RESEARCH REPORTS

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Contents

5 Business Conditions Monthly
   Peter C. Earle

11 Leading Indicators

18 Roughly Coincident Indicators

22 Lagging Indicators

26 Capital Market Performance

27 Take the Government Out of GDP
   Peter C. Earle
   Thomas Savidge

31 Inflation Declined in March, But Remains High
   William J. Luther

33 Stakeholder Statism is Coming
   Richard M. Reinsch II

37 US Economic Growth Plunges in First Quarter 2024
   Peter C. Earle

38 Sanders’s 4-Day Week Will Kill Flexible Jobs
   Vance Ginn

40 The Ratchet Effect on the Fed’s Balance Sheet
   Paul Mueller

42 Is Texas Really the Future of Freedom?
   Jason Sorens

44 Getting Monetary Policy Back on Track
   Judy Shelton

47 Texas Continues to Push Back Against ESG, But Is It Enough?
   Paul Mueller
   Thomas Savidge
In March 2023, the AIER Business Conditions Monthly Leading Indicator fell to its lowest level in five months, and the Lagging Indicator declined for a third consecutive month. The Roughly Coincident Indicator, meanwhile, rose to its highest reading since September 2023. Respectively, the index levels for March were 58 for the Leading Indicator, 83 for the Roughly Coincident Indicator, and 25 for the Lagging Indicator.

(Source: Bloomberg Finance, LP)
Leading Indicators (58)
Among the components of the Leading Indicator six rose, two were neutral, and four declined.

The rising components within the Leading Indicator included FINRA Customer Debit Balances in Margin Accounts (5.5 percent), Conference Board US Leading Index of Stock Prices (3.2 percent), the University of Michigan Consumer Expectations Index (2.9 percent), Adjusted Retail and Food Service Sales (0.6 percent), the Conference Board US Manufacturers New Orders Nondefense Capital Good Ex Aircraft (0.2 percent), and the Conference Board US Leading Index Manufacturing, New Orders, Consumer Goods and Materials (0.1 percent). The US Average Weekly Hours All Employees Manufacturing and Inventory/Sales Ratio: Total Business were both unchanged from February to March. Declining were US Initial Jobless Claims (-4.2 percent), United States Heavy Trucks Sales (-9.6 percent), the 1-to-10 year US Treasury spread (-9.9 percent), and US New Privately Owned Housing Units Started by Structure (-16.8 percent).

At the 58 level, the Leading Indicator indicates economic expansion among its component measures, albeit at the lowest rate since October 2023.

Roughly Coincident (83) and Lagging Indicators (25)
The Roughly Coincident Indicator, which at 83 reached its highest level since September 2023.

Five components of the indicator rose including the US Labor Force Participation Rate (0.3 percent), the Conference Board’s Coincident Manufacturing and Trade Sales (0.3 percent) and Coincident Personal Income Less Transfer Payments (0.2 percent) measures, US Employees on Nonfarm Payrolls (0.2 percent), and the Federal Reserve’s Industrial Production index (0.1 percent). The Conference Board Consumer Confidence Present Situation index fell 0.5 percent.

Meanwhile, the Lagging Indicator had one rising, one neutral, and four falling components in March 2024. US Commercial Paper Placed Top 30 Day Yields rose by half of one percent, and the core CPI year-over-year was unchanged. US Manufacturing and Trade Inventories fell (0.1 percent), as did Census Bureau’s Private Construction Spending (Nonresidential) (down 0.2 percent), Conference Board US Lagging Commercial and Industrial Loans (0.9 percent), and the Conference Board US Lagging Avg Duration of Unemployment (3.3 percent).

As noted last month, the Roughly Coincident Indicator has remained the most consistent of the three Business Conditions Monthly metrics, showing expansionary trends going back to late 2022 with two brief retracements in 2023 (January and October). The Lagging Indicator, on the other hand, has given mostly neutral or contractionary signals since April 2023 other than in August and November 2023.

Discussion
April and May of 2024 have seen a number of anticipated developments in the US economy materialize.

April 2024 jobless claims indicated layoffs on the rise, suggesting labor markets are cooling more rapidly than expected. More data will be needed to see if this is a developing trend or a larger-than-normal seasonal effect. If the U-3 rate, which hit 3.9 percent in February and again in April reaches the 4.0 percent level in May or June, the Fed will have an alibi for cutting rates during the summer. For the week ending May 4, initial claims for unemployment insurance surged to 231,000 on a seasonally adjusted basis, surpassing both the prior 209,000 and the consensus forecast of 212,000. Claims surpassing 250,000 would strongly suggest sagging employment conditions, which in conjunction with a 4.0 percent U-3 reading are likely to meet FOMC Chairman Jerome Powell’s stated criteria of an “unexpected weakening” permitting a more accommodative monetary policy stance. Notably, both New York and California reported the largest gains in unadjusted claims,
with California’s recent minimum-wage hike potentially leading to 30,000 to 90,000 job losses and an 0.2 to 0.5 percent increase in the state unemployment rate. For the week ending April 27, continuing claims rose by 17,000 to 1.79 million on a seasonally adjusted basis, with the insured unemployment rate steady at 1.2%. A report from Challenger, Gray & Christmas, Inc. on May 2 indicated that while job cuts decreased by 4.6 percent year-over-year in April, hiring plans were at their lowest since 2016.

Additionally, if the U-3 unemployment rate rises to 4.0 percent in the next two months, it would trigger the Sahm Rule for identifying a recession. The U-2 unemployment rate, which tracks job losses and the end of temporary jobs, increased to 1.93 percent from 1.81 percent, continuing its upward trend from last year. Another indication of weakening employment conditions, the six-month moving average of net unemployment flows, remained negative for the twelfth consecutive month.

US consumers, who for well over a year have defied predictions of flagging spending capacity, appear to be pulling back. Looking first at sentiment, elevated inflation and a cooling labor market have pushed consumer confidence to its lowest level since July 2022. Responses to Conference Board surveys suggest consumers may limit discretionary purchases going forward. The Conference Board’s headline consumer-confidence index fell to 97.0 in April from a downwardly revised 103.1, below the consensus forecast of 104.0. Expectations for the future dropped to 66.4, also the lowest level since July 2022, from 74.0 prior, a level frequently signaling economic contraction over the subsequent twelve months. Consumers are increasingly concerned about their families’ financial situations over the next six months, with 53.8 percent expecting higher interest rates in the year ahead. The assessment of the present situation dropped to 142.9 from 146.8, with fewer consumers seeing jobs as plentiful (40.2 percent vs. 41.7 percent) and more reporting difficulty finding jobs (14.9 percent vs. 12.2 percent). Perceptions of buying conditions have softened amid persistently high financing costs, with rising delinquency rates on auto loans and credit cards, particularly among low-income borrowers. Americans are becoming increasingly concerned as their incomes are squeezed, and consumption will likely continue to slow.

April 2024 statistics on actual/realized spending activity substantiates the aforementioned surveys. US retail sales stagnated after downwardly revised gains in the prior two months, reflecting the growing impact of high borrowing costs and mounting debt on consumer behavior. The US Commerce Department reported that the value of retail purchases, unadjusted for inflation, remained largely unchanged from the previous month, following a revised 0.6 percent increase in March. Much of the spending during April was on necessities such as food and gasoline. A median forecast in a Bloomberg survey of economists had predicted an 0.4 percent rise, but excluding cars and gasoline, sales actually dropped 0.1 percent. Seven out of 13 categories of retail goods posted falling sales, with declines led by non-store retailers, sporting goods, hobby merchants. Sales receipts at gas stations rose 3.1 percent amid higher pump prices, and auto sales declined. In the aggregate, both actual consumption and sentiment figures suggest a distinct softening in consumer demand, which since 2022 has been a key driver of broad economic resilience. Amid signs of declining labor market health, elevated prices and interest rates (the last time the prime rate was at its current level was in February 2001) are squeezing household finances, significantly crimping discretionary purchases. Household debt reached a record high in the first quarter of 2024 and the proportion of consumers struggling to repay debts rose, according to the Federal Reserve Bank of New York, signaling tighter budgets and less optimism among Americans.

