RECOVERY JUNE 2020

INTRODUCTION

1. What will our recovery look like after COVID 19. People have differing views, both on the length of time of the recovery, and its nature.
2. This note provides my view.

BACKGROUND

3. We need a methodology to formulate our view. A simple view is provided by the **equation of exchange**:

   MV=PY.

   Where M is the stock of money

   V is the velocity of money (the # of times a dollar turns over in a year)

   P is the price level

   Y is "real GDP"

4. With a slow down in "nominal GDP (PY), and no change in the quantity of money in the economy, the velocity (V) decreases.
5. In a "depression", V will approximate "0".
6. With our economy "closed down" because of COVID , V is close to "zero".

THE FEDERAL RESPONSE TO COVID

7. The Federal Government economic response to COVID has been to provide "money (M)" to the public; some $350 billion(by buying government bonds and mortgage securities from the public; or issuing money directly to the public). So M, in this equation of exchange, has been increased, but V remains basically at zero. So MV remains roughly at zero, even if the quantity of money is being increased.
8. Under these circumstances, real GDP (y) is likely to be small, and the price level (P) is likely to be falling (due to lack of demand for goods and services); we will have "**deflation**".

9. As the "COVID people movement restrictions" are lifted, we can expect businesses to re-open, and "real GDP" to start to increase.
10. When get closer to an open economy again, the $350 dollar public stimulus needs to be included into the former money supply. It means that as "nominal GDP (PY)" gets closer to full capacity (full capacity minus "380 x V"), the price level will start to rise; "**inflation**" will start to ensue.
11. **In summary**, with the economy shut down by COVID, we can experience "deflation"; as the economy restarts, and we approach "full capacity of production", we will start to experience "inflation". This latter situation will occur short of "full production capacity", however, due to the $380 billion dollar amount of money that has been inserted into the economy.
12. To get "true full production capacity", with close to full employment, we will need to take this $380 billion out of the economy again. We will need **taxation** to remove this extra money. $380 billion represents about some 25% of GDP. At a rate of increased taxation of 4% (of GDP) per year, it would take approximately 6 years to remove this extra money, and create a non-inflationary environment again (at full capacity). We can see that **this "helicopter money" ,distributed by the federal government, is not "cost free**".
13. **In sum. With this "microscopic view" of our situation, we are looking at at least 6 years to get back to some sense of "normalicy**".
14. But, to get a fuller picture of our situation, we need a broader view of our current economy.

A FULLER VIEW OF OUR SITUATION

15. Economies are organized around economic management systems. Our modern economies are based on Keynesian theory, formulated in the 1930's. This theory achieved practical implementation with the development of the **SYSTEM OF NATIONAL ACCOUNTS**; characterized by:

$y=c+g+i+(x-m)$. where:
y = real GDP
C= personal consumption
G= government expenditures

I = capital investment (machinery, equipment, and building structures; not financial investment)
and (x-m), represents "exports minus imports).

16. The "values" of the components in the equation were denominated in "fiat currencies". This management system received international acceptance at the **BRETTON WOODS** conference in 1947, where the US dollar was declared the international currency, anchored to gold by the declaration that "1 ounce of gold was to be valued at $35 US dollars". All other national fiat currencies were to be fixed, each to the US dollar, via fixed exchange rates.
17. The idea was that countries would only run temporary government deficits when their economies suffered a downturn in GDP; these deficits , designed to boost their economies, would be eliminated by government surpluses when their economies returned to normal, measured by GDP.
18. All US dollars could be exchanged for gold, if the owner wished to hold gold instead of dollars.
19. There were no continuing balances of "**debt or credit**" foreseen in this system.
20. In sum, this system, was to be a self-regulating system, always in "system's balance", except for short run imbalances, resulting from normal business cycles.
21. This system worked well until the 1950's, when "debt and credit" started to creep into the system on a longer term basis.
22. I remember, in the late 1940's, as a teenager, I wanted to buy a set of Arnold Palmer golf clubs (driver; 3 wood; 3, 5, 7, and 9 irons; and a putter). The store said they would put these clubs away for me, and when I gave the store the money to pay for these clubs, they would let me have the clubs. By the mid-50's one could buy these same clubs on "credit", paying for them over time, but owning, and using, the clubs immediately, in the intervening period.
23. **With the advent of this "credit and debt" activity, our economies started to expand beyond the levels sustainable by the incomes earned from GDP**. By the 1960's , the growth in this "credit and debt" realm had reached a point where the US government was becoming concerned that they would not have enough "gold reserves" to honour their commitment to exchange gold for US dollars.

