The New Practical "Laws" of Global Economics

Why Taxes are the only tool remaining!

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One of the highlights of my early career was Milton Friedman attending one of my lectures. At first I was surprised that such a great mind would take the time to come listen to what I had to say. I was not an academic. I was a global analyst and fixer-upper. But then I remembered that back in 1953, Milton had argued for a floating exchange rate system rather than a fixed exchange rate system designed at Bretton Woods during 1944. Milton had seen the free market forces adding the checks and balance to keep governments in line. As our conversation progressed, I realized I was doing what Milton had proposed and I was in the front lines. Indeed, in 1997, I testified before the House Ways & Means Committee on global taxation at the request of then Chairman Bill Archer. When you testify before Congress, they group you into panels with like persons. I was placed on a panel with other economists who were pure academics. Bill apologized for the grouping because there was just no one quite in my field. I was not theory, but practice.

I never met John Maynard Keynes. Nevertheless, as the hands-on-guy who just did not fit into that ivory tower model, I had to deal with real-world effects of the floating exchange rate system that was born in 1971 through a mere trade dispute unlike Bretton Woods. I became a globe-trotter rushing around from one crisis to another. I would meet with central bankers and even lectured before them in meetings such as in Paris or in Toronto, and was asked to fly to Beijing in 1997 to meet with the Central Bank of China during the Asian Currency Crisis. So what I had to offer was a front row seat that few ever achieved. Milton helped me appreciate the unique position I ended up in - the Bird's Eye view of the world.

There was a fierce battle between the theories of Keynes and Friedman. In effect, Keynes had advocated that government could steer the economy through the economic turmoil by manipulating interest rates and taxes whereas Friedman argued government could never steer the car and at best the key resided in the quantity of money. This battle raged between the 1950s through the 1970s. Milton was joined by Karl Brunner and Allan Meltzer, who became known as the "monetarists" that were at first treated with disdain. But the core of the monetarists theory was deeply rooted in the theories of John Locke (1632-1704), David Hume (1711-1776), John Stuart Mill (1806-1873), and David Ricardo (1772-1823). Eventually, during the Carter Administration of the late 1970s, Congress ordered the Federal Reserve to take the monetarist arguments seriously.

I did not set out with a burning desire to be an academic. Nor did I seek a journey to change the laws of economics. I was an analyst seeking only practical answers to be able to cope with the world and understand investment. Before fax machines, the analysis I produced was delivered by Western Union via telex and in the early 1980s, sending just one telex on one market cost $50 to the middle east. Every day, each market was covered in the financial group including precious metals, stock indexes, and all major currencies. The cost to take all the subscriptions could exceed $200,000 just in telex fees that adjusted for inflation in 2006 dollars would be $1.6 - $2 million. So the audience just happened to be the major institutions and government around the world. By sheer chance, what emerged was a incredible opportunity to see like Adam Smith the real movers and shakers. Finally, in 1985, I decided to open our first office outside of the United States in London. The reasoning was that if I could send just one telex to London and then allow them to redistribute from that point, the costs would decline and we could expand our client base into the lessor middle class of corporations. I met with the head of a major Swiss bank in Geneva. We had become friends and I trusted his advice. I asked him what name to use. I was assuming something European. He asked me to name one European analyst. I was embarrassed. I could not. He said that was his point. He said everyone turned to me because I was American, and Americans could care less if their currency rose or fell. But Europeans were trapped in their analysis by their patriotism. The British were always bullish the pound; the German the mark, and the French the franc.

The fundamental problems with economic theories is just that. They are theories. I did not seek to establish any new theory no less create "laws" that are fixed and unyielding. But we sometimes travel down a road and get hungry. We search for a place to eat and on that rare occasion, we stumble upon a new discovery - a great restaurant that brings a smile to our face upon remembering.

The economy is like a child, it grows and matures. We may expect one child to end up in one profession, only to discover they explore an entirely different path. The problem with economists is they have perhaps not seen what I have seen, such as the vast pool of funds that runs around the world altering the course of nations and destroying the best plans of men and politicians.

Why do we need the "New Practical 'Laws' of Global Economics" today more than ever? The reason is we are flying in a jet but are still acting as if we have a prop-plane. Many of the pilots could not make the transition to a jet because they were unable to respond quickly to consider the dramatic increase in speed. We have the same problem in managing the economy.

The theories that prevail today bounce back and forth between Keynes and Friedman with a little Marx thrown in for flavor. Do we increase money supply, lower interest rates and taxes, or just regulate everything that moves and pretend we are not taking the toys away from the kids as Marx advocated? Do we ignore the Invisible Hand of Smith to the point that we are blind to the self-interest of Government that cannot sleep at night unless it feels in complete control of our lives?