The April Consumer Price Index (CPI) data released on Wednesday, May 15th showed that underlying inflation cooled in April for the first
time in six months, indicating that price pressures are gradually easing and supporting the Federal Reserve’s strategy to maintain higher interest rates for an extended period. The core CPI reading was the lowest of the 2024, indicating some positive disinflation trends. Likely encouraging to the Fed was data showing the long hoped-for disinflation in housing rents. Growth in primary rents eased to 0.35 percent from 0.41 percent, with owners-equivalent rent (OER) rising from 0.42 percent to 0.44 percent. Market rents suggest that both OER and primary-rent inflation will continue to slow throughout 2024, with annual overall shelter inflation potentially falling to 4.0 percent by early 2025 from 5.6% in April. Nevertheless, strong inflationary pressures were evident in car insurance (up 1.8 percent). On a one-, three-, and six-month annualized basis, core CPI rose by 3.6 percent, 4.1 percent, and 4.0 percent, respectively. (In March those annualized changes stood at 4.4 percent, 4.5 percent, and 3.9 percent.)

Disinflation became somewhat less entrenched in April, with the share of core spending categories experiencing outright deflation declining to 38 percent from 42 percent. Additionally, the share of categories with moderate annualized monthly inflation of zero to 2.0 percent rose from 11 to 12 percent as categories with annualized inflation between 2 and 4 percent decreased to 5 from 6 percent. Of particular note, the share of categories with annualized inflation above 4 percent rose from 40 to 45 percent. This trend will likely be watched closely by policymakers in coming months. While the April 2024 CPI report may bolster the Fed’s confidence regarding their progress in the battle against inflation, they will look more closely at the Personal Consumption Expenditure release on May 31st. All told, after the bumpy start to 2024 Fed officials are likely to seek more conclusive data and evidence of the resumption of disinflationary trends than they might have at the end of 2023.

The weak industrial production report for April may have been worse but for unseasonably warm weather, which increased electric power output. Declines in most production categories were offset by the rise. The output of consumer durable goods and business equipment fell, suggesting manufacturers anticipate heightened sensitivity to interest rates from consumers and businesses in the months ahead. Having said that, it should be noted that the volatility of industrial production data early in the first half of a given year tends to reduce the signal value of March, April, and May reports. US manufacturing activity dropped 0.3 percent, falling short of consensus expectations. Consumer goods production increased slightly (0.1 percent) while consumer durables decreased by 1.5 percent, indicating rising concerns among producers about consumer interest-rate sensitivity. Despite that, previous gains in auto products and electronics buoyed durables manufacturing earlier in 2024, blunting some of April’s decline. Non-energy consumer nondurable goods production rose by 0.9 percent due to higher output in food, clothing, and chemicals. Mining output decreased by 0.6 percent, a less severe decline than March’s 1.1 percent drop. Capacity utilization edged down to 78.4 percent. In total, while utilities output and consumer nondurables were bright spots, the report revealed significant weakness in key business cycle indicators.

Similar results were seen on the service side in April. The sharp slowdown in activity indicates that monetary policy continues to weigh heavily on the economy, even as firms grapple with high input costs. In surveys, business managers reported “hiring freezes” and challenges related to “inflationary pressure through labor and service costs.” The Institute for Supply Management (ISM) Services Purchasing Managers Index (PMI) fell into contractionary territory for the first time since 2022, dropping to 49.4 from 51.4, below consensus expectations of 52.0. The employment sub-index declined to 45.9 from 48.5, a level which may not improve until looser monetary policy measures are taken. The prices-paid component surged to 59.2 from 53.4, with firms citing higher costs for
products and services. New orders, a forward-looking indicator of business demand, fell to 52.2 from 54.4, suggesting a broader slowdown ahead. Among the conclusions which can be conservatively drawn from the April goods and services reports: rate hikes are now conclusively exerting pressure on US manufacturing; higher prices are continuing to pose significant challenges for American businesses; and employment challenges are creeping further back in the term structure of production.

Since the spring of 2023, our view has been that US economic growth would begin contracting by September 2024. As of April/May 2024, a wide variety of indicators suggest that the anticipated decline is occurring and gaining momentum. We remain cautious, as economic statistics have been both volatile and reflective of highly unusual underlying conditions since pandemic policies were lifted three years ago. While recent data aligns with our spring 2023 forecast, the expression of waning economic circumstances may not be reflective of prior slowdowns and recessions.

(Note: Shaded areas indicate NBER-designated periods of recession.)
(Source: Bloomberg Finance, LP)
(Source: Bloomberg Finance, LP)
Debit Balances in Customers Securities Margin Accounts

Average: $888,822,21
High: $935,862 (10/03/2021)
Low: $102,842 (04/01/1997)

Inventory/Sales Ratio : Total Business

Low: 1.24 (03/31/2013)
High: 1.74 (04/30/2020)
Average: 1.42

(Source: Bloomberg Finance, LP)
Leading Indicators

June 2024

(Source: Bloomberg Finance, LP)
(Source: Bloomberg Finance, LP)
1 Year - 10 Year Bond Yield Spread

Average: 139.22
High: 344.33 (03/31/2010)
Low: -160.22 (06/30/2023)

(Source: Bloomberg Finance, LP)
Roughly Coincident Indicators
Roughly Coincident Indicators

Conference Board Coincident Personal Income Less Transfer Payments

- Average: 10090.35
- High: 15935 (02/29/2024)
- Low: 5196 (07/31/1980)

Conference Board Consumer Confidence Present Situation SA

- Average: 101.69
- High: 166.6 (07/31/2000)
- Low: 15.8 (12/31/1982)

(Source: Bloomberg Finance, LP)
Roughly Coincident Indicators

(Source: Bloomberg Finance, LP)
Roughly Coincident Indicators

US Labor Force Participation Rate SA

- Average: 64.9%
- High: 67.3 (01/31/2000)
- Low: 60.1 (04/30/2020)

US Employees on Nonfarm Payrolls Total SA

- Average: 12,961,036
- High: 15,811,111 (03/31/2023)
- Low: 8,077,101 (03/31/1983)

(Source: Bloomberg Finance, LP)
Lagging Indicators

US CPI Urban Consumers Less Food & Energy YoY NSA

Average: 3.34
High: 3.6 (06/30/1980)
Low: 0.6 (10/31/2010)

US Commercial Paper Placed Top 30 Day Yield

Average: 2.28
High: 4.62 (06/30/2000)
Low: 0.04 (05/31/2021)

(Source: Bloomberg Finance, LP)
Lagging Indicators

June 2024

(Source: Bloomberg Finance, LP)
## Capital Market Performance

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<tr>
<th>Ticker</th>
<th>Short Name</th>
<th>%1M</th>
<th>%3M</th>
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Take the Government Out of GDP

Peter C. Earle  (Senior Research Fellow)
Thomas Savidge  (Research Fellow)

With the release of the 2024 Q1 Gross Domestic Product (GDP) data by the Bureau of Economic Analysis, the question of economic growth is on many minds. Real GDP growth slowed to an increase of 1.6 percent from a year ago, lagging well behind the 2.4 percent projection. The BEA commented that the increase is due to “consumer spending, residential fixed investment, nonresidential fixed investment, and state and local government spending that were partly offset by a decrease in private inventory investment” as well as an increase in imports. It is important to note here that the increase in state and local government spending came from an increase in government employee compensation, meaning taxpayers are getting the same government services as last year at a higher cost.

The nominal GDP equation used by the Bureau of Economic Analysis (BEA) goes as follows:

$$Y = C + I + G + NX$$

Where Y is GDP or output, C is gross private consumption, I is gross private domestic investment, G is government consumption expenditures and gross investment, and NX is net exports. A common mistake, however, is that GDP gets treated as a simple accounting identity, whereby any increase on the right-hand side of the ledger must mean an increase in nominal output. That is not necessarily the case.

This analysis aims to look at how the economy is performing without government spending muddying the water. Our aim is to examine the “Gross Domestic Private Product” (GDP excluding government purchases) based on the work of economists such as Robert Higgs, Ryan McMaken, and Matthew Mitchell using updated data from the BEA.

