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Overview of Tax Driven Currencies

- The government desires to provision itself
- It levies a tax payable in its currency of issue
- The currency is a (simple) public monopoly
- This creates sellers of real goods and services who want units of that currency in return
- The government then provisions itself by using its currency to purchase the goods and services offered for sale that it desires

Overview of Tax Driven Currencies (Cont.)

- If federal spending isn't sufficient to cover the need to pay the tax and desires to (net) save units of the currency, the evidence is unemployment and excess capacity in general.
- For a any given size govt., taxes can always be set at the right level to sustain full employment

Monetary Operations

- US dollars exist only as cash, reserve balances at the Fed, and Treasury securities account balances at the Fed.
- Treasury securities are, functionally, ‘savings accounts’ at the Fed.

Monetary Operations- Sustainability

- Government spending is via the Fed crediting member bank reserve accounts.
- Operationally, this process is not constrained by revenues.
- Any constraints are necessarily political and self imposed.
- Ability to pay concerns are not applicable.
- Willingness to pay is the matter for concern.

Federal Taxation

- Federal taxes function to regulate aggregate demand, and not to raise revenue per se
- Govt. taxation is a matter of the Fed debiting member bank reserve accounts.
- The government doesn't actually 'get anything'- it just changes numbers.
- Note: if you pay taxes with cash, the cash is shredded

Federal Borrowing

- When the Treasury spends without taxing, member bank reserve account balances are credited.
- When Treasury Securities are sold, the Fed debits member bank reserve accounts and credits securities accounts at the Fed.

Federal Borrowing (cont.)

- The government going into debt is the shifting of dollars from reserve accounts at the Fed to securities accounts at the Fed.
- Paying off government debt is the shifting of dollars from securities accounts at the Fed to reserve accounts at the Fed.
- There are no grandchildren involved in this process.
- Operationally, there is no sustainability issue

Fiscal Policy

- Taxing reduces aggregate demand and creates unemployment- people looking for paid work who can’t find it
- Spending adds to aggregate demand

Federal Deficits Add to Savings

- Treasury spending in excess of taxes increases Fed member bank reserve account balances
- Govt. sales of Treasury securities shifts balances from reserve accounts to securities accounts
- Treasury securities are also financial assets we call savings

Quantitative Easing

- QE is the Fed buying Treasury Securities in the marketplace from willing sellers, which alters the term structure of rates
- This shifts private sector dollar balances from securities accounts at the Fed to reserve accounts at the Fed
- Both are US government liabilities
- Interest income earned by the private sector is reduced as per the securities sold to the Fed
- The private sector earns interest on the new reserve balances

QE is a tax!

- The $79 billion of profits the Fed turned over to the Treasury was interest that was previously being earned by the private sector
- QE analysis generally ignores this income channel
- For the government, the Fed buying securities is functionally identical to the Treasury never having issued them

Why Haven’t Interest Rate Cuts Worked?

- For every $US borrowed there is a $US saved
- The government is a net payer of interest
- Rate cuts lowered interest income for savers more than for borrowers, as net interest margins for lenders widened
- Supply side effects are deflationary- rates are a cost of production and a cost of holding inventory

The Trade Gap-
Domestic Credit Funds Foreign Savings

- Example- I voluntarily buy a foreign car
- I borrow the $ from a bank
- The bank loan creates a bank deposit
- The foreign car company gets the deposit
- I get the car and a car payment
- The bank gets a loan and a deposit
- All three are ‘happy’ and ‘in balance’

The Trade Gap- Borrowing from China

- China doesn't 'start out' with any dollars
- China sells hairdryers and tires in the US
- When China gets paid the Fed credits its reserve account
- When China buys Treasury securities the Fed debits its reserve account and credits its securities account at the Fed
- At maturity the Fed debits China's securities account and credits its reserve account
- No grandchildren are involved

The Trade Gap- Borrowing from China (cont.)

- The President, Congress, and the mainstream economists and media believe we have run out of money and are dependent on the likes of China to finance our deficit spending
- The President, Sec. of State, and Tsy Sec visit and kowtow to China, our presumed bankers, on nuclear weapons and human rights

The Trade Gap- Borrowing from China (cont.)

- Why should we care if China's dollars are in their reserve account or their securities account?
- And we express fears that China might sell its dollars and cause the dollar to go down
- Even as we send trade negotiators demanding they strengthen their currency against the dollar.

Trade Gap Facts

- Exports are real costs
- Imports real benefits
- Economics is the opposite of religion-
  it's better to receive than to give

- Full employment can always be sustained via fiscal adjustment

Trade Gap Facts

The wealth of a nation is:

- All that it can produce domestically
- Plus all that it can import
- Minus all it must export
- It's about optimizing real terms of trade and domestic employment

The Current State of Aggregate Demand

China

- Inflation severe enough to be aggressively fighting it
- Allowing currency appreciation throws exporters under the bus
- Fiscal and monetary adjustments underway
- Growth rates slowing
- Odds favor a hard landing

The Euro Zone

- The member nations have turned themselves into what financially resembles U.S. states
- Spending by the member nations is constrained by revenues
- The ECB is the entity that is the issuer of the currency and is not revenue constrained

The Euro Zone- Fiscal Policy

- All have violated the Stability and Growth Pact
- The ECB is funding the banking system and the national governments
- The ECB is controlling fiscal policy by setting terms and conditions for its funding
- Austerity is underway across the region as mandated by the ECB

The Euro Zone- Recent History

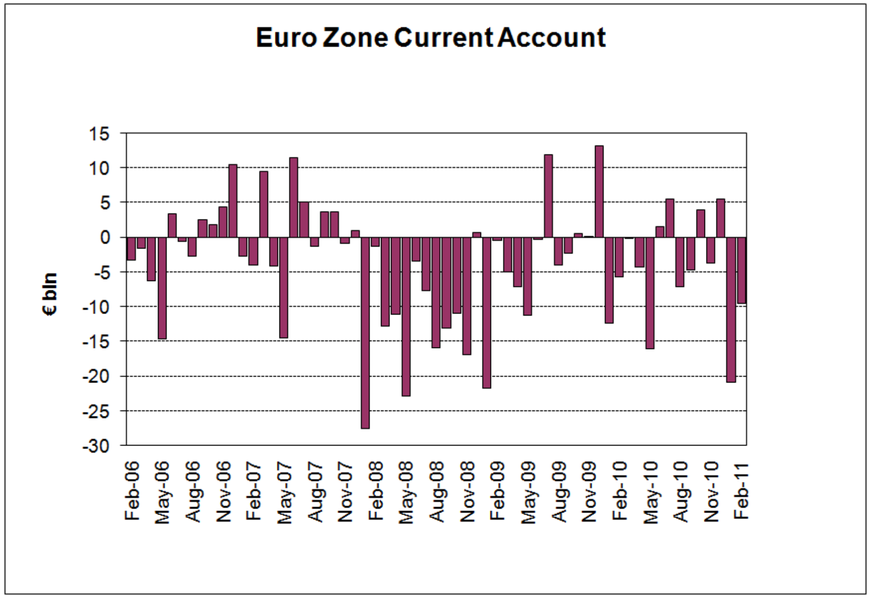
- Automatic fiscal stabilizers- falling revenues and rising transfer payments- drove up all national government deficits in 2008.
- The deficits got high enough to catch the fall in GDP and promote a recovery
- The austerity measures are proactively bringing deficits down

The Euro Zone (cont.)

- Initially, the austerity is deflationary, reducing deficits, and supporting the value of currency
- At some point deficits are insufficient to support GDP
- When that point is reached, economic weakness causes deficits to move higher and undermine the value of the currency
- Continued austerity measures then make things worse
- Markets are beginning to tell me the euro zone is very close to that point

The Euro Zone (cont.)

