The Threat of Deflation to the US and Global Economy-- Summary of Analysis,June,2014—Analyst David G. Halloran @dhalloran@cfl.rr.com

A Summary of the Problem

The problem nobody wants to admit exists is that the world may be approaching a state of deflation. The last experience with ***deflation*** *in the USA occurred in between 1928 and 1933, well beyond the living memories of most of our population today, while the cumulative* ***inflation*** *in the USA was over 50% between 1977 and 1981, and well within the memory cycle of today's workers and retirees. So, we have a "real feeling" for inflation that occurred 40+ years ago, but deflation is something relegated to the history books, of academic interest, but hardly discussed. Some of us think we ignore that possibility at our own peril.*

Today, Europe is feeling the early stages of deflation, particularly in the PIIGS countries where debt exceeds Gross Domestic Product significantly, and unemployment is rampant of the order of 30+% amongst the youth. The European Central Bank states that it will do whatever it must to defeat deflation by bringing back a mild inflation. In the US the Fed has attempted to thwart deflation by printing trillions of dollars of Federal Reserve Notes to purchase high risk elements of the banks' balance sheets, an experiment in monetizing the debt that has failed many times in the past. The vote is still out on whether the preponderance of QE initiatives, near zero percent loans, and transfer of short term to long term maturities will stimulate growth in the Keynesian style, as well as prevent deflation.

Because the impact of deflation is so deleterious to an economy, such as that experienced in Japan for the past two plus decades, and to a lesser degree in the UK, we felt the topic was worthy of research. If our analysis is even partially correct, we have a sense that, even with the current interference of government with the free forces of the market, there probably is a solution to avoid the catastrophic economic events that we experienced in the US and the world between 1928 and 1933. Some thoughts on solution alternatives are discussed herein and summarized following the problem statement, and the reader is invited to submit any comments. Several of the author's Dartmouth classmates have already done so which has been very helpful.

What is and what is the impact of deflation? Deflation is a decrease in the general price level of goods and services and occurs when the inflation rate falls below 0%. Inflation reduces the real value of money over time; conversely, deflation increases the real value of money ***IF, and remember that IF,*** *the value of the currency remains stable. Deflation is caused by a shift in the supply and demand curve for goods and services, particularly a fall in the aggregate level of demand. However, the economic data history shows that when the price of goods and services are falling,* ***consumers have an incentive to delay purchases and***

consumption until prices fall further, which in turn reduces overall economic demand. The demise of real estate prices after the 2008 financial bubble is an excellent example of that phenomenon*. Since this reduction in demand idles productive capacity, investment also falls, leading to further reductions in aggregate demand. This is the deflationary spiral that is still being experienced in Japan due to [1] their cultural tradition for personal savings of 30% as well as [2] the tradition to avoid write off losses of bad loans in order to "save face" for the customer.*

Summary of a Candidate Solution Strategy

The key near term criteria for stability in the U.S. and global economy is the stabilization of the dollar, the currency most often used for international trade and finance. With a stabilized dollar, as well as the reserves of the U.S. banks reestablished significantly after the wild investments of the '90's, banks will start lending again to small businesses that represent the employment of 70% of our labor force. Those workers, along with proprietors, and the population employed by corporate America and government, are the key sources of demand for the whole spectrum of consumer goods that are necessary to create the demand for sustenance, industrial, communication, and transportation products and services. We are a consumer demand driven economy, as contrasted with much of the global economy which is sustenance demand driven with the exception of all of Europe, including Eastern Europe and Russia, and prior British colonies such as Australia, Canada, New Zealand, and Singapore. Other former colonies such as India, Pakistan, Bangladesh, are evolving into consumer demand economies as well. China is also evolving to a consumer economy though tightly controlled by its "Leninistic Capitalistic" government!!! The trend, though bumpy, has started in Brazil. And with this evolution, the value of their currencies is strengthening and becoming competitive with the US Dollar, emphasizing the absolute need to sustain the dollar's value in order to sustain not only U.S. economic stability and competitive strength but also the stability of the currency most used for international trade and finance.

