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What Can the Government Do?

Dominating headlines recently are various government efforts to “fix” our economic problems. Beginning early in 2008, we had the Bush stimulus package of approximately \$170 Billion. Add to this amount the various funding efforts for Government Sponsored Enterprises like Fannie Mae and Freddie Mac (\$200 Billion initially plus another \$200 Billion forthcoming).

In the fall of 2008, a massive government bailout program called “TARP” (Troubled Assets Relief Program) worth \$700 Billion was rushed through Congress under the guise that without it, our credit markets would remain frozen and economic collapse was nigh. Predictably, the automobile industry, witnessing the largesse extended to other parts of the economy, wanted their share of bailout money. Congress obliged with a \$20 Billion package.

The Obama stimulus plan has added \$787 Billion in government “rescue” funds. In addition, the administration announced a controversial \$75 Billion housing rescue plan. In the last year, well over \$2 Trillion has been committed to various rescue plans to “get the economy going again”. Will these programs help the economy?

To understand the answer to that question we need to understand what government is capable of doing. Let us start at the state and local level. State and local funding originates with taxes, Federal Government funds, and extensions of credit (bond issues). Unlike the Federal Government, they do not have the luxury of spending more than they have. When they do spend more than they have, they have to cut back on the services they provide, raise taxes, travel to Washington to ask for more funding, or all of the above. Presently, 46 of 50 states are experiencing budget shortfalls, implying those states may have to implement some of those measures.

The Federal Government’s funding primarily comes via taxes and tariffs. When they spend more than they have, funding comes from other sources. The Federal Government historically has the reputation as the best credit risk so investors (foreign and domestic) are willing to lend money through Treasury sales of Bonds, Notes, and Bills. Their investor base is even broader through a unique link to the Federal Reserve allowing Fed purchases of US Treasury debt. The Fed “lends” money to the US Treasury, in a manner described in Volume 1 Issue 1, by creating bookkeeping entries. The “money” from these bookkeeping entries emerges out of thin air. The Federal Government has capabilities that others do not. However, will these capabilities really help the economy?

Government and Market Role

Now that we have established what governments can do, let us explore what the public's capabilities are.

Economies are expressions of what people do. Participants in an economy act on their own behalf (what is best for them) in a manner that meets the satisfaction of others acting on *their* own behalf. The collective action of all of these participants is the Market. Therefore, the Market is a collection of many people acting on their own behalf for the benefit of others.

What is the government's relationship to the Market? The government exists to protect the market. Government protects the market by enacting laws or regulations along two main Principles:

1. Do unto others as they would do unto you - the basis of criminal law.
2. Do what you said you would do - the basis of contract law.

If you lived in a society where you had to worry about Principle #1 or Principle #2, it would be hard to have a market. There would be constant fear that someone was trying to inflict physical harm (Principle #1) or that you could not trust your market transactions with others (Principle #2). Government is responsible for creating an environment in which a market can operate safely.

We present our fourth economic law:

Economic Law #4: MARKETS ALLOW PEOPLE TO SATISFY THEMSELVES BY SATISFYING OTHERS

As one can imagine, the Market is in a continual state of change. The Market changes due to changes in judgment on the part of its individual participants. A snapshot of the Market at any point in time reveals the "price" or exchange rate for something. The "price" or exchange rate is simply an agreement between two parties - nothing more, nothing less. As Ludwig von Mises said in *Human Action*, "*The market process is entirely a resultant of human actions*". The two key words in the quote are "human actions". Human actions create the Market.

"Human actions create the Market."

Markets tell producers what to produce and in what quantities to produce them. Markets also tell consumers what to consume and in what quantities to consume them. What if the price of filet mignon were \$0.10 per pound? How would consumers react? Similarly imagine the price of filet going to \$1,000 per pound. How would consumers react then? In both cases, the Market dictates behavior.

In order for the government to protect the market, it has to be a participant in the market. This participation is truly government’s minimum role in the market economy. Government must insert themselves in the Market to buy raw materials, equipment, and labor. They are also part of the market when they sell their goods and services. Please understand this point. The Government, like anyone else, is a Market participant. The Government is not a supernatural or mystical being orbiting earth sprinkling magic dust on its inhabitants. Moreover, the Government is nothing more than the people allow it to be. The Government is the people.