24. The US holdings of their Gold stock were down 52% by the mid-60's. The US government changed it's laws so that citizens could no longer exchange US dollars for gold. Countries, like France, were still demanding gold for dollars. Nixon, in 1971, declared the US would no longer do such exchanges for countries either. This declaration cut the US dollar loose from Gold. Inflation followed. Between 1970 and 1980, the US dollar lost 30% of its value. Unemployment was 10%. The stock market fell 48%. The government started to issue "**CARTER BONDS" DENOMINATED** in **Swiss Francs**.
25. Canada implemented "wage and price" controls. I was a newly minted PhD from Princeton in 1970. My wife and I had $8000 we invested with NATIONAL TRUST (now part of the TD bank). By 1980, our investment had shrunk to $5800. Interest rates were 15%. Economies were in turmoil.
26. It took Paul Volker, head of the Federal Reserve, to implement draconian monetary policies, to start to restore order in 1980.
27. This period in US history represented **the second "debt" JUBILEE of the 20th century in the US;** a period where debts are wiped out, personal wealth is destroyed, and the economy restarts a period of restoration. (**the first American JUBILEE of the 20th century,** occurred during the Great Depression, when Roosevelt declared all public gold holdings illegal, paying $20.67 per oz. to those who held the gold. Right after the gold was confiscated, the price of gold was raise to $32, causing a 67% drop in personal wealth at the time).
28. Volker, the Chairman of the Federal Reserve Board, in 1980, restored order to the economy and the markets. The US and the rest of the World, started out on another expansion of "debt and credit". We are now at a point where the expansion of this debt has reached ,again, a point where this debt is too large to pay back. **We are going to have to have another JUBILEE**, where debts are wiped out, and personal wealth is again destroyed. The only uncertainty is the form in which this debt destruction will take place.

WHAT LESSONS DOES THIS RECAP OF HISTORY HOLD

29. **There is a cycle here**. Our economic management system starts off with little, or no, debt. The original system was anchored to gold; the money supply is constrained by the amount of gold the country

holds. This fixed ratio, between fiat currency and gold , constrains "real growth", the "Y" in the "equation of exchange" that we saw earlier.

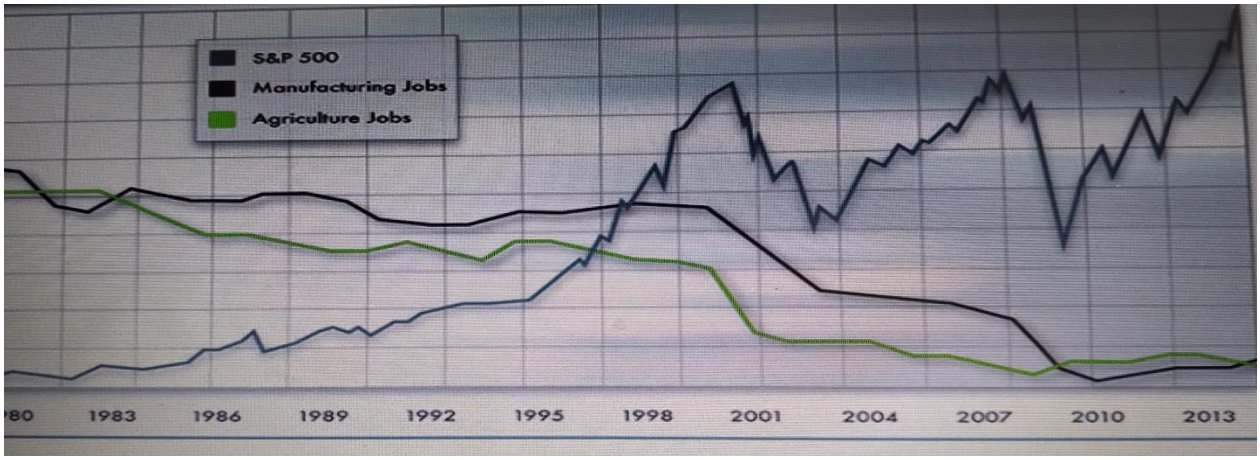
30. In order to have **real economic growth**, we must have "savings", obtained from a growth in "real GDP"; the famous relationship :

