SUFFICIENT AFFLUENCE/SUSTAINABLE ECONOMY: ECONOMICS FOR EVERYONE (PART SIX)

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"While macroeconomic policy probably contributed to the conditions in which the crises occurred, the ultimate goal of the depth of the crisis was a deeply flawed regulatory and supervisory regime, deeply flawed in design, and deeply flawed in implementation on both sides of the Atlantic, and it would be hard not to do better."

-- Paul Tucker, Former Deputy Governor of the Bank of England and Economist, commenting on the Financial Crisis of 2008

"It's not just a rock. It is forty-two pounds of polished granite, with a beveled underbelly and a handle a human being can hold."

–Popular quip within the Winter-Olympic sport of Curling

During the past five months, we have been laying out some basics of Economics for Detroit's recovery. Therefore, we have re-named this extended sub-series "Economics for Everyone," using the basics of Economics as its theme. Thus far, we have considered the fundamental purpose of Economics as one of fulfilling our needs and wants. To achieve this goal, we must manage resources that are scarce in both time and place. We have discussed the division of these resources into human and non-human ones. Extending our drilldown, we have delineated human resources into wage labor and entrepreneurial work for profit. Likewise, we have separated non-human resources into land (real estate) that earns rent, productive capital that receives interest payments, and technology (Intellectual Property) that earns a percentage, a piece of the action that is commonly referred to as royalties.

Last month, we looked at examples of entrepreneurs who orchestrate resources efficiently in order to produce goods and services. By doing this, entrepreneurs earn a fair share of profits. The purpose of this production is to satisfy the Needs and Wants of the many. Therefore, entrepreneurs take these products to relatively free markets to exchange for something of equitable value. We explored the basics of exchange through the transaction that occurs between the producer who supplies these goods and services and the consumers who demand what they need and want.

This month, we continue our foray as we look at the role of central governments in market economies. Our parallel intention with this in-depth approach is to provide background for attorneys to develop their own primers to share with their staffs and with jurors in cases involving economic issues. Ultimately, we hope that this primer will help to redirect the negative energy that has been focused on Detroit by educating our readership on how the Principles of Economics work in reality. In doing so, we hope to foster a spirit of positivity regarding the City of Detroit. With this in mind, we changed the subtitle of our series from "Understanding Detroit's Bankruptcy" to "Preparing for Detroit's Recovery" last month.

In this column, we discuss the role of central governments in general and the Federal Government of the United States in specific terms. National governments engage in many fundamental activities using the tools of taxation and spending. We may summarize their duties in two points: 1) Provide in common for the national defense of all households, businesses, and subordinate levels of government within the realm. 2) Level the so-called "playing field" in order to encourage the improvement of knowledge and skills among householders, to improve technology, to afford businesses accessibility to capital and markets, and to manage the redistribution of resources for the commonwealth in the areas of health, education, and other public goods and services.

In respect to national governments, the effectiveness in managing these two sets of tasks is measured by two yardsticks. Intrinsically, these yardsticks reflect the complex and interdependent activities of providing national defense and maintaining a level playing-field for the private sector. The first yardstick of market activity measures the gradual upward movement of market prices in respect to income—inflation. The second yardstick measures the lack of involvement by all available resources used in production, especially human labor—unemployment. Let us generalize that inflation increases as unemployment decreases. As such, a trade-off exists when government attempts to reach the vast underlying set of goals through policymaking.

In this month's article, we limit ourselves to a general discussion in order to understand how policy applied by the government of the United States is structured and how it works. Throughout most of U.S. history until the early twentieth century, the responsibility for making formal economic policy rested in the hands of Congress. Federal taxation and spending usually only constituted a small portion of national income. This limited intervention by the government was not due to any lack of need--in fact, far from it. The United States had struggled through a half dozen international conflicts and one civil war, along with causing a half a dozen depressions that followed these hostilities in pairs, major monetary and banking collapses, and other market failures. The impact of these events was inadequately measured and analyzed until the economy hit bottom during the Great Depression. The government realized that, if it could not measure what went wrong, then it could not fix the problems.