The Government, as we know it, has expanded well beyond merely protecting the market. Because of expansion over time, it is now a larger market participant. Recent government stimulus programs attempt to grow its participation further. While some contend that government’s increased participation speaks of socialism, the Austrian economist Von Mises argued in *Human Action*, that an economy is either socialist or capitalist. If the economy is socialist, then government plans everything. If the economy is capitalist, then the Market dictates what happens. As large as government has become, it remains a minority player in comparison the rest of the economy.

The chart below (Figure 1) compares Government expenditures to the size of the Market (Gross Domestic Product or GDP). The smaller bar represents Government expenditures while the larger one represents GDP. For the 20 years of data represented, Government expenditures have averaged 21% of GDP.

For comparison, at the stock market top of 1929 the percentage was 2.5%. At the other extreme, the percentage was 31% at the end of World War II.

So while government expenditures during peacetime have grown massively since 1929, they are still small compared to the rest of the market economy of the US. Since the economy is not a planned, socialist economy, the Market judges Government action as it would any other participant. Consider this point carefully; the Government IS NOT the Market but simply part of it.

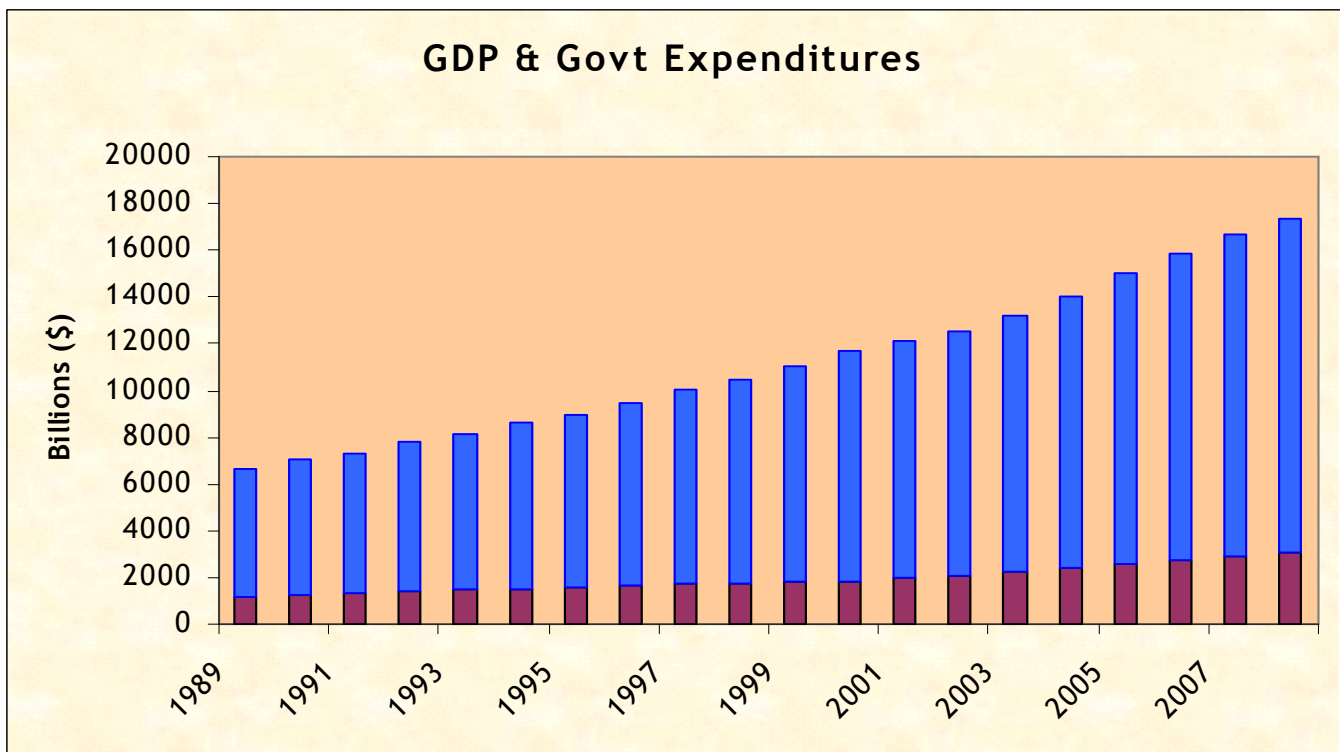


Figure 1

Government in The Market

As noted earlier, the Government is the people. The people are the Market. The Government is in the Market like anyone else albeit now by spending \$3 Trillion in 2008. Therefore, the Government cannot divorce itself from the effects of the Market. It is **NOT** separate from the Market since it is **IN** the Market. This is an important point to understand.