GDP vs GDPP: Examining the Data

We utilize the data from the BEA website, specifically from the “National Income and Product Accounts” table, in addition to Table 1.1.6 (Real Gross Domestic Product, Billions of Chained 2017 Dollars). To calculate GDPP, we subtract the G (“Government consumption expenditures and gross investment”) variable from total GDP. Note that G does not include transfer payments, such as Social Security (because Social Security or Unemployment Insurance consumption is counted towards private spending). While the average percentage of G is 25.7 percent for 1950-2023, 28.8 percent for 1950-1999, and 19.2 percent for 2000-2023, total government spending (including transfer payments) as a percentage of GDP is much higher than the variable G. This also does not consider the impact of government debt, which generates a significant level of drag on economic growth.

In previous analyses, the BEA provided inflation-adjusted numbers in chained 2009 dollars. Starting in 2018, the BEA replaced real GDP estimates in chained 2009 dollars with real GDP in chained 2017 dollars. While the BEA did not provide specific reasons for why they chose 2017 as the new base year for chained dollars, typically such adjustments are made for changes in the relative importance of certain goods and services (weighting), new data methodologies, and/or the diminishing relevance of legacy data. Despite the change in base year, however, we see similar results to the analysis provided by McMacken in 2017 using chained 2009 dollars. Like Higgs and McMacken, we use BEA Table 1.1.6.
McMaken’s findings in 2017 still hold true today: gross domestic private product growth has slumped. When comparing the average annual growth rate before and after 2000, we see a slump in the average annual growth rate. The figure below shows that the average annual growth rate of GDPP prior to 2000 was 3.63 percent while the post-2000 average was 2.34 percent. While not the stark 50 percent difference shown in McMaken’s analysis (due to data and methodological updates), GDPP has still been growing 35 percent slower per year since the start of the new millennium.

In Mitchell’s 2010 paper, he also compares these growth rates to the growth rates of the US government. Those charts have been recreated below, covering the same period as the figure above. The average annual growth rates are calculated based on the chained 2017-dollar amounts. (Federal totals include both defense and nondefense spending.)
Note that in both time periods government consumption expenditures and gross investment have consistently outpaced private sector growth. State and local governments in particular have outpaced private sector growth. Mitchell notes, and we concur, that the increase in federal transfers has played a direct and substantial role in the rapid growth in state and local governments. Although not directly measured in the BEA estimates, these transfers have allowed state and local governments to increase spending in other areas because they can rely on federal transfers to fund a significant portion of their budget.

As we noted recently, the dependence of US states upon federal funds has increased at an alarming rate. When federal policymakers inevitably make cuts to those state and local transfers, state and local governments are faced with making large, sometimes unexpected tax hikes and spending cuts to fill funding gaps. And while the federal government has states increasingly dependent upon those transfers, it has the power to exert control over state and local policy, using funding to influence policy that effectively generates an end-run on Congress and the legislative process. And when states face fiscal crises for their unsustainable budget policies, gross domestic private product suffers. The ensuing debt restructuring process drives families and businesses to flee the states in crisis, not only shrinking private investment and consumption but giving rise to an increasing number, and level, of taxation.

GDP vs GDPP Over the Business Cycle
Also noted by McMaken, the difference between GDP and GDPP helps analyze the business cycle. The figure below shows the year-over-year changes in quarterly GDP and GDPP.

We find that GDPP has year-over-year rates of increase larger than GDP (note again that this excludes government transfer payments). Additionally, GDPP falls more than GDP before recessions. While McMaken remained pessimistic about 2016, we do see a recovery up until the COVID-19 pandemic. The massive increase in 2021 followed by the slump in 2022 is emblematic of government-induced booms from massive government spending and historically expansionary monetary policy programs.

As mentioned earlier, Q1 2024 GDP estimates fell below projections. As expected, GDPP rose in tandem with GDP. The BEA release states that the decrease in inventory investment (one of the causes of GDP coming in below projections) “reflected decreases in wholesale trade and manufacturing.” The increase in consumer spending was also “partly offset by a decrease in goods,” all contributing to slow GDPP growth.
Understanding the Cost of Government

Many people believe that government spending can jump start or boost economic growth. The multiplier effect is a cornerstone of most macroeconomic classes. Yet the embrace of the concept suffers from the classic error of Frederic Bastiat’s Broken Window Fallacy in his equally famous work, What is Seen and What is Not Seen. In it, Bastiat tells the parable of a shopkeeper’s window being broken by his son. Onlookers comfort the store owner, asking, “What would happen to the glassmakers if no window were ever broken?” Sure, the glassmaker is now six francs richer because of the broken window (“What is seen”) but the cost to the shopkeeper is the next highest-valued use of those six francs (“What is not seen”).

In the private sector wealth is created through voluntary exchange. Two or more parties come together voluntarily and exchange goods or services that of equal or comparable value, benefitting all parties involved. As the late economist Walter Williams put it, “With the rise of capitalism, it became possible to amass great wealth by serving and pleasing one’s fellow man. Capitalists seek to discover what people want and then produce and market it as efficiently as possible as a means to wealth.”

Government spending, on the other hand, is not peaceful or voluntary exchange, whatever narratives attempt to frame it as such. Tax revenues are harvested from private citizens by means of coercion and extractive measures. If citizens do not comply and pay their taxes, they face fines and jail time. Paying taxes to remain free of incarceration or not face withering financial penalties is hardly indicative of cooperative exchange.

The economist James Buchanan noted that when governments decide to finance spending by taking on debt, the effects are two-fold. First, private investors purchasing government debt comes at the cost of whatever other projects investors might have otherwise invested in or provided financing for. As Buchanan put it, spending that is funded by debt is “in effect chopping up the apple trees for firewood, thereby reducing the yield of the orchard forever.” Debt-financed spending also shifts tax burdens from present to future generations. While bond investors trust that their loan will be paid back with interest, future generations will bear the cost of the government spending undertaken today.

With many Americans still feeling the sting of the current tax season, now is an especially pertinent time to reflect on how much money they’ve sent to the government: not only on April 15th, but throughout the year via withholdings, sales taxes, and other takings. Readers should ask themselves, “What could I have done with the money I paid to the government?” And even if one was fortunate enough to receive a refund, all they’ve done is extend an interest-free loan. What might have been done with the monies that were withheld?

Our goal in examining GDPP is to get readers thinking about the “unseen” costs of government and unraveling how much the US government costs private sector growth.

– April 25, 2024
Inflation Declined in March, But Remains High

William J. Luther  
(*Director, AIER’s Sound Money Project*)

Inflation is once again on the decline, new data from the Bureau of Economic Analysis (BEA) show. The Personal Consumption Expenditures Price Index (PCEPI), which is the Federal Reserve’s preferred measure of inflation, grew at a continuously compounding annual rate of 3.9 percent in March. It grew at an annualized rate of 5.1 percent in January and 4.0 percent in February.

The renewed disinflation is certainly better than the alternative. But it is nonetheless difficult to celebrate: inflation remains well above the Fed’s 2-percent average inflation target. Prices today are 8.9 percentage points higher than they would have been had they grown at an annualized rate of 2.0 percent since January 2020.

Core inflation, which excludes volatile food and energy prices, also remained elevated. Core PCEPI grew at a continuously compounding annual rate of 3.8 percent in March. It has grown at an annualized rate of 4.3 percent over the last three months and 2.9 percent over the last six months.

The latest numbers will do little to sway members of the Federal Open Market Committee (FOMC), who are set to meet next week. “We’ve said at the FOMC that we’ll need greater confidence that inflation is moving sustainably toward 2 percent before it would be appropriate to ease policy,” Fed Chair Jerome Powell said on April 16. “If higher inflation does persist, we can maintain the current level of restriction for as long as needed.”

New York Fed President John Williams expressed a similar view on April 18:

*I think we’ve got interest rates in a place that is moving us gradually to our goals, so I definitely don’t feel urgency to cut interest rates. I think that monetary policy is doing exactly what we’d like to see. Over time, the data will inform our decisions. I think, eventually, my expectation is as inflation gets all the way to 2 percent on a sustained basis, as the economy is in good balance, interest rates will need to be lower at some point. But the timing of that’s driven by the economy.*
Williams said the economic data “are strong on the labor market and GDP and spending.” On inflation, he said “it’s a little bit of a bumpy road. But, overall, the trend is — the inflation has gradually coming [sic] down.”

FOMC members entered the blackout period on April 20 and, hence, have not offered comments on the latest data. But it seems very unlikely that the observed disinflation would change their tune.