When gold was money, the capital flowed between nations only because there was, as David Ricardo explained, a comparative advantage. This was the key to international trade - their desire to purchase something one could not obtain locally or was at a significant lessor price allowing for "arbitrage" that gave birth to insurance to cover the risk of long voyages. This "arbitrage" still exists today just in the form of electronic trading on a global scale. We need a new understanding of capital and how it moves because we're not in Oz anymore Dorothy!

capital by the Japanese caused by the G-5, led to the capital

Another example is a mind twister. Between 1980 and 1985 I was giving lectures throughout Europe. The number one question I was asked; What was my opinion of the United States adopting a two-tier currency system? I understood the question only because I studied money globally and had also clients from South Africa when there was the Rand and the "Financial Rand." One currency is used domestically, but it cannot be used for any purchase of goods & services outside the country. The rand would need to be converted to the "Financial Rand" that was allowed to be used externally creating the two-tier system. The Euro-Dollar market had hit $1 trillion nearly in 1980 as did the US national debt. Europeans were convinced the way to escape the debt was for the US to create a two-tier currency. This led them to move their Euro-Dollar deposits into onshore domestic dollar deposits. They had assumed that the Euro-dollars would be new "blue" dollars worth less than the domestic "green" dollars. The more convinced the risk was perceived, the more capital flowed. The Euro-Dollar deposits declined sharply and this drove the dollar to record highs in 1985. The more bearish Europeans became, the more bullish the dollar trend. This was amazing to see. Government misunderstood creating the G-5 in 1985 announcing they wanted to see the dollar decline by 40%. The Japanese began to sell US investments taking capital back causing the yen to rise attracting others creating a bubble top.

Law #2 - Capital Moves Globally For Comparative Advantages in Currency

The traditional Ricardo model of comparative advantage was built upon a world when gold was money. We must realize that prior to 1971 with only brief exceptions, the capital flowed only because of a comparative advantage reflected in investment rates of return, to gain goods that were not available in the domestic economy, or for arbitrage insofar as the same produce available in one nation was cheaper when compared to domestic prices, then trade internationally would take place exploiting those differentials that was an early form of global arbitrage.

However, we are no longer in a world of a gold standard where money is the same relative internationally. Gold might buy more goods in one nation than another, but it is the differential in the price of goods relative to the same amount of gold that fluctuates due to other external factors - labor & transportation costs. Today, a floating exchange rate system has altered that time honored tradition and this affects every economic theory rendering them irrelevant.

(1) capital may now move according to the old principles of trade and seek an arbitrage to purchase the same goods cheaper in another land that has a comparative advantage such as lower labor costs, little or no tax rates, or on some occasions deliberate pricing below cost to gain market share (rare event).

(2) capital may also move solely because of currency fluctuations, or differentials in interest rates such as the capital outflows from Japan to gain the higher rates of interest in dollars, where no such comparative advantage exists solely due to trade, but the capital flows due to currency may in fact alter the trade balance.

Where under our first Law capital flows to avoid global risk, here we find in the calm of the storm, capital will flow purely according to the arbitrage it sees in values. This is what Milton Friedman advocated back in 1953. He saw that this natural flow would place a check and balance upon governments. In reality, this is the manner in which capital also votes relative to the politics of a nation. We are no longer in Oz. Capital will flow not because of solely the comparative advantage in trade, but in the value of money itself. They can at times both be arbitrage.

In Times Like The Present
Should we Follow Keynes or Friedman?
Or Do We Need a New Theory Altogether?

Understanding Keynes and Friedman may mean the difference between survival or economic destruction that leads always to war. The Monetarists accused Keynes of ignoring money. This is truly a critical point that must be understood. By advocating two tools interest rates and taxes, Keynes is approaching the economy indirectly. In other words, to stop some behavior the government does not like in you, it is directly attacking your wife in hopes she will cause a change in your behavior. Japan was in a very bad economic depression. It lowered interest rates to a tenth-of-one percent (0.1%), it was virtually zero. All this did was cause capital to seek interest rate profits elsewhere and did nothing to relieve the economic downturn in Japan. The final low may come in 2009 after the 1989 high. Waiting for a possible low 20 years later, is not acceptable fiscal policy. Economic declines can be very prolonged. From the 1873 Panic in the United States, the economic decline lasted overall until 1896 - 23 years later. That is a waste of generally 1/3rd of everyone's lifetime.

The Monetarists' approach is to increase the money supply, not use indirect means that hope will change events. If we simply gave everyone $1,000, there is no guarantee that they would spend it. If their confidence is still distrusting, they may just pocket the money waiting for a rainy day. This would not increase the money supply for that we measure truly in terms of velocity. If we collectively add up the economy in what we call the Gross Domestic Product ("GDP"), and we divide that by the money supply, we achieve what is known as the turnover rate (Velocity). If the money supply divided into GDP creates a velocity rate of 6:1, this means the "float" or holding period before spending is about 2 months. If we increase that rate to 12:1 the time period drops to 1 month. We define M1 money supply as:

(1) the amount of currency held outside banks
(2) the checking accounts at commercial banks (demand deposits)

This is a very narrow view of money. It does not include stocks, bonds, and real estate - three major areas where capital can reside and is considered to be "wealth" by every rational person. Where problems also enter is the assumption of a perfect-world. If the velocity is constant, then if the central bank can truly manipulate the money supply (velocity), they would have a direct tool that is far better than interest rates and taxes. However, if the velocity can fluctuate widely according to the "confidence" of the people, then manipulating the money supply would also be reduced to an indirect tool. Here is where the forces of Keynes and Friedman clash. Keynes argues that the velocity is unstable, whereas Friedman would take the opposite position.