Centralized data and information-gathering remained intermittent and haphazard until 1934. At this point, Economist Simon Kuznets took charge of work on U.S. National-Income Accounts at the National Bureau of Economic Research (NBER). Under Kuznet's guidance and theoretical input that President Franklin D. Roosevelt solicited from English Economist John Maynard Keynes, the NBER successfully reassembled fragmentary data back to 1918. Starting in 1934, Kuznets instituted data collection on a monthly basis, a procedure that continues to the present day. Moving forward, the NBER produced the first official estimations of the U.S. National Income. These reports and their accompanying economic records held data and intuition that offered Congress the light of reason that would allow it to construct more effective policies. In addition, this leap of knowledge would enable the Federal Reserve Bank not only to set its policies better but to react quickly and prescriptively to any Congressional policy-measures that ran errant.

Since the second decade of the twentieth century, the responsibility for managing economic policy of the federal government has been shared by Congress and the Federal Reserve. Though Congress held sway over any official U.S. policy prior to 1913, private-sector banking had grown powerful through influence in what one may consider as informal economic policy. Following the War Between the States that ended in 1865, the United States embarked on the Great Expansion to the West. Railroads and manufacturing grew rapidly during this period. Simultaneously, the financial institutions that fueled this industrial growth with capital produced a consolidation among banks and trusts that resulted in large financial institutions that were on par with the industrial companies that they served.

Potential problems emerged with large financial houses during the last quarter of the nineteenth century. U.S. banks had come into their own, challenging the supremacy of European banks. However, financial institutions on the other side of the pond had realized much earlier that enormous size and power could produce tsunami effects on both international banking and sovereign governments. In response to such effects, England, France, and Germany already had established central banks—banker's banks—in their respective countries throughout the seventeenth to nineteenth centuries. However, the United States had not erected any comparable financial edifice before the dawn of the twentieth century.

Among the firms themselves, the U.S. banking system controlled much of the supply and demand of capital in the country. During the decade before 1907, banking trusts had grown by 224%, national banks by 97%, and state banks by 82%. These institutions established the prevailing interest rates and availability of credit through their private and minimally regulated financial houses and the open markets. However, if a significantly large bank or trust were to fail, such an event could destabilize the entire financial sector as well as produce spillover impacts on the rest of the American economy.

Generally, the financial sector looked after its own. John Pierpont Morgan, New York's wealthiest and most well connected banker, had rescued the U.S. Treasury and many banks during the Panic of 1893. As a result, his home at 219 Madison Avenue had become a financial clearinghouse during subsequent panics, such as the watermark one of 1907. This panic is especially notable because of the preceding decade-long growth of the financial sector. In addition, this event triggered the development of a central bank in the United States.

In late October 1907, there was a run on the Knickerbocker Trust, the third-largest trust in the New York City. After Morgan and his colleagues examined the books of Knickerbocker, they found the company to be insolvent. Morgan then refused to rescue the Knickerbocker from bankruptcy. Knickerbocker president Charles T. Barney pleaded to Morgan for help in order to stop the run, but to no avail. The Knickerbocker failed and Barney committed suicide. Not unlike the collapse of Lehman Brothers in September 2008, the run on the Knickerbocker began to spill over to other financial institutions. As a result, Morgan was left with little choice but to intervene. He drew his line in the sand with the still-solvent Trust Company of America. Along with the U.S. Treasury and major New York banks, Morgan agreed to make deposits to purchase government securities from the endangered company in order to avert widespread financial disaster. Nevertheless, an economic contraction followed in the wake of these events as production decreased by 11% and unemployment more than doubled to 8%. Interestingly, Morgan's actions were a harbinger of the forthcoming central bank: he took steps similar to those that soon would be used by the Federal Reserve Bank in later crisis periods.

