in the 1980s and was a student of F.A. Hayek. He often quoted Hayek's book *The Road to Serfdom,* warning against planned economies. In the 1980s, governments worldwide made reforms that encouraged private investment, an end to price controls, and lower tax rates. Since the economic crisis of 2007-2008, the activist ideas of Keynesians have overshadowed the free market ideas of Austrians. At the same time, debt levels have climbed dramatically.

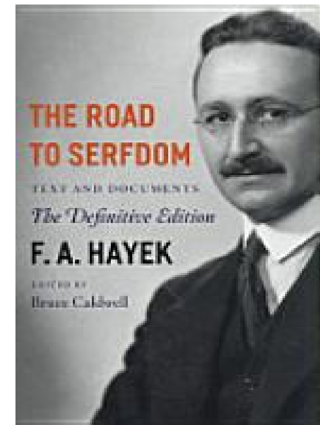
In *the Road to Serfdom*, Hayek compares a modern man to a serf in the middle ages. Life was tenuous during the middle ages, and the typical person was eager for some form of security. The feudal system attached the serf to the land and required him to work the land for a part of the year and to bear arms in exchange for protection. Thus, the serf gained a semblance of security by giving up his freedom to choose.

Friedrich Hayek: "People lose personal freedom when planners realize that their plan will only work if the government mandates that all people adhere to the plan."

Where could you live without worry or concern? Yes, you guessed it, in prison! Security comes at a price, and that price is a loss of personal freedom. You

cannot succeed in life unless you are free to fail; risk-taking, failure, disappointment, and loss are the ingredients for success. If you are not free to fail, then you are not free to succeed. The people who are willing to give up freedom for security end up living under tyranny. Tyranny is the condition where a cruel and oppressive government rules over people.

Hayek warned that centralized planning leads to tyranny, serfdom, and economic stagnation. He reasoned that tyranny is the result of government policies aimed at limiting market competition. As long as voters choose to put excessive demands on the government to protect them, governments can oblige them only by eliminating competition, entrepreneurship, innovation, and consumer sovereignty resulting in insufficient growth. Global prosperity requires real change—and that change is impossible without suffering. Instead of going with the flow and changing their policies as conditions change, planners tend to be fixated on achieving their specified goals on specified dates, regardless of changing conditions.

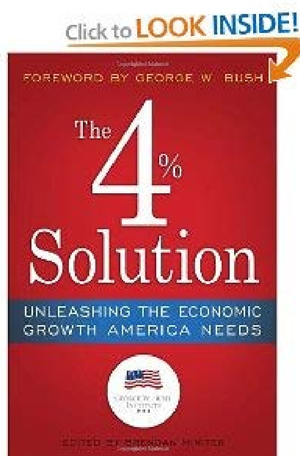


The Road to Serfdom
by F.A. Hayek
Routledge Pub., 2001
Image from Amazon.com

On January 28, 1986, even though engineers predicted failure, NASA managers authorized the launch of the *Challenger* spacecraft to meet the deadline; the shuttle exploded 73 seconds into its flight. In September 2013, experts indicated that 41 of the 91 Healthcare.gov functions were not working, and a week later another checklist showed more defects. Regardless of these warnings, the government launched the website. It failed almost immediately. According to Hayek, events like these are inevitable.

How do we solve our economic problems? Keynesians argue that our problems are more political than economic. If the crisis were economic, we could reduce corporate tax rates and red tape to encourage investment and risk-taking. Instead, in their eagerness to embrace the ideas of Keynesian economics, European and American policymakers have pursued every possible fix, except Austrian policies. Austrians believe that politicians will not fix the economy because the people who voted them into office support the status quo of entitlements.

Because Austrians believe that growth stems from savings and investing, they oppose the Federal Reserve's policy of keeping interest rates low. Austrians believe low-interest rates impede growth by limiting savings. Keynesians, on the other hand, support artificially low-interest rates in the belief that the low rates will encourage demand.



The 4% Solution
by the Bush Institute
Crown Business Pub., 2012
Image from Amazon.com

According to Austrian thinking, policies that encourage saving, delayed gratification, capital formation, risk taking, and rewards investors with reasonable profits, will lead to growth and prosperity. In the book, t*he 4% Solution,* the authors claim that a 4% growth rate can solve our economic problems. Following is a quote from the book's preface.

The 4% Solution offers clear and unflinching ideas on how to revive America's economy. It sets a positive economic goal and asks some of the top economic minds on how to achieve it. With a focus on removing government constraints.

The 4% Solution defines the policies that will allow Americans to save, invest, and create the jobs that the United States needs.[8]

We can raise wages, clean the environment, achieve full employment, pursue clean energy sources, and protect individual liberties, but only if we sufficiently grow. If we grow 5 percent, we can put 2 percent more resources toward social programs and still have a healthy 3% growth rate.

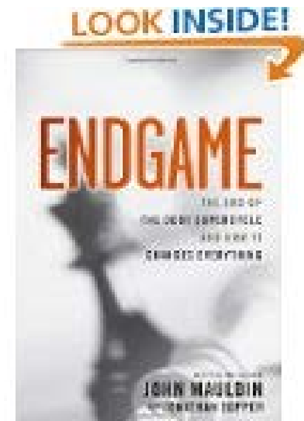
In the book *Endgame: The End of The Debt Supercycle And How It Changes Everything,* John Mauldin states:

There are only two ways that you can grow the economy. You can either increase your working-age population or increase productivity. There is no magic fairy dust to grow the economy. To increase GDP, you have to produce something.[9]

Mauldin suggests that nature can teach us something. Some California counties have full-time firefighters to fight small forest fires. Other counties have no full-time firefighters and let small fires burn. Counties with full-time firefighters have fewer small fires but more large fires. Counties that let small fires burn have fewer large fires. Mauldin concludes that when the government tries to fend off every downturn, downturns are less frequent, but once a recession occurs, it is severe.

Full Employment

Choosing to have full employment is a goal. The labor force is the number of Americans age 16 and over who are either working or unemployed. To be unemployed, you have to be available for work and actively seeking employment. The civilian non-institutional population is the number of Americans age 16 and over who are not currently on active duty, or who are not in the armed forces or incarcerated. The labor- force-participation-rate is the labor force divided by the civilian non-institutional population. We cannot have zero percent unemployment because someone is always seeking employment. The Bureau of Labor Statistics considers the economy fully employed when four to six percent of the labor force is seeking employment.



Endgame
by John Mauldin
Wiley Pub., 2011
Image from Amazon.com

The Full Employment Act of 1946 mandates the federal government to predict the employment rate for the next fiscal year. Congress must submit full employment policies if the projected rate is less than full employment. Austrian economists have objections to this bill for the following reasons:

- Business cycles are natural and therefore we should allow them to run their course, without allowing federal mandates to cause disruptions.

- Economists identify three-time lags, the recognition, decision, and action lag. The recognition lag is the lag time it takes to recognize we have a problem. The decision lag is the time it takes 535 members of Congress and the President to decide how to fix the problem. The action lag is the time it takes to implement policies. Because of time lags, the situation may have changed by the time government policy takes full effect. Consequently, government policies tend to be pro-cyclical rather than counter-cyclical, meaning they can accentuate the wide swings of the business cycle instead of smoothing them out.

- Forecasting future activity can be difficult, if not impossible.

With the Employment Act of 1946, politicians chose to stipulate economic goals, but it chose not to ask the Federal Reserve (the Fed) to manage the economy. A change came in 1978, with the passage of the Full Employment and Balanced Growth Act, also known as the Humphrey-Hawkins Full Employment Act. With this act, Congress put mandates on the Fed to ensure both price stability and full employment.

The mandate to manage the economy came with the Full Employment and Balanced Growth Act of 1978, also known as the Humphrey-Hawkins Full Employment Act.

Austrians object to this dual mandate because the cure for inflation is to reduce the money supply, and the cure for unemployment is to increase the money supply. However, the Fed cannot fight both problems simultaneously. Austrians call this a "feel good policy" because it sounds good, but it defies the rules of economics.

At times, the Fed has admitted that its policies were counterproductive, but the law forced it to do something. The Fed is effective at fighting inflation because when it decreases the money supply, people have no choice but to spend less. However, the Fed cannot force people to borrow money, which limits its usefulness when unemployment is the problem. Austrians would choose to end this dual mandate and liberate the central bank to focus on stabilizing prices.

Stable Prices

Choosing to have stable prices is a goal. Economists define inflation as an increase in the average price level. A small amount of inflation is not harmful, especially if people accurately predict it, and it occurs on a regular basis. Inflation can be severe if it exceeds five percent a year and is unpredictable. Because inflation diminishes consumers' buying power, it leads to unemployment. Erratic inflation distorts price signals, which have a negative impact on investments.

Efficiency

Choosing to be efficient is a goal. When outputs exceed inputs, productivity increases. When businesses increase productivity, in a free market, producers will elect to lower prices to gain market share. Sam Walton made Wal-Mart a success with low costs and low prices, squashing the competition in the process.

Authors of the U.S. Constitution chose to give Congress the power of the purse as a check against excessive Executive overreach. However, in 2010, The president chose to defy this provision when he decreed by executive order that the Federal Reserve would house and finance the Consumer Financial Protection Bureau. The CFPB is an independent entity that has authority over America's financial sector. Austrian economists would argue that this was a bad policy choice because Congress was not involved with its inception and has no authority over its funding. There is much debate concerning the CFPB's authority to police much of the American economy, from credit cards and mobile-phone payments to college accreditation.

The U.S. Constitution gave Congress the power of the purse as a check against excessive Executive overreach.

The crux of the debate centers on the CFPBs "single-director" structure. The president appoints the director to a five-year term giving the director a great deal of latitude to implement and enforce its self-proclaimed rules. Economists contrast this structure with other government agencies, like the Security and Exchange Commission (SEC), a committee whose members are from both political parties. The CFPB director can single-handedly overrule a judge and impose a penalty based on a new legal interpretation at any time. When politicians bring programs into existence by decree and not by rules of established law, we are well on our way down the road to serfdom. Multiple lawsuits have challenged the constitutionality of the CFPB.

The Consumer Financial Protection Bureau (CFPB) has chosen to use the concept of disparate impact to assess financial institutions. Disparate impact holds that government bureaucrats can declare a business practice to be unfair and illegal if the practice has a disproportionate *adverse impact* on members of a minority group.

Under the doctrine, the CFPB can access a fine on a firm if the firm's practices have a disproportionately adverse effect on members of a protected class of people. In other words, the CFPB can penalize a business even though no one brings a discrimination charge against the business. If the employee makeup does not adhere to the racial or ethnic mix that the CFBP mandates, the CFPB can declare the firm guilty of discrimination.

The Federal Reserve houses the Consumer Financial Protection Bureau and is responsible for its funding.

Austrians believe that disparate impact has a negative impact on economic efficiency because its actions are arbitrary. Businesses have no way of knowing that they are in

violation of the law before the fact. If a bank takes on a new client, the bank can be liable if the client engages in a verboten transaction. Thus, the application of disparate impact breeds uncertainty and therefore diminishes investments and growth.

Austrians would point out that when leaders in government make choices like this, the effects on freedom and economic growth are profound. If a bank makes a loan and the loan goes bad, regulators may charge the bank with fraud. If the loan makes a high return, regulators may find it was too profitable at the expense of a minority class of people. Banks are in the risk-taking business; without risks, there is no investment and no growth.

Fairness

Fairness is a goal. People still come to America because they believe that our economic system is fair and rewards hard work. However, the concept of fairness can be a relative thing. Is it fair that some people have more money than other people do? Should society choose to strive to have an even distribution of income?

If an economy grows sufficiently there will be more goods and services available for everyone, but a lack of growth means less for everyone.

Consider what has happened in Europe. For many years, Europe built such large and expensive social programs that almost everyone became a recipient of government largess. Europe neglected pro-growth policies in favor of income redistribution policies to the point that their economies shrank, and some countries, like Greece, went bankrupt. Excessive debt and slow growth led to downgrades in credit ratings, and as credit dried up, stronger countries, like Germany, had to bail out weaker countries.

Minimize Pollution

Choosing to minimize pollution is a goal. A major weakness of a free market system is that it cannot guarantee safe working conditions and a clean environment. Unsafe working conditions and pollution are examples of negative externalities, which are the unpleasant by-products of the industrial process.

A major weakness of a free market system is that it cannot guarantee safe working conditions and a clean environment.

Consider the case of two identical paper companies. Suppose company A has concerns about pollution and safety issues, which causes it to invest in safe machines and anti-pollution devices. Company B has none of these concerns. Consequently, Company A's costs rise, its ability to compete diminishes, and it eventually goes out of business.

The only solution to pollution is for the federal government to impose environmental regulations on all companies, which puts every company on a level playing field. The challenge is to promote a clean environment without sabotaging growth too much. All economists choose to have an active government to foster a clean environment, but they disagree on the specifics.

Although we cannot minimize pollution without government intervention, government overreach can be a problem when a single person is in charge of an agency. Debate has long existed over the effectiveness and fairness of the U.S. Environmental Protection Agency. Traditionally, the EPA has evaluated regulatory initiatives from scientific prospective first, economic perspective second, legal perspectives third and political considerations fourth. Today political initiatives come first, legal perspectives second, technical perspectives third and economic perspectives a distant fourth. Administrators can chose regulations in accordance to their political whims.[10]

Security

Security is a goal. Everyone depends on a healthy economy for his or her livelihood. Government cannot create jobs, guarantee growth, or establish security. It can only redistribute what the economy produces. If the economy produces less, society receives less. The more government forces regulations and taxes on productive people, the more obstacles there are to a healthy and productive economy. An Austrian economist would point out that the Keynesian policy of increasing government borrowing and spending eventually leads to increases in the national debt, higher taxes, and a shrinking economy.

FREEDOM AND THE NATIONAL DEBT

The federal government borrows money by selling bonds, which we call securities. A bond is simply an agreement between the borrower and the lender as to the amount, the interest rate and the maturity date. The deficit is the amount of money the government borrows each year, and the debt is the total amount of indebtedness. In the last ten years, the national debt has doubled, rising from $10 trillion to almost $20 trillion.

Excessive debt can lead to fewer choices politicians can make because more and more of the country's resources go to funding the debt instead of funding programs. Individuals lose their freedom to make choices as more of their income goes to servicing the national debt via taxes and paying on their personal debt.

> ***Excessive debt can lead to a loss of economic freedom as more and more of the country's resources go to funding the debt.***

Just how much is a trillion dollars? A trillion dollars in $100 bills would weigh 22 million pounds! If you stack one hundred dollar bills on top of each other, you would penetrate the Earth's atmosphere and keep on going — 678 miles high. Our national debt would make a stack of $100 bills 11,000 miles high. A trillion is a million million.

Excessive debt can cause a dominoes effect in the economy once the economy starts to head south. When person A owes person B, person B owes person C, and person C owes person D, well you get the idea. Now, if person A cannot pay person B, then person B may not be able to pay person C, and person C may not be able to pay person D etc. In this fashion, excessive debt can feed upon itself leading to an increase in unemployment.

Austrians and Keynesians often make different choices. What is the difference between private and government debt? Children are not responsible for the debts of their parents, but they will inherit the enormous government debt of their parent's generation. Keynesians often choose to raise taxes on the wealthy to pay for generous social programs. Keynesians believe that because the rich have so much money, this tax increase will not diminish investments or stifle growth. Austrian economists choose to stimulate growth by lowering taxes and lessoning regulations, especially on business groups, particularly on small business.

SUMMARY

The principles of absolute and comparative will help you make decisions. Absolute advantage occurs when you can do something using fewer resources than other people use. Comparative advantage occurs when you can do something with lower opportunity costs than other people. You will benefit when you learn to make decisions based on comparative advantage.

Consumers, business, foreigners, and government make decisions. The interaction among these groups determines how society grows and distributes its resources. The consumption sector is the largest and most stable sector of GDP because consumers tend to make decisions based on their perceived long-term income.

Businesses can be sole proprietorships, partnerships, or corporations. A sole proprietorship, the most popular business type, has a single owner who has the right to all proceeds and who bears unlimited liability for the company's debts. A partnership is a contractual relationship existing between two or more persons associated as joint principals in a business. All participants in a partnership are one hundred percent liable for the debts of the business.

The foreign sector can be an addition or subtraction from GDP. If we export more than we import, GDP will rise as more money enters the nation than leaves. If imports are greater than exports, GDP will shrink as more money leaves than enters.

The government sector is almost as big as the consumption sector. By government, economists mean federal, state, and local. The United States Constitution established a federalist government, which grants each level of government sovereignty in certain areas.

In a pure democracy, the majority of voters rules over the minority. In this case, the majority can take everything away from the minority. A republic is a political system based on law. The law protects the minority from the majority. Our form of government is a republic tempered by democracy.

A free enterprise system uses the price mechanism to transmit information, give incentives, and promote investments. Free enterprise needs a strong central government to enforce laws. Good laws favor order and growth; bad laws favor disorder and stagnation. Good governments promote a healthy distribution of income and help reduce negative externalities, such as pollution and unsafe working conditions.

Economists have identified eight basic goals: economic growth, full employment, stable prices, efficiency, fair and impartial sharing of goods and services, minimizing negative externalities, economic freedom, and economic security.

KEY CONCEPTS

- Absolute advantage occurs when you can do something using fewer resources than other people use.

- Comparative advantage occurs when you can do something with lower opportunity costs than other people.

- The four decision makers in the economy are consumers, business, foreigners, and government.

- In a pure democracy, the majority of voters rules over the minority.

- A republic is a political system based on law. The law protects the minority from the majority.

- All societies have to answer the three basic questions of what, how, and for whom to produce.

- Capitalism is a system whereby production is privately owned and operated for profit; there is no centralized planning by the state, and private decisions in free markets determine supply and demand.

- Prices play three roles in a free market. A change in prices conveys information from the consumer to the producer.

- Rent-seeking occurs when a company, organization, or individual uses its resources to obtain an economic gain from others without reciprocating any benefits back to society.

- Economists have identified eight basic goals: economic growth, full employment, stable prices, efficiency, fair and impartial sharing of goods and services, minimizing negative externalities, economic freedom, and economic security.

- Keynesian emphasis on government spending is a top-down approach to problems, whereas Austrian economists tend to favor policies that grow the economy from the bottom-up.

- This is a problem when funding comes from the government because political goals often supersede growth policies.

- The Keynesian consensus, which has dominated world economic councils, believes growth is largely a function of government spending, even if it necessitates a tax hike and that spending cuts are tantamount to lower growth.

- Austrian economists believe that America's problems stem from government failure rather than market failure. According to Austrian thought, a tenant of growth is a predictable future, yet government policies have caused confusion.

- Keynesian policies are the norm today.

- Friedrich Hayek, in his book *The Road to Serfdom*, warned that centralized planning leads to tyranny.

- According to Friedrich Hayek, planners tend to become fixated on achieving their specified goals on specified dates, regardless of the facts.

- Keynesian economists argue that we just need to pull the right levers to revive an ailing economy. Keynesian economists believe that if we can manage demand, we can manage the economy.

- Austrian economists believe that growth stems from savings and investing and that market interest rates encourage savings. Austrians also believe that reasonable and simple laws encourage risk taking and capital formation.

- According to Austrian economics, policies that encourage saving, delayed gratification, capital formation, risk taking, and offer rewards for investments can solve our economic problems.

- The Employment Act of 1946 stipulated economic goals, but it did not ask the Fed to manage the economy.

- The mandate to manage the economy came with the Full Employment and Balanced Growth Act of 1978, also known as the Humphrey-Hawkins Full Employment Act.

- When outputs exceed inputs, productivity increases. When businesses increase productivity, there is an incentive to lower prices to gain producers an increased market share.

- Disparate impact holds that government bureaucrats can declare a business practice to be unfair and illegal if the practice has a disproportionate *adverse impact* on members of a minority group.

- The only solution to pollution is for the federal government to impose environmental regulations on all companies, which puts every company on a level playing field.

- The federal government borrows money by selling bonds, which we call securities.

- Excessive debt can lead to a loss of economic freedom as more and more of the country's resources go to funding the debt.

FOOD FOR THOUGHT

✓ What is the difference between a democracy and a republic?

✓ What kind of system do we have in America?

✓ Why did the founders of America warn us against the dangers of democracy?

✓ What danger do we face today because of our democracy? What are your thoughts on this matter?

✓ Do you think the U.S. national debt has had a negative impact on personal freedom in America today?

✓ How does the federal government borrow money?

✓ How can an excessive national debt lead to a decline in economic freedom? Do you think our national debt is too high? How can excessive debt, both private and public debt, lead to a loss of personal freedom?

✓ When the government needs money, what are the three places it can get the money? What are the advantages and disadvantages of each?

- ✓ What are the seven economic goals a society must achieve? How is America doing in achieving these goals? How would you do things differently in terms of each goal?

- ✓ What is the difference between private and government debt? What impact does each have on the economy?

- ✓ How do Keynesians and Austrians differ concerning the national debt?

- ✓ If you were the President of the United States, what would you do in terms of the national debt?

- ✓ If the government, with the help of the Federal Reserve, can pay off the national debt with newly created money, why would this be a good or bad idea?

- ✓ Our form of government is a republic tempered by democracy. Explain.

- ✓ What is the danger in a pure democracy?

- ✓ Do you believe that America is in danger of too much democracy? Why or why not? What are some steps the country could take that would help shield us against the ill effects of too much democracy?

- ✓ What is disparate impact? How has this practice of government effected business?

- ✓ What is the difference between personal and government debt? If the national debt increases future generations will have to pay this money back, but how does the national debt effect the present generation? Do you think the federal government is justified in its policy of adding to the national debt most years?

- ✓ During the Detroit race riots of the 1960s, the police cars had emblazoned on their sides *Protectors of Liberty*. What do you suppose was the purpose of this?

- ✓ The Keynesian consensus, which has dominated world economic councils, believes growth is largely a function of government spending, even if it necessitates a tax hike and that spending cuts are tantamount to lower growth. Do you agree with this consensus? Why or why not?

- ✓ Keynesian economists believe that as long as we can manage demand we can manage the economy. They also believe that artificially low interest rates will generate more economic growth. Austrians, on the other hand, believe that too much government interference with the economy will lead to economic distortions.

- ✓ Austrians believe that when the Federal Reserve takes action to lower interest rates below the market rate, the economy suffers because there is less incentive for people to save and invest. The low interest rates also encourage more people to take risks, like in the stock market, to make up for the low interest rates. Which side of this argument do you take? Do you consider yourself an Austrian or a Keynesian? Give a brief explanation of your answer.

- ✓ There are two schools of thought concerning the Consumer Financial Protection Agency (CFPA). Keynesians tend to support the centralized power of the director. They believe that such a director can enhance efficiency. Austrians, on the other hand, tend to believe that this centralization of power can lead to a loss of personal and corporate freedom. What do you think?

CHAPTER 3:
GROWTH

Economic growth is not an option – it's a necessity to prevent a shrinkage of the economic pie. Whether you drive your car or park it, time is a cruel taskmaster. If you drive the car, the brakes and tires will wear and you will have to replace them. If you let the car sit, the body will rust and the tires will dry rot. If we do not replace what we have today, we end up with less tomorrow.

The economic problem is always present, and every society must solve the allocation problem of who gets what and how much. However, the allocation problem is easier to solve in a land of abundance than it is in a land of lack. If we do not sufficiently grow, competition will intensify for societies ever-scarcer resources.

What is the best way to grow? Slow and steady growth is easier to maintain than rapid growth because once growth subsides, unemployment ensues. It is like the difference between walking and running. Most people could walk ten miles at a leisurely pace, but few people could run ten miles without slowing down.

The European Commission has reported that the 18-euro area countries is experiencing a decline in real growth. A decline in real growth means these countries grew less than in previous years. Growth in Europe has lagged behind the U.S. for decades, but America is also experiencing slow growth. A two percent growth rate is not enough to replace everything that deteriorates each year.

THE DEGROWTH MOVEMENT, U.N. AGENDA 21 & 2030

Not everyone believes that growth is desirable. The degrowth movement is a political, economic, and social movement that supports substantial anti-pollution policies, a redistribution of income from the wealthy to the poor, and is very anti-capitalistic. The degrowth movement fosters the idea that the economy cannot grow forever because of its finite resources.

This idea of limited growth is akin to the ideas of Robert Malthus, an economist who wrote a book titled "The Principles of Population" published in 1798. Malthus postulated that because the population increases geometrically (2, 4, 8, 16 etc.) and the world's food supply can only increase arithmetically (one, two, three, four etc.), eventually the world will experience mass starvation. History has debunked his theory because the population in most of the advanced industrialized countries has grown less than geometrically and the food supply has increased more than arithmetically.

Degrowthers believe that because the increase in population consumes an ever-increasing amount of the world's resources, growth undermines the foundations of our existence on this planet. This growth exasperates global poverty as the distribution of income becomes more lopsided; growth also endangers the ecosystem. Degrowthers are also concerned that the more advanced countries are leaving less room for the poorer countries of the world to prosper. Many of the world's leaders and members of the United Nations support the degrowth movement.

Even though degrowthers favor a shrinkage of the economic pie, they do not favor recession. They believe that we can manage and control the shrinkage and therefore minimize any ill effects that anti-growth policies will have on the economy. Degrowth means a phase of planned and equitable economic contraction in the richest nations, eventually reaching a steady state that operates within the Earth's limited resources.

Genuine progress now lies beyond growth; therefore, minor changes to the present capitalistic system will not suffice. To solve the problem of growth, we need to replace the present system with a new and different economic system. Degrowthers believe that a new system can liberate the world from the burden of pursuing material excess – stuff that we do not need to live a gratifying life.

According to degrowthers, consumerism is a gross failure; consumerism is a debilitating addiction that degrades nature and prevents humankind from realizing its potential for well-being and true happiness. Degrowth policies would support a simpler way of life a way of life whereby we would produce and consume less goods and services.

To implement this "Sustainable Living" goal of the degrowth movement are U.N. Agendas 21 (1992) and 2030 (2015). Agenda 21offers a detailed plan for "Sustainable Development" that countries should implement throughout the world. On September 25-27, 2015, many world leaders met in New York City to present a new fifteen-year plan entitled "Transforming Our World: the 2030 Agenda for Sustainable Development." Agenda 2030 is a beefed up version of Agenda 21. The difference is that U.N. Agenda 2030 encompasses more than the environment. It calls for governments to seize control of the means of production. U.N. Agenda 2030 specifies how the central plan will strictly regulate everything people do in order to save the planet. "All countries and all stakeholders, acting in collaborative partnership, will implement this plan."

The thread that ties these two movements together is planning. When Hayek wrote about the ill effects of too much planning and how a planned state takes us down the road to serfdom, he did not specify the plan. Any plan that a central authority enforces will lead to the same result according to Hayek.

GROSS DOMESTIC PRODUCT (GDP)

Economists use Gross Domestic Product (GDP) to measure growth. Gross domestic product is the dollar value of all new and final goods and services produced in the country in any given year. GDP tells what we have this year that we did not have last year. Thus, we are interested in *new* goods. To avoid double counting, GDP measures *final* goods. If the lumber consumers purchased from Lowes and the new houses people bought were both counted, we would be counting the lumber twice. The house is a final good; the lumber is an intermediate good.

If the Ford Motor Company produces a car and that car sits in the parking lot, is that car a part of GDP? No, it is not. If someone does not purchase the car, it is nothing but a hunk of metal with no value and economists do not consider it a part of GDP. When someone sees the value and purchases the car, economists recognize that it has a market value of X number of dollars.

If economists measured GDP for a single year and came up with a dollar figure, how useful is this information? It would have no value. Economists must make GDP comparisons from year to year to gain knowledge of where the economy is going and how fast it is going there. It is like the adage, *an ounce of prevention is worth a pound of cure*. If we do not like where we are going, it is easier to make adjustments now before things get out of hand.

However, even this may not give an accurate picture. Because inflation varies from year to year, economists must change money GDP (nominal GDP) into real GDP. Real GDP takes out the factor of inflation. By so doing, economists can make a more accurate comparison of real growth from year to year.

Once economists have real GDP figures over several years, the percent increase or decrease from year to year gives a clear picture of growth. What is the percent increase from three to five? The percent increase is the difference between the two numbers divided by the original number. The difference is two, and two divided by 3 is a 67% increase. What is the percent decrease from five to three? The difference is two, and two divided by 5 is a 40% decrease. When economists compare the percent increase or decrease of real GDP from year to year, they can get a clear picture of growth.

Economists often rely on the Baltic Dry Index to glean information concerning worldwide growth. The Baltic Dry Index (BDI) is an economic indicator issued daily by the London based Baltic Exchange. Although "Baltic" is in the title, the index is not restricted to Baltic Sea countries. The index gauges the flow of raw materials by sea; it measures the cargo that ships carry on the high seas, such as coal, iron, and grain. Every working day, a panel of international shipbrokers submits their view of current freight cost on various routes to the Baltic Exchange. A change in the demand and/or supply of raw materials can drive the index up or down. Currently, the Baltic Dry Index has plunged to its lowest level in history. Economists will have to determine whether the severe drop is the result of oversupply or a decrease in demand for raw materials.

STANDARD OF LIVING

In the middle of the eighteenth century, about 90 percent of the world’s population lived in abject poverty, subsisting on as little as a dollar a day. Even fifty years ago, nearly half of the world’s population lived in poverty. Prosperity has made enormous strides as countries have fought poverty by increasing the average person’s standard of living. However, the standard of living for many middle-class families is either declining or stagnant today. Real wages are not increasing because of an increase in business costs, health care costs, taxes, and excessive regulations have impeded the level of investments.

A country’s standard of living is the minimum of necessities and luxuries to which a person or a group may be accustomed to or to which they aspire. Society’s standard of living will increase when a society saves and then uses these savings to make profitable investments, thus increasing productivity. Productivity increases if outputs exceed inputs.

Economists sometimes define an increase in productivity as being able to produce more per unit of time at lower per unit costs. For example, during the 1920s, about 25 percent of America's population lived on working farms, compared to about 3 percent today.

Another example is the light bulb. In 1879, Thomas Edison invented the first electric lamp. In those early days, four glass blowers could make twelve hundred bulbs a day and by 1926, workers could produce two thousand bulbs per minute. Today, fourteen glassblowing machines, each operated by only one person, manufacture about 90 percent of all the light bulbs produced in the United States. In 1900, the average American had to work several hours just to buy one light bulb; today they are cheap.

Savings can come from a country's citizens or citizens of other countries. Japan passed laws in the 1940s and 1950s that encouraged its citizens to save and, consequently, experienced an increase in investments and jobs. However, the Japanese could have built a stronger economy had banks supported the most creditworthy people instead of lending money to friends, family and people who offered the highest bribes. This favoritism led to unsound investments, bankruptcy, and government bailouts. The economic system falters when society compromises the rule of law and the government tramples property rights.

The Importance of Secure Property Rights

Suppose someone came to your house and ordered you to leave. Because this person is a threat to your life, you have no recourse but to leave and let him have the house. What can you do? You can go to the authorities. Why are the authorities willing to back you up and force this invader to leave? Because of the rule of law and law enforcement authorities, you are not alone. The rule of law protects our liberties and insulates us from unpredictability. For example, business people are reluctant to make investments if they expect the rules of the game to change. Doubt and fear are the twin killers of investment.

The Economic Impact of Taxes and Regulations

Economies stagnate when countries ignore the rule of law, implement high taxes, impose unreasonable rules, and accumulate large national debts. On the other hand, countries experience growth who have simple policies, low taxes, and pro-growth laws, respect the rule of law and have a small national debt.

European nations have imposed excessive regulations on businesses, especially Greece, France, Spain, and Italy, making it difficult, and in some cases impossible, to fire anyone. The amount of paperwork and legal proceedings that an employer must do to fire

someone is excessive. Consequently, the workers who receive most of the jobs agree to accept cash payments and work without a contract.

An increase in government regulations has led to more part-time jobs. According to the National Association of Manufacturers, federal regulations cost the U.S. more than 12% of the gross domestic product. To comply with government regulations the average manufacturing firm spends almost $20,000 per employee per year and manufacturers with fewer than 50 employees spend almost $35,000 per year. This burden of regulations placed on manufacturers effectively raises the cost of hiring full-time employees and works against productivity gains. These excessive regulations also put American producers at a competitive disadvantage with some foreign competitors.[11]

Outsourcing is the contracting out of a business process to a third party.

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The Labor Department has proposed expanding the number of workers covered by overtime rules in the Fair Labor Standards Act. The Fair Labor Standards Act, originally passed in 1938, divides the workforce into two groups. Nonexempt hourly employees (blue-collar workers) and white-collar workers. Businesses must pay blue-collar workers at least 1.5 times their regular hourly rate after a 40-hour workweek. Businesses do not have to pay White-collar workers overtime.

There is a conflict between 50-year-old definitions and modern technology. For example, most categories of information technology workers did not exist ten years ago. Employers must eliminate activities of hourly workers during off hours because of the difficulties of tracking time on the job. Thus, hourly workers do not enjoy the flexibility of white-collar workers, and at the same time, productivity is lower because the rules constrain hourly employers to arcane work rules.

President Ronald Reagan appointed a committee to investigate waste in the federal budget. He appointed J. Peter Grace to head up the commission in 1984, now known as the Grace Commission. For two years, 160 corporate executives and community leaders led an army of 2,000 volunteers to root out government waste. Volunteer contributors, with zero cost to the federal government, funded the search. The Grace Commission made 2,478 recommendations to cut costs without eliminating essential services. This document is 21,000 pages long and lays out a detailed plan to make the federal government more efficient and accountable to the American taxpayer.

The Gramm-Rudman Act of 1985 made it mandatory for the government to live within its income. Instead of implementing needed reform and adhering to the law, Congress found ways to increase borrowing and spending. Changes in federal spending need a vote by members of Congress, and every bit of waste has a champion somewhere in Congress that sees the spending as a gravy train.

Part-Time Work Can Diminish Living Standards

When the U.S. Congress passed the Affordable Care Act in 2010, referred to as ObamaCare, the way Americans finance health care changed. Many businesses, to avoid penalties, fired full-time employees and hired part-time workers who will work less than 30 hours a week. The Internal Revenue Code defines part-time employees as those persons who work 1,000 hours or less in any 12-month period; this equivocates to 30 hours a week. These events have led to a decrease in covered employees, full-time employees with full benefits, and an increase in non-covered employees, part-time employees without benefits.[12] As more Americans work part-time, living standards will diminish for many American workers.

PRODUCTIVITY AND GROWTH

How can the standard of living be high in the United States and low in many other countries? A part of the answer is a difference in natural resources, but not entirely. For example, Pakistan and Bangladesh are two deprived nations that have abundant resources, while the countries of Japan and Switzerland lack resources, yet have a high standard of living. In the first chapter of *An Inquiry into the Nature and Causes of the Wealth of Nations,* 1776, Adam Smith described how increasing productivity is the key to a country's wealth.

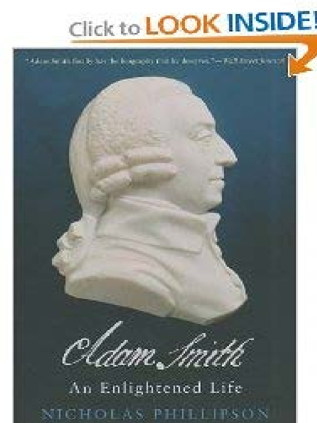
Almost everyone benefits when businesses find ways to reduce costs and prices. The business gains with higher profits and the consumer gains with lower prices. The economy gains because of robust growth and the government benefits from the higher tax revenues. Almost everyone loses when costs increase. When costs rise, businesses with price elastic demand curves suffer, and companies with inelastic curves raise their prices. In both cases, there is a decrease in aggregate demand, leading to unemployment.

In 1914, Henry Ford announced that he was going to double wages to $5 a day. Five dollars a day was double what the average person in the world was making at the time. After he had increased wages, people from all over the world came to America just to work for Henry Ford. He figured that if he paid his workers more money, they would purchase more Ford cars. This increase in demand for Ford automobiles was possible because the Ford Motor company was a large percentage America's GDP.

An increase in productivity means that outputs increase more than inputs or we can produce more at a lower per unit cost.

The year before, Ford had revolutionized manufacturing with the moving assembly line, slashing production time to just 90 minutes from 14 hours. However, Henry Ford was not the originator of the assembly line. It was Adam Smith in the 1700s who explained how a pin factory used the assembly line to divide labor and increase productivity.

Instead of skilled artisans assembling an automobile, Henry Ford devised an assembly line whereby each person on the line performed one task. This division of labor reduced costs by eliminating nonproductive activity. Because of the assembly line, the eight-hour workday, and other innovations, Henry Ford was able to underprice 88 competitors. Productivity gains like this transformed lifestyles and caused nations to prosper.



Adam Smith – An Enlightened Life
by Nicholas Phillipson
Yale University Press, 2011
Image from Amazon.com

In 1900, a man's typical on-the-job workweek consisted of 60 hours of work spread over six days. In present day dollars, the average per capita income was only $5,000. Electricity lit only three percent of homes, and only a third had running water, 15% had flush toilets.

The telephone was invented in 1876, the phonograph in 1877, motion pictures in 1893, the airplane in 1903, the radio in 1920, the television around 1945, and the iPad in 2009 and iPhone in 2010. These inventions, along with the internet, cell phones, and video games, have transformed societies.

Henry Ford was the first to offer the eight-hour workday. He figured that instead of having two shifts of nine hours, he could have three shifts of eight hours. Thereby, he could operate his factory 24 hours a day, eliminating having to pay fixed costs while his factory was idle. A healthy by-product of this shorter workday is the increase in consumer demand. For example, when Henry Ford manufactured his Model T Ford in 1909, the average person could afford a car for the first time.

Automation Increases Productivity

If a tractor can do the job of 100 workers, is it replacing 100 people? The answer is no. The truth is that if it were not for the tractor, none of the 100 people would have a job.

Consider the following story. Peter wants land cultivated for a garden. Matthew, a neighbor who has a tractor, and a plow, agrees to cultivate his land, which will take about an hour, for $25. When Peter needs his land plowed the next year, he contacts Matthew again. This time, however, Matthew says, I would be pleased to plow your field, but I no longer have a tractor. I can cultivate your land with a rake and shovel, which will take about ten hours, for $25 an hour.

Peter considers that he could buy a whole lot of vegetables for $250. He says to his friend, Last year I paid you by the job, not by the hour. If you plow my garden by hand, I will still give you $25. Being no fool, Matthew declines the offer. Because of the tractor, the buyer and seller agreed on a price; without the tractor, they cannot come to terms. Thus, the more machines a nation has, the more jobs it can provide because of the lower costs and lower prices.

Innovations Increase Productivity

An innovation is a new way of doing something. Joe lost his job after working at the local factory for twenty years. The company had purchased new machines and terminated 100 people. The economy has changed structurally and resulted in some people being unemployed. It would be difficult to convince Joe that automation generates more jobs than it replaces. Yes, this factory has fired workers, but the process of automation creates more jobs than it displaces in the macro economy. When businesses increase productivity, they can reduce their prices, which increases consumers' real incomes.

Lost jobs are mostly unskilled labor-intensive jobs, and the ones gained are the higher-skill type jobs. Companies are continually searching for skilled workers, and when they cannot find them here, they explore foreign markets.

Because America has the highest corporate tax rate in the world, and it is the only country that forces companies to pay American taxes on money earned abroad and brought home, and it has more regulations than almost any other country, growth has suffered. An example of a large and complex law is ObamaCare. Economists agree that ObamaCare has helped some people and hurt others in terms of health care. Subsidies are most generous between 100% and 150% above the poverty line, where a government policy is essentially free. Enrollment drops off the further people get from the poverty baseline. However, there is little disagreement that ObamaCare will have an adverse impact on productivity because the system is dependent on young and healthy individuals to subsidize the older and sicker generation.

The majority of the world's health-care innovation occurs in the United States, with about 71% funded by private industry. However, excessive taxes and regulations are eroding America's lead in the world. According to Congressional Budget Office estimates, the health-care law will levy more than $500 billion in new taxes over its first ten years to help pay for insurance subsidies and Medicaid expansion. These taxes include significant levies on health care industries, such as medical devices and drugs. Consequently, health-care technology companies are moving their research and development centers and jobs overseas. Compounding the problem is that the Food and Drug Administration leads the world in the time it takes to approve new medical devices. The negative impact of taxes and regulations has also convinced an ever-increasing number of foreign students to return home after graduating. It is also very difficult for high-skilled foreign workers to obtain H-1B visas. [13]

Freedom Can Increase Productivity

More than 150 years ago, the French nobleman Alexis de Tocqueville toured America and questioned why America was more successful than other countries. He concluded that America was successful because Americans believed in upward mobility and that the future will be better than the present. He witnessed that Americans strived to move up the socioeconomic ladder. We may be poor today, but through hard work, we can be rich tomorrow.

Horatio Alger's stories inspired a whole generation of Americans who rose from poverty and built successful businesses.

The ideas of Horatio Alger (1832-1899), who wrote more than 100 books for young working class males, influenced America. Alger wrote stories of poor boys who would claw their way out of poverty. A classic story was about a poor boy who, while walking to school in bare feet, crossing over the railroad tracks and passing by mansions of the rich, has a dream in his heart and a steadfast desire to succeed. He overcomes his impoverished background and rises to become a successful entrepreneur. Horatio Alger's stories inspired a whole generation of Americans who rose from poverty and built successful businesses.

Businesses that face a price elastic demand curve are hurt more than other businesses when costs increase.

Businesses that face a price elastic demand curve are hurt more than other businesses when costs increase. As you might recall from the introduction, the price elasticity of demand is a measure of a change in quantity demanded relative to a change in price. Companies that sell necessities with few substitutes can increase total revenue with an increase in their prices because the money earned exceeds the money lost. Companies that face a price elastic demand curve will experience a decline in total revenue with a price increase because the money they gain is not enough to compensate for the money lost due to a decline in sales. Large companies tend to face price inelastic demand curves, and smaller companies tend to face price elastic demand curves. Therefore, an increase in costs hurt small companies more than big ones.

REASONS PRODUCTIVITY DECLINES

Trade Restrictions

Large companies can be more efficient than small ones. When production increases, companies can find more ways to divide the labor, use by-products, employ robotics, and buy raw materials at lower prices, thus lowering costs. International trade can increase economies of scale and benefit all countries. However, trade restrictions limit the advantages of trade. The collective always favors free trade, but individual countries favor trade restrictions.

In 2010, for example, Brazil sued America for unfair and unlawful trade practices. America was subsidizing American cotton farmers, a powerful special interest group, enabling them to sell their cotton for less than the Brazilians could sell theirs. The World Trade Organization (WTO) ruled that subsidies to American cotton growers under the 2008 farm bill were a violation of U.S. trading commitments. The U.S. lost its final appeal in the

case, and the WTO gave Brazil the right to retaliate. Brazil dropped the suit when the U.S. Congress agreed to subsidize Brazilian cotton growers.

Anti-Pollution and Consumer Safety Laws

> ***Businesses left on their own do not have an incentive to curb pollution.***

Businesses left on their own do not have an incentive to curb pollution. If a business owner has a social conscience and invests in anti-pollution devices, costs increase forcing an increase in prices. The increase in prices will give competitors an advantage. Because the company fears losses, it will decide to pollute rather than spending money on anti-pollution devices. Therefore, businesses have a financial incentive to pollute.

The government can solve the pollution problem only when it enforces environmental regulations on all polluters. However, what happens when the regulations are too harsh? What happens when policymakers ignore economic growth? Government policies can hinder productivity by raising costs, entangling businesses in excessive regulations, and fostering an environment of doubt and fear. Businesses may be reluctant to invest for fear of existing government policies and policies not yet on the books.

Consider the Environmental Protection Agency's (EPA) campaign against coal. Coal-fired plants currently provide power to one-half the population, yet the EPA is forcing many coal-fired power plants to shut down because it supports alternative energy sources like solar power, natural gas, and wind power.

Taxes

The more businesses pay in taxes; the less money goes toward profits. Excessive taxes will diminish incentives to invest and grow a business. Businesses that face a price elastic demand curve will be hurt the most from high taxes. A business that face a price inelastic demand curve can raise prices to pay the higher taxes and still increase revenue. Therefore, high taxes tend to fall heaviest on smaller businesses that face price elastic demand curves, giving big businesses and advantage in the marketplace.

No one disputes the fact that society needs to pay taxes, but there is the moral question of how far the government can impose its will upon citizens. Does the government grant privileges to its citizens, or do citizens have natural rights? The first amendment to the Constitution, the Bill of Rights, establishes the freedom of speech and the second amendment encourages Americans to rebel against an oppressive government. The

following quote from Lawrence Lindsey of the Wall Street Journal shed some light on this question.

> *When you begin the argument that being a citizen is a privilege for which one should pay ever more, you very quickly find yourself on Friedrich Hayek's Road to Serfdom.*[14]

The Rule-of-Man Trumps the Rule of Law

Governmental policies trash the rule of law when they make decisions for political reasons and implement policy on an ad-hoc basis. When the federal government bailed out General Motors in 2009, it ignored current bankruptcy laws and picked the winners and losers. The government paid auto unions in full because of their generous political contributions, but short-changed bondholders and the non-union members at Delphi, GM's former parts subsidiary. Delphi, which underwent the longest corporate bankruptcy in U.S. history, lost all of its health and life insurance benefits, and 70,000 retirees lost as much as 65% of their benefits.

The rule of man takes precedence over the rule of law when persons in authority thwart the law and use their authority to enrich themselves.

Companies will make investments if they are reasonably confident about the rules of the game and market conditions. When government intervenes on an ad-hoc basis, it introduces uncertainty into the mix. Trouble begins when businesses spend less money on research and development and more on rent-seeking. This partnership between big business and government is a destructive force, undermining not just the economy and political system, but the foundations of our culture.

When rent-seeking becomes the norm, the free market evolves into crony capitalism.

When rent-seeking becomes the norm, allowing the government to pick winners and losers, the free market evolves into crony capitalism. Subsidies and mandates are just two of the privileges that government give politically connected friends. Other subsidies and mandates include grants, loans, tax credits, favorable regulations, bailouts, loan guarantees, targeted tax breaks and no-bid contracts. These subsidies and mandates protect monopolies from competition, both domestic and foreign.[15] In recent years, there has been an increase in mega mergers. These mergers have resulted in fewer but larger companies. Many of these mergers are the result of inversions in an attempt to avoid American taxes and regulations.

The National Debt Discourages Productivity Gains

With a national debt approaching $20 trillion, the U.S. government uses much of the country's resources to repay the debt instead of on other things. Because the government owes the debt to bondholders, the debt will become a problem when interest rates increase, and interest rates will increase. The large debt is one reason the Federal Reserve will be reluctant to raise interest rates.

OVERREGULATION IMPACTS PRODUCTIVITY

The Federal Railroad Administration insists that train manufacturers must paint all trains with an "F" in the front so people can tell which end is the front and which is the back. In some cities, kids cannot open a lemonade stand without a permit. A town in California disallowed a young girl to sell mistletoe to raise money to buy braces but allowed her to beg for money. Policies like these stifle the entrepreneurial spirit and make it difficult to start and build a business.

Sarbanes-Oxley Act

Congress passed the Sarbanes-Oxley Accounting Reform Act in 2002, which rewrote accounting and disclosure rules for publicly traded companies in the United States. The purpose of the Act is to prevent business scandals, a noble pursuit. The Act has given the federal government more power to intervene in credit markets. The danger is that the bill has also allowed the government to impose penalties on selected companies of its choosing.

The Sarbanes-Oxley Act of 2002 rewrote accounting and disclosure rules for publicly trades companies.

Sarbanes-Oxley established the Accounting Oversight Board and mandated corporations to deliver internal management reports to the board. Executives who approve shoddy records face fines of up to $5 million and 20 years in prison. Section 404 requires costly external audits of companies, apart from the company's financial statements. Sarbanes-Oxley is the most visible sign of overregulation and the primary reason foreign companies forgo U.S. public listing. Because large firms can absorb the high costs of compliance, they have the advantage of greater economies of scale, whereas smaller firms are less able to meet compliance costs. Congress has exempted companies with less than $75 million of assets to lessen the burden on small businesses.

Public Education

Rachel Carson Middle School in Herndon, Virginia, is full of winners. The school won a governor's award for teaching excellence for the years 2007 to 2011, and the national forum for middle-school improvement cited Rachel Carson as a school to watch. However, the federal government considers Rachel Carson a failure because it does not fit its definition of success. The No Child Left Behind Act defines success as improvement in test scores by different groups. Rachel Carson has high average scores but fails because it has achievement gaps when it breaks out test results by such categories as race, gender and income. Congress has recently passed legislation giving back to the states more autonomy.

Another example of not meeting government standards is Corinthian College, a college with over 100 campuses. Corinthian Colleges was one the country's largest for-profit educational companies in the nation and one of the largest for-profit post-secondary education companies in North America. Corinthian offered career-oriented diploma and degree programs in healthcare, business, criminal justice, transportation technology, construction trades, and information technology. Because the college failed to meet government mandates promptly, the Department of Education put the for-profit college out of business

The federal government restricted the company's access to federal funding because of what it considers inadequate marketing, excessive dropout and student loan default rates, and unfulfilled promises. Because 80% of Corinthian's revenue came from federal funding, $1.4 billion in federal financial aid each year, this action was a deathblow to the college.[16]

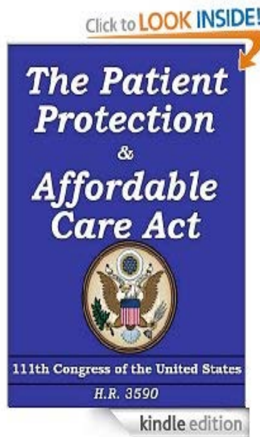
The Consumer Financial Protection Bureau (CFPB) wiped out company shareholders and creditors by suing the college for predatory lending. The government claimed that Corinthian used *aggressive collection efforts* by suspending students who failed to meet their loan obligations. The government's third complaint concerns paying staff bonuses for collecting past-due payments from students. A fourth complaint was that not enough graduates found full-time employment in their chosen field.[17]

The Department of Education is now judging all colleges and universities on graduation and retention rates, the ability of graduates to pay back their student loans, the school's accessibility to low-income students, and holding down costs. The government will tie federal funds to the ratings. Consequently, authorities are imposing funding models that take into account various performance measures related to student outcomes. Some of the measures included in these funding models are number of students earning one or more awards in a given academic year, number of students from underserved populations, who

earn an award, and number of students who complete a degree in six years of starting college. These mandates are changing the face of higher education.

These are all worthwhile and admirable goals that every college should obtain. However, this is an economics course, and this is a chapter on economic growth. So, as economists we have to consider the opportunity costs of these government policies. As more of a college's resources go to meeting mandated government goals, colleges will spend less on programs not included in the government mandates. Every college is different, yet these "one size fits all" mandates will supersede local objectives and concerns.

Patient Protection & Affordable Care Act



The Patient Protection & Affordable Care Act
111th Congress of the U.S. H.R. 3590
U.S. Government, 2012
Image from Amazon.com

Changes in health care illustrate how the government dictates economic choices, thus limiting personal choice. In 2010, President Obama signed The Patient Protection & Affordable Care Act, a 2,700-page bill, sometimes called ObamaCare, to overhaul the nation’s health care system. The original law ran for 2,700 pages, but the regulations that go with the law cover 22,000 pages.

The law extends protection to millions of people by expanding Medicaid, accepting people with pre-existing conditions, and subsidizing qualified people to help them buy insurance from companies in the government-run exchange. Policies offered on the exchange have to adhere to one of four basic government mandated plans. The bill establishes a panel of experts who have authority to determine the limits of government reimbursements for qualified people. As of this date, the majority of participants receive the subsidy.

ObamaCare has declared many insurance policies sub-par because the plans do not offer all the specifics that the National Health Care System mandates. ObamaCare has forced many people onto Medicaid. A Boston University/Harvard Medical School study suggests that ObamaCare has shifted up to 80% of people from their private insurance and onto Medicaid. However, Medicaid does not translate into quality medical care. Less than 50 percent of doctors are accepting new Medicaid patients, according to a survey by the health-care company Merritt Hawkins. Doctors often lose money when they treat Medicaid

patients. Fewer doctors mean long waits to see primary care providers and even longer waits to see specialists.

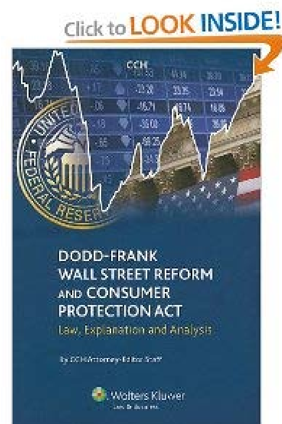
Both political parties agree that we must modify the health care law. However, there is a disagreement of how to modify the present system. Republicans would like to replace the system (not one republican voted for the health care system) whereas the democrats would like to make modifications to the present system.

The Dodd-Frank Law

At over 2,300 pages the Financial Reform Bill Congress passed in 2010, also known as the Dodd-Frank Law or Wall Street Reform and Consumer Protection Act, is the longest act the U.S. legislature has ever passed. The law was supposed to end bailouts and enhance financial stability, but Dodd-Franks liquidation authority has replaced bailouts with bail-ins. In a bailout, the government makes creditors whole by protecting creditors. With a bail-in, big banks, considered a debtor in this case, can recapitalize themselves with the savings of their creditors and depositors.

Dodd-Franks liquidation authority has replaced bailouts with bail-ins.

The banks, which the government considers too big to fail and therefore protected by the Dodd-Frank Law, make up about 60% of GDP and they control nearly 50% of all bank deposits. The four nonbank financial firms designated as systematically important are MetLife, American International Group (AIG), Prudential Insurance, and General Electric. The government will expect these firms to have ample money on hand as a capital cushion to address unexpectedly large losses and avoid harming the broader economy collapse. These companies are seeking ways to change their business in an attempt to free themselves from government regulation and the high capital requirement that Dodd-Frank imposes on them. The challenge for these companies is staying within the limits of the law and enhancing shareholder value. General Electric has divested itself of its financial unit and MetLife has moved to shed a chunk of its U.S. life-insurance business.



Dodd-Frank Wall Street Reform and Consumer Protection Act
by Wolters Klower
CCH Incorporated Pub., 2010
Image from Amazon.com

This law impacts growth by increasing regulations on businesses the government deems as too big to fail and, therefore, pose a systemic risk to the economy. Once the government protects some businesses from loss, we no longer have a capitalistic system. The law subjects American finance companies, and others, to government control. J.P. Morgan has hired 10,000 compliance officers to handle its mandates. According to the Federal Deposit Insurance Corporation, over a thousand commercial banks have disappeared since the Dodd-Frank Law. Government figures also indicate that the country is losing on average of one community bank or credit union a day under the weight of government regulations.

The Dodd-Frank Law created the Financial Stability Oversight Council (FSOC) and the Consumer Financial Protection Bureau (CFPB) and gave each agency absolute power. The FSOC can declare a financial firm systemically important based on any risk-related factors that it considers appropriate. Companies tagged with this designation are subject to an increase in government regulation. The CFPB can punish responsible lenders who in good faith offer loans that the bureau later believes to be unfair, deceptive, or abusive. Those open-ended standards set no limits on the regulator's power.[18]

The problem is that Dodd-Frank gave the un-elected council the power to rewrite the rules of insurance over the objections of insurers, insurance regulators, and Congress. A certain amount of flexibility is necessary for a law, but before Dodd-Frank, the powers Congress granted to regulators were limited; major decisions were knowable to everyone. Regulators had to be responsive to Congress; therefore, there was a consistency in policy. The Dodd-Frank Law replaces this predictability with uncertainty and fear and imposes demands on institutions never contemplated by Congress.

The Constitution empowers the President and Congress, as well as the courts, to prevent regulators from running amok with excessive, arbitrary or discriminatory regulations. However, Dodd-Frank does not honor checks and balances; it eliminates them. Instead, Dodd-Frank lets the CFPB demand more than $550 million annually from the Federal Reserve and prohibits Congress from reviewing its budget. The law caps the Fed’s contribution at 10% of its annual income each year. Once the director has decided that a cash draw is necessary, there is no power to prevent the draw. The President has limited power over the CFPB because he can remove the director only under strict circumstances.[19] When the CFPB deems a financial institution too big to fail, the

American finance is becoming more political, less vibrant, and further removed from the rule of law principles.