The debate about money may be the third oldest profession. Prior to about 600 BC, money traded in clumps of silver and gold and in some areas of Italy it took the form of cattle and later bronze. Every time there was a transaction, the metal had to be tested and weighted. King Croesus of Lydia (ca 560-546 BC)(Turkey) came up with the idea that he would pre-test and pre-weigh gold creating the first coinage. Other kings quickly caught on and it became a sweeping new trend of a show of power and wealth. Economically speaking, it was a step toward making commerce efficient and thus increased progress and the velocity of money. Trade expanded and the age of empire building followed shortly thereafter. It was Money in the form of a standard unit of exchange that furthered international trade. The reference to Jesus overthrowing the tables at the Temple states they were the tables of the "money changers" John 2:15, who were the ancient foreign exchange dealers.

Keynes disagreed with the Monetarist's view that money supply was the key. Keynes actually began with a focus upon money supply and evolved into the policy theory of interest rates and tax manipulation, whereby Milton began with the Keynesian model and reverted back to study money supply concluding that Keynes would create massive new spending that would only lead to inflation. Was he correct?

Keynes bought into the money supply model after viewing the hyper inflation of the German Weimar Republic between 1921 and 1924. Keynes viewed in his **Tract on Monetary Reform** that it was the increase in the quantity of money that caused the population to spend money faster that in turn led to escalating price adanvances. However, Keynes flipped positions after the Great Depression in his General Theory he believed it was a collapse in demand rather than money supply, that led him to his tools of interest rates and taxes. Keynes saw no reason why the velocity of money would remain stable. Keynes was not sure that a mere increase in money supply would translate into more spending of excess cash. He recognized that an increase in money supply may not produce an increase in velocity for people could stuff it in their mattresses, and thus the decline in velocity would negate the increase in money supply. Keynes also argued that others may hoard cash to also speculate in stocks or bonds. Keynes thus saw that interest rates could effect the speculative demand and in his mind had a more direct effect than money supply concluding that a increase in money supply might be offset by a increase in hoarding. Keynes thus took the anti-Monetarist position in a letter advising President Franklin D. Roosevelt:

> "Some people seem to infer ... that output and income can be raised by increasing the quantity of money. But this is like trying to get fat by buying a larger belt. In the United States today your belt is plenty big enough for your belly."

The Collected Writings of John Maynard Keynes (Vol XXI, p294)
London: Macmillan/St. Martin's Press for the Royal Economic Society 1973

Roosevelt took the money approach by (1) confiscating all gold, and (2) he then devalued the dollar offically increasing the supply of money relative to gold by revising the system from $20 for an ounce of gold to $35. This did not have the widespread effect that he perhaps secretly believed. Roosevelt also made it illegal for Americans to own gold. That was not overruled until 1975. It was presumed that if the public could still hoard gold, they would do so, and defeat the best efforts to inflate. There was something lurking in the bushes that was also the silver lining in the dark clouds of the Great Depression. It was nature and her 7 year drought of Biblical proportions as in the story of Joeseph. The Great Depression forced a new age of progress by necessity - the new age of skilled labor fulfilling the culmination of the Industrial Revolution.

Keynes thus viewed the world entirely differently. Keynes saw that the economic forces of production were motivated through interest rates and investment rather than consumption. Keynes was perhaps too deeply involved in his personal world of investment to see the other side of the street. Keynes believed that to get GDP to rise, interest rates had to be lowered that would stimulate borrowing from banks to buy the goods and services. Thus, he saw the Great Depression as a collapse in this demand.

Keynesian economics has been proven to be false just looking at the decline in Japan. The interest rates that fell to nearly zero did nothing to restart demand and because of the Floating Exchange Rate System, there was an escape value - the ability to borrow yen for next to nothing and invest it overseas earning 600% more and that would have no effect upon stimulating domestic demand. By the 1950s, Milton had moved away from Keynesian ideas he harbored in the 1940s viewing that ignoring the money supply was a serious error.

Milton broadened his view to support the idea that the demand for money and velocity was stable by turning to the long-term factors of education, health and income of the family or individual over decades - the saving for retirement approach. Milton also attacked Keynesian ideas that consumption rose and fell along with the short-term income. Milton argued that people took a longer-term view to their life and finances. Milton was correct, for there would be no market for Life Insurance if the view of the individual or family was extremely short-term. Milton then also viewed that consumption would be also stable for the long-term expectations of the family or individual.

If we look at the events of the Great Depression, it is hard to see how Keynesian economics would have really worked. Interest rates collapsed for three primary reasons with no economic effect; (1) the Fed did lower rates, (2) there was a flight to quality forcing short-term rates to near zero as we have seen recently, and (3) there was capital flight from Europe during the early stages due to the widespread defaults of European government debt that also impacted domestic policy forcing interest rates lower even if the Fed did not want to see such a decline. The Fed could not lower interest rates to stimulate the economy. That will only help during bull markets where there is "confidence" to invest for a profit in any event. Lowering taxes did not really matter because there was no payroll tax until after World War II and the rich were losing money profusely. I find it hard after just reading the memiors of Herbert Hoover and the serious documentation available to prove to me that Keynes would have helped. The massive runs on banks took place on rumors that FDR was going to confiscate gold. He denied that as absurd the night of the election. But the rumor persisted and led to massive bank runs. Hoover could not stop it for it was not a "credit" crisis as much as it was a sheer flight to quality. The majority of banks failed after the election of FDR and his inauguration. Hoover wrote letters to FDR pleading with him to reassure the people he had no such plan. But FDR remained silent. Had the Fed provided cash loans to the banks, it would have been fruitless.