- Germany has been outperforming in part due to its exports to the rest of the euro zone
- The ECB is indirectly funding the periphery's purchases of German exports
- It's all operationally sustainable for as long as the ECB agrees to 'write the check'
- And the problem is the ECB doesn't want to write the check


Euro Zone Current Account
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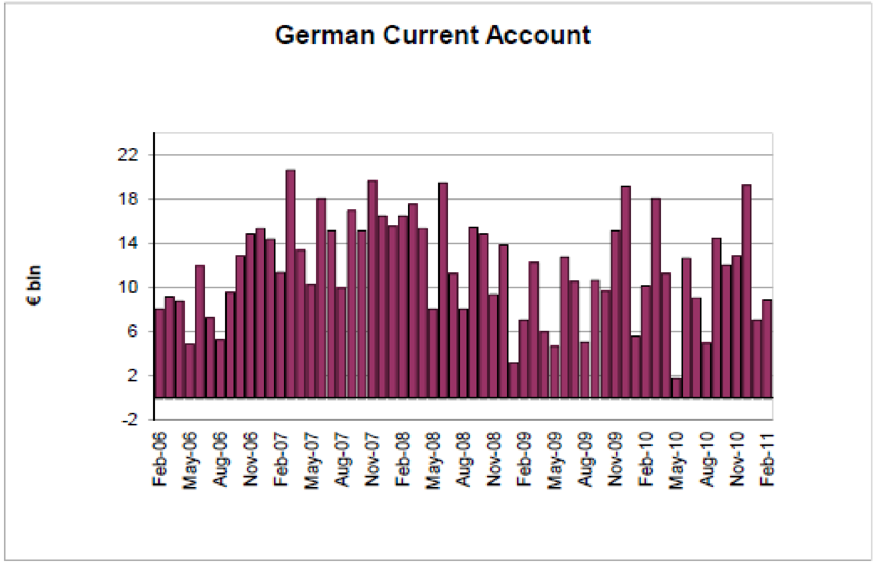
German Current Account
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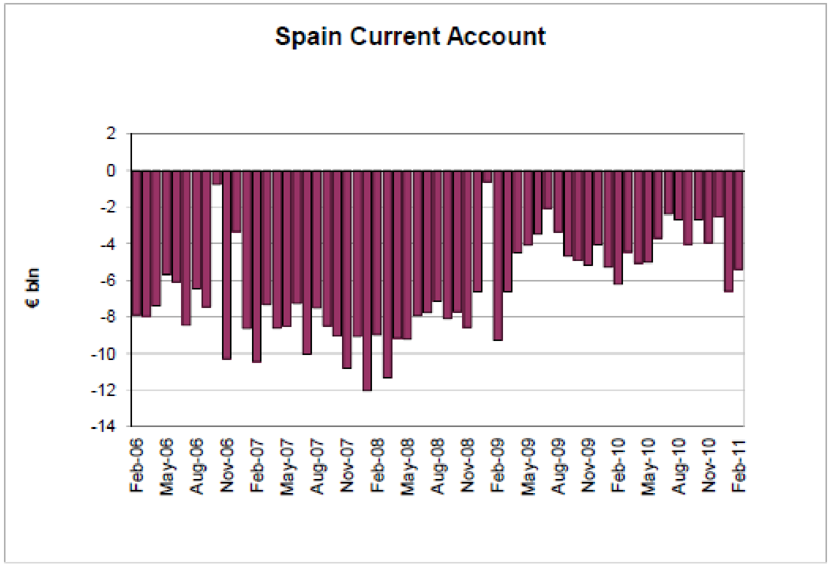
Spain Current Account
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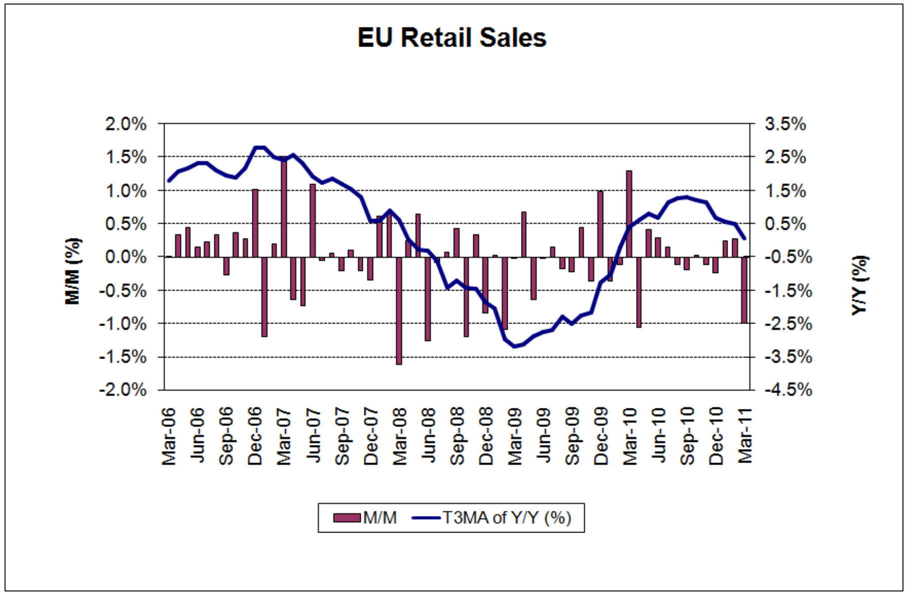
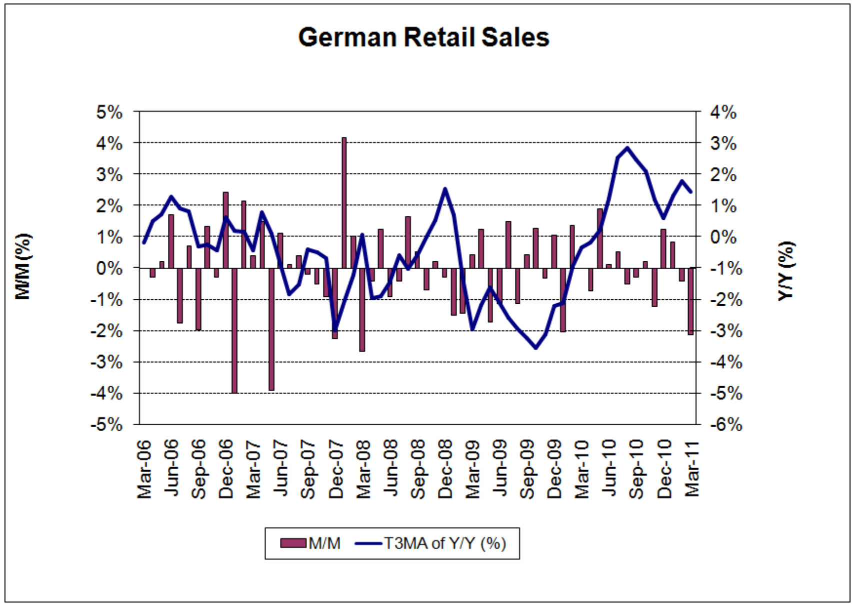
The Eurozone has never done well

EU Retail Sales fell 1.0% M/M and 1.7% Y/Y in March. Details show that sales for food, drink and tobacco fell 0.6% M/M while non-food products fell 1.1% M/M. Market expectations were for a 0.1% M/M decline and a flat Y/Y reading.



Germany has done so well the ECB had to hike rates?

German Retail Sales fell 2.1% M/M and 3.5% Y/Y in March, versus market expectations for an increase of 0.2% M/M and 1.4% Y/Y.



U.S.