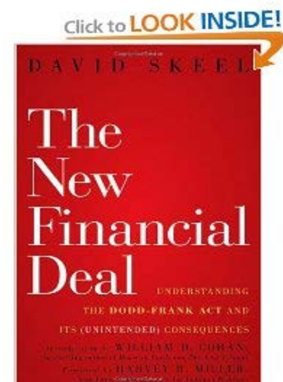
Financial Stability Oversight Council prohibits the courts from reviewing whether the regulators correctly interpreted the law.

The Financial Stability Oversight Council can declare a nonbank financial firm as a *systematically important financial institution* – which subjects them to heightened supervision by the Federal Reserve Board of Governors. This designation power makes a mockery of property rights and due process. The FSOC can now threaten large financial institutions with *systemic risk designation* with no real avenue for defense. The designation gives the government a say in basic business decisions made by financial institutions, including new requirements that are beyond written corporate laws or existing financial regulations.[20]

There are many consequences of the Dodd-Frank Law. Small and medium sized businesses are struggling to survive. Small and medium sizes businesses are struggling to get loans, students are struggling with heavy debt loads, bank fees have increased, and more and more people are having difficulty finding adequate banking services.

When the government fears the people, there is freedom; when the people fear the government, there is tyranny.

The Consumer Financial Protection Bureau and the Financial Stability Oversight Council's constitutional violations is not merely the focus of law-school debates; they pose a direct threat to economic recovery. Community banks are afraid of lending money because the CFPB might later decide that the loans were unfair. American finance is becoming more political, less vibrant, and further removed from rule of law principles. In fact, regulators can take over a struggling bank and every affiliate in the bank's network by just claiming that it may default and that its default could have significant adverse effects on the nation's stability.



The New Financial Deal
by David Skeel
Wiley Pub., 2010
Image from Amazon.com

The federal government and much of the financial system could not function without the help of private accounting firms such as Promontory, Deloitte, PricewaterhouseCoopers and Ernst & Young. Regulators and banks hire these firms to investigate suspicious activity, act as intermediaries between the government and private companies and advise financial institutions on how to comply with

complex regulatory rules. Promontory is arguably the most influential of these regulators and can receive up to $1,500 an hour for its services.

Two features of the Dodd-Frank law are the whistleblower provision and legal protection. Employees who believe that their company is in violation of the law can contact the authorities with specifics. At this point, the law protects an employee from retaliation. If, after an investigation the federal authorities find any illegalities, like fraud or tax evasion, the whistleblower gets to keep from 10 to 30 percent of any monies collected. The law also requires courts to grant the bureau deference regarding its interpretation of the federal consumer financial law. It turns the largest financial institutions into functional utilities transferring power away from the free market and gives it to Washington.

The point to the Patient Protection and Affordable Care Act, the Dodd-Frank Law, the Sarbanes-Oxley Accounting Reform Act, and the new mandates placed on institutions of learning is that the U.S. economy is fundamentally changing. These changes are leading to a concentration of power; they are trading economic growth for perceived security and making the U.S. economy less vibrant. Austrian economists would be of the opinion that contrary to good intentions, these changes will hurt productivity, and they will result in less security for most people, not more security.

The dynamic effect of these laws generates moral hazard and distorts the behavior of market participants in a way that contradicts the principles of free and open markets. In this new world order, only the largest financial institutions can survive. Meanwhile, these laws leave the American consumer with fewer choices, higher costs, and more paperwork when applying for a loan. They also leave the American taxpayer holding the bag should there be another financial collapse. According to the Federal Reserve Bank of Richmond, the federal government backs 60 percent of the liabilities in America's financial markets in one way or another.

Friedrich Hayek warned against the ill effects of planning. Tyranny results when rules rule instead of people.

Lengthy and Complex Bills Diminish Productivity

No person had understood the entire 2,700-page health bill or the 2,300-page financial reform bill before Congress passed these bills. No one understood the 6,000 page Clean Power Plan that commands states to cut carbon emissions by 32% from 2005 levels by 2030. Bills and mandates like these have fostered an atmosphere of uncertainty and fear that erodes investments, economic growth and diminishes productivity gains. Such laws

can change regulators into central planning authorities. Friedrich Hayek warned against the ill effects of planning; tyranny results when rules rule instead of people.

An Austrian would argue that the Wall Street Reform and Consumer Protection Act might prove ineffectual because detailed and complex laws tend to be ineffective. Complex laws leave room for banks to identify assets that regulators can classify as safe, but are not safe. Regulators erroneously believe that their models can predict future risk, but they cannot. Besides being ineffective, these complex laws add layers of costs to business expenses.

What is the difference between simple laws and large and complex laws? Suppose the government passed a law that made it illegal for anyone to wear a tie. Authorities could easily enforce this law because everyone knows what a tie looks like. Now let us suppose the government passes a law that makes it illegal to wear a beautiful tie. Who is to say what is beautiful? Now the government can define beautiful and can enforce the law however it chooses.

Austrian economists believe that lengthy and complex laws expose the American economy to arbitrary decisions rather than to a strict adherence to the rule of law. Austrian economists tend to believe that financial crises are pathologies of an entire system, not a few key firms. Reform must come by treating the system as a whole rather than the government micromanaging a few key firms. Keynesian economists are less suspicious of large and complex laws and they tend to favor government intervention into key industries.

We cannot maintain the kind of growth we presently have in America. Long lasting growth comes from saving and investing in new capital, machines, tools, and factories that will grow the economy. Sustainable growth stems from this increase in capital. We do not have this kind of growth today. Because we have relegated most of our production to other countries, especially China, we have neglected investment in new plants and equipment.

SUMMARY

Growth is important because things wear out. Slow and steady growth is easier to maintain than rapid growth because once growth subsides, unemployment ensues. It is like the difference between walking and running. Most people could walk ten miles at a leisurely pace, but few people could run ten miles without slowing down.

Austrians and Keynesians have differing opinions concerning growth. Austrians take a bottom-up approach to economics. Austrians support saving and investing and, therefore, favor a free money market. The more people save and invest, the more the economy grows. Austrians believe that slumps are inevitable, and, therefore, the ebbs and flows of economic activity are normal. Keynesians would like to eliminate the slumps whenever possible. Keynesians take a top-down approach to economics by favoring a pro-active federal government.

Gross domestic product (GDP) is the most common way to measure growth. Gross domestic product is the dollar value of all new and final goods and services produced in the country in any given year. What we want to know is what do we have this year that we did not have last year?

Most citizens do not mind paying reasonable taxes and adhering to sensible laws, but when laws become excessive, society begins to break down. Economies stagnate when countries ignore the rule of law, implement high taxes, impose unreasonable regulations, and accumulate large national debts. On the other hand, countries that experience growth pass reasonable pro-growth laws, respect the rule of law and have a small national debt.

The U.S. government has adopted anti-growth policies, including higher taxes, strangulating regulation, demonization of successful entrepreneurs, favoritism to labor unions and ObamaCare. Keynesian economists tend to view the economic pie as just so big, and the only way to help low-income people is to take money from the wealthy. Austrian economists tend to believe that there will always be income inequality because of differences in risk tolerance, and the way people value leisure time and creativity.

Austrians believe that people live well only if they produce well, and they produce well only if they save and invest. Growth is the key to economic well-being, and growth is a direct result of increasing productivity. Lower costs lead to lower prices, more growth, and a higher standard of living. Thus, everyone gains – consumers, business, and government. Government gains because tax revenues increase as the economy grows.

When productivity declines, costs increase, causing prices to increase. Consequently, consumers buy less, and the economy stagnates. A free market can only maintain its vitality if risk takers have a fair chance of success. The economic system does this by rewarding sound business ventures and allowing unsound business ventures to fail. To ensure adequate savings and investing, people need clear and precise rules.

Almost everyone benefits when businesses find ways to reduce costs and prices. The business gains with higher profits and the consumer gains with lower prices. The economy gains because of robust growth and the government benefits from the higher tax

revenues. Almost everyone loses when costs increase. When costs increase, businesses with price elastic demand curves are hurt, and companies with inelastic price curves raise their prices. In both cases, there is a decrease in aggregate demand, leading to unemployment.

Rent-seeking is the practice of seeking favorable treatment in Washington D.C. by influencing legislation with money. A consequence of rent-seeking is moral hazard. Moral hazard occurs when the government supports failing companies. Moral hazard diminishes the need for companies to make wise investments because if investments are profitable, a business will prosper, and if things go wrong, the taxpayer pays the bill.

KEY CONCEPTS

- If we do not replace what we have today, we will end up with less tomorrow because things wear out over time.
- Slow and steady growth is easier to maintain than rapid growth because once growth subsides, unemployment ensues.
- Gross domestic product is the dollar value of all new and final goods and services produced in the country in any given year.
- Keynesians like to measure things because to them the economy is like a machine. An Austrian, on the other hand, sees the economy more like a person. Austrians believe that the free market system may need help monetarily, but primarily a free market economy can cure itself.
- A country's standard of living is the minimum of necessities and luxuries to which a person or a group may be accustomed to or to which they aspire.
- Secure property rights embodied in the rule of law are essential to freedom and free markets.
- Outsourcing is the contracting out of a business process to a third party.

- In 1984, the Grace Commission made 2,478 recommendations covering 21,000 pages outlining how Congress can make the federal government more efficient and accountable to the American taxpayer.

- The Gramm-Rudman Act of 1985 made it mandatory for the federal government to live within its income.

- When the U.S. Congress passed the Affordable Care Act in 2010, referred to as ObamaCare, the way Americans finance health care changed.

- Almost everyone benefits when businesses find ways to reduce costs and prices. The business gains with higher profits and the consumer gains with lower prices.

- When costs rise, businesses with price elastic demand curves falter, and companies with price inelastic curves raise their prices.

- An increase in productivity means that outputs increase more than inputs or we can produce more at a lower per unit cost.

- Productivity increases with inventions, new machines and tools, and innovations, a new way of doing things.

- Inventions and innovations increase productivity.

- When costs increase, companies that face a price elastic demand curve are hurt more than companies that face a more inelastic demand curve.

- Large companies scan be more efficient than small ones.

- Because large companies tend to face price inelastic demand curves and smaller companies tend to face price elastic demand curves, an increase in costs hurt small companies more than big companies.

- Businesses left on their own do not have an incentive to curb pollution.

- When you begin the argument that being a citizen is a privilege for which one should pay ever more, you very quickly find yourself on Friedrich Hayek's *Road to Serfdom*.

- Governmental policies trash the rule of law when they make decisions for political reasons and implement policy on an ad-hoc basis.
- The rule of man takes precedence over the rule of law when persons in authority thwart the law and use their authority to enrich themselves.
- With a national debt approaching $20 trillion, the U.S. government uses much of the country's resources to repay the debt instead of putting the money toward research and development and new capital.
- The Sarbanes-Oxley Act of 2002 rewrote accounting and disclosure rules for publicly traded companies.
- The No Child Left Behind Act defines success as improvement in test scores by different groups.
- ObamaCare has forced many people onto Medicaid.
- Medicaid is similar to an equity loan that some people will have to pay back. An equity loan is a loan given against something of value, like property. If the borrower does not pay the money back, the lender confiscates the property.
- The purpose of the Dodd-Frank Law is to place blame of the 2007-2008 financial crisis on Wall Street and to increase regulation on businesses the government deems as too big to fail and therefore pose a systemic risk to the economy.
- The Financial Stability Oversight Council is free from checks and balances and the Federal Reserve funds it rather than Congress.
- American finance is becoming more political, less vibrant, and further removed from the rule of law principles.
- Friedrich Hayek warned against the ill effects of planning. Tyranny results when rules rule instead of people.
- According to Hayek, planning is planning. All plans have good intentions, all planners expect their plans to have good results in the future, and once leaders can

fully implement the plan, earth will be a better place to live. However, this top down approach to economics is opposed to the tenants of a free enterprise system. Adam Smith, in his book, the Wealth of Nations, did a good job in explaining how a system based on "self-interest" is a system that is void of central planning. Free enterprise still needs a strong central government, we still need the rule of law, and law enforcement authorities, but this is different from a totally planned economic system whereby central planners make all crucial decisions and the policies that these decisions result control every aspect of human endeavor.

- Lengthy and complex laws expose the American economy to arbitrary decisions rather than to a strict adherence to the rule of law.

FOOD FOR THOUGHT

✓ Why is it not possible to be satisfied with what we already have?

✓ What is the degrowth movement? Can we limit growth by managing a recession in such a way that will save the world's resources and improve our happiness?

✓ What does the degrowth movement have in common to the U.N. Agenda 21 program? What would Hayek say about the good intentions of these programs?

✓ What does the term outsourcing mean? Why have several American companies found it necessary to outsource their base of operation to a foreign country? What has the federal government done to stem the tide of business outsourcing to foreign countries? Why have foreign companies not outsourced the way American companies are outsourcing?

✓ In 1984, the Grace Commission made 2,478 recommendations covering 21,000 pages. What was the purpose of forming the Grace Commission? What was the Gramm-Rudman Act? What was the result of the Grace Commission and the Gramm-Rudman Act?

✓ There are three factories in a town. Each factory employs 300 workers. Now each of these factories automates and employs machines that can do the work of 100 people. Therefore, each factory lays off 100 workers. How does automation create

more jobs than it replaces? What is the difference between the kind of jobs generated and the kind of jobs lost?

- ✓ What is structural unemployment? What is the key in solving structural unemployment?
- ✓ ObamaCare has made health insurance available to thousands of people who would not have insurance without this health care law. Some people are paying more and some people are paying less than previously. What is the net impact of this health care law on productivity, especially in the health care field?
- ✓ When industry divides the labor more, the way Henry Ford did, why does this lead to an increase in productivity?
- ✓ When costs increase, companies that face a price elastic demand curve are hurt more than companies that face a more inelastic demand curve. Explain.
- ✓ Why can personal freedom lead to productivity gains? Why do countries that have a command system often suffer from a lack of productivity gains?
- ✓ Who was Horatio Alger (1832-1899)? Why did he make a difference in the developing of America in the 1800s?
- ✓ What is the rule of man? The rule of law? How does the rule of man effect productivity gains in a country?
- ✓ The Sarbanes-Oxley Act of 2002 rewrote accounting and disclosure rules for publicly trades companies. How did this law effect productivity?
- ✓ The Department of Education is now judging all colleges and universities on graduation and retention rates; the ability of graduates to pay back their student loans; the school's accessibility to low-income students; and holding down costs. How will this affect productivity for colleges? How will this affect the economy and society?
- ✓ Why did the government declare Rachel Carson Middle School in Herndon, Virginia, a failure?

- ✓ Why did Corinthian College, the largest private college in America, go out of business? Do you think what the federal government did was the right thing to do?

- ✓ When costs increase, businesses with price elastic demand curves falter, and companies with price inelastic curves raise their prices. Explain.

- ✓ Do you think a planned economic system, any planned system, is compatible to individual freedom? What is the difference between a top down approach to economics and a bottom up approach to solving the economic problem? How are the ideas of the degrowth movement and the U.N. program of Agenda 21 opposed to the ideas of Adam Smith as he explained in his book *The Wealth of Nations*?
- ✓ In your opinion, do you think that Friedrich Hayek was correct or not when he warned his readers about the ill effects that excessive planning has on the economy? Why or why not?

- ✓ Google "The Baltic Dry Index." Has it gone up or down recently? Do you think this is an indication of an oversupply of raw materials worldwide, or a decline in demand? What does this say about worldwide growth?

CHAPTER 4:
DEMAND & SUPPLY

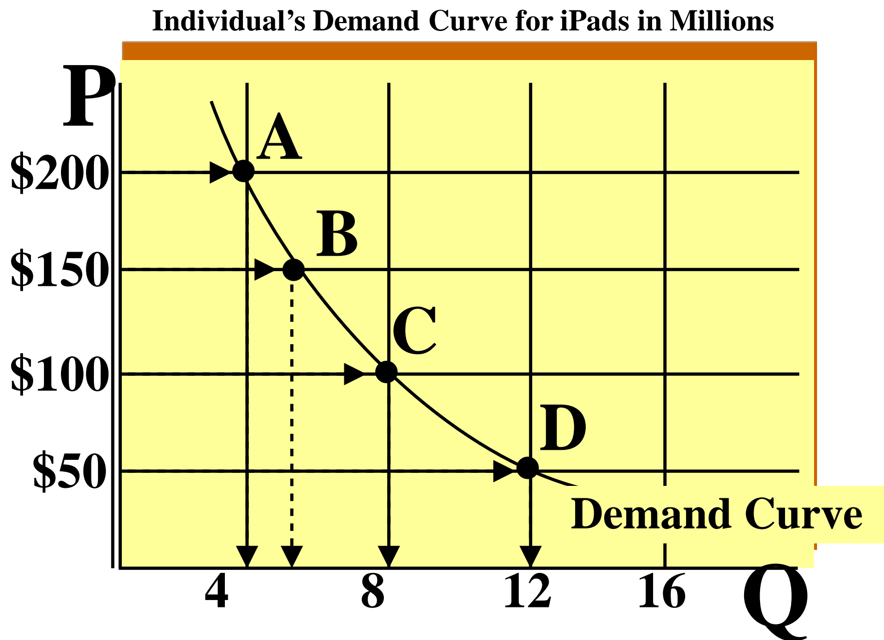
Price changes convey information from the consumer to the producer. An increase in prices let the producer know consumers want more, and a decline in prices tell the producer consumers want less. A change in the price level also gives the producer incentives. If consumers bid the price up, producers can make more money and, therefore, have an incentive to produce more. However, if consumers are not so interested, the price will fall as will the producer's incentive. Thirdly, the price mechanism gives the producer the financial ability to give consumers what consumers want because the higher prices lead to higher profits. We know this because when prices change we always assume that nothing else changes.

Price changes convey information from the consumer to the producer; give incentives to suppliers, and the financial ability to satisfy consumer wants.

Why do college graduates earn more than high school graduates do? Why do doctors make more than teachers do? Why do students with economic degrees earn high incomes? Understanding the concepts of demand and supply is crucial to answering questions by explaining the interaction of demand and supply in markets.

Before we get started, you should know the difference between a movement along a curve with a price change and a shift in the curve with a change in non-price determinants. Economists always assume that nothing else changes when price changes. If I ask you what

would happen if the price of new Cadillacs decreased by $10,000, what would you say? You would say that consumers would buy more Cadillacs. However, what would happen if other factors changed? What would happen if the price of other luxury cars dropped by more than $10,000? Then we could not come to a definitive conclusion when price changes. When price changes, we are moving along a stationary curve, but the curve itself does not change. If relevant factors other than price change, then the whole curve will shift.



DEMAND CURVES HAVE A NEGATIVE SLOPE

Consumer demand and wants are not the same things. You may want a new iPad, but you may not be able to afford it. Nor is demand the same as the need for goods and services. You may need brakes for your car, but the price of $300 may be too expensive.

The Substitution Effect

Economists give reasons for human behavior, even if their behavior is apparent. Why do consumers buy more of a good when the price decreases and less when the price increases? The substitution effect and the income effect explain this inverse relationship between price and quantity. The substitution effect recognizes that for almost anything you may want there are substitutes, at least below a particular price. The scarcity of one good relative to another helps determine a good's relative price. Keep in mind that when the

price of a good or service changes, we always assume that other prices remain constant. Therefore, if the price of Android cell phones declines relative to iPhones, consumers substitute Androids for iPhones. Economists call this principle the substitution effect of a price change.

On the other hand, an increase in the price of the iPhones, other things constant, increases the opportunity cost of Android phones. The higher opportunity cost causes consumers to substitute other phones for the now expensive Android phone, thus reducing their number of Androids demanded. Keep in mind that it is a change in the relative price – the price of one good relative to the price of other goods – that causes the substitution effect. If all prices changed by the same percentage, there would be no change in the relative price and no substitution effect.

The Income Effect

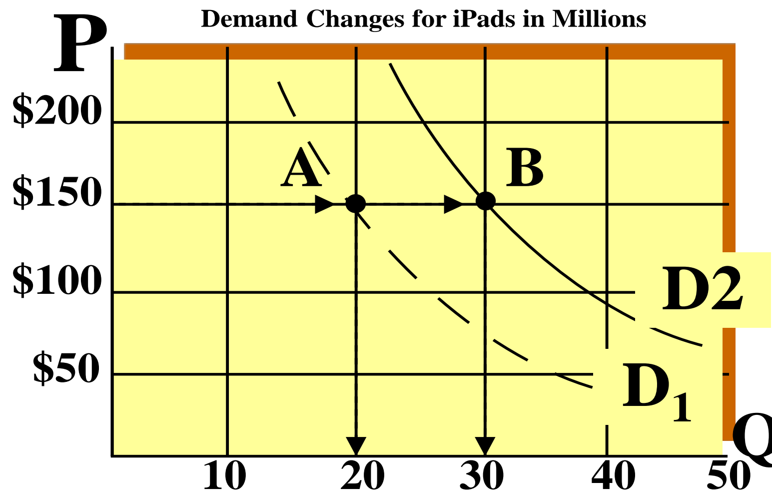
The income effect is the second reason demand curves have a negative slope. Money income is the number of dollars received per period. If prices of goods and services fall, your real income increases. Your real income, your buying power, increases because you can buy more at lower prices. When lower prices enable you to eat out four times a week instead of three times a week, you will eat out more because you can now afford it. So, as your real income increases, due to a decline in prices, the quantity demanded will increase and vice versa, everything else being equal. Thus, the income effect of a lower price increases your real income and thereby increases your ability to purchase all goods. The lower the price, the greater your real income.

REASONS DEMAND CURVES SHIFT

Real Incomes Change

Real income is a measure of buying power and, therefore, changes as prices change. When economists consider income, they always mean real income. A normal good is a good that consumers will buy more of as their incomes rise, and the demand curve will shift to the right. Steak would be an example of a normal good. An inferior good is a good that consumers will buy less of as their incomes increase. Hamburger is an inferior good and steak is a normal good.

If a non-price determinant changes, the whole curve will shift.



Tastes and Preferences Change

Consumers' tastes and preferences are always changing, causing a shift in demand curves rightward or leftward. The demand curve for a good or service will shift to the right when consumer desire increases and will move to the left when desire decreases. This change in demand may be the result of a new invention, marketing, or an event, such as a recession.

Price of Related Products Change

If the price of comparable (competing) products change, demand curves will shift. A price change causes a movement along the curve, but when prices of competing goods change, the whole curve shifts. Which way the curve shifts depends on whether consumers can substitute one for the other or if the goods are complimentary goods. If two goods are substitutes one for the other, an increase in the price of one will cause consumers to buy more of the other. Two goods are complementary goods if an increase /decrease in the demand for one will cause an increase /decrease in the demand for the other.

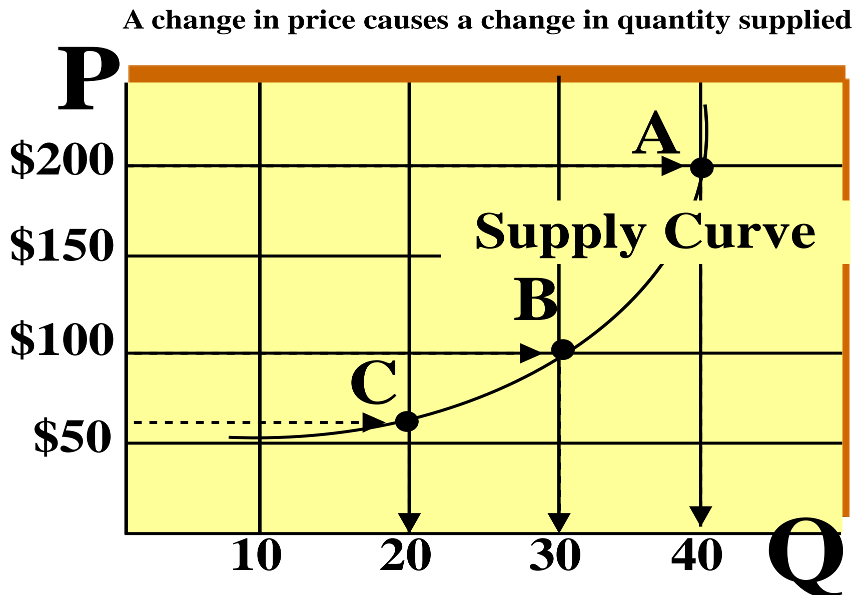
Markets Change

As more people enter the market, demand tends to increase, and as the size of the market decreases, demand tends to decrease. Have you ever wondered why there are so many strip malls? Have you noticed that restaurants often build next to a competitor? The increase in traffic flow to a location increases sales for everyone.

Expectations Change

A change in expectation can cause demand curves to shift because people tend to make decisions based on their expectation of future events. If stock investors expect the price of a stock to increase in the future, the demand for that stock will increase, and vice versa. If consumers in the housing market expect prices to increase in the future, there is a tendency for the demand for houses to increase today.

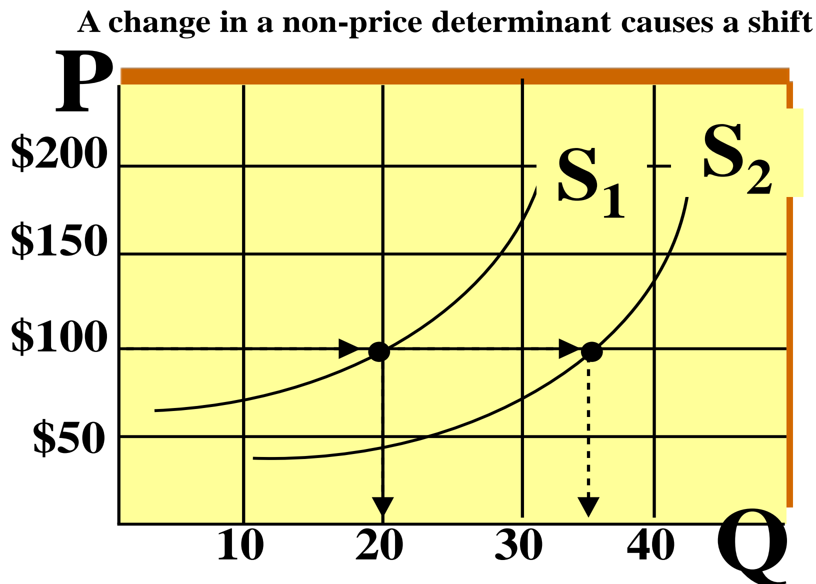
THE UPWARD SLOPING SUPPLY CURVE



When prices increase, suppliers will have an incentive to increase the quantity supplied because he/she can make more money at the higher prices. If the price decreases, the supplier makes less money and, therefore, the quantity supplied decreases. We can say this because when price changes, we always assume that nothing else changes. For example, you and other college students are the potential suppliers of labor. If wages for computer programmers increase, more students will major in computer programming, everything else being equal. If the wage rate for social workers decrease, fewer students will major in social work, everything else being equal.

SUPPLY CURVES can SHIFT

Supply curves can shift when we allow things to change other than price. Production costs, such as raw materials, labor, utilities, and maintenance are the most decisive factor shifting supply curves. When costs rise, the supply curve will shift to the left; when costs decrease, the supply curve will shift to the right. Suppliers can afford to supply more when costs decrease and cannot supply as much when costs increase. For example, when the price of fertilizer decreases, cattle farmers can afford to raise more cattle and when the price of increases, farmers will raise fewer cattle.



A Change in Technology can Shift Supply Curves

Improvements in technology contribute to better products and reduction in costs, which shifts supply curves to the right. When Microsoft came out with a tablet PC in 1999, they were not popular because they were too heavy to hold with one hand, did not have a virtual keyboard, and lacked applications. However, when Apple came out with a tablet in 2010, popularity exploded because of improvements in technology. The smaller device, the virtual keyboard, and a multitude of applications appealed to consumers.

Resource Changes can Shift Supply Curves

All businesses use relevant resources. For example, hay is a relevant resource for cattle ranchers, but not for coffee shop owners. A change in the price of hay will affect the cattle farmer, but not the coffee shop owner. An increase in the price of coffee beans affects the coffee shop, but not the cattle rancher.

Prices of Alternative Goods can Change

Vegetable farmers produce a myriad of vegetables, and each vegetable is an alternative product for all the others. A change in the price of alternative products will affect decisions. For example, suppose a farmer grows cabbage this year. Meanwhile, the government mandates more ethanol gasoline. This new mandate increases the market price of corn, giving farmers an incentive to grow more corn and less cabbage, cabbage and corn being alternative goods.

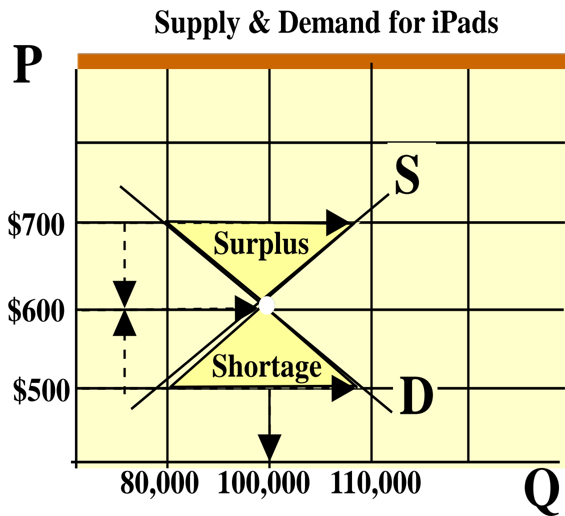
Expectations Influence Supply

Expectation is a powerful force because suppliers make decisions based on what they think will happen in the future. For example, suppose you want to start a business near Radford University. If you expect that a coffee shop would be popular, you will decide to open a coffee shop business based on your positive expectations.

MARKET EQUILIBRIUM

The market answers the three questions of what, how much, and for whom to produce. Market equilibrium is the point at which the demand and supply curve intersect, with a price agreement between the buyer and the seller. At the point of equilibrium, there is no shortage or surplus; the price clears the market and supply equals demand.

The equilibrium price is the price toward which the economy tends. Above this price, there will be a surplus and suppliers will lower the price to eliminate the surplus. Below this price, there will be a shortage, and suppliers will sell to the highest bidders.



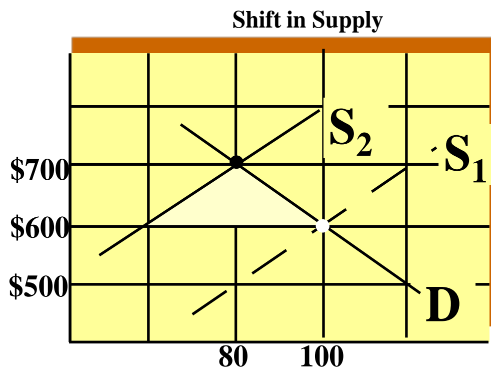
Referring to the graph to the left, imagine Apple Computer produces 100,000 iPads and sets the price at $700 each. At $700, Apple sells 80,000 units, leaving it with 30,000 unsold iPads. Apple can reduce its price to $600 to get rid of this surplus; at $600, the quantity demanded equals the quantity supplied. If Apple lowered its price to $500, there would be a shortage of 30,000 units. At 30,000 units, Apple would increase the price toward where the quantity demand equals the quantity supplied.

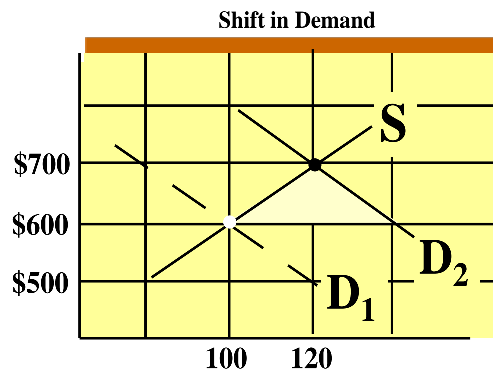
Equilibrium can Change

When variables change, demand and supply curves shift, the equilibrium changes, and markets adjust. Everything in life changes, things do not come to an abrupt halt and then stop because change is on ongoing process.

MARKETS

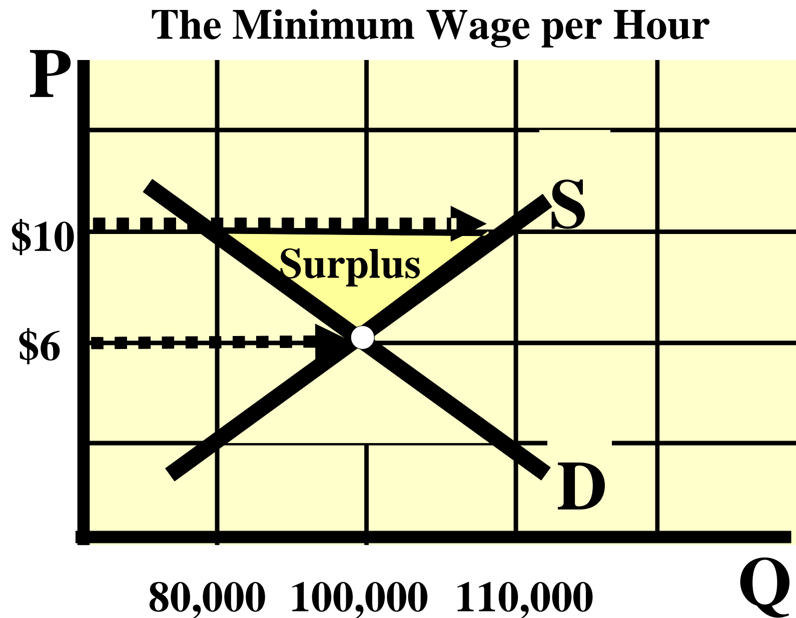
The swiftness or slowness of these changes depends on the market. In a market where there are many buyers and sellers who have no control over the price, and where everyone knows the facts and government policies do not impede market forces, the





adjustments to any change will be swift. In this case, an excessive quantity demanded or excessive quantity supplied will quickly put an upward or downward pressure on prices. The more laws prevent this flow process, the slower the adjustments and the longer it will take the market to regain its equilibrium.

PRICE FLOORS AND CEILINGS



A minimum wage law can set a price floor above the equilibrium wage. Notice there is no unemployment at the equilibrium wage of $6 an hour, the quantity of workers demanded equals the quantity supplied. Assuming this equilibrium wage of $6 an hour, when government mandates a higher wage of, let's say, $10 an hour, the number of workers demanded is less than the quantity of workers supplied.

In a free market, the wage would drop to where the quantity demanded equals the quantity supplied, restoring full employment. However, when the government imposes a minimum wage above the equilibrium wage, we end up with permanent unemployment because we are not allowing the market to adjust to changing conditions.

A consideration of a mandated minimum wage law is the effect that unemployment has on some people who will become dependent on the largesse of government. The higher the mandated wage is above the equilibrium wage, the greater the unemployment. You also have to consider that small businesses are affected a lot more than big businesses. Because most growth stems from small start-up businesses, a high minimum wage law could adversely affect growth over the long haul because it can prevent the system from adapting to changing conditions. Wage rigidity, sticky wages, can be a problem during periods of a decline in economic activity.

Keynesians argue that a redistribution of income, like unemployment benefits, stimulates the economy because of the Keynesian multiplier.

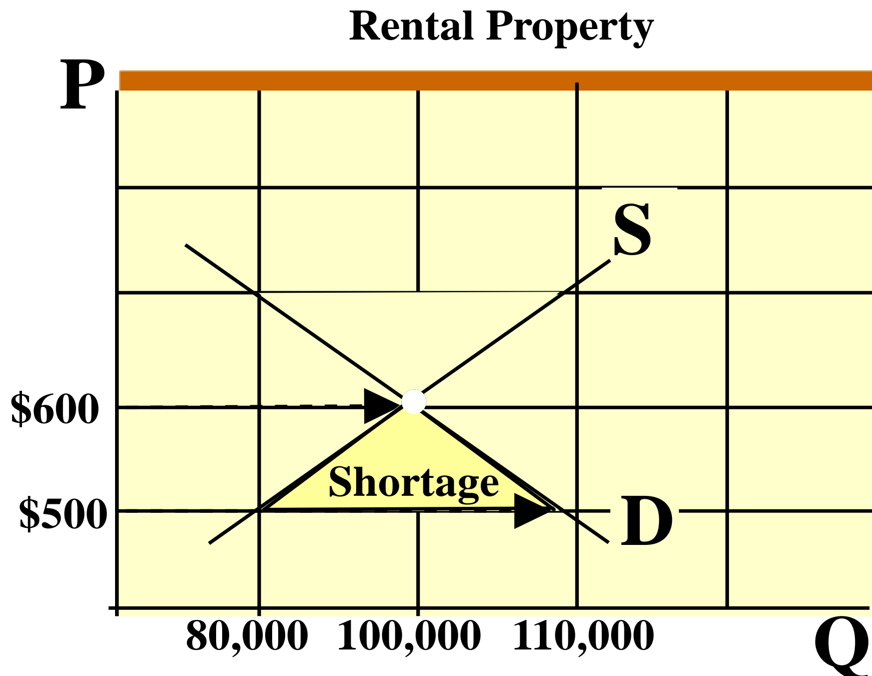
Cash transfer payments, like unemployment benefits, are at the core of Keynesian economics. Keynesians argue that this redistribution of income stimulates the economy because of the Keynesian multiplier. Because the public will save a part of each dollar they earn, but the government will spend the whole dollar, Keynesians see an increase in GDP when the government has the dollar. We will explore more about the Keynesian multiplier later in the book.

Austrians disagree with this Keynesians prognosis. Austrians believe that paying not to work means they have less incentive to work. Generous unemployment benefits also discourage business from hiring people. Because unemployment benefits raise the price at which people are willing to work, employers must pay above market wages to attract qualified employees. This raises the level of real wages and contributes to unemployment. Austrians also point out that people prefer the dignity of a job rather than welfare.

Nick Hanauer is a billionaire who made his fortune as one of the original investors in Amazon.com. He believes that current laws benefit wealthy capitalists like himself. He makes the argument that low wages and unemployment lead to lower profits. Because he believes that a strong middle class is the source of economic prosperity for everyone, he has petitioned the city of Seattle to pass a higher minimum wage law. This is a modern version of Say's Law. Say's Law states supply creates its demand. If we pay people enough to supply goods and services, they will have the money to purchase the goods and services. Thus, we get a growth economy without severe unemployment.

The government can also mandate price ceilings. Rent control is an example of a price ceiling. This government imposed low rents could cause a shortage of rental property. Suppose the equilibrium for a rental property is $600 a month. When the local government mandates a rent of $500 a month, the quantity demanded is greater than the quantity supplied resulting in a shortage.

Rent control is an example of an unfunded liability; an unfunded liability occurs when the government passes a law and transfers the cost onto someone else. The federal government can pass laws and transfer funding onto the states and states can pass laws and transfer funding to districts, and localities can pass laws and transfer liability onto private individuals.



How else could we offer more rental units at lower prices? Government could reduce taxes and impose fewer regulations on property owners, giving them more incentive to build and maintain properties. The shift to the right of the supply curve would result in more rental units and lower rents. Property owners will take care of their property because the rent received is the market rent.

So why do we have rent control laws which end up hurting almost everyone? Politics is the answer. Let us assume you are a politician running for office and you advocate increasing the supply of rental property by lowering property taxes. Most voters do not understand economics, so they believe that you favor the rich. At the same time, your political opponent promises to protect renters by imposing rent control on property owners. So whom do the voters elect? Voters elect the person who promises protection against the greedy property owners.

SUMMARY

A change in prices conveys information from the consumer to the producer as to what the consumer wants. An increase in prices let the producer know consumers want more, and a decline in prices tell the producer consumers want less. A change in the price level also gives the producer incentives. If consumers bid the price up, producers can make more money and, therefore, have an incentive to produce more. However, if consumers are not so interested, the price will decline as will the producer's incentive. Thirdly, the price mechanism gives the producer the financial ability to give consumers what they want because the higher prices lead to higher profits.

A good or service has value depending on its usefulness and level of scarcity, scarcity being defined as not enough of something to go around to everyone who wants it at a zero price. Something can be useful, but it may not have much value unless it is also scarce. Something can be very scarce, but it will not have value unless it is also useful. Usefulness and scarcity determine the market value.

Demand and supply curves indicate the usefulness and the level of scarcity of goods and services. They do this by revealing how many units consumers are willing and able to buy at various prices. The supply curve indicates the level of scarcity by how many units of a good or service suppliers are willing to supply at various prices. The demand and supply curves together determine the equilibrium price.

Economists always assume that nothing else changes when price changes. If I ask you what would happen if the price of new Cadillacs decreased by $10,000, what would you say? You would say that consumers would buy more Cadillacs. However, what would happen if other factors changed? What would happen if the price of other luxury cars dropped by more than $10,000? Then we could not come to a definitive conclusion when price changes. When price changes we are moving along a stationary curve, but the curve itself does not change. If relevant factors other than price change, then the whole curve will shift.

The price at which demand equals supply is the point toward which a free market will move. If the price is above this equilibrium price, the units supplied will be greater than units demanded resulting in a surplus, which will encourage the supplier to lower prices. If the price is below the equilibrium market price, the units demanded will be greater than units supplied, causing a shortage and higher prices.

Because demand and supply curves are always changing, market prices are in constant flux. The swiftness or slowness of these changes depends on the nature of the market. Government policies and other factors can retard the forces of demand and supply.

Demand curves will shift when there is a change in real incomes, tastes, and preferences, prices of related products, markets, and expectations. Supply curves will shift when there is a change in technology, resources, prices of related goods, prices of alternative goods, and expectations.

The swiftness or slowness of these adjustments depends on the market. In a market where there are many buyers and sellers who have no control over the price, and where everyone knows the facts and government policies do not impede market forces, the adjustments to any change will be swift.

KEY CONCEPTS

- Price changes convey information from the consumer to the producer; give incentives to suppliers, and the financial ability to satisfy consumer wants.
- Economists always assume that nothing else changes when price changes.
- When price changes we are moving along a stationary curve, but the curve itself does not change.
- Demand curves have a negative slope. When the price increases, the quantity demanded decreases, and when price decreases, the quantity demanded increases.
- Considering the demand curve, the substitution effect and the income effect explain the inverse relationship between price and quantity.
- Real income is a measure of buying power and therefore changes as prices change.
- There has to be a change in some non-price determinant in order for the demand curve to shift.
- The non-price determinants that can cause a demand curve to shift are a change in real incomes, tastes and preferences, the price of related products, the number of people in the market, and expectations.

- Supply curves have a positive slope. This means they slope upwards.

- Considering supply curves, there is a direct relationship between price and quantity. When the price increases, the quantity supplied increases and when the price decreases, the quantity supplied decreases.

- A reason for the direct relationship between price and quantity with supply curves is that as the price increases the incentive for suppliers to supply more increases. Suppliers can make more at high prices than they can at low prices. We know this to be true because we always assume that when the price changes nothing else changes.

- If some non-price determinant changes, supply curves can shift.

- A non-price determinant that cause supply curves to shift is a change in costs. When costs increase suppliers cut back production, and when costs decrease, suppliers can afford to supply more at every price level.

- Such things as workers' wages, raw materials, transportation, energy, improvements in technology and taxes, can effect production costs.

- Supply curves also shift because of price changes in resource prices, a change in prices of alternative goods, and producer expectations.

- Relevant resources are the exact resources (land, labor, capital) a business needs to produce something.

- An alternative good is a good that a business can produce with given resources as a substitute for a previous good. For example, a farmer can grow carrots or beets on the same plot of land. Carrots and beets would be alternative goods.

- A change in expectations can be a self-fulfilling prophecy. If enough consumers expect a shortage of sugar for example, and this causes a sudden increase in the demand for sugar, there may not be enough sugar on hand to satisfy the demand.

- The market answers the three questions of what, how much, and for whom to produce.

- Market equilibrium is the point at which the demand and supply curve intersect, where a price agreement between the buyer and the seller.

- The equilibrium price is the price toward which the economy tends.

- At the point of equilibrium, there is no shortage or surplus; the price clears the market and supply equals demand.

- When variables change, demand and supply curves shift, equilibrium changes and markets adjust.

- The swiftness or slowness of these changes depends on the market. The more obstructions there are the slower the adjustments.

- Technology has made these adjustments in market forces quicker and more fluid than ever before.

- A minimum wage law can set a price floor above the equilibrium wage.

- When government imposes a minimum wage **above the equilibrium wage,** we end up with permanent unemployment. This is a mathematical necessity.

- Government interference in markets may be necessary if big business has a lot of power and workers have little bargaining power. John Kenneth Galbraith, a famous economist, calls this countervailing power.

- Government can mandate price ceilings. An example of a price ceiling is rent control. These government imposed low rents could cause a shortage of rental property.

- An unfunded liability occurs when government passes a law and transfers the cost onto someone else. Unfunded liabilities can cause huge budget problems in the future.

FOOD FOR THOUGHT

✓ Suppose the government is concerned about inflation, so it is considering a wage–price freeze on all wages and prices. Is this a good idea or a bad idea? What effect

would this policy have on the price mechanism? Explain. In your answer, be sure to explain the three roles that the price mechanism plays in a free market economy.

- ✓ If the price increases for a good or service, the demand will decrease. Why is this a false statement even though consumers will buy less of the product?

- ✓ It is easy to see why demand curves have a negative slope, but why do supply curves have a positive slope. Why is it that as the price increases for a good or service the quantity supplied will increase?

- ✓ Jack gets a ten percent raise. Is Jack better or worse off?

- ✓ The Underwood Typewrite Company and Smith Corona were the two biggest suppliers of typewriters. In an attempt to increase market share in a market that was experiencing major technological changes, they vastly improved the efficiency of their typewriters through creative innovations. They both went bankrupt. What mistake did they make?

- ✓ To increase sales, the Kroger Company offered double coupons on a limited selection of food items during the first and third weeks of the month. Why did they only chose to make this offer in these two weeks? Why did they think this would increase sales on all their food products?

- ✓ Suppose that sugar is in ample supply. However, I decide to falsely spread a rumor that we are about to experience a major sugar shortage. What do you suppose will happen?

- ✓ Suppose you are a cattle farmer and you and other cattle farmers expect the price of hay to increase. What action will you and other farmers take? What will be the effect of your actions in the market for cattle?

- ✓ Suppose a company develops a drug that will vastly increase the fertility of cows. Most cattle farmers buy the drug and the number of births increase double fold. Why will this not make a difference in the supply of cattle?

- ✓ Steve Jobs, of Apple, was tired of always being at his desk to do his computer work. He thought to himself, *would it not be great if I could surf the net and email in my easy chair away from my computer*. He told his developers to drop everything they were doing and turn their attention to bringing his vision into reality. What trait of an entrepreneur was Steve demonstrating?

- ✓ Suppose you want to be wealthy someday. You want to be in a position of controlling money instead of money controlling you. Besides paying yourself first, what is the first thing you need to do? Hint, the answer has something to do with shifts in demand and supply curves.

- ✓ Suppose you are a politician running for public office. You are interested in gaining votes, so you convince voters that greedy property owners are taking advantage of renters and you can help lower rents by passing rent control laws. What will be the net effect of these rent control laws? What other policy would bring about an increase in rental property and lower rents? Why would you, as the politician, not support this alternative method of meeting most people's needs?

- ✓ The federal government wants to increase the minimum wage in all states to $10.10 an hour. Under what circumstance would this be a good idea? When would this policy be a bad idea? I am not looking for an opinion from you, but the answer is strictly mathematical. This is a question of positive economics, not normative economics. You must prove your point.

- ✓ Suppose the government passes a minimum wage law and after several years, the economy enters a deflationary period where the average price level declines by ten percent or more. What effect will this minimum wage law have on the demand and supply of labor?

CHAPTER 5:
MONEY & BANKING

Before the advent of money, there was barter. Barter is the practice of trading one good for another. When people barter, they have to find someone who has what they want and vice versa. Money eliminates this double coincidence of wants. Money can be anything that signifies someone's credit and debit in a financial transaction. In fact, most of our money is digital; it is simply bits and bytes on a computer.

Different forms of money have varying liquidity levels. The easier something is to spend, the greater its liquidity. Cash can be liquid or illiquid. You can buy a cup of coffee with cash, but you cannot rent a car or pay your mortgage with cash. Checks are liquid, but not always. People who do not know you are hesitant to accept a check from you. However, checks can be useful to pay your bills.

Gold or silver does not back up fiat money, such as the U.S. dollar. Therefore, the U.S. dollar is debt; it represents money owed to you by the Federal Reserve. President John F. Kennedy attempted to replace America's fiat money with real money on June 4, 1963. On this date, he issued Executive Order 11,110. Executive Order 11,110 gave the Treasury Department the explicit authority to issue silver certificates against any silver bullion, silver, or standard silver dollars in the Treasury. This means that Executive Order 11,110 gave the federal government the authority to introduce silver backed money into circulation. The government had circulated more than $4 billion in $2 and $5 denominations before Lee Harvey Oswald assassinated him. After the assassination, the

government withdrew silver certificates from circulation and ceased issuing the new currency backed by silver. However, Executive Order 11,110 remains on the books and is, therefore, still the law of the land.

THE VALUE OF MONEY

Money has value because it is useful and relatively scarce, the same reason that anything has value. The U.S. Treasury has engraved the words this note is legal tender for all debts public and private on every dollar bill. This statement makes it legal to pay debts with dollar bills, and therefore, helps add value to them. Private debt is a debt owed to another person, and public debt is money owed to the government.

America was able to enhance the value of the dollar beginning with the Bretton Woods Conference in 1944.

Currencies have value when foreigners need the currency of a country to buy things from that country. If a country did not have anything that consumers wanted, then its currency would be worthless around the world. Currencies have value only when people are willing to accept them for payment for valued goods and services. The general price level determines the exact value of money. Deflation increases the value of money and inflation decreases its value.

America was able to enhance the value of the dollar beginning with the Bretton Woods Conference in 1944. Seven hundred and thirty delegates attended the meeting from 44 Allied nations for establishing an international monetary system. Consequently, countries pegged their currencies to gold and promised to exchange currencies for gold upon demand. America agreed to exchange dollars at the rate of $35 per ounce of gold. This gold backing helped to give value to the dollar. Then in 1971, President Richard Nixon severed this link to gold when he closed the gold window, disallowing convertibility. After Nixon had closed the gold window, countries allowed their currencies to float, whereby the market determined value. This severing of the tie between the dollar and gold would have decreased the value of the dollar over time, except for the emergence of the Petro-Dollar System.

The Petro Dollar System propelled the American dollar into becoming the world's reserve, sometimes called standard, currency.

In the early 1970s, after the international gold standard collapsed, Americans began to live beyond their means by borrowing. The government also increased its spending with created money, putting the dollar at risk internationally as the supply of the dollar increased on the international market. Now enters Henry Kissinger and the Petro Dollar System. Under the Petro Dollar System, America entered into an agreement with Saudi Arabia. America promised military protection and Saudi Arabia promised to accept only dollar payments for its oil. This agreement was such a good deal for Saudi Arabia, soon other oil countries followed suit. This Petro Dollar System propelled the American dollar into becoming the world's reserve currency, sometimes called the world's standard currency.

A standard currency is a currency that countries use to settle international transactions. To trade with other countries, a country has to exchange its currency for the standard currency. Therefore, despite the prolific habits of Americans and the federal government, the dollar was able to retain its value because other nations needed it for international transactions. The dominance of the American dollar internationally is a reason the average American enjoys a high standard of living. However, this advantage is eroding as America has abused its leadership position, and other countries are finding alternative monetary arrangements. We will explore more details of the Petro Dollar System later in the book.

MONEY HAS DIFFERENT USES

People use money as a unit of account, store of value, standard for deferred payment, or a medium of exchange. If I say a Cadillac is worth $40,000, and a Ford is worth $20,000, I am using money as a unit of account. If I put $5,000 into a savings account, I am using money as a store of value. People cannot store a value with credit cards, and therefore credit cards are not money. When I pay for something over time, I am using money as a standard of deferred payment. When I pay cash for goods and services, I am using money as a medium of exchange.

The properties of money are scarcity, portability, and divisibility. The more scarce money is, the higher will be its value; and the more plentiful money is, the lower will be its value. If dollar bills became so plentiful that we could scoop them up off the ground, they would be worthless. When units of money increase, it takes more units to add up to the value of goods and services, thus we get inflation. People have to be able to transport money from place to place. Bills and coins are portable because they conveniently fit into your pocket. Money also has to be divisible because of different prices, so we have pennies,

nickels, dimes, quarters and dollars. Because nothing metallic backs up Federal Reserve Notes, some economists refer to them only as currency.

Commodity money is anything that serves both as money and as a commodity. A cigarette is a commodity because it is useful for something other than money, but people can use cigarettes as money. Prisoners use cigarettes and other items as a medium of exchange in prisons. Token money is money that exceeds the value of the metal in the coin. There is only pennies worth of silver in quarters. When the metal content becomes more than the face value of the coin, people will melt the coins to sell the metal, a practice called debasing the currency.

BANKING HISTORY

The first bankers were goldsmiths in the middle ages. Back in the middle ages, 1154-1485, people used gold and silver as a medium of exchange. Goldsmiths were persons who offered a haven for gold. When people deposited gold, they would receive a certificate, which they could use to redeem their gold in the future. Goldsmiths realized that they could lend a part of their gold holdings and lend it out at interest. As long as goldsmiths had enough gold on hand to meet day-to-day transactions, the system flourished. This is essentially how our modern banking system works. Because banks lend out most of their cash holdings, only a small fraction resides in bank vaults to meet day-to-day transactions. This is why we call our banks system a fractional reserve system.

COMMERCIAL BANKS AND THE FED

The U.S. banking system consists of a network of privately owned commercial banks, and government sanctioned Federal Reserve Banks. America's central bank is the Federal Reserve, often referred to as the Fed. A commercial bank is an institution that accepts demand and savings deposits and makes loans to the public. A demand deposit is an account by which a bank pays no interest and on which people can write checks. A savings deposit is an account whereby a bank allows depositors to receive interest.

Commercial banks make a profit by attracting funds by paying interest or offering other services and lending the money out at interest. Commercial banks get their legal status from the state's banking commission or the federal government. Commercial banks can be national or state chartered. All national banks belong to the Federal Reserve System,

but membership is optional for state banks. There are approximately 7,000 banks in America, but over half of total assets reside in the following six banks: Bank of American Corporation, JP Morgan Chase and Co., Citigroup Inc., Wells Fargo and Co., Goldman Sachs Group Inc., and Morgan Stanley.

The federal government protects banks from losses but then regulates them. This relationship has consequences because banks find ways to thwart the regulations, and in turn, the government penalizes banks for their irregularities or illicit acts. For example, Goldman Sachs Group, Inc. paid $550 million to settle claims by the Securities and Exchange Commission (SEC) that it misled investors. When Bear Stearns and Washington Mutual, two financial firms, faced bankruptcy because of fraudulent activity, the federal government encouraged JP Morgan to acquire their assets. The SEC fined JP Morgan Chase & Co. $13 billion for its transgressions but mostly for the sins of Bear Stearns and Washington Mutual.

MONETARY POLICIES

Monetary policies are policies of the Federal Reserve to regulate the nation's money supply.

Monetary policies are policies of the Federal Reserve to regulate the nation's money supply. If we have an inflation problem, the Fed will make it more difficult to borrow money, and if we have unemployment, the Fed will make it easier. When the Fed changes the availability of money, interest rates change; loose policies will lead to lower interest rates, and tight policies will lead to higher interest rates. Monetary policies can be ineffective at fighting unemployment because, although the Fed can make it easier to borrow money, it cannot force people to borrow. Unemployed people will not borrow money just because of low-interest rates. A liquidity trap occurs when banks cannot lend enough money; insufficient borrowing traps money in banks because of excessive liquidity.

We have a fractional reserve banking system, meaning that banks are required to keep a fraction of their assets in reserve. Banks can only lend money from their excess reserves, money above their required reserves. The Fed influences a bank's liquidity by encouraging an increase or a decrease in bank's excess reserves. The greater the excess reserves, the higher the bank's liquidity and the more money the bank can lend. The Fed will boost bank's liquidity during periods of unemployment and diminish it during inflationary times. The Federal Reserve can also influence the money supply when it collaborates with the federal government. When the federal government sells bonds to the

Federal Reserve, and the Fed creates money to buy the bonds, the money supply can increase when the government spends this money.