Milton viewed the Great Depression from a money perspective. He was correct, the fears and uncertainty of the times led to hoarding of gold. This no doubt contributed to what Milton saw as a collapse of one-third of the money supply during the Great Depression. It is hard to imagine promising to lower taxes and interest rates would have much impact when the world seems to be ending.

I believe it was Abe Lincoln who argued that you can fool some of the people some of the time, but you cannot fool all of the people all of the time. This is clearly a lesson politicians need to learn. The people do look to the future and will spend more of their income if they "feel" that their home is rising in value. When housing prices decline, savings rise, because people do in fact respond to their longer-term expectations. This brings us to the question of tax cuts and do they even work? In 1964, a tax cut was made and this was viewed as a permanent cut in payroll taxes. The economy exploded and there was the great boom in mutual funds that led to wild speculation with the high in 1966. By the time we see the collapse, there was fear about inflation due to the spending for the Vietnam War. In 1968 Congress passed what it marketed as a temporary tax surcharge to stop inflation. True, consumers spent less, but they drew down savings to maintain their consumption. In 1975, there was then a temporary tax rebate to stimulate the economy going into the steep decline for 1976. None of these changes in temporary taxes did anything significant. Where the 1964 payroll tax cut took place and was perceived as permanent, there we find a surge of investment planning for the long-term as Friedman expected.

The empirical evidence suggests that one-time rebates will <u>not</u> stimulate the economy because the people are quite frankly - not stupid! The <u>only</u> historical evidence of a tax cut stimulating the economy is a permanent change not one-offs!

We are not concerned with the absurd arguments that the average person does not weigh the budget deficit when he is buying eggs. These sorts of criticisms malign the intuitive nature of the people as a whole. For example, when Paul Volker raised interest rates to unheard of levels to fight inflation in the early 1980s, my mother and her sister ran out and bought CDs for 10 years at banks with interest rates of about 15 percent. She did not ask me any advice. She instinctively knew this was a deal of a lifetime. For the next decade, they made a fortune. Did they weigh inflation relative to the interest rate? Perhaps. But they clearly did not see inflation as rising faster than the rate of interest or they would have hesitated as was the case during the German Hyperinflation. Did they have a model? No! Did they make some instinctive decision based upon personal observation without empirical data? Absolutely. Sorry, trying to impute knowledge that must be somehow quantitative on a professional level to the general public, makes no sense. Sometimes we forget, that if enough little old ladies run out and shift their demand deposits to long-term fixed rates, they do cause a contraction in M1 as we calculate our world.

Milton was correct. Keynesian models promote inflation with no objective. They are indirect and may assume that an increase in government spending will be inflationary, but this is just not always true, if there are external factors that are offsetting the spending such as a capital withdrawal from outside the domestic economy. The assumption that even within a closed economy that an increase in spending will create economic growth of a tangible nature is also false - just look at the German Hyperinflation. We saw the period of the 1878 start of inflation deliberately created and targeted to increase the money supply by overvaluing silver relative to gold, failed to produce the expected result for gold was being drained by foreign investors replacing it with silver until the entire experiment led to J.P Morgan having to bailout the nation lending the US Treasury gold. The deliberate creation of money that was cheaper than the world standard, led not to economic growth, but economic decline in a similar fashion to the German Hyperinflation of the 1920s, but to a much less extent.

Law #3 (Gresham's Law) BAD Money Drives Out Good

While Gresham's Law was based upon a Gold Standard and that by debasing the precious metal content causes the hoarding of higher content coinage, in a floating exchange rate system, it still works by driving real wealth out of a nation fleeing to another currency by creating excess currency.

Law #4 Only Permanent Reductions in Taxes Produce Economic Stimulation

The average person may not understand fancy statistics, but they will also not be induced by false statistics. The average person reacts according to their own personal view of the economy, which is why one-off tax reductions will not have an economic impact but will be hoarded for the rainy day unless the average person "sees" and "expects" economic changes.

Interest Rates - Taxes - Money Supply
So is that the Best We have Got?

As much as I respect Milton Friedman, I must be honest. There are no plain assumptions that we can tolerate. We cannot assume that velocity will remain a constant because people will hoard and fear spending in times of economic decline. Likewise, let us not kid ourselves that raising and lowering interest rates will have any meaningful effect upon the economy or the behavior of its participants.

Setting aside the accolades, the government could not help but lower interest rates during an economic decline. Capital will flee to government debt as long as it perceives the risk to be in the private sector. Hence, capital will move to the government debt bidding higher in price forcing yields (interest rates) to decline. So Keynesian theory does not work. It is assuming government has some effect when it is not in the driver seat. If it keeps interest rates so artificially high, private economic commerce will collapse and government expenditures would rise sharply due solely to interest rates causing both the money supply and economy to collapse. Lowering interest rates below world levels as did Japan in the 1990s, fuels capital flight to higher yields preventing domestic increases in money supply defeating any intended stimulation package.