When a government bureaucrat or elected leader comes on TV and announces a bold plan for rescuing some institution or another, it is **NOT** without consequence. The consequences WILL be felt. *There is no magic dust Government can sprinkle on a problem to make it disappear.* Presently we have a government allocating unprecedented amounts of magic dust to “fix” these problems. The public has not recognized the magic dust effect. They clamor for more. Upon announcing the first bailout and stimulus plans, it became a stampede for Washington.

The recent home rescue plan is a perfect example. After announcing a \$75 Billion rescue plan to stave off foreclosures, a segment of the population wanted to know where their rescue plan was. While some criticized the plan on the merits of the Market, others wondered about their exclusion. The magic dust hit Main Street.

Is the government the most cost-efficient participant in the Market? Before you answer that question, ask yourself this question. Can a Market participant who believes it can raise all the money it wants (meaning spend all the money it wants) be the most cost-efficient?

To summarize, we have a Government that:

- a) Is an active Market participant
- b) Currently spends 21% relative to all Market activity (and soon much more)
- c) Has no spending discipline
- d) Does not consider its participation in the Market (magic dust effect)

Government vs. The Market

Two large forces will work against the Government. The first is the Government's actions versus the size of the overall Market. The second is the effect of massive deflation versus Government spending action.

The Government will need to borrow close to \$2.5 Trillion dollars in the current fiscal year to fund all of the bailout and rescue programs and the normal budget deficit. Where does one find \$2.5 Trillion? Recently an estimate of the entire world's net free savings was calculated - the figure was less than \$2.5 Trillion.

Therefore, it appears the Government will have to ask other countries for help. Where was Secretary of State Hillary Clinton's first trip overseas? It was to China. This is no coincidence. The Chinese are going to be the greatest source of funding for the borrowing. Unfortunately, for the United States when one goes overseas with hand extended for money, the other party wants something in return. The return will be economic assurances that the US get its house in order since it is unlikely the Chinese could continue to fund borrowing like this again next year. Additionally there will no doubt be political concessions. The Chinese are also part of the Market, in this case, the world Market.

In the event help from overseas is insufficient, the Government must rely on the Federal Reserve to conduct its moneymaking operation. The Market will not particularly care for this since it knows such moneymaking is nothing but pure inflation. Inflationary recognition spells doom for existing holders of US Treasury Bonds and Notes since they will lose confidence in a borrower relying on money making to fund itself. When confidence is lost, the fear of default (non-payment) increases and the public wants to dump the Bonds and Notes. Alternately, the public may want to hold Bonds and Notes but at a much higher interest rate payment meaning greater costs for financing.

The Government does **NOT** make the Market rules. The Market WILL tell the Government how to play by the rules

Government vs. The Market

The recent stimulus plan focuses on public works, expenditure on public enterprises (infrastructure repairs, mass transit, build/repair federal buildings, energy projects etc.) and aid to the poor and unemployed. The efforts are not wrongheaded since our infrastructure does need repair and other projects in the plan may be worthwhile. The Market effects, however, are profound.

- I. In order to run all of these projects, government must increase in size. An institution capable of raising nearly unlimited funding is inefficient by default. Inefficiency compounds by government size increases. The Market tends to punish inefficient players. Tolerance of inefficiencies is not a perpetual condition.
- II. The Government, being part of the Market, made the decision NOT to embark on these projects before. Was it wrong to withhold these projects in the past? What makes it correct now? If the projects were undesirable before, the Market must not have needed them. Proposing unwanted projects to the Market does not bring equivalent value to the Market.
- III. Government spending means funding that might have gone for other projects the Market wanted, instead move towards projects deemed worthy by bureaucrats.