The Zero Interest Rate Policy, ZIRP, is a Fed strategy to put downward pressure on interest rates. When unemployment is a problem, the Fed may choose to increase bank's liquidity and push interest rates down to near zero. When interest rates are near zero, the Fed can no longer lower interest rates, making monetary policy less effective. When banks experience a liquidity trap, the Fed looks for other ways to force banks to lend money. The new buzzword the Fed uses to refer to this strong-arm policy is macroprudential. Absence a liquidity trap, the Fed can affect change in bank's liquidity by changing open market operations, the discount rate, the federal funds rate, and reserve requirements.

The Zero Interest Rate Policy, ZIRP, is a Fed strategy to put a downward pressure on interest rates.

Open Market Operations

Congress did not establish the Federal Reserve so that it could make a profit, although it is a virtual money machine. The official purpose of the Fed is to improve stability by tempering the twin problems of inflation and unemployment. The most common monetary policy is buying or selling securities, which the Fed can do from banks or on the Open Market.

Congress did not establish the Federal Reserve for making a profit, although it is a virtual money machine.

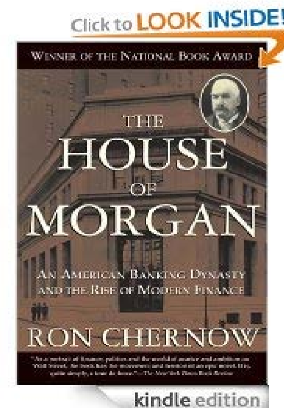
The Open Market is a place where people buy and sell bonds. Open market decisions, made by the Open Market Committee, is the most common monetary policy. Suppose you buy a bond for $8,000 with a face value of $10,000 that matures in ten years. At the end of ten years, you can redeem the bond for $10,000. Instead, let us suppose that two years after the original purchase you decide to sell the bond to the highest bidder. Whoever owns the bond when it matures can receive $10,000 from the original issuer of the bond. Not all bonds work like this, but this will give you an idea of how the bond market works.

The Open Market is a place where people buy and sell bonds. Open market decisions is the most common monetary policy.

A change in interest rates will affect a bond's price, rising interest rates will reduce its market price and falling interest rates will increase the price. Bond sellers have to lower their prices when interest rates are increasing to attract buyers. Bond sellers can raise prices when interest rates are falling because they are in a better bargaining position.

When banks purchase securities from the Fed or in the open market, their excess reserves decline because they have less cash and more securities on hand. When banks sell securities, their excess reserves increase because they now have more cash.

Suppose we have an unemployment problem. The Fed now buys bonds from banks or buys them in the Open Market; let us say $100 million worth of bonds. We can postulate that the Fed purchases $50 million worth of bonds from commercial banks and $50 million from government bond dealers, business corporations, and individuals. When a commercial bank sells $50 million worth of bonds to the Federal Reserve, its bond holdings decline by $50 million, and the Fed credits the bank's reserves by $50 million. The bank's liquidity increases as its excess reserves increase, allowing the bank to lend more money. If it succeeds in lending more money, perhaps by lowering interest rates, demand increases and employment increases.



The House of Morgan
by Ron Chernow
Grove Press Pub., 2010
Image from Amazon.com

Suppose we have an inflation problem. In this case, the Fed will sell bonds in the Open Market or directly to banks. How does the Fed convince banks and others to buy its bonds? The Fed will offer to sell the bonds at a low price. Banks will now exchange cash for bonds, which decreases the bank's excess reserves, leaving less money to lend. When banks lend less money, demand decreases, putting downward pressure on prices.

Changing the Discount and Federal Funds Rate

The discount rate is the interest rate that banks pay when they borrow money from the Federal Reserve. The Fed can influence the money supply by changing the discount and federal funds rates. When a bank's reserves fall below a certain level, the bank will borrow money from the Fed. The federal funds rate is the interest that banks pay when they borrow money from one another.

A higher discount rate makes it more expensive for banks to borrow money from the Fed, and a lower rate makes it less expensive. During inflationary times, the Fed wants banks to borrow less money, and during periods of unemployment, the Fed wants banks to borrow more money. Changing the discount rate affects the entire financial community because bankers, business people, and investors often make decisions based on expected changes in interest rates.

The prime interest rate is the interest rate charged by banks on short-term loans made to large commercial customers with the highest credit score. The prime interest rate is the lowest rate banks offer, although the government subsidizes some loans, and they seem lower than the prime rate. When the Federal Reserve lowers the discount rate, the prime interest rate should decline, and, after a time lag, other interest rates fall. The same is true when the Federal Reserve raises the discount rate; the prime interest rate should eventually increase.

Changing Reserve Requirements

The Federal Reserve can raise reserve requirements during periods of inflation and lower them during recessionary times. Higher reserve requirements lower a bank's excess reserves and lower reserve requirements raise a bank's excess reserves. If a bank can lend out more money because its excess reserves increase, demand increases, and jobs opportunities should increase. However, notice again that banks cannot force people to borrow more money. There are reasons during recessionary times that people may not borrow more money despite the bank's efforts to lend more money. Even though changing reserve requirements can be the most powerful monetary tool, it is the least used because changes in reserve requirements can adversely affect a bank’s business plan. It is like changing the rules half way through the game. This may cause instability in the banking system.

ORGANIZATION

Congress divided the United States into twelve Federal Reserve districts when it passed the Federal Reserve Act in 1913, with each district having a Federal Reserve Bank and at least one branch bank. The two decision-making bodies of the Federal Reserve are the Board of Governors and the Federal Open Market Committee (FOMC), with the Board of Governors being the primary decision-making body. The President appoints each of the seven members from a list given to him by the Fed and submits his nomination for approval to the Senate. Board members serve for one 14-year term, exceptions being the chairperson

and vice-chairperson who serve repeating four-year terms with the President's approval. The seven board members and five Federal Reserve Bank presidents make up the FOMC. The president of the New York bank serves as a permanent member of the FOMC while other bank presidents rotate as members each year. The FOMCs sole purpose is to make decisions regarding the buying and selling of securities.

HISTORY OF THE FEDERAL RESERVE

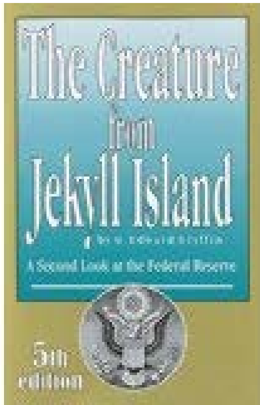
Will Rogers used to say that the three great inventions since the beginning of time are fire, the wheel, and central banking. Congress chartered the first central bank in the United States from 1791 to 1811. It handled 20% of the nation's money supply, with state banks supplying the rest. The idea of a central bank was not popular with everyone; Thomas Jefferson saw it as an engine for speculation, financial manipulation, and corruption. Congress abolished the central bank in 1811. However, in 1816 the federal government chartered its successor. President Andrew Jackson believed that the bank favored prominent businesses over ordinary people, and he destroyed the Bank by vetoing its 1832 charter and withdrawing funds in 1833. He rescinded the bank's charter for the following reasons: It concentrated control, encouraged foreign interests, served the rich, exercised too much control over Congress, and it favored northeastern states over other states.

The Federal Reserve became a reality because of a flaw in the Constitution. The Supreme Court has the final word in interpreting the meaning of the Constitution. What this group of appointed men decree has been accepted as law of the land, whether or not it is by the text of the Constitution or the intent of its framers. In other words, the Supreme Court can make decisions that are obviously contrary to the Constitution, yet its decisions become the law despite the contrary wording of the Constitution.

The Constitution specifies that Congress shall issue our money and determine its value.

Constitutionalists, people who study the Constitution, question the legality of the Federal Reserve Act because it gives private banks the license to create money, issue money, determine its value, and lend it at interest to the government and other borrowers. Article 1 – Section 8 of the U.S. Constitution gives Congress the power to coin money and regulate the value. However, the Supreme Court decreed that Congress could delegate this power to the bankers. If Congress can delegate one of its constitutional responsibilities to others, it can give away all of its power.

G. Edward Griffin is the author of the book *The Creature from Jekyll Island*. Following is a quote from the book.



The Creature from Jekyll Island
by G. Edward Griffin
American Media Publication., 2010
Image from Amazon.com

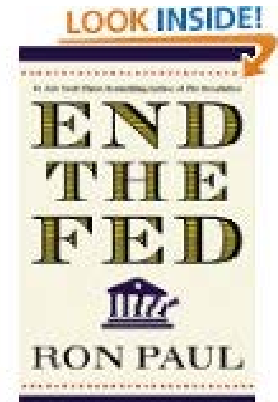
The Federal Reserve System was concocted not to stabilize the economy but to put economic control into the hands of a few people who agreed not to compete with one another. They needed to smear lipstick on the pig by giving it a different name that people would misinterpret as being part of the federal government and not a cartel-driven central bank. The name they came up with was the Federal Reserve System, and to this day, many people assume that it is a part of the Federal government; it is not and never was.

The Federal Reserve got its start on Jekyll Island in 1910, then a privately owned island off the coast of Georgia. The participants of that meeting represented the most powerful banks in the nation and had financial roots in the largest banks of Europe. Those American institutions included the J.P. Morgan companies, the banking conglomerate of William Rockefeller, and Kuhn, Loeb, and Company, the Rothschild banks of England and France and the Warburg banking consortium of Germany and the Netherlands. Historians believe that Paul Moritz Warburg was the mastermind behind the Federal Reserve System. This group represented a financial trust (competitors that agree to cooperate) that controlled approximately ¼ of the wealth of the entire world.

In the Saturday Evening Post, on February 9, 1935, Frank Vanderlip, who was at the meeting, published a detailed account of this secret meeting. Vanderlip explains that the meeting was secret because the purported reason for the Federal Reserve was to break the grip of the money trust, but they were the money trust!

In 1913, during the presidency of Woodrow Wilson, during the Christmas break when many members of Congress went home for the holidays, Congress passed the Federal Reserve Act. Now, instead of the federal government having the power to print money, the Fed loans money into existence at interest. Why else would every dollar bill have written at the top *Federal Reserve Note*? A note being an IOU, it signifies a debt. The Fed is a for profit private corporation who can legally create money, it can charge debtors interest, and banks can confiscate people's property if they default on their loans.

The Fed makes most of its money through interest on U.S. government and mortgage backed securities. Presently the Fed owns the majority of mortgages and U.S. government bonds. The Federal Reserve also makes money through interest on loans made to banks and by selling stock in the Federal Reserve System to member banks.



End the Fed
by Ron Paul
Grand Central Pub., 2009
Image from Amazon.com

The debate over the validity of the Federal Reserve continues today. *End the Fed* is a book written by Ron Paul, a former member of the U.S. House of Representatives, in which he challenges the legality and the usefulness of the Federal Reserve. This book debuted at number six on the New York Times Best Seller list. Ron Paul takes the stand that the Fed is both corrupt and unconstitutional. Paul contends that the Fed is a cartel that is adept at privatizing losses while socializing losses. The Fed can socialize losses by bailing out big banks, as it did in the financial collapse of 2007-2008.

THE FDIC

The government established a public agency in 1933 called the Federal Deposit Insurance Corporation (FDIC), as a response to frequent bank failures between 1930 and 1933. The purpose of the FDIC is to promote stability by instilling customer confidence in banks by ensuring each bank account up to a specified amount. Currently, that amount is $250,000. The FDIC can also serve as Receiver for a bank's assets in the case of bankruptcy.

TWO POLICY CHANGES BY THE FED

There have been significant changes in Fed policies since the financial collapse of 2007-2008. First, Congress granted the Fed permission to pay interest on a bank's reserves, which is potentially problematic in that it discourages banks from making loans to individuals and businesses. Faced with a

There has been a significant change in Fed policies since the financial collapse of 2007-2008.

choice of making loans to the private sector or collecting risk-free interest from the Federal Reserve, many banks have chosen the risk-free option. With more money flowing from banks to the Fed, less money is available to lend to the public, especially with the artificially low-interest rates.

Another development since the financial collapse of 2007-2008 is that for the first time in history, the Fed announced that it would grant loans to entities other than commercial banks or the federal government. Since 2008, the Fed has been lending money to favored businesses while refusing loans to others. Instead of letting the market decide who gets these loans, the Fed now makes many of these decisions.

THE DEMAND DEPOSIT MULTIPLIER

The demand deposit multiplier explains how the banking system can multiply the money from every deposited dollar, depending on the reserve requirement. The following explanation makes two assumptions: that all banks are exactly meeting their reserve requirement and that banks can lend out all of their excess reserves. For the sake of simplicity, let us assume that all reserve requirements are 50 percent though ten percent would be more realistic.

Consider what happens when a customer deposits $100 and writes a check for it. The bank will keep $50 in reserve to meet the reserve requirement and lend out $50. Whoever borrows the $50 will spend or invest it, so let us suppose he/she spends it on clothing. At the end of the day, the clothing store deposits the $50 in its bank. When the second bank receives the $50, it will keep $25 and lend out $25. Whoever borrows the $25 will spend it and whoever receives the $25 will put it in their bank. Now the third bank will keep $12.50 and lend out $12.50 and so on to the last penny.

The demand deposit multiplier determines how much total spending increase when someone makes a bank deposit. The formula is $D = 1/R$, and R represents the reserve requirement. In the above example, the required ratio is 50 percent or ½; therefore, $D = 1/½$ or 2. Taking the multiplier 2 and multiplying it times the initial deposit of 100 dollars, we see that total spending increases by 200 dollars. This process works in reverse when people withdraw money. This is money multiplication, not money creation.

When the multiplier is two, the Fed will increase the money supply by one-half of the desired goal. For example, to increase the money supply by $200 billion, the Fed would initially increase the money supply by $100 billion.

CONFLICTING POLICIES

Keynesians support our present fiat money system and central banking; Austrians support a money system that gold and silver backs, or at least something that a central authority cannot create out of thin air. Austrians call U.S. dollars currency, they do not call it money because they believe that it is not real money.

Keynesians believe that the Fed is necessary to manage the country's money supply, and Austrians believe it has caused booms and busts by misallocating resources.

Keynesians believe that the Fed is necessary to manage the country's money supply, and Austrians believe it has caused booms and busts by misallocating resources. Keynesians believe that policymakers can make sound policies with accurate predictions. Austrians believe that life is unpredictable, and therefore economics is not a pure science. Keynesians tend to support discretionary policies, saying the Fed should make decisions based on the situation. Austrians believe that a money system based on a set of clearly defined rules should govern our monetary system. If we are going to have a central bank, the bank should be a part of the government and it should adhere to a predetermined set of rules whereby policies do not change from time to time based on the whims of banking authorities.

Keynesians and Austrians disagree on the subject of interest rates. Keynesians tend to think that low-interest rates will encourage more borrowing and, therefore, increase aggregate demand. Austrians are more concerned that the low-interest rates will adversely impact saving and investing. Austrians believe that market forces should determine interest rates. The artificially low interest rates encouraged by the Fed may increase demand in the short run, but economic growth ultimately depends on the country's ability to save and invest. Austrians point out that artificially low interest rates discourage savings in traditional savings accounts and encourage risk taking as people chase after higher returns on their savings. Instead of the elderly putting their money in safe money market accounts, the low-interest rates force them to invest in the stock market and other risky ventures.

Keynesians believe their policies can alter market conditions, Austrians believe that ultimately monetary policies cannot change market conditions.

A big difference between Keynesians and Austrians hinges on their differing opinions concerning the free market. Keynesians believe their policies can alter market conditions, Austrians believe that ultimately monetary policies cannot change market conditions. Austrians would point to the actions of Switzerland as an example of this.

Under a gold standard, monetary authorities cannot create money, but with a fiat currency, there is no limit to how much money banking authorities can create.

Switzerland tried for several years to manage the market by pegging their currency, the franc, to the euro. When market pressures tended to increase the value of the franc relative to the euro, Swiss banking authorities increased the supply of francs to bring the value down, keeping it at par with the euro. Eventually, however, their efforts were in vain due to the huge costs, and the Swiss lifted the peg and let their currency seek its equilibrium. Therefore, the value shot up almost overnight, to where it would have been without the peg. So, instead of changes taking place slowly over several years, giving everyone a chance to adjust to the changing conditions, panic and major disruptions occurred due to the rapid change in events.

How did the Swiss banking authorities influence the value of their currency? To understand how authorities can manipulate markets, you must understand how monetary authorities can create money out of thin air. Under a gold standard, monetary authorities cannot create money, but with a fiat currency, there is no limit to how much money banking authorities can create. To create means to make something from nothing. Economists call this quantitative easing or monetizing the debt.

QUANTITATIVE EASING (MONETIZING THE DEBT)

The Federal Reserve is the federal government's bank. Just like you can put money into your bank and then write checks against the money, the federal government deposits money in its account at the Federal Reserve and then writes checks against that money.

The only way the federal government borrows money is by selling bonds, which we call securities. Economists call these bonds securities because the federal government has never defaulted on a loan, and therefore, its bonds are very secure. When the federal government sells bonds to the Federal Reserve, and the Fed creates new money to purchase these bonds, economists call it monetizing the debt or quantitative easing (QE).

When you put 100 dollars into your bank account, your bank credits your account by one hundred dollars. Notice that your money now is simply electronic; your money is ones and zeros on a computer. If you had one hundred dollars to deposit at your bank and the bank teller made a mistake and credited your account by one thousand dollars, could you spend that thousand dollars and is that thousand dollars real money? The answer to both questions is yes.

Now you can understand what happens when the federal government sells bonds to the Federal Reserve. The Fed can purchase bonds by using existing currency, or it can create the money by crediting the federal government's account by X amount. The Fed designates this credit by simply pushing a few keys on its computer. Notice what is happening here. The Federal Reserve creates money out of thin air, and then lends it out and collects interest on this newly created money! The Fed can do the same when it purchases bonds from the private sector. How is it legal for a cartel owned by private banks to create money and then lend it out at interest? Moreover, how is it possible that the bank can reposes people's properties if they default on their loans? The Federal Reserve Act of 1913 made this practice legal.

The Federal Reserve can cause inflation by increasing the money supply more than goods and services increase. When dollars become more plentiful, the value of each dollar diminishes; therefore, it takes more of them to add up to the value of whatever you buy.

So why have massive amounts of money created over several years not caused an inflation problem in America? For the creation of new money to cause inflation, it has to circulate throughout the national economy.

The **first** reason QE has not caused inflation is that a lot of this new money has flowed into other countries instead of circulating in America. Because the U.S. dollar is the world's standard currency, there is a huge demand for it by other countries.

In order for the creation of new money to cause inflation, it has to circulate throughout the national economy.

Second, when banks receive this newly created money but do not lend it out to the public, the money will not cause inflation. Banks have kept trillions of dollars of excess reserves at the Fed rather than lending the money to the public. There is less risk when banks deposit the money at the Federal Reserve than there is if the banks had lent the money to people. One reason for keeping reserves at the Fed is that the Fed pays interest on deposits.

The **third** reason we have not experienced more inflation is the sluggish economy. Because of the economy's slow growth rate, the velocity of money is very slow. When economists say that velocity is slow, they mean that a dollar changes hands from person to person at a slow rate. During boom periods, money changes hands very quickly, but during economic slumps, money changes hands very slowly. A decrease in the velocity of money can inhibit inflation despite the increase in the quantity of money in circulation.

The **fourth** reason an increase in the money supply may not cause inflation is that banks have paid out $250 billion-plus in penalties to the federal government in recent years. Banks would have lent this money to the public, but instead the money went into the government's coffers. It is almost as if the nation's largest banks have become a giant ATM for the federal government. Even though the federal government may spend a large part of this money, some of it does not get back into the national economy. For example, the government may use some of the money to pay interest on the national debt owed to foreigners. If the velocity of money declines relative to the money supply, the economy could experience deflation. Instead of a rise in the average price level, the average price level declines during deflationary times.

Austrian economists believe that the very existence of quantitative easing as a policy tool creates unpredictability as traders speculate whether the Fed will intervene again. By replacing large decentralized markets with centralized control by a few government officials, the Fed is distorting incentives and disrupting normal free market business practices.

Because Austrians believe in sound money, money that has some form of backing or at least is restricted by a set of rules, they do not agree with the Fed's policy of quantitative easing. One reason Austrian economists disfavor quantitative easing is that near-zero interest rates channel credit to the government, corporations, and wealthy individuals. Because making loans to small businesses and people with low and medium incomes is riskier than lending money to more affluent people, banks shut the door on the little person. In a market system, banks allocate credit based on the price of credit and the riskiness of the borrower. The result of quantitative easing and artificially low interest rates is that low-interest rates tend to channel money to the safest borrowers, which are seldom the best job creators.

In a market system, banks allocate credit based on the price of credit and the riskiness of the borrower.

Austrians also believe that quantitative easing also leads to malinvestments. Malinvestments are investments that only take place with artificially low interest rates. Once a market correction takes place and price signals normalize, many of these

investments falter. The easy credit leads to a boom and the correction leads to a bust. In the 1940s, Ludwig von Mises and Friedrich Hayek warned us about the ill effect of easy credit. Hayek won the Nobel Prize in economics in 1974, along with Gunnar Myrdal, in part for his work on this boom and bust theory of easy credit. His work showed that artificially low interest rates and excessive credit creation result in a volatile and unstable imbalance between saving and investing.

The Fed's expansionary monetary policy can hurt foreign nations. When the United States increases the money supply, dollars on the global market tend to increase. The increase in dollars tends to reduce the dollar's value, and, in essence, raises the value of other currencies. For example, when the value of Brazil's currency, the cruzeiro, increases in value relative to the dollar, Brazilian products become more expensive to non-Brazilians, which inhibits exports.

Austrians point out that America is not alone with the practice of quantitative easing. Quantitative easing has trapped central banks in Japan and Europe in the same loop as the United States. These central banks believe that zero interest rates stimulate the economy and combat deflationary pressures. Despite their efforts of QE, however, median incomes along with prices and growth remain sluggish.

After years of sitting on the sidelines, the European Central Bank (ECB) has joined the fray and has engaged in its QE policy. These expansionary monetary policies usually weaken a country's exchange rate, which boosts exports. Austrians see quantitative easing generally, and the ECB bond-buying program, in particular, as a major political negative if it gives European governments a further excuse to avoid needed economic reforms.

Austrians believe that central bankers, in both America and elsewhere, should be urging their governments to pursue practical pro-growth solutions that would encourage private investment and new jobs. The economic pie will continue to shrink unless there is an increase in after-tax profits of small businesses and an increase in investment start-ups.

In most of the developed world, policy makers have opted the easy way out with quantitative easing (QE) instead of making hard choices.

In most of the developed world, policymakers have opted the easy way out with quantitative easing policies instead of making hard choices. Austrians compare QE to a person who takes drugs. The drug masks the pain for a while and even brings about a brief feeling of euphoria, but once the drug wears off, the economy plunges into despair. With each go around of QE, it takes more money to achieve that high feeling and eventually the

system will crash as more and more QE causes major distortions in the market. Monetary policies has its uses, but it cannot perform miracles.

THE FED ACTS AS A NATIONAL CLEARING HOUSE

Have you ever wondered what happens to your check after you cash it? Before we find out, let us see what happened to checks in the days of old. In the early days of banking, banks would give checks to a messenger who would walk to other banks to exchange the checks for money. One day, a tired and thirsty messenger stopped at a pub. While he was waiting for his pint, another messenger came in, tired and thirsty from his daily walk. They sat together, each with his bag of checks, discussing their routes. After talking a bit, they discovered they could save themselves some legwork by exchanging their respective checks and marking them canceled.

Consider messenger A on his way to Messenger B's bank with $750 worth of checks and messenger B on his way to Messenger A's bank with $800 worth of checks. What about the extra $50 that Messenger A owes Messenger B? In this case, each bank keeps track of who owes whom what. It was not long before these meetings became the first clearinghouse. The Federal Reserve serves as a common clearinghouse for all banks in the United States.

THE FED HELPS THE FEDERAL GOVERNMENT

Traditionally the Fed has worn many hats. A critical role is to act as the federal government's bank. Just like any bank, the Fed accepts government deposits and honors checks written against these deposits. Another function is to help keep currency and coin in good repair. The Fed replaces worn bills with new bills printed by the Federal Bureau of Engraving and Printing. Banks need to replace paper money periodically because the life span of dollar bills, especially one-dollar bills, is short. The average lifespan of a one-dollar bill is 18 to 22 months. This short life span of dollar bills is one reason Canada has replaced all its currency with plastic bills. Plastic lasts a lot longer than the fabric bills the U.S. uses.

The Fed Helps Enforce the Dodd-Frank Act

Congress has no authority over the Consumer Financial Protection Bureau (CFPB) because a Presidential executive order brought it into existence in 2010. The Dodd-Frank Wall Street Reform and Consumer Protection Act placed it under the Federal Reserve for funding purposes. However, the Fed has no authority over this bureau.

The CFPB protects consumers from abusive and deceptive practices and has almost unlimited control over the nation's financial sector. Its jurisdiction includes banks, credit unions, securities firms, payday lenders, mortgage-servicing operations, foreclosure relief services, debt collectors, and any financial company operating in the Unites States. At the end of each fiscal year, after the Fed meets its annual operating expenses, it gives ten percent to the Consumer Financial Protection Agency.

Austrian economists oppose the CFPB because they believe it is unconstitutional and is outside the control of elected officials. Presidential executive order, and not the Senate, established the CFPB. Because the CFPB does not depend on Congressional funding, Congress does not have the power of the purse over it. The CFPB has the authority to bail out any financial institution it deems systematically important, but it cannot define what systemically important means. Austrians are also concerned that the American taxpayer is on the hook for any bailouts the CFPB approves. Another criticism is that it promotes big government by politicizing financial decisions and helps undermine key aspects of the free market.

Keynesian economists defend the Consumer Financial Protection Bureau for the following reasons:

- First, it signals that the Fed will keep short-term interest rates low for a long time.
- Second, it encourages spending and investing by keeping interest rates low.
- Third, it moves investors from lower-yield, safe securities into equities and other risky assets, thereby boosting stock prices and making households richer and firms more willing to invest.
- Fourth, it devalues the dollar on the international market, making American goods and services less expensive to foreigners.

GLASS-STEAGALL ACT and the VOLCKER RULE

In 1933, Congress passed the Glass-Steagall Act, calling for the separation of commercial and investment banking.

Banks who used depositors' money to make risky investments aggravated the Depression of the 1930s. Many of these investments soured as the depression progressed and made the downturn worse. In 1933, Congress passed the Glass-Steagall Act, calling for the separation of commercial and investment banking. Commercial banks used depositors' money to make loans, whereas investment banks used funds from wealthy individuals for risky investments. The government did not regulate investment banks, giving them license to take sizeable risks. The lack of regulation suited wealthy people because risky investments are more fun and potentially more profitable than safe investments. The government did regulate commercial banks so that they could not put depositors' money at substantial risk.

The Glass-Steagall Act allowed the government to regulate banks so that they could not put depositors' money at substantial risk.

In the 1990s, investment banks were making enormous profits in activities that the Glass-Steagall Act made unlawful for commercial banks, and commercial banks wanted to share in the bounty. The lobbying efforts of the investment community succeeded in convincing Congress to repeal the Glass-Steagall Act with the Financial Services Modernization Act of 1999. The Financial Services Modernization Act allowed banks to compete with investment banks in these risky ventures, leading to a repeat of the banking collapse of the 1930s in 2007.

As part of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Volcker Rule, prohibits proprietary trading by banking entities – in effect, reintroducing a significant portion of the Glass-Steagall Act's static divide between banks and security firms. Proprietary trading occurs when a company trades stocks, bonds, currencies, commodities, or other financial instruments, with the firm's money as opposed to customer's money, to make a profit for itself. The Volcker Rule is 77 pages long with another 882 pages of explanation. The Commodity Futures Trading Commission had only five days to adopt the rule in order to meet a wholly political and arbitrary deadline.

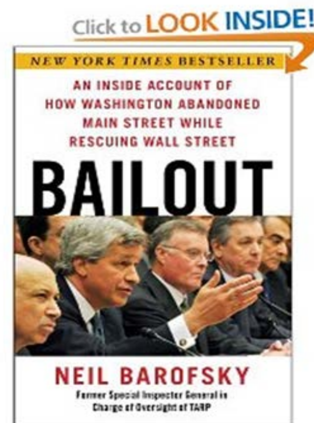
Keynesians tend to support the Dodd-Frank Law and the Volcker Rule, whereas Austrian economists do not. Austrian economists point out that the Dodd-Frank Law encourages rent-seeking because businesses can sway regulators and gain favorable

treatment. In the fog of uncertainty, business interests will always trump noble intentions. When transgressions do occur, regulators are usually the last ones to predict them. Small local banks cannot afford the costs of compliance to the Dodd-Frank Law as well as larger banks can afford the costs.

If you understand the basics behind the Glass-Steagall Act of 1933 and the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010, you get a glimpse of differing philosophies of Keynesians and Austrians. The Glass-Steagall Act was simple because it made a distinction between commercial banks and investment banks and required little government involvement. In contrast, the Volcker Rule is an attempt to micromanage banks and is rife with regulations that can be very confusing. As mentioned above, it does not even make clear which financial institutions it has authority over.

TROUBLED ASSET RELIEF PROGRAM (TARP)

The repeal of the Glass-Steagall Act in 1999 encouraged banks to take excessive risks, which paved the way to the financial collapse of 2007-2008. On September 18, 2008, Treasury Secretary Henry Paulson, and Fed Chairman Ben Bernanke held a meeting with legislators to propose a $700 billion bailout for banks. Paulson reportedly told Congress, if you do not do this, we might not have an economy on Monday!



Bailout
by Neil Barofsky
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Image from Amazon.com

The Emergency Economic Stabilization Act, which implemented the Troubled Asset Relief Program (TARP), became law on October 3, 2008. Although the bulk of the money went to the nation’s biggest financial institutions, authorities used some of it to bail out automobile, insurance, and housing companies.

Austrian economists believe that the Emergency Economic Stabilization Act of 2008 codifies into law the concepts of rent-seeking and moral hazard. Rent-seeking and moral hazard is a dangerous combination because it benefits the few at the expense of the many; it has a tendency to privatize profits while socializing losses.

> ***When the state spends in haste, society will repent at leisure.***

Neil Barofsky became the first special inspector general overseeing the Troubled Asset Relief Program (TARP). In his book, *Bailout,* he writes about his experiences in Washington D.C. and reveals how he was stymied every step of the way, especially by the Treasury Department. He explains how the government shuffled more than $700 billion dollars out the door with almost no oversight. Much of the money simply went to paying large bonuses to elite bankers, the same bankers who contributed to the collapse.

Once private businesses accept bailout money, they are no longer for profit companies. Businesses should be profit-seeking institutions, but after they accept bailouts, they become servants of political masters who do not care about profits. Politicians tend to view these corporations as social institutions meant to achieve social outcomes that are frequently at odds with making profits.

TARP and other bailout programs since 2008 represent a demarcation point concerning the rule of law. After TARP, there grew one set of laws for elite bankers and favored big businesses and another set of laws for everyone else. The Department of Justice has admitted not prosecuting bankers for fear that the fall out of mass prosecutions would undermine the banking industry. Very few bankers have gone to prison regardless of their actions during and after the financial collapse of 2007 and 2008. Some economists believe that the lack of persecutions is the result of an elite class of people protecting their own kind. When there is a revolving door between certain business leaders and government officials, we end up with crony capitalism.

SUMMARY

Congress passed the Federal Reserve Act in 1913, thus creating a central bank for the United States assuming broad responsibilities in the interest of the national economy. The Federal Reserve Act divided the country into twelve districts with each district having a Federal Reserve Bank and at least one branch bank. These reserve banks carry out the policies of the Federal Reserve, sometimes called the Fed.

The federal government charters all national banks and all national banks are obligated to follow the rules and regulations of the Fed. For example, member banks have to buy stock in the Federal Reserve System and obey the reserve requirements set down by it. States charter state banks and they have the option of belonging to the Federal Reserve System or not. Banks must maintain liquidity to retain the confidence of their depositors. Maintaining liquidity is perhaps the most powerful constraint in making a profit.

The Federal Reserve helps the federal government by serving as its bank, offering checking services, aiding the Treasury in borrowing money, and keeping currency and coin in good condition. The Fed also acts as a national clearinghouse for checks.

The Federal Reserve has the responsibility of regulating the nation's money supply. If we have an inflation problem, the Fed will make it more difficult to borrow money. If people borrow and spend less money, the decline in demand will eventually lead to a decline in prices. On the other hand, if unemployment is a problem, the Fed will make it easier to borrow money. Monetary policies are the collective actions of the Federal Reserve.

The Board of Governors is the central decision-making body of the Federal Reserve System. Seven persons and the presidents of five Federal Reserve Banks make up the open market committee of the Federal Reserve System. The president of the New York bank serves as a permanent member of the committee, and the presidents of the other banks rotate as members annually. The Federal Open Market Committee has authority regarding open market policies, which is the buying and selling of government securities (bonds). The Fed is technically autonomous, but members of the Board of Governors are political appointees, so there is usually a working relationship between the Federal Reserve and the federal government.

The three tools of the Federal Reserve are buying and selling government securities, raising or lowering the discount rate, and raising or lowering reserve requirements. The most common tool is buying and selling government securities, and the least common tool is changing reserve requirements.

Monetary policies are more effective against inflation than unemployment. By restricting the money supply, demand eventually declines, which ultimately leads to a decline in prices. It is a different story when we have an unemployment problem. The Federal Reserve can make it easier for people to borrow money, but it cannot force them to do so.

A challenge to the Fed's monopoly came in 1963 when President John F. Kennedy attempted to replace our fiat money with real money. Executive Order 11,110 gave the

Treasury Department the explicit authority to issue silver certificates against any silver bullion, silver, or standard silver dollars in the Treasury. This means that for every ounce of silver in the U.S. Treasury's vault, the government could introduce new money into circulation based on the silver bullion physically held there. As a result, the government circulated more than $4 billion in $2 and $5 denominations. Kennedy's assassination ended the printing of ten dollar and twenty dollar notes. However, Executive Order 11,110 is still on the books and is, therefore, the law of the land.

KEY CONCEPTS

- Different forms of money have varying liquidity levels. The easier something is to spend, the greater its liquidity.

- President John F. Kennedy attempted to replace our fiat money with real money on June 4, 1963 when he issued Executive Order 11,110. Executive Order 11,110 gave the Treasury Department the explicit authority to issue silver certificates against any silver bullion, silver, or standard silver dollars in the Treasury.

- Despite the fact that the U.S. dollar is a fiat currency and not back up by anything metallic, the dollar has value because it is useful and relatively scarce. When the dollar becomes less useful and/or less scarce, it will have less value.

- The general price level determines the exact value of money. Deflation increases the value of money and inflation decreases its value.

- America was able to enhance the value of the dollar beginning with the Bretton Woods Conference in 1944 when 44 allied nations agreed to peg their currencies to gold at fixed rates and the dollar became the world's standard currency.

- Then in 1971, President Richard Nixon severed this link to gold when he closed the gold window, disallowing convertibility. After Nixon had closed the gold window, countries allowed their currencies to float, whereby the market determined value.

- America was able to regain its position as the world's standard currency when it established the Petro Dollar System in the early 1970s.

- A standard currency is a currency that countries use to settle international transactions.

- The properties of money are scarcity, portability, and divisibility.
- The U.S. banking system consists of a network of privately owned commercial banks, and government sanctioned Federal Reserve Banks.
- Monetary policies are policies of the Federal Reserve to regulate the nation's money supply.
- We have a fractional reserve banking system, meaning that banks are required to keep a fraction of their assets in reserve.
- The Fed cannot control the nation's money supply, but it can influence it by influencing a bank's liquidity.
- The Fed will boost bank's liquidity during unemployment and diminish it during inflationary times.
- The Zero Interest Rate Policy, ZIRP, is a Fed strategy to drive interest rates down to zero.
- A liquidity trap occurs when economic conditions bottle too much money in banks. Despite low interest rates, banks still cannot lend enough money.
- When banks experience a liquidity trap, the Fed looks for other ways to force banks to lend money.
- Absence a liquidity trap, the Fed can affect a change in bank's liquidity by changing open market operations, the discount rate, the federal funds rate, and reserve requirements.
- Open market operations entails the buying and selling of government securities.
- The discount rate is the interest rate the Fed charges banks to borrow money.
- The federal funds rate is the interest rate banks charge one another to borrow money.
- The reserve requirement is the ration of how much banks must keep in reserve, money that banks cannot lend.

- The two decision-making bodies of the Federal Reserve are the Board of Governors and the Federal Open Market Committee (FOMC), with the Board of Governors being the primary decision-making body.
- The Federal Open Market Committee makes decisions as to the buying and selling of government securities.
- To stem inflationary pressures the Fed would sell securities and to alleviate unemployment the Fed would buy securities.
- The Fed makes most of its money through interest on U.S. government and mortgage backed securities.
- A Presidential executive order brought the Consumer Financial Protection Bureau into existence and placed it under the Federal Reserve for funding purposes.
- The demand deposit multiplier explains how the banking system can multiply the money from every deposited dollar, depending on the reserve requirement.
- Keynesians believe that the Fed is necessary to manage the country's money supply, and Austrians believe it has caused booms and busts by misallocating resources.
- The deficit is the amount the government borrows in any one year; the debt is the summation of deficits from previous years, the total the government owes.
- When the federal government sells bonds to the Federal Reserve, and the Fed creates new money to purchase these bonds, we call it monetizing the debt or quantitative easing.
- In order for the creation of new money to cause inflation, it has to circulate throughout the national economy.
- In a market system, banks allocate credit based on the price of credit and the riskiness of the borrower.
- Quantitative Easing distorts the market system.

- The Federal Reserve is responsible for implementing provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act.

- Austrian economists oppose the Consumer Financial Protection Bureau because they believe it is unconstitutional and is outside the control or influence of any elected official.

- In 1933, Congress passed the Glass-Steagall Act, calling for the separation of commercial and investment banking.

- The Glass-Steagall Act allowed the government to regulate banks so that they could not put depositors' money at substantial risk.

- Congress repealed the Glass-Steagall Act with the Financial Services Modernization Act of 1999.

- The Financial Services Modernization Act allowed banks to compete with investment banks in making risky ventures.

- The Volcker Rule prohibits proprietary trading by banking entities – in effect, reintroducing a significant portion of the Glass-Steagall Act's static divide between banks and security firms.

FOOD FOR THOUGHT

- ✓ President John F. Kennedy attempted to replace our fiat money with real money on June 4, 1963 when he issued Executive Order 11,110. Executive Order 11,110 gave the Treasury Department the explicit authority to issue silver certificates against any silver bullion, silver, or standard silver dollars in the Treasury. What would have happened to the Federal Reserve and the practice of quantitative easing if silver backed our money supply? Do you think this would have been a good thing or a bad thing? Why or why not? Virtual currencies are fiat currencies, yet they can be very stable. Why do you suppose a virtual currency, like bitcoin, can be more stable than our current monetary system?

- ✓ After President Nixon had closed the gold window in 1971, countries allowed their currencies to float, whereby the market determined value. This severing of the tie between the dollar and gold would have decreased the value of the dollar over time, except for the emergence of the Petro-Dollar System. Besides helping to establish

the dollar as the world's standard currency, can you speculate on how else this policy tide America to foreign countries?

- ✓ In 1833, President Andrew Jackson announced that the government would no longer use the Second Bank of the United States, the country's national bank at the time. He then used his executive order to remove federal funds from the bank. Why do you suppose he did this? Do you believe that the federal government should abolish the Federal Reserve? What effect would this have on the economy?

- ✓ The Zero Interest Rate Policy, ZIRP, is a Fed strategy to drive interest rates down to zero. When unemployment is a problem, the Fed may choose to increase bank's liquidity and push interest rates down to near zero. What effect do these artificially low interest rates have on the economy? Do you think our policymakers are correct and are doing the right thing to improve our economic system? How do you think these low interest rates help and hurt the economy? Who does ZIRP help and who is does it hurt?

- ✓ When the federal government sells bonds (securities) to the Federal Reserve and the Fed creates money to buy these bonds, economists call this practice quantitative easing, or monetizing the debt. Some people in government believe that this practice is not harmful because we owe the money to ourselves. If Peter and Paul are in the same family and Peter borrows money from Paul, the family is no worse off. What do you think?

- ✓ The Federal Reserve became a reality because of one flaw in our Constitution. The Supreme Court has the final word in interpreting the meaning of the Constitution. What this group of appointed men decree has been accepted as the law of the land, whether or not it is in accordance with the text of the Constitution or the intent of its framers. The Constitution specifies that Congress shall issue our money and determine its value. What are your thoughts on this matter? Do you think the Supreme Court is justified in its decision to allow the Federal Reserve to determine the value of our money?

- ✓ A Presidential executive order brought the Consumer Financial Protection Bureau into existence and placed it under the Federal Reserve for funding purposes. However, the Fed has no authority over this bureau. At the end of each fiscal year, after the Fed meets its annual operating expenses and pays the Consumer Financial Protection Agency ten percent of its assets. What did this executive order do to the checks and balances that our Constitution put into place? Do you think that Congress

should have been included in the establishment of this institution and given the power of the purse over the Consumer Financial Protection Bureau?

- ✓ Keynesians believe that the Fed is necessary to manage the country's money supply, and Austrians believe it has caused booms and busts by misallocating resources. Keynesians believe that policymakers can make sound policies with accurate predictions. Austrians believe that life is unpredictable, and therefore economics is not a science. Keynesians tend to support discretionary policies, saying the Fed should make decisions based on the situation. Austrians tend to favor rules, meaning the Fed should base policy on a predetermined set of rules. Which school of thought would you place yourself? Why do you think this way?

- ✓ The federal government borrows money by selling bonds, which economists call securities. Economists call them securities because the federal government has never defaulted on a loan, and therefore, the bonds are very secure. The Federal Reserve can create money to buy these bonds. Economists call this process quantitative easing, or monetizing the debt. Do you think this is a good idea? Why or why not?

- ✓ The national debt rose during the 1980s, as President Reagan cut taxes and increased military spending. It fell during the 1990s, due to decreased military spending, increased taxes and the 1990s boom. The debt rose sharply in the wake of the 2007–08 financial crisis and continued to increase thereafter. Some people are not concerned about our debt situation because they believe that this is money we owe to ourselves and that the pay back will not come until much later. What do you think? Are you, or your parents, having to currently pay for their share of the national debt?

- ✓ The Financial Services Modernization Act of 1999 repealed the Glass-Steagall Act and allowed banks to compete with investment banks in making risky ventures. Was this a good or bad idea? Why do you think this way? What would you have done if you were in charge in 1999?

- ✓ The Emergency Economic Stabilization Act, which implemented the Troubled Asset Relief Program (TARP), became law on October 3, 2008. The bulk of the money went to the nation's biggest financial institutions. Do you think this was a good policy? Who was hurt and whom did this policy help? Would you have done things differently?

- ✓ When the Congress established the Federal Reserve in 1913, it did not have the authority to lend money to the federal government at interest. However, when the United States prepared for World War II in 1914, Congress amended the Federal

Reserve Act to allow the Fed to lend money at interest to the U.S. Treasury to help pay for the war. Was this a good idea? Why do you think so? What has been the long-term implications of the Fed lending money to the federal government?

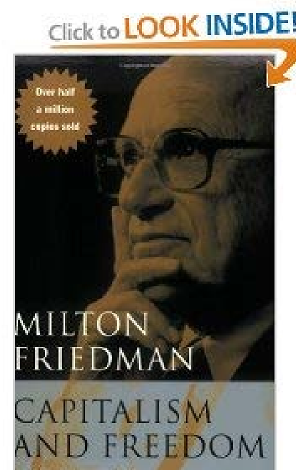
- ✓ G. Edward Griffin, in his book *The Creature from Jekyll Island*, claims that the Federal Reserve System as concocted not to stabilize the economy but to put economic control into the hands of a few people who agreed not to compete with one another. When participants in a group decide not to compete with one another but instead agree to collaborate and thus act as if they were a monopoly, economists call this type of organization a cartel. Do you think that it is a good idea for a country to have a central bank? If so, should the bank be a part of the government or not? Why or why not?

- ✓ Policy makers of most countries of the world have tried to bring about prosperity by increasing the money supply. When central banks create money to buy bonds, economists call this practice quantitative easing. Hayek and the Austrians believe that this practice of easy money and the artificially low interest rates that result, lead to malinvestments and a boom and bust cycle. Who do you think is correct? The Keynesians who advocate easy money polices to stimulate demand and therefore grow the economy or the Austrian viewpoint that artificially low interest rates ultimately lead to recession.

CHAPTER 6: GOVERNMENT

Milton Friedman, in his book *Capitalism and Freedom*, explores the concept of freedom. He believes that we must guard against the tyranny of an oppressive government. Friedman explains why freedom is not free; we must protect and nurture our freedom to survive. The freedom that exists in capitalism is weak and fragile, not strong and enduring.

According to Friedman, the concentration of power is the greatest threat to freedom. He believed that power corrupts and absolute power corrupts absolutely. Societies that put the equality of outcome as a top priority end up with neither equality nor freedom. One of the great mistakes is to judge policies by their intentions rather than their results. Programs that are intended to help the



Capitalism and Freedom
by Milton Freedom, 1962,
University of Chicago Press
Image from Amazon.com

needy can have the opposite effect from their intent. Societies that put freedom as a top priority end with a greater degree of freedom and equality.

Free markets are efficient, but even Austrians believe that they cannot provide us with everything we want or need. Market failure is a condition whereby the unrestrained operation of markets yields socially undesirable results. Consequently, we have to modify the free market to rectify its inadequacies. We need a strong central government because it

- provides us with a uniform system of weights and measures.
- enforces contracts.
- safeguards private property.
- provides strong national defense.
- provides public goods.
- protects us against social costs.
- encourages merit goods.
- helps poor and disadvantaged people.
- enables funding of programs by establishing a tax system.
- establishes and enforces rules of the game.
- promotes competition.
- regulates natural monopolies.
- promotes a fair distribution of income.
- helps promote full employment and stable prices.

PRIVATE AND PUBLIC GOODS

A private good has substitutes; you do not have to share it with others. On the other hand, everyone can consume a public good regardless of who pays for it. Examples of public goods are safe communities, public education, roads, and a strong national defense. This free rider problem is why the government imposes taxes to pay for public goods.

The reason the free market cannot adequately provide public goods is that some people receive benefits without bearing any of the costs.

We take for granted a good road system whereby we can drive across the country without paying tolls. However, this luxury would not be possible without government. If it were not for the government, entrepreneurs would build roads and charge

people to drive. With the absence of government regulations, there would be no uniformity in the roads, some would be narrow, some wide, some gravel, others dirt. The only way to have uniform roads is for the government to tax and use the money to build and maintain roads. Consequently, the government levies a tax on each dollar of gasoline sold. This way, people who drive the most, pay the most. Economists call this the benefits received principle of taxation.

MERIT GOODS

A merit good is a good that satisfies a want or need, like public education and safe foods. Merit goods are those goods and services that the government feels that people will under consume, and which the government should subsidize. Government should provide these goods free at the point of use so that consumption does not depend primarily on the ability to pay for the good or services.

The government promotes merit goods by subsidies or regulation. Public education is a merit good (it is also a public good) because all society benefits from educated, law abiding citizens. Labeling of food ingredients is a merit good because it benefits healthy living. The government discourages smoking by putting excessive taxes on cigarettes and forces smokers to pay more for health insurance.

Merit goods can be encouraged by a first party or a third party law. For example, laws requiring motorcycle drivers to wear helmets protects the driver (the first party) but do not protect other people (a third party), whereas laws that mandate better brakes protect everyone. Economists generally agree on the merits of third party laws because the government should protect society from the reckless behavior of individuals. However, economists generally disagree on the merits of first party laws because the only person protected is the person in question. The market for merit goods is an example market failure. A free market cannot protect individuals from the reckless behavior of people who do not consider the ill effects of their actions on other people.

SOCIAL COSTS

Negative externalities occur when businesses pass costs onto society. Unsafe working conditions, the depletion of nonrenewable natural resources, and pollution are examples of negative externalities. Social costs can be sickness or the opportunity costs of

not being able to swim in a polluted river. The government taxes, subsidies, and regulates to minimize negative externalities.

Free Markets Cannot Solve the Problem of Social Costs

Consider the socially conscious Alpha paper company, which responsibly disposes of waste products, installs safe machines, and recycles resources. On the other hand, Beta Company passes costs onto society by not installing safe machines, by not recycling, and freely polluting. Consequently, Beta Company can charge a lower price and still make a profit; forcing Alpha Company into bankruptcy. Neither the manufacturing company, Beta Company, nor Beta's customers, are willing to pay for a clean environment. The company wants to produce products at the lowest cost possible, and the consumer wants to purchase them at the lowest price possible. Therefore, the government has to tax, subsidize, and regulate to level the playing field. Government intervention allows Alpha Company to follow its social conscience, forcing Beta Company to minimize its negative externalities, and forcing the consumer to pay higher prices.

Who is Responsible for Minimizing Social Costs?

Society must limit social costs, but who is responsible – states or the federal government? Texas has sued the federal government, challenging its ability to take over the state's air pollution authority. Texas claims the government is impeding its legal rights and has asserted that the Environmental Protection Agency's (EPA's) actions violate the Clean Air Act. Another conflicting case between the state and federal government jurisdiction is over greenhouse-gas permits. Presently the federal government requires power plants to obtain greenhouse-gas permits from the federal government (instead of the state) before building new facilities or making major modifications to existing ones.

Obviously, there is a trade-off between a clean environment and growth, but the solutions are not obvious. For example, the EPA requires power plants to install maximum achievable control technology to reduce mercury emissions and other trace gasses. Some people believe that the ruling will force many coal-fired plants, a major source of America's energy, to shut down. According the EPA, this rule is necessary to provide a national standard for the release of mercury, arsenic, chromium, and acid gasses into the air. Yes, environmental laws are necessary to protect society from excessive pollution and all the problems pollution causes. However, for every unit of gain toward a cleaner environment, the opportunity cost increases by a multiple the closer we get to a perfectly clean environment. So, at what point should society say enough is enough? What cost are we willing to pay and what level of pollution can we tolerate? What is a reasonable level of pollution?

THE ENVIRONMENT AND GROWTH

American farmers have diverted 40 percent of corn production from food to fuel, yet the National Academy of Sciences claims that ethanol production increases greenhouse gas emissions and raises food prices worldwide. The National Association of Clean Air is another agency that claims the burning of higher ethanol blend causes an increase in emissions of nitrogen oxides and other harmful pollutants.

So why is the EPA supporting ethanol? One reason is that the ethanol industry has significant political influence. Another reason is that the beliefs of one-person dictates decisions and that one-person can be biased. The EPA administrator can issue mandates without Senate approval.

THE PROBLEM WITH LENGTHY and DETAILED LAWS

Our federal income tax system became law in 1913 under President Woodrow Wilson, the same year Congress passed the Federal Reserve Act. In 1913, the law was one page, today it is about 72,000 pages. As discussed above, lengthy and detailed laws force the government to make value judgments. A complicated and lengthy law can say whatever authorities deem. This leaves the door open to arbitrary decisions, politics, and rent-seeking. When laws become so complex and unpredictable, no one can understand the whole of it, such as our tax laws.

A progressive income tax system with exemptions and deductions allows politicians to make concessions and exceptions for favored groups, giving big corporations, those with the big bucks, an advantage over their competitors.

Lengthy and detailed laws forces the government to make value judgments. A complicated and lengthy law can say whatever authorities say it says.

A favorite gambit for Congress is to make the laws so long and convoluted that only the big players will have the resources to comply. These added costs make American companies less competitive around the world. A flat rate tax system, whereby almost everyone pays the same rate regardless of income, would be much simpler and more efficient, but it would leave little room for politics.

Consider the federal Work Opportunity Tax Credit which typically lowers a company’s taxes by thousands of dollars per employee, but which frequently goes

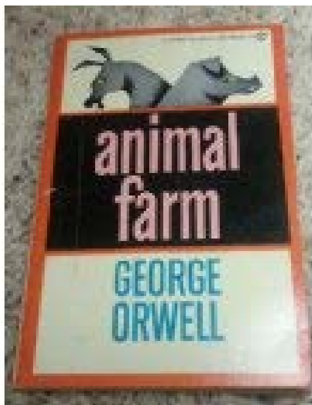
unclaimed, largely because it is such a hassle to win approval. It requires extensive time and paperwork for each worker.

Another targeted break, the tax deduction for energy-efficient buildings, often requires computer modeling costing as much as $50,000, which leaves business owners weighing whether the credit is worth the expense. While many companies say it is too complicated to claim tax breaks, the ones who try can find themselves embroiled in complex disputes with the Internal Revenue Service.

The Rule of Law is Jeopardized

The concentration of power in the name of fairness has jeopardized the rule of law.

Austrians believe that the concentration of power has jeopardized the rule of law. They believe that American society is at the mercy of the federal government – a government that decides who does and who does not succeed. The new elite are special interest groups, political cronies, and wealthy lobbyists. Consider the following examples where the rule of man trumps the rule of law.



***Animal Farm* by George Orwell, 1946**
Image from Amazon.com

When the Senate refused to confirm the President's picks for the National Labor Relations Board (NLRB), the President proclaimed the Senate to be in recess and appointed the members anyway. This action made a mockery of that chamber's advice-and-consent role. When the President disagreed with federal laws criminalizing the use of medical marijuana, he instructed the Justice Department not to prosecute transgressors. The auto bailouts turned contract law on its head when the White House subordinated bondholder's rights to those of its union allies, which is contrary to bankruptcy laws. The government can imprison people for killing bald eagles, yet companies that produce wind power are exempt from the law. Congress passed ObamaCare, yet declared the law is invalid for members of Congress and their staff. The Environmental Protection Agency issued new ethanol mandates on 143 refineries but exempted one lucky refinery for political reasons. The executive branch has made multiple changes to the Affordable Care Act without Congressional involvement, contrary to the constitution. According to the Constitution, the Executive does not have the legal authority to draft laws.

George Orwell, in his book *Animal Farm*, set out to show how power inevitably corrupts, no matter how noble the intent. In his book, a group of animals centralizes control over the farm to ensure equality. The novel ends with the barnyard commandments, high on their righteousness, reducing the commandments to only one, which is "All animals are equal, but some animals are more equal than others."

Animal Farm illustrates that power corrupts and absolute power corrupts absolutely. Presently, many millionaires, health-care providers, energy companies, political groups, and other politically favored groups are the most equal. The point to the book is that so long as a government grows so too will government-created inequality.

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GOVERNMENT PROGRAMS

The idea of wealth redistribution stems from the Progressive Movement in the last quarter of the 19th century. Americans had tamed the frontier, built cities and grew businesses, and established a country, but not all citizens shared in the new wealth. People birthed the Progressive Movement because they perceived deficiencies in the economic system. Keynesians tend to support the ideas of the Progressive Movement more than Austrians do. The modern Progressive Movement has had a significant impact on education, health care, tax policies and other federal programs.

The goals of the Progressive Movement are to change other people by having them adopt the Progressive vision.

Social Security (SS)

The Federal Insurance Contributions Act (FICA) includes two separate taxes. Social Security tax and Medicare. Monthly benefits depend on past earnings and retirement age. The Social Security Administration estimates that in a few years, the system will begin to withdraw money from the Social Security Trust Fund. However, the money will not be there. Instead of letting the funds accumulate in the

Because social security is a pay-as-you-go system, it is the world's largest Ponzi scheme.

Trust Fund and earn interest, Congress has used the money for general purposes and replaced it with non-negotiable IOUs. A non-negotiable IOU is an IOU that the public cannot buy and sell. The government stores these Treasury bonds in filing cabinets in an old warehouse in Charleston, West Virginia.