Market participants continue to expect the Fed will cut its federal funds rate target this year — just not anytime soon. The CME Group reports a 70.1 percent chance that the federal funds rate target range will remain at 5.25 to 5.5 percent following the July meeting. But the odds fall to 42.1 percent for the September meeting, 32.6 percent for the November meeting, and just 20.0 percent for the December meeting.

Market participants also doubt that rates will fall as far as Fed officials have projected. In March, the median FOMC member projected the federal funds rate target range would fall to 4.5 to 4.75 percent. The CME Group, however, reports an 88.6 percent chance that the federal funds rate target will exceed that range following the December meeting.

FOMC members will almost certainly vote to hold their target rate constant next week. The real question is whether they will offer any additional guidance on when they might begin to cut the target rate and how quickly the target rate might fall. At present, it seems likely that rates will remain high for some time. But that could change quickly if real economic activity were to falter.

– April 26, 2024
Stakeholder Statism is Coming

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A unification of forces has produced the array of Environmental, Social, and Governance (ESG) policies that have fervently emerged across Europe and in America in the past two decades. Broadly defined, ESG promises environmental activism, egalitarianism across races and genders, and an aspirational commitment to social justice, enforced in and through corporations. How should we think about this incredibly skilled and powerful movement that has enlisted our largest and most successful corporations in its efforts, along with a host of transnational institutions, NGOs, and national and subnational governments? Is ESG an actual threat to free institutions, most notably markets and civil society? Or, as advocates contend, do ESG policies provide better pricing and risk factors to what are dangerous, risky, and environmentally unsound practices? Will ESG help us to both earn money and do well by serving people and the planet?

Answering these questions in a compelling way is Paul Tice’s *The Race to Zero: How ESG Investing Will Crater the Global Financial System*. Tice spent decades on Wall Street working for JP Morgan Chase, Lehman, and BlackRock. This book’s critical analysis of ESG highlights that the entire financial industry has been co-opted in a giant swindle by an aggressive global scale humanitarian ideology. On almost every page Tice illuminates a tremendous con job being perpetrated in full sight of finance professionals, who know better, but lack the courage to state clearly that ESG’s promises are fraudulent in operation, destroy investor wealth, and enrich discrete groups of players who sharply influence the allocation of capital under ESG.

That effort has required Wall Street professionals to “willingly suspend disbelief and forgo the traditional financial approach” of “comparing leverage metrics, cash flow margins, and earnings momentum.” Instead, they are now “sizing up carbon footprints, checking on water and electricity usage, and making sure companies are paying their ‘fair share’ of corporate taxes.”

In general, ESG follows the trajectory of efforts by the progressive left to replace a free, voluntary, and competitive society and its institutions with centrally ordered institutions on behalf of social justice and a plethora of auto-generating rights. In many respects, ESG is just another version of top-down coordinated efforts by progressives to engineer their preferred society. ESG’s variation on left-progressive ideology, Tice observes, is sustainable investing, that “subjective environmental, social, and governance factors should drive corporate policy and investment decisions, as opposed to objective financial metrics and returns.” Primary elements hold the sustainable, salvific ESG glue together: ending global poverty, preventing climate change, and striving for social justice, generally. Of these elements, Tice observes, “climate change remains the highest-priority ESG issue.” The ideological urgency it adds to the entire concept of sustainable investing has made resisting the sweep of ESG incredibly difficult for financial institutions and professionals.

As Tice notes early in the book, “the master ESG list is kept, not by financial market participants, but rather by an informal working group comprised of the United Nations (UN), the World Economic Forum (WEF), liberal politicians, academics, environmental activists, social justice warriors, and the media.” The list itself, typically of progressive ideology, changes and evolves. But the constant is sustainable investing, which “redefines all of the core tenets of progressive ideology over the past 100 years as corporate policy goals and investment criteria.”

ESG reveals that we confront ideology and the desire to seek rents by “doing good” with other people’s money. That mixture reinforces a phalanx of organizations convinced that their efforts
would save the world, so long as they have access to a steady stream of institutions delivering capital and rents in their preferred fashion. Attempting to diminish greenhouse gas emissions is incredibly expensive, of course, so the grand narrative must drown out any voices pointing to feasibility, accountability, and consequences.

Tice stresses that ESG’s plan for integrating capitalism into its objectives has always involved replacing shareholder capitalism — a central tenet of American corporate law — with stakeholder capitalism. Tice notes the foundational 1987 Brundtland Report, which built its recommendations for sustainable capitalism on stakeholder theory. The two became a natural fit. The former provides the grand narrative needed to reset capitalism for ideological purposes, that is, a market system that leaves no carbon footprint, generates little pollution of any kind, provides equity for all, and directs profits to the marginalized and oppressed. Stakeholder theory provides the legal and administrative means for accomplishing these objectives.

Stakeholder theory asserts shareholders cannot claim company profits, because corporations must serve stakeholders: employees, suppliers, customers, not to mention unions, non-profits, NGOs, the state, even society at large. Stakeholder capitalism’s effectual truth places shareholders last in line, behind a list of participants that keeps expanding. Tice details how the WEF and UN combined their efforts around stakeholder capitalism to accomplish their broader goals. Initially named the European Management Forum, which held its annual meeting in the ski resort of Davos, Switzerland, it was renamed the World Economic Forum in 1987. Led by German engineer and economist, Klaus Schwab, who stresses in his first book *Modern Company Management* (1971) that capitalism must adopt “the corporatist model prevalent in Germany and other Western European nations during the postwar period.” He suggests a legal arrangement scarcely distinguishable from stakeholder capitalism whereby businesses, labor, and the state engage together to achieve shared public goods, frequently involving government and union representatives sitting on a corporation’s board of directors. One of the prime aims of the Governance platform is to mandate gender and race requirements on company boards, a position endorsed by NASDAQ, the state of California, alongside BlackRock and other major financial institutions. The expectation would clearly be for the federal government to begin mandating seat requirements for groups of people on publicly traded corporation boards, if not closely held companies, in due time.

Schwab’s stakeholder capitalism has necessarily evolved to a global standard in his book *Stakeholder Capitalism: A Global Economy that Works for Progress, People and Planet* (2021) to reflect the priorities the UN has identified in its Sustainable Development Goals for 2030. Schwab now focuses on a global agenda for companies to pursue in the operations of their businesses. The new stakeholders are really two: “people and the planet.” As Schwab grandiloquently put it, “the planet … is the central stakeholder in the global economic system.”

The UN’s most decisive contribution to ESG occurred in 2005 and 2006 under the direction of its then-Secretary General Kofi Annan who convened an international summit in 2005 to discuss ways that the global financial sector could be harnessed to serve global goals of equality, environmental justice, human rights, labor rights, etc. In 2006, the UN formed the Principles for Responsible Investing (PRI) to extend hard ESG tentacles into the financial industry globally, focusing heavily on Europe and North America to “benefit the environment and society as a whole” and ensure a “sustainable global financial system.” The PRI fields a membership encompassing as of March 31, 2023, 5,381 signatories from over 90 countries with an aggregate of $121.3 trillion in assets under management. Core membership for PRI remains in Europe, home of more than half the group’s signatories. PRI’s work is dominated by six principles, with each principle entailing action items for members to pursue.
Members pledge themselves to the following for ESG: integrate, engage, push, proselytize, collaborate, and report on all their efforts (and everyone else's efforts). In a word, control. Tice notes in his book that behind PRI was the realization that all these efforts are for naught without adherence by the financial sector. The financial and investment sector couldn't be left alone to do the measured work of capitalism if UN and WEF sustainability goals were going to be accomplished.

The ESG pricing function is not working as advertised. PRI, Tice observes, wanted by 2027 to ensure that financial markets price ESG risk as “the main discriminant factor in determining the cost and availability of capital for specific industries and issuers.” To accomplish that requires the clearing away obstacles that might stand in the way, notably, the fiduciary rules between management and shareholders, and investors and their clients.

Tice argues no data shows that ESG drives “relative value,” nor “the availability or cost of capital for different sectors and issuing companies.” ESG proceeds in a socially pressuring manner while also promising to create value for investors. The latter is not true. Markets readily ignore ESG-driven pronouncements. This is incredible, Tice says, given the size and scope of the PRI’s global membership. Tice concludes that “empirical evidence has shown little correlation between ESG factors, corporate performance, and investment returns.” Energy debt and equity prices remain aloof, despite years of ESG’s hectoring them and investors about their environmental crimes.