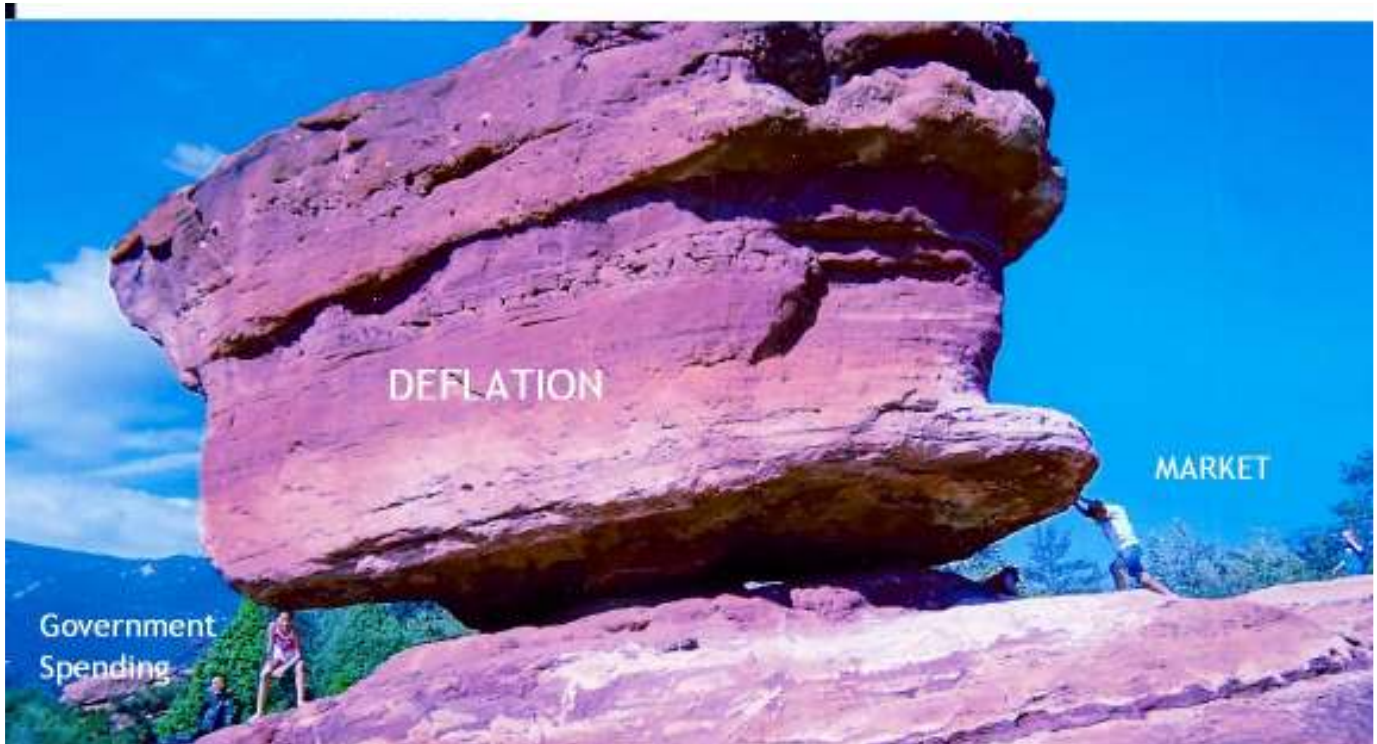
Is Economic Law #4 in effect in the above points? Did market participants satisfy themselves in order to satisfy others? If the clock is turned back to 2007 (at the height of the stock market), how would the Market (American people) react to spending such money? The reaction is unlikely to be favorable.

There is a psychological component at work. Our leaders perceive the cost of inaction to be higher than the cost of all these plans. The cost of all these plans will be felt immediately and in the future. Despite all of this new spending, the Government portion relative to GDP will be small. A proportionately small amount of spending cannot adequately move an entire Market. In this case, it is spending not requested by the Market.

In the battle waged between the Government and the Market, the Government is like any other participant, albeit a very large one. If the Government were a large company, it is unlikely that it could borrow the sums of money it has in the past. It would be impossible to borrow what is required now after massive spending for stimulus packages and various bailouts and rescue efforts. The Market judges Government expenditures just like any other market participant.