Because social security is a pay-as-you-go system, it is the world's largest Ponzi scheme. A Ponzi scheme is one in which the participants receive returns on their contributions from the latest contributors. For example, suppose that I assure you and others that I am an excellent investor, and that I can triple your money in five years. Instead of investing your money in the markets as I claimed, I pay you ample returns from the money I collect from new people I bring into the system. The plan begins to fall apart when there are fewer new people. Social security relies on a constant influx of new people. Social Security is the opposite of how private insurance typically works. Insurance companies pay claims from the return on their principle while preserving the principle.

Unemployment Benefits

Unemployment benefits compensate people who have lost their jobs and who are actively seeking employment. The program does not include persons who are entering the workforce for the first time, or persons who quit their jobs. Congress writes the rules, and individual states administer and provide much of the funding. There is a social reason for unemployment benefits, but there is also the economic reason that unemployment benefits support spending during times of unemployment.

Medicare

Medicare is a four-part program that provides health insurance to people sixty-five years and older and some young permanently disabled people. Medicare has four parts: Part A is Hospital Insurance, Part B is Medical Insurance, and Part D covers prescription drugs. Medicare Advantage plans, also known as Medicare Part C, provide an alternative means to receive Parts A, B and D benefits. By 2030, only 2.4 workers will support one elderly person.

With more than 1.5 million baby boomers enrolling in Medicare annually, the program's future is one of the most important economic issues for anyone fifty years or older. Health care costs are the most unpredictable part of retirement, and Medicare remains an excellent deal for retirees. However, fraud and abuse is a significant problem with Medicare. The bigger the program becomes, the more difficult it is efficiently manage the program. Large programs have a tendency to become so unwieldly that the administration has a difficult time managing the program.

Medicaid

While Medicaid covers health care costs for low-income people, there is a critical difference between Medicare and Medicaid. Medicare is an insurance program, and Medicaid is an equity loan. Depending on state law, the state may have the right to all assets upon the death of the recipient, up to the cost of Medicaid benefits received. For example, if a person had received $50,000 in benefits, upon that person's death the government will confiscate his or hers assets up to $50,000. There are limits to what the state can seize. However, the law is extremely complex and leaves a great deal to the government's discretion. The fact that Medicaid is an equity loan has not been a huge problem in the past because only poor people with few assets were eligible for the program. However, ObamaCare has changed this scenario because it increases the number of people eligible for Medicaid by dropping the asset requirement.

Medicare is an insurance program, and Medicaid is an equity loan.

James Madison warned in the Federalist Papers about laws so voluminous that people cannot read them or so incoherent that they no one can understand them. A typical provision of Medicare, for instance, reads like this:

> *In the case of a plan for which there are average per capita monthly savings described in section 1395w–24 (b)(3)(C) or 1395w–24 (b)(4)(C) of this title, as the case may be, the amount specified in this subparagraph is the amount of the monthly rebate computed under section 1395w–24 (b)(1)(C)(i) of this title for that plan and year (as reduced by the amount of any credit provided under section 1395w–24 (b)(1)(C)(iv) [2]of this title.*

Patient Protection and Affordable Care Act

The Patient Protection and Affordable Care Act of 2010 (ObamaCare) is one of the most complex pieces of legislation in U.S. history. One provision requires U.S. citizens and legal residents to have qualifying health coverage. People without coverage will pay a tax penalty.

The Patient Protection and Affordable Care Act of 2010 (ObamaCare) is one of the most complex pieces of legislation in U.S. history.

The 15-member Independent Payment Advisory Board embodies ObamaCare's fundamental values and beliefs. The Board believes that health decisions are too critical to leave to the people receiving the care (patients), the people providing the care (doctors and hospitals), the people paying for the care (taxpayers), or even the people who got the government involved in the first place (politicians). This independence of the IPAB rubs many Congressmen the wrong way because they would forfeit control. Many Congressmen do not want to give our medical system a free hand in a free market, but neither do they want decisions made by a central committee.

Other people believe that the designers of ObamaCare intended the system to fail because the ultimate goals is a single payer system. A single payer system is a system whereby the federal government has full and complete control over health care. One criticism of ObamaCare is a concern about the unfunded liability it brings to the table.

When a health insurer fails, the state insurance commission liquidates the company and sells off the assets. The commission then transfers any pending or outstanding obligations to policyholders, doctors, or hospitals after the liquidation to the remaining insurers doing business in state, based on market share. Thus, when health insurers fail, failures have a tendency to cascade because the law places the debts and obligations of the failed insurers unto the backs of the insurance companies that remain in business. Austrian economists would view this as an example of government planning. Friedrich Hayek warned his readers about the ill effects that excessive planning has on the economy.

Health and Human Services Department (HHS)

ObamaCare has turned the Health and Human Services Department into a massive venture capital investor for health care. Awash in ObamaCare dollars, HHS has a growing investment portfolio that includes everything from new insurance companies to health-care start-ups to information technology. HHS already makes more grants than all other agencies combined, and it is the patron of health care for about thirty-three percent of Americans via Medicare, Medicaid, or both. The problem is that HHS spends its resources badly. Ernst & Young, a large accounting firm, did an annual external audit of the HHS balance sheet in November 2011 and found that HHS cannot accurately track its spending. The agency is in violation of numerous federal accounting rules written specifically for the bureaucracy, to say nothing of the financial reporting required of public companies.

The HHS inspector general has revealed that his team could barely monitor HHS because its staff is too busy chasing the criminals exploiting HHS's incompetence. The Government Accountability Office estimates that criminals steal about $48 billion annually from taxpayers through entitlement fraud.

POSSIBLE SOLUTIONS

Austrian economists believe that long and detailed laws, like the 2,700-page health care bill and a 2,300-page financial reform bill, cause problems. Adding to the confusion is the fact that a bill can be very long and include unrelated topics. The length and complexity of such laws are why some states have given line item veto power to their governors. With line item veto power, the governor can go through a bill line by line and veto portions of it. However, the Supreme Court has ruled that the President does not have line item veto power at the federal level. When President Bill Clinton used the line-item veto, the Supreme Court declared it unconstitutional.

Perhaps the Commonwealth of Virginia has the best solution in terms of lengthy bills by requiring a bill to cover one topic, and the name of that topic must be in the heading of the bill. This process eliminates pork barrel spending. Pork barrel is the appropriation of government spending for localized projects. The Virginia Legislature passes numerous bills every year, but each bill is only one paragraph.

Austrian economists condemn many of the policies of government regulators as they try to micromanage-sophisticated markets. Austrians believe a better strategy would be to simplify the rules to avoid unintended consequences. Austrian economists recommend taking politics out of markets as much as possible.

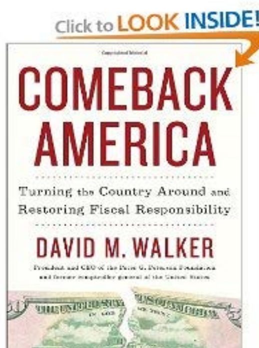
DISINCENTIVES CAN BE A PROBLEM

Government programs can act as a disincentive for certain people to put forth the effort to earn income by being productive at a job. Once a recipient’s income increases beyond a certain point, he or she will begin to lose housing, food and childcare subsidies. As his or her income continues to rise, their marginal tax rate increases reaching 100 percent at some point. When the marginal tax rate hits 100 percent, that means that for every extra dollar earned the government takes a dollar away.

The Tax Foundation has published an International Tax Competitive Index. According to the foundation, the index measures the extent to which a country’s tax system adheres to two principles of tax policy: competitiveness and neutrality. A competitive tax code is one that limits taxation on businesses and fosters investment. A tax code that is not competitive drives investment elsewhere, leading to slower economic growth. By neutrality, the Tax Foundation means a tax system that seeks to raise the most revenue with the fewest economic distortions.

According to the Tax Foundation, the United States ranks thirty-second of the thirty-four industrialized countries in the Organization for Economic Co-operation and Development (OECD) for tax neutrality. Tax neutrality is the characteristic that taxes do not interfere with the natural flow of capital toward its most productive use. According to the Tax Foundation, America's tax system is at odds with tax neutrality.

UNFUNDED LIABILITIES



Comeback America
by David Walker
Random House Inc., Pub. 2010
Image from Amazon.com

Unfunded liabilities occur when the government commits itself to spending money on programs but does not make adequate provisions to fund the program into the future. Therefore, the government is incurring a liability without proper funding. Social Security is a huge unfunded liability. Unless Congress makes changes, the program will eventually implode.

Were the government to confiscate the total adjusted gross income of American taxpayers, plus corporate taxable income, it would not be enough to balance the budget. Balancing the budget means that the government spends only the money it receives.

David M Walker, a former comptroller general, says that the country’s dysfunctional democracy is preventing a return to fiscal sanity. He has been warning people of a fiscal collapse. He believes we have a long-term structural deficit problem because of unfunded liabilities.

TAXES

A flat income tax is a tax whereby everyone pays the same tax rate regardless of income. Flat tax systems are in place in several states. A pure flat tax system would eliminate deductions, tax credits, and most exemptions. A flat tax would be the simplest form of income tax. Despite these advantages, there is little hope of change. The main reason for our current progressive income tax system is that it allows for politically motivated exceptions to the core provisions of the law. The law itself is short and simple, but the politically motivated exceptions are long and complicated.

The U.S. income tax system is a graduated or progressive income tax system. A graduated tax taxes citizens based on their ability to pay; the wealthy pay more proportionately than do low-income people. With a progressive tax, the government taxes each dollar earned based on the income bracket that dollar falls. For example, let us suppose that there is a different tax bracket starting at a taxable income of $20,000. Your taxable income would be your income after you take credit for deductions and exemptions.

Below $20,000, the percentage is ten percent and over, fifteen percent. If your taxable income is $22,000, you will pay ten percent on all taxable income below $20,000, and you will pay fifteen percent on the two thousand dollars above the threshold of $20,000.

Our income tax system has exemptions and deductions. Each exemption subtracts X amount of dollars from your total income. You pay taxes on your taxable income, not your gross income. You count as one exemption if you file as a single person. Each qualified person counts as one exemption. American taxes have increased over the years because each exemption is worth less and less over the years. Four exemptions would have shielded almost 70% of your earnings from federal income tax in 1948 — today the same four exemptions will shield only 17%.

The U.S. income tax system is a graduated or progressive income tax system.

Deductions are the second category, such as the interest paid on your mortgage and charitable donations. If these two categories (exemptions and deductions) are greater than the standard deduction, you fill out the long form and itemize your deductions. If the exemptions and deductions are less than the standard deduction, you claim the standard deduction.

The government foresaw a collection problem in 1942 when it doubled income taxes. In those days, taxpayers mailed their annual tax payments directly to Washington. However, as spring arrived in 1943, it became clear that many citizens might not file tax returns. Henry Morgenthau, the Treasury secretary, confronted colleagues about the nightmarish possibility of mass tax evasion. Now meet Beardsley Ruml, a man of ideas who observed that people preferred installment payments. Instead of

In 1942, Beardsley Ruml, a man of ideas who observed that people preferred installment payments. Instead of citizens paying their annual taxes all at once, government could make businesses collect taxes from each paycheck and forward the funds directly to Washington.

citizens paying their annual taxes all at once, the government could make businesses collect taxes from each paycheck and forward the funds directly to Washington. No longer would the employee have to face his tax bill square in the eye.

Government bases the gasoline tax on the ability to pay principle of taxation. The benefits received principle taxes people the most who receive the most benefits from the tax. Because consumers pay the tax on each gallon they purchase, the people who drive the most pay the most. In turn, these taxes go to fund the building and maintaining roads.

A regressive tax is a tax that falls heavier on the poor than on the wealthy. For example, a tax on food is regressive. Jack has an annual income of $100,000, and Bill has an annual income of $50,000. Both Jack and Bill have similar eating habits, and both spend about $200 weekly on groceries. Bill bears the greater burden because a dollar to him is worth more than a dollar to Jack.

A regressive tax is a tax that falls heavier on the poor than on the wealthy.

Alternatives to our present income tax system are a value added tax (VAT), national sales tax, and a flat tax. The value-added tax is a form of consumption tax; it is a tax on the purchase price of a good or service. It is a tax on the value added to the product, material, or service. The value added is the sales price minus the cost of materials and other taxable inputs. A VAT is like a sales tax in that ultimately the government only taxes the consumer. It differs from a sales tax in that, whereas consumers pay the sales tax once, a VAT tax taxes everyone in the supply chain. A national sales tax would work similarly to the way state sales taxes work.

The Alternative Minimum Tax (AMT) is a parallel tax system and comes with a different set of rates and deduction rules.

The Alternative Minimum Tax (AMT) is a parallel tax system and comes with a different set of rates and deduction rules. Taxpayers who qualify pay it only if their AMT tax amount is higher than their regular taxes. Even though some deductions still exist with the AMT, including those for mortgage interest and charitable donations, some key tax breaks are lost. Some of the lost tax breaks are state and local income taxes and property taxes, child tax credits, and home-equity loan interest.

By law, when you file your income tax the IRS obligates you to figure out whether you have to pay AMT or file under the traditional tax system. Congress changes the rules yearly and allows for adjustments according to the inflation rate. Economists call this indexing. When the government changes the rules of the game on a regular basis, it makes it difficult for people to make good decisions and thus undermines the rule of law.

NATIONAL BUDGET

Off-budget spending makes it difficult to access government spending from one year to the next. Off-budget spending is spending that Congress does not count as part of the regular budget and therefore it does not appear in official records. Off-budget spending, in short, is a tool used to conceal the true cost of government programs. Today, two off-budget entities that Congress once considered on a budget are the Social Security System and the U.S. Postal Service. In the case of Social Security, the trust funds are off budget and administrative costs are on a budget. Any losses that the Federal Reserve are off budget as well.

Currently, the U. S. Postal Service is losing millions of dollars a day, so the Senate votes to give it billions of additional dollars, but delays reforms that would save money. Postal Service management, to its credit, has a credible plan to put the agency on a firmer financial footing. The Post Office has closed about half of its mail processing centers and thousands of unnecessary post offices—letting local stores do the heavy lifting. However, the Senate continues to throw up one obstacle after another preventing further policy changes.

Washington Speak makes it difficult to understand government spending. For example, if I pay $100 in year one and $200 in year two, we would say that I spent 100% more in year two than I spent in year one. Washington calculates spending in a different way. If Congress spends $100 in year one and says that it plans to spend $200 in year two, but instead spends $150 in year two, it claims it cut spending by $50!

The federal budget year begins September 1 of each year. In the previous January, Congress receives a budget proposal from the Executive Branch regarding spending for the next fiscal year. After the House makes adjustments, it gives the budget to the Senate. After modifications, the Senate passes it on to the President, who in turn, sends a modified version to the House, and around and around she goes until September 1 when the new fiscal year begins. It rarely works out this way – a continuing resolution temporarily extends spending at the previous year's level.

MONOPOLIES AND NATURAL MONOPOLIES

One company dominates an industry in a monopolistic market. Because monopolies tend to concentrate in markets with price inelastic demand curves, their

existence puts the consumer at a disadvantage. Consequently, we have anti-trust laws aimed at limiting monopolies.

However, there are times when monopolies can benefit the consumer. Natural monopolies trump the competition. Examples of natural monopolies are power and cable companies where the government restricts competition in return for price controls. The government gives protection on one hand but takes away freedom on the other hand. A natural monopoly exists when one firm can serve an entire market at a lower per-unit cost than multiple firms. Natural monopolies are usually local companies serving a small geographic area.

Imagine a situation whereby various power companies served a locality, with each company having their power source, poles, and cables. Imagine the unnecessary duplication of resources and the blight on the environment. One set of poles and wires is more efficient and environmentally friendly than several. There is also a problem of startup costs. It is very expensive to provide power. Before private investors commit their capital, they have to be assured of X number of customers. When the government grants a business monopoly status, the investors can better gauge the potential customer base. Without this guarantee of protection from competition, investors may not be willing to invest.

SUMMARY

Free markets are efficient, but they cannot provide us with everything we want or need. Market failure is a condition whereby the unrestrained operation of markets yields socially undesirable results. Consequently, we have to modify the free market to rectify its inadequacies. We need a strong central government because it

- provides us with uniform system of weights and measures.
- safeguards private property.
- enforces contracts.
- provides strong national defense.
- provides public goods.
- protects us against social costs.
- encourages merit goods.
- helps poor and disadvantaged people.
- enables funding by establishing a tax system.

- establishes and enforces rules of the game.
- promotes competition.
- regulates natural monopolies.
- promotes a fair distribution of income.
- helps promote full employment and stable prices.

A private good has substitutes and no one has to share it with anyone else. Everyone can consume a public good regardless of who pays for it. Examples of public goods are safe communities, public education, roads, and a strong national defense.

A public good does not have substitutes, and all can share it. The reason the free market cannot adequately provide public goods is that some people receive benefits without bearing any of the costs. This free rider problem is why the government imposes taxes to pay for public goods.

We also need government to protect us against social costs. Social costs are the cost of production for which businesses bear no responsibility but pass the responsibility to society. Examples of social costs are pollution, unsafe working conditions, and the depletion of nonrenewable natural resources. In a free market, here is a tendency toward high social costs. Government's challenge is to intervene without sacrificing productivity, growth, and personal liberty.

Government promotes merit goods and helps disadvantaged people. A merit good or service is one that the government considers desirable and, therefore, encourages it by subsidy or regulations. In this aspect, the government is acting as a parent-guardian over its citizens. Public education and healthy foods are examples of merit goods. Sometimes the government will discourage or forbid the sale of unhealthy or dangerous goods, such as street drugs and cigarettes.

Short and simple laws are easy to understand and easy for citizens to comply. Long and detailed laws can be difficult to understand and difficult to comply. They can be difficult to enforce and can be arbitrary. Often the rule of man replaces the rule of law when laws are too big and complex.

As the size of the federal government has grown, so have government programs making it difficult to cut government spending. The programs responsible for the majority of government spending are social security, unemployment benefits, Medicare, Medicare, and ObamaCare. Once programs become a part of the system, they tend to grow without limit. This eventually puts a strain on the system politically and economically.

Unrestricted freedom can lead to monopolies. Big business can exploit the consumer by charging high prices, producing less quantity, and offering poor quality goods. The government has passed anti-trust laws to prevent market concentration. However, not all monopolies are bad. Natural monopolies can better suit our needs than smaller competing companies. Power companies and cable companies can meet the needs of localities better when government grants them monopoly status.

The concentration of power in the name of fairness has jeopardized the rule of law. American society is ever more at the mercy of a federal government – a government that decides who does and who does not succeed. The new elite are special interest groups, political cronies, and wealthy lobbyists and the losers are everyone else.

The Tax Foundation has published an International Tax Competitive Index. According to the foundation, the index measures the extent to which a country's tax system adheres to two principles of tax policy: competitiveness and neutrality. A competitive tax code is one that limits taxation on businesses and fosters investment. A tax code that is not competitive drives investment elsewhere, leading to slower economic growth. By neutrality, the Tax Foundation means a tax system that seeks to raise the most revenue with the fewest economic distortions.

According to the Tax Foundation, the United States ranks thirty-second of the thirty-four industrialized countries in the Organization for Economic Co-operation and Development (OECD) in terms of neutrality. America also has the world's highest corporate tax rate, including state taxes. In addition, the United States is the only country that taxes money earned in foreign countries when companies bring that money back home to the United States.

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KEY CONCEPTS

- The greatest threat to our freedom is the concentration of power. Power corrupts and absolute power corrupts absolutely.
- A private good has substitutes; you do not have to share it with others.

- Everyone can consume a public good regardless of who pays for it.
- A merit good is one that satisfies a want or a need.
- Negative externalities occur when businesses pass costs onto society.
- Free markets cannot solve the problem of social costs.
- Lengthy and detailed laws force the government to make value judgments. Authorities can interrupt a complicated and lengthy law to suit their purposes.
- When laws become so complex and unpredictable, no one can understand the whole of it.
- The concentration of power in the name of fairness has jeopardized the rule of law. American society is ever more at the mercy of the federal government.
- George Orwell, in his book *Animal Farm*, set out to show how power inevitably corrupts, no matter how noble the intent.
- Because social security is a pay-as-you-go system, it is the world's largest Ponzi scheme. A Ponzi scheme is one in which the participants receive returns on their contributions from the latest contributors.
- Unemployment benefits compensate people who have lost their jobs and who are actively seeking employment.
- Medicare provides health insurance to people sixty-five years and older and some permanently disabled people who are younger than sixty-five.
- Medicaid covers healthcare costs for people of low income.
- Medicare is an insurance program, and Medicaid is an equity loan.
- James Madison warned in the *Federalist Papers* about laws so voluminous that they cannot be read, or so incoherent that they no one can understand them.
- The Patient Protection and Affordable Care Act of 2010 (ObamaCare) is one of the most complex pieces of legislation in U.S. history.

- A single payer system is a system whereby the federal government has full and complete control over health care.

- According to the Tax Foundation, the United States ranks thirty second of the thirty-four industrialized countries in the Organization for Economic Co-operation and Development (OECD) for tax neutrality.

- An unfunded liability occurs when the government commits itself to spending money on programs but does not make adequate provisions to fund the program into the future.

- A flat income tax is a tax whereby everyone pays the same tax rate regardless of income.

- The U.S. income tax system is a graduated or progressive income tax system.

- Our income tax system has exemptions and deductions. Each exemption subtracts X amount of dollars from your total income. You pay taxes on your taxable income, not your gross income.

- Government bases the gasoline tax on the ability to pay principle of taxation.

- A regressive tax is a tax that falls heavier on the poor than on the wealthy.

- Alternatives to our present income tax system are a value added tax (VAT), national sales tax, and a flat tax.

- The Alternative Minimum Tax (AMT) is a parallel tax system and comes with a different set of rates and deduction rules.

- When the government changes the rules of the game on a regular basis, it makes decisions very difficult.

- Off-budget spending makes it difficult to access government spending from one year to the next. Off-budget spending is spending that Congress does not count as part of the regular budget and therefore does not appear in official records.

- The federal budget year begins September 1 of each year.

- One company dominates an industry in a monopolistic market. Because monopolies tend to concentrate in markets with price inelastic demand curves, their existence puts the consumer at a disadvantage.

FOOD FOR THOUGHT

- ✓ What is the biggest threat to our freedom? How does the U.S. Constitution and the Bill of Rights protect our personal freedom? Do you believe the Constitution is a document that should be very difficult to alter, or do you think society can alter it easily to suit the times?

- ✓ Merit goods can be encouraged by first party and third party laws. For example, laws requiring motorcycle drivers to wear helmets protects the driver (the first party) but do not protect other people (a third party), whereas laws that mandate better brakes protect everyone. Almost everyone would agree on the merits of third party laws, but so you agree that the government should pass first party laws? Why do you think this way?

- ✓ If only business owners had a social conscience, if they simply would not pollute our rivers and air, we would not need government to pass costly anti-pollution laws. What do you think about this statement?

- ✓ American farmers have diverted 40 percent of corn production from food to fuel, yet the National Academy of Sciences claims that ethanol production increases greenhouse gas emissions and raises food prices worldwide. The National Association of Clean Air is another agency that claims the burning of higher ethanol blend causes an increase in emissions of nitrogen oxides and other harmful pollutants. If the National Academy of Sciences and the National Association of Clean Air are against burning higher ethanol blends in our gasoline, why do you suppose many politicians in Congress support higher levels of ethanol?

- ✓ What is the problem of too detailed and complex laws?

- ✓ How does the concentration of power jeopardize the rule of law? In terms of planning, what would Friedrich Hayek say about the concentration of power? What would John Maynard Keynes, or at least Keynesians, say about the concentration of power? There is a difference between Keynes and the policies of modern day Keynesians.

- ✓ When insurance companies pay out claims they usually take money from interest, not the principle. In other words, insurance companies invest the money they receive from policyholders and pay off claims from the return that the investments have made, not from the original principle. In this way, insurance companies can remain solvent even in the worst of times. Do you think the federal government should treat Social Security this way? What is the present method of paying out Social Security benefits? Why could this lead to big problems in the future? Why is this similar to a Ponzi scheme? What is a Ponzi scheme?

- ✓ Medicare is an insurance, but Medicaid is an equity loan. What is the difference? Do you think the present system is fair? How would you change it if you do not agree to the present state of affairs?

- ✓ The Patient Protection and Affordable Care Act of 2010 (ObamaCare) is one of the most complex pieces of legislation in U.S. history. Do you support ObamaCare? Would you support free market principles in our health care system instead, or would you support a single payer system? Why do you think so?

- ✓ According to the Tax Foundation, the United States ranks thirty second of the thirty-four industrialized countries in the Organization for Economic Co-operation and Development (OECD) for tax neutrality. What does this statement mean? Why do you suppose the United States has fallen so far in terms of tax neutrality?

- ✓ An unfunded liability occurs when the government commits itself to spending money on programs but does not make adequate provisions to fund the program into the future. Therefore, the government is incurring a liability without proper funding. Social Security is a huge unfunded liability. Is this a good idea? How would you do things differently if you do not agree with the present situation?

- ✓ Milton Friedman once said that the arguments for capitalism are subtle and sophisticated, while the arguments for collectivism are simple and emotional. Do you agree or disagree? What did Milton Friedman mean by this?

- ✓ One company dominates an industry in a monopolistic market. Because monopolies tend to concentrate in markets with price inelastic demand curves, their existence puts the consumer at a disadvantage. Consequently, we have anti-trust laws aimed at limiting monopolies. However, there are times when monopolies are beneficial; we call these natural monopolies. What is a natural monopoly? Is this a good idea to grant companies monopoly status?

- ✓ Whether through corporate inversions or the acquisition of U.S. firms by foreign companies, Washington is encouraging corporate takeovers based on tax considerations rather than on use of a set of assets. Even though the federal government has taken action to try to prevent inversions by American firms, the practice is alive and well in America. What do you think are the possible consequences of more and more business making decisions for tax reasons rather than economic reasons?

CHAPTER 7:
FISCAL POLICY

There are two macroeconomic problems, inflation and unemployment, and there are two categories of macroeconomic solutions to these problems, monetary and fiscal policies. Monetary policies are policies of the Federal Reserve, and fiscal policies are policies of the federal government. Economists call economic policies that accentuate business cycle fluctuations, pro-cyclical, and policies that moderate the swings of business cycle, counter-cyclical.

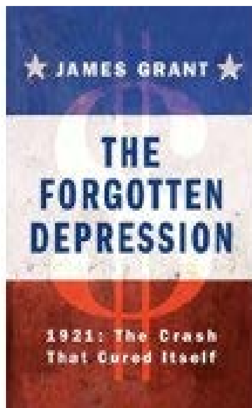
There are two macroeconomic problems, inflation and unemployment, and there are two macroeconomic solutions to these problems, monetary and fiscal policies.

The Fed will attempt to increase the money supply during periods of unemployment and decrease it during inflationary times. The government will use its fiscal policies to adjust spending, borrowing, taxes, and other policies to stimulate aggregate demand during periods of unemployment. The government rarely uses fiscal policies to fight inflation because any cut in government spending hurts a special interest group. Most of government spending goes to entitlement programs, such as social security. Permanent fiscal policies are more effective than temporary policies because most people base their spending decisions on their expected long-term real income more than their current income.

Balancing the budget is of less concern to Keynesians than to Austrians because Keynesians have embraced the idea of functional finance. Functional finance is the philosophy of aiming fiscal policy at achieving potential GDP regardless of what those policies do to the national debt or any other long-term consequence. Austrians are more concerned about deficit spending and the long-term effect of government policies.

Monetary policies are better at fighting inflation than unemployment. The Fed can always decrease the money supply to lower aggregate demand, but it cannot always increase the money supply. Even though the Fed can make it easier for people to borrow money, it cannot force anyone to borrow money. In times of growing unemployment, there are reasons people will not borrow more money despite the lower interest rates. Unemployed people, or people who fear they may be unemployed, will not borrow money just because of lower interest rates.

THE AUSTRIANS



The Forgotten Depression
by James Grant
Simon & Shuster, 2014
Image from Amazon.com

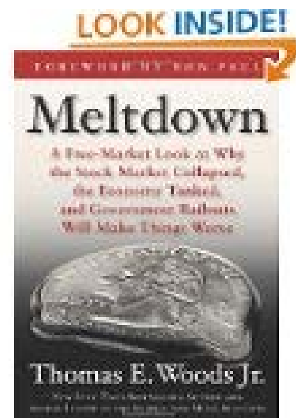
Austrian economists believe in Say's Law. Say's law states that supply creates its own demand. Because suppliers paid wages to people to supply goods and services, Say's Law postulates that consumer demand will be sufficient to sustain full employment because workers will use their earnings to consume these goods and services. There may be unemployment at times because of a mismatch between wants and supplies, leakages, and natural disasters, but ultimately a free market economy will tend toward full employment.

Leakages are monies that leave the income stream. Leakages occur when citizens pay taxes, import goods, and save. Inversely, injections are monies that enter the income stream, such as government spending, exports, and lending. Austrians believe that planned leakages equal planned injections over the long run and that ultimately unemployment is voluntary.

Laissez-faire, which is a French term that means, allow them to do or leave alone, is a philosophy that authorities followed before the Depression of the 1930s. An example of laissez-faire occurred in 1921 when the economy recovered quickly from depression

without government intervention. Austrians support laissez-faire policies and believe that discretionary fiscal policies cause more harm than good. A discretionary fiscal policy is a policy whereby someone, or some group, has to decide what to do about this or that. For example, if we have an unemployment problem and Congress decides to lower taxes to encourage more jobs that would be a discretionary fiscal policy.

A good book written on the subject of the depression of 1921 is *The Forgotten Depression*, 2014, by James Grant. Mr. Grant argues that government addressed the severe downturn in the American economy in 1920-21 with a policy of nonintervention. As unemployment increased, President Harding refused to take action, preferring to let prices and wages continue to fall. Rather than increased activism, he called for smaller government. By late 1921, commodity prices and economic activity reversed their decline and started to rise. [21]



Meltdown
by Thomas E. Woods Jr
Regnery Pub., 2009
Image from Amazon.com

Most educators believe that the laissez-faire policies of President Hoover in the early 1930s aggravated unemployment, and Roosevelt saved American capitalism with his New Deal Programs after 1933. Austrians disagree. Austrians believe that the policies of the New Deal hampered recovery. The book Meltdown, by Thomas Woods Jr., 2009, is a compelling read on the subject.

President Herbert Hoover favored active fiscal policies by launching public works projects, raising taxes, and extending emergency loans to failing firms. He lent money to states for relief programs and encouraged businesses to raise wages.

In the presidential election of 1932, Roosevelt chided the Hoover Administration for too much spending and intervention. Nevertheless, when FDR took office in 1933, he expanded programs by raising taxes, establishing public works and social welfare programs and encouraged investments by keeping prices as high as possible. Austrians believe that, instead of being a positive force on economic events, these Hoover-Roosevelt policies prevented the economy from seeking its full employment equilibrium.

Austrians believe that the economic recovery would had come sooner and the recovery would had been longer lasting if the government had taken a laissez faire approach to economics. Austrians believe that a free market will ultimately seek a full employment equilibrium.

KEYNES and the GREAT DEPRESSION

In his book, *The General Theory of Employment, Interest, and Money,* 1936, the Keynes argued that the neoclassical viewpoint was true in the special case but was not necessarily true in the general case. Thus, he included the word *general* in the title of his book.

Because Keynes believed the economy was tending toward a less than full employment equilibrium in the 1930s, he advocated policies of managing demand as a way to climb out of the Great Depression. Because a change in fiscal policies shifts the equilibrium, a strong fiscal stimulus was necessary to restore the economy to full employment equilibrium. Therefore, the government should borrow more by selling securities (bonds), increase spending and lower taxes to increase aggregate demand to push the economy to its full employment equilibrium.

Notice that the goal is not simply full employment, the goal is to position the economy so that it is tending toward full employment. According to Keynes, once the economy is tending toward full employment, there is little need for fiscal stimulus policies. Politicians, however, liked the idea of fiscal policies so much that they helped foster the idea of Keynesian economics, the idea that the government should always manage demand.

THE EMPLOYMENT ACT OF 1946

Although government spending decreased after 1945, the post-World War II era witnessed government expansion. Because of the Employment Act of 1946, the federal government had the responsibility of promoting maximum employment, production, and purchasing power. Now that President had to submit an annual economic report to Congress stating current levels of employment, production and purchasing power, the government took on a greater responsibility to use its tools to achieve full employment.

Liquidity Trap, the Multiplier, and Paradox of Thrift

Keynesians justify fiscal policies for three reasons: fiscal policies can avoid a liquidity trap, take advantage of the balanced budget multiplier, and prevent the paradox of thrift from leading to insufficient demand.

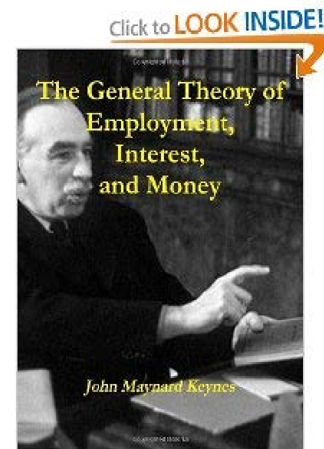
Because banks are liquid when they have excess reserves, a liquidity trap occurs when banks cannot lend, or get rid of, enough of their excess reserves. The situation traps

them into holding too much money. Because the low-interest rates may not motivate consumers and investors to borrow money, the economy is stuck in a rut. A liquidity trap causes an interruption in the circular flow of money and worsens the decline in aggregate demand.

Because banks are the heart of the economy, banks must act as a conduit for money; money comes in, and money goes out. It is like your heart; blood flows in, and blood flows out. If the flow of blood slows down too much, you become anemic or worse, and so it is with the economy. If consumers and investors do not borrow enough money, the only solution is for the government to borrow the trapped money and inject the money into the economy. Thus, the solution to a liquidity trap is deficit spending. Keynesians like to use the term priming the pump to describe deficit spending. You may have a perfectly good pump and lots of water in the ground, but you will not get any water unless you prime the pump by pouring water into the cylinder before you start pumping. Keynesians justify deficit spending because it stimulates demand, and therefore, prevents a liquidity trap.

Austrians see the logic in deficit spending during periods of a liquidity trap. Austrians, therefore, are in agreement with Keynes on this one. However, as mentioned earlier, there is a difference between Keynes and the Keynesians. Whereas Keynes advocated deficit spending only when there was a liquidity trap, the Keynesians tend to support deficit spending more often.

The second reason Keynesians justify deficit spending is because of the balanced budget multiplier. The government balances the budget when it spends what it takes in through taxes. The balanced budget multiplier recognizes that consumers will save a portion of their income whereas the government spends all of its income. Therefore, deficit spending can be justified because a dollar in the hands of government has a greater multiple effects than a dollar in the hands of consumers. If you follow this line of reasoning, savings becomes a drag on the economy during periods of unemployment. Keynesians expect that for every dollar the federal government borrows and spends, spending increases by a dollar fifty. Keynesians also use the balanced budget multiplier to justify higher taxes.



The General Theory of Employment, Interest, and Money
by John Maynard Keynes
BN Pub., 2008
Image by Amazon.com

Austrians have a different point of view. Austrians believe that eventually the economy will recover from a depression on its own as long as government policies do not

hamper the self-adjusting mechanism of the system. Because Austrians believe that savings and investing are sources of growth, too much government borrowing and spending can be counterproductive. While Austrians tend to disfavor discretionary fiscal policies, they do tend to favor monetary policies.

The third reason Keynesians justify deficit spending is the paradox of thrift. The paradox of thrift is a paradox of economics, popularized by Keynes, but first presented by Bernard Mandeville in 1714 with his publication of *The Fable of the Bees*.

A bedrock of Keynesian Economics is the paradox of thrift. The paradox of thrift promotes spending over saving because any increase in personal saving can be harmful to the economy.

The paradox states that if everyone tries to save more money, then aggregate demand may be insufficient to support full employment. The paradox of thrift promotes spending over saving because significant increases in personal saving can be harmful to the economy.

The paradox of thrift is an example of the fallacy of composition, what is true for the individual may not be true for the whole. Thriftiness may be good for the individual, but collective thrift may not be good for the whole economy because it diminishes consumer demand. Therefore, the paradox of thrift justifies the Keynesian policies of government borrowing and spending.

Austrians support policies that encourage savings. The more people save, the more money banks can make available to borrowers. Austrians postulate that when banks lend this money to consumers and investors, the economy grows as consumption and investments increase. The private sector is better at investing then the public sector.

Fiscal Policies, Pork Barrel Spending, and Rent-seeking

Pork barrel spending and rent-seeking influence government policies. Pork barrel spending is the appropriation of government spending for localized projects. Meanwhile, politicians will accept financial support from businesses in return for special favors. Rent-seeking favors large businesses over the small business because the small independent businessperson cannot afford to engage in rent-seeking.

Washington D.C. has 18,000 lobbyists, representing 12,000 clients who spent $2.5 billion in a recent year. An additional 10,000 unregistered lobbyists are working outside Washington, D.C. You can find out who these lobbyists are, who their clients are, and how much money they spend at http://www.opensecrets.org/lobby/.

Fiscal Policies and Unions

Fiscal policies affect small business and non-union workers the most and big business and union members the least.

Over the past several years, there has been a decline in private unions (unions that bargain with businesses), but an increase in public unions (unions that deal with governments). Private unions have limited power because businesses need to make a profit. Public unions have more power because government does not have to make a profit and politicians can raise taxes to pay for union benefits. Because of this, state laws hold private and public unions to different standards, placing more restrictions on public unions than on private unions.

Unions can represent a large voting bloc.

Costs increase when private unions bargain for a wage increase-exceeding worker's productivity gains. To cover the increase costs a business may have to raise its prices. If the business faces a price inelastic demand curve, it can raise the price to cover its higher costs and still make a profit. However, if the business faces a price elastic demand curve, it will experience a decline in revenue with a price hike.

Public unions, as contrasted with private unions, have more bargaining power because they can put pressure on governments for higher wages and benefits. Governments tend to give into these wage demands because governments face inelastic demand curves. The inelastic demand curves allow governments to give into the wage demands without suffering revenue losses when they raise taxes. Another reason politicians tend to support union demands is politics. Unions can represent a large voting bloc and often they have hefty finances to support favored politicians.

Austrians and the Failure of Fiscal Policies

Austrians point out that when special interests acquire more benefits than society can afford, it diminishes efficiency.

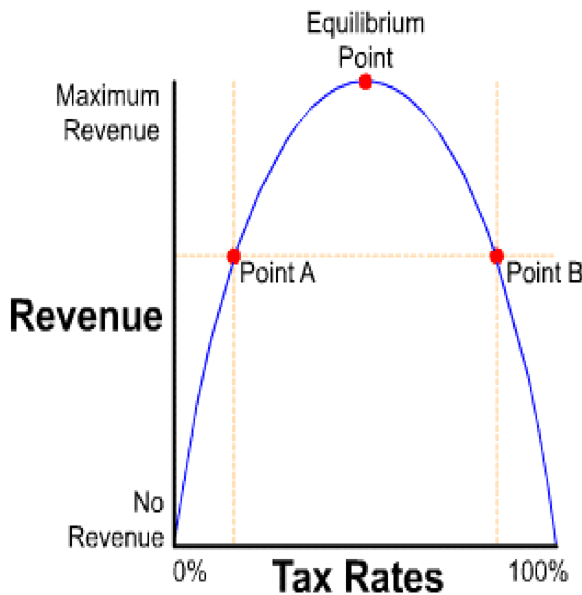
What happens when leaders are more concerned with wealth distribution than growth? Draw a line and label it security floor. This line represents a financial level by which the government will not allow most people to fall. Draw another line above this and label it success ceiling. Where does the money come from to maintain the security floor? It has to come from people who have the money it has to come from the ceiling. The higher the security floor, the lower the success ceiling.

Austrians also believe that discretionary fiscal policies can cause problems if we miscalculate the natural unemployment rate. If the government estimates that the natural unemployment rate is 4 percent, but it is 5 percent, fiscal policies may be ineffective as they try to reach a level of employment that the economy cannot keep.

Austrians believe that if we had a king who had absolute power, possessed all knowledge, and who always made the right decisions, then discretionary fiscal policies would be affective and beneficial to the economy. However, because we live in a democracy with 535 members of Congress, 100 serve in the U.S. Senate and 435 serve in the U.S. House of Representatives, and a president who may have a limited knowledge of how a free market economy operates, there are limitations to discretionary fiscal policies. Having a knowledge of the principles of economics is not a prerequisite when running for Congress or President of the United States. Therefore, Austrian economists believe that discretionary fiscal policies tend to be pro-cyclical rather than counter-cyclical.

Austrians believe that if we had a king who had absolute power, possessed all knowledge, and always made the right decisions, then discretionary fiscal policies would be beneficial.

Fiscal Policies and the Laffer Curve



What effect will a tax increase have on government revenue? The answer depends on where the economy is on the Laffer curve. When the government increase taxes starting from a zero tax rate, a tax increase will increase government revenues because citizens will see the benefits the tax revenues can provide them and the taxes do not inflict much pain. Point A represents this situation. When taxes increase beyond a certain level, however, government revenues will decrease because the high taxes will diminish incentives to work, save, and invest. Point B represents this situation. Beyond a certain level of taxation, people will try to avoid taxes by legal or illegal means; they will escape to

other countries, work less, cheat on their taxes, or seek the underground economy. Beyond the equilibrium point, tax revenues will decline with an increase in taxes.

Because America is the only country that forces international companies to pay taxes twice on the same income if the corporations bring the money back to America, international companies are reluctant to bring money back to America. Instead of using their money to make investments, companies keep their money abroad and borrow money to make the investments.

This double taxation has also led to the practice of inversions. As mentioned above, inversion is the practice of an American company purchasing a foreign company and switching their domicile to that foreign country. Burger King, an American based company, purchased Tim Hortons Inc., a Canadian company, and moved its headquarters to Canada. Because the government realized that many companies were avoiding taxes this way, Congress passed laws making this practice more difficult for American companies. When American companies found that it was unprofitable to invert, many of them resorted to selling themselves to foreign companies as a way of avoiding American taxes.

AUTOMATIC STABILIZERS

Austrian and Keynesian economists disagree on the merits of discretionary fiscal policies, but tend to agree on the merits of automatic stabilizers. Automatic stabilizers go into effect automatically. For example, Congress has passed a law that governs unemployment insurance, it has written the guidelines, and Congress has already appropriated the money. If a person meets the requirements, they get the money. Automatic stabilizers are fiscal policies, but they are not discretionary. Authorities do not have to make decisions when and how they spend the money; this happens automatically depending on how politicians have written the law. Automatic stabilizers are less political than discretionary fiscal policies.

Automatic stabilizers limit sharp upswings of the business cycle and help stimulate the economy during recessions. For example, the progressive income tax can be an automatic stabilizer. As the economy heats up, and incomes rise, the increase in taxes act as a drag on demand and thus tempers the fires of inflation. During slumps, when incomes decline, taxes fall leaving more money in the hands of consumers.

Austrian economists prefer monetary policies, the free market, and automatic stabilizers when faced with an economic problem. Austrians are not in favor of most

discretionary fiscal policies. Keynesian economists believe in automatic stabilizers as well, but they put more credence on discretionary fiscal policies than do Austrians.

FOR THE ADVANCED LEARNER

There is a multiple effect on each dollar injected into the income stream. Let us assume that people will spend one-half and save one-half of each dollar they earn. Economists define savings as money earned but not spent. Savings can be taxes, social security, insurance, and similar payments as well as optional savings.

The marginal propensity to consume (MPC) measures the amount that consumers tend to spend out of their income. The marginal propensity to save (MPS) is the amount that people tend to save out of any addition to their income. If people spend and save one-half of their income, money received, then the MPC is one-half, and the MPS is one-half.

The marginal propensity to consume (MPC) measures the amount that consumers tend to spend out of their income. The marginal propensity to save (MPS) is the amount that people tend to save out of any addition to their income.

When Sandra receives $100, she will buy a widget from Susan for $50. Now that Susan has received $50, she will spend $25 to buy a widget from Bill, who in turn spends $12.50 to buy a widget from Sam, who in turn spends $6.25, and so forth. Out of the original $100 injection, total spending increased by about $200, that is, $100 + $50 + $25 + $12.50 + $6.25, etc. Instead of going through this mathematical process, we can use the Keynesian multiplier to calculate the effect that an increase in spending has on the economy. The Keynesian multiplier is 1/MPS. If MPS is one-half, and one divided by one-half is two, therefore the multiplier is two. If we take the multiplier 2 and multiply it times the original amount of money spent, $100, we get $200.

Keynesians believe that with knowledgeable people in charge possessing correct information, and these people know the value of the multiplier, discretionary fiscal policies can be beneficial.

Now suppose economists estimate that national income has to increase by $2 billion to achieve a full employment equilibrium without causing inflation. If the government

spends an additional $2 billion, national income increases by $4 billion, causing inflation. Instead, the government should increase spending by one billion to achieve the desired increase of two billion dollars. If discretionary fiscal policies are to be effective, economists and politicians must understand the value of the multiplier.

Keynesians believe that with knowledgeable people in charge possessing correct information, and these people know the value of the multiplier, discretionary fiscal policies can be beneficial. Although Austrians see the logic in the Keynesian multiplier, they doubt that policymakers can use this information beneficially. Since when did Congress make decisions based on economics and not politics?

The Accelerator

There can be a multiplier beyond the simple multiplier because of induced investments. For example, suppose the government spends one billion dollars on a new highway. If the MPS is one-half, we know that one billion-dollar increase will generate two billion dollars of spending. However, there may be an accelerator effect if the new road will encourage businesses to invest in gas stations, restaurants, and motels.

Suppose companies invest $1.5 billion in new ventures because of the new highway. Because the MPS is still one-half, there are a multiple effects of two on this $1.5 billion. In other words, a $1.5 billion in increased investments would eventually cause $3 billion of additional spending. Instead of the initial one billion leading to an increased spending of two billion, there is an increase of five billion dollars, two billion because of the multiplier and three billion because of the accelerator.

The accelerator effect complicates decisions for policymakers because the accelerator is not always present. For example, suppose the economy is operating at less than full capacity. When spending increases, businesses will use plants already in existence rather than invest in new ones. The accelerator effect is more likely to take place when the economy is operating at full capacity.

A FINAL WORD

Austrian economists believe that discretionary fiscal policies are ineffectual for the following reasons. First, we have to know if we have a problem or not, and whether we are in a full employment equilibrium or not. Then we have to know the value of the multiplier and the accelerator. Then we have to use discretionary fiscal policies to shift the

equilibrium to a full employment equilibrium. If we have to raise taxes, we have to know where we are on the Laffer curve. Also, politicians have to make sure that their forecasting is accurate. There is also the problem of time lags. Because of the recognition, decision and action lags, discretionary fiscal policies tend to be out of step with the times. Most important of all, we have to assume that Congress and the President make decisions based on economics and not politics! After knowing all of this, Austrians would question whether constructive policies are possible given our budget and debt restraints and the dynamic effect of the foreign sector.

SUMMARY

There are two macroeconomic problems, inflation, and unemployment, and there are two macroeconomic solutions to these problems, monetary and fiscal policies. Monetary policies are policies of the Federal Reserve, and fiscal policies are policies of the federal government. The Fed will attempt to increase the money supply during periods of unemployment and decrease it during inflationary times.

The government will use its fiscal policies to adjust spending, borrowing, taxes, and other policies to stimulate aggregate demand during periods of unemployment. The government does not use fiscal policies to fight inflation because any cut in government spending hurts this or that special interest group. Permanent fiscal policies are more effective than temporary policies because people base their spending decisions on their expected real income more than their current income.

Austrian believe in Say's Law. Say's law is the idea that supply creates its demand. Say’s Law postulates that consumer demand will be sufficient to sustain full employment because workers use their earnings to consume. There may be unemployment at times because of a mismatch between wants and supplies, leakages, and natural disasters, but ultimately the economy will tend toward full employment.

There is an interesting comparison between the depression of the early 1920s and the depression of the 1930s. The government did not try to combat the Depression of the 1920s, whereas the 1930s government was very active. President Warren Harding vacillated as what to do in 1920, but the depression ended before he could take action. In contrast, the Great Depression changed popular opinion in favor of demand management economics.

Most economists agree that automatic stabilizers are useful, but there is disagreement on the validity of discretionary fiscal policies. Austrians believe we should rely on monetary policies, the free market, and automatic stabilizers. Keynesian economists believe that if we just had more knowledge, wisdom, and enough support, discretionary fiscal policies would work to stabilize the economy during economic downturns.

Austrian and Keynesian economists disagree on the merits of the discretionary fiscal policy but tend to agree on the merits of automatic stabilizers. Automatic stabilizers go into effect automatically. For example, Congress has already passed the law that governs unemployment, it has written the guidelines, and Congress has already appropriated the money. Automatic stabilizers limit strong upswings of the business cycle and help stimulate the economy during recessions.

KEY CONCEPTS

- There are two macroeconomic problems, inflation and unemployment, and there are two macroeconomic solutions to these problems, monetary and fiscal policies.
- Economists call economic policies that accentuate business cycle fluctuations pro-cyclical; policies that moderate the swings of business cycles they call counter-cyclical policies.
- The Fed will attempt to increase the money supply during periods of unemployment and decrease it during inflationary times.
- Monetary policies are better at fighting inflation than unemployment because banks cannot force people to borrow money during recessionary times.
- Say's Law postulates that consumer demand will be sufficient to sustain full employment because workers use their earnings to consume.
- Austrians support laissez-faire policies and believe that discretionary fiscal policies cause more harm than good. Austrians do favor automatic stabilizers.
- In his book, T*he General Theory of Employment, Interest, and Money*, 1936, John Maynard Keynes argued that the neoclassical viewpoint was true in the special case but not the general sense.

- The Employment Act of 1946 gave the federal government the responsibility to promote maximum employment, production, and purchasing power.

- A liquidity trap is a situation whereby conditions trap money in banks and the banks do not lend the money despite lower interest rates.

- According to Keynes, the solution to a liquidity trap is for the federal government to borrow the money.

- The paradox of thrift states that if everyone tries to save more money during times of economic recession, then aggregate demand will fall and will lower total savings because of the decrease in consumption and economic growth.

- If unions bargain for wage increases exceeding productivity gains, costs increase.

- Private unions have limited power because businesses need to make a profit; public unions wield more bargaining power because government does not have to make a profit.

- Keynesians believe that fiscal policies are beneficial; Austrians doubt the effectiveness of discretionary fiscal policies to bring about long-term economic stability.
- Keynesians and Austrians tend to agree on the effectiveness of automatic stabilizers.

- The Laffer curve recognizes that a tax increase starting from zero will increase tax revenues, but when taxes increase beyond a certain point, tax revenues will decrease.

FOOD FOR THOUGHT

✓ Keynesian economists believe that with enough knowledge, sufficient tools, and wise decision makers, discretionary fiscal policies can temper the wide swings of the business cycle and help foster economic growth. Assuming you support Austrian economics, how would you dispute this idea?

✓ Say's Law states that supply creates its own demand. When businesses produce something, workers were paid wages. Therefore, workers will have the money to

buy whatever business produces. Do you agree or disagree with this idea? Why do you think this way?

- ✓ The basic concept of Keynesian economics is that as long as government can control demand, it can control the economy. Explain why Austrians do not agree with this statement. Give an explanation which side of this disagreement you take.

- ✓ When public unions bargain for pay raises greater than their increase in productivity, government costs increase. It is easy for the government to pass on these higher costs to taxpayers because the benefits that society receive tend to face relatively inelastic demand curves. What does this mean? Is this a reason public unions have a lot more bargaining power than do private unions? Why or why not.

- ✓ Austrian economists believe that discretionary fiscal policies tend to be pro-cyclical rather than counter cyclical. What does this mean? Do you think discretionary fiscal policies can be counter cyclical? Why or why not?

- ✓ For Keynesian policies to be effective, we have to know if we have a problem or not, and whether we are in a full employment equilibrium or not. Then we have to know the value of the multiplier and the accelerator. Then we have to use discretionary fiscal policies to shift the equilibrium to a full employment equilibrium, assuming we have knowledge of the full-employment equilibrium. If we have to raise or lower taxes, we have to know where we are on the Laffer curve. Then, politicians have to make sure that their forecasting is accurate. There is also the problem of time lags, the recognition, decision and action lags. We also have to assume that Congress and the President make decisions based on economics and not politics!

- ✓ Considering all these things, do you believe that Keynesian discretionary fiscal policies can be affective? If you believe that Keynesian policies cannot be effective, what should be alternative economic policies during periods of unemployment? If you had absolute authority, what changes would you make to our economic system to make it function smoothly, increase productivity, and preserve individual freedoms?

- ✓ Considering world events, and assuming that government' policies remain unchanged, what do you think will happen to the world economy in the coming years? What are you doing now to prepare yourself for the future? Do you think that the country will continue its present policies, or do you see major changes that

will change the economy and society structurally? How do you think this will affect you personally?

- ✓ Where do you think the U.S. economy is on the Laffer Curve? If Congress votes for a tax increase, what will happen to the government's tax revenues? If Congress only raises taxes on the wealthy, the top one percent of taxpayers, how will this affect the economy?

CHAPTER 8:
INFLATION & DEFLATION

The Bureau of Labor Statistics defines inflation as a pervasive and general rise in the average price level. When dollars become more plentiful, when they increase more than goods and services increase, the value of each dollar diminishes, everything else being equal. When this happens, it takes more dollars to add up to the value of whatever it is you buy.

WHOM DOES INFLATION HURT?

Inflation hurts people on fixed incomes the most and people on flexible incomes the least.

Inflation can be personal; different people can experience different rates of inflation. For example, inflation hurts persons on fixed incomes. The elderly are susceptible to higher prices because many elderly have fixed incomes. The elderly can also be hurt when the things that they normally buy increase in price more than the things that young people purchase. For example, the cost of health care and medical devices have been increasing more than the price of electronics.

Lenders are hurt the most when the lender expects a low inflation rate but experiences a high inflation rate over the term of the loan. If the lender expects an inflation rate of 5% and wishes to make a 7% real return, he will charge 12% interest. However, if the inflation rate ends up to be 12%, then the lender receives back the same amount he lent out in real terms. His nominal return is 12%, but his real return is zero. In this case, the lender loses and the borrower gains. If the inflation rate is less than expected by both parties, then the lender gains and the borrower loses.

There is nothing wrong with a slow and steady rise in prices. Some economists believe that a slow and steady increase in average prices is a good thing,

Inflation can hurt savers. If you put money in a savings account, and you receive 4% interest, but the inflation rate is 10% in the same period, then your real return is a negative 6%. When you take money out of savings, you are getting back 6% less, in real terms. Negative returns is the primary reason savers will take money out of savings and put it into the stock market. During periods of low interests rates and higher inflation, savers will be more willing to take risks in the hopes of gaining in real terms.

There is nothing wrong with a slow and steady rise in prices. Some economists believe that a slow and steady increase in average prices is a good thing, especially when people correctly anticipate the rise in prices. Inflation that is high and erratic, however, can cause havoc for almost everyone. In fact, any sudden and pronounced change in prices, either up or down, can cause problems.

You should not confuse inflation with the price mechanism.

You should not confuse inflation with the price mechanism. It is imperative that we let prices change in response to changes in demand and supply. When demand increases more than supply, the rise in price lets the producer know what the consumer wants, gives incentives to satisfy consumer wants, and allows profit so the producer can afford to increase supply.

PRICE INDEXES

There are several price indexes, but the Consumer Price Index affects (CPI) almost everyone. The CPI measures price increases for a particular imaginary basket of goods and services. The goods and services in the basket are those consumers typically and often

purchase. As time goes on, and things change, government statisticians take some things out of the basket and include other things. For example, typewriters are rare, and cell phones are common.

The consequences of inflation can be confusing when the Bureau changes the definition of the consumer price index (CPI), an index that affects all government transfer programs. Recipients of government programs receive a cost of living adjustment (COLA) each year depending on the CPI. Therefore, when the Bureau changed the meaning by taking out price increases of food and energy, it changed the rules of the game.

Other price indexes are the GDP Price Deflator and the Wholesale Price Index. The GDP index measures all prices in the economy and the wholesale price index measure the rise in the price of only wholesale goods, not retail goods. There are different indexes because economists ask different questions. One index or another can answer some questions the best. The CPI is most popular because it measures consumer prices.