Likewise, if money supply is just increased assuming it matters not how it is increased or spent, this sort of untargeted wholesale spending will promote inflation causing capital flight to other lands. Currently, there are proposals to spend money on infrastructure. This is a throw back to Roosevelt and the WPA. But this demonstrates how a little-bit of knowledge can be dangerous. The WPA worked because unemployment rose to 25% during the Great Depression when we were still 40% agrarian when there was a 7 year drought known as the Dust Bowl . Government was still quite small. The federal reserve was created only in 1913 and there was the Interstate Commerce Commission. There was no payroll tax and no social security. Today, the growth in government state and federal has become nearly that 40% level. More government programs may kill the entire goose bringing back the good-old days and the complaints against Constantine the Great (306-337AD) that there were more people collecting taxes than paying them. For unemployment today to reach 25%, it would require a collapse in governments throughout the states and municipalities. This becomes possible because we have the federal income tax competing for revenue against the state and local entities causing the tax base to collapse.

In our modern-day economy, the king has no clothes, but no one will tell him. Money is created by velocity. This is agreed upon by all persons. The leverage in the banks they created with their unregulated derivatives markets between themselves is at least 30:1. Our definition of money is far too narrow today. It cannot be limited to demand deposits and cash. It must include bonds, stocks, and all such financial instruments from money-market funds to derivatives. If we stop ignoring reality, just maybe we can figure out the rules. If derivatives are not money, then what were we so stressed about bailing out bankers? It is not real! Right? Poof! It's not there as a magic trick. We have to stop defining money so narrowly if we rush to bailout housing, banks, and manufacture but none of that we consider money. So how do we fix what we do not even define properly?

Once we accept reality and ask the average person if his house is part of his assets he considers wealth, then we will realize that the true picture of money is what people believe it to be - not what economists claim. This is why we are bailing out ~~the~~ mortgage-derivative crisis, because it is money. Hence, if the electronic money created by the private sector through velocity includes the 30:1 leverage, we can see that increasing the money supply to compensate for the decline in the velocity that was effected by the 30:1 leverage, brings into focus the problem of money supply. There is no way to increase the government spending by 30 times to offset the decline in velocity. Even if we look at a 10 fold increase, it is still far beyond what could be absorbed. This type of an increase in money supply would be hyperinlationary to say the least. It would be wide spread that everyone would be influenced and capital would then run to tangible assets and flee government debt forcing that also to go into default or just be monetized.

Because we are in a global economy, if the Fed buys bonds to inject capital into the economy, those bonds may be held by foreign investors who take the money home. If we lower interest rates so far, capital will flee to other lands to get the higher yield as what took place in Japan. We live in a whole new world

The Last Tool Standing

Obviously, we cannot just create vast amounts of cash and just spend it wildly without creating a wave of inflation that would cause real capital and wealth to flee to other lands. We cannot artificially raise or lower interest rates against the natural trend without either causing a competing force that attracts capital or fuels the asset inflation. Nor can we drop interest rates or raise them arbitrary to world levels without causing capital to flee for higher yields or foreign capital to arrive taking interest earnings home draining domestic resources. Interest rates & money supply are subject to global trends.

This is why we have the New Practical "Laws" of Global Economics. We are not alone and whatever we do with money supply or interest rates can attrack or repell both domestic and foreign capital. We cannot continue under false assumptions. We must face reality. Why did Milton come listen to me? Because where we may have disagreed on the presumption that the velocity of money was stable, we agreed on one point that stands behind these "Laws" of economics. Milton saw that a floating exchange rate system back in 1953 would act as a check and balance upon the governments of the world. Many criticized Milton and thought he was nuts. But he was correct. He saw in theory in 1953 what I have witnessed in practice. This is were theory and observation have met. Whatever we do, we will effect the world just as the world will effect what we do. This is perhaps implicit in the "contagion" that people see as the debt crisis spread around the globe like the latest strain of flu.

The money supply and interest rates are truly created not by the man sitting behind the curtain in Oz. They are created by the interaction of the people and how they respond to both private and public events that impact their long-term and short-term financial expectations. This is the essence of the "flight to quality" dictated by the Invisible Hand of Adam Smith, who wrote "it is not from the benevolence of the butcher ... that we expect our diner, but from [his] regard to [his] own interest." Wealth of Nations, Vol I, p26-27 (Oxford: Clarendon ed. 1976).

As already explained, both money supply and interest rates cannot be confined to purely domestic impact. We cannot count on the "benevolence" of foreign investors or states to simply buy our debt to stimulate our economy contrary to their own self-interests. We have to respect international capital flows or we will send our own economy back into the stone age. We cannot stimulate domestic issues exclusively by using purely interest rates or money supply theory by government spending.

The last domestic tool standing is taxes. Here too, we can raise taxes and send capital fleeing taking with it jobs. But we can lower taxes to create jobs domestically as well. Taxation is a barbaric relic of the past to increase the money supply of the state (king) like war. We are no longer on the Gold Standard so there is no need to tax or wage war for profit when money is electronic anyway. We must distinguish that state & local government need taxation because they lack the power to create it. They must learn to be competitive to attract jobs, but the Feds no longer need income taxes. Money can be created in a disciplined manner. Milton even suggested a negative tax rate that was an automatic payment to lower income that enabled a steady increase in money supply. The payroll tax merely borrows from the poorest interest free and then hands back a refund as if it were Christmas. The 1964 tax cut was a permanent cut and that sparked economic growth. One-off tax cuts in troubled times never worked because when confidence is low, people will save rather than spend for the future.