Problem and Solution Analyses

A very perceptive assessment on the impact of deflation was reported by Albert M. Wojnilower, Ph.D., a well-known economist active in the New York financial community, in a March, 2014 paper. Dr. Wojnilower pointed out some of the idiosyncrasies of the US economy that are having a profound impact on our economic growth and which also affect the global economic situation. Here are excerpts from Dr. Wojnilower's remarks on the forces that are appearing to be deterring that growth**.**

"It was last May [2013] that ex-Chairman Ben Bernanke first ruminated about an impending "tapering" of the Federal Reserve's longer-term security purchases. Although he also vouchsafed that short-term rates would be continued near zero even after the purchases had been phased out, Treasury notes and bond yields

jumped instantly, and stock prices fell. Why? Many market participants took Bernanke's remarks to imply that he sensed the long-awaited speed-up in economic growth was arriving. While this pleased Main Street, it brought to the fore Wall Street's major worry: *that a stronger economy would prompt the Fed to end the deluge of cheap money that was fueling a gigantic volume of virtually riskless "carry trades."* The "carry trades" strategy sells a currency with a relatively low interest rate and uses the funds to purchase a different currency yielding a higher interest rate. With Bernanke's announcement, there was speculation that business growth might revive inflationary expectations and negate this form of virtually risk free investment."

"The lesson of the Volcker years is that when the Fed fights inflation, security prices will collapse and the history of that period explains why modest economic growth is seen as benign, but strong expansion is not welcome by the financial community. Although long-term interest rates need to fall if genuine prosperity is to be achieved, they will not because of the market's fear that this would justify "tighter money" and preclude the virtual "free money" made available by the Fed's QE policies."

Since spring of 2013, real GNP has been growing at about 2½% and easier credit has empowered households to overspend and under save to an extent that is unlikely to deteriorate further. Ironically, however, the rise in mortgage rates triggered by Bernanke's statements is inhibiting the housing markets. The revival in home prices, purchases, and construction, which had shot up from severely depressed levels, has slowed abruptly suggesting some home prices may be entering the deflation cycle. Home purchases are, of course, a principal factor in driving demand for the additional products required for home needs such as furnishings, appliances, landscaping and the like, hence growth in consumer demand, the principal driving force of the U.S. economy at ~70% of GDP. Consumer demand drives our economic engine.

Deflation would also exacerbate the difficulties government faces for financing of their various programs, thus increasing the deficits and adding to the debt. With falling prices, the value of the dollar increases permitting consumers to purchase more for their dollar, albeit by waiting until prices fall further. *That increased value of money is non-taxable because the government will tax the citizens' numerical income, not their adjusted income with greater purchasing power due to price deflation, or the converse in inflation. Deflation can also attack the banking system where loans due are based on the amount of money loaned regardless of its current value. But, as economic conditions worsen, there are more defaults of loans as we have seen in the current crisis, and some banks are forced out of the business.*

With consumer demand stagnant, business investment continues to support the current level of economic activity, but will show few signs of increasing investment because of no-growth demand. Further, investment in new

methods and products destroys existing jobs in the short run rather than creating new ones, though we are witnessing an expansion of competitive product lines in the Information Technology sector while the balance of the economy remains stagnant. Meanwhile, defense as well as civilian government spending is being capped by the profound change in political attitudes and divisiveness associated with annual deficits and a growing $17+ Trillion national debt. On the other hand, major gains in domestic energy production, as well as in the use of health care (reflecting greater numbers of insured's), are boosting economic activity. In sum, the aggregate trend of economic growth has been slow and smooth, but change is evident beneath the surface as evidenced by the Information Technology sector, and potentially by the Energy sector depending on a change in Federal Government policy on expanding carbon energy production. This is worth a further look encapsulated in the following paragraphs.

The US is Now World's Top Energy Producer, and has the capacity to grow to the principal exporter of energy in the next three years with essential government policy changes in the Environmental area as well as the basic free enterprise system. Thanks to fracking technology and horizontal drilling techniques, the United States has gone from a large-scale energy importer to the world's top producer — a development with far-reaching consequences. America produced an average of about 12.1 million barrels of crude oil, natural gas liquids, and biofuels a day in 2013 — that's 300,000 barrels a day more than Saudi Arabia and 1.6 million more than Russia, the two previous leaders. U.S. production of crude oil alone rose by a record 991,000 barrels a day last year, according to the International Energy Agency. And oil imports declined by 16 percent, from $310 billion to $268 billion. Fracking has enabled shale-gas production in North Dakota, Texas, and the formation that crosses West Virginia, Ohio, Pennsylvania, and New York to account for 44 percent of total U.S. natural gas output.