The rule of 72 will give you an idea of the impact of inflation over time. Take any incremental increase and divide the number into 72 and you will get an approximation of how long it will take prices to double. For example, if the inflation rate is 2% each year, it will take about 36 years for prices to double (72/2=36). If the inflation rate is 4% over time, it will take about 18 years for prices to double (72/4=18).

The rule of 72 will give you an idea of the impact of inflation over time. Take any incremental increase and divide the number into 72 and you will get an approximation of how long it will take prices to double.

HISTORY

Rome got into trouble between 218 A.D. and 268 A.D. when the government financed a large army, embarked on expensive public works projects and raised taxes. Entrepreneurship fell off and tax evasion increased. The government increased coins in circulation and debased the currency by replacing gold and silver in coins with a cheaper metal until the coins value was only one five-thousandth of its original level. Diocletian blamed merchants for the inflation problem, and in 301 A.D., he attempted a price freeze. His edict led to shortages and hoarding, which led to penalties against hoarding. These and other policies made all citizens wards of the state.

When Germany entered the First World War in 1914, it opted to finance the war by borrowing money instead of raising taxes. After the war, Germany increased the money supply in an attempt to reduce the value of the mark to encourage exports. Germany's actions culminated in a classic currency war involving many of the world's economies. Prices rose more than fivefold each week from July to November of 1923. By 1924, inflation had radically redistributed the wealth of Germany, hitting the middle class the hardest. The poor had little money to lose while the rich transferred theirs into forms not adversely affected by inflation, such as deposits in foreign banks, precious metals, and land. The ill effects of inflation fell heaviest on people with fixed incomes, while debtors had their debts wiped out.

Erich Remarque's novel, *The Black Obelisk*, 1923, describes events in Germany during this period.

> *Workmen are given their pay twice a day now--in the morning and in the afternoon, with a recess of a half-hour each time so that they can rush out and buy things--for if they waited a few hours the value of their money would drop so far that their children would not get half enough food to feel satisfied.*

Zimbabwe experienced hyperinflation in 2006 when the price of a single sheet of toilet paper was $417 in Zimbabwean dollars and a roll was $145,750, making the price of necessities that of luxuries. Public school fees and other ever-rising government surcharges exceeded the monthly incomes of many urban families lucky enough to find work. In 2006, the government printed trillions of new Zimbabwean dollars to keep ministries functioning and to shield the salaries of key supporters.[22]

THE BRETTON WOODS MONETARY SYSTEM

> ***A paramount concern at the Bretton Woods Conference in 1944 was replacing the British currency as the standard for settling international transactions.***

World War II had a devastating effect on the global monetary system. A plan for restoring order came in 1944 at Bretton Woods, New Hampshire with a meeting of 730 delegates from 44 Allied nations. Of paramount concern was replacing the British currency as the standard for settling international transactions. Large gold reserves in America made the U.S. dollar a preferable

replacement. Thus, the Bretton Woods system was born, whereby the government linked the dollar to gold at a pre-determined rate of $35 per ounce. Because all countries pegged their currencies to gold at predetermined rates, all countries knew the value of their currency and currencies of their trading partners. This arrangement of fixed exchange rates facilitated international trade. The U.S. dollar became the standard currency in international trade because the U.S. guaranteed payment of gold in return for dollars upon demand. When people believed that the dollar was as good as gold, they were willing to deal in currencies rather than exchanging gold.

However, this fixed international exchange rate system was not to last because of the inflationary 1970s. It was not so much inflation as it was the different inflation rates among trading partners. If America experiences a 10 percent inflation rate, the value of the dollar declines by 10 percent. If England has a 15 percent inflation rate, the English pound drops in value by 15 percent. With the values of these currencies changing relative to one another, how can these countries trade while they assume fixed exchange rates?

The fixed international exchange rate system established at Bretton Woods was not to last because of the inflationary 1970s.

America's inflation problem began in 1969 when President Richard Nixon inherited a recession from Lyndon Johnson, who had simultaneously spent generously on the Great Society and the Vietnam War. Congress continued to fund the war and continued to increase social welfare spending. Nixon was able to enhance his political career by convincing the Fed to increase the money supply just as voters were casting ballots.

President Nixon imposed wage-price controls in 1971, ran budget deficits, and announced he was a Keynesian. The Nixon deficits caused foreigners to flee the dollar for other currencies as foreigners lost faith in the U.S. economy. Consequently, on August 15, 1971, President Richard Nixon told a national television audience that the gold standard, or what little of it remained, was kaput.

After this, the United States refused to value the dollar at 1/35th of an ounce of gold and closed the gold window. Before President Nixon severed the ties between the dollar and gold, the Federal Reserve could not create money as it does today. In those days, someone had to dig the metal out of the earth or entice it into American vaults with money-friendly policies. With the closing of the gold window, nations could no longer demand payment of gold in return for U.S. dollars. Governments replaced a fixed rate system with a freely flexible international exchange rate system. In a freely flexible system, currency values are determined by the market. Thus, the dollar became a fiat currency; a currency that is not backed up by gold or silver.

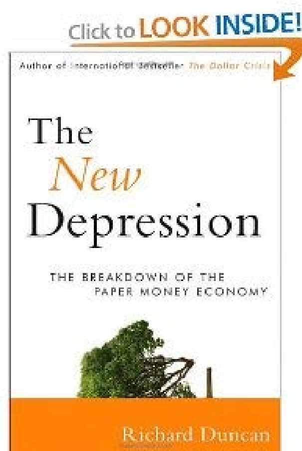
Inflation was 9% in 1973 and reached a high of 14% by 1980. For a three-month period in 1980, the prime interest rate, the lowest interest rate available to the public, was 21 percent. Imagine what would happen if the federal government had to pay 20 percent interest on a $20 trillion debt!

The Petrodollar System

In the 1970s, many countries lost confidence in the U.S. economy because of Washington's prolific social programs and chronic deficit spending. As governments abandoned the U.S. dollar, Washington looked for ways to reinvigorate demand for the U.S. dollar. The solution to a declining U.S. dollar was the petrodollar system.

The Nixon Administration held a series of high-level talks with Saudi Arabia and other oil-producing nations, with the goal of requiring these countries to price their oil in dollars. A petrodollar is a U.S. dollar that oil producers demand from customers in exchange for selling their oil. American enticed oil nations to cooperate by offering military assistance and protection for the region's oil fields. Now, instead of dollars for gold, as under the Bretton Woods arrangement, the new petrodollar system, established in 1974, became dollars for oil.

Credit Creation has Replaced Growth Policies



The New Depression
by Richard Duncan
Wiley Pub., 2012
Image from Amazon.com

A new economic model took shape when nations broke the ties between money and gold. Now instead of countries seeking growth policies, growth took a back seat to credit creation and consumption. There is a grave danger that this credit-fueled economic paradigm will break down.

Richard Duncan, in his book, *The New Depression*, explains that we have creditism and not capitalism. Creditism has created extraordinarily rapid growth for decades, but it has hit its limit to produce more growth because we can no longer pay off national debts without creating ever more money.

Creating new money to stimulate the economy is like a person taking drugs to feel high.

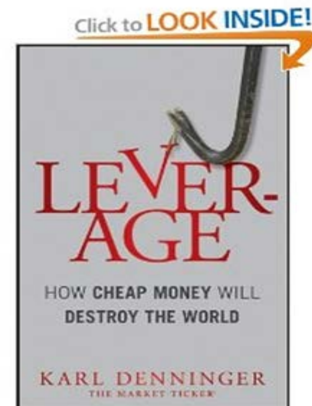
A drug addict may feel good for a while, but eventually the craving returns, except this time it takes a higher dose to attain the same feeling. Eventually, no amount of drugs can bring back that feel-good state because the drugs have decimated the body. At this point, the only cure is an agonizing and painful withdrawal process. At some point, quantitative easing will be ineffective.

Fiat Currencies

When nations replace sound money with fiat currencies, inflation is never far behind. Under the gold standard, we could not increase the money supply unless we increased the quantity of gold. However, with a fiat monetary system, there is no limit on money creation.

When much of the world was on the gold standard in 1933, the U.S. was in a depression, and people were trading their dollars for gold. President Roosevelt put an end to this practice by making it illegal for Americans to possess gold and required citizens to exchange their gold for paper money at the rate of $20.67/ounce. He then raised the price of gold to $35/ounce, thus gaining windfall profits. The final nail in the coffin of the gold standard came when President Nixon refused international banks the privilege of exchanging dollars for gold in 1971.

In Karl Fenninger's book, *Leverage – How Cheap Money Will Destroy the World*, he shows how money creation will destroy economies. The major countries of the world have gone from capitalistic systems to crony capitalism, where powerful interest groups control the levers of government policy. Instead of slow and steady growth, the rich and powerful engineer economic bubbles so that they can take advantage of the wide swings. Special interest groups profit as the economy zooms upward, and the government protects them from losses when the economy tanks.



Leverage – How Cheap Money will Destroy the World
by Karl Denninger
Wiley Pub., 2011
Image from Amazon.com

Money is the lifeblood of an economic system. When quantitative easing, monetizing the debt, dilutes the value of money, it is like a person whose blood is too thin; there are not enough nutrients in the blood to sustain a healthy body. When the Federal Reserve increases the money supply too much, it will reach a point of not being able to sustain a vibrant and healthy economy.

THE VALUE OF MONEY

This note is legal tender for all debts public and private is on every U.S. dollar. Dollars have value because the federal law recognizes dollars as payment of a debt and because dollars are scarce. Fiat currencies, like the dollar, become less valuable when they become less scarce. The words Federal Reserve Note at the top of every dollar bill makes dollars a debt instrument of the Federal Reserve.

The words *NOVUS ORDO SECLORUM* are at the bottom of the one-eyed pyramid on every one-dollar bill; the phrase means a new order of the ages. The phrase signifies the beginning of the new American Era as of the date of the Declaration of Independence. Treasury has written the phrase Annuit Coeptis on the left of each dollar bill above the one-eyed pyramid. The phrase means she/he/it approves of the undertakings or she/he/it has approved of the undertakings.

An alternative to our present money system is to take the authority of money creation away from the Federal Reserve and give it back to the U.S. Treasury. As discussed earlier in Chapter 5, this is what happened in 1963. On June 4, 1963, the government attempted to strip the Federal Reserve Bank of its power to loan money to the government at interest. President Kennedy's Executive Order 11,110 gave the Treasury Department power to issue silver certificates against silver bullion in the U.S. Treasury. The government, not the Federal Reserve, could introduce new money into circulation, but only to the extent of its silver holdings in its vault.

After the assassination of President Kennedy, the U.S. Treasury ceased issuing Silver Certificates. If the government had allowed Silver Certificates to circulate, it would have given the U.S. government the ability to repay its debt without going to the Federal Reserve. The federal government could still issue silver certificates because Executive Order 11,110 remains valid.

The international community is moving to replace the U.S. dollar as the world's standard, or reserve currency. The UN Conference on Trade and Development has advocated replacing the dollar with a managed international exchange rate system. I will discuss this later in the book.

An alternative to our present money system is to take the authority of money creation away from the Federal Reserve and give it back to the U.S. Treasury.

Virtual currencies, like Bitcoin, could become standard currencies. Governments or central banks have nothing to do with virtual currencies. Virtual currencies only exist as ones and zeroes on computers. The difference between virtual currencies and fiat currencies is that a precise set of rules constrain the amount of the virtual currency that the system can bring into existence. Fiat money, like the American dollar, is not subject to any restraints. If a well-defined set of rules limited the number of dollars that the Federal Reserve could bring into existence, then the existence of virtual currencies would not be necessary.

Bitcoin is a virtual currency created in 2009 by an unknown person using the alias Satoshi Nakamoto.

Bitcoin is a virtual currency created in 2009 by an unknown person using the alias Satoshi Nakamoto. People can use Bitcoin for transactions without banks or governments. International payments can be easy and cheap because Bitcoins are not subject to government regulation. People create Bitcoins by competing using computers to solve complex math puzzles. The winners store Bitcoins in a digital wallet. Because a set of rules determine how many Bitcoins authorities can bring into existence, Bitcoins maintain their value. If there is a demand for the currency, but the supply is limited, then the currency will have value in the marketplace. There is a need for the U.S. dollar, but the supply of the dollar is unlimited, and there you have the difference.

Whether Bitcoin succeeds in becoming a widely accepted currency or not, the underlying technology is here to stay. No digital currency will replace the dollar soon, but Bitcoin, or at least the technology, is here to stay because Bitcoin is more than a currency. Bitcoin is open-source and copyright free, and, therefore, accessible to everyone. A volunteer army of developers has made Bitcoin secure.

When goldsmiths invented banks in Florence Italy in the late 1400s, a centralized system of managing money came into existence. Because banks acted as intermediaries in financial transactions, people did not have to trust strangers as they did previously; they could now trust their banks. Thus, the evolution of banks made possible the Renaissance, the Industrial Revolution, and the modern age.

We now have a new form of currency that people can exchange among themselves online without the help of banks. Society determines economic value by the currency's usefulness and its level of scarcity. A decentralized monetary system based on bits and bytes can be a viable money system as long as enough people support it. Physical currencies are tokens that represent a shared standard of value by keeping track of who owes whom what, virtual currencies can do the same.

A very good book on the subject of virtual money is *The Age of Cryptocurrency: How Bitcoin and Digital Money are Challenging the Global Economic Order*, by Paul Vigna and Michael J. Casey, St. Martin's Press, 2015.

CAUSES OF INFLATION

Demand-pull inflation occurs when the aggregate demand curve shifts to the right. Not every increase in demand will cause higher prices as it depends on where the short run aggregate demand curve falls on the aggregate supply curve.

During periods of high unemployment, factories will be idle, as well as machines, tools, and workers. In this case, when demand increases, prices need not increase because there are no shortages, there is plenty to go around for everyone. The lack of competition for unused capacity explains the horizontal supply curve.

As demand continues to increase, the economy eventually runs out of some resources causing shortages. Now some prices will increase as demanders bid against one another for the scarce resources. At this point, the supply curve starts an upward trend.

Theoretically, as demand continues to increase the economy runs out of all resources at the going prices. Because the system cannot build factories and train skilled workers overnight, all prices rise. At this point, the supply curve is vertical because the only way to solve the allocation problem is through an increase in the general price level, quantity cannot increase until after a time lag.

Cost-push inflation occurs when costs increase more than productivity increases. A shift to the left of the supply curve causes the general price level to rise.

Cost-push inflation is more problematic than demand-pull inflation. If prices are high because demand is high, they will promptly respond to a reduction in demand. But, when prices are high because high costs, prices will not respond as quickly to a decrease in demand because a business will not have an incentive to lower prices. The government could curb demand by using fiscal policies, and the Federal Reserve could moderate demand by using its monetary policies, yet prices will temporarily remain high.

Cost-push inflation is more problematic than demand-pull inflation.

The quantity theory of money ultimately determines the price level. The quantity theory of money is MV = PQ; where M is the money supply, V is the velocity of money (how quickly money changes hands), P is the general price level, and Q stands for the quantity of goods and services or GDP. Dividing both sides of the equation by Q, economists state the quantity theory of money as P = MV/Q, showing that prices will increase as the money supply or velocity increases, or quantity decreases.

POSSIBLE REMEDIES to REDUCE INFLATION

Possible remedies for inflation include reducing the money supply, escalator clauses in contracts, fiscal restraint, wage-price freezes, eliminating trade restrictions and productivity gains.

Reduce the Money Supply

When inflation is persistent and deep-rooted, it will take time before a reduction in the money supply will start to lower prices. Before prices begin to head south, the economy will experience unemployment. As the unemployment problem worsens, the public demands the Fed and government to take action to stimulate the economy. Employment improves when the Fed reverses itself and increases the money supply, but this will cause more inflation. Now the public demands action to bring a halt to the inflation problem. When authorities restrict the economy, the unemployment problem worsens. Policy reversals were common during the 1970s resulting in a cycle of increasing prices and unemployment.

The reason an increase in the money supply caused inflation in the 1970s, but not today, is that the velocity of money was rising in the 1970s, whereas today velocity is decreasing. In the 1970s, consumers were flush with cash because of the wealth creation of previous generations and the fact that people were not as much in debt as they are today. The present generation has squandered some of their wealth by prolific spending, and the government has confiscated the rest by way of higher taxes.

How did we get off this merry-go-round in the 1970s? In 1980, Paul Volcker, then Chairman of the Federal Reserve, decided to keep a tight rein on the money supply. Mr. Volcker became unpopular as the economy experienced a severe recession in 1980 and 1981. However, he refused to increase the money supply to combat unemployment, and the price level eventually subsided. Once he got a handle on the inflation problem, he was able to concentrate on the unemployment problem and for the rest of the 1980s we experienced prosperity and moderate prices.

Escalator Clauses

Escalator clauses permit changes to a contract, such as basing a worker's wage on the inflation rate plus a certain percentage. Escalator clauses allow wages to decline as inflation declines without affecting real income. Loan contracts can include escalator clauses by which financial institutions adjust interest rates every year based on the inflation rate. Instead of paying a fixed percentage, the borrower would agree to pay a small percentage, say 2 percent, plus the inflation rate. This way, as the inflation rate declines, so will loan payments. During inflationary periods, banks will insist on escalator clauses to protect them from inflation.

Escalator clauses allow wages to decline as inflation declines without affecting real income.

Fiscal Restraint

The government can help solve an inflation problem by decreasing spending and increasing taxes. Of course, if we increase taxes, we assume that the government will use the money for debt reduction and not spend it, which is a big assumption. Another problem with fiscal restraint is the impact on special interest groups. Special interest groups are always eager to protect their share of the federal budget and politicians are reluctant to harm their constituency.

The government can help solve an inflation problem by decreasing spending and increasing taxes.

A Wage-Price Freeze

A wage-price freeze may work temporarily, but eventually, we have to lift a wage-price freeze to prevent bankruptcies and inequities. Also, because efforts to control wages tend to be more successful than efforts to control prices, workers will demand exceptions from the law. When we remove the freeze, producers will raise prices even more in anticipation of another price freeze.

Wage price controls distort resource allocation by preventing the price mechanism from equalizing supply and demand and, therefore, address the symptoms rather than the causes of inflation. The side effects of these price controls is a decrease in personal freedoms and an increase in illegal activity. Many would be law abiding citizens are forced into unlawful activities.

A wage-price freeze is an attempt to thwart market forces. History has shown us that we can force the market to go places it would not naturally go, but eventually the market will seek its equilibrium.

Relax Trade Restrictions

The relaxation of trade restrictions will lead to lower prices as countries find it less expensive to trade with one another. Free trade would open the doors to more competition, encourage comparative advantage, and foster the attributes of economies of scale.

Increase Productivity

All problems are easier to solve with productivity gains. Lower costs will lead to lower prices as business compete for customers. Prices would decrease with productivity gains along with a stable money supply. However, as long as the money supply increases more than goods and services increase, we would still have an inflation problem.

DEFLATION

Deflation is a persistent and general decline in the price level. Recessions can cause deflation as aggregate demand plummets. Although a drop in the price level benefits consumers, the lower prices depress profit margins. People who gain from deflation are people who are debt free and pay for most things in cash. Creditors also benefit because they receive more highly valued dollars from debtors.

Japan became the first major economy since the Great Depression to fall into extended deflation. Deflation continues in Japan despite the fact that Japan's central bank has been monetizing vast amounts of government debt for several years in the hopes of raising prices. The anemic velocity of money explains why Japan’s economy remains moribund. The process of stimulating demand to increase prices is what economists call reflation.

Sticky wages can be a problem. The demand for labor may decline, but because of unions and government regulations, wages do not come down right away. In this case, demand can soften, prices can fall, but many businesses may find it difficult to cut workers' wages.

When consumers borrow money, they often have a choice of a paying a fixed or a variable interest rate. Some mortgage loans have fixed rates whereby the interest rate does not change with changing market rates. In this case, interest rates would be sticky, causing interest payments to remain relatively high when debtors' incomes fall. This problem of sticky interest costs during recessions can be problematic for the government as well. Imagine what would happen to the federal budget when tax revenues decline during a recession, but interest costs on a $20 trillion debt remain fixed for a time.

A slow but steady decline in prices is one thing; a sudden drop in prices is something else. With a slow decline in prices, the economy has a chance to adjust to the lower prices, but when prices fall suddenly, adjustments are painful. Recall the rule of 72. With a drop in prices of two percent, it will take 36 years for prices to fall by a half. However, a decline of ten percent will cause prices to half in just seven years.

A deflationary period will keep interest rates low or even negative. Deflation will act as a deterrent to savings, which is the bedrock for growth. Chronically low-interest rates minimize monetary policy. During periods of unemployment, the Fed will reduce interest rates to encourage an increase in demand, but if interest rates are already near zero, the Fed cannot lower them further. We could enter a period with negative interest rates. A negative interest rate would mean that you would have to pay your bank to hold your money in a savings account instead of the bank paying you interest. Japan has gone through periods of negative interest rates.

Before the financial collapse of 2007-2008, few economists would have suspected a relationship between quantitative easing and deflation. A common belief among economists is that an increase in the money supply will cause inflation, not cause deflation. However, some economists now recognize that quantitative easing can lead to deflation. Because quantitative easing has kept interest rates close to zero, banks have been reluctant to lend money to the public. Instead, banks have deposited some of the money at the Federal

Reserve because the Fed now pays interest on this money; they have invested the money into the derivatives market, and lent some of it to foreigners, thus stifling domestic consumer demand.

Quantitative easing has led a concentration of wealth. Because quantitative easing has encouraged an increase in speculation, and because these investments have grown in value, quantitative easy has helped rich people over poor people. Therefore, despite the lack of economic growth, banks and wealthy persons have thrived. The Dodd-Frank Act of 2010 has codified this trend of the rich getting richer through government policies that favor one group of people over another. According to the law, in the event of an economic collapse, losses that banks incur in the derivatives market receive compensation before the government helps creditors. If you put money in a bank, you are a creditor because you have essentially made a loan to the bank. In the event of insolvency, big banks are to recapitalize themselves with savings of their creditors and depositors.

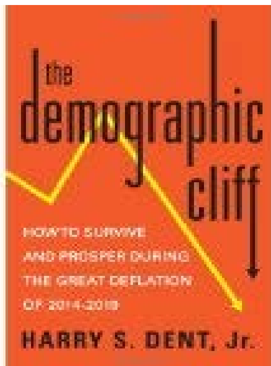
Quantitative easing has fueled the fires of the derivative market. The derivatives market is the financial market for derivatives. A derivative is an asset whereby something else derives its value. That other asset that derives the value of a derivative can be anything. Essentially, a market forms from bets that investors make with one another about the outcome of some future event. The parties to the bet write their terms down and a piece of paper. Whoever owns this piece of paper at the specified future date and who is on the winning side of the bet, collects from the losing party. Investors can buy and sell this piece of paper many times before the specified future event takes place. Whoever owns this piece of paper, which is the derivative, collects from the losing party. In this fashion, investors create value out of thin air.

> ***The derivatives market is the financial market for derivatives. A derivative is an asset whereby something else derives its value.***

Farmers have used forward contract for thousands of years. Let's assume that you are a corn farmer. Without a forward contract, you will sell your corn in the fall for whatever the market price of corn is at the time. If the price is high, you can make a good profit, but if the market price is low, you can lose. Because you are risk adverse, you enter into a contract with someone to buy your corn on a specific date for a specific amount of money, called the strike price. In this fashion, you avoid the risk of a down market. You gain from the arrangement if the strike price is higher than the market price, and you lose if the strike price is lower than the market price. However, the purpose of the contract is not so much to win or lose, but rather to enhance certainty into an uncertain market.

However, financial firms often enter into these types of contracts in the hopes of correctly anticipating the outcome of some future event to make a profit. At $600 trillion plus, the derivatives market is the largest market in the world. When the Federal Reserve keeps interest rates low through quantitative easing, financial firms have an incentive to borrow money and invest in the derivatives market. The spread between the low interest rates and the high returns in the derivatives market makes possible huge profits. You will learn more about the derivatives market in chapter 12.

THE DEMOGRAPHIC CLIFF



The Demographic Cliff: How to Survive and Prosper During the Deflation of 2014-2019
by Harry Dent
Penguin Group., 2014
Image from Amazon.com

In his book, *The Demographic Cliff*, Harry Dent argues that the next big crash will bring a period of deflation. He believes that the demographics of the retiring baby boomers and the smaller generation following will reduce prices. With a general collapse of the system and the lack of job opportunities for the young generation, there will be a slowdown in economic activity, which will depress prices. At the same time, there will be a lot of deleveraging taking place. Deleveraging is the process reducing debt and rapidly selling assets.

The general price level will also fall when the economic bubble bursts. Dent believes we are in a bubble brought about by excessive liquidity, too much debt, and as in all bubbles, it will burst causing unemployment and falling prices.

DEFLATION AND INSOLVENCY

Consumers can afford to buy more as prices fall. Businesses also gain because their costs decrease with deflation. So, it looks like everyone wins – except for one thing! The one thing that will spoil the party is excessive DEBT.

Deflation is good for consumers, but it hurts debtors, including the federal government.

Deflation hurts debtors because wages tend to fall with the general price level. Likewise, tax revenues tend to fall along with falling prices. The federal government benefits from inflation because it can pay back its enormous debt with depreciated dollars. With deflation, the opposite happens. Because government owes the debt in money terms, it becomes difficult to pay back the money as tax revenues decline. The same goes for individuals. For example, if you owe $20,000 on a car loan, it becomes increasingly difficult to make the same monthly payments as your money income declines. Thus, deflation can lead to private and public insolvency. These events will have a profound effect on the financial markets.

SUMMARY

The Bureau of Labor Statistics defines inflation as a pervasive and general rise in the average price level. When dollars become more plentiful, the value of each dollar diminishes. Therefore, it takes more dollars to add up to the value of whatever it is you want to buy. When dollars increase more than goods and services increase, the economy experiences inflation.

There are several price indexes, but the Consumer Price Index affects (CPI) almost everyone. The CPI measures price increases for a particular imaginary basket of goods and services. The goods and services in the basket are those consumers typically and often purchase. As time goes on, and things change, government statisticians take some things out of the basket and include other things.

By correctly anticipating the inflation rate, employers and employees can agree on contracts compatible with the expected inflation rate, but unanticipated inflation breeds uncertainty. When inflation is unanticipated, completing contract agreements is more difficult, and whoever estimates the inflation rate incorrectly will lose the most.

Inflation hurts people on fixed incomes the most. It causes havoc by distorting price signals while it diminishes real wages and causes unemployment. Inflation can also affect individual freedom as it enlarges the public sector at the expense of the private sector.

There are two types of inflation, demand-pull, and cost-push inflation. Demand–pull inflation occurs when an increase in aggregate demand pulls prices up. Cost-push inflation occurs when business costs increase, forcing an increase in prices. Cost-push inflation is harder to remedy because of time lags. If prices are high because of high costs, demand must decline significantly for an extended time before prices fall. Cost-push inflation is problematic because it takes a time to lower costs and prices.

When nations replace sound money with fiat currencies, inflation is never far behind. Under a sound money system, like the gold standard, we cannot increase the money supply unless we increase our gold holdings. However, there is no limit to increasing the money supply with a fiat system.

The quantity theory of money ultimately determines the price level. The quantity theory of money is $MV = PQ$; where M is the money supply, V is the velocity of money (how quickly money changes hands), P is the general price level, and Q stands for the quantity of goods and services or GDP. This equation can be restated $P = MV/Q$, showing that prices will increase the money supply and the velocity of money increases.

Possible remedies for inflation include a reduction in the monetary growth rate, fiscal restraint, a mandatory wage-price freeze, a voluntary wage-price guideline program, elimination of trade restrictions, and an increase in productivity. Deflation is a persistent and a general decline in the price level.

One explanation of why quantitative easing has led to deflation is that the practice has kept banks alive by encouraging speculative investing instead of lending the money to consumers. The speculation in markets has allowed wealth to become more concentrated whereby the rich have gotten richer, and the poor have gotten poorer. Therefore, despite the lack of economic growth, banks have thrived because of the quantitative easing.

Deflation is good for consumers. Consumers can afford to buy more as consumer prices fall. When the price of gasoline falls, people can afford to take trips they did not have the means at the higher gas prices. Businesses can gain because there costs decrease with deflation. It looks like everyone wins – except for one thing! The one thing that will spoil the party is excessive DEBT. Inflation helps debtors because debtors can pay back their debts with devalued money.

Deflation hurts debtors because wages tend to fall with the general price level. Likewise, tax revenues tend to fall along with falling prices. The federal government would benefit from inflation because it could pay back its massive debt with depreciated dollars. With deflation, the opposite happens. Because government owes the debt in money terms, it becomes difficult to pay back the money as tax revenues decline. The same goes for individuals. For example, if you owe $20,000 on a car loan, it becomes increasingly difficult to make the same monthly payments on the loan as your buying power declines with a decline in your real income.

KEY CONCEPTS

- The Bureau of Labor Statistics defines inflation as a pervasive and general rise in the average price level.

- Inflation affects persons on a relatively fixed income the most.

- You should not confuse inflation with the price mechanism. It is imperative that we let prices change in response to changes in demand and supply.

- There are several price indexes, but the Consumer Price Index affects (CPI) almost everyone. The CPI measures price increases for a particular imaginary basket of goods and services.

- A paramount concern at the Bretton Woods Conference in 1944 was replacing the British currency as the standard for settling international transactions.

- In 1944 the Bretton Woods system was born, whereby the government linked the dollar to gold at a pre-determined rate of $35 per ounce. Because all countries pegged their currencies to gold at predetermined rates, all countries knew the value of their currency relative to currencies of their trading partners.

- The fixed international exchange rate system was not to last because of the inflationary 1970s. It was not so much inflation as it was the different inflation rates among trading partners.

- On August 15, 1971, President Richard Nixon told a national television audience that the gold standard, or what little of it remained, was kaput. The United States declined to value the dollar at 1/35th of an ounce of gold and closed the gold window.

- After 1971, governments of major countries allowed their currencies to float. In other words, countries allowed the market to determine the value of a country's currency.

- When nations replace sound money with fiat currencies, inflation is never far behind.

- The major countries of the world have gone from capitalistic systems to crony capitalism where powerful interest groups control the levers of government policy.

- Money is the lifeblood of an economic system.

- Dollars have value because federal law recognizes dollars as payment of debt and because dollars are scarce.

- An alternative to our present money system is to take the authority of money creation away from the Federal Reserve and give it back to the U.S. Treasury.

- Another alternative to Federal Reserve Notes is Bitcoin. Currencies, like Bitcoin, can replace the U.S. dollar at times.

- A system of virtual currencies, like Bitcoin, present society with a decentralized solution to the financial trust problem.

- Demand-pull inflation occurs when the demand curve shifts to the right along the supply curve, causing an increase in the average price level.

- Cost-push inflation occurs when wages and other costs increase more than productivity increases. A shift to the left of the supply curve causes the general price level to rise.

- The quantity theory of money ultimately determines the price level. The quantity theory of money is $MV = PQ$; where M is the money supply, V is the velocity of money (how quickly money changes hands), P is the general price level, and Q stands for the quantity of goods and services or GDP.

- When inflation is persistent and deep rooted it will take time before a reduction in the money supply will start to lower prices.

- All problems are easier to solve with generous productivity gains.

- Deflation is a persistent and general decline in the price level.

- Ultimately, all prices rise and fall together.

- Some economists now recognize that quantitative easing can lead to deflation.

- Deflation hurts debtors because wages tend to fall with the general price level.

FOOD FOR THOUGHT

- ✓ Suppose you put $5,000 in a savings account at your bank and the bank pays you 5 percent annual interest. During the year, the inflation rate is 7 percent. What happens to your real income when you take $5,000 out of your savings account?

- ✓ Your friend Joe is in the habit of complaining about the rise in prices of the things he buys. Is this a sign that we have an inflation problem? Why or why not?

- ✓ When the federal government changes the definition of the consumer price index (GDP), depending how officials change the definition, what effect does this have on people who receive government benefits?

- ✓ Suppose the world's major countries have a fiat monetary system. At the same time, these countries have rules whereby monetary authorities cannot increase the money supply more than the country's growth rate. In other words, if GDP increases by ten percent from one period to the next, the money supply cannot increase more than ten percent in the same period. Would there be much difference between this system and a gold standard system?

- ✓ For a three-month period in 1980, the prime interest rate, the lowest interest rate available to the public, was 21 percent. What would happen if the government had to pay 20 percent interest on the national debt of 18 trillion dollars?

- ✓ Instead of dollars for gold as under the Bretton Woods arrangement, a new international monetary system, the Petrodollar System, came into being. Under the Petrodollar System, countries need U.S. dollars to purchase oil from most oil producing countries. This Petrodollar System has helped keep the value of the dollar high on world markets. What will happen to the standard of living for America's middle class if the Petrodollar System falters?

- ✓ President Kennedy's Executive Order 11,110 gave the Treasury Department power to issue silver certificates against silver bullion in the U.S. Treasury. If the Treasury Department had continued to issue silver certificates after Kennedy died, how would this had changed our monetary system? Do you think the Treasury should

issue silver certificates? Do you support the Federal Reserve as the only authority over our nation's money supply?

- ✓ The UN Conference on Trade and Development has advocated replacing the dollar with a managed international exchange rate system. Do you think this is a good idea? How would this affect America?

- ✓ An alternative to Federal Reserve Notes is Bitcoin. Virtual currencies can replace the U.S. dollar. Do you think this would be a good idea? Why or why not?

- ✓ Suppose we were having a problem with hyperinflation. Do you think it would be a good idea for the federal government to impose a wage price freeze on the nation? Why or why not?

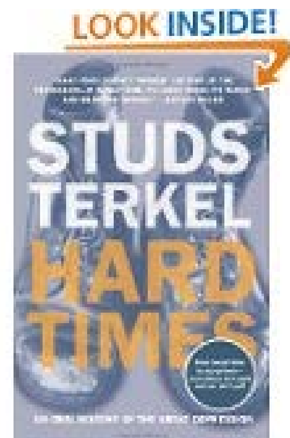
- ✓ Many countries of the world have been engaged in quantitative easing to solve their economic problems. Is this a good idea? Why or why not?

CHAPTER 9:

UNEMPLOYMENT & STAGFLATION

Economists like to quip that a recession is when your "neighbor" is out of work and depression is when "you" are out of work!

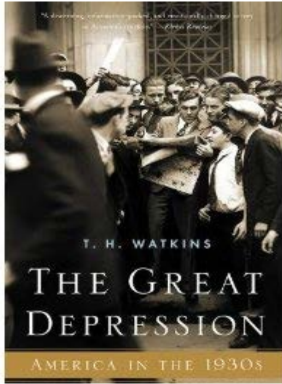
The difference between recessions and depressions is not clear, except that all economists agree that a depression is worse than a recession. America has witnessed three major depressions: 1837, 1893, and the Great Depression of the 1930s. Other years of high unemployment occurred in 1857, 1873, 1907 and 2007-2008. We had a severe downturn in 1920, but the economy quickly recovered.



Hard Times
by Studs Terkel
Random House Inc. Pub., 1970
Image from Amazon.com

Can we have another depression? Some economists believe that not only is it possible, but it is inevitable. If we fail to learn from the past, we will most assuredly repeat the past. Although this time, things will look different. So, what lesson can we learn from the past? A good place to start is with the Great Depression of the 1930s.

THE 1930s GREAT DEPRESSION



The Great Depression
by T.H. Watkins
Little Brown & Co.
Image from Amazon.com

What caused the unemployment rate to reach 25% in the 1930s? Producer's greed in the 1920s was a factor. Business owners believed that high prices and low wages would guarantee extravagant profits. This scheme worked for a while because of rapid growth; this was the Roaring Twenties! However, the low wages and high prices eventually led to insufficient demand causing a buildup of excessive inventory and unemployment.

Excessive inventory, inventory above the level desired, is a cause of unemployment. Once business owners realize that they are producing more than they are selling, and their warehouses are piling up with unsold inventory, they will cut back production and lay off workers. Risky investments accelerated the downward spiral as investors scrambled to protect their fortunes by taking enormous risks. The economy quickly headed south without unemployment benefits to support demand.

Farming compounded the problem because farmers were a large segment of the population. During World War I, farmers produced record crops and livestock to handle the increase in demand. When prices fell after the war, farmers tried to grow even more to pay their debts, taxes, and living expenses. In the early 1930s, prices dropped so low that many farmers went bankrupt and lost their farms, thus putting downward pressure on the economy.

Three events caused an increase in unemployment in the early 1930s, the Smoot-Hawley Tariff, a tax increase, and a reduction in the money supply. The government meant for the Smoot-Hawley Tariff to protect the American worker by increasing the price of foreign products. By raising the price of foreign goods, the reasoning goes, the demand for domestic products would increase, and thus American firms would hire more workers. Instead, it diminished consumer’s buying power. The increase in taxes further reduced real incomes and consumer demand. When the Federal Reserve increased interest rates by decreasing the money supply, aggregate demand fell further, aggravating unemployment.

Three events caused an increase in unemployment in the early 1930s, the Smoot-Hawley Tariff, a tax increase, and a reduction in the money supply.

Why did the Fed raise interest rates? Foreigners were taking their money out of the United States because they feared the unstable American economy. The government considered this money exodus a threat to the economy and figured that if the Fed raised interest rates, foreigners would keep their money here to earn the higher rates. The Fed raises interest rates by decreasing the money supply. However, because the problem was insufficient demand, unemployment worsened with less money in circulation.

By 1933, total output in the United States fell one-third from its previous level, and unemployment reached 25 percent. Living conditions worsened as wages fell and because there were no unemployment benefits and fewer social welfare programs than is the case today. As the depression spread to other countries, suffering intensified, leading the way to massive changes.

Just as quantitative easing lowers interest rates by increasing the money supply, the Fed raises interest rates by decreasing the money supply.

MEASURING UNEMPLOYMENT

The Bureau of Labor Statistics gives unemployment statistics monthly by measuring what percent of the labor force is seeking employment. The labor force consists of people who are at least sixteen years of age and who are actively seeking employment. The Bureau surveys about 60,000 households each month, mostly by knocking on doors. Surveyors make their door-to-door trek, asking such questions as the length of job search, age, and status in the household, race, and gender. The Bureau measures the unemployment rate by dividing the number of unemployed persons by the labor force.

The government declares a recession when the economy experiences at least two consecutive quarters (three-month periods) of a decline in real gross domestic product (real GDP).

Discouraged workers are people who would like a job, but who have quit looking for work. Discouraged workers can be young people who have postponed looking for a job, students extending their college years, and people who have applied for long-term disability benefits after losing their jobs. The Bureau considers part-time workers fully employed. Another category of employment is under-employment, which measures the extent of people with jobs below their qualification. Despite these shortcomings, as long as our methods are consistent from one period to the next, we can still get a good idea of whether things are getting better or getting worse.

The government declares a recession when the economy experiences at least two consecutive quarters (three-month periods) of a decline in real gross domestic product (real GDP). Economists define GDP as the market value of new, domestically produced final goods and services. There are four sectors that make up GDP: the consumption sector (C), the investment (business) sector (I), the government sector (G), and the foreign sector. The foreign sector is the difference between imports and exports (X-M). The four elements of GDP are:

- **Market value** – economists calculate GDP by multiplying the prices of goods and services by their quantities. Economists adjust money GDP to real GDP to get an accurate comparison from one period to the next.

- **New** – economists only include goods that producers make in the current accounting period, which is normally the current calendar year.

- **Domestically produced** – economists only include goods that producers make in the nation.

- **Final goods and services** – because the value of each intermediate step is in the value of the final product, economists only include the final value in the measure of GDP. This eliminates double counting.

Rather than relying on government statistics, most economists rely on the National Bureau of Economic Research (NBER) definition of a recession. Ever since 1920, the NBER has reported on general economic conditions in the United States. Over time, the NBER developed a reputation for measuring the economy's performance in an evenhanded and practical way. There are two reasons economists prefer the NBER measure. First, the government only measures GDP on a quarterly basis, and the NBER measures GDP on a monthly basis. Second, the official GDP numbers are subject to frequent revisions, making it difficult to assess trends.

The NBER defines a recession as "a significant decline in activity spread across the economy, lasting more than a few months." The NBER focuses primarily on four separate

pieces of information: Industrial production, employment, real income, and wholesale and retail sales.

There may be weaknesses in any government statistic, but as long as methods are consistent, we can approximate the situation. The important thing with any statistic is to show if things are getting better or getting worse. If they are getting worse, an ounce of prevention is worth a pound of cure. In other words, if we see a problem on the horizon, it is better to do something about it now instead of waiting it to manifest itself. Once the problem is upon us, it becomes painful and harder to find solutions.

TYPES OF UNEMPLOYMENT

The different types of unemployment are frictional, structural, seasonal, and cyclical. The various unemployment types are not mutually exclusive; they can exist simultaneously.

Frictional unemployment

Frictional unemployment is unemployment that would exist even in the best of times. Recent high school and college graduates will always be looking for work; some businesses will always experience loss, and some people will always seek better opportunities. Full employment exists when four to six percent of the workforce is seeking employment.

Structural unemployment

Structural unemployment occurs when the skills demanded by employers do not match the skills or location of the unemployed. We know that change is inevitable, and changes in technology sweep out the old and bring in the new. The technology eliminates some jobs and births others. For example, DVD rental companies have gone out of business while Netflix has prospered. Blockbuster faced bankruptcy because the owners considered themselves a video rental business, but their business was not rentals, it was entertainment. Another example is Microsoft. Microsoft thought that Apple Computer would never succeed with its new and novel device, the iPad. However, Apple sold six million units on the first day and has revolutionized the mobile device industry. All of these events bring about change that alters the economy and changes job opportunities.

America’s high corporate tax can cause structural unemployment as the high taxes force businesses to give money to the government instead of spending the money to grow their business. Not only is America's corporate tax rate the highest in the world, but also the rules are more onerous than in other countries. For example, the U.S government taxes profits earned abroad and returned to America.

Thus, American companies can pay income tax twice, once in the foreign country it is earned and again in America when the money comes home. Other countries have some form of territorial tax system that imposes little or no tax on repatriated earnings. U.S firms have kept funds earned in foreign countries, in the host country. U.S. companies have borrowed money to make investments instead of bringing funds back home. The more roadblocks the government places in front of U.S. corporations, the more businesses leave America. The more companies leave America, the harder the government tries to tax, which encourages more companies to leave, and the cycle perpetuates itself.

America’s corporate tax, the highest in the world can cause structural unemployment.

The tax evasion tactics of U.S. corporations and wealthy individuals have moved Congress to act with the passage of the Foreign Account Tax Compliance Act (FATCA) in 2010. FATCA requires that all world financial institutions make available to the U.S. Internal Revenue Service (IRS) full documentation of their American customers. The IRS will then do due diligence to make sure that these people are compliant with American tax laws.

FATCA requires that all world financial institutions make available to the U.S. Internal Revenue Service (IRS) full documentation of their American customers.

FATCA provisions are:

- FATCA targets non-compliance by U.S. taxpayers with foreign accounts.

- FATCA focuses on reporting by U.S. taxpayers certain foreign accounts and offshore accounts.

- FATCA focuses on reporting by foreign institutions about financial accounts held by U.S. taxpayers or foreign entities in which U.S. taxpayers hold a substantial ownership interest.

If banks fail to report this information, the U.S. government will withhold thirty percent of all monies paid to the financial institution. It is hard to know the long-term impact of this law on foreign relations, but FATCA will set back the American dollar as the world's standard currency.

The U.S. government will also deny or revoke passports for U.S. citizens who have not paid their taxes. The State Department will block Americans with delinquent tax debt from receiving new passports and will rescind existing passports of people who fall into that category. The internal Revenue Service, using a threshold of $50,000 of unpaid federal taxes, compiles the list of affected taxpayers. The IRS has the authority to seize a person's assets if need be. This provision effects about seven million U.S. citizens living abroad, who need their passports for many purposes, including for work visas or residency permits, registering a child for school, banking, and checking into a hotel, who may not be receiving mail from the IRS. Mistakes by the bureaucracy could have disastrous consequences for U.S. citizens living abroad. The government did not design IRS data systems to accommodate the different styles of international addresses, which can impede the delivery of mail to affected persons.

The new health care law, ObamaCare, the Financial Reform bill, the impact of the Consumer Financial Protection Bureau, FATCA, tax law changes, and others have resulted in structural unemployment. These structural changes will have an enormous impact on future growth and employment.

Seasonal unemployment

Shifts in the labor force, that is, a change in demand and supply of labor, can cause seasonal unemployment. Lifeguards lose their jobs at the end of summer. Migrant workers lose their jobs at the end of the harvest. Carpenters find few jobs in the cold months of January and February, and so forth. Seasonal unemployment is temporary and does not present a problem.

Cyclical unemployment

Cyclical unemployment occurs with business cycle swings, increasing during recessions and decreasing during expansions. Some jobs are more susceptible than other jobs to the ups and downs of the business cycle. For example, the housing market is one of the first affected by the recession, and carpenters are often the first to experience the pains of growing unemployment. Full employment is the level of unemployment when there is no cyclical unemployment.

STAGFLATION

Economists used to believe that unemployment and inflation could not coexist. For years, economists believed in the Phillips Curve, which showed an inverse relationship between inflation and unemployment. When we had inflation, we had full employment, and when we had unemployment, we experienced stable or falling prices. However, in the 1970s, we experienced the problems simultaneously. The misery index, whereby economists sum the inflation and unemployment indexes, hit 21 in 1980. Stagflation presents us with a policy dilemma because when the authorities restrict the economy, unemployment worsens; when they stimulate the economy, inflation worsens.

Stagflation occurs when inflation and unemployment coexist.

So, can we fight both problems concurrently? The answer depends on whether we consider the short run or the long run. Over the short term, we have few options. In the early 1980s, the solution to stagflation occurred when the Fed allowed unemployment to worsen while keeping a tight rein on the money supply. This resulted in a serious recession in 1981.

Stagflation presents us with a policy dilemma because when the authorities restrict the economy, unemployment worsens; when they stimulate the economy, inflation worsens.

However, once inflation subsided, the Fed eased up on the money supply and the unemployment problem subsided. In the long run, we have options that are more promising. Despite what we do, we must boost growth. By establishing stable monetary policies, reasonable taxes, and regulations, the aggregate supply curve will shift to the right, resulting in lower prices, increased output, and more jobs.

The 1970s was a decade of stagflation (about 10 percent) due to an increase in costs, which caused a shift to the left of the aggregate supply curve. Higher labor costs and rising oil prices by the Organization of Petroleum Exporting Countries (OPEC) caused the aggregate supply curve to shift to the left. Labor costs increased because unions bargained for higher wages greater than productivity gains. As you can see in the graph above, a shift to the left of the aggregate supply curve causes higher prices and more unemployment.

In the 1974-75 recession, there were times when monetary policies were pulling in one direction while fiscal policies were pulling in the opposite direction.

In the 1974-75 recession, there were times when monetary policies were pulling in one direction while fiscal policies were pulling in the opposite direction. Given the option, politicians will choose to fight unemployment because stimulative policies are politically popular. The Federal Reserve will choose to fight inflation because monetary policies are less political and more effective at fighting inflation.

Because the cure for inflation is to reduce the money supply, and the cure for unemployment is to increase the money supply, the Fed cannot fight both problems simultaneously. We have to solve supply side problems with supply side solutions.

WHAT TO DO?

All economists agree that increasing productivity is the long-term solution to stagflation. However, economists disagree on how to use monetary and fiscal policies in the short-term. Keynesians tend to favor an activist approach to the problem. In other words, authorities would adjust fiscal and monetary policies to suit the given situation at any one point in time. Austrians, on the other hand, tend to support stable policy settings. Stable policy settings adhere to a predetermined set of rules.

Economists call this activist approach fine-tuning the economy. It is like the economy is a machine and the machine can be controlled by a set of dials. Economists and politicians would turn the dials in accordance to current and anticipated economic events.

Economists who support stable policies, the Austrians, tend to ignore short-run fluctuations and only consider the long run. Economists sometimes refer to this approach as coarse tuning the economy. For example, the Federal Reserve should increase the money supply each year only to compensate for growth, GDP. And, the government should strive for a balanced budget over the long run, deficits in bad times and surpluses in good times.

Whether economists prefer active policies or rules, they agree on three things: we should pay more attention to lag effects; we should avoid sharp policy changes, and we should emphasize the long run. Whatever one favors, politics will always get in the way. It is foolish to assume that politicians understand economics, and naive to think that that they make decisions based on only economics.

Policy makers have to consider the impact of lengthy rules and regulations on productivity. What looks good in theory may not be attainable in real life. Large bureaucracies tend to be inefficient when they implement their policies in the real world.

CAN WE LEARN FROM HISTORY?

In 1980, Paul Volcker, Chairman of the Federal Reserve, committed the Fed to curbing inflation by letting interest rates climb. By June of 1981, inflation was 13.5%, and the prime interest rate was 21%! President Reagan was willing to tolerate a recession to stop inflation and let Volcker operate with little interference. At this time, Reagan lowered business taxes and lessened regulations. When inflation finally subsided, Volcker reversed course, the economy recovered, and for the rest of the 1980s America experienced full employment and stable prices.

History and sensible economics advocate business-friendly growth policies, yet we have done the opposite. Instead of promoting pro-growth policies and low taxes, we have increased regulations and raised taxes. Austrians believe these Keynesian policies will increase the national debt and bankrupt the country. If we continue to create money, we could experience a repeat of the 1970s, higher prices, and rising unemployment. The whipsaw effect of inflation and deflation will cause imbalances in markets; there will be a downward economic spiral as people hesitate to make decisions.

If interest rates increased the way they did in the 1970s, the federal government would be in an impossible situation paying interest on 20 trillion dollars. The only way to pay this interest would be to create the money. However, this creation of money would result in hyperinflation and the destruction of the American republic. Of course, the government could choose not to pay its creditors, but this would also lead to total economic collapse of the world economy.

SUMMARY

The Bureau of Labor Statistics gives unemployment statistics monthly by measuring what percent of the labor force is seeking employment. The labor force consists of people who are at least sixteen years of age and who are actively seeking employment. The Bureau surveys about 60,000 households each month, mostly by knocking on doors. Surveyors make their door-to-door trek, asking such questions as the length of job search, age, and status in the household, race, and gender. The Bureau measures the unemployment rate by dividing the number of unemployed persons by the labor force.

What caused the unemployment rate to reach 25% in the 1930s? It all started with producer's greed in the 1920s. Business owners believed that high prices and low wages would guarantee high profits. This scheme worked for a while because of rapid growth; this was the Roaring Twenties! However, the low wages and high prices eventually led to insufficient demand causing a buildup of excessive inventory and an increase in unemployment. Excessive inventory, inventory above the level desired, is a cause of unemployment. Once business owners realize that they are producing more than they are selling, and their warehouses are piling up with unsold inventory, they will cut back production and start laying of resources. One resource is labor.

The Bureau of Labor Statistics declares a recession when the economy experiences at least two consecutive quarters (three-month periods) of a decline in the real gross domestic product (real GDP). Economists define GDP as the market value of new, domestically produced final goods and services. Four sectors make up GDP: the consumption sector (C), the investment sector (I), the government sector (G), and the foreign sector (F).

The different types of unemployment are frictional, structural, seasonal, and cyclical. These types of unemployment are not mutually exclusive; they can all exist simultaneously.

For many years, economists believed a tradeoff existed between inflation and unemployment. That is, inflation is typically high when unemployment is low and is low when unemployment is high. In other words, we could bring about lower prices with more unemployment or increase employment at the expense of inflation. However, in the 1970s, we had these problems simultaneously, so what gives?

Cost-push inflation caused the "worst of both worlds" predicament of growing inflation and unemployment in the 1970s. Because cost-push inflation is not very responsive to a decline in demand, typical Keynesian policies were not effective against inflation in the short run. Instead, many prices remained high, even though the high costs lowered demand. Prices came down eventually with a prolonged decline in demand, but this aggravated the unemployment problem.

Rising prices and increasing unemployment pose a policy dilemma for monetary and fiscal authorities. If they attempt to use discretionary monetary and fiscal policies to lower prices, the unemployment problem worsens with little effect on prices in the short run. If, on the other hand, the government stimulates the economy to create additional jobs, the inflation problem worsens as the increase in demand pulls prices up.

Inflation or unemployment is bad enough, but to have both problems together is much worse. All economists agree that a solution would be to revitalize the industrial base. If investments in capital goods were to increase productivity, we could solve the twin problems of inflation and unemployment. This solution is not as simple as it sounds. If we have an inflation problem in the double digits, increasing productivity enough to bring down prices is difficult. The best thing to do, therefore, is to give a business an incentive to increase productivity.

History and sensible economics advocate business-friendly growth policies, yet we have done the opposite. Instead of promoting pro-growth policies and low taxes, we have increased regulations and raised taxes. Austrians believe that these Keynesian policies are increasing the national debt and bankrupting the country. If we continue to create money, we could experience a repeat of the 1970s, higher prices, and rising unemployment. The whipsaw effect of inflation and deflation will cause imbalances in markets; there will be a downward economic spiral as people hesitate to make decisions.

KEY CONCEPTS

- What caused the unemployment rate to reach 25% in the 1930s? It all started with producer's greed in the 1920s. Business owners believed that high prices and low wages would guarantee extravagant profits.

- Three events caused an increase in unemployment in the early 1930s, the Smoot-Hawley Tariff, a tax increase, and a reduction in the money supply.

- Just as quantitative easing lowers interest rates by increasing the money supply, the Fed raises interest rates by decreasing the money supply.

- The Bureau of Labor Statistics gives unemployment statistics monthly by measuring what percent of the labor force is seeking employment.

- There may be weaknesses in any government statistic, but as long as our method of measuring is consistent from one period to the next, we can at least get a general idea if things are getting better or getting worse.

- The different types of unemployment are frictional, structural, seasonal, and cyclical. The different unemployment types are not mutually exclusive; they can all exist simultaneously. Some are temporary while others are more deeply rooted.

- Frictional unemployment is unemployment that would exist even in the best of times.

- Structural unemployment occurs when the skills demanded by employers do not match the skills or location of the unemployed.

- Shifts in the labor force, that is, a change in demand and supply of labor can cause seasonal unemployment.

- Cyclical unemployment occurs with the business cycle swings, increasing during recessions and decreasing during expansions.

- FATCA requires that all world financial institutions make available to the U.S. Internal Revenue Service (IRS) full documentation of their American customers.

- Stagflation occurs when inflation and unemployment coexist.

- The 1970s was a decade of stagflation (about 10 percent) due to an increase in costs causing a shift to the left of the aggregate supply curve.

- The solution to stagflation is to move the aggregate demand curve to the right.

- Keynesians economists tend to favor an activist approach to the problem of stagflation and Austrians tend to support stable policy settings.

- Austrians believe that these Keynesian policies are increasing the national debt and bankrupting the country.

FOOD FOR THOUGHT

✓ In your opinion, where are we going economically? Do you think things are getting better or getting worse? Do you think we could have another depression? Why or why not?

✓ One policy to fight an unemployment problem is to raise tariffs against imported goods in order to raise the price. If there is an increase in demand for American goods, employment will increase. Do you think this is a good idea?

- ✓ Quantitative easing is the practice of creating money to increase the money supply. If everyone has more money, consumers can buy more goods and services. This increase in demand will generate more jobs and grow the economy. Do you agree with this statement? Do you think this is a good economic policy? Why or why not?

- ✓ Structural unemployment occurs when the skills demanded by employers do not match the skills or location of the unemployed. A major cause of structural unemployment is automation and other technological changes. Do you think we could increase employment if the government issued policies that would discourage automation? Explain your answer.

- ✓ The tax evasion tactics of U.S. corporations and wealthy individuals have moved Congress to act with the passage of the Foreign Account Tax Compliance Act (FATCA) in 2010. FATCA requires that all world financial institutions make available to the U.S. Internal Revenue Service (IRS) full documentation of their American customers. Will this policy help or hurt America economically? Explain your answer.

- ✓ Stagflation occurs when inflation and unemployment coexist. Why does stagflation present a policy dilemma for Keynesians economists? What would a typical Austrian solution be to the problem of stagflation?

