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RESEARCH REPORTS

AIER publishes over 100 articles per month that are distributed in digital form. Research Reports contains Business Conditions Monthly plus 10 of the most representative, chosen here for popularity, variety, and relevance. These articles are often reprinted in venues around the web, including *Seeking Alpha*, *Intellectual Takeout*, *Mises Brasil*, and dozens of other outlets. To read all of them, go to

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BUSINESS CONDITIONS MONTHLY

Peter C. Earle
RESEARCH FACULTY

The AIER Leading Indicator remained essentially neutral in February 2023, maintaining the level of 58 from the previous month. Our Roughly Coincident Indicator rose from 50 to 92 in February 2023, with the Lagging Indicator falling from 50 to 33.

Over the past year, the Leading Indicator has declined from generally neutral levels to a preponderance of contractionary indications (below 50) between July and December 2022. This coincides with a US economic landscape characterized by the highest inflation in two generations, a historically aggressive monetary policy response, and a brief recession followed by a tepid recovery. In January and February 2023, the index again rose above 50, but only marginally. The current reading is best characterized as a return to the generally neutral levels that prevailed between August 2021 and June 2022 (with a slight spike to 63 in January 2022).

While the Roughly Coincident Index rose from a neutral 50 in January 2023 to a broadly expansive level of 92 in February, clarification is required. Of its six constituents, five were positive, indicating a broad positive trend. But among those five, four increased by less than .20% above the neutral range from January to February 2023. Thus while constituting an expansion per the rules of the diffusion index's construction, the actual economic significance of those increases is likely less remarkable than the consequent index number (92) suggests. The Roughly Coincident Indicator has, over the last year, oscillated between moderately and broadly expansive readings with the exception of a January 2023 dip to the neutral (50) level.

The Lagging Indicators continued a downward trend which began in January 2023. After spending ten of the last twelve months at a level of 83 with a slight decline to 67 in September 2022, the new year has seen the constituents of the index fall first to a neutral 50, and now to 33. Here too, as in the case of the coincident readings, two of the four components registered changes only marginally below the neutral threshold but constituting an overall downtrend nevertheless.

In all, ten of the twenty-four measures composing the three indices within the Business Conditions Monthly for February 2023 showed month-to-month changes one half of one percent outside the neutral range. This is likely a continuation of the "churn" that resulted in the overwhelmingly neutral Leading (58), Coincident (50), and Lagging (50) readings last month. While the Roughly Coincident indicator suggests a broad uptrend, the actual quantitative internals of that component considered in light of the Leading and Lagging Indicators as well as the backdrop of continued economic uncertainty suggest continued neutrality in the broad economic outlook.

Leading Indicators (58)

Three economic indicators registered significant moves among the leading indicators in February. US heavy truck sales fell by over 10 percent month-to-month, bringing the decline in that index from the start of 2023 to 11 percent. On the upside, private new housing starts rose by over 9 percent and the 1-to-10 year US Treasury yield spread tightened by 5 percent, albeit within the context of a steeply inverted US Treasury yield curve. Among the twelve constituents of the Leading Indicator Index seven rose and five declined between January and February 2023. In addition to private new housing starts and the 1-to-10 year US Treasury yield spread, the University of Michigan Consumer Expectations Index, the inventory/sales ratio, the three Confidence Board indices (the Leading Index of Stock Prices, the Leading Index of Manufacturers New Orders, and the Manufacturers of New Orders of Nondefense Capital Goods, etc.) all rose in February 2023. Falling in addition to US heavy truck unit sales were initial jobless claims, US

average weekly hours worked (all employees), adjusted retail & food service sales, and debit balances in brokerage margin accounts.

Coincident (92) & Lagging Indicators (33)

Five of the six Coincident Indicators increased from January to February 2023. The three Confidence Board indices in this category (Consumer Confidence Present Situation, Coincident Personal Income Less Transfer Payments, and Coincident Manufacturing and Trade Sales) were all higher, as were US labor force participation rate and US employment (non-farm payrolls). US Industrial Production, however, was essentially flat for the first two months of 2023. As mentioned previously, though, while those five components were higher in February than they were in January, four of them were less than 0.20 percent higher than the neutral threshold. Thus while the 92 level is correct in terms of index calculation, it is somewhat unrepresentative of the tenor of roughly coincident US economic activity in February 2023.

AIER's Lagging Indicators saw its January 2023 neutral bias shift to a negative trend, with four of the six measures within it declining. The US Census Bureau's Private Construction Spending on Nonresidential Structures, January 2023 headline CPI (year-over-year), manufacturing and trade inventories, and the Conference Board's Lagging Commercial and Industrial Loans all declined. The Confidence Board's US Lagging Average Duration of Unemployment and the yield on a composite of short-term interest rates rose. Unlike the internals of the Coincident Indicators, the components of the Lagging Indicators evidenced less ambiguity in their broad turn negative with the exception of the small pullback in the month-over-month change in US manufacturing and trade Inventories.

Taking into account the trivial changes within the Roughly Coincident Indicators Index, the overall sentiment relayed by the February 2023 Business Conditions Monthly is one of continued neutrality. The last time that the three current index levels, 58 (Leading), 92 (Roughly Coincident), and 33 (Lagging) were seen similarly configured was during a five month period between August and December of 2021 inclusive.

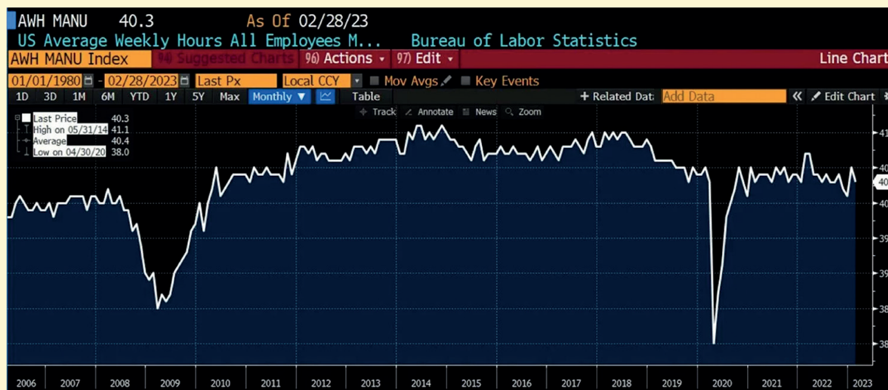
	Leading	Coincident	Lagging
Aug-21	58	100	33
Sep-21	54	92	25
Oct-21	50	83	25
Nov-21	50	75	33
Dec-21	50	75	42

Throughout January and February 2023, it became evident that the disinflationary trend that had begun in the late summer and autumn of 2022 was losing momentum. Service prices continued to rise, and core inflation remained broadly elevated. Those factors, plus uncommon strength in both labor markets and retail consumption, have led to rising estimates of the Federal Reserve's terminal policy rate. Consequently,

speculation regarding what has been called the "most anticipated recession in US history" has increased. The inconclusive status of the US debt ceiling standoff provided an additional headwind on top of the downward revision of 4th quarter US GDP from 2.9 percent to 2.7 percent. Last but not least, the one year anniversary of the Russo-Ukrainian War on February 24th, alongside growing Chinese economic support for Russia, suggests a long, grim slog ahead. In addition to monetary and fiscal policy uncertainty, the increasing scope of the war in southern Europe has implications for energy prices, trade policy, and government spending. Uncertainty remains elevated, as does risk.

Errata: In the January 2023 Business Conditions Monthly an erroneous chart was shown. The Leading Indicator tracking sales/inventory trends was shown as the Institute for Supply Management's Manufacturing Orders Inventories or Book Bill Ratio, when in fact the US Census Bureau's Manufacturing and Trade Inventory/Sales Ratio is in use. Also, the chart of Debit Balances in Margin Accounts was displayed in reverse date order (most recent to the left). Corrections will appear on the AIER website.

LEADING INDICATORS (1980 – present where possible)



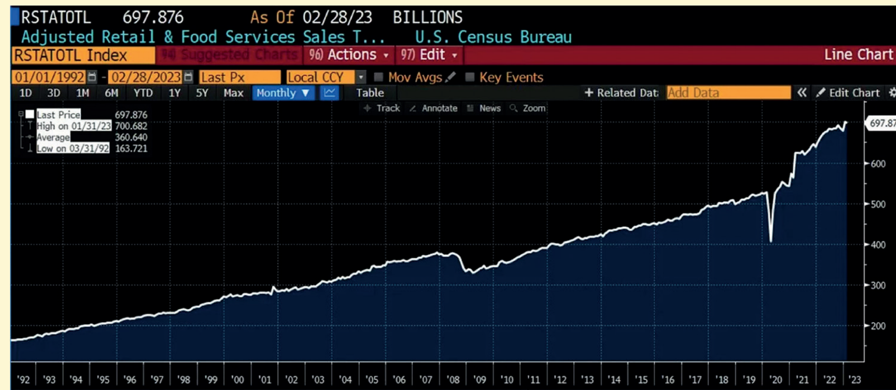
INJCJC 192k For Mar 11 Next Release 23 Mar 08:30 Survey 198k
US Initial Jobless Claims SA
Department of Labor
INJCJC Index
Line Chart
01/01/1980 - 02/24/2023
Last Px
Local CCY
Mov Avgs
Key Events
Monthly
Table
Last Price 190.0
High on 03/31/20 5946.0
Average 389.0
Low on 03/31/22 171.0
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019
2020-2024

LEI NWCN 115241.00 As Of 02/28/23 MILLIONS
Conference Board US Leading Index Manuf...
Conference Board
LEI NWCN Index
Line Chart
01/01/1980 - 02/28/2023
Last Px
Local CCY
Mov Avgs
Key Events
Monthly
Table
Last Price 0.115M
High on 01/31/00 0.158M
Average 0.125M
Low on 10/31/82 82255.00
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019
2020-2024