"The hydrocarbon boom in the United States is driven by fracking," according to a report from the Hoover Institution headlined "Three Cheers for Fracking." In the 1970s, some experts predicted that America would run out of natural gas, and between the early 1990s and 2008, U.S. oil production fell steadily. World oil prices rose and American imports increased, especially from unstable, often unfriendly nations. "Fracking has upended all of this," declared Gary D. Libecap, a research fellow at the Hoover Institution and an economics professor at the University of California, Santa Barbara. Fracking and horizontal drilling enable drillers to extract hydrocarbon deposits that would otherwise be inaccessible or too expensive to extract.

As a consequence, fracking has:
· Lowered overall energy prices;
· Increased U.S. exports of natural gas;
· Eliminated imports of liquid natural gas by the United States, saving $100 billion a year;

· Benefited most world economies by tempering oil and gas price increases
· Lowered U.S. demand for oil from Venezuela, where rulers have

been increasingly autocratic;
· Shown the way for new oil and gas production in Europe, reducing dependence on supplies from Russia and helpful during the Ukrainian crisis;
· Expanded American manufacturing due to lower and more certain energy costs compared to other nations;
· Contributed to a reduction in greenhouse gas emissions as the country shifts from coal-fired energy plants to natural gas-fired facilities;
· Directly increased U.S. employment in oil and gas extraction by 28,000 jobs between 2007 and 2011 alone, and indirectly by 45,000 in new employment in support industries.

Fracking and natural gas production, Libecap concludes, have been "good for the economy, good for democracies worldwide, and good for the environment." It could be even better. According to the Institute for Policy Innovation, the federal government owns 28 percent of U.S. land, including 62 percent of Alaska and 47 percent of 11 Western states. Companies would be willing to drill there, but the Federal Government has delayed and denied drilling permits, and production on federal lands has fallen 23 percent since 2007. With these developments in the Energy field, and a continuing prospect for the export of the US vast and very economical coal resources to elements of the world where it will not be contributing to air pollution, these developments can initiate the economic stimulus from increased energy demand and supplies and the development of investment and job associated with delivering those energy project to market.

Abroad, prospects are lackluster. In Japan, where the need for more expansionary monetary policy has been recognized, but it remains to be seen whether this will overcome the scheduled pitfall of a higher consumption tax. Current economic data from Japan is discouraging. Eight years ago, a similar effort failed; this time, the internal contradictions are seen more clearly and one may hope for a better outcome. China remains a big question mark associated with a policy of concentrating internal political power to be reconciled with a shift toward liberalized personal consumption and private business? The same might be asked of Russia and Turkey. In Latin America, the economic prospects for Argentina, Brazil, and Venezuela are gloomier than they seemed not long ago due to internal political turmoil. In the Eurozone, the southern tier remains seriously depressed (although it has largely stopped declining), while Germany and much of the north continue to prosper, albeit with only slow growth. The Ukrainian conflict is dashing hopes that the world will enjoy freer trade as contrasted with more severe trade sanctions, and we have reported on that separately**.**

Nearly five years have passed since the recession ended in the US. Insofar as employment, GDP, or labor incomes are concerned, the recovery has been

sluggish. As individuals confront and react to their more uncertain futures, past business cycle patterns are less likely to recur. In our financial system, growth of GDP requires growth in aggregate credit to business, consumers, and the government, as well as in credit's literal twin, debt. When, as at present, private credit fails to grow sufficiently, government borrowing must fill the gap if economic growth is to continue. Unfortunately, government spending can be plagued by waste and even corruption. However, if we promote faster growth of private credit, sooner or later people will borrow and banks will lend excessively in an addictive process that leads to bubbles. **"We have booms and depressions not because of lack of economic expertise, but because they are hard-wired into human nature." concludes Dr. Wojnilower**