Tice stresses, however, that even though ESG can’t cash the checks it writes, the movement itself may become more dangerous as it enters a new stage: state enforcement. One method for state action is “greenwashing” investigations. ESG portfolios underperform conventional portfolios, as they underweight or eschew “bad” and “dirty” industries and companies. The inevitable temptation is greenwashing by investment firms who label funds as compliant with ESG factors, but are conventional non-ESG funds that have been falsely labelled to signal appropriate virtue. What counts, then, as an ESG fund? Tice notes the inevitable investigations and enforcement actions against investment firms for the crime of greenwashing under European governments. Similar suits and government enforcement efforts will happen in America, led by the SEC.

The list of federal agencies proposing or implementing rules within the ESG wheelhouse is large: the Department of Labor, the SEC, Federal Acquisition Regulatory Council, the Federal Reserve, and Office of the Comptroller of the Currency. This is surely an expanding list. The only solution against what is becoming a frontal assault on capital markets and shareholder corporate form, Tice argues, is to fight back.

On one level, Tice observes, climate change is the symbol of every effort for ESG interventions. Those who would defend a classical liberal order must take it squarely on, noting that markets themselves can better price this risk without ESG. Moreover, Tice himself is incredibly skeptical that doomsday is coming, and he measures his case against the allegedly accurate UN statistics that the earth is warming, and the oceans are rising, hence the need for ESG intervention on a global scale. Tice also notes that antitrust suits should be pursued by targeted companies against the non-profits and NGOs who have colluded and organized boycotts against them. The path for an aggressive counterstrategy lies open under current antitrust law, a fact acknowledged by ESG proponents who try to legislatively exempt their collusion efforts from these suits.
Ultimately, the ESG movement is the latest in a dark legacy of attempts to subvert corporate America from within. Somehow, business leaders keep embracing the ideas of people who hate them. The true ESG goal remains to raise the cost of capital or choke it completely for the unclean sinners in the current economy. Many say the ESG tide appears to be receding as its goals prove unworkable. Tice’s book demonstrates the opposite. ESG now finds favor in progressive governments and bureaucracies to enforce its dictates at large on society. We are entering a new, more pronounced phase of its power. Prepare accordingly.

– May 2, 2024
US Economic Growth Plunges in First Quarter 2024

Peter C. Earle
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The release of 1st quarter 2024 Gross Domestic Product (GDP) on April 25th surprised virtually all forecasters. The first three months of 2024 were characterized by a notable deceleration in US economic growth, marking an almost two-year low. The same data release revealed that inflation, as measured by US GDP Personal Consumption Core Price Index (quarter-over-quarter), accelerated 3.7 percent, ahead of an expected 3.4 percent, disrupting a brief period characterized by robust demand and subdued price pressures. Those conditions previously fostered optimism for a so-called soft landing.

The initial estimate of GDP showed an annualized quarterly growth rate of 1.6 percent, falling short of all economists’ predictions (surveys anticipated 2.5 percent). This deceleration was predominantly attributed to a rapid decline of personal consumption, which increased at a slower-than-anticipated pace of 2.5 percent (versus estimates of 3.0 to 3.5 percent). Moreover, a widening trade deficit exerted the most significant downward pressure on US economic growth since 2022. These figures signal a significant loss of momentum after a surprisingly robust economic performance last year.

Business inventories weighed on growth for a second consecutive quarter, and private capital expenditure remained weak. However, upon excluding the impact of inventories, government spending, and trade, inflation-adjusted final sales to private domestic purchasers — an essential metric for gauging underlying demand — rose at a rate of 3.1 percent. The GDP report further indicated a substantial increase in spending on services, the most significant since the third quarter of 2021, driven primarily by expenditures on healthcare and financial services. But spending on goods declined for the first time in over twelve months, primarily constrained by reduced purchases of motor vehicles and gasoline.

Outbreaks of stagflation, characterized by simultaneously elevated inflation and decelerating economic growth, present a formidable challenge for policymakers. While a recession typically prompts central banks to implement interest rate cuts, stagflation has historically been associated, at least early on, with contractionary monetary policy measures — despite weakening growth trajectories. Recent financial market developments reflect an increasing recognition of this possibility, with options on Secured Overnight Financing Rate (SOFR) futures indicating a 21.4 percent probability of a Fed rate hike by December, marking its highest level since the Federal Reserve signaled the conclusion of its previous rate-hiking cycle. Of note, however, is that another feature of the outbreak of stagflationary conditions — rising unemployment — has not yet actualized. US labor markets are softening, though, and warrant continued monitoring.

Since the end of the pandemic, there have been periods of economic weakness evoking both the onset of a recession and the emergence of stagflation (“stagflation lite”). In April 2023, we forecast slowing US economic growth possibly leading to a recession by September 2024. Unlike most prognostications, which anticipated a recession by the end of 2023, our more patient position was based upon a number of factors, one of which was the acknowledgement that sizable fiscal stimulus measures could engineer higher GDP readings. (Another was our repeatedly vindicated view that pandemic-era policy distortions could persist for years.) At this juncture, it remains too early to determine whether the first quarter 2024 GDP reading is an isolated bout of weakness or the beginning of a contractionary trend. Presently, it should serve as a stark reminder of the fragility underlying much of the post-COVID economic growth, built as it has been atop the unsustainable pillars of fiscal and monetary stimuli.

– April 26, 2024
Sanders’s 4-Day Week Will Kill Flexible Jobs

Vance Ginn
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Imagine a small business owner navigating the complexities of trying to be profitable, as most small businesses close in the first two years, and to provide a reasonable work-life balance for their employees. Enter the “Thirty-Two Hour Workweek Act,” proposed by Senator Bernie Sanders, which seeks to mandate a reduction from 40 to 32 hours at the same pay.

While well-intentioned, this bill simplifies the nuanced balance of modern work environments and threatens the flexibility crucial to businesses and workers.

The Act proposes to amend the Fair Labor Standards Act of 1938. Sanders suggests this change will fairly distribute productivity gains, decrease stress, and improve life quality. However, this sweeping reform would harm sectors where extended hours are essential due to operational demands or competitive pressures. It would also hurt the needs of workers and their families.

Current data from the Bureau of Labor Statistics show that the average workweek for full-time private sector employees is about 34 hours per week. This means employers and workers are already negotiating work arrangements that deviate from the traditional 40-hour workweek based on mutual needs and economic conditions. The BLS table below shows the different average weekly hours by major industry.

In sectors like healthcare or manufacturing, where longer shifts are common, limiting hours might reduce employees’ earnings if they are willing to work more. With their thin profit margins, small businesses could face severe challenges, potentially leading to job cuts, reduced services, or even closures, especially in rural or disadvantaged areas. Only leisure and hospitality and other services industries have average hours at or below 32 hours. Those are typically lower-skilled, lower-paid jobs, with many working part-time for various reasons.

This flexibility in the private sector allows employers to manage labor costs effectively and workers to adjust their schedules for optimal work-life balance.

The proposed 32-hour workweek represents a significant opportunity cost, not only in economic terms but also in worker and employer
liberty. America faces a worker shortage, with job openings exceeding the number of unemployed individuals. Reducing work hours could exacerbate this issue, particularly as many Americans juggle multiple or part-time jobs to make ends meet. This policy would add another layer of complexity and constraint in a market that requires more flexibility, not less.

This act would disproportionately affect small businesses, which typically operate with tighter profit margins and may find the increased labor costs unsustainable. These businesses might be forced to reduce their workforce, cut back services, or, worst cases, shut down altogether. The impact on employment could be profound, especially in rural or economically disadvantaged areas where small businesses are often major employers.

Compensatory flexibility, where businesses adjust other aspects of employment such as benefits or job duties to offset mandated costs, could mean that workers end up with less flexible schedules, reduced benefits, or increased job demands as employers strive to maintain profitability. Total earnings, including pay and benefits, are much higher than average weekly pay, so a government mandate like this would worsen the situation.

Looking globally, countries like France have long experimented with reduced work hours (the 35-hour workweek). The results have been mixed, with some reports suggesting a negligible impact on employment and others indicating increased stress for workers who have to compress the same amount of work into fewer hours. These mixed outcomes underscore the risks of applying such policies universally without considering industry-specific and cultural contexts.