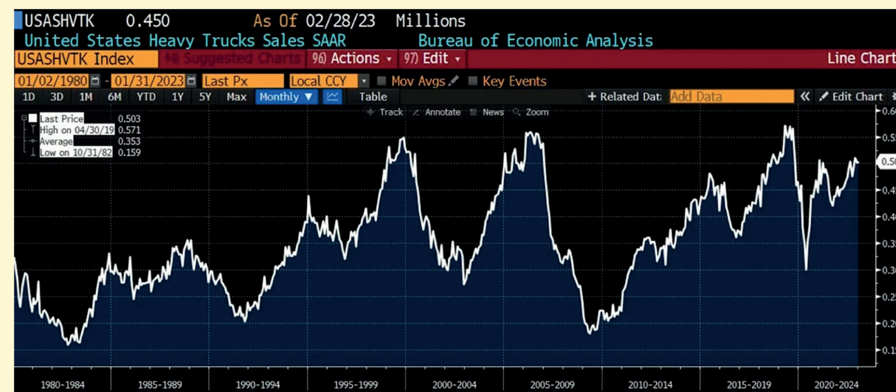
LEI STKP 4079.68 As Of 02/28/23
Conference Board US Leading Index Stock...
Conference Board
LEI STKP Index
Line Chart
01/01/1980 - 02/28/2023
Last Px
Local CCY
Mov Avgs
Key Events
Monthly
Table
Last Price 4079.68
High on 12/31/21 4674.77
Average 1210.79
Low on 04/30/80 102.97
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019
2020-2024

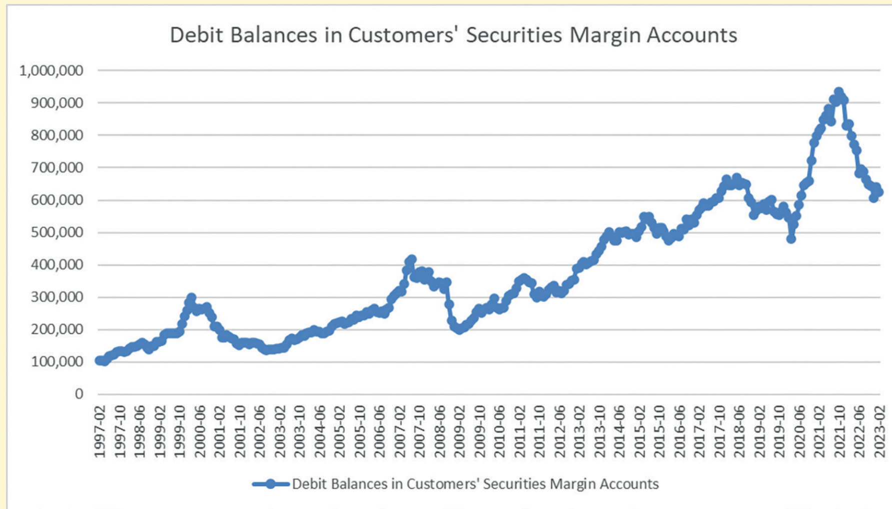
LEI MNO 36087.00 As Of 02/28/23
Conference Board US Manufacturers New O...
Conference Board
LEI MNO Index
Line Chart
01/01/1980 - 02/28/2023
Last Px
Local CCY
Mov Avgs
Key Events
Monthly
Table
Last Price 36087.00
High on 06/30/00 49202.00
Average 35032.48
Low on 12/31/82 20990.00
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019
2020-2024

NHSPSTOT 1450k For Feb Next Release 18 Apr 08:30 Survey --
US New Privately Owned Housing Units St... U.S. Census Bureau
NHSPSTOT Index
Line Chart
01/01/1980 - 02/28/2023
Last Px
Local CCY
Mov Avgs
Key Events
Monthly
Table
Last Price 1450
High on 01/31/06 2273
Average 1362
Low on 04/30/09 478
2000
1450
1000
500
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019
2020-2024

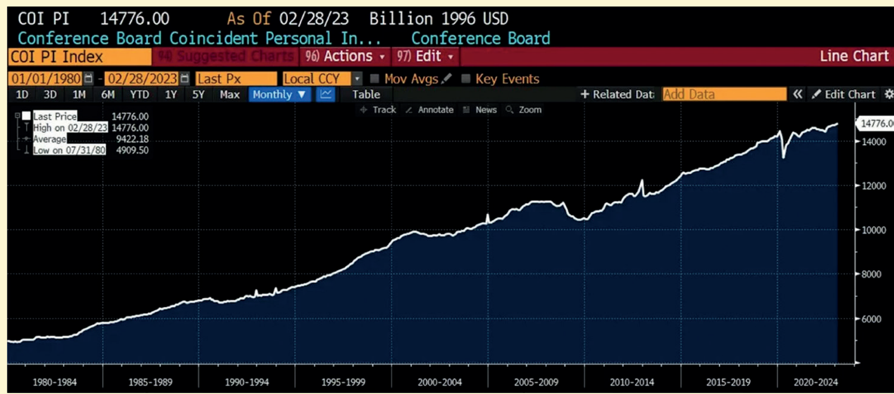

RSTATOTL 697.876 As Of 02/28/23 BILLIONS
Adjusted Retail & Food Services Sales T... U.S. Census Bureau
RSTATOTL Index
Line Chart
01/01/1992 - 02/28/2023
Last Px
Local CCY
Mov Avgs
Key Events
Monthly
Table
Last Price 697.876
High on 01/31/23 700.682
Average 360.640
Low on 03/31/92 163.721
697.876
600
500
400
300
200
'92 '93 '94 '95 '96 '97 '98 '99 '00 '01 '02 '03 '04 '05 '06 '07 '08 '09 '10 '11 '12 '13 '14 '15 '16 '17 '18 '19 '20 '21 '22 '23

MGT2TB 1.34 As Of 01/31/23 SA
Inventory/Sales Ratio : Total Business U.S. Census Bureau
MGT2TB Index
Line Chart
01/02/1980 - 01/31/2023
Last Px
Local CCY
Mov Avgs
Key Events
Monthly
Table
1 / (Last Price) 0.746269
High on 03/31/11 0.806452
Average 0.711325
Low on 04/30/20 0.574713
0.80
0.746269
0.70
0.65
0.60
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019
2020-2024

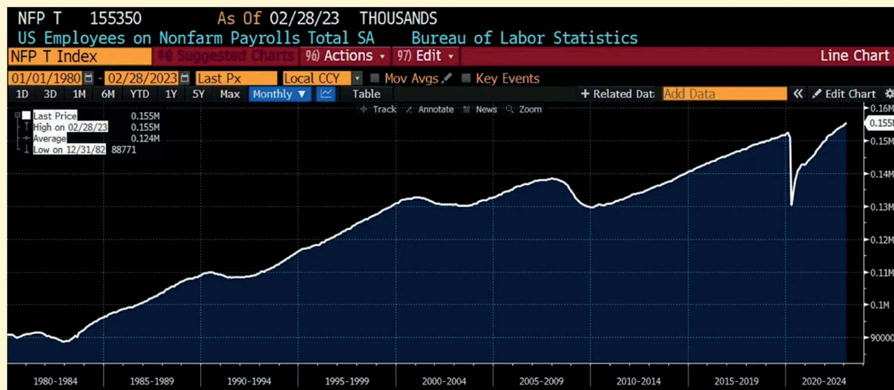

USASHVTK 0.450 As Of 02/28/23 Millions
United States Heavy Trucks Sales SAAR Bureau of Economic Analysis
USASHVTK Index
Line Chart
01/02/1980 - 01/31/2023
Last Px
Local CCY
Mov Avgs
Key Events
Monthly
Table
Last Price 0.503
High on 04/30/19 0.571
Average 0.353
Low on 10/31/82 0.159
0.600
0.550
0.503
0.450
0.400
0.350
0.300
0.250
0.200
0.150
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019
2020-2024

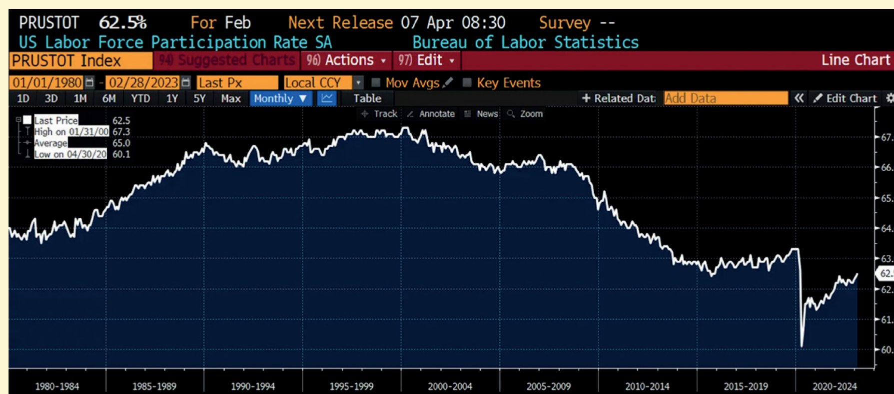


ROUGHLY COINCIDENT INDICATORS (1980 – present where possible)

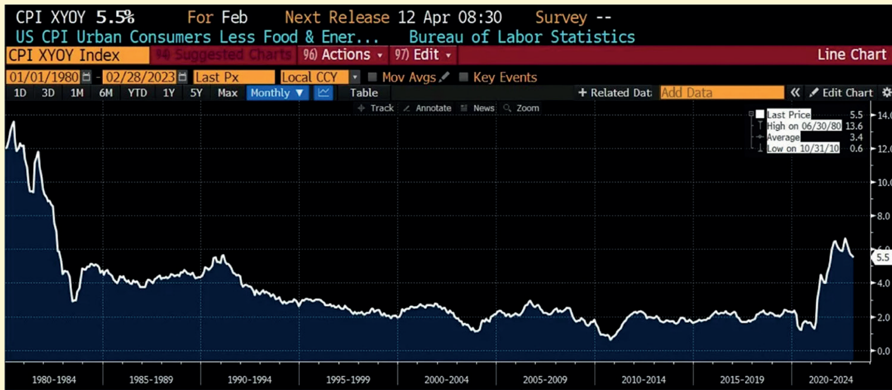

COI PI 14776.00 As Of 02/28/23 Billion 1996 USD
Conference Board Coincident Personal In... Conference Board
COI PI Index
Line Chart
Last Price 14776.00
High on 02/28/23 14776.00
Average 9422.18
Low on 07/31/80 4909.50
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019
2020-2024