The ONLY difference between Government and others in the Market is public confidence. Without this confidence, the thought of proposing such spending would be laughable. When banks or the automakers ran into trouble last fall, did they approach the Market for loans or did they float new stock issues? No, they approached the Government who now must approach the Market asking for money. Consider that banks and automakers (and others) are using the Government as a proxy to raise money for them. The Market made no move, nor did those entities consider approaching the Market for money. The Sentinel's Economic Law #1 says CREDIT = CONFIDENCE. The Government will experience serious problems when this confidence wanes.

“The ONLY difference between Government and others in the Market is public confidence.”



Government vs. Deflation

The illustration above serves as a metaphor for government spending in the face of deflation. Deflation is a reduction in the amount of outstanding credit. The Sentinel's second Economic Law says "DEFLATION IS A LACK OF CONFIDENCE". Government spending faces an unprecedented task holding up that rock of deflation that is about to crush it.

The Market has become extremely reliant on credit. The inaugural issue of this publication demonstrated how most of what we consider money today is really credit. Credit requires repayment of the original loan plus interest. Additional credit creates interest due. Additionally, companies, individuals and governments often require new credit in order to satisfy old credit. Think of it like refinancing a home loan. When financing a home loan, a new loan pays off the old one.

Credit grows so fast that if plotted on a graph (Figure 2) it looks like a hockey stick. The hockey stick pattern is exponential growth.

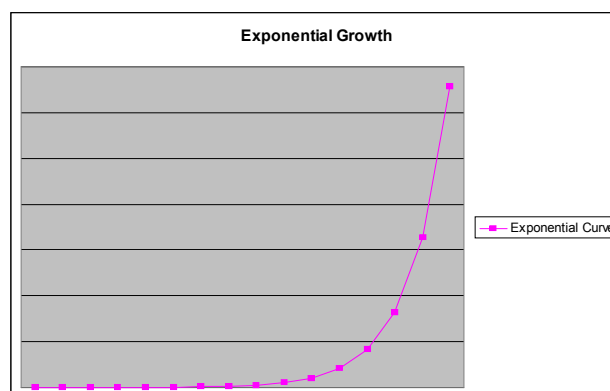


Figure 2

Can credit continue to grow in a hockey stick pattern? It looks like the curve is going straight up in the air. Mathematically speaking, the curve can continue to grow like a hockey stick. Unfortunately, human emotions do not always fit precise mathematical models. The brain's rational pre-frontal cortex may tell a person this credit pattern is sustainable but their limbic or emotional brain starts the fear process which diminishes confidence. The mountain of debt created in the credit expansion must still be paid. The realization of this condition is a catalyst for the deflationary process.

What starts deflation is the opposite of what started inflation - confidence. Confidence was high during the inflation and now is weakening. Let's examine data indicating diminishing confidence. Two charts capture diminishing confidence. Figure 3 is a plot of bank credit of commercial banks. After a sharp increase in the 3rd and 4th quarter of 2008, bank credit has shrunk noticeably. The reduction in bank credit is deflationary.

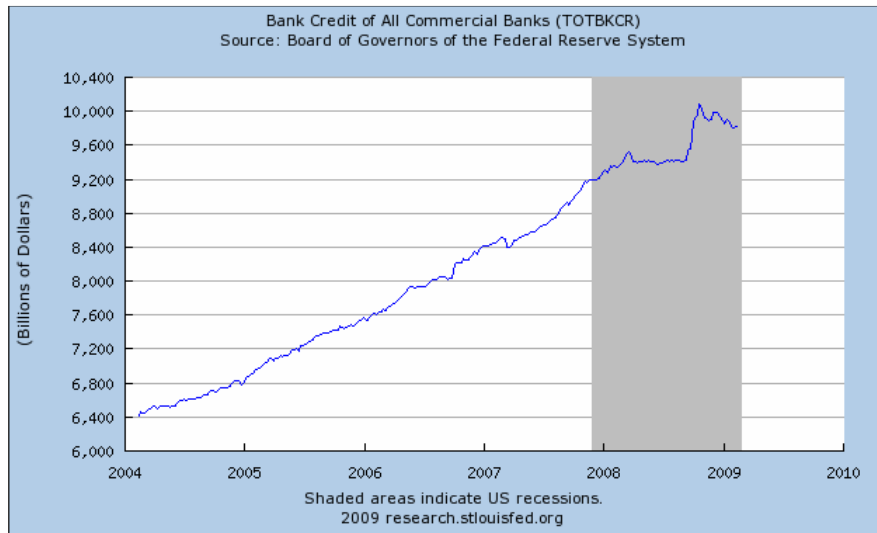


Figure 3

Figure 4 illustrates the deflation in US real estate that has declined on average 30%. If the average decline per home is multiplied by the total number of homes, the loss is a stunning \$8 Trillion! This decline is deflation on a grand scale.