- Automatic fiscal stabilizers were responsible for the U.S. recovery that began in 2009
- The deficit has been large enough to support modest GDP growth and gradually bring down the output gap as well

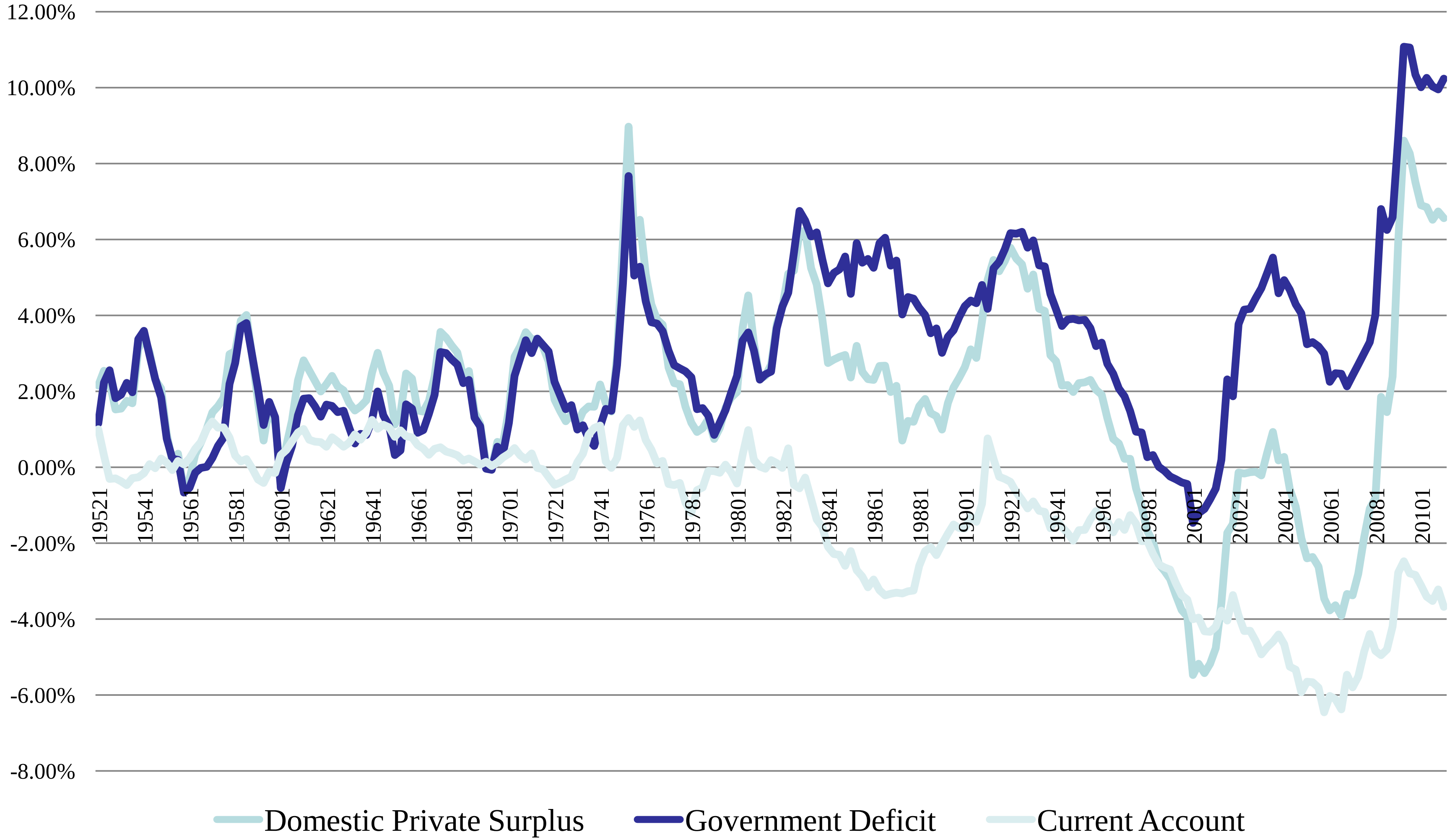
U.S. (cont.)

- Low interest rates have not led to excess demand
- The 0% fed funds rate and QE shifted interest income from savers to lenders and borrowers
- The $79 billion Fed transfer to Treasury had been interest earned by previous bondholders
- Bank net interest margins have widened as income shifted from savers to banks

U.S. (cont.)

- The U.S. Congress is embracing deficit reduction, which reduces aggregate demand
- Both sides agree that the deficit and sustainability is a serious problem that must be addressed
- Both sides agree that the U.S. could become the next Greece and funding is at risk
- Both sides have presented multi $trillion deficit reduction proposals

Sector Financial Balances as a % of GDP
1952q1 to 2011q1



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Friday's Employment Report

- The positives have been well publicized, but here are a few negatives from Goldman:

- The labor force participation rate was unchanged during the month, indicating that the rise in the unemployment rate reflected job losses rather than an influx of persons into the labor force.

- The employment-to-population ratio fell slightly to 58.4% from 58.5% previously.

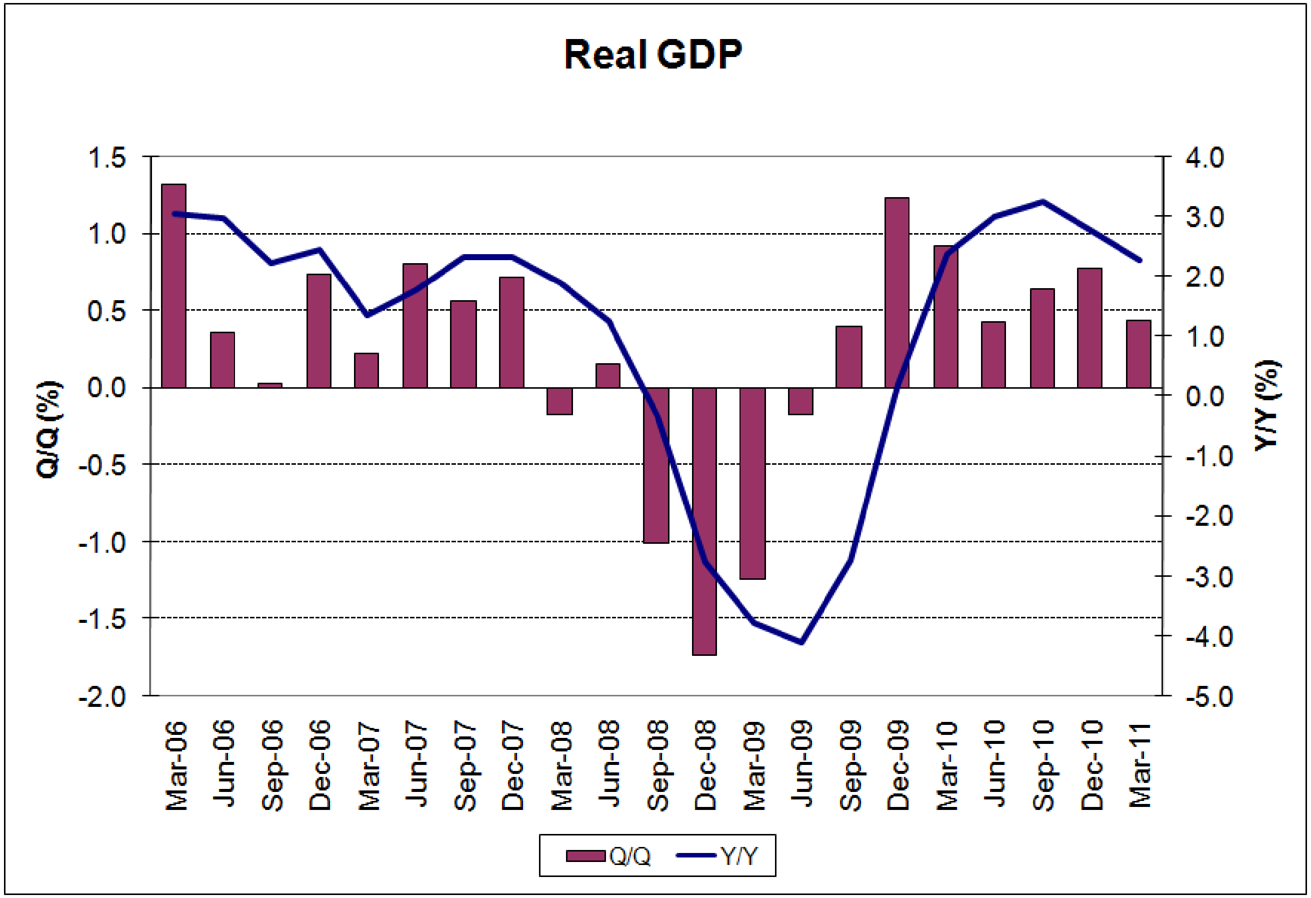
- After the unemployment Report, our Current Activity Indicator (CAI) showed growth of 2.3% in April, down from 4.0% in March.