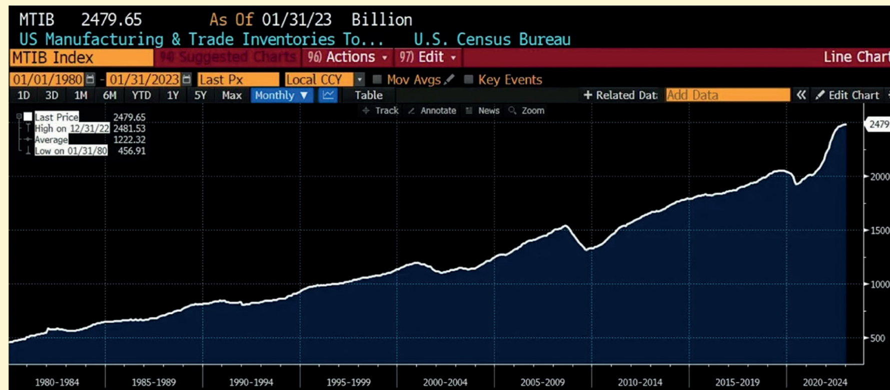
CONCPSIT 152.8 For Feb Next Release 28 Mar 10:00 Survey --
Conference Board Consumer Confidence Pr... Conference Board
CONCPSIT Index
Line Chart
Last Price 152.80
High on 07/31/00 186.80
Average 100.53
Low on 12/31/82 15.80
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019
2020-2024

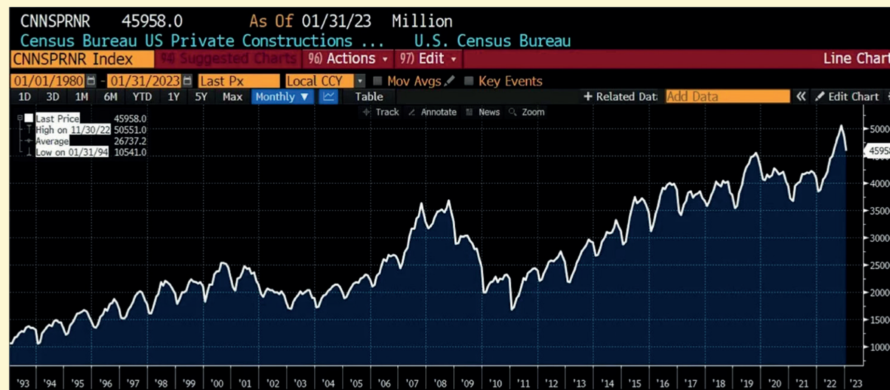

NFP T 155350 As Of 02/28/23 THOUSANDS
US Employees on Nonfarm Payrolls Total SA Bureau of Labor Statistics
NFP T Index
Line Chart
Last Price 0.155M
High on 02/28/23 0.155M
Average 0.124M
Low on 12/31/82 88771
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019
2020-2024


PRUSTOT 62.5% For Feb Next Release 07 Apr 08:30 Survey --
US Labor Force Participation Rate SA Bureau of Labor Statistics
PRUSTOT Index
Line Chart
Last Price 62.5
High on 01/31/00 67.3
Average 65.0
Low on 04/30/20 60.1
1980-1984
1985-1989
1990-1994
1995-1999
2000-2004
2005-2009
2010-2014
2015-2019
2020-2024

LAGGING INDICATORS (1980 – present where possible)







CAPITAL MARKET PERFORMANCE

icker	Short Name	%1M	%3M	%1YR	3 Year Annualized	5 Year Annualized	10 Year Annualized
SPR	S&P 1500 Composite Index	-3.69%	+3.15%	-11.49%	17.8275	8.8568	12.0808
SPXT d	S&P 500 Total Return	-2.98%	+3.86%	-9.94%	17.5755	9.2093	12.2435
SPX d	S&P 500 INDEX	-3.13%	+3.40%	-11.46%	17.5532	9.1920	12.2279
MID d	S&P 400 MIDCAP INDEX	-9.45%	+.55%	-10.78%	20.9382	5.7981	10.6431
RTY d	RUSSELL 2000 INDEX	-10.35%	-.17%	-16.35%	17.4017	3.0186	9.0331
SXXP d	STXE 600 (EUR) Pr	-5.00%	+2.12%	-3.12%	17.9578	6.3249	8.3557
TLT US d	ISHARES 20+ YEAR	+3.45%	+2.39%	-20.63%	-9.6328	-.2053	.8454
QLTA US d	ISHARES AAA - A	+.58%	+.83%	-9.67%	-.6353	1.1852	1.5054
CRY d	TR/CC CRB ER Index	-4.63%	-6.28%	-12.69%	25.0302	5.5362	-.8178
XAU	Gold Spot $/Oz	+7.84%	+9.07%	+2.23%			
XAG	Silver Spot $/Oz	+3.23%	-5.96%	-10.59%			
ILM3NAVG	Bankrate 30Y Mortgage Rates Na	+.88%	+5.98%	+51.87%			
ILM1NAVG	Bankrate 15Y Mortgage Rates Na	+.33%	+5.47%	+63.23%			
MB301ARM	5 Year ARM	+2.89%	+1.97%	+69.35%			
ILA3NAVG	Bankrate 30Y Fixe Mtg Refis Na	+1.05%	+3.84%	+88.83%			

(All charts sourced via Bloomberg Finance, LP)

The Unconstitutional Tax on "Unrealized Capital Gains"

PHILLIP W. MAGNESS
Research and Education Director

The Biden Administration's 2023 budget bill made headlines by proposing a so-called "billionaire tax," imposing a 25-percent minimum rate on the "unrealized capital gains" of the wealthiest Americans. The Biden measure rests on an economic falsehood. The new proposal rests on the work of far-left academics such as Thomas Piketty and Gabriel Zucman, who erroneously claim that wealthy Americans pay a lower tax rate, on average, than the poor. This assertion arises from a compounding of basic empirical errors, beginning with the blurring of the distinction between income (annual earnings) and wealth (net worth) as well as a fair amount of intentional statistical manipulation.

In addition to being premised on bad economic reasoning and contrived evidence, Biden's proposed wealth tax will also likely face another obstacle: it is blatantly unconstitutional.

To see how, we must turn to the text of the Constitution itself. Article I, Section 8 of the document establishes the "Power to lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States" with the stipulation that these measures must be uniform. A separate clause in Article 1, Section 9 stipulates that "No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken."

When read together, these two clauses divide the taxing power of the federal government into two categories: direct and indirect taxation.

If a tax is indirect, it may meet constitutional muster by simple uniform application across the entire country. Consider a national excise tax on alcohol sales, one of the earliest and longest-standing federal tax measures in existence. Under the current federal excise tax, distilled spirits are taxed at $13.50 per proof gallon, regardless of the state in which they are purchased and consumed. A parallel tax similarly covers liquor that is imported from abroad, again, meeting the uniformity requirement by applying to all states.

A direct tax, by contrast, must meet the apportionment requirement of the Capitations clause, with one notable exception arising from a later amendment. As originally designed, this meant direct taxes had to be divided in proportion to the population of each state, and then assessed within the population of that state. Since state population is the determinant, this formula could conceivably lead to 50 different tax rates, under the Constitution's design. The resulting system would likely face insurmountable political opposition, in addition to being impractical to implement and enforce.

So, how did the Constitution originally differentiate direct and indirect forms of taxation? That subject came up in one of the first major Supreme Court cases, *Hylton v. United States* in 1796. Borrowing his reasoning directly from Adam Smith's *Wealth of Nations,* Justice Paterson wrote that "All taxes on expenses or consumption are indirect taxes." The Court, accordingly, affirmed the constitutionality of a federal sales tax on carriages, finding that it was not subject to the apportionment formula of the census.

This outcome precluded the need to elaborate on direct taxation, however, the legal arguments from the case also settled that question. Alexander Hamilton's brief for the case defines direct taxation

to include "capitation or poll taxes," "taxes on land and buildings," and "general assessments, whether on the whole property of individuals, or on their whole real or personal estate." All other taxes, Hamilton continues, "must of necessity be considered as indirect taxes."

Although the Court determined that the carriage tax fell outside of the direct-tax classification, another federal tax almost a century later would run afoul of the apportionment rule. In 1894, Congress established a federal tax of two percent on incomes over $4,000. The measure sparked a complex array of legal challenges, on the basis that Congress had laid a direct income tax without meeting the apportionment requirement from the census. The following year, the Supreme Court struck down a key provision of the new income tax measure. Taxes on income derived from interest, dividends, and rent, the Court ruled in *Pollock v. Farmer's Loan & Trust*, qualified as direct taxation. Since this tax did not meet the apportionment requirement, the Court struck it down.

The fallout from the *Pollock* ruling dominated national politics for the next decade, as opponents of the existing tariff-based revenue system lobbied to replace it with an income tax. The impasse finally broke in 1909, when Congress adopted the 16th Amendment (ratified in 1913).

This Amendment authorized the modern federal income tax, but not by repealing the older apportionment rule of Article 1, Section 9 as is commonly assumed. Rather, the 16th Amendment carved out a very specific exception to the existing clause. As its text states, "Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration."