How does the preceding assessment impact the concerns about the possibilities of deflation? The answer used presently for falling aggregate demand is stimulus, either from [1]the central bank by expanding the money supply [M1], or by the [2]government fiscal authority to increase demand through government purchases [^ M2], including be able to borrow at interest rates which are below those available to private entities in the market. The Fed and the Treasury have been doing both. Such monetizing of the debt, now at 45 Billion Dollars per month, down from 85 Billion, provides the Treasury funds to pay the government's bills, as well as increased liquidity which is welcomed in the financial sector for carry trades, discussed earlier, as well as increased demand for the purchase of attractive stocks. The greater money supply created by the Fed goes into investments and raises the demand, hence prices of investments. The increase in the stock market values is less a measure of economic progress rather than a measure of increased liquidity by the newly created money by the Fed. That increased liquidity goes to the creditors who in turn invest it in the market or to the bankers for rebuilding bank reserves which faltered in 2008. These reserves have recovered significantly by transferring their higher risk debt such as securitized mortgages to the Federal Reserve balance sheet. Such liquidity does not get to the core of the economy that generates the full spectrum of demand--- small businesses and individuals that represent 70% of the labor force in the US, hence a sustained sluggish recovery persists. ***Further, in spite of the improvement in their reserves posture, the banks have a disincentive to lend to growing businesses until those businesses or individuals have proven market growth potential which new businesses cannot demonstrate when the demand in the economy is down, and which is what is still happening in Japan and showing those same symptoms in Europe and the US.***

The stimulus increases the national debt as well. The Fed has been creating, electronically, now 35 billion dollars per month, down from 85 billion per month, and sending it to the Treasury for the Federal Government to pay their bills including the interest on the 17 Trillion dollar

debt. That interest in FY'13 was $415,688,781,348 and covered interest due on Treasury notes and bonds, Foreign debt, Savings bonds, State and Local Government series, and Government Account Series [money borrowed from Trust funds, like Social Security,] to pay for current operations. About 50% of that debt is owed to the Fed in the Trust Fund accounts [owing the debt to ourselves] which probably precludes the possibility of a default on Treasuries, Foreign debt, Savings bonds and the like. But, the debt liability remains and, if unpaid, is deferred to our descendants.

But, here is the "Rub", the real point of the story! With the proliferation of liquidity created electronically, but with NO REAL ASSOCIATED VALUE in that increase liquidity, the value of the dollar can decrease which exacerbates the demand situation because investors will convert to other currencies that have retained their value. Such investment decisions transfer demand elsewhere where increased value can be obtained, thus aggravating the deflationary spiral in a US Dollar Economy. A recent example of this is the falling value of the dollar vs. the Euro [which has also been a weak currency now shored up in part by the ECB [European Central Bank]. A contrasting situation is the US dollar vs. the Canadian dollar which, at parity, had curtailed tourism, investment and purchases in Canada. With the decreased value of the Canadian dollar vs. the US Dollar as a result of interest rate reductions generated by the Canadian government, interest in tourism and investment in Canada by those using the US dollar as their currency base is on the increase with the advantageous exchange rate of ~$1.09 Canadian for the US dollar. With that change from parody, Walmart announced a 500 million dollars expansion plan in Canada creating 7500 new jobs.

These dynamics in the relationships of currency valuation are the reason that economists like Steve Forbes, David Stockman, and Arthur Laffer, and historians like Newt Gingrich are reminding us constantly to protect the value of the dollar. But, that will require reducing the stimulus which will pull back the stock market advantages of the current policy. Many speculate that the new Fed chairwoman, Janet Yellen, will lead the FOMC to sustain the stimulus as well as liquidate short term Treasuries by purchase of longer term, 30 year Treasuries, in the so-called Operation Twist. This would defer the principal pay back dates on the US's massive debt by decades, and leaving them to our descendants. However, policies such as these may degrade the relative value of the dollar.

