



Economic Data
A Report Card on Our Economic Policies

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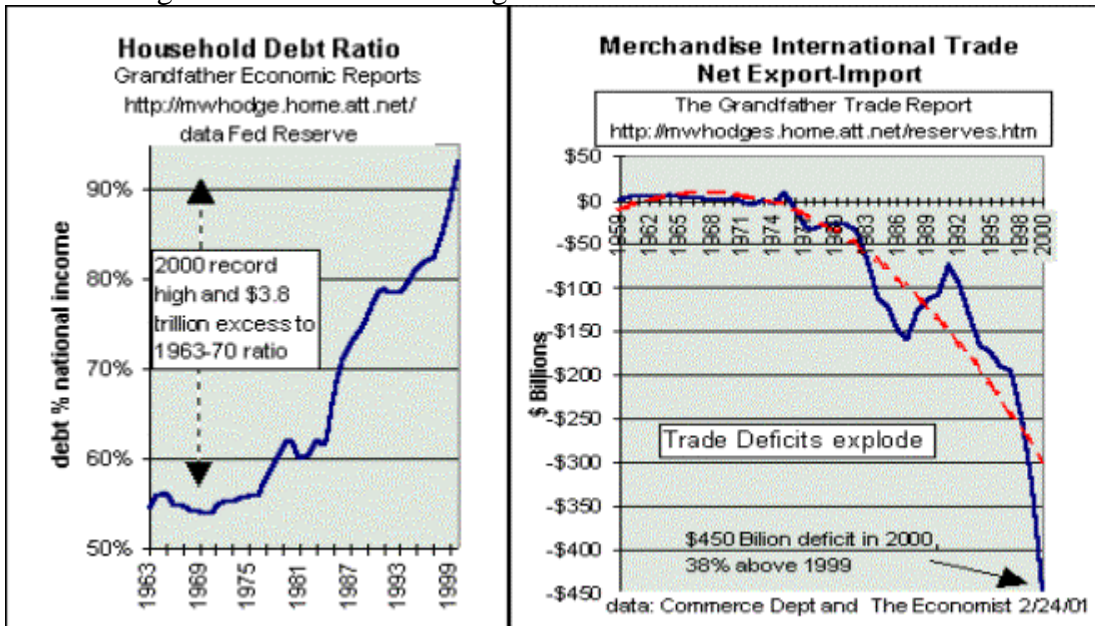
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Current economic trends are worrisome. This article will highlight some of the most important economic data and point out critical trends. Conclusions will be presented at the end of the article.

(As a veteran economic forecaster, I must caution you against reliance upon ANY forecast of the future, positive or negative. The data that we use to forecast the future is by its nature, history. Happily, the future is full of surprises. Regardless of one's expertise, objectivity or wisdom, most major events cannot be foreseen.)

Key Economic Trends & Concerns

- 1) Increasingly, U.S. citizens have gone deeper into debt to pay a standard of living that we are not earning—
- 2) Increasingly, Americans are purchasing more from abroad than we sell –
- 3) Increasingly, the federal government relies on foreign loans to finance our deficit spending (again, to maintain a standard of living that we are not earning) -
- 4) Increasingly, Americans spend, rather than save, a higher percentage of our incomes -
- 5) Our trading partners are either unable or unwilling to become a source of demand for the goods and services produced in the U.S. –
- 6) Over the past year many of the largest U.S. based corporations have reported either declining earnings or substantial losses -
- 7) Over the past 5 years, the taxes on capital gains having been a growing percentage of the revenues and budgets for states and federal government.



Many, maybe even most, Americans believe that over the past 5 or 6 six years, America has balanced its budget and even reduced its debt. Nothing could be further from the truth!

- In the 1980s debt increased by \$9.5 trillion while national income increased by \$2.4 trillion or, 2.1 times more debt per dollar of added national income.
- In the 1990s debt increased by \$15.4 trillion (or 52% of all \$30 trillion debt now outstanding) while national income increased \$3 trillion or, 5.1 times more dollars of debt per dollar of national income. In the 1990s, the rate of debt accumulation grew 143% more rapidly than we experienced in the prior decade.

In its August 2001 annual assessment, the International Monetary Fund (IMF) said "the yawning current account deficit raised the risk of a sharp depreciation in the U.S. currency." On 25 July 2001 former Federal Reserve Chairman *Paul Volcker* told the Senate Banking Committee hearing on risks of growing balance of payment deficit, "We are a debtor nation with nil personal savings and are absorbing a significant portion of other countries savings. These huge and growing external deficits are symptoms of imbalances in the national economy and the world economy that cannot be sustained."