- ✓ The Full Employment and Balanced Growth Act of 1978 mandated that monetary and fiscal policies ensure that we have full employment and stable prices. We may have inflation and unemployment problems in the short run, but as long as the federal government takes decisive action, we will always have full employment and stable prices over the long run. Do you agree or disagree with this statement. Why or why not? What would you do if you were in charge?

- ✓ The national debt is about 20 trillion dollars. Do you think it would be a good idea for the federal government to print 20 trillion dollars and pay off the national debt? What do you suppose would happen if interest rates increased to twenty percent as they did in the 1970? Do you think there would be a breakdown of law and order in the country? Do you think the situation would affect other nations?

CHAPTER 10:

INTERNATIONAL TRADE

A country has to import the things it wants and needs to make up for what it lacks domestically. However, if a country continued to import without exporting, it would eventually run out of money. It would be like persons who continually spend more than they earn. Therefore, a country has to export to import.

The U.S. population is less than 5 percent of the world's population, yet we import most of the world's traded goods.

The U.S. population is less than five percent of the world's population, yet Americans import most of the world's traded goods. Shirts come from Bangladesh, Levi jeans from Mexico, Timberland shoes from Thailand, coffee from Brazil and bananas from South America. America's top four trading partners are Canada, China, Mexico and Japan.

American manufacturing has to import 100% of 19 strategic metals. The U.S. has domestic resources for 18 of these 19 metals and minerals, but a maze of government regulations has made mining difficult. Without mining reform, these excessive regulations will starve the U.S. for the resources it needs to build everything from smartphones to

weapons systems.[23] The U.S. is militarily vulnerable because of its dependence on foreigners for these primary metals. Restrictions, such as the law forbidding the export of oil, can cause bottlenecks as these laws cause rigidity in the face of changing market conditions.

DOMESTIC VERSUS FOREIGN LABOR

Suppose you own a widget business. You can stay in the U.S. and pay high wages or move to Mexico and pay low wages. However, the high pay in America could be less expensive on a per unit basis when considering inputs and outputs. The hourly wage is the input, and the number of units produced per hour is the output.

Suppose you pay the American worker ten dollars an hour and he produces one hundred widgets per hour. Now let us assume you would pay the Mexican worker a dollar an hour, and he produces only five widgets per hour. On a per unit basis, the American worker is less expensive despite his higher hourly wage.

Seamstresses in Bangladesh, who work for global brands, including Tommy Hilfiger, Calvin Klein and Gap, earn about $38 a month.

In a capital-intensive industry, the benefits of a superior infrastructure, the advanced telecommunications network, a highly educated and skilled workforce, and modern technology offset the advantages of low wages. Consequently, high-tech companies stay in America and low-tech companies, such as textile firms, relocate to places like Bangladesh where wages are low. Tailors in Bangladesh, who work for global brands, including Tommy Hilfiger, Calvin Klein and Gap, earn about $38 a month.

ECONOMIES OF SCALE

When a company grows, it experiences greater economies of scale because of a reduction in its long run average cost curve. For example, a large $200,000 tractor is more efficient than a small $25,000 tractor. A farmer who owns 5,000 acres of land can buy the expensive tractor, but the small farmer must use the less expensive, less productive tractor.

If a country chooses not to trade with other countries, it is like a small, less efficient farmer, and if it trades with other nations, it is like the farmer with 5,000 acres.

International trade enlarges the market, leading to a greater demand for products. For example, Boeing Aircraft could not produce its 747 jumbo jets if it could not sell them internationally because the American market is too small to justify the costs.

ABSOLUTE AND COMPARATIVE ADVANTAGE

A country has an absolute advantage if it can produce a good with fewer resources than other countries. Each country has an absolute advantage in something. For example, Brazil has an absolute advantage in coffee due to its climate and geography. Likewise, the United States has an absolute advantage in wheat due to its good farmland and climate.

Now, suppose that America had an absolute advantage in producing handmade wicker baskets. Does this mean we should produce baskets? The answer is no, because of high opportunity costs. In other words, if we were to spend time with baskets, we could not spend the same time in the technology field. We may be better than other countries at making baskets, but the opportunity cost would be high.

A country has a comparative advantage if it can produce a product with lower opportunity costs than other nations. A country may have an absolute advantage in a product, but it would be a mistake to produce that product unless it also had a comparative advantage.

BARRIERS TO TRADE

Free and open trade provides the greatest efficiencies and the highest living standards for almost everyone; yet, all countries restrict trade by way of tariffs, quotas, orderly marketing arrangements, and taxes.

Tariffs

A tariff is a tax levied on imports. Tariffs bring in revenue, but governments can also impose tariffs to shield American companies from foreign competition. The high tariffs pressure foreign companies to raise their prices to compensate for the tariff, giving American companies a price advantage. For example, American sugar companies can charge a higher price for sugar because foreign corporations who import sugar, or any products that contain sugar, have to pay high tariffs.

Quotas

Quotas set a maximum quantity of imported goods. When the supply curve shifts to the left with an increase in costs, prices rise. Consequently, the quota gives the domestic producer a price advantage over foreign competitors.

Orderly Marketing Arrangements

A foreign country may agree to limit exports to avoid mandatory restrictions. Meanwhile, the countries negotiate terms beneficial to both sides. Thus, these Orderly Marketing Arrangements (OMA's) are a form of trade restriction.

Relative Tax Rates

As discussed above, most countries tax domestic companies according to where they earn an income, making homegrown companies globally competitive. The U.S. is a rare exception. Domestic corporations must pay a corporate rate of 35% on all foreign-generated revenue brought back to America. For example, the Dutch-based Unilever only pays taxes to Ireland on monies earned in Ireland. However, Pfizer Corporation, an American company, pays taxes to Ireland and pays taxes on the same income when they bring the money back to America.

You might recall our discussion in chapter 9 about the Foreign Account Tax Compliance Act (FATCA). FATCA requires that all world financial institutions make available to the U.S. Internal Revenue Service (IRS) full documentation of their American customers. In chapter 7, I discussed the practice of inversions. Inversion is the practice of American companies purchasing a foreign company and switching their domicile to that foreign country to avoid the double taxation that FATCA imposes on them. In 2015, Pfizer merged with Allergan Corporation of Ireland. This Pfizer-Allergan merger is one of the largest takeovers ever in the healthcare industry, worth an estimated $160 billion.

WHY RESTRICT TRADE?

If all countries relaxed their trade restrictions, almost all countries would benefit economically. So why do countries restrict trade? Some of the following reasons for trade restrictions are valid, some are not valid, and some are valid only for individual countries at certain times.

National Defense

If an enemy restricts the flow of war supplies, the country will lose its ability to continue the conflict. Israel, for example, is a country surrounded by enemies. Even though Israel may not have a comparative advantage in manufacturing guns, it would still produce them. Therefore, trade restrictions that would help protect Israel from its enemies would be justified. There are times when other priorities will take precedence over efficiency.

Protect Jobs

Protecting domestic jobs from foreign competition is perhaps the weakest justification for restrictions because companies can justify almost any protectionist policy. Politicians have an incentive to protect special interest groups because the saved jobs are visible, whereas the jobs lost are not apparent. Even unemployed workers may not know that they are losing their jobs because of protective tariffs.

When countries try to push their unemployment problem off onto other countries, we call this practice a beggar-my-neighbor policy. Unemployment can be like a hot potato as countries attempt to push their unemployment problems off onto their neighbors. As the government restricts citizens from buying foreign products, foreign unemployment increases and diminishes their buying power. Foreigners may then retaliate by imposing restrictions against domestic products, causing higher prices, lower quantity goods, and reduced living standards for everyone.

We call this back and forth exchange among countries a tariff war, and no one wins a tariff war. What goes around comes around; whatever a nation gives out it gets back. When a country tries to export its unemployment problem, it puts into motion events that will eventually cause the country to experience even more unemployment.

Protection against Low Foreign Wages

Low wages allow some nations to export labor-intensive products at low prices. Textile companies can reduce their costs by contracting labor in low-wage countries, like Bangladesh. Politicians may argue that employment can increase by restricting labor-intensive products from other countries. However, this argument ignores the virtues of comparative advantage. For example, America is a highly capitalized economy; therefore, America should concentrate on capital-intensive and not labor-intensive products. A worker who is paid a dollar an hour but that worker produces something that has a market value of two dollars is more expensive than a twenty-five dollar an hour worker but produces something that has a market value of one hundred dollars.

A Nation Can Diversify by Restricting Trade

Countries tend to experience feast or famine when they depend on few exports. Therefore, the government should impose tariffs against some foreign products to promote product diversification at home. This argument might be valid for developing countries that are dependent on a few exports, but it does not apply to the large industrial nations of the world.

Protect Infant Industries

Just as adults need to protect babies, governments need to protect infant industries until they can compete on their own. A foreign competitor may have the advantages of established markets and economies of scale, putting the domestic business at a disadvantage. By protecting the domestic business, the domestic company may be able to grow until it can compete successfully. Once the domestic company matures, the government can lift the restrictions. This argument is valid assuming that politicians are willing to eliminate the protection at some point. However, because of rent-seeking, the tendency is for the protective policies to remain in force beyond the point when the government should lift the protection. When this happens, the economy suffers because the inefficiencies lead to higher prices and fewer choices.

Protection from Dumping

Dumping occurs when foreign governments pay domestic companies to export their products, which may allow them to sell their products to foreigners below cost. Consequently, competing businesses in the importing country ask for protection from the government.

Sometimes these claims are valid and sometimes they are not. For example, the Commerce Department has dismissed dumping charges lodged against Mexican companies by producers of Florida fruit and vegetables because vegetables are perishable. All growers sell below cost at some point in the season and make it up in others.

The U.S. steel industry has demanded protection because of dumping claims. In the past, the U.S. steel industry has argued that trade restrictions were not doing a good enough job in keeping out cheap steel imports. Not wanting to offend steel companies, the Commerce Department has responded with high tariffs. All businesses that use steel, and all consumers who buy products made from steel, end up paying higher prices for goods when the steel prices increase.

EXCHANGE RATES

When President Nixon closed the gold window in 1971, the world embraced a freely flexible international exchange rate system. After 1971, governments of major countries allowed their currencies to float. In other words, nations allowed the market to determine the value of a currency. If the demand increased relative to supply, the value increased. If demand decreased relative to supply, the value decreased. There are ways that a country can influence the demand or supply of their currency on the international market. Economists call this a dirty float and, therefore, have some input in determining values, but the world today operates on a freely flexible international exchange rate system. However, there are exceptions.

> ***When President Nixon closed the gold window in 1971, the world embraced a freely flexible international exchange rate system. After 1971, governments of major countries allowed their currencies to float.***

Some countries peg the value of their currency to a major currency, usually the U.S. dollar, or to a group of currencies. For example, China has a managed float system whereby it pegs its currency to a basket of major currencies that includes the U.S. dollar. A cornerstone of China's economic policy is maintaining the yuan exchange rate to benefit its exports.

In a freely flexible international exchange rate system, interest rates, the expected inflation rate, and the stability of a country influence demand. People want to keep their money where they can earn a high rate of return, where the rate of inflation is low, and where the money would be safe. In the past, the best place to meet these criteria was the American dollar. Although the American dollar remains stable, only the future will tell what effect changing world events will have on the dollar's value.

A unique reason people desire the American dollar is that the dollar is the world's standard reserve currency. As discussed in Chapter 8, because of the Petrodollar System, the U.S. dollar remained the standard currency, despite closing the gold window in 1971. Even though the euro is the second largest traded currency next to the American dollar, a European company still has to convert euros to dollars for international transactions.

Today, more than 60% of all foreign currency reserves in the world are in U.S. dollars – but there are significant changes on the horizon as some of the biggest countries are making alternative agreements. China and Russia have been quietly arranging to move away from the U.S. dollar over the past few years. China and Japan struck a deal, which will promote the use of their currencies when trading with each other. China and the United

Arab Emirates have agreed to ditch the U.S. dollar and use their currencies in oil transactions.

When nations demand fewer dollars, the value of the dollar on the world market declines. The UN Conference on Trade and Development (UNCTAD) has declared that the current system is not working, and countries should replace the system with a new managed float system.

A unique reason people desire the American dollar is that the dollar is the world's standard reserve currency.

What happens when the dollar is no longer the world's standard currency? The standard of living for the average American will fall. American's buying power has remained high because of the dollar's strength on the international market. When another currency, or a group of currencies, replaces the dollar, and the demand for the dollar subsidies, American's purchasing power will diminish. The decline in the dollar's value will also make it more difficult for America to pay interest on its enormous national debt because each dollar paid to foreigners will have a lower value.

CURRENCY WARS

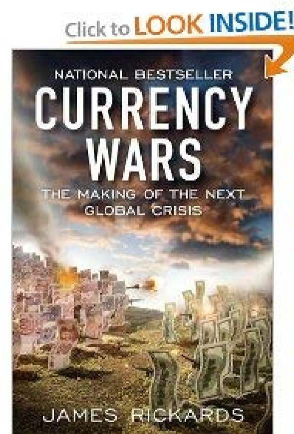
A country can achieve a competitive advantage when its currency falls in value relative to other currencies. Therefore, countries may compete by lowering the value of their currencies; economists call this a currency war. When a country's currency falls in value relative to other currencies, its products become less expensive for foreigners. Thus, more money enters the country. At the same time, foreign goods become more expensive, so less money leaves the country. This change in the relative value of currencies benefit exporters but hurts importers. Countries can engage in a currency war by influencing the demand and supply of their currency on the world market. Currency wars are always a zero-sum game, someone wins, and someone loses.

Countries with high valued currencies are like people who spend all their money without saving; they sacrifice the future for present consumption. Countries with low-valued currencies are like people who sacrifice current consumption for future gain; nations can use this excess money for investments. These investments will grow the economy over the long run.

As discussed in chapter five above, in 2014, Switzerland's central bank flooded the market with francs in the hope of keeping its currency from climbing against the euro,

wagering an amount approaching Switzerland's gross national output. Because Switzerland had pegged its currency, the franc, to 1.20 to the euro, its flooding the market with francs was an attempt to maintain the 1.20 franc to euro ratio in the hopes of keeping the franc from climbing in value.

However, by January of 2015, Switzerland realized that its policy of maintaining the ratio was futile. When the European Central Bank expressed its intention to engage in a massive bond-buying program that would weaken the euro, Switzerland scrapped its policy of capping the franc at 1.20 to the euro. Almost immediately, the franc soared more than 10% against both the euro and the dollar.



Currency Wars
by James Rickards
Portfolio Hardcover Pub., 2011
Image from Amazon.com

Switzerland's stock market experienced a massive one-day decline. Investors feared the move would hurt the nation's economic outlook because a stronger franc makes the nation's exports less competitive in global markets. We can force the market to move in the short term, but eventually the market will prevail.

America is in a unique position when it comes to a currency war with other nations. The Federal Reserve's practice of quantitative easing has led to an increase in dollars abroad and has put downward pressure on its value. At the same time, however, the demand for the dollar remains high because of its status as the world's reserve currency. Another reason the dollar can remain strong in the early stages of a currency war is that value is a relative thing. If other currencies fall in value, then the American dollar becomes more valuable in relative terms.

We can force the market to move in accordance to our wishes in the short run, but in the long run, the market will always prevail.

Fed officials are not as concerned with a revaluation of the American dollar because America is less dependent on foreign trade as compared with many other nations. Exports account for only 13% of U.S. economic output. Even though a stronger dollar weighs on exports, the broader economic impact is limited. Moreover, a stronger dollar means that American will pay less for imported oil, which can be a big boost to the economy.

A strong dollar can hurt U.S. companies that have a presence in foreign countries. The strong dollar can hurt multinational corporations in several ways. Companies' sales may be high in the international market, but when companies convert the foreign currency back into American dollars, the real return on investment takes a big hit. The changing currency values can also cause a mismatch between costs and sales. This mismatch makes it more difficult for export-oriented companies to compete. To make matters worse, the negative effects of a currency revaluation can damage the value of a corporation's stock price.

When the world's central banks abandon their responsibility for global exchange-rate movements, the whole world shakes. When each national bank pursues their monetary policy for domestic purposes, in this world of fiat currencies, it becomes a race to the bottom. No global economic system can prosper if countries only look out for themselves without regard to how their actions affect other countries. A currency war can make things worse when unemployment becomes a hot potato. With each country passing laws, abandons fiscal and monetary restraint, and imposes trade restrictions on other countries, the world will slip into depression.

ADJUSTMENTS

The balance of trade concerns exports and imports. If more money enters the country than leaves via trade, we call this a favorable balance of trade or a trade surplus. However, there are many other ways money can enter or leave a country. For example, when Americans go abroad, money leaves, and when foreigners visit America, money enters. The term balance of payments refers to the total quantity of money entering or leaving the country. If more money enters the country, we call it a favorable balance of payments or a payments surplus. If more money leaves than enters, we call it an unfavorable balance of payments or a payments deficit.

If more money enters the country than leaves via trade, we call this a favorable balance of trade or a trade surplus.

A freely flexible international exchange-rate system will automatically correct a country's balance of payments problem. For example, suppose that the United States has a deficit problem with too much money leaving the country. As dollars become more abundant on the international market, its value will decrease, making foreign goods more expensive for Americans and American goods cheaper for foreigners. A reversal occurs when Americans buy less from foreigners, and foreigners buy more from Americans.

Now, what happens if America experiences a payments surplus? With more dollars entering the country than leaving, the supply of dollars on the global market decreases. A scarcer dollar will make it worth more. Now Americans will buy more from foreigners, and foreigners will purchase less from America. This reversal eliminates the problem of too much money entering the country. Thus, over time, the equilibrium point, the point toward which the economy tends, is where the amount of money leaving a country equals the amount of money entering the country.

THE INTERNATIONAL MONETARY FUND

Countries with a balance of payments problem can borrow money from the International Monetary Fund (IMF) through Special Drawing Rights (SDR's), which is an entity composed of mixed currencies. Suppose the value of the dollar was to plummet. The U.S. government could then approach other countries, such as Germany and Japan, and request that the IMF transfer United States SDRs to the accounts of those countries. In return, Germany and Japan would supply the United States with euros and yen. The United States could then use the euros and yen to buy dollars around the world, thus increasing the value of the dollar as compared with the euro and yen.

A flexible international exchange-rate system with selective intervention can solve some currency problems in the short run, but only stable economies will stabilize currencies over the long run. Despite what a nation does to influence its exchange rate, instability will cause foreigners to flee that country's currency over the long run.

THE EXPORT-IMPORT BANK

The Export-Import Bank, a New Deal Program of the 1930s, helps U.S. companies sell products to foreign customers, mostly by providing or guaranteeing loans. This bank will finance banks when private banks do not want to take the risk. The top beneficiaries have been big business, like Boeing, General Electric, and Caterpillar, but many customers are small businesses. Boeing Aircraft has been the bank's biggest beneficiary.

While the Import-Export Bank announced a $14 billion dollar profit in a recent year, the Congressional Budget Office disagrees. The Congressional Budget Office projects that if the bank had used fair market accounting, the bank would have lost $2 billion dollar loss instead.

As with every other government program, politics plays a huge role in the bank's policies. Congress has imposed mandates on the bank. There are quotas for businesses owned by women and minorities. In 2013, the bank adopted guidelines to limit lending to coal.

Many other countries have similar banks, including China, Japan, South Korea, and most European countries. Some economists believe the bank is a prime example of crony capitalism and distorts the free market to benefit a few connected corporations. Think rent-seeking – those who pay get to play.

Despite these objections, Congress has always reauthorized the Export-Import Bank. The first time the bank’s reauthorization was truly in doubt was in 2012 when 93 House Republicans opposed it. However, with the tide of politics ever changing, and the fear of crony capitalism on the rise, we shall see if the bank continues to receive support.

SUMMARY

To make up for what the country lacks, it has to import the things it wants and needs from other nations. If a country continued to import without exporting, it would eventually run out of money. It would be like a person who continually spent money, but never earned income. Therefore, a country has to export to import.

When a company grows, it experiences greater economies of scale because of a reduction in its long run average cost curve. For example, a large $200,000 tractor is more efficient than a small $25,000 tractor. A farmer who owns 5,000 acres of land can buy the expensive tractor, but the small farmer must use the less expensive, less productive one.

If a country chooses not to trade with other countries, it is like a small, less efficient farmer, and if it trades with other nations, it is like the farmer with 5,000 acres. International trade enlarges the market, leading to a greater demand for products. For example, Boeing Aircraft could not produce its 747 jumbo jets if it could not sell them internationally because the American market is too small to justify the costs.

A country has an absolute advantage if it can produce a good with fewer resources than other countries. Each country has an absolute advantage in something. A country has a comparative advantage if it can produce a product with lower opportunity costs than other nations. A country may have an absolute advantage in a product, but it would be a mistake to produce that product unless it also had a comparative advantage.

Countries prosper when they produce goods and services with a comparative advantage and practice free trade. Tariffs, quotas, and orderly marketing arrangements restrict international trade. So why do we have trade restrictions?

Trade restrictions are the norm because they

(1) protect an industry for national defense reasons.

(2) protect specific domestic jobs.

(3) protect some domestic industries from cheap foreign labor.

(4) diversify a country's economy.

(5) protect infant industries.

(6) protect some domestic industries from dumping.

Inflation can result because of trade barriers. Higher costs may diminish the producer's ability to compete with foreign companies because of higher domestic prices. For example, many American companies find it difficult to compete globally with products containing sugar because sugar is so much more expensive in the United States than anywhere else.

International trade requires the exchange of currencies in the international exchange market according to current exchange rates and market forces of demand and supply determine exchange rates. If the demand for a currency increases compared with the supply on the international market, the value of that currency will increase. If the demand for a currency declines relative to the supply, the value of the currency will decline. A clean float occurs when the laws of supply and demand determine values, and a dirty float occurs when countries interfere with market forces. Alternatively, some countries peg the value of their currencies to a major currency. If the U.S. is experiencing unemployment, we want the value of the dollar to fall. If inflation is a problem, we want the value of the dollar to increase.

International trade affects employment and prices. Thus, a country should have a balance in its balance of payments over the long run. If a country experiences a favorable balance of payments problem over an extended time, the massive influx of money could cause inflation. A chronic unfavorable balance of payments problem over an extended time can cause unemployment.

If a country is experiencing either inflation or unemployment, the forces of demand and supply of its currency will adjust to alleviate the problem. Over the long run, money leaving a country tends to equal money entering. A nation can influence the value of its currency by doing the following:

(1) Sell reserves of foreign currencies kept on hand.

(2) Decrease the supply of its currency abroad.

(3) Use monetary and fiscal policies.

(4) Seek help from the International Monetary Fund.

A unique reason people desire the American dollar is that the dollar is the world's standard reserve currency. As discussed in Chapter 8, the U.S. dollar remained the standard currency despite the closing of the gold window in 1971 because of the Petrodollar System. The Petro Dollar System came into being when America promised Saudi Arabia and other oil countries the military protection of their oil fields in exchange for an agreement that nations had to use the U.S. dollar when purchasing oil. Even though the euro is the second largest traded currency next to the American dollar, a European company still has to convert euros to dollars for international transactions.

When countries compete with one another by lowering the value of their currency to give them a competitive edge, economists call this conflict a currency war. When a country's currency falls in value, its products become less expensive to foreigners, and it sells more to foreigners.

A low valued currency makes exports cheaper to foreigners. However, a low valued currency makes imports more expensive. Countries with high valued currencies are like people who spend all their money without saving; they sacrifice the future for present consumption. Countries with low-valued currencies are like people who sacrifice their present consumption for their future gain; countries can use this excess money for investments. These investments will grow the economy over the long run. Countries can influence the value of their currencies by influencing the demand and supply of their currency on the world market. Currency wars are a zero-sum game, someone wins, and someone loses.

A flexible international exchange-rate system with selective intervention can solve some currency problems in the short run, but only stable economies will stabilize currencies over the long run. Despite what a nation does to influence its exchange rate, if it experiences persistent high rates of inflation and is unstable, foreigners will flee that

country's currency. Pro-growth policies will help keep the value of a nation's currency stable over the long run.

America is in a unique position when it comes to a currency war with other nations. The Federal Reserve's practice of quantitative easing has led to an increase in dollars abroad and has put downward pressure on its value. At the same time, however, the demand for the dollar remains high because of its status as the world's reserve currency.

KEY CONCEPTS

- The U.S. population is less than 5 percent of the world's population, yet we import most of the world's traded goods
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- Tailors in Bangladesh, who work for global brands, including Tommy Hilfiger, Calvin Klein and Gap, earn about $38 a month.
- When a company grows, it experiences greater economies of scale because of a reduction in its long run average cost curve.
- A country has an absolute advantage if it can produce a good with fewer resources than other countries.
- A country has a comparative advantage if it can produce a product with lower opportunity costs than other nations.
- Countries prosper when they produce goods and services with a comparative advantage and practice free trade.
- A tariff is a tax levied against imports.
- Quotas set a maximum quantity on imported goods.
- American companies must pay a corporate rate of 35% on all foreign-generated revenue brought back to America. This has caused an increase in tax evasion by multinational firms.
- FATCA requires that all world financial institutions make available to the U.S. Internal Revenue Service (IRS) full documentation of their American customers.

- Inversion is the practice of American companies purchasing a foreign company and switching their domicile to that foreign country in order to avoid the double taxation that FATCA imposes on them.

- Free trade will lead to economic growth and increasing living standards for almost everyone.

- However, there are times when other priorities will take precedence over efficiency.

- When countries try to push their unemployment problem off onto other countries, we call this practice a beggar-my-neighbor policy.

- When President Nixon closed the gold window in 1971, the world embraced a freely flexible international exchange rate system. After 1971, governments of major countries allowed their currencies to float.

- In a freely flexible international exchange rate system, interest rates, the expected inflation rate, and the stability of a country influence demand.

- Today, more than 60% of all foreign currency reserves in the world are in U.S. dollars – but there are significant changes on the horizon as some of the biggest countries are making alternative agreements.

- When countries compete with one another by lowering the value of their currency to give them a competitive edge, economists call this conflict a currency war. When a country's currency falls in value, its products become less expensive to foreigners, and it sells more.

- In 2014, Switzerland's central bank flooded the market with francs in the hope of keeping its currency from climbing against the euro, wagering an amount approaching Switzerland's gross national output.

- By January of 2015, Switzerland realized that its policy of maintaining the ratio was futile. When the European Central Bank expressed its intention to engage in a massive bond-buying program that would weaken the euro, Switzerland gave up and the Swiss National Bank scrapped its policy of capping the franc at 1.20 to the euro.

- We can force the market to move in accordance to our wishes in the short run, but in the long run, the market will always prevail.

- America is in a unique position when it comes to a currency war with other nations because the American dollar is the world's standard currency.

- A freely flexible international exchange-rate system will automatically correct a country's balance of payments problem.

- Countries with a balance of payments problem can borrow money from the International Monetary Fund (IMF) through Special Drawing Rights (SDR's), which is an entity composed of mixed currencies.

- The Export-Import Bank helps U.S. companies sell products to foreign customers, mostly by providing or guaranteeing loans.

FOOD FOR THOUGHT

✓ Suppose you own a widget business, and you have the choice of staying in the U.S. and paying high wages or moving to Mexico where the wages are lower. Would all U.S. companies gain by moving their operations to a country that has low wages? Explain your answer.

✓ If a tractor can do the work of 100 people, for every tractor we could eliminate 100 more people would have jobs. Is this statement true or false? What do you think?

✓ A country can maximize its welfare if it produces the goods and services that it is best at producing. Is this a true statement? Why or why not?

✓ FATCA requires that all world financial institutions make available to the U.S. Internal Revenue Service (IRS) full documentation of their American customers. The reason for FATCA is that U.S. corporate giants prefer to keep their foreign earnings abroad to avoid paying corporate taxes. Do you think that FATCA is a sound economic policy?

✓ A unique reason people desire the American dollar is that the dollar is the world's standard reserve currency. What will happen to the American economy if the dollar is no longer the world's reserve currency?

- ✓ A currency war is a situation whereby nations take action to lower the value of their currency to encourage an increase in exports and other nations do the same. If a lower valued currency makes foreign products more expensive, why do countries engage in currency wars? Who wins a currency war?

- ✓ With a freely flexible international exchange rate, the system automatically corrects trade imbalances. The system is self-adjusting restoring equilibrium. Explain.

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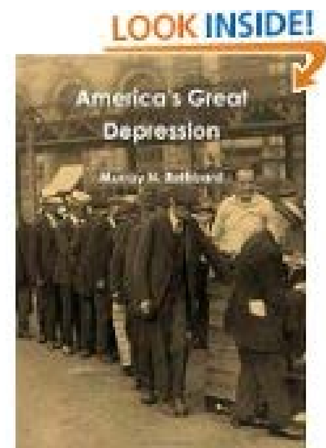
CHAPTER 11:
BUSINESS CYCLES

All advanced industrial economies have swings in economic activity from highs, which economists call expansions, to lows, called recessions or depressions. Economists call this ebb and flow the business cycle. Whether we are talking about communism or capitalism or every type system in between, the business cycle is ever-present. The term business cycle is misleading in that it implies a consistency in the timing and duration of upswings and downswings, but most economists doubt this regularity. Expansions and recessions occur at irregular intervals and last for varying lengths of time.



America's Great Depression
by Robert S. McElvaine
Times Books Pub., 1993
Image from Amazon.com

DEMAND MANAGEMENT ECONOMICS

Conditions during the Great Depression were fertile ground for the ideas of John M. Keynes and demand management economics; the Depression paved the way for a greater role of the federal government and the Federal Reserve. After the Employment Act of 1946 empowered the federal government to pursue maximum employment, and after

Congress cemented this commitment with the Humphrey-Hawkins Act in 1978, the government fully embraced the ideas of Keynesian economics.

Opinions vary concerning this activist approach. One viewpoint is that the Humphrey-Hawkins Act strengthened the Full Employment Act of 1946 while others believe it weakened the government's role by imposing impossible mandates on the Federal Reserve. The Fed will increase the money supply during periods of unemployment and reduce the money supply during inflationary times, but it cannot do both with stagflation.

Austrian economists criticize these mandates because they are reactive rather than pro-active. Instead of concentrating on long run growth, it forces authorities to ignore long run growth and stability. Where did we get the idea that we could control events? History offers some answers.

In the 1930s, classical economists believed that the government should practice laissez-faire because the market was self-adjusting toward full employment, and the Fed prevented market forces from seeking equilibrium when it intervened with monetary policies.

The Fed will increase the money supply during unemployment and reduce the supply during inflation, but it cannot do both in a stagflationary period.

By the 1960s, most economists embraced the ideas of John Maynard Keynes. Keynesians seemed to use the correct monetary and fiscal policies to smooth out the wide swings of the business cycle. Indeed, the economy experienced full employment and stable prices from 1961 to 1969. At this time, economists who criticized Keynesian economics, primarily the Austrians from the Chicago School of Economics, were in the minority. There was a resurgence of Austrian economics during the 1980s, but presently Keynesians hold the seat of power in the United States.

THE FOUR PHASES OF THE BUSINESS CYCLE

Business cycles have four phases. When the economy reaches the end of its expansionary period, economists say that it has reached its peak. After the peak, the economy slides into a recession and eventually reaches a trough, which is the bottom. After the trough, business activity picks up, and the economy recovers. Consumption, investment, government, and the foreign sectors all influence the business cycle, each part contributing to economic stability or instability.

Consumption Sector

The consumption sector tends to be a stabilizing force in the business cycle because consumers are habitual, especially when it comes to non-durable goods. Consumers can consume non-durable goods, such as food, within a short time. Regardless of income, people need to eat and stay warm. Durable goods have a longer life span, such as automobiles.

When consumer incomes fall, they will try to maintain their spending habits by taking money out of their savings, or someone else's savings, by borrowing. They can also dissave by withdrawing money from real savings. For example, a boat valued at $10,000 represents real savings.

The consumption sector tends to be a stabilizing force in the business cycle.

Investment Sector

The investment sector is very unstable. Investors make decisions based on interest rates and their expected rate of return. If investors have doubt and fear about the future, they will be reluctant to invest, regardless of interest rates. Because investors are dependent on expectations of future profit, lengthy and complicated laws can impede investments. When authorities flout the rule of law, investors will hesitate to make bold moves.

Government Sector

Government policies can accentuate the highs and lows of the business cycle, especially concerning the long lag effects of discretionary fiscal policies. Economists compare the plight of decision makers to that of a helmsman, the captain of a ship. Imagine yourself as the captain of a large ship headed across the ocean from New York City to London England. Rough weather has thrown you off course, pushing you too far north. You turn the wheel to the right, but the momentum of the ship carries you too far to the south, forcing you to turn the wheel to the left. However, the ship's momentum pushes you too far north again, so you turn the wheel to the right. This pattern continues as you zigzag across the Atlantic Ocean.

Keynesians and Austrians tend to agree on the merits of automatic stabilizers, but disagree when it comes to discretionary fiscal policies.

Most economists agree that automatic stabilizers, such as unemployment benefits, have a positive effect on the economy. One of the reasons for the severity of the Great Depression was that there were no unemployment benefits. When people lost their jobs, they quit spending and the country quickly slipped into depression. Thus, automatic stabilizers tend to smooth out the swings of the business cycle.

Keynesians and Austrians tend to agree on the merits of automatic stabilizers, but disagree when it comes to discretionary fiscal policies. Keynesians believe that with proper econometric models, the government can make wise decisions and moderate the swings of the business cycle. Austrian economists are more cautious of discretionary fiscal policies.

Foreign Sector

The foreign sector can have a counter-cyclical or a pro-cyclical influence on the economy. The foreign sector is counter-cyclical when it moderates the business cycle. For example, suppose there are inflationary pressures due to an increase in aggregate demand. Without the foreign sector, this increase in demand would bear heavily on the domestic economy and feed inflation. If a portion of the increase is for foreign products, there is less chance of inflation at home.

The foreign sector can have a counter-cyclical or a pro-cyclical influence on the economy. The foreign sector is counter-cyclical when it moderates the business cycle.

The Fed's practice of quantitative easing is an example of this cushioning effect. A central bank implements quantitative easing by buying government and mortgage-backed securities with newly created money. Typically, massive purchases of mortgage-backed securities would cause inflation because of the enormous flood of new funding into the domestic economy.

The foreign sector can be pro-cyclical because the more we trade with foreign nations; the more external events affect us.

The foreign sector can be pro-cyclical because the more a country trades with foreign nations; the more critical are external events. For example, if Greece, Italy, Spain, or Portugal declares bankruptcy, this would impair the American market. International trade also makes Americans more vulnerable to the global businesses cycle. A boom in other countries will stimulate the U.S. economy, and a bust will negatively affect the American economy.

EXCESSIVE LEVERAGE

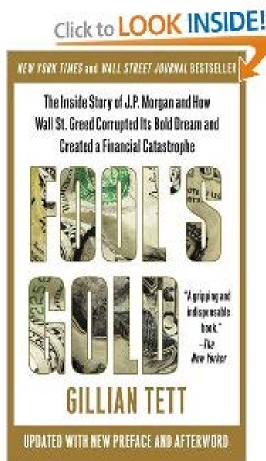
Economies with little debt will experience moderate fluctuations in the business cycle, but economies with excessive debt tend to experience wider swings. In the early 2000s, financial firms borrowed huge amounts of money using high-risk mortgages as collateral. By the mid-2000s, commercial companies were borrowing money with a 30 to one ratio (for every 30 dollars borrowed they had one dollar as collateral).

Excessive leverage can accentuate the highs of the business cycle because it boosts investing. Leverage can multiply gains, but it can also increase losses. With a debt-to-equity ratio of one-to-four, investors can increase their gain by a factor of four. With a debt-to-income ratio of forty-to-one, investors can increase their gain by a factor of 40. In like manner, investors can experience losses by these same ratios. Because collateral can be shaky, the excessive debt adds an element of instability.

After the economic collapse of 2007-2008, banks tightened credit by requiring 20 percent down for mortgage loans. However, after this brief hiatus from risky loan practices the Federal Housing Agency (FHFA) announced an easing of mortgage loan requirements. The FHFA collaborated with Fannie Mae and Freddie Mac to encourage an increase in mortgage loans by lowering the down payment requirement from 20 percent to only 3 percent.

Congress established Fannie Mae in 1938 and Freddie Mac in 1970 to add liquidity to the mortgage market. When you take out a loan, the contract between you and the bank represents the primary market. Your bank will usually sell your mortgage to Fan and Fred in the secondary market. Be selling mortgages, banks gain ready cash to lend to other people. Fan and Fred then make their profit by the process of securitization. Securitization is the process whereby financial institutions repackage multiple loans into a single financial asset, divide them into three different tiers (called tranches) and then sell off bits and pieces to investors. Credit worthy loans are in the top tier, and high-risk loans are in the bottom tier, the toxic waste category. Economists call this collection of loans a Collateralized Debt Obligation (CDO) or a Mortgage Backed Security.

With only a 3 percent down payment, a modest decline in home prices will put new homebuyers underwater, meaning they will owe more on their house than what the house is worth in the market. A deflationary period can trap homeowners if they need to move because of a job change, or they can no longer make the mortgage payments. The lack of equity forces them to sell at a loss or default on their mortgage loan. Therefore, any fall in house prices can lead to financial ruin. This was a common occurrence in the financial collapse of 2007-2008.



***Fool's Gold* by Gillian Tett**
Free Press, 2009
Image from Amazon.com

Labor mobility has been a strong point for the typical American worker, but when a person is underwater on their mortgage, the freedom to relocate diminishes. The possibility of loan defaults is why Fan and Fred stopped guaranteeing loans with down payments of only 3 percent in the first place.

An excellent book on the subject is Fool's Gold by Gillian Tett. The book explains how the economic collapse of 2007 and 2008 was self-inflicted. Ms. Tett explains how financial incentives within banks and other financial firms, as well as the rating agencies, warped regulatory structures. The book is a fascinating read because she explores the human foibles that led to the collapse. Fool's Gold reads like a novel, full of suspense and intrigue.

Financial Instruments Lose Value

By 2006, individuals, businesses, banks, and governments began to receive billions of dollars less in payments as debtors defaulted on loans. Within months, hundreds of billions of dollars of perceived assets vanished. By late 2007, consumer and business spending was down, and the recession ensued. By 2008, the realization of disappearing assets spread around the globe, culminating in a financial panic.

The Fed Takes Action in 2008

> ***Late in 2008, the rapidly eroding confidence in the financial system caused several major financial firms to collapse.***

Late in 2008, the rapidly eroding confidence in the financial system caused several major financial firms to collapse. Many banks and insurance companies faced bankruptcy, and private citizens experienced enormous losses. Fearing that these conditions could usher in another great depression, the Federal Reserve took action to stem the tide. For the first time in history, the Fed began lending money to nonbank corporations. Additionally, it purchased obligations from Fannie Mae and Freddie Mac. Then it agreed to exchange billions of dollars of risk-free federal bonds for high-risk private bonds held by commercial entities.

These actions helped relieve the panic and conditions improved. Just as JP Morgan and others envisioned, the Federal Reserve saved the day by being a lender of last resort.

Too Big to Fail or Too Big to Save?

When the government bails out failed businesses, does this practice stabilize the business cycle, or does it sow the seeds of even greater long run gyrations in the future? Keynesians tend to support bailouts because they believe that the failure of large corporations will systematically lead to a full-fledged economic collapse. Austrians, who usually do not support bailouts, argue that bailouts prevent the economy from finding its floor and thus inhibit the economy from seeking its equilibrium.

General Motors (GM) was losing billions of dollars per year before the government partially nationalized it in 2009. For years, GM routinely agreed to generous labor contracts with the United Auto Workers Union (UAW). By the time the 2007-2008 recession hit, GM was uncompetitive due to high labor and high pension costs. In previous times, the company would have declared bankruptcy and the bankruptcy courts would have sorted out who gets what. Other businesses would have purchased the assets of GM and started producing cars. Instead, the U.S. government, with the help from the Canadian government, granted money to GM that allowed it to continue, with all its previous baggage intact.

Just as the American government has bailed out domestic companies, international authorities have bailed out whole nations. Authorities granted Greece a series of loan extensions for years. Puerto Rico, a U.S. territory, defaulted on billions of dollars of loans, putting the United States in jeopardy. When these international events occur, solutions are tricky because of a lack of international bankruptcy laws.

Loan defaults, especially international loan defaults, hurt both the debtor countries and bondholders. With other countries in precarious situations, loan defaults by a few can lead to a chain of events culminating in massive loan defaults of several countries. These massive loan defaults could usher in a world depression as the scope of the situation makes bailouts impossible.

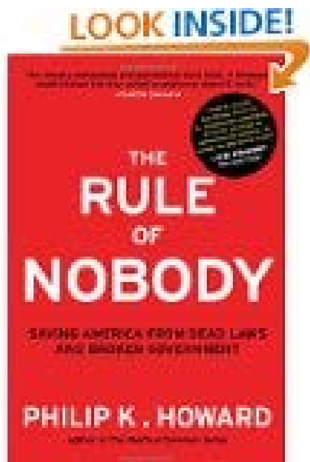
A NEW AGE OF INDUSTRIALIZATION?

The recession of 2007-2008 has ushered in something called industrial policy. President Obama claimed in 2009 that the government must make strategic decisions about

strategic industries. The government has earmarked billions of dollars to support favored industries, such as renewable energy, while amassing roadblocks to other sectors, such as coal.

The National Labor Relations Board, the Equal Employment Opportunity Commission, the Occupational Safety and Health Administration and the Office of Federal Contract Compliance Programs are teaming up to rewrite employment, labor and workplace law. The effect of these changes is uncertain. What we do know is the Fed has reshaped credit markets on a grand scale and moved us further away from a free market system.

RULES VS. PRINCIPLES



The Rule of Nobody: Saving America from Dead Laws and Broken Government
by Philip K. Howard
2014, W.W. Norton & Company
Image from Amazon.com

We have become a nation of rules. Windowsills have to be so many feet and inches off the ground, restaurants have to serve food at set temperatures, and businesses have to perform numerous studies before they can build anything. The No Child Left Behind Law dictates precisely what students learn in each grade, forcing teachers to teach to the test. Strict rules throw spontaneity and creativity out the window. Everyone has to know the rules, and everyone has to comply with the rules.

When a doctor sees a Medicare or Medicaid patient, a specialist has to verify that the patient falls under one of the 140,000 different categories in order for the physician to receive payment. In this world of rules, no human being is in charge - we are all subject to the letter of the law – and once authorities establish the rules they are almost impossible to change. Authorities may retire or die, but the rules live far into the future. In this world of rules, everyone is subject to the letter of the law. Meanwhile an inflexible bureaucracy bogs down the system where lengthy and complicated laws reign.

Another problem with rules is that each government agency can have their set of rules or guidelines. The Department of Labor has a set of directives for independent contractors. Government guidelines are a way of establishing standards without the legality

of mandatory rules. Businesses are troubled when the Labor Department has one set of rules concerning independent contractors, and the IRS has a different set of rules.

Principles, on the other hand, provide broad goals while leaving human beings in charge. Nursing homes should offer a home-like environment and should be safe. Nursing homes should feed patients healthy and wholesome food. Patients should enjoy the social atmosphere along with privacy. Nursing homes should make available cultural and educational enrichment opportunities in a setting free from loud noises, such as blaring televisions. Someone is in charge when principles apply. Some local person has the authority to make sure the nursing home meets the spirit of the law. There is always someone in authority who can enforce the principles.

Inflexible rules bog down economies as if they were standing in quicksand. The economy remains in a perpetual trough where youth unemployment and underemployment act as a curse on the young generation. An economy based on principles, on the other hand, is flexible and better equipped to adapt to changing conditions.

Philip K. Howard does an excellent job explaining our current state of affairs in his book *The Rule of Nobody – Saving America from Dead Laws and Broken Government.* He writes of how rules have constrained and bogged down economies of the world, including the United States. In a world of rules, no one is in charge because the rules rule instead of people. Rules have replaced principles in society; they have transformed the way we live and interact with one another. Following is a quote from the book's preface.

> *No official has authority to make a decision. Law has crowded out the ability to be practical or fair. Mindless rigidity has descended upon the land, from the schoolhouse to the White House, to, sometimes, your house. Nothing much works, because no one is free to make things work...*
>
> *American government is run by millions of words of legal dictates, not by the leaders we elect or the officials who work for them.*
>
> *America is at a dangerous place. Big change will happen, whether you want it or not, because the current structure is not sustainable.*[24]

John Yates is the captain of the *Miss Katie*. He was fishing for grouper in the Gulf of Mexico when the Florida Fish and Wildlife Commissioner boarded the boat for a routine inspection. The Commissioner charged Mr. Yates with having aboard 72 grouper fish smaller than the 20 inches allowed. When he got into port, federal officials counted only 69 undersized fish. The agents charged him with violating the anti-shredding provision of the Sarbanes-Oxley Act, which carries a 20-year prison term. John Yates was a victim of rules ruling and no one is in charge with common sense to go against the rules.

Howard's explanation of the difference between principles and rules is similar to the ideas of Friedrich Hayek.

The Justice Department has used rules to extract multi-million-dollar settlements from banks. The Department has applied fines to lenders for not having a quality-control process that follows Federal Housing Administration guidelines. If there are mistakes, such as misstating a borrower's income by a tiny amount, the Justice Department can hold lenders liable for up to three times damages.

When planners realize that the only way for the plan to work is to mandate that everyone adhere to the plan, the road serfdom is complete.

Howard's explanation of the difference between principles and rules is similar to the ideas of Friedrich Hayek. In *The Road to Serfdom,* he explains how excessive planning leads to a loss of all personal freedom. When planners realize that the only way for the plan to work is to mandate that everyone adhere to the plan, the road serfdom is complete.[25]

SUMMARY

All advanced industrial economies have swings in economic activity from highs, which economists call expansions, to lows, which economists call recessions or depressions. Economists call this ebb and flow of economic activity the business cycle.

Whether we are talking about communism or capitalism or every type system in between, the business cycle is ever-present. The term "business cycle" is misleading in that it implies a consistency in the timing and duration of upswings and downswings, but most economists doubt this regularity. Expansions and Recessions occur at irregular intervals and last for varying lengths of time.

Business cycles have four phases. When the economy reaches the end of its expansionary period, we say that it has reached its peak. After the peak, the economy slides into a recession and eventually reaches a trough, which is the bottom. After the trough, business activity picks up, and the economy recovers. Consumption, investment, government, and the foreign sectors all influence the business cycle, each part contributing to economic stability and instability.

Change is inevitable, and the boom and bust cycle of the economy is a natural process. During recessions, an Austrian would tend to support monetary policies, but would be skeptical of discretionary fiscal policies. Keynesians tend to favor fiscal policies over monetary policies. The Employment Act of 1946 and the Full Employment and Growth Act of 1978 conceptualize the ideas of Keynesian economics by giving the federal government mandates to use monetary and fiscal policies to ensure full employment and stable prices.

Keynesians believe that monetary policies alone may be ineffective because of a liquidity trap and, therefore, fiscal policies can revitalize the economy in the presence of a liquidity trap. Keynesians also stress the importance of the Keynesian multiplier and the accelerator. The multiplier recognizes that for every dollar spent, there is a multiple effect as people spend and save. The accelerator kicks in when the increase in spending leads to induced investments.

The consumption, investment, government and foreign sectors influence the business cycle. The consumption sector helps stabilize the economy because consumers will find ways to maintain their spending habits regardless of economic changes, at least for a while. On the other hand, the investment sector is very volatile. If investors are pessimistic, low-interest rates may not lead to an increase in investments. When the low-interest rates fail to spur on borrowing when consumers and investors are unresponsive to the lower interest rates, the economy experiences a liquidity trap. According to Keynes, the only way out of a liquidity trap is for the government to borrow more and inject the funds back into the economy via discretionary fiscal policies.

To increase investments, investors have to be confident about the future. The government sector can be a stabilizing or destabilizing force depending on which fiscal policies it uses. The foreign sector can be stabilizing or destabilizing depending on how dependent a country is on the foreign sector. Both Keynesians and Austrians agree that slow but steady growth is better than booms and busts.

Excessive leverage adds to the booms and busts of the business cycle. Debt can be a good thing in the short run because it helps grease the wheels of demand and therefore growth. However, excessive debt can be disastrous in the long term as massive defaults accelerate a downward swing. When prices plummet, assets vanish. For example, trillions of dollars of financial assets can disappear overnight with a stock market crash.

Austrian economists would not support government bailouts of large corporations during busts. Austrians believe that bailouts can lead to crony capitalism, moral hazard, and an expansion of the national debt. Government bailouts move us farther away from a free market system. Keynesians, on the other hand, would favor an active federal government when it can take up the slack of a malfunctioning economy.

Austrians see a similarity between the ideas of Friedrich Hayek and a society based on rules. In *The Road to Serfdom,* the planned economy leads to serfdom, a loss of all personal freedom. In *The Rule of Nobody,* Phillip Howard explains how rules rule, and long and detailed regulations take precedence over people.

KEY CONCEPTS

- All industrial economies have swings in economic activity from highs, which economists call expansions, to lows, which economists call recessions or depressions. Economists call this ebb and flow of economic activity the business cycle.

- The Employment Act of 1946 empowered the federal government to pursue maximum employment, production, and purchasing power.

- Congress cemented this commitment with the Humphrey Hawkins Act (the Full employment and Balanced Growth Act) in 1978 by mandating full employment and stable prices as a policy goal.

- The Fed will increase the money supply during unemployment and reduce the supply during inflation, but it cannot do both in a stagflationary period.

- The four phases of the business cycle are peak, recession, trough, and recovery.

- The consumption sector tends to be a stabilizing force in the business cycle because consumers are habitual.

- The investment sector is very unstable. Investors make decisions based on interest rates and their expected rate of return.

- Government policies can accentuate the highs and lows of the business cycle, especially concerning the long lag effects of discretionary fiscal policies.

- Most economists agree that automatic stabilizers, such as unemployment benefits, have a positive effect on the economy.

- Keynesians and Austrians tend to agree on the merits of automatic stabilizers, but disagree when it comes to discretionary fiscal policies.

- The foreign sector can have a counter-cyclical or a pro-cyclical influence on the economy.

- Economies with little debt will experience moderate fluctuations in the business cycle, but economies with excessive debt tend to experience much wider swings.

- Excessive leverage can accentuate the highs of the business cycle because it boosts investing. However, once it heads south, excessive debt adds fuel to the fire.

- The recession of 2007-2008 has ushered in something called industrial policy. President Obama claimed in 2009 that the government must make strategic decisions about strategic industries.

- We used to be a nation based on principles; we have become a nation based on rules.

- Principles, on the other hand, provide broad goals while leaving human beings in charge.

- In a society of rules, everyone has to know the rules, and everyone has to comply.

- Inflexible rules bog down economies as if they were standing in quicksand.

- Howard's explanation of the difference between principles and rules is similar to the ideas of Friedrich Hayek. Hayek explains how excessive planning leads to a loss of all personal freedom.

- When planners realize that the only way for the plan to work is to mandate that everyone adhere to the plan, the road serfdom is complete.

FOOD FOR THOUGHT

- ✓ The idea behind Keynesian economics is that as long as we can manage demand we can manage the economy. Do you agree or disagree with this? Explain your answer.

- ✓ The economy can have many problems, including inflation and unemployment. However, when policymakers get their eye off growth policies, most all problems worsen. Do you agree or disagree with this statement? Explain your answer.

- ✓ Economies with little debt will experience moderate fluctuations in the business cycle, but economies with excessive debt tend to experience much wider swings. Why is this so?

- ✓ When the government bails out failed businesses, does this practice stabilize the business cycle, or does it sow the seeds of even greater long run gyrations in the future?

- ✓ The recession of 2007-2008 has ushered in something called industrial policy. President Obama claimed in 2009 that the government must make strategic decisions about strategic industries. Do you think this is a good idea? Why or why not?

- ✓ We have become a nation of rules rather than a nation based on principles. What is the difference? Which type system would you rather live? What are the pros and cons of each? What point does Phillip Howard in *The Rule of Nobody* make concerning rules? How is this similar to the ideas of Friedrich Hayek?

- ✓ When planners realize that the only way for the plan to work is to mandate that everyone adhere to the plan, the road serfdom is complete. Do you agree or disagree? Explain why.

CHAPTER 12:
FINANCIAL CRISIS 2007-2008

The financial crisis of 2007-2008 is a story of intrigue, under the table dealings and mystery, excessive pride, ambition, and greed, of epic battles where heroes are villains and villains are heroes. How is it that the financial system of the United States and much of the world stood on the brink of total collapse? How is it that a domino effect of loan defaults by highly leveraged people came perilously close to throwing the world into economic darkness? What are the events that led to the financial crisis of 2007-2008?

We can begin the story with the Community Reinvestment Act (CRA) of 1977, an act that Congress has amended three times, in 1989, 1995, and 2005. This Act provided a framework for financial institutions to promote banking services to all members of a community. In essence, the CRA prohibited redlining, denying or increasing the cost of banking to residents of racially defined neighborhoods and encouraged efforts to meet the credit needs of all community members.

This act popularized subprime loans. Banks make prime loans to creditworthy customers and make subprime loans to people with poor credit scores. Consequently, banks relaxed their lending standards with new types of loans. Thus, no money down, variable or adjustable rate, and Alt-A loans became popular. Adjustable rate mortgages begin with low-interest rates, called teaser rates, and increase yearly according to a fixed schedule.

Alt-A loans (nicknamed liar loans) are loans whereby bank officials do not ask potential borrowers to verify their credit information on loan their loan applications.

In 1993, President Clinton teamed up with Roberta Achtenberg, the assistant secretary of the Department of Housing and Urban Development (HUD). Their goal was to increase home ownership in poor and minority communities. Roberta began to threaten, harass, and bully banks to provide mortgages to people who previously did not qualify for loans. Consequently, between 1993 and 1999, more than two million low-income people became new homeowners.

In her two-year tenure, she set up a national grid of offices staffed by attorneys and investigators who enforced anti-discrimination laws against the banks. Banks were compelled to fall into line and started to make thousands of loans with lenient terms and, in some cases, without requiring a down payment. A healthy mortgage market in the mid to late 1990s made mortgage defaults minimal. Nevertheless, these events sowed the seeds of an economic meltdown.

THE GLASS-STEAGALL ACT OF 1933

As you might recall from our discussion of money and banking in Chapter 5, in 1933 Congress passed the Glass-Steagall Act, calling for the separation of commercial and investment banking. The purpose of this act was to prevent commercial banks from putting depositors' money at significant risk. Whereas the law regulated commercial banks, it did not regulate investment banks. Therefore, investment banks were free to make risky investments for their wealthy clients.

Investment banks were banks that did business with wealthy individuals.

In the 1990s, investment banks were making enormous profits in activities that the Glass-Steagall Act made unlawful for commercial banks, and commercial banks wanted to share in the bounty. The lobbying efforts of the banking community succeeded in convincing Congress to repeal the Glass-Steagall Act with the Financial Services Modernization Act of 1999. The Financial Services Modernization Act obliterated the difference between commercial banks and investment banks and allowed banks to compete with investment banks in the derivatives' market. Thus, the lobbying effort via rent seeking by big banks was successful.

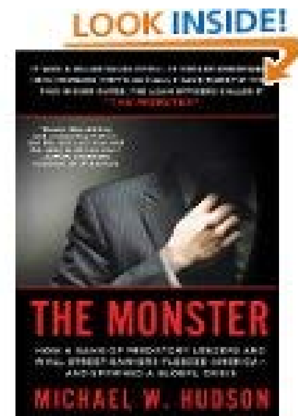
One of the few persons who saw a danger in the derivatives market was Brooksley Born, the chairperson of the Commodity Futures Trading Commission (CFTC.). The federal CFTC is the agency that oversees the futures and commodity options markets. Brooksley was the chairperson of the CFTC from August 1996 to June 1999. The government authorized the CFTC to detect fraud in the over-the-counter derivative's market. An over the counter market is a market void of an exchange whereby participants divulge financial information so that investors can make informed decisions. With an over-the-counter market, there is no way of knowing the facts except what the seller wishes to divulge. When she looked into the market, she became concerned about the dangers it posed to the entire economy.