The only viable tool we have is the federal income tax. The only way to spark a economic boom and create jobs, is to eliminate it and make American labor competitive. The jobs would pour back just as Hong Kong grew because it had only

a 15% tax rate that was lower than the rest of the world. There are those who would assume that if government printed the money it needed that that would be inflationary. This is a matter of definition. They forget that we issue trillions of dollars through our borrowing in the form of bonds. However, if bonds, stocks, real estate and derivatives are outside of our definition of money, then this 18th century thinking makes sense. Sorry. In the real world a bond is still money.

Between 1986 and 2006, the national debt rose from about $2.1 trillion to $8.5 trillion. This took place not in printing money, but in bonds. In fact, we were forced to issue more debt just to pay the interest on debt. The interest payments for this 20 year period was $6.141 trillion. Had we printed the deficit between taxation and spending (excluding interest), that would have amounted to only $259 billion a far cry from the bailouts. If we are already committing billions if not beyond 1 trillion for rescue, we cannot afford to borrow on top of this.

The very idea that we borrow money rather than print it is somehow less inflationary is absurd and a throw-back to the Gold Standard when nature controlled the quantity of money. Spain borrowed heavily on the gold it expected from America. When its treasure ships didn't show up and it lost the Spanish Armada against England, the default destroyed the bankers in Venice and relegated both Spain and Italy to almost third world status. The Spanish Inquisition merely caused the jews to flee to Holland transferring banking to Northern Europe. We cannot afford the same mistakes. Borrowing is a ancient tradition when there was no other choice.

The Gold Standard & Cronic Shortage of Money

They say history is biased - for it is written by the victor. But we can also remember things of days long since past with rose-colored glasses. Some see gold as almost a religion - the savior that will deliver us from the evil of inflation. That is just not true. The boom-bust cycle existed in ancient times as well and always we find no matter what system is in place, there is someone who always spends too much.

The Gold Standard was a world that was not so simplistic. In ancient times, it provided the incentive for war - the best way to increase money supply. In fact, one of the reasons there are so many ancient coins that have survived is there was the practice of burying the payroll before battle so that the other side was denied the spoils of war.

The Gold Standard also meant that the way to create more money was through reducing the metal content - debasing the quality of the metal. Those who were looking to be dishonest had two options - (1) counterfeiting, or (2) clipping. Take a coin out of your pocket and you will see reeding on the edges of an American dime or quarter for example. This was an old anti-clipping device that was to prevent those who would shave a little off of every coin collecting a pile of scrap metal. This gave rise to banks issuing notes to at first guarantee the payment in the proper amount of precious metals of good currency meaning unclipped coinage.

However, the greatest problem with the Gold Standard was the inability to create money other than war, altering contents, or changing the ratio of silver to gold as the Silver Democrats tried in the late 1800s. The money supply was in the hands of nature and thus was subject to boom and bust cycles based also upon the discovery of metal. The California Gold Rush of 1849 contributed to the economic boom that led to the Panic of 1857.

The disadvantage of the Gold Standard was the inability to create a steady new supply of money to keep pace with the growth in population and economic

needs. Going back to the Gold Standard is not the answer to long-term economic growth nor would it solve the current economic crisis. In fact, it would create an economic contraction that would end flexibility to even deal with the problem.

This is separate and distinct insofar as gold providing a private source of wealth that remains a store of value. The reason gold emerged as money because it was a valued commodity and recognizable in all lands. They use gold for jewelry in India and China the same way they use it in Russia, Europe, or the Americas. It is a scarce commodity that there would not be enough of if every person in the world wanted just 1 ounce for themselves. Whether or not gold is the "official" monetary unit or the check against fiscal irresponsibility is of no importance. In the spirit of liberty, allowing gold to remain as the private store of wealth is far better. That was the very issue that Roosevelt sought to eliminate - the ability to hoard gold as a hedge against government. This is also why Roosevelt confiscated gold so he could devalue the dollar relative to gold thereby any such profit would default to the government - not the individual hoarding the gold.

All the problems with the Gold Standard emerged from the inability to create money when needed. Milton argued that the deficit spending advocated by Keynes would lead to only inflation rather than economic growth. Ineed, Keynes himself did not advocate perpetual deficit spending year after year. Once the government received his blessing, they just ran with the ball, but the goal-post was past decades ago. Looking at the Federal budget since 1936, the only years in which there was not a deficit were far and few between:

1947, 1948, 1949, 1951, 1956, 1957, 1960, 1969, 1998, 1999, 2000, 2001

During the 72 years between 1936 and 2008, there were only 11 years that produced a budget surplus. This is not a very good record for Keynesian economics. Once the concept of deficit spending was introduced by Keynes, it was seriously abused. But the problem was not so much the deficit, but the fact that at the same time there was the pretense of maintaining a Gold Standard at a fixed quantity of dollars to an ounce of gold while the supply of dollars was being increased and the gold supply was declining. This culminated in the first break with the two-tier Gold Standard whereas gold began to trade on the London exchanges freely, that was followed by the closing of the gold window in 1971 when there were more dollars than gold to redeem them. The reality of perpetual deficit spending under the Gold Standard came home with shocking force.