- The deceleration mostly reflects weaker survey-based data (e.g. the non-manufacturing ISM and Philly reports), and indicates a cooling in overall growth early in Q2.

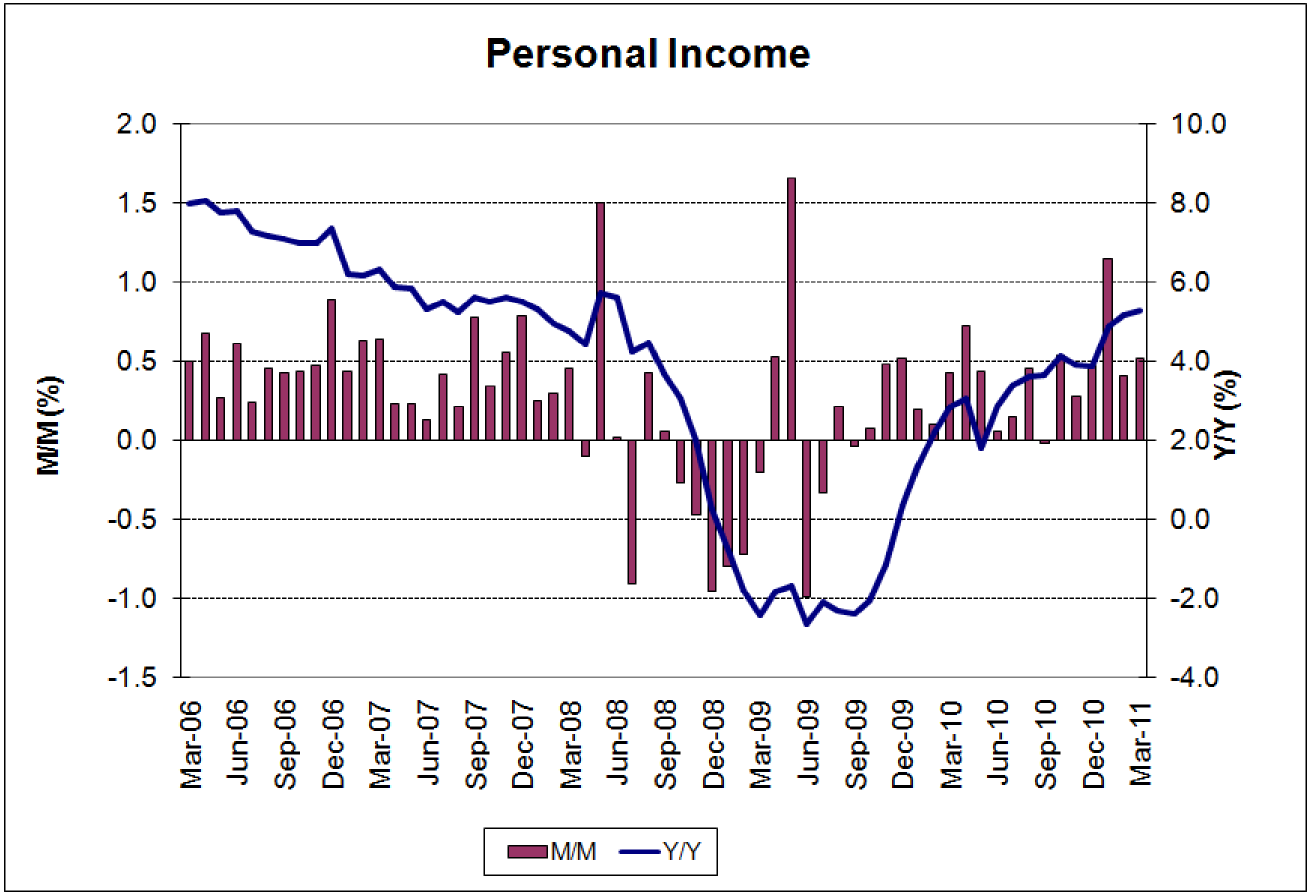
US Headlines

- **ISM non-manufacturing Index slumped to 52.8 in April, the lowest since August, from 57.3 in March**
- **Fed Presidents Signal Employment Growth Too Slow to Remove Record Stimulus**
- **Jobless Claims jumped by 43,000**