As mentioned previously, but worthy of repeating, the key near term criteria for stability in the economy is the stabilization of the dollar. With a stabilized dollar, as well as the reserves of the banks rebuilt significantly after the wild investments of the '90's, banks will start lending again to

small businesses that represent the employment of 70% of our labor force. Those, along with proprietors, and the population employed by corporate America and government, are the key sources of demand for the whole spectrum of consumer goods that are necessary to create the demand for sustenance, industrial, communication, and transportation products that provide those consumer goods. We are a consumer demand driven economy, as contrasted with much of the global economy which is sustenance demand driven, with the exception of all of Europe, including Eastern Europe and Russia, and prior British colonies such as Australia, Canada, New Zealand, and Singapore. Other former colonies such as India, Pakistan, Bangladesh, are evolving into consumer demand economies as well. China is also evolving to a consumer economy though tightly controlled by its "Leninistic Capitalistic" government!!! The trend, though bumpy, has started in Brazil. And with this evolution, the value of their currencies is strengthening and becoming competitive with the US Dollar, emphasizing the absolute need to sustain the dollar's value in order to sustain our economic and competitive strength.

Given our current economic stagnation and government gridlock on controlling the deficit and reducing the debt, the US dollar is in the world's financial crosshairs. Foreign investors appear to be dumping US Treasuries in favor of US equities. US corporate profits offshore equal 10% of US GDP but the labor is all offshore. Much of our manufacturing work is sent overseas to avoid the US corporate income tax of 35%, the highest in the world, and take advantage of lower labor costs and resident country tax incentives. China is populated by American and European financed corporations taking advantage of more competitive labor and tax environments.

A number of economists, stock market strategists and other experts have claimed that the US economy is improving and that the outlook for both economy and stock markets is excellent. These views are based on the S&P 500 at an all- time high in September, 2013, and the unemployment rate at 7.4 percent, also in September and December, and at 6.7% in April, 2014, the lowest in four years. However, that unemployment number does not include those who are underemployed, part-time, or have ceased the job hunt. which, when added to the unemployed represents 14+% of the labor force.

In addition to the weakness in the housing and employment markets, business investments in capital goods have been very modest due to the concerns about the economy and the competence of our Federal government, both the Executive and the Congress.

Business investments in capital goods for manufacturing facilities slowed to a year over year rate of 4.4% the 2nd quarter of 2013 from a 14.3%

rate a year earlier. We have not yet been able to get the comparable rate for the spring of 2014 and will supplement this report when received. This business investment number reflects the lack of confidence of small business and the lending banks that support them in the growth of the economy and the relevance and competence of government policy.

A "Take Away" Point.

While our analysis has concluded that deflation can be a major threat to the US and Global Economies, we include in a following section the counter argument that the enormous creation of liquidity by the Fed will generate just the opposite problem, inflation, which we experienced in the seventies. However, there is one common "take away" point that appears in both schools of thought, and that is the value of the dollar must be stabilized in order to have an orderly conversion or insertion into the economy of the vast liquidity the Fed has created. The value of the dollar must be protected. Foreign nations have long trusted the United States to maintain a sound dollar, but that trust is starting to come to an end. Russia has recently agreed to sell oil to the Chinese, accepting "Renminbi" as payment. Fortune 500 companies from McDonalds to Morgan Stanley have issued bonds denominated in Chinese Renminbi. Even the London Stock Exchange now has a thriving Renminbi bond business. But it underscores this growing theme of the end of the US dollar's dominance– one of the most critical trends in the world today and a crucial part of our former dominance as a world power. China is investing portions of its US dollar reserves to buy up natural resources/commodities all over the globe, and by so doing removing the threat of holding a dollar reserve that may appear to be decreasing in value. Japan is starting to use its dollar reserves to build up its defense capability given current conflicts with China.

In sum, what the Fed has succeeded in doing is liquefying the big banks and vastly increasing their reserves, as well increasing demand for equities in the stock market with the added liquidity. The Fed has been pumping away for years with the policies of QE1, QE2, QE3, Operation Twist and ZIRP and the process has impacted America's middle class. With

interest rates close to zero, which constrains the free operating forces of the market, the man on the street receives next to nothing for his savings. An increasing number of Americans have

given up trying to find a job while that number seeking food stamps has grown to almost 48 million low and no income people, plus significant fraud has also become evident. Taxpayers financed the SNAP program [Supplemental Nutrition Assistance Program], Food Stamps, with $77Billion in 2013.