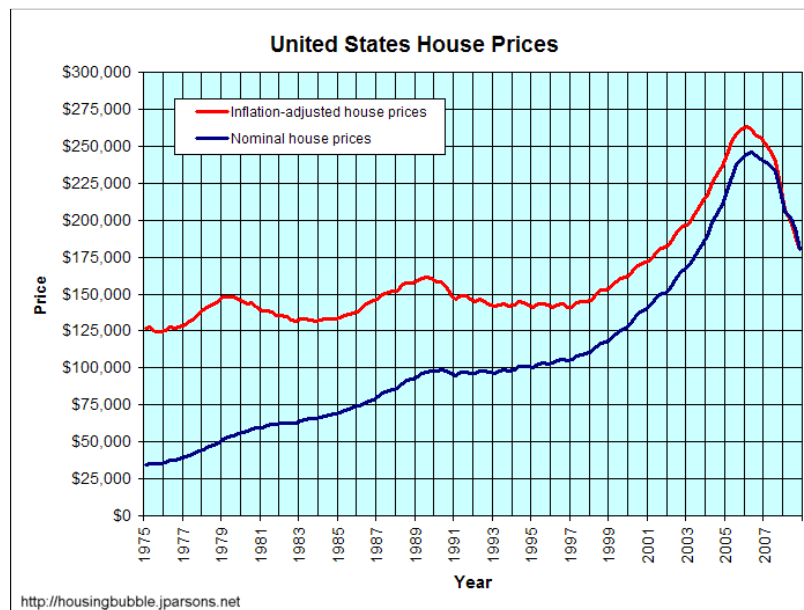


Figure 4

Considering stock market losses of \$7 Trillion, collectively individuals have lost a staggering \$15 Trillion in these categories. Stock market and real estate losses make individuals appear less wealthy on balance sheets. The paper wealth financing is no longer possible. Bankruptcy increases, foreclosures and other asset sales make for poorer credit risks. As such, lenders (banks) cannot approach credit creation as they did in the past. The banks' earlier loans are now placing a great burden on their balance sheets.

Another aspect of credit deflation is the consideration by banks to rescind up to \$2 Trillion in credit card lines - roughly half of the outstanding amount!

Need more signs of deflation? When a loan of credit money is paid, there is a reduction in the amount of outstanding credit. As more people and businesses repay loans, the credit in the economy contracts further. Complementary to this action is an increase in savings on the part of individuals. The savings rate, which had plummeted since the bear market low of 1982 and had gone negative in 2005-2006, has spiked sharply in the last few months (Figure 5).