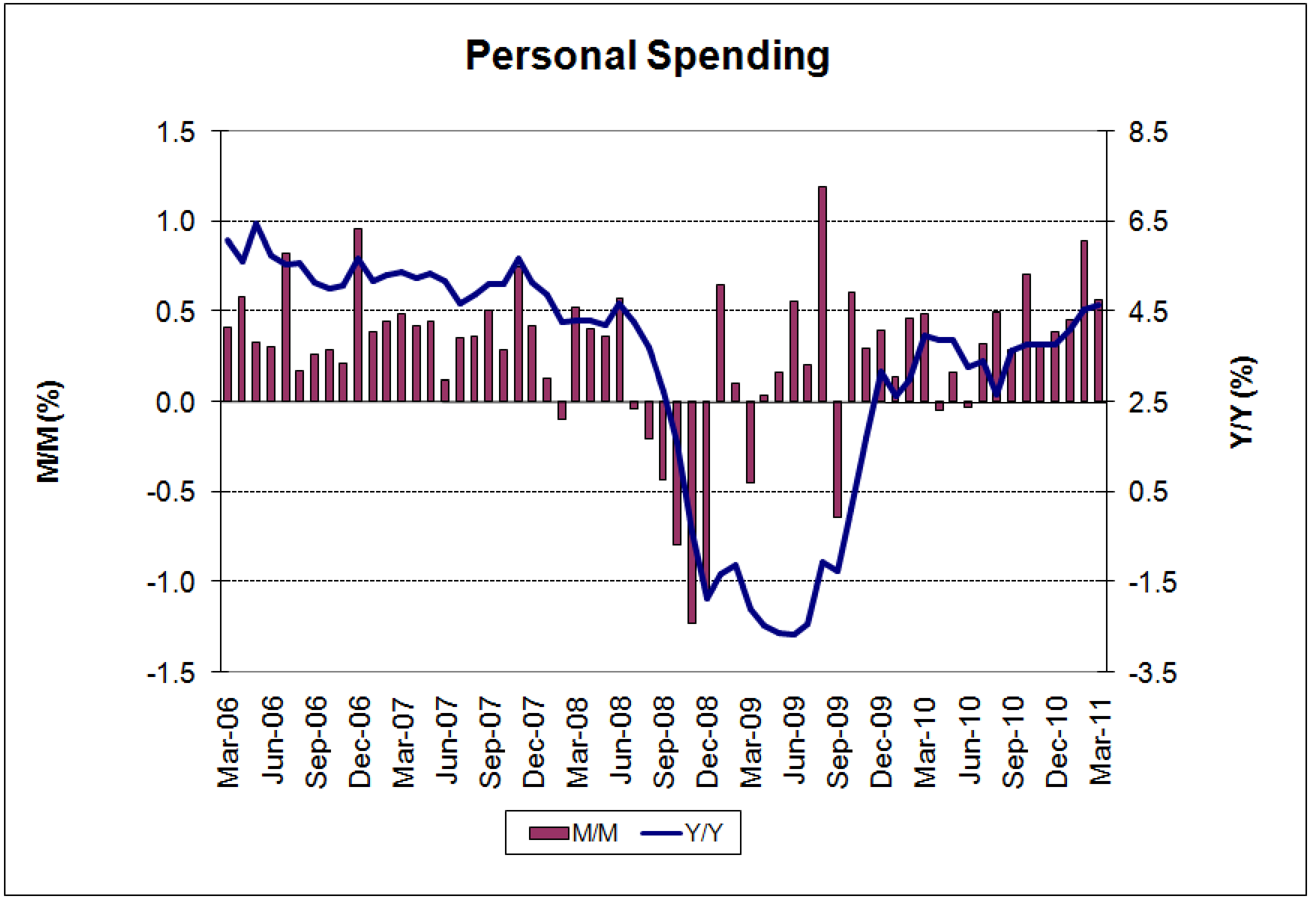
Not much of a US recovery



Personal income growth rates still lagging

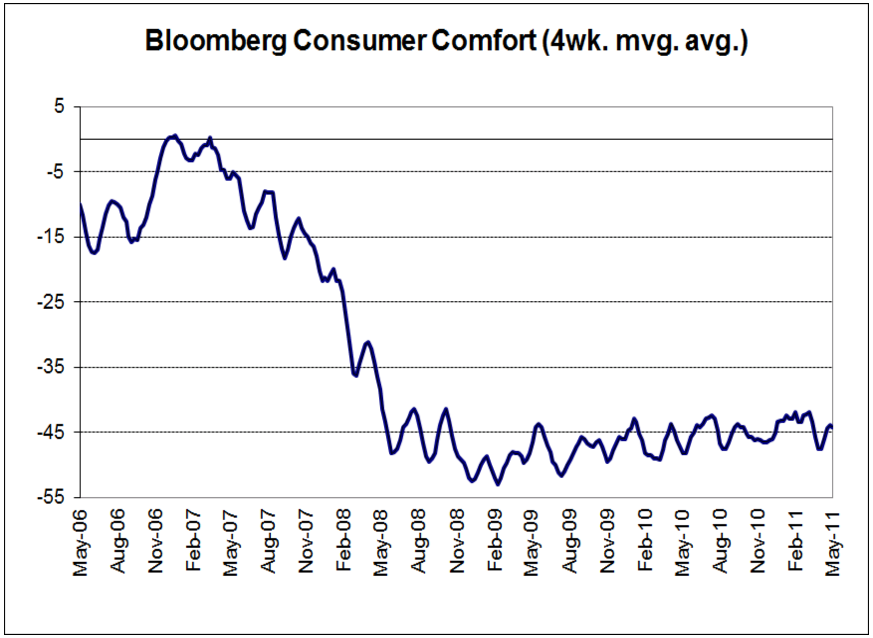


Personal spending lagging as well



Typical US survey patterns

The Bloomberg Consumer Comfort Index declined from -42.6 to -45.1. The state of the economy component climbed from -78.2 to -74.3. The personal finance component deteriorated from -0.3 to -9.2. The buying climate fell from -49.2 to -51.8. This series is slowly trending higher from its absolute lows.



A quick look at prior recoveries

- Sub prime boom
- .com boom
- S and L boom
- Emerging market dollar debt boom

Japan

- Japan has been fighting deflation for decades
- 0 rates and QE have not proven inflationary
- When deficit spending did get high enough to reduce the output gap, deficit reduction was engaged which reduced aggregate demand

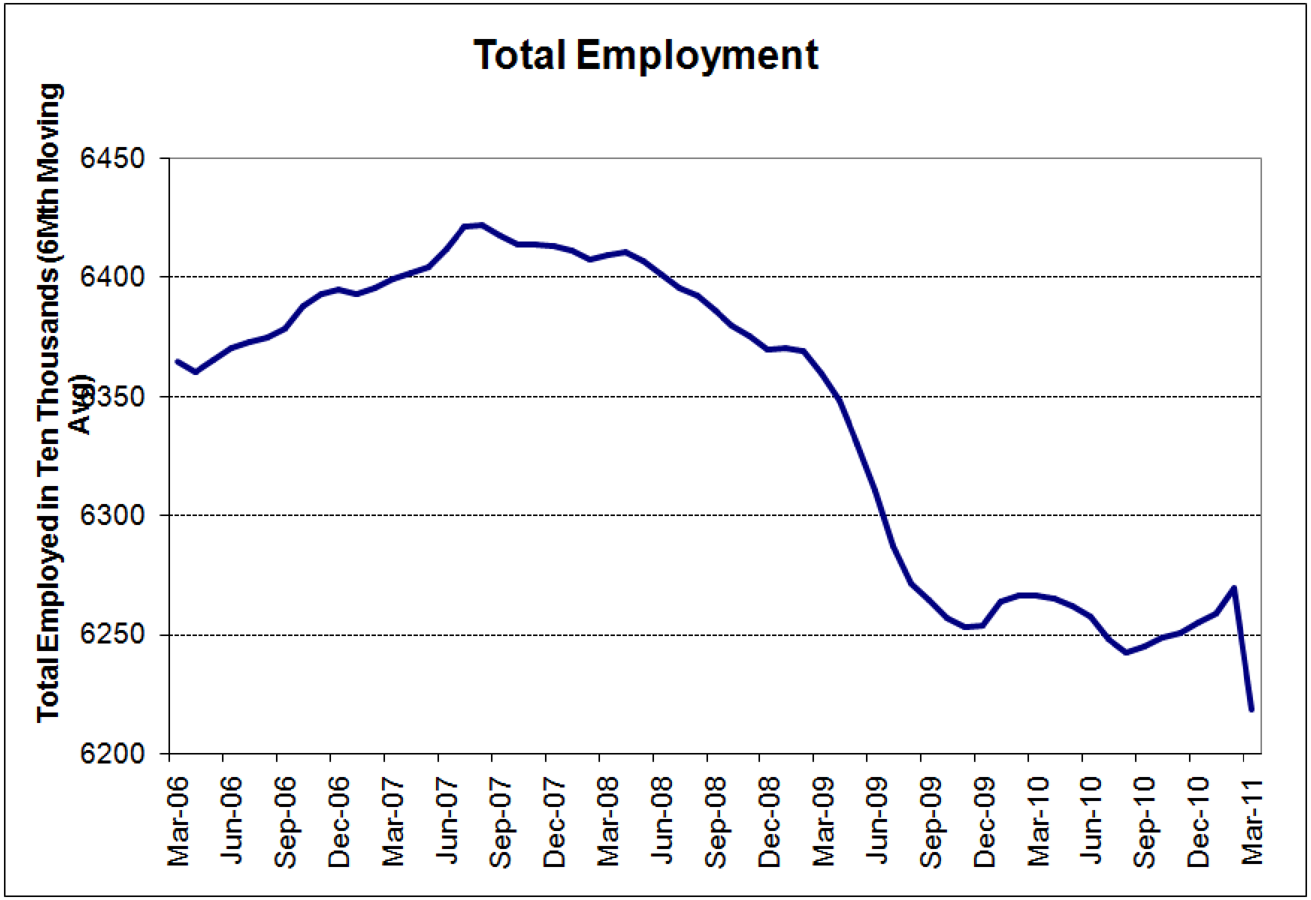
Japanese Sustainability

- There is no actual sustainability risk with regards to funding any size deficit
- There is always inflation risk, but Japan has been trying to emerge from deflation for decades
- Japan, however, believes they are at risk of facing a sudden, catastrophic funding crisis, much like Greece, and is acting accordingly