Yellen will probably continue Bernanke's policies and this continued increase in liquidity will be welcomed by the financial markets but will continue to destroy the wealth building of the middle class. The rich are getting richer, but the middle class is shrinking into low income families, and there in the middle class is the source of the largest demand for consumer products, real estate, and transportation. Without that demand, deflation may set in. If the 'new' Yellen Fed is successful in turning the current trend to deflation into acceptable mild inflation, we'll see it in the bond/gold ratio, so the experts say. But we could also see it in a crashing dollar if the Fed delays much longer. The US economy is staggering and that will call, politically, for continued Fed generosity which will exacerbate the problem. Priming the economy with 45-85 billion dollars liquidity monthly has done little to create more demand, hence jobs; in fact, it contributes to destroying jobs by the trend to move them off shore to avoid high corporate income taxes, health care taxes, and the prospects of getting better value for the investments made in foreign countries.

David Stockman, Reagan's Budget Director, recently summarized our dilemma as follows "What has been growing is the wealth of the rich, the remit of the state, the girth of Wall Street, the debt burden of the people, the prosperity of the beltway and the sway of the three great branches of government - that is, the warfare state, the welfare state and the central bank...What is flailing is the vast expanse of the Main Street economy where the great majority have experienced stagnant living standards, rising job insecurity, failure to accumulate material savings, rapidly approaching old age and the certainty of a Hobbesian future where, inexorably, taxes will rise and social benefits will be cut."

In hyperinflation all tangible assets retain value such as gold, shares, and property. In deflation, such as Japan has experienced for more than 25 years, the government sucks in everything, raising

taxes, cutting benefits so that people simply migrate onto the welfare state such as the USA seems to be starting to do with all of our handout programs such as Food Stamps to the needy and disabled, which is certainly justified, unemployment benefits including to those not seeking employment, corporate welfare for programs of political interest, and a variety of "markup" programs intended for special interests. The cost by state of the complete "freebie" program is documented at the close of this report in the Appendix.

The author believes this report approximates the reality of today, June of 2014. Tis a dynamic world and we will adapt the report as the data and dynamic changes. As an example of change and the inherent anomalies in "pat" equations like supply and demand, look at the price of gasoline given the current upheaval in the Middle East, a primary source of oil. *On the supply side, if we compare current conditions to 18 months ago when oil was about $90 per barrel, we find that supplies have increased. We currently have almost 30 million more barrels in storage now than back then. The US is also producing more oil than it ever has, with production up 15% during 2013 and up nearly 12% so far this year. Clearly supply restrictions are not the cause of higher prices. Now what about oil demand? If the supply of oil has been increasing, it would follow from basic supply and demand principles that the higher price must be a result of increased demand that has outpaced supply. However, that's not the case. The usage of gasoline in the US peaked in 2006 and has been trending down. As a result of improved technologies and standards, the US is using about 8% less gasoline now than back then. Increasing supply and declining demand is the recipe for lower prices, so why is the price of oil skyrocketing?* ***The uncertainty of the future is that answer.*** *Traders and speculators in the commodity are fearful and have driven prices up.* [Iraq, Ukraine] *So far not even one barrel of oil has been disrupted by either the situation in Ukraine or Iraq. But what has been disrupted is the peace of mind of energy traders. In anticipation of possible supply related problems, speculators have driven the price of oil above its natural equilibrium. If and when tensions de-escalate, we should see oil come back down a bit. Even in 'free markets,' it is not just supply and demand that matter.* ***The expectations of supply and demand are just as important.*** After all, investors must position themselves for how supply and demand will be in the future, not now things sit currently.