The Bottom Line

Arbitrary spending even on infrastructure will do nothing but create perceived inflation before it even hits the economy. The work programs of the Great Depression made sense only because there was a natural disaster in the form of the Dust Bowl that lasted 7 years. It is true that unemployment rose to 25%. However, it was only 8.9% in 1930 deep into the start of the Depression. It reached above 20% only when the Dust Bowl destroyed jobs given we were still 40% agrarian in our work force. Unemployment began to decline with the WPA, 1935 20.3%, 1936 16.9%, 1937 14.3%, 1938 19% and 1939 17.2%, but as you can see, we have a selected memory for what really worked and what did not. Unemployment in 1940 stood at 14.6% and at the end of World War II, it was 1.9%. It was not the WPA that changed the economy, it was the war. This has led to some claiming also selectively that war is good for the economy. We began the first peacetime draft in 1940 that was approved on September 14, 1940 but it was Pearl Harbor on December 7th, 1941 that officially started the war for Americans then declared war against Japan on December 8th followed by a declaration against Germany and Italy on December 11th, 1941.

The WPA was instituted May 6th, 1935. It provided a vital role in creating jobs not lost by the credit crisis in the financial markets, but by the Dust Bowl. The collapse of the Austrian Credit-Anstalt in May 1931, began a credit crisis contagion that swept the world creating a wave of business failures as we are seeing today with General Motors. Unemployment was the worst in Germany hitting 5.6 million in 1932 while Britain was 2.7 million. These were the conditions that not merely led to the election of Roosevelt in 1933, but Adolf Hitler also in 1933. From the September sanction of Germany in 1938 by Britain and France, it was but only about 3.141 years later to Pearl Harbor. The US had declared its neutrality in Europe on September 5th, 1939 when Germany invaded Poland. It was the war and not our participation that ended the depression, but we became the arms and food dealers for Europe. By the end of the war, the US stood with 76% of world gold reserves. That created American wealth - not policy or even peacetime trade.

Today, if we wage war, we spend our resources and the economy declines much as what took place in Europe. War is good for the economy, <u>only when you are the arms dealer, not the aggressor</u>. Today, the work force is nearly 150 million. If we subtract the agricultural sector from the Great Depression, unemployment hit at about 10%. Since 1995, the US unemployment rate is between 4%-6%. But this is also not a fair view of the economy. As of 2005, federal government civil employment is about 2.7 million. The military personnel is about 500,000 (Army), 54,000 (Navy), 353,000 (Air Force, and 20,000 (Marines) with about 41,000 (Coast Guard). This brings the federal government consumption of labor to about 3.7 million or about 2.4% of the civil work force. Outside the Great Depression, the worst bout of unemployment came in 1975 when it hit 8.5% and did not drop below 7% until 1987. The peak during the economic decline between 1980 and 1985 took place in 1985 at about 7.2%. We did see 7.5% for 1992 that led to a brief popular movement for Ross Perot and the victory of Bill Clinton in the Presidential elections. To reach 25% today, we would see sweeping political changes and massive political unrest. It would be impossible without the collapse of state and local governments since we see that agriculture accounts only for about 3% currently.

The US Gross Domestic Product ("GDP") is now about $15 trillion annually. If we assume the high side of a budget for one year will be $3 trillion, the total federal tax collected stands at about 17% of the GDP. If we spent that same amount of money on infrastructure, by the time that filters into the economy, the effect would be too-little-too-late. We would need another layer of oversight and costs to even administer such a project. If we simply eliminate the federal tax collection, that would be an immediate shot in the arm. But this too would fall short unless the people see this as a permanent reduction. Companies would not relocate for a mere one-off reduction. What we need is a three-punch solution.

We already know that interest rates and wholesale increases in the money supply will not be limited in scope to the domestic economy. Whatever we do to relieve the economic pressure (lower interest rates - or - increase spending), is more likely to cause foreign capital to flee. This will further contract the domestic money supply and would most likely prolong the economic depression.

We must consider what seems to be the most radical solution, but in 21st Century economics instead of 18th Century, it is far more targeted and practical. If we eliminate the federal income tax and stop the borrowing, we can jump start the economy and provide that boost to confidence that the permanent tax cut did in 1964 compared to the unsuccessful one-off tax cuts that went more to increase savings than spending.

We cannot lose sight of the fact that the federal government is now also competing for tax dollars against the states and cities who are now in trouble

and cannot create money as the federal government can do. Unless we now consider a 21st Century definition & solution, then the 18th Century theories will cover the speculative losses for investment banks, not Wall Street, and create only work programs for stock brokers and programmers to learn how to fix bridges and roads. That seems one way to lower skills opposite of the policy of the WPA in 1935.

I.) Eliminating Federal Income Tax

(1) Will signal a permanent and immediate change to the public restoring "confidence" in the future and will result in immediate economic relief.

(2) Will shift the tax to make domestic labor cheaper whereby corporations who move offshore would then be subject to tariffs and excise taxes but not on domestic labor depending upon what nation they moved to.

(3) Eliminate the competition with the states & local government that will only be petitioning for bailouts of their own, for as real estate prices decline, the tax base will implode creating a contraction in revenues forcing the states and local government to layoff workers.

(4) Eliminate the high costs of collecting taxes we do not need due to the evolution of what we define as money.