Congress may accordingly levy a direct tax on income earnings without needing to meet the census-based apportionment stipulation. It has done so from 1913 to the present day, under the all-too-familiar form that we fill out every April. Note, however, that the Amendment's text does not exempt other forms of direct taxation from the apportionment requirement.

A tax on "unrealized capital gains" cannot be a tax on income, as no income is generated in the process, only an estimated increase in valuation. It is "unrealized" by definition. Indeed, post-16th Amendment jurisprudence has generally held that money must be "realized" and received in order to qualify as income, most notably the 1920 case of Eisner v. Macomber.

If Biden gets his tax, it would face a steep and immediate constitutional challenge. The administration is likely banking on a series of extremely tendentious arguments by far-left law professors to argue that previous jurisprudence on this question should be discarded. These arguments often begin from the assumption that *Pollock* was wrongly decided, and openly advocate judicial activism from the bench, as a strategy to bypass the apportionment requirement through semantic games. Even supporters of the idea concede that this strategy is unlikely to pass muster with the current Supreme Court.

It's a fitting realization. Much like the contrived economic arguments behind the wealth tax, its legal arguments are a result of politically motivated reasoning to bring about a new tax system that the Constitution prohibits.

– March 13, 2023

The Biden Budget: Smoke, Mirrors, and Class Warfare

NIKOLAI G. WENZEL
Research Faculty Member

As an academic economist, my job is to pursue the truth, so I am always flummoxed by the rhetoric coming out of that great regulatory factory on the Potomac, belching negative externalities that gum up the economy. In 2000, I chided the Trump-led CARES Act as a stimulus bill that wasn't. Only about 20 percent of the $2 trillion bill was targeted at health measures (and it's unclear what percentage of that was actually targeted at COVID); another 30 percent involved welfare relief that was barely means-tested, and smelled, along with the remaining and murky 50 percent, like election-year pork. Most importantly, the Act did nothing to ease the COVID-era supply-side problems, as it failed to target regulation and other barriers to commerce.

In 2021, the Biden administration followed suit with ARPA, which spent another $2 trillion. Of that, less than10 percent was dedicated to public health, 40 percent to direct payments (including checks for a whopping 85 percent of American households), 25 percent to stimulate an economy that wasn't in recession, and the rest a grab bag of federal handouts. Over the span of a year, the Trump and Biden administrations oversaw the spending of an additional $5 trillion beyond an already-bloated budget. After a flurry of other enormous spending bills pushed by the Biden administration, we now have the proposed 2024 Biden budget. In the White House's own words, the budget isn't just a spending proposal, but the President's "vision to build on the work this Administration has done to make a real difference in people's lives." The budget proposal is full of class warfare, contradictions, and empty rhetoric.

It is tempting to start with a constitutional argument. First, there is nothing in Article II of the Constitution that grants the President the power to propose legislation and spending (which, in effect, is what the proposed budget does). At best, the President, in his State of the Union address to Congress may "recommend to their Consideration such Measures as he shall judge necessary and expedient." The very idea that the executive – meant to execute the laws, and not write them – should propose a budget comes close to violating Article I, section 7, which states that "All Bills for raising Revenue shall originate in the House of Representatives." Second, there is a world of difference between the goals of that $6.8 trillion and the limited powers (fewer than 20) enumerated in Article I, section 8. But, these days, arguments for actually reading the Constitution seem to fall somewhere between quaint and antiquated.

In proposing $6.8 trillion of spending over 184 pages, the budget has a few provisions that stand out:

1. Implement a 25 percent minimum tax on billionaires
2. Increase the top marginal tax rate from 37 percent to 39.6 percent
3. Increase in the corporate tax rate from 21 percent to 28 percent
4. Bolster Medicare and Social Security through special taxes
5. Create troubling industrial policy, especially in infrastructure and technology

The substance and rhetoric of the proposed budget are troubling. In typical election-year class warfare,

the Biden administration is proposing a raft of new taxes to make sure "the wealthy" pay their "fair share." The administration wants to accomplish this through a "billionaire minimum tax" of 25 percent on all income, including adjustments to the capital gains tax, and by increasing the top marginal tax rate from 37 percent to 39.6 percent. If we look behind the rhetoric, we will see that as of 2020 (the most recent year for which figures are available), the top 1 percent of taxpayers pay 42 percent of total tax revenue; the top 5 percent pay 63 percent, and the top 10 percent pay 74 percent of total revenue. If anything, Americans with higher income are already paying *more* than their "fair share." On a related note, it is troubling for the health of a democracy that the top 50 percent of taxpayers accounts for 98 percent of revenue. Effectively, this means that half the taxpayers are not participating financially in the federal budget, yet face incentives at the ballot box to push for more spending. Alas, while this may be an existential crisis for a democracy, it does not make for good electoral politics.

The Biden administration is evincing a major cognitive disconnect when it comes to competitiveness. On one hand, the administration created a Competition Council in 2021, through an executive order (EO 14036 of July 2021), with 72 initiatives and mandates to 14 government agencies to increase US competitiveness. On the other, the administration has consistently been increasing regulation, advancing the weight of government in the economy, pushing for a national minimum wage increase, and increasing the federal minimum wage by executive order. In this budget proposal, the administration is doubling down on its anti-competitive actions, not just through individual income tax increases, but also by proposing a significant jump in the corporate tax, which will hurt American competitiveness. As a small-but-typical indicator, the budget simultaneously attempts to raise taxes on oil companies and to lower energy costs for consumers.

In its marketing of the proposed budget, the White House is proudly crowing that the budget will "cut the deficit by nearly $3 trillion over 10 years." Unfortunately, this is all smoke and mirrors – and rather disingenuous. The deficit, an annual measure of the difference between revenue and outlay, is ultimately irrelevant. What matters is the national *debt*, which currently stands at $31.6 trillion, or about 125 percent of GDP. A smaller deficit is nice, but the Biden budget does not lower the national debt, which continues to *increase* a breakneck speed, due to debt servicing and continued federal profligacy. The Biden budget would in fact increase the national debt by about $17 trillion over the next decade (see Table S-1 in the proposed budget). A small annual decrease in the rate of growth of the national debt is no consolation.

Before COVID, federal spending stood at about 20 percent of GDP, then temporarily peaked at about 30 percent of GDP, with the massive Trump-Biden spending bills. The Biden budget now proposes federal expenditures of about 25 percent of GDP – lower than the COVID-era frenzy, but higher than pre-COVID spending. This is a move in the wrong direction, and a classic example of the ratchet effect described by economist Robert Higgs: "once a crisis has passed, state power usually recedes again, but it rarely returns to its original levels; thus each emergency leaves the scope of government at least a little wider than before." One is reminded of George Orwell's *1984* (part 1, chapter 4):

> It appeared that there had even been demonstrations to thank Big Brother for raising the chocolate ration to twenty grammes a week. And only yesterday […] it had been announced that the ration was to be REDUCED to twenty grammes a week. Was it possible that they

> could swallow that, after only twenty-four hours? Yes, they swallowed it. […] The eyeless creature at the other table swallowed it fanatically, passionately, with a furious desire to track down, denounce, and vaporize anyone who should suggest that last week the ration had been thirty grammes.

Beyond tired class warfare rhetoric and anti-competitive measures, the Biden administration is attempting to increase not only the size of the state (through more taxing and spending), but also the scope of the state, through misguided commercial and industrial policy.

+The good news is that the budget is unlikely to pass through a divided Congress. The bad news is that this proposed budget is further confirmation of the Biden administration's fatal conceit that it can run the economy. The worse news may be that Congress doesn't come up with anything substantively better.

– March 15, 2023

Has the Discount Window Mystery been Solved?

PETER C. EARLE
Research Faculty

On January 25th, I wrote about the increasing borrowing activity taking place at the Fed's discount window. I commented that, despite popular perceptions, not all the borrowing at the discount window is driven by emergencies. But I also added that with rapidly rising interest rates, and the money supply contracting for the first time in decades and possibly the quickest that it ever has, the beginning of a liquidity crisis was nevertheless a distinct possibility.

I wrote then:

> Nothing is conclusive yet. In about 18 months, the identity of the firms which have been tapping the Fed's discount window starting in March 2022 will become publicly available. If those funding requests simply stem from navigating the ongoing effects of the economic maelstrom of 2022, we'll learn at that time. If something worse is brewing, much sooner.

It is not yet known whether Silicon Valley Bank (SVB) was the firm, or one of several, borrowing at the discount window. There are several things we do know, however. First, the SVB collapse is the second-largest bank failure in US history. Second, that the bank had been desperately trying to sell assets and lost a few billion dollars doing so. And third, as of late December, SBV held 57 percent of its total assets in investments while the average among 74 similar competitors was about 42 percent. Of those investments, $108 billion were in US Treasury and agency securities — an asset class which had its worst year on record in 2022.

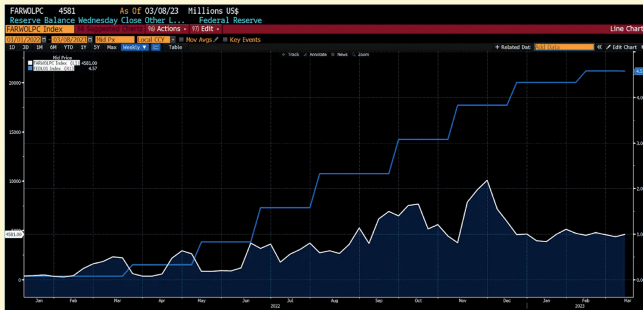
In November 2021, the stock hit an all time high of $755 per share, then joined the rest of the market in the 2022 price declines. March has proven brutal. After drifting sideways between about $250 and $350 since the start of 2023, the stock price fell from $283 on Monday, March 6, to hover in the $267 range on March 8 and 9, and then collapsed to $106.04 on Thursday March 9. At just before 9am this morning, March 10, trading was halted.