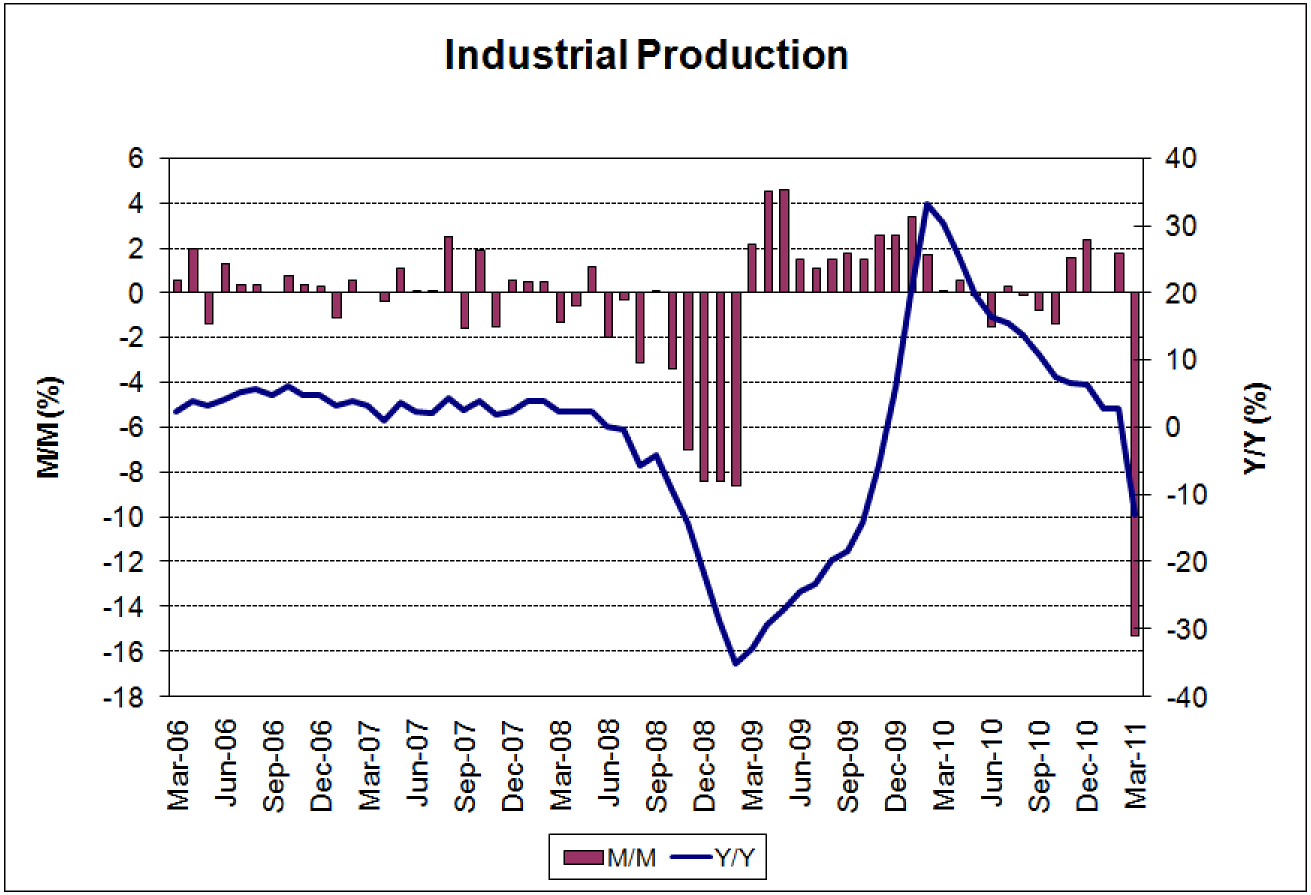
Japan (cont.)

- Since the March 11 earthquake economic activity has declined substantially
- Japan is facing major rebuilding expenses
- They are reluctant to increase their deficit spending, and are instead proposing tax hikes
- This means no fiscal measures are anticipated to support aggregate demand