(5) Eliminate the cost and delay in creating a new administration to oversee some sort of program that would take years to actually produce any economic effect, whereas simply returning what was received in income taxes (not social security) is a clean way to jump-start the economy - immediately!

a.) To those who will argue Marx's philosophy that the rich will get more, well they also paid more, and it is the concentration of capital that creates the pool of funds that banks then lend that will eliminate the credit crunch. If someone has $1 billion in cash and he is now enticed to deposit it with a bank because we also will eliminate the $100,000 FDIC limitation that prevents big money from being lent out and merely insure all deposits because we install better regulation to prevent gaps with unprecedented leverage, then we should have no problem securing all deposits, that will suddenly attract capital from around the world as well. This will benefit the average wage earner and stop the Marxism that caused both Russia and China to see the light that we remain blind preferring to live in the dark.

II.) Eliminate the National Debt By Monetization

(1) FDR confiscated gold so he could devalue the dollar. This was limited to the times because we were still on a Gold Standard. By monetizing the debt, we would not create a dramatic change in inflation because in the real world, when we issue bonds, we may not define that as "money" in terms of M1, but in the practical perspective, we look at how much we owe and judge that as money issued regardless of what we call it.

(2) Between 1986 and 2006, the interest expenditures to keep the debt in place accounted for almost 72% of the increase in the debt. We are funding our mortgage with a Visa card.

(3) Those who believe that this would be inflationary are just misguided for the marketplace already sees the same amount of dollars held as assets in the form of bonds and replacing that same amount with dollars will save as we have seen 72% of the overall growth in debt that we could never repay in any event, and no government actually believes they will in fact pay off their debt for that would be a contraction of money supply unprecedented to date.

(A) Eliminating the Insurance Limitation at the FDIC

(1) There is no reason why we should not insure all deposits in commercial banks, for this would replace government debt and make vast sources of cash available for lending and would eliminate the credit crunch overnight.

(2) If we insure all commercial bank deposits, this will also attract foreign capital increasing the capital reserves for lending.

(3) Investment Banks should be excluded for they are higher risk and not part of the "real" commerical network with local branches that service the community. Those who wish to deal with such banks should also suffer the higher risk for higher yield

a.) There must be a single regulatory body with no gaps in the regulation where the greatest danger has historically been the leverage.

b.) There must be transparency and only openly regulated exchanges where counter-parties must have the asset to support the position, not mere reputation.

(B) Social Security Reform

(1) By eliminating the borrowing and taxation at the federal level considering the income tax (direct taxation), this will also automatically rehabilitate the Social Security program and make this into a real savings plan that would then invest the funds becoming a national wealth fund to also enable it to face the entitlements coming sooner than later where the public also have lost faith in ever seeing a real dollar.

(2) Once freed from the investment in government bonds, this fund can create tremendous economic progress for the future by even allocating 3% for venture capital in sizable new innovations that will greatly advance medicine, science, and technology.

III.) National Health-Care Program

(1) We need to establish a national health-care program for all that will relieve the coming crisis in pension funds of cities, states, federal government, and corporate America. The costs are so steep, even service jobs are leaving for a salaried employee costing $50,000, ends up costing on average $125,000 between taxes and health-care along with pension costs.

(2) We must face the facts, that the purpose of society is the cooperative efforts of society to seek lower costs and security, not much different why people were willing to be a serf so that when danger came, they got to run behind the wall of the castle.

(3) A national heath-care program is vital to our survival for the costs are rising so rapidly, corporates are passing those costs on to employees and the quality of life is collapsing.

(4) We must stop the nonsense, pass tort-reform, stop the crazy lawsuits, and the costs will come back in line to where they once were 20 years ago when small companies handed out health-care that covered the whole family of every worker. The lawyers will find another area to exploit, or perhaps they too have to tighten their belt for the good of the nation before we don't have one anymore.

(5) Eliminate trade barriers to cheaper drugs from Canada and force them back in line as well. This is our future we are talking about, we have seen what the investment bankers did to the economy with their outrageous leverage and unregulated shadow markets, let us not wait until hospitals close because people can no longer afford health-care.

(6) We need urgent attention for as unemployment rises, children will now die for the "greed" of this industry is destroying the very thing they claim to be protecting.

S U M M A T I O N

This three-punch solution is critical to our survival. We must respect that there are just sometimes in history that we have a choice to make a real effort to change the trend, or to bullshit our way around the facts only to postpone the reality. No one expects the national debt to ever be paid. We can continue to live in our 18th Century world and pretend that if we print the money it will be some how more inflationary than printing bonds and spending 72% more to keep them going when there is no plan to ever retire them anyway.

It is time to create a control burn before we explode from our own nonsense. It is not to late to save the day. But we have to start to make realistic plans and address the honest issues. The Investment Bankers have blown-up their world as they always do. They have never got it right even once! They create models that ignore the big events because they thought they don't happen that often. Well it happened and now they are begging to cover their losses. Healthcare and the wave of entitlements is going to hit shore like a tsunami. Are we going to just once plan for the future, or is democracy the worst kind of government because there is too much talk and no action?

Just for once, let use update our definition of what is money and we will see that printing dollars or bonds is really the same thing except bonds are the gift that we keep having to pay for generation after generation. End the stupid borrowing. We are not in Oz anymore. Gold is not money. Let us start understanding the modern world we live in today.

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