Silicon Valley Bank (2020 – present)

(Source: Bloomberg Finance, LP)

Federal Depository Insurance Company (FDIC) filings indicate that US banks took over $600 billion worth of unrealized losses last year, a large portion of which was generated by precipitously falling bond prices amid the Fed's aggressive interest rate hikes. In addition to holding $108 billion in Treasuries during the worst year in history for such securities, SVB's books include $74 billion in loans, a portion of which were undoubtedly extended to local tech companies. Tech companies have recently been under pressure as well, and are cutting costs.

Fed Discount Window activity vs.
Effective Fed Funds rate (2020 – present)



(Source: Bloomberg Finance, LP)

Since the end of 2019, Federal Reserve policies have pumped up the monetary base by trillions of dollars. As kids today say, “Money printer [went] brr.” The reversal of that process and the tightening of financial conditions has driven annualized M2 growth negative for the first time on record. Whereas, until recently, contractionary policies were broadly impacting the profitability of interest-rate-sensitive firms, for some it is now threatening their survival.

KBW Bank Index (white) vs. annualized growth in M1 (orange)
and M2 (blue) monetary aggregates (2022 – present)

(Source: Bloomberg Finance, LP)

The value of loans taken when rates were low have plunged, and depositors are expecting higher rates. Financial institutions and firms which borrowed from them amid two decades at lower-than-normal rates are already experiencing the effects of simple normalization. The combination of the SVB development on top of yesterday’s disclosure by Silvergate Capital Corp that it would cease operation amid the wreckage of the cryptocurrency industry, couldn’t come at a much worse time. Estimates for the Fed’s terminal policy rate are creeping toward 6 percent amid persistent inflation in services and too-strong-for-comfort employment data. If history and market-implied policy rates are any guide, it won’t take much more pain in the financial sector for the Fed to begin easing rates again.

We won’t know for another twelve or fourteen months whether Silicon Valley Bank (or any of the other banks being thrown overboard today) were the ones borrowing at the Fed’s discount window. But it is increasingly likely that whatever firm(s) it was, exigency was the driver.

– March 10, 2023

Economic Development Deals Are a Curse, Not a Blessing

STEPHEN C. MILLER
Secretary of the Corporation

As states periodically consider renewing and increasing economic development incentives, they would do well to consider the problem of the Winner's Curse. The Winner's Curse is a common result of competitive auctions, where the bidder who "wins," say, a used car, is overly optimistic about its condition and value and thus overpays for it. Congratulations, you have won the auction and must pay top dollar.

Economic development incentives are states' primary weapon to attract business and prevent them from locating elsewhere. To borrow an analogy, they are in a gunfight with other states. To abandon economic development incentives would be to lose the bidding war. The problem is, because of the Winner's Curse, the winning state is poised to shoot itself in the foot.

The programs' supporters insist that economic development incentives work. But their evidence is almost always flawed and anecdotal, with an emphasis on the jobs "created" by the businesses receiving incentives. An example in my own state is Alabama's "winning" of a Mercedes plant in the 1990s. Given the evidence, that doesn't look like a win to me, nor did it to The *New York Times* in 1996. Careful analysis shows that Alabama won the battle for Mercedes but ultimately lost by overpaying, as is usually the case with these programs.

Proponents often cite economic impact studies in support of the incentive packages, but — and I cannot stress this enough — economic impact studies are not evidence, not even a little bit. They are *predictions*, often wildly optimistic, of the overall increase in economic activity based on a multiplier effect steeped in the Keynesian economic logic of circular flows. Enormous benefits are always predicted by these studies, but do they materialize?

Based on simple division, each Mercedes job cost Alabama taxpayers roughly $170,000. If the incentives succeeded, there would be clear evidence that the benefits exceeded the costs, not for Mercedes and its suppliers, but for the taxpaying public. No such evidence exists. The evidence could be gathered, but lawmakers tend to lose interest in quantifying economic impact once taxpayers' money has been spent. Such studies could be done with current statistical inference techniques, comparing economic growth in areas where new businesses have received economic development incentives to those where new businesses have located but did not receive the incentives. It would be irresponsible for lawmakers to renew or expand incentive programs without first gathering this information.

Politicians often claim the incentives yield a high return on investment. The real question is whether those returns helped Alabama's economy, or just politicians and their cronies. Existing research suggests the real benefits go to politicians, not the public. It also turns out that most firms do not choose to move because of the incentive packages. One study estimates that 75 to 98 *percent* of relocating firms would choose the same location with or without economic development incentives. Additional studies of incentive programs in Missouri, Florida, Michigan, and Arkansas, in addition to a thorough national study, have shown that the programs fail to generate comprehensive economic benefits. Economists have even written books about this topic, demonstrating and explaining the failures of these programs. If lawmakers are not aware of this

extensive research on targeted incentives, they should be. Ignorance is no excuse for harmful policies.

Caution is especially warranted in lower-income states like Alabama. Given the hundreds of millions spent on Alabama development incentives, and the large multiplier effects assumed in impact studies, Alabama should have experienced greater economic growth than the states with which it competes. According to Forbes, Alabama has ranked 40th out of all states in economic growth over the past 15 years. If this is winning, what does losing look like?

Lawmakers' support of these programs is unwarranted, and they should welcome a discussion concerning the value to taxpayers. Rather than complain about the objections from "dismal scientists," they should weigh the overwhelming evidence in favor of economic freedom, and against the lackluster performance of development incentives.

This metaphorical gunfight is not best won; it is best avoided. "Winning" would be a curse. If states want to be attractive to businesses, they should make themselves attractive to all companies by simply lowering taxes and regulatory barriers across the board. Bribing businesses to locate in your state is not free enterprise; it's a form of cronyism. It turns what should be a competitive process between firms into a political competition between states. The first step toward winning is to stop losing.

– March 24, 2023

What To Do About Deficits, Debt

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Federal budget hawks are in a pickle. Having predicted nine out of the last zero debt crises, those of us worried about the trajectory of US government spending have the inevitable task of convincing the public that *this time is different.* It's going to be a tough sell, but we have to try. Uncle Sam's spending binge is unsustainable. It can't continue forever, and it won't. Our time is running out.

According to the Congressional Budget Office's projections, the 2023 deficit will total $1.4 trillion. It will average $2.0 trillion per year for the next ten years. US indebtedness, already at record levels, will inevitably rise. Federal debt already exceeds 120 percent of GDP. If spending trends continue, debt will rise to 195 percent of GDP in thirty years. These numbers are unprecedented in America, even in wartime.

There's no guarantee that the United States can sustain debt levels this high. Bond markets could get spooked well before mid-century. If so, woe to the global financial system! The immense number of portfolios built upon a "risk-free rate of return" from Treasuries will take a horrible beating.

We can't tax our way out of the fiscal hole. For the past fifty years, tax revenues ranged from 14 percent to 19 percent of GDP. Despite significant variation in the tax code over that time, it seems there's a relatively narrow window for federal receipts, determined by the underlying structure of the economy. Prudence dictates we treat 20 percent of GDP as the absolute maximum for government revenues.

Covering the gap means painful-but-necessary spending cuts, or outright inflationary finance.

Modern Monetary Theory (MMT), until recently a hot topic among the economic commentariat, holds that governments face no fiscal constraints, only real resource constraints. As long as government can print money, the MMT view goes, it can always cover its bills.

Advocates of this absurd position have gotten rather quiet lately, for obvious reasons. We tried running the printing presses to cover government debt during the COVID years, and 40-year-high inflation was the result. But we need to put this in perspective. A 33-percent expansion in the money supply from 2020 to 2022 covered roughly half of the government debt added during that period. Imagine how much worse it would be if we relied exclusively on the Fed papering over our profligacy!

That leaves spending cuts. The current partisan haggling over the debt ceiling may yield some beneficial reforms, but we shouldn't count on it. Both the Democratic president and Republican House have taken entitlement reform off the table. As anyone familiar with budgetary arithmetic knows, this guarantees the problem will never be solved. Social Security, Medicare, and Medicaid are the bulk of "mandatory" federal spending, put on statutory autopilot by yesteryear's politicians. CBO projects these will rise to 15.3 percent of GDP by 2023. In contrast, discretionary spending and interest expenses will be 6.0 percent and 3.6 percent, respectively.

The cuts must come from entitlements. There's not enough fat elsewhere to trim.

The economic consequences of fiscal unsustainability will be severe. Eventually, investors will suspect Uncle Sam can't repay his bills. They'll demand higher real interest rates on government

bonds to compensate for the increased risk. Once that happens, servicing the debt will gobble up an uncomfortably large share of government expenditures. Public services will get squeezed. Partisan polarization will increase as a result. When there's less largesse to disperse, the hyenas must fight evermore-fiercely over the remaining scraps.

"A society grows great when old men plant trees in whose shade they know they will never sit," goes an ancient Greek proverb. For a self-governing republic to thrive, each generation must steward the public purse with great care. But for three generations, our "old men" opted to chop trees down rather than plant them. Now we bear the costs.

An intergenerational injustice was inflicted upon us. But we have no right to amplify that injustice for those who follow. When it comes to fiscal follies, this time is different. Let's not pass the buck. Instead, let's make the necessary sacrifices to ensure the long-run integrity of the United States. Let's plant the trees.

– March 15, 2023

The Tooth-Fairy Economics of Slavery Reparations

DAVID R. HENDERSON (Senior Fellow)

PHILLIP W. MAGNESS (Research and Education Director)

The reparations movement has gained tremendous ground in recent years by offering promises of compensation to the descendants of slavery's victims in the United States. The proposal forms the centerpiece of the *New York Times* 1619 Project, which is now a multi-million-dollar docuseries on the Hulu streaming service. A reparations task force in San Francisco recently recommended $5 million payments to African-American residents, and several Democratic members of Congress have pressed the Biden administration to prioritize the same cause at the federal level. Reparations have even made their way into children's programming, with a recent episode of the Disney cartoon "The Proud Family" depicting them, angrily and self-righteously, as society's obligation to African-Americans.