Corporate Earnings, Tax Revenues & Federal & State Spending Deficits

At present, foreign investors believe that the US dollar will remain strong, US corporations will enjoy growing productivity and higher profitability, and the federal budget is well planned and sustainable. It only makes sense that they should invest in our stock market and buy the bonds to finance the US government deficit. However, these perceptions seem to be changing rather rapidly.

The primary key to keeping the U.S. dollar strong, which has been a great force in bolstering both the rising prices of U.S. stocks and allowing our Federal government to finance its growing debt, has been the myth that U.S. corporations are and will continue to be strong and profitable. The arithmetic of calculating the debt to equity ratio of a business is very simple. It is equally simple to aggregate these numbers for all businesses to determine the trends in equity buildup versus debt buildup. Here, is the crux of the matter: While it is clear the past decade has been one of greatly expanded incomes and consumption for many, it is equally clear that the creation of debt has far outweighed the creation of wealth, by businesses, consumers, the states and federal government!

Corporations now have tax loss carry forwards mounting in the 100's of billions of dollars. Tax revenues on corporate incomes will likely remain anemic for several years to come.

Politicians, both democrats and republicans, have persuaded the media to write countless articles on how much progress these politicians have made and how reformed they are in their spending habits. Let us look at the evidence.

In the past 8 years, what the US Treasury Department reports as "Federal Debt" has grown by 39.5%. In addition to what our government calls "Federal Debt", we have many additional types of off-balance sheet debt – that is, the US taxpayers have additional trillions in liabilities and potential liabilities that are not counted in the widely acknowledged debt. Space will not permit me to list all the US taxpayer's obligations which are not enumerated in the official federal debt numbers. I will list just a few: liabilities to future Social Security beneficiaries, the un-funded federal employees retirement obligations, obligations to cover losses in private pensions, and obligations to cover losses in the small business administration. In the 1990s congress greatly expanded the lending of such organizations as Fannie Mae and other consumer lending organizations.

U.S. taxpayers are now obliged to pay for consumer defaults on mortgages and students loans, far in excess of \$1 trillion dollars.

This is considered a prudent use of tax dollars by some, in fact, it is not. However, and this is key: The debt that we have incurred in the past decade **MUST** be paid by future generations of workers, and that debt level continues to grow. See chart below:

| | |
|------------|------------------------|
| 09/29/2000 | \$5,674,178,209,886.86 |
| 09/30/1999 | \$5,656,270,901,615.43 |
| 09/30/1998 | \$5,526,193,008,897.62 |
| 09/30/1997 | \$5,413,146,011,397.34 |
| 09/30/1996 | \$5,224,810,939,135.73 |
| 09/29/1995 | \$4,973,982,900,709.39 |
| 09/30/1994 | \$4,692,749,910,013.32 |
| 09/30/1993 | \$4,411,488,883,139.38 |
| 09/30/1992 | \$4,064,620,655,521.66 |

American and foreign investors have been snookered into thinking that the spending habits of US politicians have been reformed. The above numbers are taken from the official US Treasury website: <http://www.publicdebt.treas.gov/opd/opdpenny.htm>

The Most Blatant Example of Unmitigated Gall of Politicians

On September 5, 2001, Dallas Federal Reserve System president, Robert McTeer, met with the editors and writers of the Dallas Morning News. His tone has markedly changed over the last year. He still touts the Wall Street myth of the New Economy, but he has "been humbled a little bit." McTeer continues to ask consumers to pull the economy out the current slowdown. Now, instead of buying an SUV, McTeer is asking customers to "use their cell phones more and upgrade" to help out the beleaguered telecom sector. A couple of months ago McTeer asked everyone to "hold hands and buy an SUV". The most notable quote from McTeer follows; *"They've [consumers] been doing something that's probably irrational from the point of view of the individual consumer because they all need to be saving more: saving for retirement, saving for college and all that. But we'd be in bad trouble if they started doing that rational thing all of a sudden. We're happy that they're spending. We wish that they didn't have to run up a lot of debt to do it. But it's not something we're terribly worried about right now because their assets are high."* Also notable, McTeer expects unemployment will rise above 5%, even if the economy starts picking up. (Source: www.prudentbear.com)

Businesses operate with simple, easy to understand and hard to execute rules. A cardinal rule for business is to expand a business needs a greater sales volume or higher prices for the goods it sells. A second rule for business is if you don't have increasing sales or you cannot raise prices, the only way to increase profits (which is what every business is all about) is to cut expenses. It is simple.