A derivative is a bet between two parties on the outcome of some future event.

THE DERIVATIVES MARKET

As you might recall from Chapter 8, derivatives are legal agreements that involve bets between parties on the outcome of some future event. As discussed above, economists call these legal agreements derivatives because some future event derives the value. Derivative contracts are a part of the futures market because the results will take place in the future. Let us revisit this concept.

The following hypothetical case may never happen, but it will give you an idea of how derivative markets work.



The Monster: How a Gang of Predatory Lenders and Wall Street Bankers Fleeced America – and Spawned a Global Crisis
by Michael Hudson
Times Books Pub., 2010
Image from Amazon.com

Suppose you and I make a bet on the weather on a particular day a month from now. I say that it will rain, and you bet that it will not rain. We then draw up a contract binding our agreement based on this future event. Whoever owns this piece of paper on the specified day and is on the winning side of the bet, collects money from the other party. Investors enter into derivative contracts over the price of stocks, agricultural products, foreign exchange rates, or anything else.

The notional value of derivatives in today's market is about $600 trillion! Because the value of derivative contracts depend on some future event, and because the future is uncertain, investors rely on the formulas of mathematical wizards, called Quants, to base their predictions. One such formula is the Black-Scholes Formula.

Suppose you have authority over a large sum of money, presume you are in charge of a retirement fund or the finances of a country. One day a salesperson from Bear Stearns Investment Bank (Bear is now a part of JP Morgan Chase Bank) walks into your office and asks if you are interested in buying a security. The security has a triple-A rating and has a history of paying 25% return. “Wow,” you say, “that’s a great deal; what is it?” So he says, “Hey, I’m busy - do you want this or not.” Because Bear Stearns has an excellent reputation, and the security has the highest credit rating, you take the deal without knowing the particulars. Few people knew what they were buying in the derivatives market leading up to the financial collapse of 2007-2008.

An over-the-counter-derivative is an agreement between two parties, and only the two parties are privy to the facts.

The core problem with the derivatives market was excessive leverage. When the government established the Securities and Exchange Commission (SEC) in 1934, it set banks debt to capital ratio at 12 to 1. A ratio of 12 to 1 means that a bank had to have at least one dollar in reserve to lend 12 dollars. This rule limited the extent that banks could use leverage.

The SEC abolished this debt-to-net-capital rule in 2004 when it allowed large investment banks to determine their debt to income levels based on their risk management computer models. Instead of adhering to the previous twelve to one debt to capital ratio, the new norm became forty-to-one; banks could invest 40 dollars with only one dollar in reserve.

The shadow banking system is a term for the collection on non-bank financial intermediaries that provide services similar to traditional commercial banks.

The forty to one debt to capital ratio made enormous profits possible in the derivatives market. But, when the economy began to head south in 2007, this excessive leverage led to the collapse of all five investment banks. The banks were Goldman Sachs, Bear Stearns, Morgan Stanley, Merrill Lynch, and Lehman Brothers. Lehman had assets worth $691 billion; when GM went bankrupt several years later, it had assets worth just $91 billion. By September 2008, the crisis became a financial meltdown of epic proportions.

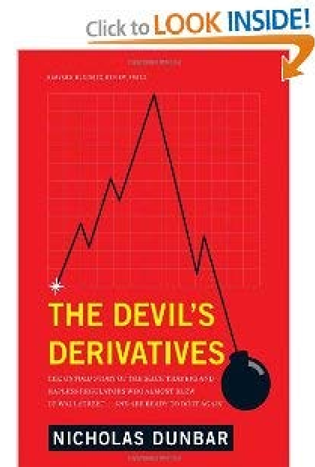
To stem the tide of the economic collapse, the Federal Reserve allowed these investment banks to purchase commercial banks, and thus the Fed granted these new entities holding bank status. A bank holding company is a large corporation that owns a bank; the Fed grants holding bank companies the same protections of commercial banks.

HEDGING

Hedge funds often use the futures market to offset one investment against another. For example, an appreciated asset may offset a depreciated asset. Hedge funds are a part of the shadow banking system because they compete with commercial banks. Hedge funds act like banks but without a banking license, and, therefore, fall outside of federal oversight.

Investors often use forward contracts as a hedge against potential losses. Farmers have hedged against the potential of future losses by using forward contracts for thousands of years as discussed in Chapter 8 above.

Unlike mutual funds that have to stick with stocks or bonds, hedge funds can invest in almost anything – land, real estate, stocks, derivatives, currencies etc. Hedge funds often use borrowed money to give them more leverage, but this also amplifies the risk factor.



The Devil's Derivatives
by Nicholas Dunbar
Harvard Business School Pub., 2011
Image from Amazon.com

A hedge fund is partnership between the fund manager and investors. The investors contribute money, with high minimum contributions, and the general manager invests the money according to the fund's strategy. The manager's goal is to maximize investor returns while eliminating, or at least, minimizing, the risk factor. Economists use the name "hedge" because the aim of these funds is to make a profit regardless of which way the market moves. You "short" the market when you bet that the price of a stock will decline.

Forward contracts are common in foreign exchange markets. Because the values of currencies can fluctuate widely and unexpectedly, forward contracts are commonplace in international transactions. Likewise, because of the uncertainties in the derivatives market, participants use forward contracts to hedge against future events.

BROOKSLEY BORN

Now let us get back to Brooksley Born. From her vantage point as chair of the Commodity Futures Trading Commission, she was aware of how quickly the over-the-counter derivatives market was growing and how little federal regulators knew about it.

Brooksley saw the danger in the market, including major fraud; speculation was leading to dramatic failures.

Brooksley saw fraud and over speculation leading to dramatic failures. One example is Orange County, California, which went bankrupt because of high-risk bets in the derivatives market. These failures are alarmed Brooksley because few in government even knew about derivatives, yet all the biggest banks were dealers in the market. Her concern was that a major default in the market could cause a domino effect throughout the economy. For example, Proctor & Gamble lost $200 billion and sued its derivative's dealer, Bankers Trust, for fraud alleging that the bank had sold them complex derivatives without proper explanation. In 1996, Bankers Trust settled with Proctor & Gamble, forgiving most of the debts.

Now here is where things get interesting. When Brooksley contacted the Treasury Department, the Federal Reserve, and the Securities and Exchange Commission about her concerns, not only were they complacent, but they questioned whether Brooksley had the authority to take action.

Events took a turn when banks rescued Long-term Capital from bankruptcy in 1998 when it was on the losing side of a derivative contract.

So why was Alan Greenspan, who was Chairman of the Federal Reserve from 1987 to 2006, opposed to any oversight of the derivative's market? Alan Greenspan is a disciple of Ayn Rand, who wrote the book, *Atlas Shrugged*, in 1957. Rand believed that the market should be free of all government regulation. Here we have the Chairman of the Federal Reserve, who handles regulating the banking system, opposed to regulation. When Brooksley had a private conversation with Alan Greenspan and pointed out extensive fraud in the derivatives market, his response was that the CFTC should not persecute fraud because the market would take care of it.

Events took a turn when banks rescued Long-term Capital, a hedge fund, from bankruptcy in 1998 when it was on the losing side of a derivative contract. The banks told Congress that the LTCM problem was the exception to the rule and was not indicative of the derivative's market. Congress accepted this argument and passed the Commodity

Futures Modernization Act (CFMA) of 2000. The CFMA stripped the Commodity Futures Trading Commission of all responsibility for derivatives and forbade the Securities and Exchange Commission (SEC) and state regulators from interfering with over-the-counter derivatives.

CREDIT-DEFAULT-SWAPS (CDSs)

The whiz kids of JP Morgan Bank met in Boca Raton, Florida, in the early 1990s, and brainstormed ways to convince the Fed to reduce the bank's reserve requirement. Thus, the credit-default-swap (CDS) was born. A credit-default-swap occurs when one party pays another party to assume the risk of default. It is sort of like an insurance policy against loan losses whereby the purchaser of the swap transfers risk of default to the seller of the swap. In the event of a default, the seller makes payment to the buyer.

Credit-default-swaps convinced the Fed that banks' loss exposure had diminished and agreed to lower the bank's reserve requirement. Thus, the CDS succeeded in its original intent. The bad news came later when both the buyers and the sellers of swaps abused this sound business practice. A closer look at credit default swaps, and how they were instrumental in exasperating the financial collapse of 2007-2008, will enlighten your understanding of the economic collapse.

Credit Default Swaps and Real Insurance

The buyer of a credit-default-swap (CDS), which is a legal piece of paper, pays the seller quarterly, semi-annually or annually. Credit default swaps have value because investors can buy and sell them. Whoever owns the CDS receives payments from the purchaser. Economists consider a CDS a derivative because the underlying bonds determine its market value.

Real insurance policies guard against irresponsibility and fraud. Unlike CDSs, insurance policies have provisions for deductibles, policy limits, and higher premiums for people who represent a high risk. You cannot buy an insurance policy on your house twenty times its value, especially if it has burned down five times in the last decade. You also cannot buy a home policy if you do not own a home. If you have five convictions for drunk driving, you may not be able to buy automobile insurance, and if you can, it will be very expensive. Not so with credit default swaps.

Unlike real insurance, credit-default-swaps have no deductibles or policy limits and place no constraints on buyers. If you have the money, you can buy as many of them as you wish, even on securities you do not own. You can bet that either the security or the company issuing the security will fail.

Wall Street was able to sell high-risk securities because sellers convinced potential buyers that CDSs could protect them from loss. Consider real insurance. In the event of a disaster, the insurance policy limits the total liability of the insurance company to the extent of the damage. However, in the case of CDSs, as long as someone was willing to sell them, there was no limit to the size of the liabilities or risks.

Credit Default Swaps are Alive and Well

Before the financial crisis, only large borrowers participated in credit-default-swaps. After the 2007-2008 crisis, credit-default-swaps fell out of favor with large borrowers. Currently, investors are increasingly using credit-default-swaps when they trade in small companies in financial trouble. These CDS trades can influence factors that push some companies toward default and other companies away from default.

It is kind of like investors who short the market and, therefore, gain when the price of their stock declines. When an investor goes long on an investment, it means that he or she has bought a stock believing that its price will rise in the future. Conversely, when an investor goes short, he or she is anticipating a decrease in share price. If the price declines, the investor makes a profit, if the price increases, the investor incurs a loss.

The growing popularity of CDSs makes it difficult to discern investors' actual objectives. For example, hedge funds sold CDSs on RadioShack, betting the company would not default, and then lent the company money making sure there would be no default. There have been cases where shareholders of companies support policies that will lead to bankruptcy because they bought CDSs betting that their business would default on its loans. In other words, because they bought a CDS if the company goes bust, they gain, and if the company recoups and makes good on its debts, the investors lose.

FANNIE MAE AND FREDDIE MAC

Prior to 1999, the government required Fannie and Freddie to buy only prime mortgages. After 1999, the Community Reinvestment Act (CRA) put mandates on Fannie

and Freddie to purchase a minimum amount of sub-prime loans from banks and persecuted banks that failed to meet these terms.

Throughout the 2000s, Fan and Fred increased their purchases of subprime mortgage loans. These policies did not initially cause problems, but they had the effect of adding fuel to the fire beginning in 2007. When millions of homeowners defaulted on their mortgages in 2007 and 2008, Fannie and Freddie lost billions. Thus, they relinquished their quasi-government status and reverted to complete government control in 2008. Presently, Fannie and Freddie own most of the mortgages in America.

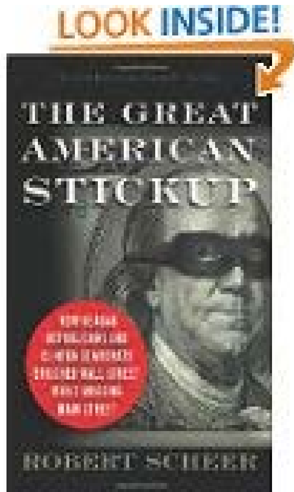
Some politicians have spent years arguing that private lenders created the housing bubble and that Fan and Fred came along for the ride. The Securities and Exchange Commission begs to differ. The SEC has come out with a report with evidence showing how the failed mortgage giants turbocharged the crisis.

The report shows that Fannie degraded its underwriting standards to increase its market share in subprime loans. The SEC also shows how Fannie forced private lenders into the subprime market. In July 1999, Fannie and Countrywide Home Loans Company entered an alliance agreement that included a reduced documentation loan program called the Fast and Easy Loan. Angelo Mozilo, Countrywide's founder, and Fannie were business partners in the subprime mortgage market. Countrywide found the customers while Fannie provided the taxpayer-backed financial capital. As Fannie expanded its subprime loan purchases and guarantees, the SEC alleges that executives hid the risk level from investors.

By 2008, more than half of all U.S. mortgages were subprime or otherwise weak while the majority of these loans sat on the books of government agencies, especially Fannie and Freddie Mac. This emphasis on lending money to people with poor credit ratings culminated in a huge housing bubble by 2007 and 2008.

History could repeat itself with Fannie Mae's issuance of an affordable lending product called the Home Ready mortgage aimed at helping lower and moderate-income people to access a mortgage. Fannie Mae claims that its integrated suite of risk management tools and its innovative online education requirement will protect homeowners from default.

A critical factor in the mortgage collapse was the abundance of adjustable rate mortgages and Alt-A mortgage loans, liar loans, issued from 2000 to 2008. As with credit default swaps, there is nothing amiss with adjustable rate mortgage agreements, the problem stemmed from the use of these type mortgages, not the arrangement itself. The problem arose from greed and deceitfulness on the part of lenders.



The Great American Stickup
by Robert Scheer
Nation Books Pub., 2010
Image from Amazon.com

The proliferation of adjustable rate mortgages made it easier for banks to find customers and increased the risk of loan defaults once the economy softened. Instead of penalizing Countrywide for its transgressions and exposing the practices of Fannie Mae, the government chooses to hide these dealings by pressuring Bank of America to purchase Countrywide and Merrill Lynch. Since then, Bank of America has paid about $75 billion in penalties for crisis-era legal problems, primarily stemming from the fraudulent loans of Country Wide Financial Corporation and Merrill Lynch & Co. So here we have the federal government putting pressure on a bank to purchase a business entity to hide unsavory business practices, and then penalizes the bank for the wrong doings of the acquired entity. The four biggest U.S. banks by assets have so far agreed to pay the federal government about $125 billion in crisis-related settlements and penalties, without, in most cases, admitting or denying culpability.

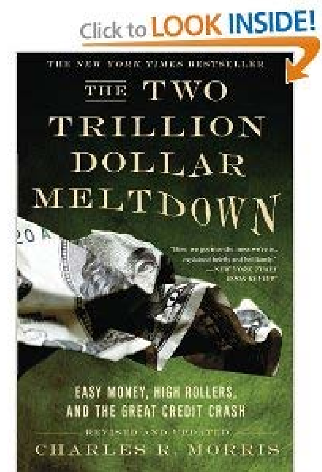
COLLATERALIZED DEBT OBLIGATIONS (CDOs)

Investment banks could not compete with Fannie and Freddie in the home mortgage market because Fan and Fred could offer low returns to investors and still attract customers because of the perceived government guarantee against loss. Indeed, investors did not suffer loss after the crash because the government bailed out Fan and Fred in 2009. Banks realized, however that they could securitize any form of debt. Asset-Backed Securities is an umbrella term economists use to describe a security backed by a pool of assets.

Credit-default-swaps and collateral debt obligations are sound business practices. The problem was not in the practice, but the problem was in the types of loans that banks securitized in combination with the volume of sales. If the loan types firms securitized had met at least minimum standards of creditworthiness, they would have never contributed to the economic collapse. Instead of securitizing only top rated debts, financial firms securitized high-risk loans in the toxic waste category. When JP Morgan, the originator of

the credit-default-swap, learned that other banks were forming CDSs made up of junk bonds, it was appalled.

Despite the dealings in high-risk loans, economic problems would have been contained if the transactions were small, which they were not. Charles Morris does an excellent job in his book *Two Trillion Dollar Meltdown – Easy Money, High Rollers, and the Great Credit Crash* of explaining how we got into a credit crunch. He explores the financial markets, the policy misjudgments, and the delusions that led to the greatest credit bubble in history. He explains how excessive leverage led to a massive disruption in global markets and how government leaders are still downplaying the problem. According to Morris, the restructuring that is required to fix the problem will be very painful.



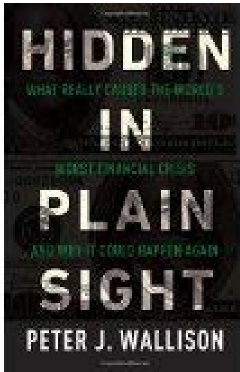
The Two Trillion Dollar Meltdown
by Charles Morris
Public Affairs, 2008
Image by Amazon.com

TRIPLE A CREDIT RATINGS

If the kinds of loans in a CDO were in the toxic waste category, how could banks sell them to investors? Government and retirement funds mandated that investments could only be in triple-A rated investments, the highest rating. Standard and Poor's and Moody's are credit rating agencies that corporations pay to assess their debt instruments. How is it that the rating agencies could give junk bonds a triple-A rating?

Now Joe Cassano, who was head of the Financial Products Division of American International Group (AIG) from 2001 to 2008, enters the picture. AIG is an insurance and financial services conglomerate that was once the largest insurer in the world. The Financial Products Division and Joe Cassano made billions of dollars for its parent company the American International Group. Because the credit-default-swap market was not a regulated market, Cassano could sell as many credit-default-swaps as he wanted without considering how the company would pay the claims in the event of massive defaults. However, the finances of the Financial Products Division and its parent company, AIG, could not be co-mingled. This is something the purchasers of the CDSs did not know.

Banks argued that when they purchased a credit-default-swap from AIG on a CDO, the CDO should have a triple A rating because AIG had a triple A rating. Therefore, even though there was a likelihood of default, the risk level was low because AIG was backing the CDO. In other words, investors in the CDO were safe because, if people stopped making their mortgage payments AIG would pay. When the government accepted this argument, Cassano was able to sell billions of dollars' worth of credit-default-swaps. Banks could now sell billions of dollars' worth of junk CDOs because of the triple-A rating.



Hidden in Plain Sight: What Caused the World's Worst Financial Crises and Why Could it Happen Again
by Peter Wallison
Encounter Books, 2015
Image from Amazon.com

Investors had a misconception of the relationship between the parent company, AIG, and its subsidiary, the Financial Products Division. The Financial Products Division of AIG was self-financed; the finances of the parent company were not available to the Financial Products Division. Investors assumed that they were one in the same. Consequently, Cassano was able to sell vast amounts of credit-default-swaps without collateral to back them because this was an unregulated industry.

Because the SEC did not regulate the industry, Cassano operated with no restraints and investors were not privy to all the facts. When the bubble burst in 2007, AIG was on the hook for billions of dollars while lacking sufficient funds to make good on its credit-default-swaps. When the financial panic broke out in 2007, AIG needed a government bailout.

THE COLLAPSE!

The easy money policies of the Federal Reserve during the 1990s, the deregulation mania, and excessive leverage resulted in a big bubble during the 2000s. Now add some greed to the mix, throw in some hubris, mix it all up with some stupidity, and we have all the makings of a housing bubble and the seeds of a massive collapse.

It is important for you to understand how this story unravels because there is a possibility that history could repeat itself. Because the government simply threw a lot of money at the problem and because of a lack of meaningful structural changes that could prevent a repeat of these events, we could be in for another rough ride.

When the housing market collapsed in 2007-2008, and housing prices declined, many homeowners with subprime loans found themselves upside down on their mortgage. Being upside down on a mortgage means a person owes more on their house than what the house can sell for on the market. What made matters worse is that these same individuals took out equity loans against their appreciated houses. The bubble burst when many homeowners stopped making their mortgage payments.

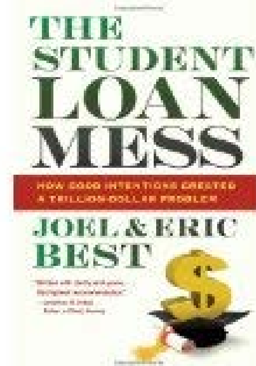
Marking to market accounting played a role in the ensuing downturn. As you might recall, marking to market is the practice of revaluing an asset according to the price it would fetch if the owner would sell it on the open market, regardless of what the owner actually paid for it. Once the market headed south, investors who had bought assets on the margin were subject to margin calls. These margin calls forced them to sell in a depressed market and caused many of them into bankruptcy. Once investors became insolvent, the cascading effect of liquidations exasperated the financial crises.

Some economists believe that a similar bubble is building in the student loan market, which now exceeds one trillion dollars. The average student owes about $30,000 when they graduate. Consequently, there has been an increase in college graduates moving back home with their parents. With an increase in rents overall, and the burden of paying student loans for many years, many college graduates will never own their own home.

SECURITIZATION IN THE STUDENT LOAN MARKET

So what is the current situation with securitizing debt into CDOs? Securitization is alive and well in the student loan market. Asset-Backed Securities (ABS) financed a large portion of the student loan boom. Students owe more than $1 trillion to the federal government; this debt exceeds total credit card debt.

At the peak of the housing market collapse in 2007-2008, 10% of homeowners fell behind on their payments. The Federal Reserve Bank of New York has found that a whopping 44% of student borrowers are not making payments. According to the Department of Education, students borrow over $100 billion annually, a figure that rises each year.



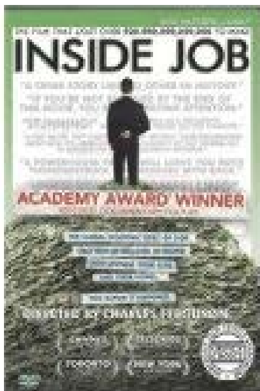
The Student Loan Mess: How Good Intentions Created a Trillion Dollar Problem
by Joel and Eric Best
University of California Pub., 2014
Image from Amazon.com

This practice resembles lending practices that overheated the housing market before the financial crisis when banks and lenders relaxed standards to push more and more Americans into homes through subprime mortgages. When we add to the student loan situation the relaxation of mortgage lending practices, such as Home Ready Loans discussed above, we could face another crisis.

THE AFTERMATH

When JP Morgan created the credit-default-swap (CDS) in the1990s, the practice of swapping risk made good economic sense, as did the practice of securitizing debt into collateralized debt obligations. These methods still make good economic sense. Problems occur when banks abuse the practice. What has Congress done about the problem? Rather than penalizing the abusers, Congress has criminalized honest mistakes, poor judgment, and ignorance; it has created an atmosphere of fear and intimidation. Consequently, there has been an increase in mergers among big corporations and a decline in the small business market.

INSIDE JOB



Inside Job **- A Documentary narrated by Matt Damon Image by Amazon.com**

Inside Job is a documentary film, narrated by Matt Damon, which provides a comprehensive analysis of the global financial crisis of 2007-2008. Through exhaustive research and extensive interviews, the film traces the rise of a financial sector that went rogue and had an enormous impact on politics and academia. The film takes place in the United States, Iceland, England, France, Singapore, and China. You can watch the video free on the internet. This film is very entertaining and full of information. In my opinion, this is the best documentary film you will find that captures the essence of the financial crisis that almost destroyed the economy of the nation and the world. Could we have another meltdown like the one in 2007-2008?

THE SIMPSON-BOWLES COMMISSION

The Simpson-Bowles Commission recognizes that the ultimate solution to our economic problems is economic growth. Real sustainable growth can only happen when society uses sufficient savings for productive investments.

President Obama formed the Simpson-Bowles Commission, co-chaired by Erskine Bowles and Alan Simpson, to find remedies for the credit crisis in February 2010. The commission outlined an ambitious package of spending cuts and tax increases. The plan called for deep cuts in spending, a gradual rise in the federal gasoline tax, limiting popular tax breaks, the child tax credit, and the earned income tax credit. It also called for an increase in the retirement age for Social Security and gave options for overhauling the tax system. It called for cutting Pentagon weapons programs and reducing cost-of-living increases for all federal programs, including Social Security. Following is an excerpt from the document's preamble.

> *We cannot play games or put off hard choices any longer. Without regard to party, we have a patriotic duty to keep the promise of America to give our children and grandchildren a better life.*
>
> *Our challenge is clear and inescapable: America cannot be great if we are broke. Our businesses will not be able to grow and create jobs, and our workers will not be able to compete successfully for jobs of the future without a plan to get this crushing debt burden off our backs.*
>
> *Ever since the economic downturn, families across the country have huddled around kitchen tables, making tough choices about what they hold most dear and what they can learn to live without.*
>
> *They expect and deserve their leaders to do the same. The American people are counting on us to put politics aside, pull together not pull apart, and agree on a plan to live within our means and make America strong for the long haul.*

> *As members of the National Commission of Fiscal Responsibility and Reform, we spent the past eight months studying the same cold, hard facts. Together, we have reached these unavoidable conclusions: The problem is real. The solution is painful. There is no easy way out. Everything must be on the table. And Washington must lead.*

In 1984, the Grace Commission made 2,478 recommendations to cut costs without eliminating essential services.

The Simpson-Bowles Commission recognizes that the ultimate solution to our economic problems is economic growth. Real sustainable growth can only happen when society uses sufficient savings and provides incentives for productive investments. There is no easy fix to our problems, and no amount of creditism will grow the economy in the long run. Although more than 60% of Congress supported its recommendations, with the support of both Democrats and Republicans, the report did not see the light of day. Leaders in government have chosen to ignore the findings and recommendations of the Simpson-Bowles Commission and have shelved the document. The government has taken no action to implement any of the Commission's recommendations. There have been severe cuts in military spending, but they are unrelated to the Simpson-Bowles Commission.

Does all of this sound familiar? As you might recall from our discussion on growth in Chapter 3, President Reagan established the Grace Commission in 1984. For two years, 160 corporate executives and community leaders led an army of 2,000 volunteers to root out government waste. Volunteer contributors with zero cost to the federal government funded the search. The Grace Commission made 2,478 recommendations to cut costs without eliminating essential services. The Grace Commission is a document that covers 21,000 pages laying out a detailed plan to make the federal government more efficient and accountable to the American taxpayer.

Flesh and blood make the economy, not bricks and mortar. If all the people in the world disappeared and left all the buildings and machines intact, there would be no economy.

You might also recall from Chapter 3 that Congress passed the Gramm-Rudman-Hollings Act in 1985 as a follow-up to the Grace Commission, otherwise known as the Balanced Budget and Emergency Deficit Control Act. This act made it mandatory for the government to live within its income.

The law provided for automatic spending cuts to take effect if the president and Congress failed to reach established spending targets. The act gave the U.S. comptroller general authority to order spending cuts when necessary to meet the stated goals. Because the courts declared the law unconstitutional, Congress passed a revised version of the bill in 1987. However, instead of implementing needed reform and adhering to the law, Congress found ways to increase borrowing and spending. Changes in federal spending need a vote by members of Congress, and every bit of waste has a champion somewhere in Congress that sees the spending as a gravy train. So not much has changed.

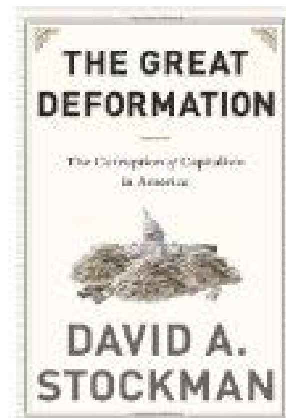
Flesh and blood make the economy, not bricks and mortar. If all the people in the world disappeared and left all the buildings and machines intact, there would be no economy. What is true for individuals is true for the economy. If you were to spend more money than you earned and you ignored the principles of wealth building, you would eventually go broke, same with cities and countries.

Many nations and municipalities are paying the price of prolific spending and borrowing while ignoring pro-growth policies. The longer the United States refuses to heed the warnings of the Grace Commission, the Simpson-Bowles Commission and ignores the Gramm-Rudman-Hollings Act; the worse will be our economic situation.

THE GREAT DEFORMATION

The biggest threat to our future is an expanding federal government and a shrinking the economic pie. According to Congressional Budget Office projections, federal spending will increase as a percentage of GDP well into the future. Taxes will have to increase to fund this massive federal budget! When the economic system slips into crony capitalism, almost everyone suffers, and the middle class diminishes.

Quantitative easing and low interest rates over several years have benefited the wealthy to the detriment of the middle class. The majority of the newly created money has not gotten down into the general economy where it would have benefited most people.



The Great Deformation – The Corruption of Capitalism in American **by David A. Stockman- Public Affairs, 2013. Image from Amazon.com**

The word deformation means a change for the worse. David Stockman has written a book entitled *The Great Deformation – The Corruption of Capitalism in America*, Public Affairs, 2013. Following is an excerpt from this book.

> *The American state, especially the Federal Reserve, has fallen prey to the politics of crony capitalism and the ideologies of fiscal stimulus, monetary central planning, and financial bailouts. These forces have left the public sector teetering on the edge of political dysfunction and fiscal collapse and have caused America's private enterprise foundation to morph into a speculative casino that swindles the masses and enriches the few…* [26]

SYNOPSIS & SUMMARY

The recession of 2007-2008 was arguably worse than any other recession since WWII, and it also ranks among the six or so worst America has experienced. Home foreclosures hit record levels as millions of people lost their jobs. Some economists call the period of 2007 and 2008 the Great Recession.

The Community Reinvestment Act (CRA) of 1977 provided a framework for financial institutions to promote banking services to all members of a community. Another milestone would be the appointment of Roberta Achtenberg to the Department of Housing and Urban Development (HUD) in 1993. Roberta spearheaded the administration's goal to increase homeownership in poor and minority communities and forced banks to comply with government mandates. The easy money policies of this era sowed the seeds of destruction for the financial sector and the general economy.

Giving into the pressure by HUD and Fannie and Freddie Mac, mortgage-lending institutions began issuing loans that almost anyone could qualify. Compounding the problem, under pressure from Congress, Fannie Mae and Freddie Mac began pushing more and more lenders to lend money to people with dubious credit history. These easy lending standards led to the housing boom and contributed to the subsequent crash.

When interest rates started to increase in 2004, people with variable rate loans failed to make their mortgage payments, which paved the way for massive loan defaults. When borrowers found themselves underwater, they abandoned their houses and the economy slumped into a recession. When people realized how worthless their investments were going to be, a worldwide panic ensued.

In late 2008, the Federal Reserve acted to stem the tide of an economic meltdown. Before 2008, the Fed had lent funds to commercial banks and the federal government. After 2008, the Fed gave hundreds of billions of dollars to nonbank corporations and began purchasing obligations of Fannie Mae and Freddie Mac. It also agreed to exchange billions of dollars of risk-free federal bonds for billions of dollars of high-risk private bonds. These actions merged the interests of the private sector and the government sector closer than ever before. Instead of the government making structural reforms spur economic growth, the Fed embarked on a massive quantitative easing program. The creation of new money led to a huge bubble and bubbles have a tendency to burst.

By the mid-2000's, the world had become like a giant Chicago in the Al Capone era of the 1920s. Al Capone could steal thousands of dollars from people and give them a turkey for Thanksgiving dinner, and most people were grateful. The ruling oligarchs have stolen vast amounts, both in terms of money and in terms of lost opportunities, and yet so many people are grateful for what little they receive. The financial community received billions of dollars in bailout funds without admitting any wrongdoing, with no money going to bankrupt homeowners. So far, no high-ranking bank official has been accused, tried, and found guilty of any wrongdoings leading up to the financial collapse of 2007-2008.

The economic collapse of 2007-2008 has resulted in fundamental changes to societies and the world economy, leaving citizens adrift in a sea of uncertainty and searching for their identity. There was a time when a country identified itself by ancestry and culture, but no longer. Anyone can become an American citizen by going through the legal process and agreeing to constitutional principles. Therefore, as America moves further away from its original political and economic structures, it will lose its identity more thoroughly than a state defined by a common ethnic and cultural background.

The fabric of America's identity are the institutions of individual liberty, free contracts, jury trials, uncensored news media, regular and free elections, open competition, private property rights, religious freedom, and habeas corpus which protects us from illegal imprisonment. Well-informed citizens must be active in the political process to maintain freedom. A free and unbiased press and freedom of expression is paramount to any free society.

The epic collapse of 2007-2008 will cause significant changes in America. The meltdown has forced onto us two possible paths – the Keynesians approach leading to more government control or Austrian policies favoring free market principles. The winner of this epic battle will determine our destiny far into the future.

KEY CONCEPTS

- Department of Housing and Urban Development (HUD) administers programs that provide housing and community development assistance. The Department also works to ensure fair and equal housing opportunity for all people.
- In the 1990s, HUD put pressure on banks to make mortgage loans to people who lived in poor and minority communities.
- Banks were compelled to fall into line and started to make thousands of loans without requiring a down payment.
- In 1933, Congress passed the Glass-Steagall Act, calling for the separation of commercial and investment banking.
- Investment banks were banks who did business with wealthy individuals. Their funds did not come from depositors as with commercial banks, but came from the large payments of investors seeking profit.
- Congress repealed the Glass-Steagall Act with the Financial Services Modernization Act of 1999. This act obliterated the difference between banks and investment banks.
- A derivative is a bet between two parties on the outcome of some future event. The underlying bet determines the value of a derivative.
- After the Financial Services Modernization Act of 1999, the government allowed banks to speculate in the lucrative derivatives market.
- The notional value of derivatives in today’s market is about $600 trillion!

- An over-the-counter-derivative is an agreement between two parties, and only the two parties are privy to the facts.
- A security is a tradable financial asset of any kind. The asset can be a bond whereby one party promises to pay another party a return, or profit.
- The core problem with the derivatives market was (and is) excessive leverage.
- The shadow banking system is a term for the collection on non-bank financial intermediaries that provide services similar to traditional commercial banks.
- Hedge funds are a part of the shadow banking system and are a competitor to commercial banks. Hedge funds act like banks but without a banking license, and therefore fall outside of federal oversight.
- Brooksley Born, the head of the Commodity Futures Trading Commission from 1996-1999, saw the danger in the derivatives market, including major fraud.
- When Brooksley contacted the Treasury Department, the Federal Reserve, and the Securities and Exchange Commission about her concerns, not only were they complacent, but they questioned whether Brooksley had authority to take action.
- A credit-default-swap occurs when one party pays another party to assume the risk of default. It is sort of like an insurance policy against loan losses.
- Economists consider credit-default-swaps a derivative because the underlying bonds that the CDS is insuring determines its market value.
- Unlike real insurance, credit-default-swaps had no deductibles or policy limits and placed no constraints on buyers.
- The Community Reinvestment Act (CRA) of 1977, which Congress amended in 1999, put mandates on Fannie Mae and Freddie Mac to purchase X amount of sub-prime loans from banks in 2004.
- To satisfy government mandates, banks relaxed their lending standards with new types of loans.

- Prior to 1992, the government required Fannie and Freddie to buy only prime mortgages. After 1992, Congress required them to purchase subprime mortgages and persecuted banks that failed to make substantial loans to low-income persons.

- To meet these mandates Fannie Mae, Freddie Mac, and banks had to experiment and improvise.

- Fan and Fred looked for ways to recoup their profits because of the CRA and HUD mandates, and thus the Collateralized Debt Obligation (CDO) came into being.

- Economists call the practice of bundling loans securitization. Fan and Fred securitized their mortgage loans by forming collateral debt obligations (CDOs).

- Instead of securitizing only top rated debts, financial firms securitized high-risk loans in the toxic waste category.

- Credit-default-swaps and collateral debt obligations are sound business practices. The problem was not in the practices; the problem was in the types of loans that banks securitized in combination with the volume of sales.

- Standard and Poor's and Moody's are credit rating agencies which corporations fund to rate their debt instruments.

- Standard and Poor's and Moody's gave collateral debt obligations triple A ratings, the highest rating, because the CDOs had purchased credit default swaps from companies like AIG, and AIG had a triple A rating.

- The easy money policies of the Federal Reserve during the 1990s, the deregulation mania, and excessive leverage resulted in a big bubble during the 2000s.

- The bubble burst when homeowners stopped making their mortgage payments.

- The Simpson-Bowles Commission recognizes that the ultimate solution to our economic problems is economic growth. Real sustainable growth can only happen when society uses sufficient savings for productive investments.

- In 1984, the Grace Commission made 2,478 recommendations to cut costs without eliminating essential services.

- The Gramm-Rudman Act of 1985 made it mandatory for the government to live within its income.

- Leaders in government have chosen to ignore the findings and recommendations of the 2010 Simpson-Bowles Commission, the Grace Commission, the Gramm Rudman Act, and have shelved these documents and their recommendations.

- The recession of 2007-2008 was arguably worse than any other recession since WWII, and it also ranks among the six or so worst America has experienced.

FOOD FOR THOUGHT

✓ The American dream for many people is to own their own home. To help people attain their dream the federal government pressured HUD and banks to lend money to low income people who otherwise could not afford to buy a house. Do you think this was a good idea? Why do you think so? How would Austrian economists view this policy? A Keynesian?

✓ A variable rate loan is a loan whereby the interest rate increases in subsequent years, and Alt-A loans (nicknamed liar loans) are loans whereby bank officials do not ask potential borrowers to verify their credit information on loan applications. Do you think these types of loans helped or hurt most mortgagees?

✓ When the easy money policies encouraged a record number of low-income people to buy houses, these easy money policies manifested a bubble. As housing prices skyrocketed, more and more people took out equity loans against the appreciated value of their homes. What happened when the bubble burst?

✓ A derivative is a bet between two parties on the outcome of some future event. Derivative contracts are a part of the futures market because the results will take place in the future. Can you partake in the derivatives market? How so?

✓ An over-the-counter-derivative is an agreement between two parties, and only the two parties are privy to the facts. An exchange, like the New York Stock Exchange, requires participants to divulge pertinent information so that investors know what they are buying. Do you think it is a good idea to mandate investors must buy and sell derivatives on an exchange? Why or why not?

- ✓ The forty to one debt to capital ratio made huge profits possible in the derivatives market. Was it a good or bad idea for the Securities and Exchange Commission (SEC) to allow this generous capital to debt ratio for participants in the derivatives market? What was the result of this policy in 2007-2008? Why does excessive leverage ultimately lead to economic collapse?

- ✓ Hedge funds are a part of the shadow banking system and are a competitor to commercial banks. Hedge funds act like banks but without a banking license, and therefore fall outside of federal oversight. Do you think the government should regulate hedge funds? Why or why not?

- ✓ When Brooksley Born saw the danger in the derivatives market, including major fraud, why were her concerns ignored by the Federal Reserve and government officials? Who was correct in their assessment of the derivatives market, Brooksley or the government?

- ✓ A credit-default-swap occurs when one party pays another party to assume the risk of default. It is sort of like an insurance policy against loan losses. Is this a good business practice? Why or why not?

- ✓ The Community Reinvestment Act (CRA) of 1977, which Congress amended in 1999, put mandates on Fannie Mae and Freddie Mac to purchase X amount of sub-prime loans from banks in 2004. Both the CRA and HUD encouraged banks to relax their lending standards so they could satisfy the new mandates. What was the result of this mandate?

- ✓ In years past when a person went to a bank to take out a mortgage loan, the bank would keep the mortgage and receive payments over time. This practice rarely exists today because most banks sell mortgages in the secondary market where the loans become a part of a collateralized debt obligation (CDO). What does this mean? Explain. Do you think CDOs are good for the economy? Why or why not?

- ✓ When the housing market collapsed in 2007-2008, and housing prices declined, many homeowners with subprime loans found themselves upside down on their mortgage. What is a subprime loan? What does it mean to be upside down on a mortgage?

- ✓ Securitization is alive and well in the student loan market. What does it mean that financial companies have securitized student loans? Is this a good or bad for the economy? Why or why not?

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LEARNING MATERIALS

Chapter 1: *The Economic Problem* - Questions

1 The "invisible hand" described by Adam Smith refers to the
   a. allocative role of markets and market forces.
   b. importance of government intervention and central planning.
   c. actions of planners in directing the economy.
   d. role of monopolized industries in leading the nation.

2 When is a good or service *scarce*?
   a. It is rare and hard to come by.
   b. There is not enough of it available for everybody who wants it for free.
   c. There is plenty available for everyone who wants it.
   d. There is a shortage.

3 In economics we assume that people are rationale because
   a. eventually their wants are satisfied.
   b. their wants and desires are constant from one time period to the next.
   c. they always attempt to maximize their welfare when making a choice between two alternatives..
   d. they always seek as much knowledge as possible when making decisions between alternative choices.

4 Scarcity is an economic problem
   a. only in capitalist economies.
   b. only in command economies.
   c. only in poor countries.
   d. in every country and in every household.

5 Economic analysis would be unnecessary if there were no
  a. taxes.
  b. government.
  c. scarcity.
  d. money.

6 Because resources are scarce,
  a. opportunity costs are zero.
  b. people must make choices among alternatives.
  c. all human wants and desires can be satisfied.
  d. resource prices are flexible.

7 Economics deals with the problems caused by
  a. scarce resources and unlimited wants.
  b. scarce resources and limited wants.
  c. abundant resources and unlimited wants.
  d. abundant resources and limited wants.

8 Resources are divided into the following broad categories:
  a. men, money, and machines.
  b. saving, spending, investment, and capital.
  c. human, technological, and government.
  d. land, labor, capital, and entrepreneurial ability.

9 In economics, "land" refers
  a. only to plots of ground on the surface of the earth.
  b. to the specific area of the earth in a country or region.
  c. to rural regions as distinguished from urban areas.
  d. to any and all natural resources.

10 Physical and mental human effort in the attempt to solve the economic problem is defined in economics as
  a. labor.
  b. manpower.
  c. productivity.
  d. performance.

11 Labor is ultimately derived from
  a. capital.
  b. technology.
  c. natural resources.
  d. time.

12 In economics, “financial capital” refers to
   a. money used to buy capital.
   b. stocks, bonds, and other financial assets.
   c. the seat of government.
   d. machines, buildings, and tools used in the production of goods and services.

13 Which of the following is an example of capital?
   a. A hammer in the hands of a professional carpenter.
   b. An economics professor’s knowledge of economics.
   c. The building in which your economics class is located.
   d. The amount of tuition you paid for this class.

14 An entrepreneur is
   a. an intermediary between buyers and sellers in the marketplace.
   b. the organizer who seeks profitable opportunities and is willing to accept risks.
   c. a business organization involved in using inputs to produce output.
   d. the administrator who runs an enterprise without accepting any risk of financial loss.

15 The driving force which directs and grows the economy in a free market economy is
   a. physical capital.
   b. technological ability.
   c. entrepreneurship.
   d. human labor.

16 In a production process, profit is the payment received by
   a. capital.
   b. labor
   c. technology.
   d. an entrepreneur.

17 Profit is also known as
   a. rent.
   b. mark-up.
   c. the monetary aggregate.
   d. the residual claimed by the entrepreneur.

Chapter 1: *The Economic Problem* - Answers

1. A. The interaction between buyers and sellers in a free market is an example of the "invisible hand."

2. B. Scarcity means that there is not enough of something so that everyone who wants it cannot have it for free. In this case, how do we decide who gets? Everything that is scarce will have a price; the price determines who gets and who does not get.

3. C. In economics, we assume that people are rationale and when given a choice, they want more rather than less. Each time you make a choice between alternatives, the choice made is the one that you believe will increase your total welfare.

4. D. The only way not to have scarcity is for everyone to have everything they want for free, an impossible situation. In a free market economy, everything that commands a price is scarce.

5. C. All of economic analysis revolves around the fact that we live in a world of scarce resources. Therefore, the problem becomes, how do we meet people's wants and needs in this world of scarcity?

6. B. No matter what economic system people live in, people experience scarcity.

7. A. No matter what political system people live under there will always be people who want more than the economy can provide them free.

8. D. The four resources to grow an economy are land, labor, capital, and in a free market, entrepreneurship. In a command system, the fourth resource would be the government.

9. D. A land resource is anything from the earth. Some examples of a land resource are timber, fresh water, fertile land, copper, iron ore, gold, silver, and anything else that people use from the earth to produce goods and services.

10. A. The labor that we are talking about here is directed and productive labor. When society directs labor to produce goods and services efficiently, the result is a productive economy.

11. D. This is particularly true when it comes to skilled labor. It takes time to acquire the knowledge and skills to be productive in this high tech economy we live in.

12. A. Capital consists of the machines and tools used in production. The money to buy these machines and tools economists call financial capital.

13. A. The hammer in the hands of a professional carpenter is capital because carpenters use hammers to build things that they will be sell in the market.

14. B. In a command economy, the government decides what and how to produce; in a free market, the entrepreneur is instrumental in these decisions.

15. C. Anyone can be an entrepreneur; it does not necessarily take a lot of money. Entrepreneurship is an attitude. If you have dreams of owning your own business and have a plan to start and develop that business into a profitable venture, and take action on your dreams, you are an entrepreneur.

16. D. Economists call the reward to someone to take risks in a business venture profit.

17. D. Residual is that which is left over. When one tallies up the total revenue and the total costs because of a business venture, if there is something left over, economists call that something *profit*. Economists define losses as a *deficit.*

Chapter 2: *Choices* - Questions

1. A perfectly free market can provide society with everything it needs. True/False

2. If the federal government interferes with the price mechanism too much, communication among its parts will begin to break down as price signals blur. True/False

3. Rent-seeking occurs when big business financially supports politicians to influence legislation. True/False

4. Moral hazard occurs when the system insulates business from risk and therefore these businesses behave differently than they would otherwise. True/False

5. If we developed a fertility drug doubling the number of cows, economists would say that the supply of cows has increased. True/False

6. According to Fredrich Hayek, which of the following is a result of centralized planning?
    a. Private individuals own resources.
    b. The price mechanism coordinates economic activity.
    c. Competitive markets guide resources to their highest-valued use.
    d. The loss of personal freedom.

7. It is folly for a society to want more goods and services. When society has plenty of everything, people should be satisfied with what they have and not always want more. True/False

8. Some economic goals are conflicting. True/False

9. Pollution is a negative externality. True/False

10. America is rich enough in natural resources and capital that Americans would not suffer in the absence of international trade. True/False

11. The old adage of “the rich get richer and the poor get poorer” is an accurate assessment of how the economy works. True/False

12. Crony capitalism can lead to moral hazard. True/False

13. The law of comparative advantage states that the person who should produce a good is the person who
    a. has the lowest opportunity cost of producing that good.
    b. can produce that good using the fewest resources.
    c. will produce that good using the most expensive resources.

14. Comparative advantage
    a. is the practice of securing economic favors from government.
    b. leads to the most efficient allocation of resources and the greatest combined output.
    c. eliminates specialization, so that each person produces for all of his own needs independently.

15. What is crony capitalism?
    a. Occurs when cronies participate in the free enterprise system.
    b. A system where success in business depends on close relationships between business and government.
    c. An economic system that is free of government interference.
    d. An economic system that is highly regulated.

16. Because of specialization and comparative advantage, most people
    a. consume only what they produce themselves.
    b. consume the products produced by their family and friends.
    c. consume the products of many other specialists.

17. The “division of labor” refers to
    a. discrimination in labor markets.
    b. separating a job into smaller tasks completed by different people.
    c. one worker who divides his time among different jobs and duties.
    d. defining a job according to the appropriate sex.

18. Specialization of labor
    a. increases productivity without creating any problems.
    b. reduces productivity, and is usually eliminated by business firms.
    c. can create problems of boredom and repetitive motion injuries.
    d. prevents the introduction of more sophisticated and efficient production techniques.

19. When the government bails out business from a bad situation, where does the government get the money?
    a. Taxes.
    b. Debt
    c. The money is created
    d. all of the above

20. If the government borrows to increase spending, we do not pay for it now, only later.
    a. True
    b. False
    c. Can't tell
    d. Depends on who lends the money.

Chapter 2: *Choices* – Answers

1. False. The market fails in many aspects of meeting our needs and therefore society has to modify the market.

2. True. A free market system can only function smoothly if there is ample communication among its various parts.

3. True. When a business decides support a lobby effort in Washington D.C instead of spending the money on better production, we call this practice rent-seeking.

4. True. Moral hazard is a consequence of rent-seeking. Society throws caution to the wind when society does not hold people responsible for their actions.

5. False. Economists only consider events if there is a market transaction. Economists are less concerned about how many cows we have standing on four feet as they are about how many cows farmers bring to market.

6. D. In Friedrich Hayek's book *The Road to Serfdom* he explains how centralized planning can lead to a loss of personal freedoms and economic stagnation.

7. False. The problem of being satisfied with what we already have is that everything wears out over time. If we do not consistently replace what we have, tomorrow we will have less.

8. True. People in any society face conflicting goals because of opportunity costs. If we spend more on a clean environment, we will have fewer resources for other things, and vice versa.

9. True. Negative externalities are the negative by-product of the industrial process.

10. False. Despite America's natural resources and capital, Americans could not achieve a high standard of living if America did not trade with other nations.

11. True. There is a natural law whereby those people who have the most receive more than people who have less. The more you have the more money you will receive. The less you have the less money you will receive. If you have money in the bank the bank will pay you interest, if you lack money to buy a car and you have to borrow money, you pay money in interest.

12. True. Crony capitalism is a system whereby the government and a small group of individuals control the economy to benefit only themselves. This presents a moral hazard situation because even in failure these people gain financially and therefore are risk adverse.

13. A. If you make $7 an hour and have to pay someone $8 an hour to paint your house, you have a comparative advantage of painting the house yourself. However, if you make $20 an hour, you do not have a comparative advantage in painting the house yourself.

14. B. Should a country produce those goods that it is best at producing? Not necessarily. For example, let us suppose Americans were better than any anyone else was at producing handmade wicker baskets. Should we spend our time and energy producing baskets? No, because that time and energy would be better spent in the technology area, like computers.

15. B. Instead of the government regulating and overseeing the business sector the government becomes a partner of big business.

16. C. Because of specialization and the fact that people pursue activities that they have a comparative advantage in, means that we do not have to be self-sufficient. By specializing and then buying from one another, our standard of living increases.

17. B. One of the characteristics of a modern industrial society is a greater specialization of labor. This is one reason why productivity and a resultant higher standard of living is possible than in less developed economies.

18. C. On an individual basis, the division of labor has the downside of boredom and physical and emotional problems.

19. D. These are the three places the government gets money, it can raise taxes, it can borrow the money, or it can create the money out of thin air.

20. B. A dollar spent today is a dollar society pays for today regardless of where it comes from. We pay for it in terms of either higher taxes, higher interest rates, or inflation.

Chapter 3: *Growth* - Questions

1. Which of the following factors are most important to achieve a high standard of living?
    a. It must have abundant land good for farming.
    b. It must have an abundant supply of raw materials.
    c. It must have an educated workforce.
    d. It must encourage entrepreneurship and provide incentives to work, save, and to make a profit.

2. Rational households with limited resources attempt to maximize
    a. the amount of goods acquired.
    b. the amount of services obtained.
    c. marginal utility.
    d. average utility.
    e. total utility.

3. It takes 14 glassblowing machines, each operated by only one person, to produce 90% of all the glass bulbs used in the U.S. This is an example of how automation leads to a loss of jobs over the long run.

4. The key to wealth building is to
    a. borrow as much money as you can and make risky investments.
    b. work and save a part of what you earn.
    c. make wise investments with your savings.
    d. both b and c.

5. Which of the following best describes Japan's mistake in the 1990s?
    a. Marginal analysis
    b. Economies of scale
    c. Moral hazard

6. Let's say that you are driving 65 mph in a 45 mph zone. A police officer stops you and gives you a ticket for driving 20 mph over the speed limit. This is an example of
    a. the rule of law.
    b. the rule of man.
    c. suffering the consequences.
    d. paying the price of driving.

7. Let's say that you are driving 45 mph in a 45 mph zone. A police officer stops you and gives you a ticket for driving 20 mph over the speed limit in anticipation of a bribe. This is an example of
    a. the rule of law.
    b. the rule of man.
    c. negative intensions.
    d. the rich get richer and the poorer get poorer.

8. In a business sense, productivity increases when output increases more than input.

9. The assembly line technique of production can increase productivity by
    a. making better use of robotics.
    b. eliminating non-productive activity.
    c. enabling workers to become more efficient performing the same task over and over again.
    d. all of the above.

10. Which of the following is an example of rent-seeking?
    a. Cotton farmers pay money to politicians to influence legislation, such as raising tariffs against Brazilian cotton.
    b. People looking for rental property seek available apartments in the newspaper.
    c. Property owners seek out the highest paying renters.

11. Because machines replace people’s jobs, the more we automate the fewer jobs we will have. True/False

12. An increase in productivity enables a business owner to produce more goods per unit of time at a lower per unit cost. True/False

13. Up to a certain point, improvements in capital will result in an increase in productivity. True/False

14. The key behind economies of scale is that the more we divide the labor the more productivity increases, at least up to a certain point. True/False

15. International trade leads to greater economies of scale. True/False

16. Federal laws that redistribute the wealth, to take from the wealthy and give to the less fortunate, always lead to economic stagnation. True/False

17. A persistent decline in productivity will cause an increase in unemployment. True/False

Chapter 3: *Growth* - Answers

1. D. A country can have abundant resources and an educated work force, but if it does not provide opportunities and give the proper incentives, it will not grow.

2. E. Households make individual decisions based on their marginal utility; in the process, they maximize their utility.

3. False. In a micro sense this could be a true statement, but in a macro sense the statement is false because more machines leads to lower costs, lower costs lead to lower prices, lower prices leads to an increase in buying power, and this leads to more production and jobs.

4. D. Wealth building is a two-step process: save a part of your earnings and then learn how to make profitable investments with your savings.

5. C. Moral hazard is the consequence of the practice of the government supporting failing companies. The consequence is that there will be less incentive to make careful investments in the future if there is the belief that the government will pay for any losses.

6. A. The rule of law. The law says that you can get a ticket for speeding according to the law.

7. B. The rule of man refers to a situation whereby whoever is in authority uses his authority to enrich himself. Sometimes this can be contrary to the rule of law.

8. True. This is one definition of an increase in productivity. Another way to look at an increase in productivity is to produce more per unit of time at a lower per unit cost.

9. D. The assembly line is contrasted to the skilled craftsmen technique of production whereby one or a small group of workers would do the assembling.

10. A. Rent-seeking is the term used to describe the practice of special interest groups putting money into politician's pockets in order to influence legislation to their benefit.

11. False. In a free competitive market, automation leads to more jobs because it lowers costs of production, which allows for lower prices, an increase in buying power, more sales, more production, and more jobs.

12. True. The key to economic growth is to increase productivity. By becoming more efficient, the lower costs and lower prices increase buying power and raises the standard of living for the average person.

13. True. New and better machines increase productivity because they tend to be more efficient and require fewer repairs, which helps lower costs.

14. True. The more we divide among workers the more non-productive activity we can eliminate and the more productivity increases, at least up to a certain point. Economists call this economies of scale. Diseconomies of scale set in beyond a certain point when productivity begins to decline.

15. True. The more we trade with other nations, the greater the economic pie, and the more ways we can divide labor among different countries.

16. False. There is a natural principle that says, "He who has will be given more and he who has not, that thing which he does not have will be taken away." If you have money in savings, the bank gives you more money. If you do not have money and need to borrow from a bank, the bank takes money away from you in the form of interest. Therefore, some amount of redistribution of wealth may be necessary to prevent too much wealth concentration in a few hands.

17. True. A decline in productivity causes an increase in costs, and an increase in costs will lead to an increase in prices, eroding consumer buying power and a decline in consumer demand, leading to an increase in unemployment.

Chapter 4: *Demand & Supply* - Questions

1. At a given time and in a given marketplace, the entire market demand curve indicates the
   a. quantity of a good consumers would be willing and able to purchase at a given price.
   b. quantity of a good consumers would be able to purchase at a series of prices.
   c. quantity of a good consumers want to purchase at a given price

2. Assume Samantha likes hot dogs and hamburgers equally, and the price of hamburgers (a normal good) declines. She will most likely purchase more hamburgers; this is a reflection of the
   a. income effect.
   b. substitution effect.
   c. income and substitution effects.

3. If the price of a good declines from $5.00 per unit to $4.00 per unit, and you continue to purchase 5 units of this good, as you had in the past, your real income has
   a. decreased by $5.00.
   b. increased by $4.00.
   c. decreased by $4.00.
   d. increased by $5.00.