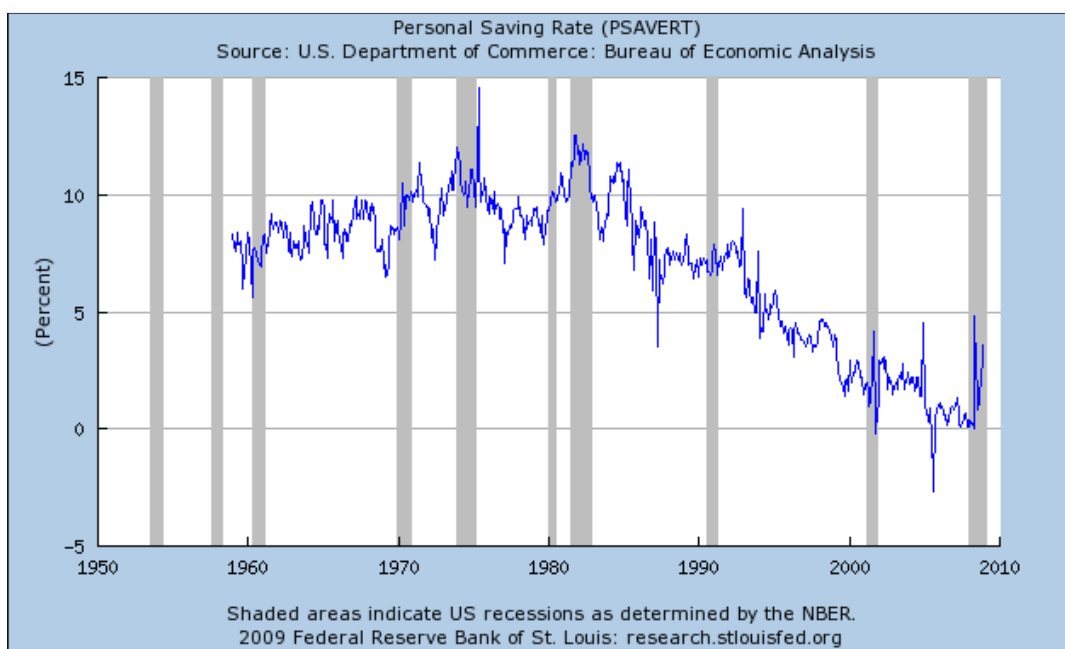


Figure 5

Presently there is \$52 Trillion in outstanding US credit market debt. Consider that debt the foundation from which more deflation can occur. That foundation is several times larger than the rock in the illustration earlier in this section.

The Government is attempting to fight deflation by creating \$2+ Trillion in spending. At least \$15 Trillion has already deflated in just the stock and real estate markets. Add to this amount the other deflationary forces at work. Can \$2+ Trillion of spending overcome all of the deflation that has and will occur? Not a chance. Government is going all out with borrowing and spending to replace the borrowing the public is unwilling to do. After an administration of a credit appetite suppressant, the public will not return to the banquet table anytime soon.

While we may have more roads, bridges, public transportation, and shiny new federal buildings after the stimulus, it will NOT address the underlying cause of the deflation and will not cause people or businesses to start spending again. A future issue discusses how to accumulate wealth and it is not by spending.

Summary

The Government, in betting terms, is now “all in”. They have encouraged the Federal Reserve to lower interest rates to near nothing. They have provided rescue funds for banks, insurance companies, auto manufacturers, and homeowners. They have taken equity positions (stock ownership) in banks. They have passed two domestic stimulus bills totaling in the neighborhood of \$1 Trillion dollars. The Federal Deposit Insurance Corporation (FDIC) has temporarily raised the insurance on bank accounts to \$250,000.

The ideal role for Government is to defend the market by establishing laws or regulations protecting the basis of contract and criminal law. Government expenditures were 2.5% compared to US GDP at the stock market top of 1929. They are now much larger. Yet despite this larger size, Government is a participant in the Market (collective action of participants) just like any other individual or business. The Market in which the Government plays is not just in the US. Foreign participants are part of the Market as well. The Market judges Government like any other enterprise. The Market will punish poor Government decisions.

Government is in a desperate race to fight the deflation occurring in the economy. The force of deflation is coming from all sides. Businesses, consumers, and banks have assumed a more defensive posture concerning the creation of more credit - they want less. The Government desperately wants the aforementioned to spend. Consumers have little savings so the spending cannot originate there. Businesses are in a state of contraction and bloated inventories, so the spending cannot originate there. Banks have faced their own poor investment decisions and loan defaults so their lending is more cautious. If these groups are unwilling (less confident), they cannot be made to participate in credit creation. Government is not capable of making people borrow or making banks lend. In a credit economy when people do not borrow and banks do not lend, credit expansion halts. When loans are paid and loan defaults increase, that is a contraction of the amount of outstanding credit. Contraction of credit equals deflation.

The Government is attempting to replace the spending/lending not occurring by the three groups mentioned. Unfortunately, the Deflation Rock in the earlier illustration will crush government spending attempts. There is simply too much deflation occurring for Government to counteract it.

Government is not a separate entity outside of the Market. It is in the Market and now is “all in”. What remains is how the Market will judge the actions of the Government. This publication firmly believes the Market will judge Government actions harshly. The next issue explores some of the implications of the Market’s harsh judgment.

The Government has placed nearly all their chips in this game on the side of inflation. The Market has their chips on the side of deflation. The dealer is spinning the roulette wheel. The fans nervously await the outcome.

The Sentinel

“The Market will punish poor Government decisions.”