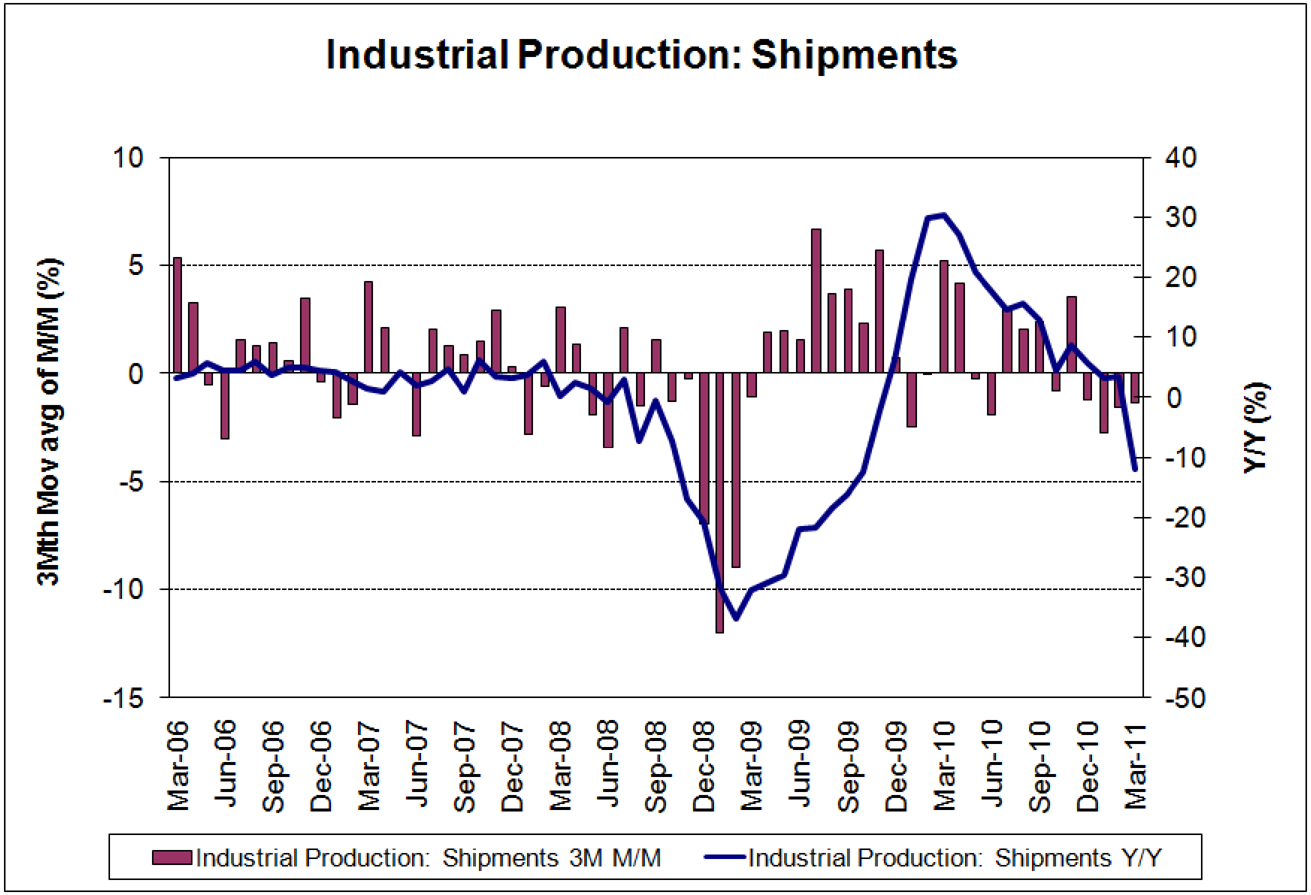
Japan severely hurt by the earthquake



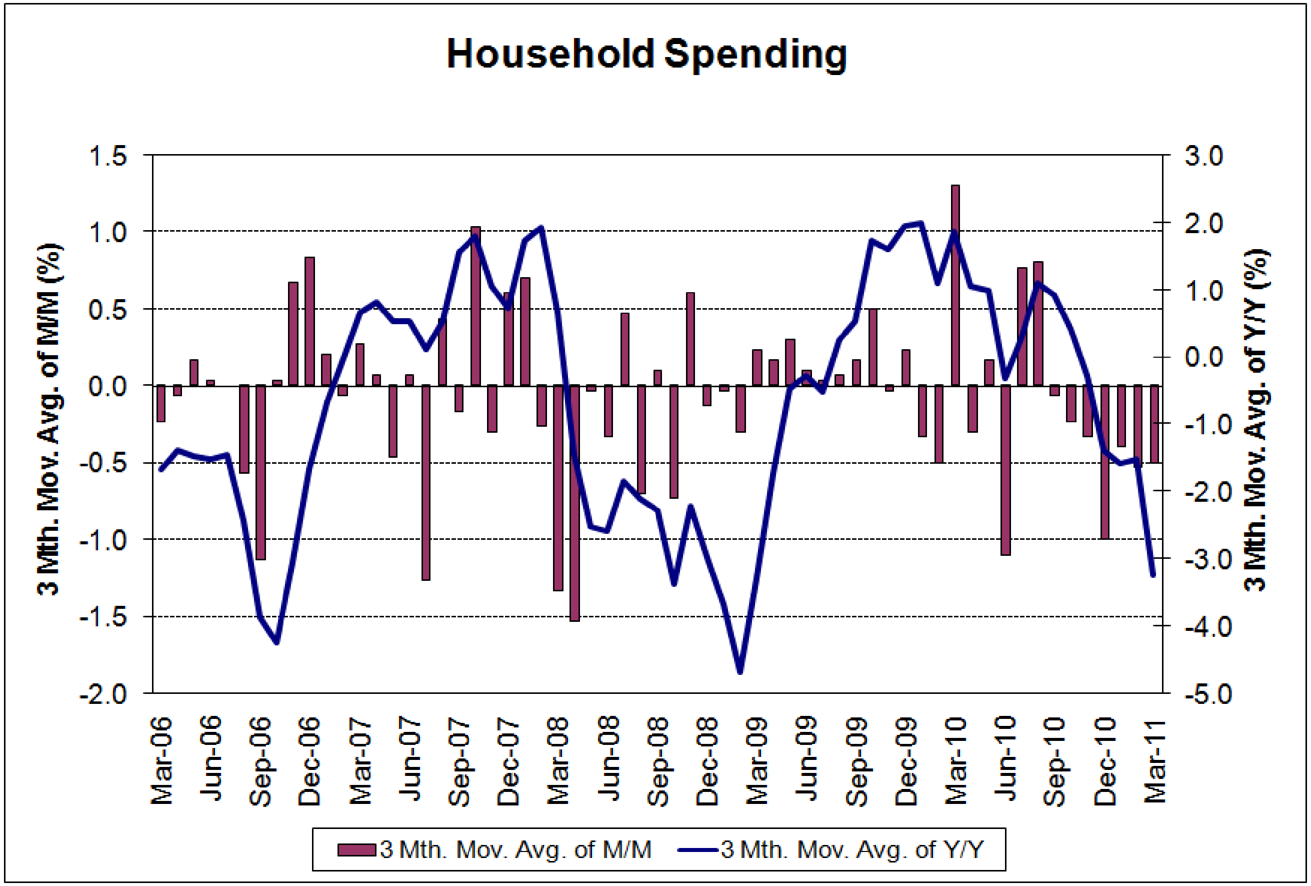
And output is path dependent



Decline had begun before the earthquake



Decline had begun before the earthquake



UK

- The UK’s budget deficit escalated to over 12% of GDP during the recession.
- This was sufficient to turn around the economy and initiate a recovery
- Subsequently the UK engaged in substantial pro active deficit reduction measures that are already dampening aggregate demand and have yet to fully take effect

UK Sustainability

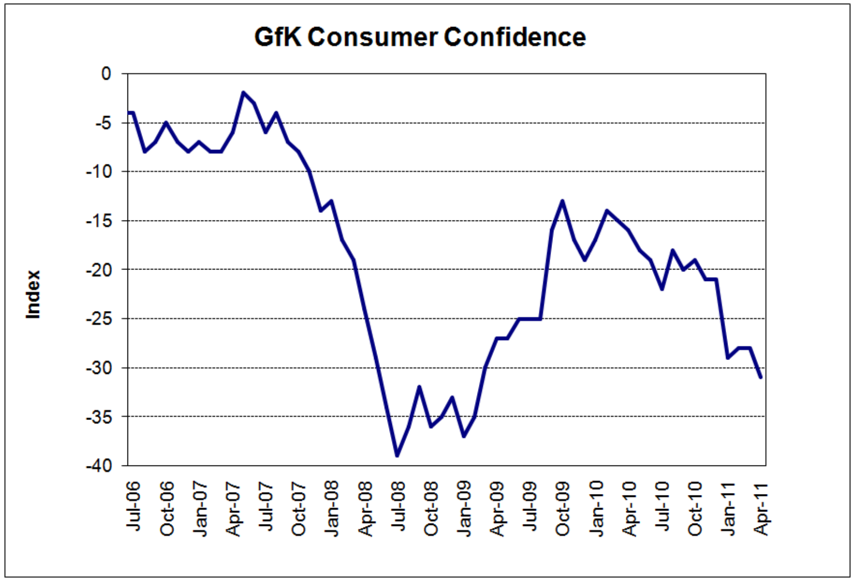
- There is no actual financial sustainability issue for UK public finance
- There are always inflation risks, but never solvency risks
- Unfortunately the UK believes it could face sudden, catastrophic funding issues, much like Greece, and has acted accordingly.