The Counter to Take Away Point

"The great liquidity tsunami of the post-Crash era is coming to an end. But the inflationary after effects are only just beginning. The Fed is now actively tapering its QE programs. The $85 billion per month QE 3 and QE 4 programs have been reduced to $45 in asset purchases billion per month. While this still comes to an annualized rate of $540 billion in purchases per year, it marks a significant shift in Fed policy. The Fed has engaged in the single largest monetary experiment in

history, betting the US economy and banking system on theories that have little to no evidence of success…both Japan and the UK have proven that QE does not generate sustainable growth: both countries have engaged in QE efforts equal to over 25% of their GDPs…neither have seen sustained economic growth. So, one would conclude from this position that if the stimulus does not generate sustainable growth in demand, then it will generate an enormous inflation with fixed demand with a vastly increased money supply that will drive prices higher and higher just like excessive liquidity has driven equity prices higher and higher. The author subscribes to the theory that slow growth will reduce demand, commencing a commensurate drop in prices followed by a "hold back period" by the demand curve expecting a further drop followed by the deflationary cycle. Other economists cite the Japan and UK cases and evidence that subsidy did little to generate long term growth. We agree and suggest the Fed terminate all of its stimulus programs to allow the demand and supply curves to align themselves "with nature" as Milton Friedman would say, and allow the free forces of the market to generate the corrections in all elements of the economy that will culminate in sustained growth of 4 to 5% commensurate with the growth in population.

The author believes that the administration and Congress, current and prior, are inept in economic matters, driving them all toward political not economic goals, and attempting to cover their ineptness with deceit, and sometimes even corruption, on all sides of the "aisle." We also feel that the integrity of the government to follow the principles of the free market, which made this economy's greatness function by permitting "The Invisible Hand" of demand and supply to operate freely and which is the "economic expression of the will of the people", that commitment has also collapsed. The politics of reelection has replaced the commitment to free markets. The question with all this happening is "Are we in the maelstrom of a major *"tipping point"?"* Is this the beginning of *"The Great Readjustment"* in this "*Year of Debt*"? …The petro-Dollar is starting to become the petro-Yuan when it was revealed that China paid huge sums for oil from Russia in Remindi, or Yuan, and not Dollars.

Why is the Fed tapering, finally!! The official reason is that the recovery is now strong enough not to need the stimulus. There are two problems with the official explanation. [1] is that the purpose of QE has always been to support the prices of the debt-related derivatives on the balance sheets of the banks "too big to fail." The other [2]is that the Fed knows that the recovery is a statistical

artifact of deflating GDP with an understated measure of inflation!!!!---don't need to be a math major to spot that deception.

No other indicators--employment, labor force participation, real median family income, real retail sales, or new construction--indicates economic recovery. On the contrary, it appears we may be in the early phases of a Deflationary Cycle as opposed to a Recovery with controlled inflation.

One possible explanation for the tapering is that the Fed has created enough new dollars with which to purchase the worst part of the banks' balance sheet problems to transfer them to the Fed's balance sheet, while in other ways enhancing the banks' profits. With that job done, the Fed can slowly back off. The problem with this explanation is that the liquidity that the Fed has created has found its way into the stock and bond markets and into emerging economies. However, that liquidity has done nothing to stimulate the basic economy. And, curtailing the flow of liquidity would crash the markets bringing on a new financial crisis.

Why is the Fed doing this? The Fed's bond purchases and the banks' interest rate swap derivatives have made a dent in the supply of Treasuries available. With income tax payments now flowing in, fewer Treasuries are being issued in order to put pressure on interest rates. This permits the Fed to make a show of doing the right thing by reducing bond purchases. As a weakening economy becomes apparent as the year 2014 progresses, calls for the Fed to support the economy will permit the Fed to broaden the array of instruments that it purchases. This may well breed more uncertainty and impact the value of the dollar.

The dollar is the Globe's reserve currency and is weakening. Currently the Russian Duma is discussing legislation that would eliminate the dollar's use and presence in Russia, and we perceive that to be a part of the Putin strategy to exploit the weakness of our foreign policy and the US leadership. The Ukraine crisis will no doubt effect this deliberation. Other countries are also moving away from the dollar. Recently the Nigerian central bank reduced its dollar reserves and increased its holdings of Chinese Yuan, and destitute Zimbabwe, which was using the US dollar as its own currency, switched to Chinese Yuan. The recent Russian- Chinese gas agreement was conducted in Yuan, not dollars, and the Chinese are

known to be purchasing basic mineral commodities and using their portfolio of dollar instruments for payment.