The rhetoric around these proposals often adopts a moralizing tone about restitution for past injustices, many of which are all too real. As a matter of economics, though, reparations advocates offer surprisingly little in the way of viable solutions. If the US government tried to implement the reparations program that the 1619 Project espouses, we would get huge increases in both taxes and inflation. Yet the key economist advising on this proposal denies that *any* taxes would have to increase.

In the climactic conclusion to the Hulu series, 1619 Project creator Nikole Hannah-Jones explains that "reparations is not just about slavery, but about decades of government-backed legal apartheid deployed against the descendants of the enslaved." As we pointed out in "The 1619 Project Vindicates Capitalism," in the *Wall Street Journal* on February 22, 2023, "almost every example presented is the result of government policies that, in purpose or effect, discriminated against African-Americans." The particular interventions we highlighted were eminent domain, racial redlining of mortgages, and enforcement of union monopolies that excluded black people.

But the only remedy for the mislabeled track record of government-inflicted injustice, viewers are told, is a massive government redistribution program with a price tag of $13 trillion. Let's put this in perspective in two ways. First, $13 trillion is over half of current US GDP. Second, it amounts to $312,000 per black man, woman, and child. If you gasp at San Francisco's $5 million and think $312,000 is no big deal, realize that $310,000 in reparations per person, multiplied by about 41.6 million African-Americans, is quite a big deal.

Ms. Hannah-Jones interviews Duke University economist William A. Darity, one of the most prominent academic voices behind the $13 trillion number. Darity has advanced similar dollar amounts in his scholarly work, including a 2022 article in the *Journal of Economic Perspectives*. As with the Hulu episode, he offers this figure while eliding difficult questions about financing this redistributive payout.

Vaguely sensing that there's no such thing as a free lunch, Hannah-Jones asks where the federal government would get the money to pay such a massive amount. Wouldn't taxes have to be raised, she queries. Mr. Darity confidently asserts that no such action is necessary.

"It's a matter of the federal government financing it in the same way that it financed…the stimulus package for the Great Recession" and the COVID-era CARES Act, Darity continues. To do

so, the federal government need only “spend the money but without raising taxes.”

This verges on tooth-fairy economics.

The cold reality of public finance means that every government outlay must be paid eventually, whether through taxes in the present, higher inflation, which is also a tax, or higher taxes on future generations. The federal government has no good option when it comes to just “spending the money.”

If the Federal Reserve monetized the whole amount, base money, which is currency in circulation plus bank reserves, would increase by $13 trillion. M2, the conventional measure of the money supply, is 3.96 times the monetary base. If that relationship held, then increasing the monetary base by $13 trillion would increase M2 by 3.96 times $13 trillion, which is $51 trillion. M2 is currently $21 trillion. $51 trillion is a whopping 245 percent increase. So if the spending occurred all in one year, inflation would be about 240 percent. Critical Race Theory would unite with Modern Monetary Theory in an inflationary spiral.

What if the Fed didn’t buy any of the new debt? Then future taxpayers would be on the hook. In a given year, the federal government raises about $4.8 trillion in revenues. So paying off just the new $13 trillion debt would require almost three years of federal revenue.

The only other alternative to increasing current taxes, creating massive inflation, or increasing future taxes would be to enact massive cuts in other programs. Remember earlier this month when, in his State of the Union address, President Biden accused congressional Republicans of wanting to sunset Social Security and Medicare? If the $13 trillion reparations were paid, sunsetting those programs, or reining them in by a double-digit percent, would almost certainly be on the table.

Almost everyone who designed the government’s discriminatory programs is long gone from office; most are dead, as are all plantation owners who perpetrated the original atrocities of slavery. So the vast majority of people who would shoulder the financial burden of reparations are people who had nothing to do with either slavery or the century of discriminatory policies that followed.

How about instead going through the various federal programs, and state and local programs, for that matter, that intervene in markets or violate property rights, often in discriminatory ways, and ending them? It would be great if Nikole Hannah-Jones and William Darity signed on to this 2023 project.

– March 7, 2023

Minimum Wage Hurts Whom It Claims to Help

MICHAEL MUNGER

Senior Fellow

Not long ago, I flew into a small Ohio airport. Don't ask why, sometimes Ohio just happens and you have to deal with it. Arriving late (having flown Delta: "Delayed Every Last Time Always"), I didn't get in until after 11 pm. And I was worried about picking up my rental car, because all the car company desks were dark.

Then my phone vibrated; I had a notification on the Hertz app: "Slot B17, code 2946," and some instructions. I went to a box, entered the code, and removed my key from the B17 door. My car was in parking spot B17, and I got in the car and drove off.

In 2011, Marc Andreesen famously said "Software Eats the World." His claim was that the "problem is even worse than it looks because many workers in existing industries will be stranded on the wrong side of software-based disruption and may never be able to work in their fields again." Well, my experience in Ohio made me wonder: have the folks who once worked at the Hertz counter found new jobs? Their experience was in public-facing retail, but those jobs are disappearing fast.

You've seen it in other industries. Once you walked up to the fast food counter and read some words from the menu board out loud. Giant burger, enormous fries, vat of drink, a combo meal. The person behind the counter then looked for the corresponding printed words on his cash register. Unsurprisingly, software ate this world. All you have to do is turn the cash register around. *You* can press those buttons yourself on a kiosk touch screen. You can enter the payment yourself, and get your own receipt, because software is recording, charging, and transmitting your order to more software on the back line of the restaurant.

At grocery store, self-checkout is now a replacement for a cashier. When I was growing up, the only place you could "check yourself out" was a mirror, but now some stores don't have any cashiers at all except for handicapped customers who make a special request.

The coronavirus pandemic also contributed to the decline in service jobs, of course, so we can't attribute all the employment loss to software. But overall, the number of people working service jobs, and the number of hours worked by those who have jobs, have fallen steadily since 2019.

The overall problem can be put in the form of an analogy, the kind you used to work on when you were studying for the SAT:

[software] *is to [_________]*

as

[robotics/automation] *is to* ***[manufacturing].***

The correct answer to the "fill in the blank" is service jobs. In other words, where in the 1960s and 1970s we were all talking about automation causing "technological unemployment," the new low-hanging fruit for job replacement is service jobs. Bizarrely, the solution of many current political analysts is that the solution is to raise the minimum wage, which disproportionately affects service work.

Let's think about that logic for a second.

Minimum Wage

Service jobs are falling because software is replacing human workers at an extraordinary rate. We all see

it in some areas — groceries, rental cars, fast food, movie tickets, and so on — but it is also happening in other areas that we don't see — accounting, information requests, scheduling, reservations, almost any service that can be routinized. What will happen if we try to fix this problem of disappearing jobs with an increase in the minimum wage?

You don't have to have a PhD in economics to be able to predict the consequences. But I do have a PhD in economics, so let me give it a shot:

- Even if it "works," and does not reduce employment at all, there are still many dimensions on which a minimum wage makes work uncomfortable for the least-well-off, because of competition along other margins.
- The best interpretation one can attach to the minimum wage's effect, in the period before software started to eat the world, was that the increase in unemployment was less than you might expect. But it still caused reduced employment or reduced hours, much of the time and for any large increase.
- The reduction in the amount of work, especially hours, for those who are still employed, has been much more pronounced in recent years. This is particularly true in areas (such as Seattle) where the bump in hourly pay wage was large enough to create a "living wage." Unsurprisingly, the effects are to 1) raise wages for those who still have jobs (the law requires that), and 2) cut the number of jobs, and the number of hours worked (the laws of economics require that).
- Even if there were a large positive effect on wages and no effect on unemployment, the increased prices for products and services produced by minimum wage workers would significantly harm the least-well-off, out of proportion to the assumed benefit, which is dubious in the first place.

Recently, I wrote about the conflict between directionalists and destinationists. Some destinationists — such as my good friend Richard Salsman — would argue that the problem with the minimum wage is that it interferes with freedom of contract.

But you don't have to buy that argument to be persuaded that raising the minimum wage right now is a terrible idea. If you care about the people struggling to keep their jobs in a difficult economy, you should oppose raising the minimum wage: *it hurts the very people you want to help.* Being able to work, and feel productive, is an important part of the social aspect of our economy. Service jobs are disappearing fast enough, without having the process accelerated by misguided support for increasing the minimum wage.

– March 19, 2023

FDIC: No Savior Then or Now

ROBERT E. WRIGHT
Senior Research Faculty

If you think the US banking system has problems now, ninety years ago this month a new President shuttered the entire banking system for a week. Knock on wood that does not happen again, as we would likely get a dangerous central bank digital currency (CBDC) out of it. But some good might still come of the current crisis if policymakers would only look to history for clues.

Every major financial crisis since the Panic of 1907 has led to some government intervention that has created yet-bigger problems down the road. The crisis in 1907, which was largely caused by the Great Quake in San Francisco the year prior, led to the creation of the Federal Reserve System ("the Fed"). That institution was supposed to implement Bagehot's Rule (which should be called Hamilton's Rule) during crises. In other words, it was supposed to lend freely at a penalty rate to all borrowers who could post sufficient collateral. Instead, in the 1930s, during a severe economic downturn that it helped to cause, the Fed largely watched as wave after wave of bank failures sank the US further into what we now call the Great Depression.

Come November 1932, frightened American voters ousted incumbent Republican Herbert Hoover from the Oval Office, in favor of New York governor Franklin Delano Roosevelt (FDR), a rich politico crippled by polio. Cunningly, FDR ran as a moderate, attacking Hoover for spending too much. After securing election, however, FDR and his so-called Brain Trust group of advisors started making radical noises about going off the gold standard and taxing the rich and such. As his inauguration on Saturday, March 4 approached, a wave of bank failures began, inducing many governors to declare statewide bank "holidays." Upon taking office, FDR declared a nationwide "holiday" effective Monday, March 6. That meant no deposits or withdrawals; even the Fed district banks shut down.