These costs would further exacerbate the connection between people and work by many across the country. Work is also a moral issue, we bear responsibility to “be fruitful and multiply.” Moreover, work brings dignity, value, productivity, and the best path out of poverty. David Bahnsen’s latest book Full-Time Work and the Meaning of Life highlights these virtues of work and how government interventions in the labor market destroy many of its benefits.

Rather than imposing hour restrictions or other government mandates, politicians at the federal, state, and local levels, as appropriate, should remove government barriers to work and let the market work. These policies that would benefit workers include reducing or eliminating most occupational licenses, reducing or eliminating minimum wages, and ending the tax exclusion of employer-sponsored health insurance. These pro-growth policies would allow for more dynamic labor market movements, and spending less and cutting taxes would leave workers with more earnings to support flexible work choices. Also, many companies are already voluntarily innovating with remote work, flexible hours, and four-day work weeks without government mandates. These changes are often driven by the competitive need to attract and retain the best workers and the recognition that happy, well-balanced employees are more productive.

Improving work-life balance is commendable, but the “Thirty-Two Hour Workweek Act” would hinder rather than help. By championing policies that limit government intervention thereby supporting work flexibility and innovation, we can foster a labor market that thrives and adapts organically, benefiting all sectors of the economy and ensuring that both employers and workers enjoy true freedom in crafting their work lives.

– April 29, 2024
The Ratchet Effect on the Fed’s Balance Sheet

Paul Mueller
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Pay no attention to the balance sheet behind the curtain. In the wake of the recent FOMC meeting, few people are talking about the Fed’s balance sheet. While the FOMC took no action on their interest-rate target, they enacted a significant change to their quantitative tightening policy. This change tells us that the Fed is quite happy with the new normal of providing massive liquidity to markets with very little accountability.

Fed officials began its quantitative tightening in August 2022 to help bring inflation down, allowing maturing securities to “roll-off” the balance sheet rather than be reinvested. They capped the monthly roll-off of agency debt and mortgage-backed securities (MBS) at $35 billion and the monthly roll-off of Treasury securities at $60 billion. This meant the balance sheet could decline by up to $95 billion per month.

Over the past twenty months, the Fed’s balance sheet has declined about $1.5 trillion (to $7.4 trillion). It’s a reasonable start, but even at that rate the Fed’s balance sheet would not return to pre-pandemic levels until sometime in early 2027 — assuming leadership didn’t engage in any emergency lending or liquidity facilities in the interim.

But now that they have reduced how many Treasury securities can roll-off each month by $35 billion, we have no reason to believe that they intend to return to a pre-pandemic “normal” balance sheet. At this rate, the balance sheet will barely fall below $6 trillion by the end of next year. And of course, the pre-pandemic balance sheet of $4.5 trillion was more than four-and-a-half times bigger than its balance sheet had ever been pre-2008.

Even if one were sympathetic to the Fed nearly doubling its balance sheet in response to the recent pandemic, there’s no avoiding the double-speak of calling a quantitative tightening program balance sheet “normalization.”

About forty years ago, Robert Higgs pointed out that government spending expands dramatically during crises and does not return to its previous level after the crisis has abated. This “ratchet effect” is one of the most pervasive phenomena in politics.

Although the Fed was not entirely immune from the ratchet effect, the growth of its balance sheet was fairly constrained for most of its history. The Fed targeted interest rates by buying or selling bonds through open market operations. It could not simply buy as many bonds as it wanted because that would drive interest rates to zero. But that changed after the 2008 Global Financial Crisis (GFC).

Fed chairman Ben Bernanke opened Pandora’s Box after 2008, the Fed no longer engaged in open market operations to maintain an interest-rate target. Now it uses a corridor or floor system, raising the fed funds rate by raising the rate it paid banks on their reserves. This then expanded to include interest paid on repo agreements with non-bank financial institutions.

The FOMC now had an entirely free hand to purchase as many securities as they wanted for any reason they wanted. And purchase they did, sometimes for almost no reason at all.

Perhaps one could excuse the Fed for creating large liquidity facilities and emergency lending during the 2008 GFC. But can we excuse the Fed for increasing its balance sheet when there was no crisis? The Fed’s balance sheet grew from $870 billion in August 2007 to $2.3 trillion in 2010, during worst financial crisis and recession since the Great Depression. The ratchet effect would suggest that, with the crisis receding, the balance sheet would shrink some, but not all the way back to its
Instead, it kept growing! The Bernanke Fed added another two trillion dollars to its balance sheet between 2010 and 2014 after two more rounds of quantitative easing. Why? Because unemployment remained higher, and economic growth slower, than Bernanke wanted. And inflation was near zero so...why not?

The recklessness is clear in hindsight. The federal debt has increased over $20 trillion dollars since 2010, which would never have been possible were Fed’s balance sheet less than a trillion dollars. Furthermore, the explosion of its balance sheet has normalized discretionary emergency liquidity facilities. Most people barely batted an eye at the $400 billion created to manage the fallout from Silicon Valley Bank’s failure.

Between 2014 and 2019 the Fed’s balance sheet declined slightly, but even before the pandemic it had rebounded to $4.3 trillion. Then in two years (from March 2020 to April 2022) it more than doubled to a stunning $8.9 trillion.

Given that it took almost two years to get back down to $7.4 trillion, and the recent meeting chose to slow the run-off pace by effectively about fifty percent, no balance sheet normalization is realistic to expect. Barring some unexpected new pressure, the Fed’s balance sheet is unlikely to drop below $6 trillion, let alone get back to $4.5 trillion or even lower. The ratchet effect has locked us in a world with a massive Fed balance sheet — and the insidious problems of runaway deficit spending and easy bailout monetary expansion that come with it.

– May 3, 2024
Is Texas Really the Future of Freedom?

Jason Sorens  
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Texas Attorney General Ken Paxton was schooled on X recently. After he claimed “a unanimous 9-0 win at the Supreme Court” in a takings case, a “Readers added context” note was added to the post, noting, “Texas did not ‘win’, in fact it was the complete opposite. A 9-0 (sic) against Texas allowing the ranchers (sic) lawsuit to move forward.”

You see, Paxton is defending the state from a claim for compensation for a government taking of property rights. That’s not exactly something you’d expect from a liberty-loving Texan.

The episode points up the mythology around many Texans’ attitudes toward freedom. “For as long as Texas has been Texas, it has recognized that property rights are crucial to a free society,” Paxton’s post read – even as his office’s position in the suit is to limit those very same property rights.

Texans perceive themselves to care a lot about freedom. As Claremont McKenna political scientist Kenneth P. Miller has written, Texas consciously remade itself in the 20th century from a Southern state into a Western state. The “cultural makeover” involved monuments, museums, expositions, and public art that “developed a narrative in which Anglo settlement, the Revolution, the Alamo, and San Jacinto became metaphors for American Manifest Destiny and the winning of the West,” a narrative that connected to values of “self-reliance” and “libertarianism.”

So that’s where the self-image comes from. But here’s the problem: Texas’ institutions and policies continue to bear something of an old statist legacy. In the Cato Institute’s Freedom in the 50 States study, Texas scores a mere 17th, behind even the southern states of Florida (#2), Tennessee (#6), Missouri (#8), Georgia (#9), and Virginia (#12).

This ranking of Texas surprises many readers (especially Texans!). After all, isn’t the Texas economy rather successful? Millions of Americans have moved to Texas in the last twenty years, especially from uber-left states like California. Isn’t this the best proof that the red-state model works?

Texas has indeed gotten two big things right: loose local land-use regulation and no state personal or corporate income tax. The first policy provides abundant housing at lower costs. Businesses are attracted not just because they pay no tax on profits earned there. They can also pay lower nominal wages but still hire workers who enjoy a lower cost of living in Texas.

As a result, Texas has grown. Between 2010 and 2020, its net domestic migration rate was 5.2 percent, according to the Census Bureau. Not bad. Yet Texas’ net domestic migration rate between 2010 and 2020 was just 12th in the country. Its rate between April 2020 and June 2022 (the latest available date) was 11th. People talk about migration to Texas because the absolute numbers are huge, but the absolute numbers are huge because Texas is such a big state. As a proportion of their size, in-migration has been far more significant in places like Nevada, Idaho, and South Carolina.