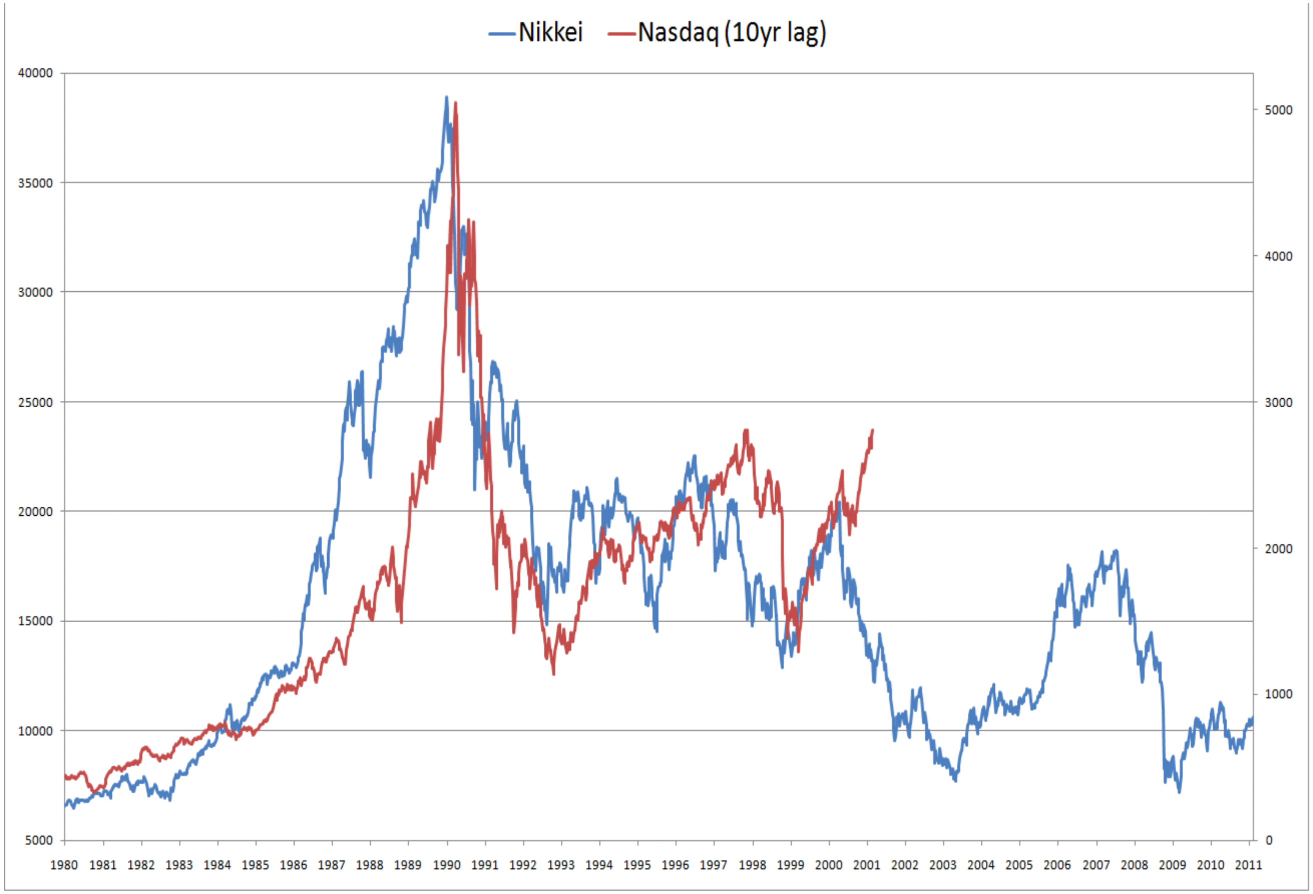
UK Headlines

- U.K. Manufacturing Index Dropped to Seven-Month Low in April (Bloomberg)
- U.K. Retail-Sales Outlook Worsens (Bloomberg)
- U.K. Construction Growth Slowed in April on Homebuilding (Bloomberg)
- U.K. April Services Growth Slows More Than Economists Forecast (Bloomberg)
- 'The UK Will Need a Bailout Soon': Jim Rogers

(additional UK austerity measures kicked in April 1)

The GfK Consumer Confidence Index worsened 3pts to -31 in April, its weakest level since February 2009. The worst level on record (-48) was reached in January 2009. Expectations for the overall index were for a 1pt improvement to -27. Expectations for the general economic situation over the coming 12 months slipped 1pt to -30. The climate for major purchases gauge worsened 2pts to -31.




Nikkei
Nasdaq (10yr lag)
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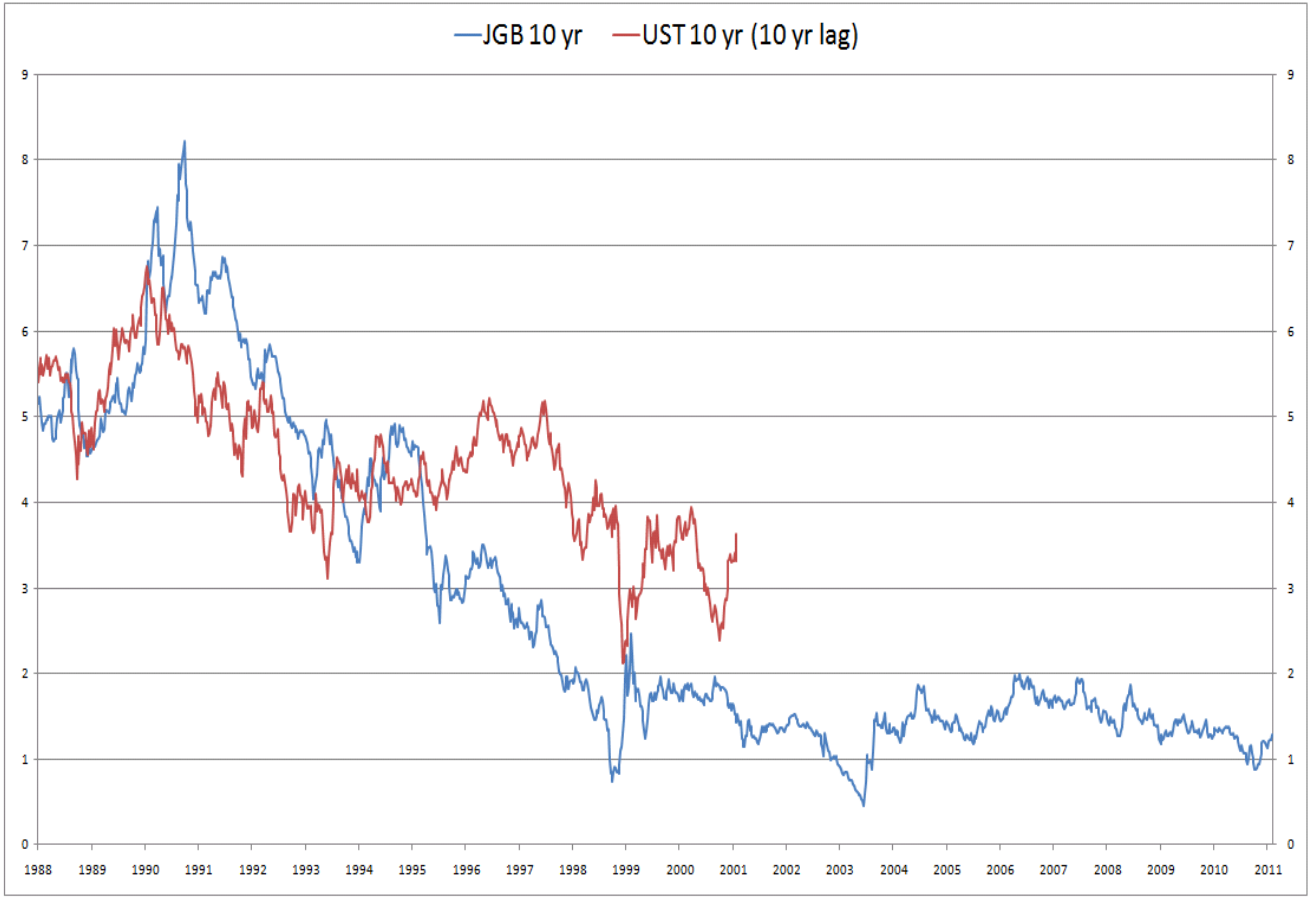
JGB 10 yr
UST 10 yr (10 yr lag)
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Conclusion

Global concerns about inapplicable sustainability risk have resulted in a global austerity measures that are suppressing aggregate demand.

Furthermore, disdain for budget deficits have resulted in reliance on what's called monetary policy that in fact has no bearing on aggregate demand, and may in fact be working to reduce it.

Government finance is sustainable, but growth is at risk.

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