What happened next was brilliant in its own way. On Sunday, March 12, FDR took to the radio for the first of his famous "fireside chats." During the 13-minute monologue, he first thanked the American people for accepting the shutdown calmly. Then he clearly, accurately, and succinctly explained how the country's fractional reserve banking system worked. Then he explained that he had shut down the banking system because perfectly sound institutions were being destroyed by runs on their deposits. That part of the speech established his credibility by telling Americans what they already knew in plain, frank terms.

Next came the Big Lie. During the week, FDR and Congress had worked together "patriotically" to rebuild the nation's "economic and financial fabric." The situation was so dire that the government had worked at unprecedented speed to differentiate sound banks from unsound ones. Only the sound ones would reopen, and with sufficient cash "to meet every legitimate call." This newly printed money from the Bureau of Engraving was "sound" because it was "backed by actual, good assets."

FDR then provided credible-sounding details. The next day, banks in the twelve Federal Reserve cities adjudged by the Treasury to be sound would reopen. On Tuesday, banks adjudged by the clearinghouses to be sound in some 250 US cities would reopen. Starting on Wednesday, banks in more remote areas would reopen subject to "the Government's physical ability to complete its survey." He made clear that

all banks that passed unspecified "common sense checkups" would receive federal assistance and would reopen, even if they were chartered by states and not members of the Federal Reserve system. "I am confident," he said in his radio-friendly voice, "that the state banking departments will be as careful as the National Government in the policy relating to the opening of banks and will follow the same broad policy." He also claimed that it was safer to put money into a reopened bank than "under the mattress."

As for the banks that would not be allowed to reopen, they would be reorganized, with help, if necessary, from the federal government's Reconstruction Finance Corporation, one of the expensive boondoggles that FDR had berated Hoover for creating. FDR explicitly did not promise, however, that individuals would not suffer losses. He then thanked the American people again for taking the shutdown in stride and put the fate of the system in their hands. "Together," he closed, "we cannot fail."

As banks reopened over the following week, depositors, on net, returned the funds they had hastily withdrawn in previous weeks. The "chat" served its purpose well by establishing the new President's credibility and even likability. This was, of course, before he took everyone's gold and started jailing people for opposing him politically or not going along with his centralized economic planning scheme, the Blue Eagle. The remarks stand in stark contrast to the general banalities made by George W. Bush during the Global Financial Crisis, and the curt statement about the Silicon Valley Bank failure recently made by Joseph R. Biden. In short, FDR had the twin advantages of not yet being reviled by a large portion of the population, and of being an effective communicator.

Again, FDR explicitly did not insure deposits, he only promised the soundness of banks that reopened. It is therefore strange that, in the popular mind, the Federal Deposit Insurance Corporation (FDIC) often gets credited with the banking system turnaround. The FDIC's official website links to FDR's March 12 speech and claims that it was formed "at the depth of the most severe banking crisis in the nation's history," though the legislation creating it was not passed until mid-June and the FDIC did not have a chairman until mid-September, well after the bank holiday crisis had passed.

It is true that the US did not suffer from massive waves of bank runs again until the 21st century, but that record is hardly attributable to the FDIC. For decades after the New Deal, banking regulators engaged in financial repression by mandating the maximum interest rates that banks could pay for deposits, and imposing other rules that constrained competition and risk-taking. The United States also became the world's dominant economy after World War II, its dollar the equivalent of gold. The FDIC's sole job during that long period of prosperity was to close down a few small unlucky or poorly run banks.

Another federal deposit insurance scheme, the Federal Savings and Loan Corporation (FSLIC, often pronounced Fizzlick) supervised and insured the deposits of a now largely defunct type of savings bank called a Savings and Loan (S&L). Financial repression of S&Ls, combined with the Great Inflation of the 1970s, forced rapid deregulation. That saved the S&Ls temporarily but allowed them to engage in new, risky activities, like buying foreign bonds and oil-prospecting loans, which soon put many of the institutions in the red. Instead of shutting them down, though, FSLIC decided to keep them afloat, which in most instances merely led to bigger losses ultimately borne by taxpayers. The situation became so bad that the government shut down its own agency, transferring its responsibilities to the FDIC.

Deregulation of the commercial banking industry in the 1990s found the FDIC wholly unprepared, largely because it did not understand the lesson

from FSLIC or its own effects on banker behavior. By rendering depositors docile and inattentive, the existence of deposit insurance, particularly with premiums not adjusted for risk, allows bankers to increase profits, but at the cost of increasing the likelihood of failure. Many economists believe that deposit insurance is actually a net negative, because US states and foreign countries with more deposit insurance have less stable financial systems, especially when regulators allow financial institutions to be competitive and innovative. Rather than a savior, then, the FDIC is unnecessary and even pernicious, and expanding insurance to previously uninsured depositors, as was recently done in the SBV case, is likely to lead to more and bigger bank failures.

Note, too, that the FDIC did not completely stop bank runs from occurring during the 2008 crisis, nor during the present unpleasantness. True, nothing like the waves of failures that struck three times during the Great Depression have returned as of the time of writing, but then again, even the Great Recession, the COVID Recession, and whatever the US economy is experiencing now did not come close to matching the Depression's duration.

Moreover, a private remedy shunted aside by the New Deal might well prove superior to deposit insurance. It imposed double liability on bank stockholders, making them keen to find the right tradeoff between bank profitability and riskiness and inducing them to monitor bank behavior closely. It is true that double liability did not help to thwart the Depression's bank-failure waves, but that was because many states did not actually enforce the liability rule strictly enough to have the intended effect on incentives.

It is not clear that some sort of enhanced stockholder liability has yet returned to the Overton Window, but it is possible that Americans will point out the hypocrisy of the Biden administration's raising taxes on the rich with one hand while bailing them out with the other. Scaling back deposit insurance, combined with a credible policy of putting failure costs onto their rightful owners, stockholders, instead of onto taxpayers might become politically possible. It sounds progressive, yet smartly done could also be sound policy.

– March 19, 2023

Silicon Valley Bank: Bespoke, Woke, and Restoked?

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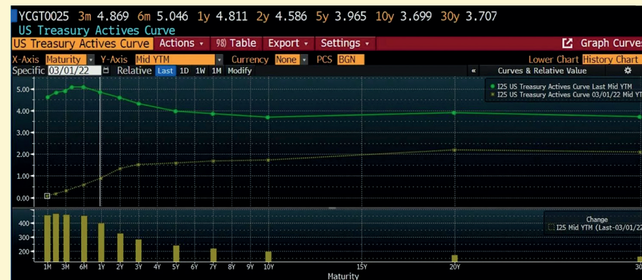
As these things tend to, the collapse of Silicon Valley Bank (SVB) has given rise to a host of wide-ranging discussions. Again comes a long weekend of fear and conjecture, so familiar to anyone remembering Lehman weekend, the guiding of Bear Stearns into JP Morgan's commercial embrace, airlines dropping like flies after September 11, jitters over the fate of Long-Term Capital Management in September of 1998, and so many others. And yet, by the time I was just finishing this writing, the situation had (at least temporarily) abated.

Let's start at the beginning. What happened?

A Classic Mismatch

First: This is not a case involving bad assets. It also, at least so far, does not seem to be one of fraud or intentional misdoing (that, as always, may change.) SVB was felled, fundamentally, by a duration gap. A duration gap is a measure of interest risk and the product of an asset-liability mismatch. When short-term liabilities fund long-term assets, such as US Treasury and agency bonds in the case of SVB, rising interest rates can generate tremendous losses. Rates on short-term liabilities are variable, while the income generated by the long-term assets (bonds and agencies owned) are fixed.

A look at the one year shift in the US yield curve depicts the one year changes in the US Treasury yield curve concisely. The yellow line is the yield curve on March 1, 2022, and the green line is the yield curve on Friday, March 11, 2023.



(Source: Bloomberg Finance, LP)

While this simple illustration does its job, in reality, the circumstances for SVB and institutions like it are worse. The actual short-term liabilities, bank deposits, tend to be costlier than the short-term Treasury obligations that compete with them. To accumulate deposits, banks must offer higher rates of interest than such instruments and compete with rates being paid on deposits at other banks. Most importantly, the increase in yields is associated with losses on the bonds, which manifests as deep losses to the financial institution's equity. Although the one-year change in 20- and 30-year US Treasury yields was small, the impact on the prices of those bonds was abysmal. Last year, the longest-dated US Treasuries lost over 39 percent of their value. In addition to those losses, the illiquidity of off-the-run (aged) bonds with long maturities is notorious. Prices of mortgage securities also cratered as interest rates rose from just under 2 percent to over 6 percent. Additional losses were likely sustained amid efforts to liquidate them.

Typically, banks attempt to address duration gaps by anticipating interest rate changes and their effects in advance. Some use interest rate swaps, trading away fixed interest payments for payments that "float" along with rising rates. For others, a process

called immunization (too soon?) is undertaken which changes the composition of the portfolio to decrease the mismatch, minimizing or eliminating a gap in duration. SVB was in the midst of attempting such a shuffle, but as the losses associated with several early bond sales became known and capital-raising alternatives were proposed, $42 billion in deposits fled with near instantaneity.

The good news is that SVB's problems are largely idiosyncratic. Like most regional banks, SVB's depositor base was much less diversified than nationwide banks. But in the case of SVB, that narrow exposure came in the form of its depositor base being concentrated in tech start-ups, a type of firm that not only burns through cash, but quickly and at an unpredictable rate. Consequently, SVB had a more tenuous, volatile deposit base than many of its regional bank peers elsewhere in the United States. Additionally, those start-up firms are tethered together by a handful of large venture capital (VC) firms which advise them, leading to herding behaviors. This was a factor as well. As rumors about SVB's health began to spread in the last few days, VCs apparently told their portfolio firms to shift their deposits elsewhere — which they did, en masse.