4. When the price of a normal good declines, you have
   a. an income effect but no substitution effect.
   b. a substitution effect but no income effect.
   c. no income effect or substitution effect.
   d. an income effect and a substitution effect.

5. A typical demand curve will normally have a
   a. positive slope.
   b. horizontal slope.
   c. vertical slope.
   d. negative slope.

6. The negative slope of a demand curve implies that as the price
   a. declines, quantity demanded increases.
   b. declines, quantity demanded decreases.
   c. increases, quantity demanded increases.
   d. increases, the demand curve becomes steeper.

7. In moving along a given demand curve, quantity changes in response to a change in
   a. consumer taste.
   b. consumer incomes.
   c. consumer expectations.
   d. the price of the good.

8. Which of the following would economists not consider a normal good?
   a. Steaks.
   b. Flour.
   c. Oranges.
   d. Meals at restaurants.

9. Which of the following would economists not consider compliments?
   a. Shoes and socks.
   b. Tennis racquet and tennis balls.
   c. Coke and Pepsi.
   d. Automobiles and gasoline.

10. Which of the following would economists not consider substitutes?
    a. Butter and margarine.
    b. Coke and Pepsi.
    c. Fords and Chevrolets.
    d. Hamburgers and French fries.

11. The price of Ford automobiles increases and the price of Chevrolets remains constant, the demand for Chevrolets will
    a. increase.
    b. decrease.
    c. decrease then increase.
    d. increase then decrease.

12. As the wage (price) of computer programmers increases, more college students are willing to major in computers. This is known as the law of
    a. demand.
    b. variable proportions.
    c. supply.

13. In the case of a normal good, an increase in consumers' incomes would shift the
    a. demand curve inward.
    b. supply curve inward.
    c. supply curve outward.
    d. demand curve outward.

14. An improvement in technology would shift the
    a. demand curve inward.
    b. demand curve outward.
    c. supply curve inward.
    d. supply curve outward.

15. When a demand curve shifts from left to right because of a change in a non-price determinant, which of the following describes what is happening? There is a(n)
    a. decrease in demand.
    b. decrease in quantity demanded.
    c. increase in quantity demanded.
    d. increase in demand.

16. Which of the following would cause a shift of a demand curve from left to right?
    a. An increase in the number of consumers.
    b. An increase in the price of a complementary good.
    c. A decline in consumers' incomes.
    d. A decline in consumer optimism.

17. Which of the following would cause a shift in a demand curve from right to left?
    a. An increase in the price of a substitute good.
    b. An increase in the number of consumers.
    c. A decrease in the price of a complementary good.
    d. a decline in consumers' incomes if it is a normal good.

18. A shift from left to the right of a supply curve would result in
    a. a decrease in quantity supplied.
    b. an increase in supply .
    c. a decrease in supply.
    d. an increase in quantity supplied.

19. Which of the following could not cause the shift of a demand curve from left to right?
    a. A decrease in the price of a complement.
    b. An increase in the price of a substitute.
    c. A decrease in the price of the good in question.

20. As a certain type of clothing becomes more fashionable, we would expect its equilibrium price
    a. to decrease and quantity will remain constant.
    b. and quantity will decrease.
    c. to increase and quantity to decrease.
    d. and quantity to increase.

Chapter 4: *Demand & Supply* Answers

1. B. Demand curves measure the relationship between a series of prices and quantities demanded not just one price and quantity.

2. B. The *substitution* effect is when the price of a good falls, consumers will substitute it for other goods, which are now relatively more expensive. The *income* effect is when the fall in the price of a good increases consumer's real income, making them more able to purchase all goods.

3. D. Real income is income measured in terms of the goods and services it can buy. In this case, a fall in the price of $1.00 and you buy 5 units, your buying power increased by $5.00.

4. D. A normal good is one that consumers will buy more of as their income increases. The income effect recognizes that consumers will buy more of a good when their

incomes increase, the substitution effect recognizes that consumers will or will not buy an alternative product based on the relative price difference.

5. D. A negative slope is a downward slope from left to right. With price on the vertical axis and quantity on the horizontal axis, price and quantity will always move in the opposite direction.

6. A. As price changes the demand itself does not change because the curve itself remains fixed. What changes is the quantity demanded measured on the horizontal axis.

7. D. There is a difference between the terms a "change in demand" and a "change in the quantity demanded." A change in demand means the whole curve changes. A change in the quantity demanded means that there is a movement along a stationary demand curve.

8. B. Flour is a product that people will not necessarily buy more of just because their income increases.

9. C. Compliments are goods that consumers use together, like bread and butter. Coke and Pepsi are substitutes for one another.

10. D. Although economists consider hamburgers and French fries substitutes because they are both food, of the choices given above, the other choices are more substitutes than are hamburgers and French fries.

11. A. A factor that will cause a shift in demand is when the price of a substitute good changes. As the price of Ford cars increases, consumers will demand more Chevrolets because of the relative price difference.

12. C. As a college student, you are interested in majoring in subjects that will make you marketable when it comes time to look for a job. As wages for computer programmers increase, more college students will choose to major in computers. As the wage of social workers decreases, fewer students will choose social work.

13. D. A normal good is a good that consumers will buy more of as their income increases.

14. D. For example, as business owners apply technological improvements to manufacturing computers, suppliers of computers are able to supply more computers at every price level.

15. D. This represents an increase in demand.

16. A. The number of consumers in the market will result in an increase in the demand for a good or service. Likewise, a decrease in the number of consumers in the market will lead to a decrease.

17. D. If it is a normal good consumers will buy fewer units as their income decreases. A shift to the left of the demand curve represents a decrease in demand.

18. D. A shift to the right of a demand curve along an upward sloping supply curve (all supply curves are upward sloping) will cause the equilibrium price to increase and the equilibrium quantity to increase.

19. C. A change in the price of a good does not change the demand curve, it changes the quantity demanded as measured on the horizontal axis. When price changes, there is a movement along the curve, but the curve itself does not change.

20. D. This is because there will be an outward shift of the demand curve.

Chapter 5: *Money & Banking* - Questions

1. Barter works best
    a. in the absence of a double coincidence of wants.
    b. when many different product are available in the economy.
    c. when money is relatively available to establish relative prices.
    d. when each trader has what the other wants and wants what the other has.

2. A coincidence of wants happens exists when
    a. two people want the same thing at the same time.
    b. one person wants to but two different things at the same time.
    c. the individual who has what I want, also wants what I have.

3. The essential characteristic required before any substance can function as money is that
    a. it be issued by the government.
    b. it be backed by a precious metal.
    c. the supply of it be unlimited and uncontrolled.
    d. people accept it as money.

4. To say that money functions as a medium of exchange is to say that
    a. it is the preferred form of compensation for fortune-tellers, mediums, and those. through whom the spirit world is contacted
    b. it is the generally accepted form of payment for goods and services.
    c. it is the common unit of expressing the value of goods and services.
    d. it is bought and sold on the stock exchange.

5. School administrators announce the following schedule of fees for the next academic year: In-state tuition, $175 per credit hour; Out-of-state tuition, $400 per credit hour; Room-and-board, $3,000 per semester. This is an example of money functioning as
    a. a medium of exchange.
    b. a store of value.
    c. fiat money.
    d. a unit of account.

6. Mary Ellen deposits $100 into her savings account each month. Her daughter Carolyn keeps all her pennies in a piggy bank. These are examples of money functioning as
   a. a store of value.
   b. commodity money.
   c. a medium of exchange.
   d. a standard of deferred payments.

7. All of the following are examples of commodity money except
   a. cattle.
   b. gold.
   c. tobacco.
   d. $10 Federal Reserve notes.

8. All of the following are functions of money except
   a. medium of exchange.
   b. unit of account.
   c. index of prices.
   d. standard of deferred payment.

9. All of the following are problems with commodity money except
   a. often commodity money deteriorates in storage.
   b. often commodity money is too bulky for major transactions.
   c. often commodity money is not divisible into small and uniform units.
   d. often commodity money is viewed as an unfair competitor by suppliers of fiat money.

10. Whatever functions as money must be
    a. authorized by the government.
    b. accepted for deposit by banks.
    c. backed by precious metals like gold or silver.
    d. limited in supply.

11. In the United States economy, which one of the following is not money?
    a. A Susan B. Anthony $1 coin.
    b. A checking account at a bank.
    c. A 25-cent piece (i.e., a quarter).
    d. A $100 U.S. Government savings bond.

12. The difference between bank notes, Federal Reserve notes, and fiat money is that
    a. fiat money is redeemable for gold or silver, but the others are not.
    b. bank notes are redeemable for gold or silver but the others are not.
    c. fiat money derives its acceptability as money from the precious metal which “back” it.

13. Money is legal tender if
    a. people willing accept it in payment of debts.
    b. it is backed by gold or silver.
    c. it is commodity money.
    d. the government says it is.

14. An important function of commercial banks, in addition to storing money and keeping it safe, is to
    a. print new currency.
    b. issue fiat money.
    c. mint coins.
    d. make loans.

15. The first bankers were probably
    a. carpenters.
    b. stock brokers.
    c. goldsmiths.
    d. sea captains.

16. In the world of banking, checks are
    a. written instructions from a depositor to the bank.
    b. written instruction from one depositor to another.
    c. a form of commodity money.
    d. token money.

17. Fractional reserve banking occurs when
    a. a bank has reserves which exceed it deposits.
    b. a bank has reserves which are equal to its deposits.
    c. a bank has reserves which are less than its deposits.
    d. some depositors lose their deposits through poor banking management.

18. When prices rise
    a. the purchasing power of money rises.
    b. the purchasing power of money falls.
    c. the purchasing power of money remains unchanged.
    d. the purchasing power of money either rises or falls, depending upon the size of the national debt.

19. Which of the following is most critical for the maintenance of an efficient, productive economy?
    a. Money backed by gold or silver.
    b. Steadily rising prices.
    c. An unlimited and unregulated supply of money.
    d. A properly functioning monetary system.

20. The United States is said to have a dual banking system because
    a. some banks make mortgage loans and some banks do not.
    b. some banks have state charters and some have national charters.
    c. two different types of banks are authorized to issue bank notes.

Chapter 5: *Money & Banking* - Answers

1. D. Barter requires a coincidence of wants; each person has to have exactly what the other wants.

2. C. A problem with barter is how people can divide alternate goods or services. If one person wants eggs and the other wants a pound of beef, but the second person still has cattle, what to do?

3. D. Money can take just about any form as long as people accept and exchange it. Money can even be an electronic impulse on a computer. All that is necessary is to keep track of someone's debit and someone else's credit in a financial transaction.

4. B. Money has several purposes; one is that consumers to buy and sell in the market place use it. This is using money as a medium of exchange.

5. D. People are using money to measure the cost of education in this case.

6. A. Another purpose of money is that people can use it as a store of value. Money put into savings to be available at a later point in time is using money as a store of value.

7. D. Commodity money is money that has some intrinsic value other than money. Cattle, gold, and tobacco have value other than money. Federal Reserve notes (dollar bills) do not have value except as money.

8. C. People use money as a medium of exchange, a unit of account, and a standard of deferred payment.

9. D. Different forms of money always compete, this is not a problem; in such a case a good money will drive out bad money. Economists call this phenomenon Gresham's Law.

10. D. Because money can be just about anything, the government does not need to sanction it. However, it does need to be limited in supply to have any value.

11. D. U.S Government savings bonds are not transferable in terms of ownership. Therefore, people could not use them as money.

12. B. Bank notes are papers promising a specific amount of gold or silver to bearers who presented them to issuing banks for redemption; an early type of money.

13. D. Legal tender means that the courts of the land recognize certain pieces of paper as payment of personal and public debt (public debt is tax money owed to the government). This is why is says on each of our dollars, "*This note is legal tender for all debts public and private*."

14. D. We have a partial reserve banking system. Banks only keep a part of their assets in reserve, the rest is free to lend out; the interest earned on the money that banks lend out is one way banks make a profit.

15. C. In the very early days of capitalism, gold and silver were the primary forms of money. When a person had a lot of gold, he would want to keep his gold safely somewhere. Therefore, he would give his money to a goldsmith. These goldsmiths, in turn, discovered that they could lend a portion of their gold holdings out to make interest income. Thus, they became our first banks.

16. A. A check is simply instructions to a bank to free the funds in a person's bank account.

17. C. A fractional reserve banking system is a system that allows its banks to lend out a portion of every dollar deposited in the bank. This is what allows a bank to make a profit.

18. B. As prices rise, it takes more money to buy the same amount of goods and services as used to be the case. This is what we call inflation.

19. D. A stable and properly functional monetary system is a pillar, which people build an economic system.

20. B. If you wanted to start a bank, you would need a license. You could get a license from the federal government or the state banking commission. If you got your license from the federal government, you would be a national bank and would have the word national in your name.

Chapter 6: *Government* - Questions

1. Which of the following is a function of government?
    a. Make and enforce the rule of law.
    b. Provide public goods.
    c. Encourage merit goods.
    d. All of the above

2. The largest single item of expenditures in the federal budget is
    a. Social Security and Medicare.
    b. national defense.
    c. welfare.
    d. interest on the national debt.

3. As a percent of GDP, federal spending is about
    a. 3%.
    b. 5%.
    c. 12%.
    d. 25%.

4. The new fiscal year for the federal budget begins on the first day of
    a. January.
    b. April.
    c. July.
    d. October.

5. A continuing resolution is
    a. an annual determination on the part of Congress to improve the budget process.
    b. a decision to maintain a specific spending level *ad infinitum*.
    c. a temporary extension of spending authority into the new fiscal year.

6. The problem of pollution can
    a. be solved if businesses had a social conscience.
    b. be solved with enough public awareness.
    c. can only be solved with effective laws.

7. Which of the following is an example of a third party law?
    a. Motorcycle drivers must wear a helmet.
    b. You must wear a seat belt when driving.
    c. Cars must be inspected periodically.

8. Which of the following is *not* an entitlement program?
    a. Social Security.
    b. Medicare.
    c. Aid to Families with Dependent Children.
    d. Federal research grants.

9. One proposal for reforming and improving the budget process is to
    a. switch to a two-year or biennial budget process.
    b. remove the Council of Economic Advisors from the process.
    c. require more detail in the various line items of the budget.
    d. provide for automatic annual increases in all budget categories.

10. Since 1960 the federal government has experienced a budget deficit every year but
    a. one.
    b. two.
    c. three.
    d. four.

11. An example of a capital expenditure in the present for which shifting the cost to future generations through deficit financing might be justified because those future generations will also share in its benefits is
    a. Social Security.
    b. interest on the debt.
    c. welfare.
    d. a highway.

12. Automatic payroll deduction of tax payments became law in the U.S. for the first time in
    a. 1776.
    b. 1865.
    c. 1936.
    d. 1942.

13. When U.S. imports exceed exports, foreigners accumulate dollars which they partially invest in assets in the United States, thereby providing all of the following *except*
    a. an additional means of funding federal deficits.
    b. a source of capital investment in U.S. cities and towns.
    c. buyers for U.S. corporations and real estate.
    d. a supplement to the growing U.S. saving rate.

14. Until 1980, most of the national debt was the result of
    a. wartime borrowing.
    b. inflation.
    c. bad monetary policy.
    d. wasteful Congressional spending.

15. The federal debt will decline as a percentage of GDP only when
    a. GDP increases more slowly than the debt increases.
    b. prices are held constant.
    c. GDP and the debt increase at the same rate.
    d. GDP increases faster than the debt increases.

16. Which of the following statements is correct?
    a. Only a small portion of the national debt comes due during one year.
    b. Interest payments on the national debt are about 35% of the budget.
    c. A one-percentage point increase in the nominal interest rate increases the annual interest costs of the federal government.

17. The question of who bears the burden of the debt is complicated by all of the following factors except
    a. how high the interest rate paid on government loans is.
    b. what will be the rate of unemployment in the future.
    c. how much of the publicly held debt is held by foreigners.
    d. whether the borrowed funds purchase capital goods or not.

18. Of the national debt held by the public, foreigners now hold
    a. a lot of the total
    b. not much of the total.
    c. less and less as time goes on.

19. Each time you buy a gallon of gasoline, you pay a tax; this tax goes to building and maintaining roads. This is an example of
    a. the ability to pay principle of taxation.
    b. the benefits received principle of taxation.
    c. a progressive tax.

20. Social Security is the world's largest Ponzi Scheme because
    a. the money collected is saved in the money markets to earn interest.
    b. it is a government program.
    c. the money paid out in day two was collected in day one.

Chapter 6: *Government* - Answers

1. E. The government has many functions. A free enterprise system can only function and prosper with a strong central government, but the question is – what role should the government play and how large should it be while encouraging growth and preserving our freedom?

2. A. Social Security, Medicare and Medicaid make up about 40% and interest on the debt about 20%.

3. D. The federal government spends about one quarter of all spending.

4. D. The fiscal year used to begin on June 1, but to give Congress and the President more time to finalize the budget, Congress pushed the fiscal year forward to October 1. Therefore, the federal fiscal year begins October 1 to September 30.

5. C. When Congress and the President fail to finalize the budget by October 1, the government continues to operate based on the last year's spending levels; we call this a continuing resolution.

6. C. Any business with a social conscience and who invests in anti-pollution devices will experience higher costs than competitors will and therefore will not be able to compete, everything else being equal.

7. C. Laws requiring helmets and seat belts only protect the first person, not others. But laws requiring cars to be inspected annually can protect people in the car as well as others.

8. D. Entitlement programs are programs whereby Congress doles out guaranteed benefits for those who qualify under government transfer programs such as Social Security, Medicare, and Aid to Families with Dependent Children.

9. A. A two-year cycle would give legislatures more time to debate and finalize our federal budget.

10. B. The last year that the federal government balanced the budget was 2001.

11. D. Only a highway is tangible and long lasting. The other choices produce nothing tangible.

12. D. It was in 1942 that Beardsley Ruml introduced the idea of payroll deduction as an alternative to tax payers writing out checks once a year to pay their taxes.

13. D. With more money leaving the country than entering the country, U.S. savings rate will decrease.

14. A. Historically most of government borrowing was the result of a war. Starting in the 1970's, under Lyndon Johnson's *Great Society Programs*, deficit spending increased yearly.

15. D. Whether we consider the debt high or low depends on how big it is in relation to GDP. If GDP increases more than the debt increases, the debt will decline as a percent of GDP.

16. C. With a total national debt of over $18 trillion, the interest paid on this increases every year. Thus, even a one percent increase in the interest rate the government has to pay translates into a lot of money.

17. B. An increase in the unemployment rate does not change the makeup of how much any particular group owes of their debt share.

18. A. The amount our national debt owned by foreigners has increased in recent years and complicates our debt situation.

19. A. People who drive the most end up paying more taxes than people who drive less.

20. C. Because Social Security is a "pay as you go" type program, as the number of people who pay into the system declines relative to the number of people who receive benefits, the burden on those people who pay increases.

Chapter 7: *Fiscal Policy* - Questions

1. Fiscal policy
    a. uses the federal government's power of spending and taxation to affect employment, price levels, and GDP.
    b. uses the federal government's power over the money supply and interest rates to affect employment, the price level, and GDP.
    c. can affect employment and price, but not the level of GDP.

2. In the short run, an increase in transfer payments will most likely decrease
    a. real GDP.
    b. the federal debt.
    c. unemployment.
    d. the money supply.

3. John M. Keynes is best known for advocating
    a. a policy of annually balancing the budget.
    b. deficit spending during depressions.
    c. the fixed-growth-rate monetary rule.

4. If government purchases of goods and services increase by $10 billion when the MPC is .8 and the MPS is therefore .2, then
    a. real GDP will increase by $16 billion.
    b. real GDP will increase by $20 billion.
    c. real GDP will increase by $40 billion.
    d. real GDP will increase by $50 billion.

5. When automatic stabilizers kick in to counteract recessionary forces
    a. aggregate demand rises above its pre-recession level.
    b. the deficit falls below its pre-recession level.
    c. the government tends to have more of a deficit, which is intended to stimulate the economy.

6. The balanced budget multiplier
    a. is greater than 1.
    b. is less than 1.
    c. is equal to 1.
    d. can be more or less than 1.

7. Let’s say inflation remains stable and huge government budget deficits drive up market interest rates. This will cause
    a. foreign investment in the U.S. to increase.
    b. imports to decrease.
    c. the foreign trade deficit to decrease.
    d. the value of the dollar to depreciate relative to foreign currencies.

8. Which of the following steps does *not* belong in a sequence reflecting the impact on international markets of increased borrowing?
    a. The U.S. Treasury sells securities.
    b. The sale of securities drives up interest rates.
    c. The rising value of the dollar leads to increased U.S. exports and reduced imports.

9. Which of the following would neutralize and offset the stimulating effect of deficit spending?
    a. Increased saving.
    b. Increased investment spending.
    c. Increased personal consumption expenditures.
    d. A decrease in taxes.

10. All of the following are variables that can be manipulated to affect fiscal policy except
    a. personal income taxes.
    b. government expenditures on goods and services.
    c. government expenditures on unemployment benefits.
    d. the rate of interest.

11. A $100 billion dollar increase in government spending increases real GDP more than a $100 billion reduction in net taxes because
    a. some of the dollars consumers gain from the tax reduction will be saved.
    b. some of the dollars consumers gain from the tax reduction will be spent on services.
    c. consumers will spend some of it on foreign goods.

12. When the MPC is .75, a decrease in net taxes of $100 billion will increase the equilibrium level of real GDP by
    a. $75 billion.
    b. $100 billion.
    c. $300 billion.

13. The effect of a change in net taxes on the quantity of real GDP demanded equals the resulting shift in the consumption function times
    a. the marginal propensity to consume.
    b. the marginal propensity to save.
    c. the autonomous net tax multiplier.

14. When net taxes and government purchases are reduced by the same amount
    a. there will be an increase in real GDP equal to the size of the reduction.
    b. there will be a decrease in real GDP equal to the size of the reduction.
    c. there will be an increase in real GDP that depends upon the size of the multiplier.
    d. there will be a decrease in the real GDP depending on the size of the multiplier.

15. Which of the following is an example of fiscal policy?
    a. The Federal Reserve Board reduces interest rates.
    b. The local school board raises teachers' salaries.
    c. General Electronics Corp. borrows $100 million to build a new factory.
    d. The federal government reduces personal income tax rates.

16. All of the following are components of the aggregate expenditure function which may be examples of fiscal policy except
    a. government expenditure for social security.
    b. consumption expenditure for appliances.
    c. investment expenditures for capital equipment.
    d. government expenditures for highway construction.

17. According to Keynesian economics, when we have an unemployment problem an effective fiscal policy might be to
    a. reduce market prices.
    b. reduce interest rates.
    c. increase the money supply.
    d. increase government purchases.

Chapter 7: *Fiscal Policy* - Answers

1. A. Fiscal policies are policies of the federal government to influence demand. During periods of inflation we would want demand to decrease, during periods of unemployment we would want demand to increase.

2. C. The purpose of an increase in government spending when used as a fiscal policy is to put unemployed people back to work.

3. B. Before the Great Depression of the 1930's Classical economics was the accepted belief. According the Classical thinking, the economy was always tending toward a full employment equilibrium; therefore, there was no need for government intervention. Keynes believed that the economy could tend toward a less than full employment equilibrium; in this case, there was need for government intervention to move the economy to a full employment equilibrium.

4. D. The formula for the multiplier is 1/MPS. Because the MPS is 2/10, which equals 1/5, the multiplier is equal to one divided by 1/5 or five. Now take the multiplier and multiply it by the spending increase and you get *5 x $10 billion = $50 billion.*

5. C. Unemployment benefits is an example of an automatic stabilizer. During recessions the economy experiences insufficient aggregate demand, the unemployment benefits help to increase aggregate demand.

6. A. It is greater than one because when the government increases taxes and increases spending by the same amount there is a positive stimulus effect because if citizens had the money they would save a portion of it, but when the government has the money it spends all of it.

7. A. As interest rates in America increase relative to interests rates in foreign countries, everything else remaining the same, will give foreigners an incentive to put their money in America to take advantage of the favorable interest rates.

8. C. Higher interest rates in America will attract foreign investment. However, to invest in America, foreigners need American dollars, thus the demand for dollars increases in the world market, increasing the dollar's value. Foreign products are now less expensive to Americans and American products more expensive to foreigners.

9. A. The more people can save the less dependent they will be on the government when they retire.

10. D. The Federal Reserve influences interest rates. The Fed's ability to increase or decrease the nation's money supply gives it some influence as to what happens to interest rates.

11. A. The multiple effect is greater when the government has the $100 billion because it will spend all of it - if citizens have the money, they will save a portion of it - depending on the Marginal Propensity to Consume (MPS).

12. C. -MPC/ (1-MPC) = -.75/.25 = -3; -3 x -$100 billion = $300 billion.

13. C. The autonomous net tax multiplier is the ratio of a change in equilibrium real GDP demanded to the initial change in autonomous net taxes that brought it about; the numerical value of the multiplier is
-MPC/ (1-MPC).

14. D. The multiplier works in reverse. If there is a reduction of X amount of spending, real GDP will decrease by a multiple of that decrease.

15. D. Fiscal policies are policies of the federal government for the purpose of increasing or decreasing aggregate demand to fight either unemployment or inflation.

16. A. Government spending on Social Security is simply a transfer payment; the government takes money from one group and gives it to another group.

17. D. All of the above would help when we are in a less than full employment equilibrium; but only an increase in government purchases is a fiscal policy, the others are monetary policies.

Chapter 8: *Inflation & Deflation* – Questions

1. Inflation is defined as a(n)
   a. increase in some prices.
   b. increase in the price of a specific commodity (or service).
   c. sustained increase in the general price level.
   d. sustained increase in the price of a specific commodity (or service).

2. A sustained increase in the general price level is called
   a. deflation.
   b. inflation.
   c. disinflation.
   d. hyperinflation.

3. Demand-pull inflation is induced by an
   a. inward shift in the aggregate demand curve.
   b. inward shift in the aggregate supply curve.
   c. outward shift in the aggregate supply and demand curves.
   d. outward shift in the aggregate demand curve.

4. Cost-push inflation is typically induced by an
   a. inward shift in the demand curve.
   b. inward shift in the aggregate supply and demand curves.
   c. outward shift in the demand curve.
   d. inward shift in the supply curve.

5. Which of the following is a pattern with cost-push inflation?
   a. Aggregate supply decreases and ultimately causes the price level to increase.
   b. Aggregate demand and aggregate supply both decrease, which ultimately causes the price level to increase.

6. Which of the following explains demand-pull inflation? Aggregate demand
   a. decreases and the price level increases.
   b. increases and the price level increases.
   c. and aggregate supply both increase causing the price level to increase.

7. The Consumer Price Index measures the cost of
    a. all goods and services produced in the U.S. economy.
    b. all goods produced in the U.S. economy.
    c. a fixed market basket of consumer goods and services produced in the U.S. economy.

8. If the inflation rate is 14% per year, and your nominal income increases by 13% per year, your real income
    a. declines slightly.
    b. increases slightly.
    c. increases substantially.
    d. does not change.

9. A reduction in the rate on inflation is known as
    a. deflation.
    b. disinflation.
    c. inflation.
    d. hyperinflation.

10. If the deflation rate is 10 percent per year, and your nominal wage rate increases by 11 percent per year, your real wage will
    a. increase slightly.
    b. increase substantially.
    c. not change.
    d. decrease slightly.

11. The real rate of interest can best be expressed as the
    a. nominal interest rate minus the real rate.
    b. inflation rate minus the nominal interest rate.
    c. nominal interest rate minus the inflation rate.
    d. inflation rate minus the real interest rate.

12. If the annual inflation rate is 5% per year, and the nominal interest rate is 6%, the real interest rate is
    a. 1% per year.
    b. 5% per year.
    c. 6% per year.
    d. 11% per year.

13. Which of the following would best define interest?
    a. Dollar amount paid to lenders to forego consumption.
    b. Payment for abstinence.
    c. Dollar amount paid by borrowers to lenders to forego present consumption.
    d. Dollar amount paid by lenders to borrowers to forego present consumption.

14. Megan recently borrowed money to purchase an automobile at a nominal interest rate of 8% per year. If the inflation rate is 6% per year, what is the real rate of interest on the loan?
    a. 6% per year.
    b. 8% per year.
    c. 4% per year.
    d. 2% per year.

15. If borrowers and lenders correctly anticipated price changes, what would happen to the real rate of interest if the price level changed? Real interest rate would
    a. increase.
    b. decrease.
    c. decrease by the amount of the price increase.
    d. not change.

16. The misery index consists of the
    a. inflation rate minus the unemployment rate.
    b. unemployment rate minus the inflation rate.
    c. unemployment rate plus the inflation rate.
    d. unemployment rate minus the growth rate.

17. The average rate of inflation during the Great Depression of the 1930s was
    a. very high.
    b. moderate.
    c. zero.
    d. prices actually declined, we experienced deflation not inflation.

18. If the CPI is 220 one year and 210 the next, the annual rate of inflation is measured by the CPI is approximately
    a. -4.5%.
    b. -2.3%.
    c. 220%.

Chapter 8: *Inflation & Deflation* – Answers

1. C. Economists do not consider all increase in prices inflationary. Some prices always increase because of the workings of the price mechanism. Only when the general level of prices increase over time can we say that we have inflation.

2. B. Economists define *deflation* as a sustained decrease in the average price level. *Disinflation* is a reduction in the rate of inflation. *Hyperinflation* is a very high rate of inflation.

3. D. If you draw a downward sloping demand curve and an upward sloping supply curve on a piece of paper and then move the demand curve to the right, you will see that prices will increase. Economists call this *demand-pull inflation.*

4. D. If you draw a downward sloping demand curve and an upward sloping supply curve on a piece of paper and then move the supply curve to the left, you will see that prices will increase. Economists call this *cost-push inflation.*

5. A. A factor that can cause a shift in supply is a change in costs. As costs increases the supplier cannot not afford to supply as much at every price level as used to be the case. A leftward shift of the aggregate supply curve will cause prices to increase. Economists call this *cost-push inflation*.

6. B. Because the downward sloping demand curve is moving to the right along an upward sloping supply curve, the increase in demand will pull the general price level upward.

7. C. The Consumer Price Index does not measure the prices of all goods and services, but only a particular basket of goods and services. As times change and consumers buying habits change, what goes into this basket changes.

8. A. With inflation increasing 1% more than your income increases, your buying power, or real income, goes down by 1%.

9. B. If inflation in year one is 6% and 5% in year two, we experience disinflation. We still have inflation in year two, but the inflation rate is lower than in the previous year.

10. B. With a deflation rate of 10% (a fall in the average price level) and a raise in pay of 11%, your real income would rise by 21%.

11. C. For example, in the previous question, your buying power went down by 1% because 14% minus 13% equals -1%.

12. A. If you pay 6% to borrow money, but you repay the loan in dollars that have decreased in value by 5%, the true cost to you for the loan is only 1%.

13. C. People with money can either spend it or save it. In order to forego present consumption, these people need an incentive. The more interest they can earn on their savings, the more incentive there is to save.

14. D. By paying back an 8% loan with 6% deflated dollars, the true cost of the loan is only 2%.

15. D. With future price changes exactly anticipated by both borrowers and lenders, interest rates would increase at the same level as prices, and therefore the real interest rate would not change.

16. C. Because people are adversely affected by inflation and unemployment, to be affected by both results in real misery.

17. D. The inflation rate prior to WWII was not only low but during the 1930's we actually experienced substantial deflation because of the Great Depression.

18. A. The rate of increase or decrease between two numbers is the difference between the two numbers divided by the original number. The difference between 220 and 210 is -10. Negative 10 divided by 220 is equal to a negative .045, which is -4.5%. The answer is a negative number because the CPI has decreased in this example and not increased.

Chapter 9: Unemployment & Stagflation – Questions

1. Stagflation is defined as the "double trouble" of higher inflation combined with an increase in
    a. the money supply.
    b. unemployment.
    c. the price level.
    d. corporate profits.

2. The labor force is defined as
    a. individuals over the age of 16 years
    b. non-institutionalized individuals over the age of 16 years.
    c. non-institutionalized individuals over the age of 16 years who are working.
    d. non-institutionalized individuals over the age of 16 years who are working or looking for work.

3. Individuals are counted as unemployed if they have
    a. no job.
    b. no job and are not looking.
    c. no job but looked for a job at least once in the last four weeks.
    d. no job but looked for a job at least once in the last six months.

4. The labor force participation rate is defined as the
    a. percent of population above the age of sixteen years.
    b. ratio of the number in the labor force to the population of working age.
    c. ratio of the number employed to the population of working age.
    d. civilian labor force divided by the total labor force.

5. In the 1970s, as more women entered the labor force, the result was that the
    a. labor force participation rates for females increased.
    b. labor force participation rates for females decreased.
    c. unemployment rate declined.
    d. labor force declined.

6. Workers temporarily unemployed but who normally find jobs quickly are called
    a. frictionally unemployed.
    b. cyclically unemployed.
    c. seasonally unemployed.
    d. structurally unemployed.

7. Workers who are unemployed because they lack the skills needed by employers are called
    a. frictionally unemployed.
    b. cyclically unemployed.
    c. seasonally unemployed.
    d. structurally unemployed.

8. Which of the following occupations would least likely experience seasonal employment?
    a. Lifeguard.
    b. Department store Santa.
    c. Ronald McDonald clown.
    d. Easter Bunny.

9. Which of the following occupations would most likely be subject to seasonal unemployment?
    a. Automobile mechanic.
    b. Appliance salesperson.
    c. Television repairperson.
    d. Farm worker.

10. Full unemployment is considered as being equal to the level that combines all of the following except
    a. frictional unemployment.
    b. cyclical unemployment.
    c. seasonal unemployment.
    d. structural unemployment.

11. Most economists believe the current level of full employment is represented by an unemployment rate between
    a. 0 and 2%.
    b. 4 and 5%.
    c. 7 and 8%.
    d. 9 and 10%.

12. What effect would the enactment of compulsory unemployment insurance laws have on unemployment rates? They would
    a. increase unemployment rates.
    b. decrease unemployment rates.
    c. have no impact on unemployment rates.
    d. decrease the number of discouraged workers.

13. Which of these is likely to increase the most in a severe recession?
    a. Frictional unemployment.
    b. Seasonal unemployment.
    c. Structural unemployment.
    d. Cyclical unemployment.

14. When workers are overqualified for their current jobs or can find work only part-time, we refer to this as
    a. unemployed.
    b. discouraged workers.
    c. not in labor force.
    d. underemployed.

15. Which of the following about discouraged workers would be correct? They are
    a. counted in the labor force.
    b. not counted in the labor force or unemployment numbers.
    c. counted in the labor force and the unemployment numbers.
    d. not counted in the labor force but are counted in the unemployment numbers.

16. Because of the way discouraged workers and part-time employment are reflected in the official statistics, the official unemployment rate
    a. overstates the unemployment problem.
    b. understates the unemployment problem.
    c. truly reflects the level of unemployment.
    d. overstates the size of the labor force.

17. An individual with a Ph.D. in physics, who can only find employment in a pizza parlor, would normally be considered as
    a. a discouraged worker.
    b. underemployed.
    c. overemployed.
    d. unemployed.

18. Which of the following events ushered in the Great Depression of the 1930s?
    a. The Smoot Hawley Tariff.
    b. A decrease in the money supply.
    c. An increase in taxes.
    d. all of the above.

19. What was the purpose of the Smoot-Hawley Tariff in the early 1930s?
    a. To raise money.
    b. Encourage international trade.
    c. To help bring down inflation.
    d. To increase the price of imports.

Chapter 9: *Unemployment & Stagflation* – Answers

1. B. Stagflation occurs when the economy is stagnating and inflating at the same time.
2. D. The definition of unemployment is what it is because of how the government defines it. D is simply the government's definition.
3. C. By definition, a person has to be actively seeking gainful employment at least once a month to be considered unemployed.
4. B. This is the government's definition of the *labor force participation rate*.

5. A. The ratio of the number women in the labor force increased in relation to the population of working age people.

6. A. Frictional unemployment is the normal job search type of unemployment. Recent high school graduates and college graduates are examples of workers who are frictionally unemployed.

7. D. Improvements in capital and technology lead to more jobs, but the jobs may remain vacant if the people in the work force do not have the training and skills to meet the requirements for the jobs.

8. C. Lifeguards, Santa's, and the Easter Bunny have seasonal jobs. A Ronald McDonald clown can experience unemployment during any season.

9. D. Farming is very subject to the seasons, the other possible answers are not subject to changes in the seasons.

10. B. Full employment includes frictional, seasonal, and structural unemployment, but not cyclical unemployment.

11. C. Making up that 5% and 6% are everyone who is included in frictional, seasonal, and structural unemployment. Even in the best of times, there will be certain people who will be actively seeking employment.

12. A. The easier it is to remain unemployed, the longer people will take to find a job.

13. D. Cyclical unemployment is the type of unemployment that is most susceptible to changes in the economy. Economic downturns effect certain jobs before others. For example, carpenters are normally first effected by a recession.

14. D. A person with a doctorate degree who can only find a job flipping burgers at McDonalds is an example of *underemployment*.

15. B. One of the weaknesses in using the unemployment rate as an indicator of how well the economy is doing is that it does not consider the discouraged worker.

16. B. A discourage worker is one who has looked for work for a long time, would still like to have a job, but has quit looking for work because of discouragement.

17. B. Economists still consider this person fully employed, but is underemployed because their job is well below their qualifications.

18. D. The buildup of excessive inventory due to business greed led to the unemployment problem in the early 1930s.

19. D. Politicians believed that if we raised the price of imports Americans would buy domestic products. However, the higher prices led to a decrease in buying power, which made the unemployment problem worse.

Chapter 10: *International Trade* – Questions

1. International trade leads to greater economies of scale. True/False

2. Opportunity cost is that which people give up in the best alternative endeavor when making a decision between two alternatives. True/False

3. Comparative advantage occurs when a country can produce goods and services at lower costs than other nations. True/False

4. A quota is a tax levied against a specific good being imported into a country. True/False

5. The low foreign wages in the textile industry is one reason why Americans pay such low prices of clothing. True/False

6. Because the United States is so big and richly endowed with so many natural resources we can always win a tariff war against other countries. True/False

7. American companies often petition Congress to impose tariffs against foreign competitors. True/False

8. Given a certain demand curve, if events push the supply curve to the right, the price level will increase. True/False

9. The gains from trade are due primarily to the fact that
   a. the wealth of large, industrialized nations can be spread throughout the world.
   b. total world output increases when each country specializes.
   c. countries can boost their economies by increasing exports.

10. The source of gains from trade
    a. are tariffs.
    b. is self-sufficiency.
    c. is autarky equilibrium.
    d. is comparative advantage.

11. Mutually beneficial trade cannot occur
    a. when each country has its own comparative advantage.
    b. if one country has absolute advantages in the production of every good.
    c. when the opportunity costs of producing each good are equal for both trading partners.
    d. if total world production equals total world consumption.

12. To maximize worldwide gains from trade, the country which should produce a good is the country that
    a. has the lowest opportunity cost of producing that good.
    b. can produce that good using the fewest resources.
    c. will produce that good using the most expensive resources.

13. Comparative advantage
    a. exists only when one producer can make the product using fewer resources than any other producer.
    b. leads to the most efficient allocation of resources and the greatest combined output.
    c. eliminates specialization, so that each country produces all of its own needs independently.

14. When the world price of an internationally traded product is greater than a country's domestic equilibrium price,
    a. the domestic price will prevail, and the world price is irrelevant.
    b. the country's import line is horizontal.
    c. the country's exports of the product will increase.

15. Trade restrictions in the real world
    a. are extremely rare, due to the economic benefits of specialization and trade.
    b. hurt domestic producers and benefit foreign consumers.
    c. hurt domestic producers and benefit domestic consumers.
    d. hurt domestic consumers and benefit domestic producers.

16. A tariff is
    a. a tax on imports only.
    b. a tax on exports only.
    c. a tax on either imports or exports.
    d. a luxury tax.

Chapter 10: *International Trade* – Answers

1. True. The market enlarges with international trade, so up to a certain point productivity increases as we experience a greater division of labor.

2. True. Each time you make a decision, you incur an opportunity cost; each time there is something you have to give up. That which you give up in the best alternative is your opportunity cost of making the decision you did.

3. False. Comparative advantage occurs when a country can produce something with lower opportunity costs than other nations. Lower costs would be an example of absolute advantage. To be successful countries make decisions based on comparative advantage, not absolute advantage.

4. False. A quota limits the quantity of a good that a company can import into a country. A tariff is a tax placed on an import.

5. True. The low wages in foreign countries, like Bangladesh, is the main reason American pay low prices for new clothes.

6. False. No one wins a tariff war.

7. True. This is an example of rent-seeking.

8. False. A movement to the right of a supply curve will push prices down, not up.

9. B. By each county specializing, each country becomes more efficient for several reasons; one reason is that business can eliminate non-productive activity. Total world output increases because of the resultant greater efficiency.

10. D. *Comparative advantage* is the ability of a country to produce something at a lower opportunity cost than other producers face. Even if Americans could make handmade wicker baskets better than any other country, we should not manufacture them because our opportunity costs would be so high, for example, time spent with the baskets would be time not spent on high technology products.

11. C. Countries trade because they have different opportunity costs in producing goods and services.

12. A. All counties should specialize in the goods and services with the lowest opportunity cost. In so doing, they would be maximizing their productivity and welfare.

13. B. When a country produces a good that it has low opportunity cost, it is taking advantage of its comparative advantage. By producing goods with low opportunity costs, it is giving up less in terms of foregone production than producing alternative goods.

14. C. Consumers will often buy goods and services based on relative price differences. If a country's price of a good is less expensive that the alternative goods offered in the world market, demand will increase along with exports of that good.

15. D. Domestic consumers are hurt because the trade restrictions force them to pay higher prices than otherwise. Domestic producers benefit because of less foreign competition.

16. C. When a country places a tax on an import or export, economists call the tax a *tariff*. Congress would place a tariff on an import to discourage the importation of a particular good; Congress would place a tariff on an export to discourage the exportation of a product.

Chapter 11: *Business Cycles* – Questions

1. What is the basic idea behind Keynesian Economics?
    a. If we let the natural adjustments to take place, the economy will repair itself.
    b. Because the economy is always tending toward a full employment equilibrium we should let the economy correct any malfunctions itself without government intervention.
    c. When the economy is tending toward a less than full employment equilibrium, we should use our discretionary fiscal policies to push the economy to a full employment equilibrium.

2. The idea behind Keynesian Economics is that if we can manage demand we can manage the economy. True/False

3. Because of the Keynesian successes during the 1930s and the 1960s, we know now that we can control the economy by controlling demand. True/False

4. Which of the following is an example of a leakage?
    a. Banks lend money out a business owner.
    b. Foreigners buy U.S. products.
    c. People put their savings in a bank.

5. Which of the following is an example of an injection?
    a. Foreigners buy U.S. products.
    b. People put their savings into a bank.
    c. People pay their taxes.

6. Gross Domestic Product (GDP) is defined as the market value of all
    a. resources produced in one year by U.S. firms.
    b. final goods and services produced in one year by all resources located in the U.S., regardless of who owns these resources.
    c. final goods and services produced in one year in the U.S. by resources owned by U.S. citizens.

7. What makes the investment sector so unstable?
    a. It is the largest sector of GDP.
    b. It takes time to decide what to do about an investment.
    c. Investors make decisions based on their expectations of what they think is going to happen in the future.
    d. all of the above.

8. Fear and uncertainty are the twin killers of investment. True/False

9. A decrease in interest rates will lead to an increase in investments. True/False

10. Which of the following is an example of the acceleration principle?
    a. The bank lends out money and the borrower buys something with the money.
    b. Apple invents a new product and Best Buy increases its' sales volume.
    c. The state builds a new highway and as a result, businesses build several gas stations along the highway.

11. Conditions during the Great Depression of the 1930s were fertile ground for the ideas of John Maynard Keynes, and the age of demand management economics was born. True/False

12. The Employment Act of 1946 committed the federal government to ensure maximum employment, production, and purchasing power. True/False

13. By the 1960s, most economists embraced the ideas of Keynes and believed in demand management economics. True/False

14. Because of the unusually long economic expansion from 1961 to 1969, fine-tuning of the economy was widely accepted. True/False

15. Consumer demand for durable goods tend to be more stable than the demand for nondurable goods. True/False

16. When you withdraw money from savings economists say that you have dissaved. True/False

17. A cornerstone of Keynesian economics is the belief that without the government borrowing money, the system can trap money in banks. Keynes called this a liquidity trap. True/False

18. The investment sector of the economy tends to be very unstable, whereas the consumption sector tends to be very stable. True/False

19. Along with the concept of a liquidity trap, the Keynesian multiplier is the second biggest reason why economists and politicians support Keynesian economics. This is what economists call the "balanced budget multiplier." True/False

20. The belief in the balanced budget multiplier has led to huge increases in government borrowing and spending since the 1960s.

Chapter 11: *Business Cycles* – Answers

1. C. Fiscal policies can shift the aggregate demand curve to the right and thus shift the economy to a full employment equilibrium.

2. True. Economists thought that by managing demand using discretionary fiscal policies, we could manage the economy and guide it to a full employment equilibrium.

3. False. When stagflation hit us in the 1970s, we learned that because the problem was a supply problem we could not solve it with demand remedies.

4. C. When money leaves the income stream, that is it no longer circulates, we call it a leakage.

5. A. When foreigners buy U.S. products money flows into our income stream, we thus call it an injection.

6. B. This is the official definition of GDP.

7. C. Because investors base their decisions on expectations and because so many things can influence expectations, the investment sector tends to be unstable.

8. True. Because investors base their decisions on future expectations, doubt and fear of what might happen will lessen the level of investments.

9. False. The answer is false because it is not true all of the time. If expectations are very negative, then a decline in interest rates may not be sufficient to spur on investments, but we say that everything else is equal, then a decline in interest rates should lead to an increase in investments.

10. C. The acceleration affect takes place because of induced investments. The new highway induced businesses to build gas stations.

11. True. During the 1930s, the economy was in a deep depression and President Franklin Roosevelt supported the ideas of deficit spending and an enlargement of government programs, both of which supported the ideas of Keynesian economics.

12. True. The Employment Act of 1946 represented the first time that the federal government codified into law its responsibility to achieve full employment by way of active fiscal policies.

13. True. The 1960s was a decade when the ideas of demand management economics favored by Keynes became widely accepted by academia and Washington DC.

14. True. Nothing succeeds like success, or so it appears. The expanding economy during the 1960s helped solidify the dominance of Keynesian economics both in Washington DC and at most of the mature universities in the nation. Harvard University became the leading university supporting the Keynesian philosophy with the University of Chicago being one of the few universities supporting Austrian economics.

15. False. A durable good is a good that lasts for a long time, like an automobile. A nondurable good lasts for a short time, like food. When consumer's expectations change or their incomes change, purchases of nondurables will not change very much, but the demand for durables will change a lot.

16. True. Savings is the act of putting money into savings, dissaving is the act of taking money out of savings.

17. True. Academia accepted the idea of a liquidity trap and therefore embraced the ideas of Keynesian economics. If banks could not lend out enough money to consumers and business, then it was up to the federal government to borrow the money and inject it into the income stream.

18. True. The consumption sector is very stable because consumers tend to be very habitual. When events change, their actions do not change right away. Because of savings and dissavings, consumers will maintain their previous spending habits, at least for a while. However, because investors make their decisions based on their expectations of future events, any change that will cause them to be more pessimistic or optimistic will have a profound effect on the level of investments.

19. True. The idea that that a dollar in the hands of the government has a greater stimulative impact on the economy then that dollar in the hands of individuals garnered wide spread support for increasing the national debt and increasing government spending.

20. True. The balanced budget multiplier recognizes that when individuals have a dollar they will spend most of it, but save some of it. But, when the government has the money, it will spend all of it. Therefore, there is a larger multiplier effect on the economy when the government has the dollar instead of individuals.

Chapter 12: *Financial Crisis 2007-2008* - Questions

1. A derivative is
   a. the type of stock that pays dividends.
   b. a bond that has value derived from the profits of a government or a corporation.
   c. a financial instrument whose value is derived from tax revenues.
   d. a financial product whose value is derived from the price of something else.

2. A derivative is simply an agreement between two parties betting on some outcome that will occur in the future, the agreement is binding and the participants cannot transferred it to a third party.

3. Because no one can accurately predict the future and with so many uncertainties, the buyers and sellers of derivatives would often rely on some complicated mathematical model to determine future value.

4. In 1996, Bankers Trust settled with Proctor and Gamble, forgiving most of the $200 billion lost in the derivatives market.

5. An over-the-counter derivatives market is a market where
   a. only the two parties are privy to the facts of the contract.
   b. the participants have to divulge extensive financial data to that the investors know what they are investing their money.
   c. both stocks and bonds are bought and sold.
   d. only the very wealthy can participate.

6. Congress passed the Commodity Futures Modernization Act of 2000, which stripped the Commodity Futures Trading Commission of all responsibility over the derivatives market and forbade the SEC from interfering with over-the-counter derivatives.

7. A subprime mortgage is a mortgage made to persons with poor credit histories.

8. Fannie Mae and Freddie Mac are two government agencies who make mortgage loans.

9. Prior to 1992, the government required Fannie Mae and Freddie Mac to buy only prime mortgages. After 1992, Congress required Fan and Fred to purchase subprime loans as well.

10. The practice of hedging one's exposure to risk goes back hundreds, if not thousands of years, whereby farmers would hedge against possible future losses.

11. A hedge is a position established in one market in an attempt to offset exposure in price fluctuations in another market.

12. When Brooksley Born was investigating the derivatives market as head of the Commodities Futures Trading Commission
    a. there were some spectacular failures by entities that were speculating with little restraint.
    b. almost no one in government were familiar with derivatives.
    c. all the biggest banks were dealers in the derivatives market.
    d. all of the above.

13. Basically Allen Greenspan, the Chairman of the Federal Reserve before the financial crisis of 2007 – 2008, believed that
    a. greed is so strong in human nature that it is necessary to regulate markets.
    b. the market can solve all problems.
    c. a centrally controlled economy would be the most efficient economic system.
    d. big business is at the root of most of our economic problems.

14. Let's suppose you are a farmer and you want to protect yourself from the uncertainties of the market. To add an element of certainty to your business you enter into a ______ _______ with a bank.
    a. futures contract
    b. balloon payment
    c. vertical contract

15. By 2007 Long-term Capital, a hedge fund that had highly leveraged its bets. This means that Long-term Capital
    a. never took risks.
    b. had deep pockets.
    c. made risky bets with borrowed money.
    d. was very careful with its money.

16. What is a hedge fund?
    a. An investment fund opened to a limited range of investors, professionals and wealthy people.
    b. A retirement fund like a teachers union.
    c. A federal bond that protects people from inflation.
    d. A financial instrument that offers high returns in the bond market.

17. What was the purpose of the Commodity Futures Trading Act of 2000?
    a. To give the Commodity Futures Trading Commission a free hand to regulate the derivatives market.
    b. Stripped the CFTC of all responsibility over the derivatives market.
    c. Banned states from interfering with the derivatives market.
    d. Both b and c are answers.

18. Many events transpired between 2000 and 2010, which greatly aggravated the financial meltdown. Which of the following events transpired?
    a. The government took no action to regulate the market.
    b. Wall Street firms were showering Washington with $1.7 billion in campaign contributions and $3.4 billion on lobbyists.
    c. The practice of rent-seeking was excessive.
    d. all of the above.

19. What was the purpose of the Glass-Steagall Act of 1932?
    a. This act gave banks more opportunities to invest in the derivatives market.
    b. This act merged investment banks with commercial banks.
    c. This act separated commercial banks from investment banks.

20. What was the Financial Services Modernization Act of 1999? This act
    a. gave more teeth to the Glass-Steagall Act of 1932.
    b. made it so that banks could participate in the derivatives market the same as investment banks.
    c. Allowed commercial banks to take depositors money and put it at great risk, similar to the way they did leading up to the Great Depression of the 1930s.

Chapter 12: *Financial Crisis 2007-2008* - Answers

1. D. The word derivative comes from the word derived; some external event determines its value. For example, you and I make a bet on the weather next Monday, if I am correct you owe me $100, if you are correct I owe you $100. So this contract has value because of an event that will take place next Monday.
2. False. Investors can buy and sell derivative contracts multiple times before the strike date, the date the agreement becomes binding.
3. True. Because the value of derivative contracts depend on some future event, and because no one can for certain predict the future, participants in this market often relied on some formula derived by mathematical wizards called Quants, like the Black Scholes Formula, to base their predictions on.
4. True. In 1994, the Federal Reserve raised interest rates and caused Proctor and Gamble to lose on a derivative bet. Proctor and Gamble's losses mounted as the Fed raised interest rates several more times. To avoid a legal lawsuit and bad publicity, Bankers Trust decided to take the loss instead of Proctor and Gamble.
5. A. An over the counter market is a market void of an exchange whereby participants divulge financial information so that investors can make informed decisions. With an over-the-counter market there is no way of knowing the facts except what the seller wishes to divulge.
6. True. The Commodity Futures Modernization Act of 2000 closed the door to any government oversight of the derivatives market.
7. True. A prime loan is a loan made to credit worthy individuals. Subprime loans are more risky due to the poor credit histories of the people banks give the loans.
8. False. Fan and Fred do not make loans; they purchase mortgage loans from banks. The purpose is to increase the flow of funds in the mortgage market. Instead of a bank receiving monthly payments over a long period, they could get their money right away and thus have more cash to relend.

9. True. Congress was eager to make almost everyone in American a homeowner. Thus, they pressured Fan and Fred to make more subprime loans to qualify more people for mortgage loans. In turn, banks came up with ingenious, and sometimes fraudulent, ways to convince people to borrow money.

10. True. The practice of hedging is a sound business practice and has a lot more to do with stability than it does with gambling. Farmers will enter into a futures contract with someone by agreeing to sell their produce at a certain price (called the strike price) in the future regardless of what happens in the market. In this fashion, hedging protects the farmer from the vagaries of the market. At times, the strike price is lower than the market price and at other times, it can be higher than the market price.

11. True. Just as farmers use hedging to stabilize events, hedge funds (investment companies) will play off one possible scenario against another to protect themselves from any sudden market changes. Just like with the farmer, the main objective is stability. A key element in successful investing to avoid losses. Goldman Sachs Group, Inc. tries to make investments in things where profit is a certainty.

12. D. Despite the enormity of the derivatives problem, all the big players in government and banks vilified her for her attempt to rein in the excess of this market.

13. B. He believed free markets void government restrictions or regulation.

14. A. A futures contract is a way to hedge your bets on some future event. In this case, the farmer would agree to sell his crop for a set price on some date in the future. If the market price is greater than the agreed upon price, the farmer makes less money.

15. C. To be highly leveraged means that you put at risk a huge amount of money but only have a small amount of money on hand to back up any bad bets.

16. A. A hedge fund attempts to establish a position on one market to offset price fluctuations in another market.

17. D. The CFTA gave banks total freedom in the derivatives market, which is today a $600 trillion market.

18. D. Self-explanatory

19. C. One of the causes of the Great Depression of the 1930s was that banks were taking depositor's money and putting the money in highly leveraged and risky investments. This act prevented this practice by commercial banks but allowed investment banks a free hand.

20. C. Both b and c are answers. The FSMA obliterated the safety measures of the Glass-Steagall Act of 1932.

ABOUT THE AUTHOR

Ken was born in Grosse Pointe Michigan. After graduating from Grosse Pointe High School in 1963, he attended Eastern Michigan University where he majored in Economics and English with a minor in History. He attended Wayne State University in Detroit Michigan in 1969 where he earn a Master's in the Art of Teaching Mathematics while teaching mathematics in the inner city of Detroit for four years. He then attended Eastern Michigan University to work on his Masters in Economics.

He has been married to Kay Long since 1970 and has three children. He has been teaching the Principles of Economics at New River Community College in Dublin, Virginia since 1972. *Macroeconomics – Austrians vs. Keynesians* is Ken's third book. He has had published by D. Van Nostrand a Principles of Economics book and he has written a personal finance book, *Personal Finance – Beware of Wolves in Sheep's Clothing*.

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