The above chart measures the U.S. merchandise trade balance each year since 1959. It shows that the USA had run a surplus with our foreign trading partners, meaning we sold enough goods to other nations to pay for what we purchased from them. We are now running massive deficits. If a country runs a trade deficit it means that the country is borrowing from the rest of the world so that it can spend in excess of the gains from its own production. This means the USA is less

competitive than before. NOTE: The U.S. is setting record negative trade balances each year. Since 1992, deficits have exploded.

As a result, our manufacturing base declined from 30% of GDP in 1953 (when we had a trade surplus) to 16% in 1999--and much of the smaller balance is foreign-owned. The majority of our trade deficit in 1999 was created by importing \$271 billion more than we exported in manufacturing goods --add zooming oil imports to that and you have the cause of our trade deficit.

This chart shows year 2000 performance was a \$450 billion trade deficit - - the largest negative trade balance in history. Adding up the negative US performance for the years shown totals \$2.6 trillion. Stating this simply - our children owe foreigners \$2.6 trillion of their future national income, because their parents and grandparents consumed resources in excess of what they produced themselves.

China for the first time surpassed Japan as the country with the largest trade gap with the United States. America's deficit with China surged 22 percent to a record \$83.8 billion, followed closely by the deficit with Japan, which rose 10.8 percent to a record \$81.3 billion. America's deficit with the 15-nation European Union rose 29 percent to \$55.5 billion. These nations may benefit from trade barriers against U.S. goods, unfortunately the U.S. is blocked in most cases from taking corrective action without first gaining approval from the World Trade Organization - meaning the U.S. may have placed more of its trade destiny in the hands of others, than ever before.

The 2000 trade deficit was 39% above our trade deficit of 1999, which was 31% above 1998, which was 25% above 1997. This vividly shows how America is living beyond its means - it consumes more goods made by others than it produces - resulting in exploding debts in favor of foreigners, in addition to record high domestic debt ratios of household, business and the domestic financial sectors.

As can be seen in the pattern since the mid 1970's - America's has used increasingly higher levels of overall debt. This indicates the U.S. has become less competitive, despite claims of recent improved productivity (mostly realized only by a narrow part of the economy and primarily by revising how they measure productivity and inflation).

How can the US government claim that we have an increasing level of worker productivity when at the same time our competitive position in the world is in retreat? The US cannot claim to be both increasingly "productive" and show ever expanding trade deficits and debt encumbrances. The cause of the so-called 'economic boom' of the 1990's was caused primarily by debt, both internal and foreign - which cannot forever resist the law of gravity.

Moody's Investors Service said Friday that it has downgraded almost half of all bonds that were in the lower half of its junk-bond rating system at the end of last year. The default rate is also soaring. It recently reached 8.3 percent, and is expected to rise above 10 percent in the first quarter of next year, according to Moody's.

Examine August auto sales: GM: -7.6%; Chrysler: -24%; Ford: -8.4%; Toyota: +7.2%; Lexus: +12.2%; Honda: -0.4%; Acura: +23.7%, second best month ever; Hyundai: +46%; Volkswagen:

+13%, best August since 1978; Audi: +1.8%; Mazda: +1.3%; Mitsubishi: +2.8%, best August ever; Kia: 41%, best sales month ever; Mercedes-Benz: +0.8%, best August ever; Porsche: -6%, Expect 10% for the year; Jaguar: +5%; Saab: 12%, best August since 1987; Volvo: +18.6, best August ever. This trend cannot continue.

FHA loan delinquencies rose again in the second quarter to another record. Delinquencies rose 79 basis points to 10.79% from the first quarter. Other loans are also recording higher delinquencies. Loans backed by the Veteran's Administration rose 41 basis points to 7.63%, while the total pool of home loans in the country rose 26 basis points to 4.63%.

The Conference Board announced that July's Help-Wanted Advertising Index was flat with June's reading of 58. Last July the reading was 82. The weakness is widespread according to Ken Goldstein, economist with the Conference Board, "All major areas of the country, most of them with distinctly different industrial demographics, appear to be reacting in lock-step to changes in the macro-economy. This is not a typical recession pattern and suggests the profit squeeze is hitting every sector in the economy." Goldstein is not overly optimistic on the near-term, "it might not get much better real soon, but it's probably not going to get much worse." Not much worse, probably! Opinions are often colored by hopes but this one surely is based on nothing but hope.