A Predictable Bray

No sooner does a firm keel over than calls for a bailout or some other government rescue ring out. The effrontery that attends the call to hurl taxpayers beneath the wheels of the business failure bus is perhaps the most enduring dividend of a chain of government rescues beginning with the Penn Central loan guarantees in 1970. While the early, official comment from Treasury Secretary Janet Yellen is that there will be no bailout, as of this writing (5pm Sunday March 12, 2023) various sources are reporting depositors lining up at a number of other banks in SVB's geographic and commercial ambit. While SVB is not a systemically significant financial institution, it's worth mentioning that vast numbers of banks have large holdings of long-bonds purchased at record high prices and rock-bottom interest rates. Although the majority of them are not likely to be as precariously situated as SVB and its dubiously viewed neighbors are, a systemic problem of some magnitude may still lurk below the surface.

A few additional words which, in a few days or weeks may, and hopefully do, prove irrelevant.

Government rescues are frequently marketed as having been profitable or, at the very least, not losing taxpayer money. Those claims are best taken with the proverbial grain of salt. First, because if that's true, it's purely accidental. However marketed, bailouts usually occur under duress and little (if any) economic calculation accompanies them. They tend not to be cost-effective in light of the risk taken. And even if they are, it doesn't matter. It's not as if I will receive a check for my portion of the rewards reaped. There's no conceivable reason why I, living 3,036 miles from Silicon Valley, should contribute even the meagerest financial support to a regional bank, much less to one that had an extraordinarily concentrated deposit base and was negligently slow to attempt to immunize its bond portfolios.

Some Silicon Valley start-ups may not be able to make payroll? That's unfortunate. Certain VC portfolios may suffer damaging writedowns? That, too, is a shame. Many non-tech firms that service high tech clients — caterers, cleaning services, headhunters, accounting practices — may see their businesses irreparably harmed? Possibly. Hopefully these are all temporary setbacks. In some cases, they will not be. Yet I am aware of nothing under the sun that obligates anyone, anywhere, to sacrifice so little as a Continental dollar to alleviate their circumstances, whether they were aware of the possibilities or not.

Too-big-to-fail has arguably become a competitive advantage, if the number of times that SVB being the "13th largest bank in America" was repeated over the weekend is any indication. Moral hazard is sewn into the fabric of American business culture now. And that's all the more reason to let these banks fail sloppily, invite better-run competitors to acquire their remnants, and allow depositors to feel the full ramifications arising with the indefinite restitution of funds beyond the FDIC guarantees. It is in that way, and that way alone, that lasting lessons are learned. For a few generations, anyway.

The Alms of Wokeness

In the post-FTX world, no account of corporate incompetence or wrongdoing is complete without a review of the subject's political activism. In the case of SVB, a line that figured prominently on the values page of the website (before it was replaced by the sterile FDIC receivership page) is that "[they] take responsibility." About that, we shall see.

More interestingly, the SVB website spared no opportunity to trumpet a commitment to gender, race, and ethnicity within their workforce and senior-executive ranks. It did so in an appropriately data-effusive manner including percentages, charts, and the like. Another quantitatively intensive page, explaining its Greenhouse Gas/carbon footprint policy, did so as well. One wonders, if some of that computational power had been directed at conducting simple "what-if" simulations regarding the future path of interest rates, would a greater calling have been fulfilled?

On Twitter over the weekend, an account (now locked) commented that

> [t]he SVB collapse has been devastating in more ways than one: They supported women, minorities, & the LGBTQ community more than any other big bank.This includes not just diverse events, but actual funding. SVB helped us move one step forward; without them, we move two steps back.

Those sentiments deftly dismiss the more salient issue: SVB was a mismanaged bank. Whatever communities it served so faithfully in the past are now facing the uncertainties associated with fiscal maladministration. Maladministration, one finds, is exactly like its victims: unbiased, genderless, raceless, and ageless. Clients of many banks which focused on risk management, instead of leftist ideologies, slept soundly this weekend.

It's likely that over the past weekend SVB depositors were as pleased with their bank's deep commitment to diversity, equity, and inclusion as individuals with funds in FTX brokerage accounts were to learn about Sam Bankman-Fried's devotion to "effective altruism." And while it will be likely derided as a specious association, it is curious that virtually all of the firms which have recently detonated in spectacular fashion were devout standard-bearers of the environmental, social, and governance (ESG) doctrine. Perhaps wounded and hamstrung depositors, employees of firms dependent upon those deposits, and the many vendors, suppliers, contractors, and other businesses impacted by the bank's implosion will find solace in knowing that (although their money is either lost or will be inaccessible for some period of time) SVB was included in Bloomberg's Gender-Equality Index for five years running.

In Flux…This Very Moment

I'd written, "The SVB story is as fluid as these come and will develop on an hourly, rather than a daily, or weekly, timeframe." And as soon as I wrote those words, I was informed of an announcement made jointly by the US Treasury, the Federal Reserve, and the FDIC. Evidently another financial institution,

Signature Bank, was closed by regulators today. And, more crucially, SVB depositors will have access to their entire account balances tomorrow. Does this set a new precedent, whereby FDIC deposit insurance limits ($250,000 per account) are perfunctory? The Fed also indicated that it will make additional funds available as necessary through a Bank Term Funding Program (BTFM) backstopped by the Treasury's Exchange Stabilization Fund. Is this a de facto return to monetary easing, to some extent or another? Does this development signal the beginning of the end of the Fed's attempt to quash inflation, or serve as a nudge toward shifting the goalposts to an above-2-percent-per-annum inflation target?

S&P March 2023 E-mini Futures vs.
DXY Index (Sunday evening, 12 March 2023)

(Source: Bloomberg Finance, LP)

In a chorus which has become familiar, the S&P 500 futures just leapt upward, as the dollar fell with equal fervor. Relief for equities, a snub to the greenback. At 7:45pm EDT on an otherwise quiet Sunday night in March, this is what that kicking the can down the road looks like.

– March 13, 2023

Fed Raises Rate, But Signals Potential Pause in May

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The Federal Open Market Committee (FOMC) moved forward with an anticipated 25-basis-point increase in its federal funds rate target on Wednesday. It no longer, however, "anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time." Now, the FOMC "anticipates that some additional policy firming may be appropriate." In the post-meeting press conference, Chairman Powell called attention to the words "some" and "may."

Why did the FOMC soften its language? It is certainly not because the FOMC has tamed inflation.

Inflation remains high and shows little sign of moderating. The consumer price index (CPI) grew at a continuously compounding annual rate of 4.4 percent in February. Core CPI, which excludes volatile food and energy prices and is therefore thought to be a better indicator of future inflation, has risen in recent months. In November, core CPI inflation was just 3.7 percent. It increased to 4.8 percent in December, 4.9 percent in January, and 5.4 percent in February. That suggests the Fed still has some work to do on the inflation front.

The softer language cannot be due to the FOMC's getting its target into the sufficiently restrictive range, either — because it hasn't. The most recent 25-basis-point hike raises the nominal target range to 4.75 to 5 percent. With core inflation greater than 5 percent, the real (inflation-adjusted) interest rate target range is still negative! Despite this, the FOMC left its terminal rate projection for 2023 unchanged at 5.1 percent, which would be consistent with a target range of 5.0 to 5.25.

The FOMC softened its language not because its job is done, but because it expects to get some help from financial markets going forward.

As Powell explained in the Q&A:

> The intermeeting data on inflation and the labor market came in stronger than expected and, really, before the recent events, we were clearly on track to continue with ongoing rate hikes. In fact, as of a couple weeks ago, it looked like we would need to raise rates — over the course of the year — more than we'd expected at the time of our SEP in December. […] So, we also assess, as I mentioned, that events of the last two weeks are likely to result in some tightening of credit conditions for households and businesses and thereby weigh on demand, on the labor market, and on inflation. Such a tightening in financial conditions would work in the same direction as rate tightening. In principle, as a matter of fact, you can think of it as being the equivalent of a rate hike— or, perhaps more than that. Of course, it's not possible to make that assessment today with any precision whatsoever. So our decision was to move ahead with the 25 basis point hike and to change our guidance, as I mentioned, from 'ongoing hikes' to 'some additional hikes may be — some policy firming may be appropriate.' So, going forward, as I mentioned, in assessing the need for further hikes we'll be focused as always on the incoming data and the evolving outlook — and, in particular, on our assessment of the actual and expected effects of credit tightening.

In other words, FOMC members believe the recent bank failures are a sign that credit conditions are tightening, and will continue to tighten in the near term. But they don't yet know how much credit will tighten and, correspondingly, how much nominal spending will slow. The more credit tightens on its own, the less the Fed will need to do to bring down inflation.

It is difficult to ignore the parallels between the FOMC's view today and its position throughout most of 2021. That's worrisome.

Throughout 2021, FOMC members were convinced that inflation was primarily driven by supply constraints, and would decline on its own as those constraints eased up. In each post-meeting statement from March 2021 to September 2021, the FOMC said inflation had risen or was elevated, "largely reflecting transitory factors." In late summer and early fall 2021, however, the incoming data suggested the members were wrong: prices accelerated as real output recovered. And, yet, Fed officials seemed reluctant to revise their beliefs. The FOMC did not soften its post-meeting statement until November 2021, when it said the high inflation largely reflected "factors that are expected to be transitory." Powell would retire the term transitory by the end of the month. And, in December 2021, the FOMC revised its statement to acknowledge demand-side factors.

Even then, the FOMC was slow to act — suggesting that it had not given up on the supply-side transitory inflation view entirely. It did not raise its federal funds rate target until March 2022. It did not raise rates by 50 basis points or more until May 2022.

Instead of acting quickly and decisively in 2021, FOMC members waited around for some help. That help never came, and inflation was much worse than it otherwise might have been.

Then they were looking for help from recovering supply chains. Now, they are looking for help from tight financial markets. It's time FOMC members help themselves — or, God help us all.

– March 23, 2023

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