Economic growth is a similar story. The Bureau of Economic Analysis’ real personal income data tell us that Texans’ incomes grew by 3.0 percent per year between 2008 and 2021. Again, not bad. But that was 11th in the country. By contrast, California grew by 3.2 percent per year during that period, putting it into 9th place.

Still, the only other solid-blue state in the top 11 was Washington (3.4 percent), which lacks a personal income tax. A good case can thus be made that red-state economic policy attracts residents and business investment – or at any rate, that deep-blue-state policy repels them.

So Texas has done fine. Yet it doesn’t exemplify robust economic freedom. Here’s why.
First, local government is expensive. The Texas local tax burden is the 5th highest in the US, and the local debt burden is high too. (All those shiny new high school football stadiums are expensive!) This wouldn’t be a problem if local governments were highly responsive and accountable to residents. But Texas’ complex school finance formula means that much of the revenue raised in some districts is shipped out of district. In fact, the state actually incentivizes many districts to raise taxes higher to receive what is effectively a kind of matching grant. Nominally “local” property taxes in Texas are in reality anything but.

Second, Texas has lots of regulations in certain areas. In fact, it’s the last-place state in Freedom in the 50 States’ index of occupational freedom. The Archbridge Institute’s comprehensive survey of licensing barriers finds that Texas has the second-most “barriered” occupations in the country. Like other southern states, Texas has a powerful state medical association that successfully lobbies to limit advanced practice registered nurses’ scope of practice. The Texas legislature has been eager to mandate health insurance coverages beyond the federally defined “essential benefits.” It also ties the hands of insurers that try to use the HMO “gatekeeping” model to keep costs down. Texas also has had problems with its tort liability system. Texas jurisdictions have periodically shown up on the “Judicial Hellholes” list maintained by the Americans for Tort Reform Foundation.

Third, Texas lags on personal freedoms. Texas’ “lock ‘em up and throw away the key” approach to criminal justice might or might not make sense for violent crimes. But it’s surely unreasonable that the state can sentence you to life in prison for a single marijuana conviction that does not involve children. Nor is privacy exactly a priority: Texas actually requires a thumbprint on file from every driver. For a long time, Texas’s security-first orientation meant that open carry was banned and concealed carry strictly regulated. While the state now has joined the “constitutional carry” ranks, some small restrictions still set Texas apart from the very freest states on this issue. Civil asset forfeiture is an example of how law enforcement interests trump property rights in Texas. Authorities can seize private property and then forfeit it by a mere preponderance of the evidence showing. Citizens bear the burden of proof when they want to make an innocent-owner claim. Under some circumstances, the revenue from forfeiture accrues to law enforcement. That incentivizes policing for profit.

Education freedom remains a hot-button issue in Texas. Right now the state doesn’t regulate private or home schools very much. But it also doesn’t have any educational choice programs at all, a glaring disability for a conservative state. The governor has been pushing, and after largely successful Republican primaries for choice advocates it seems likely that next year the state will finally get a robust choice program.

Texas does several big things really well, and I’m rooting for them to improve elsewhere. But let’s not pretend Texas is the free-market archetype for the country. Florida, Arizona, South Dakota, and New Hampshire are more pro-freedom than Texas. They’re just not as loud about it.

– May 6, 2024
Getting Monetary Policy Back on Track

Judy Shelton
(Contributor)

A book that offers up the weighty observations of leading economists, academics, and policymakers on the highly topical subject of monetary policy should rightfully be a runaway bestseller. The trick, though, is to make the discussion not only relevant for readers, but engaging and motivating. While Americans are plenty focused on the angst-inducing effects of inflation, it turns out that endless dissection of Federal Reserve foibles using graphs, tables, charts, and econometric formulations, does not exactly generate a page-turner.

As a monetary economist who respects the work of the notable scholars and policymakers who participated in the Hoover Institution’s annual Monetary Policy Conference held in May 2023 — this volume comprises the presentations, responses, and discussions from that gathering — it is awkward to admit that reading through the proceedings was a bit of a chore.

Don’t get me wrong. It would be well worth the effort if “Getting Monetary Policy Back on Track,” edited by Michael D. Bordo, John H. Cochrane, and John B. Taylor, concluded with bold new proposals for putting the Fed on the high road toward achieving price stability — notwithstanding that the Fed’s definition of “stable prices” is hardly the same as providing sound money.

Alas, after tracing various digressions on the timing of monetary policy decisions, interspersed with well-mannered debates over whether Fed officials deserve criticism for misdiagnosing inflation and waiting too long to act, the overall impact was underwhelming. Which suggests that getting monetary policy “back on track” in accordance with the recommendations of leading economic policymakers may not constitute the blockbuster issue — as inflation persists — that resonates with the public.

It’s not that money isn’t pertinent to the lives of everyone (it is) nor that the world’s top-tier monetary economists are lacking in analytical skills (they aren’t). The problem is that meaningful discussion about something so fundamental as money has largely been culturally outsourced to high-level experts — as if the average citizen is incapable of defining what traits would be most desirable in the nation’s official medium of exchange, unit of account, and store of value.

Thomas Jefferson didn’t see it that way. In his twelve handwritten pages entitled “Notes on the Establishment of a Money Unit, and of a Coinage for the United States,” penned in 1784, Jefferson identified three main considerations for adopting a money unit for Americans: It should be 1) convenient to use, 2) easy to understand, and 3) familiar. The goal was to facilitate commerce, not complicate it.

Jefferson believed the Spanish dollar, widely circulated among the newly independent states, best satisfied those conditions. But it was imperative that the new money unit for the United States be accurately defined in terms of a specific weight of gold or silver. “If we determine that a Dollar shall be our Unit,” he wrote, “we must then say with precision what a Dollar is.” People had to be able to rely on the integrity of America’s common currency.

For Jefferson, the needs of citizens were foremost in establishing the monetary standard, because it would serve as their primary tool for measuring value. Just as government should function as a servant to the people, not vice versa, money should provide a dependable unit of account for free people engaged in free enterprise. Jefferson trusted in the capabilities of individual citizens to make choices that would benefit themselves, their countrymen, and their nation. What else would we expect from a man whose belief in democratic self-governance defined America?

Why, then, have we moved so far away from this
concept of money, instead turning its regulation over to an agency of government whose officials pursue activist monetary policy at the expense of stable purchasing power, and who view the steadfastness of the nation’s money unit as an economic policy variable to be managed?

In this frame of mind, the task of reviewing the arguments presented by notable monetary economists is already hindered by an inner resistance to tackling a perennial question yet again: Should monetary policy be determined by a formal rule or be based on the discretionary judgment of central bank officials? It’s an important question. But it’s been some three decades since economics professor John Taylor of Stanford University published his oft-cited paper, entitled “Discretion versus Policy Rules in Practice.” And so far, discretion is winning. Janet Yellen, serving in 2015 as Federal Reserve Chair, told members of the House Financial Services Committee: “I don’t believe that the Fed should chain itself to any mechanical rule.”

Nevertheless, the first three presentations in the book celebrate the 30-year anniversary of the Taylor Rule, which suggests how central banks should move interest rates in response to inflation and other economic conditions. The conference discussion included an acknowledgment by former Fed vice chair Richard Clarida that Taylor-type rules are “ubiquitous” in the briefing books prepared by staff for Fed officials ahead of monetary policy meetings — even if they are not enforceable. Perhaps those wary of the outsized role of discretion in determining interest rates can take comfort in believing that rules-based approaches offer guidance, at least.

Another three presentations address the subject of financial regulation, focusing on what can be learned from the March 2023 collapse of Silicon Valley Bank. Suffice it to say that massive fiscal stimulus resulted in generationally high inflation, which precipitated, if belatedly, a surge in Fed-engineered interest rates, driving down the value of bank assets, triggering a massive outflow of deposits. Citing fiscal irresponsibility as the culprit, as opposed to regulatory and supervisory shortcomings, former Fed Vice Chair for Supervision Randal Quarles framed the most valuable lesson: “Don’t do that again.” Others blamed lax enforcement by bank examiners and misdirected stress tests.