Conclusions

- 1) To avoid rising state and federal budget deficits, Americans must continue to supply our state and federal governments and their various agencies with the growing supply of funds that they demand. The sources of these funds are taxes and loans. It seems clear that, given the contracting economy, both sources of these funds will become scarcer.
- 2) If this is so, interest rates, for all maturities, will rise.
- 3) If this is so, the sources of funding government will become scarcer still.
- 4) At present, the imbalance between the quantity of goods and services that we must produce to maintain the current levels of economic activity and the quantity for their demand, is very much out of balance,
- 5) Current domestic demand and more particularly foreign demand for US produced goods and services is contracting. Consumer demand will likely fall further and the numbers of personal and business bankruptcies and unemployed people in the US will swell further.
- 6) Additional economic contraction will set in motion a significant chain of events that, in sum, will force further, perhaps very significant economic contraction.
- 7) If the imbalance between supply and demand is not remedied (soon) by new sources of demand, many Americans will face very significant challenges.

Our businesses have been on a debt spree as well. The overall credit rating of America's leading corporations has deteriorated markedly.

International securities brokerage firms have built very elaborate mechanisms to profit from the growing trend to finance one's standard of living with debt. Brokerage firms exist to find willing lenders. If they had any propensity to be conservative in their lending practices, they would be replaced by the more aggressive sales types.

Lessons from the Past

1) In 1928, finding an economist who was concerned about the economy was nearly impossible. The newspaper headlines were full of optimism. (I encourage students to read some of the leading US newspapers in the 1920's. The microfilm sections of major libraries will afford this opportunity.)

2) What economist foresaw (while in the middle of the great depression in the 1930's) that a world war would not only pull us out of the worldwide depression, but actually provide the growing demand that lead to vastly more prosperous western-world economies.

3) In particular, who amongst the legions of economists foresaw Japan, after being devastated during the war, rising to become the second ranking economy in the world, less than 25 years?

Until the mid-1980's Japan's economy was growing nearly twice as fast as ours. Sometimes storm clouds result in brief sun showers and other times they result in life threatening tornadoes. America's economy, today more than ever, is very closely linked to economic changes in interest rates, energy costs or terms of foreign trade, variables outside of the control of politics. Remember, two very important facts: 1) we can never predict the behaviors of foreign countries, and 2) after observing economic changes, determining their meaning and importance may be equally difficult. There is just so much economic data. And we are yet to know just how the human beings, as a group, may react to major crises. All economic activity, in a free economy, is the result of consumers and producers making many types of choices. We really can't know what we will have until we're faced with it. That said, we must try to identify some of the major trends that may bring the greatest forces on tomorrow's business climate.

In the middle of April 1999, before the market peaked, the top 36 Internet stocks had a market capitalization equal to the entire Japanese market, some \$2.8 trillion. In the 1980's, Japanese economists suggested that the land under the Imperial Palace in Tokyo had an equivalent value to all the land in California. Economics professors and "professional" investors were equally taken in by this non-sense.

The guardians of the US financial system, politicians, sound like the structural engineer who when asked to determine the safety of a building replies; "I can only clarify how safe a building is after a building collapses". While acknowledging that bubbles that burst were "scarcely benign" Greenspan claimed that they "need not be catastrophic" and pointed to the example of Japan where the bursting of the financial bubble a decade ago "did not lead immediately to sharp contractions in output or a significant rise in unemployment". That is not at all encouraging, is it?

Since the collapse of the Japanese financial bubble, their economy has stagnated terribly, despite implementing the largest government spending programs, relative to GDP, in the industrialized world. The US may suffer a similar outcome. If so, being the largest consumer market in the world, we might drag down all of our trading partners along with us.

I repeat, I must caution you against relying on ANY forecast of the future, positive or negative. The data that we use to forecast the future is by its nature, history. Happily, the future is full of surprises. Regardless of one's expertise, objectivity or wisdom, most major events cannot be foreseen. This is my report card on our nation's economy today.

America became the leading industrial power in the world largely because we provided the greatest individual liberty and a system of rewarding the most productive members of society. Not so today. Much of our growing lack of productive competitiveness stems from carrying the weight of onerous government taxation and regulation by government bureaucracies that force businesses into less competitive positions in international trade. (How and why government has grown so large is beyond the scope of this article. However, I cannot resist stating that when capitalists reward workers with greater equity, they are less likely to demand government-based solutions.)