The Federal Reserve is very much aware of the flight away from the dollar into gold and other currencies such as the Remindi. Because of this flight the Fed must manipulate the gold price in order to hold it down to sustain the dollar as well as be able to free up gold for delivery. *The Fed knows that the ability of the US to pay its bills in its own currency is the reason it can stand its large trade imbalance, its heavy debt burden, and is the basis for US power.* With China and Japan as the largest creditors to the US, should the dollar lose the reserve currency role, the US becomes just another country with balance of payments and currency problems but with a decreasing market to sell its dollar bonds in order to finance its budget deficits. Calling in that debt by China and Japan, and others because of a weakened dollar will not only weaken the dollar further, but minimize its attractiveness to other creditors to support the USA voracious appetite for debt.

Conclusion at this Juncture of the Economy Evolution

Arguments for impending Deflation or impending Inflation have been offered herein, and candidate solutions suggested for either case. The single common conclusion in either case is that the value of the dollar must be protected and with the Fed continuing to taper its QE program, now 35 Billion of electronic money printing per month, that is moving in the right direction and, we hope, for the right reasons. We will take another glimpse into this dynamic economic situation in early autumn and reissue the report with those findings.

Another conclusion, but a technical one that probably is only of interest to simulation buffs like MOI, is that our glimpse into the array of economic computer models, which we initially entered this study with an intent to improve upon, are not only dated from data from the past which does not take into account many of the economic and political dynamics we cited in the report such as the Duma considering outlawing use of the dollar, Russia selling two years' worth of natural gas to China in Remindi, and the impact of the Ukrainian economic bailout by the IMF. Models do not replicate single event inputs well. Consequently, we have deferred any plans to modify ICON to cope with this situation and, instead, are pursuing a more qualitative study --- it reminds us of the study we did during the dissertation preparation on the functionality of the

Soviet Economic System during its "hay day" where over 11,000 bureaucrats calculated the cost and price of every item for distribution to Russians, from a stick of gum to an automobile, and did this weekly. While some may credit, and rightly, elements of US policy that brought about the demise of the USSR, it really died of its own economic weight by government trying to manipulate the economy. It didn't work then, and, Washington and the Fed, it doesn't work now. Karl Marx wrote one thing that I really believe when he said "Wirkshaft macht alles" "Economics dictates everything". Thanks Karl, but leave it to the "wirkshaft" and not to the government.

Appendix

- **Sources for the data included are available on request from dhalloran@cfl.rr.com or 407-468-6970**
- **Appendix showing State by State all up cost of welfare. Prepared by CATO**

The Cato Institute released a study showing that welfare benefits pay more than a minimum wage job in 33 states and the District of Columbia. Even worse, welfare pays more than $15 per hour in 13 states. According to the study, welfare benefits have increased faster than minimum wage. It's now more profitable to sit at home than it is to earn an honest day's pay.

Hawaii is the biggest offender, where welfare recipients earn $29.13 per hour, or a $60,590 yearly salary, all for doing nothing. Here is the list of the states where the pre-tax equivalent "salary" that welfare recipients receive is higher than having a job. Go to the CATO Website to obtain the detail corroborating data.

1. **Hawaii: $60,590**
2. **District of Columbia: $50,820**
3. **Massachusetts: $50,540**
4. **Connecticut: $44,370**
5. **New York: $43,700**
6. **New Jersey: $43,450**
7. **Rhode Island: $43,330**
8. **Vermont: $42,350**
9. **New Hampshire: $39,750**
10. **Maryland: $38,160**
11. **California: $37,160**
12. **Oregon: $34,300**
13. **Wyoming: $32,620**

14. **Nevada: $29,820**
15. **Minnesota: $29,350**
16. **Delaware: $29,220**
17. **Washington: $28,840**
18. **North Dakota: $28,830**
19. **Pennsylvania: $28,670**
20. **New Mexico: $27,900**
21. **Montana: $26,930**
22. **South Dakota: $26,610**
23. **Kansas: $26,490**
24. **Michigan: $26,430**
25. **Alaska: $26,400**
26. **Ohio: $26,200**
27. **North Carolina: $25,760**
28. **West Virginia: $24,900**
29. **Alabama: $23,310**
30. **Indiana: $22,900**
31. **Missouri: $22,800**
32. **Oklahoma: $22,480**
33. **Louisiana: $22,250**
34. **South Carolina: $21,910**