The most daring second-guessing of Fed actions (including its failure to act) was conducted by Mickey Levy, chief economist for Berenberg Capital Markets LLC and a longstanding member of the Shadow Open Market Committee. In his paper entitled, “The Fed: Bad Forecasts and Misguided Monetary Policy,” Levy did not pull punches. “Poor judgment, misguided assessment of data, and a failure to heed the lessons of history have contributed to the Fed’s errors.” Levy documented the Fed’s collective myopia in projecting future inflation and interest rates and cited the hazard of groupthink for accumulated policy mistakes. “Like so many organizations, the Fed has a ‘circle the wagons’ mentality in which FOMC members are encouraged (feel pressure) to support the institution’s views and not deviate very much.”

Unfortunately, such straightforward criticism — glorious while it lasts — gets artfully clawed back by other conference participants who note there was “uncertainty about the persistence of undesirably high inflation” after it emerged in 2021. Also, while it did not prove wise to dismiss as “transitory” the rapid upward trajectory of prices, the Fed was understandably reluctant to validate inflation narratives that ran counter to its claim that inflation expectations were firmly anchored. Then, too, as one discussant, a former Fed official, pointed out: Didn’t all ten of the countries in the G10 likewise fail to hike rates before inflation exceeded the target?

The book’s penultimate section, entitled “Toward a Monetary Strategy,” begins with a presentation by James Bullard, head of the Federal Reserve Bank of St. Louis at the time and
former voting member on the Federal Open Market Committee. Bringing up the impact of stimulative fiscal policy, Bullard affirmed: “The monetary and fiscal policy response to the pandemic created too much inflation.” Less convincingly, he suggested that the prospects for disinflation look “reasonably good” as fiscal stimulus recedes. Philip Jefferson, a Fed board member since May 2022 and the current vice chair, assured conference participants that the Fed was already well “on track” after 500 basis points of tightening its policy rate. Jeffrey Lacker and Charles Plosser, both former presidents of Federal Reserve district banks, suggested that the Fed should improve its public communications — which seemed rather anticlimactic. Referring to various monetary policy rules when discussing the likely future path of interest rates would be most helpful to clarify Fed thinking, they suggested. “This would not require taking the step of committing to any one particular rule.”

In short, the problem with plowing through this book, while it is certainly edifying, is that some readers might be left feeling depressed about the prospects for stable money. It seems as if the experts identify much more closely with the central bankers — the practitioners of monetary policy — than with those forced to contend with the negative consequences of bad decisions. Economics is a social science, after all. Monetary economists should perhaps put less emphasis on science, in favor of giving more consideration to the social and moral implications of monetary policy failings.

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Texas Continues to Push Back Against ESG, But Is It Enough?

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In late March, the Texas Permanent School Fund (TPSF), a perpetual fund established to support Texas public schools, announced it was pulling $8.5 billion from BlackRock. The TPSF pulled this money because the asset manager was using investor funds to push Environmental, Social, and Governance (ESG) practices by boycotting fossil fuel and energy companies. While BlackRock holds some shares in fossil fuel companies such as ExxonMobil, Philips 66, Occidental Petroleum, and Valero Energy in its massive portfolio, over the past several years the company has called for “Sustainability as BlackRock’s New Standard for Investing.” That means it actively encourages other companies it owns shares in, such as large financial and insurance firms, to shift away from fossil fuels. Hence the 2021 Texas law requiring state agencies to divest from companies that “shed investments to reduce greenhouse gas emissions,” which TPSF cites in its letter to Blackrock.

But even though the TPSF has pulled funds from Blackrock, if they follow the advice of “proxy advisory firms,” such as Institutional Shareholder Services (ISS) or Glass Lewis & Co (Glass Lewis), then TPSF funds will still be used to push ESG. Proxy advisory firms take on the search cost of making an informed shareholder vote and supposedly act in the best interest of the investor. By recommending that shareholders vote for proposals and board members committing to reducing emissions, implementing diversity, equity, and inclusion (DEI) policies, and other politicized ideals, proxy advisory firms demonstrate that the best interests of the investors are a low priority.

Pursuing ESG priorities allows asset managers to put their own political crusades ahead of the interests of shareholders. And who are the shareholders? Not the Gordon Gecko ESG advocates portray, but ordinary men and women. The TPSF manages funds designated for education on behalf of Texas taxpayers. If the funds have lower returns because of asset managers’ ESG crusades, Texas taxpayers are on the hook.

A litany of evidence shows that funds using ESG investing strategies perform worse than funds without these strategies. ESG investing fails because the political constraints prevent investors from purchasing otherwise profitable investments, and from having greater diversification, which leaves millions of dollars on the table.

Previous claims that ESG can be profitable have been thoroughly debunked. In 2022, an MIT study found “widespread and repeated” changes in historical ESG scores without explanation. Studies that claimed ESG practices make companies more profitable, showed that often profitable companies were looking for ways to signal their success and landed on trying to get a good ESG rating.

As Paul has discussed extensively elsewhere, ESG advocates often use high-pressure tactics to persuade a few key people to sign onto their agenda or shame them into complying. Furthermore, ESG criteria create a world with less achievement and greater conflict, and which sacrifices individual rights for the sake of the “collective good.”

TPSF parting ways with BlackRock sends a clear message that Texas taxpayers do not want to pay for ESG priorities. BlackRock officials denied that these funds were being used to push ESG, but that has not assuaged the TPSF’s concerns, citing BlackRock’s “dominant and persistent leadership in the ESG movement.”

Although BlackRock CEO Larry Fink has disavowed terms like ESG or DEI, Blackrock will not necessarily stop engaging in social activist investing. Instead, they will change the branding to less politically unpopular terms like “sustainable,” or “responsible” investing.

ESG initiatives are still being pushed through proxy advisory firms. Two firms dominate this field: ISS (the largest proxy advisory firm) and Glass Lewis & Co.
Lewis. Huge numbers of investors rely on these firms’ recommendations and “robovote,” meaning they follow a proxy advisor’s recommendations without any independent review. A report from the Manhattan Institute found that 86 percent of robovoting investors used ISS while 14 percent used Glass Lewis. The root of proxy advisory power comes from a 2003 SEC rule requiring investment funds to publish their votes. To maintain compliance with SEC regulations, these firms were incentivized to “outsource” their votes to proxy firms. In 2020, the SEC issued a rule that applied public filing requirements, other documents, and anti-fraud provisions (including the ability to sue proxy advisors) would apply to proxy advisory firms, drawing a lawsuit from ISS. In 2022, key portions of the rule were repealed by the SEC to assuage proxy firms’ concerns. SEC Commissioner Hester Peirce noted that these rapid changes would damage the commission’s credibility and make people wonder if they are responding to “political rather than market signals.” In February 2024, the US District Court for the District of Columbia ruled in favor of ISS, stating that the 2022 partial repeal was insufficient and the SEC’s authority over the matter was invalid.

For example, in 2021 ISS proxy voting guidance led the Employees’ Retirement System of Texas (owning 1.519 million shares) and the Teacher Retirement System of Texas (owning 871,536 shares) to vote their shares in favor of placing ESG advocates, who want to reduce fossil fuel development and use, in three of the four open board positions at Exxon-Mobil — the largest fossil fuel company in the world. Owning such large share amounts meant that the Texas funds had a significant amount of voting power.

The fund managers in Texas only realized what had occurred after the votes had been cast. Had the fund managers known and made changes to the shareholder votes, the outcome of the ExxonMobil Board Elections probably would have been different. This issue spurred the 2021 law that pushed Texas agencies to divest from asset managers pushing ESG.

The clear solution to the proxy advisory firm problem comes from greater competition. Removing barriers to entry allows additional proxy advisory firms to offer alternatives that focus solely on financial factors, and would force ISS and Glass Lewis to reconsider their positions to remain competitive. In addition, regulations on firm voting can be reformed to decrease dependence on proxy firms. Further, state funds can also require asset managers and proxy advisory firms alike to act solely in the financial interest of the fund and prohibit the use of “non-pecuniary” factors.

While we hope the TPSF no longer robovotes its shareholder proxies, state and local funds and private wealth managers still do. Pulling money from asset managers who put environmental, social, and governance goals over the interests of their clients is a good start. But until the proxy advisory firms change their priorities, or become less relevant, shareholders will find that their votes are being used to push ESG without their consent.

– May 23, 2024