S = I,

where "I" represents **capital investment** (not financial investment), and "S" represents " **personal savings**, determined by the amount of money left over from **personal disposable income**, **after subtracting personal consumption**, represented in the **NATIONAL ACCOUNTS**, which itself mirrors the "**growth in real income**" in our economies.

31. All of these "metrics" derive from the **NATIONAL ACCOUNTS. CREDIT** derives from **DEBT** (its mirror image), which is **outside the national accounts framework**. It is an add-on. **Debt** can only be , ultimately, eliminated by using some of tomorrow's **REAL GNP** to pay it back (paying back debt , in our common parlance, is really transferring debt from one party to another, in monetary term). It can only be permanently eliminated by using real resources to eliminate it).

32. The counterpart of "debt" is financial wealth, represented in the **STOCK MARKETS** of the world. When we speak of the **FINANCIALIZATION** of our economies, this is what we mean; the percentage of our economies that consist of "financial wealth", rather than the **wealth of REAL THINGS** (those created by GDP). Conceptually, we can see this distinction in the graph below:



The "black line", representing the "S&P" stock market in the US, captures the combination of the real growth of GDP and the financialization in the US economy. The employment data, represented by the manufacturing and agricultural sectors in the US, is a proxy for the "real GDP growth (employment x productivity = real GDP) . The gap between these two curves is a good representation of the financialization component of the US economy, fueled by "CREDIT EXPANSION".

33. In the **next JUBILEE**, the "financial wealth", represented by the **"GAP"** between the **S&P CURVE the EMPLOYMENT** curves here, will be wiped out. Most of this financial wealth will disappear. The cycle of credit expansion will start over again.

34. What can we do to stop a repeat of this cycle? During the first **AMERICAN JUBILLE**, in the 1930's, a group of economist, from the University of Chicago, put forward the **CHICAGO PLAN**. It proposed 100% reserve banking; meaning there could be no credit extended, outside the framework of **"REAL GDP**". There could be no financialization of economies. Fiat money would be tied to "real value", like gold.

35. Such an arrangement would take away the power of **the FED**. The **Federal Reserve officials**, and the **ELITE** close to them, would

lose their dominance in managing the economy, and making excessive amounts of wealth. This dominance in governing economies still remains. **The economic management system must be changed if we are going to remove "the cycles of debt" and the false security of "financial wealth**".

36. **THIS STORY IS WHY WE SHOULD NOT EXPECT A QUICK RECOVERY FROM CORONA-19**.

POSTSCRIPT: Brian Greene a physicist, in his most recent book, entitled UNTIL THE END OF TIME, describes the physicist's view of the universe. He describes two "physical" forces, competing in it's development: evolution and entropy. Evolution describes the development of the universe after the "big bang"; entropy describes it's decay. Ultimately, entropy is going to win, and the universe will cease to exist.

When one reflects on our economic management systems, the same two kinds of forces are present: the limits imposed on our "real" growth (GDP); and the desire to "live and grow" beyond these constraints. Does Greene's description for the universe have anything to tell us about our quest?

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