In response to the ongoing problems with the structure of American banking, Senator Nelson Aldrich of Rhode Island organized a secret meeting of the leading bankers in the United States at their exclusive club on Jekyll Island, Georgia, in November 1910. At this meeting, Aldrich and the bankers drafted the Aldrich Currency Report as the foundation of our new currency system. Aldrich and other supporters championed the proposal through the National Monetary Commission for almost three years of very heated resistance from many corners of American society. Opponents viewed this concept of a central bank as a power-grab by Wall Street interests. Nevertheless, Congress passed the Federal Reserve Act and President Woodrow Wilson signed it into law on 23 December 1913. Later, Wilson stated that he unwittingly ruined his country by allowing our government to be controlled by a small group of dominant men. (To see Wilson's original quote, go to his book *The New Freedom,* Doubleday, Page, and Company, 1913.) The passing of the Federal Reserve Act led to the establishment of the Federal Reserve Banking System. This system is composed of a Board of Governors that oversees twelve district banks. These district banks regulate the banking industry and issue currency. Note: even though this Creature of Jekyll Island was given birth by Congress, the Federal Reserve Bank began as--and remains--a private-sector entity.

Today, the responsibilities for making and enacting economic policy remain split between Congress and the Federal Reserve. Congress holds the reins for policies administered through increases and decreases in both government spending and taxation. We refer to this kind of strategy as Fiscal Policy. The Federal Reserve administers policy through the private banking sector. It does this by increasing or decreasing the amount of currency in circulation by buying and selling government securities on the open market. In addition, the Fed sets the percentage rate for minimum-reserve amounts of currency that banks must hold and establishes the interest rate charged to banks when they approach the Federal Reserve as the lender of last resort. In brief, purchasing securities from banks enables the Fed to increase the amount of currency in circulation immediately. Likewise, when the Fed decreases the rate of the minimum reserve-requirement or lowers the rate of interest that it charges as a lender of last resort, it enables banks to create more money in the economy through making loans to businesses and consumers. These actions form the basis of our Monetary Policy.

Though created by the members of Congress, the Federal Reserve had a rough relationship with them as well as the Council of Economic Advisors and others during its early decades of existence. This conflict occurred because of the political divisiveness that existed during the formative period of the Federal Reserve. However, Congress has settled into its role as the politicized policymaker while the Fed has remained apolitical (as much as can be expected given the party affiliations of its officers). However, with the emergence of computers, electronic data, and other advancements in information technologies, the degree of understanding and cooperation between the complementary policymaking entities has increased in recent decades.

By nature, Congressional policy enacted through taxation and spending bills tends to be very bulky and slow-moving. The process of Fiscal Policymaking remains beset with sequential time lags. First, a member of Congress must recognize a problem and then introduce a bill to remedy the situation. Between the Senate and the House, this bill passes through rewrites, committees, and deal-making before it finally passes into law, if at all. Once passed, the spending or taxation program must be implemented through the appropriate government agencies. Overall, the entire process may take years before the desired effect takes place. The economic need may change over time, though the package remains static. Therefore, the resulting remedy may be counterproductive.

On the other hand, the Fed takes action that works quickly. Its Open Market Committee meets eight times per year to decide how much in government securities it should buy or sell. Once the decision is made, the implementation begins, most often immediately. When a buy occurs, new currency enters into the reserves of banks that make loans. Old currency leaves the system when the Fed sells securities to the banks. In addition, changing the reserve ratio for banks produces a rapid effect, though it may take time afterward for lenders to find borrowers. By law, banks can lend a multiple of the available excess reserves that they hold. This excess is what remains after the banks meet their reserve requirements. When the Fed lowers the reserve ratio, banks are left holding more excess reserves. The greater the amount in excess reserves, the greater the dollar value in loans that they can make. Finally, banks that lend money to one another as the second-to-last-resort lender compete with the Fed. If the Fed lowers its rate—the Discount Rate—banks must lower their rates to remain competitive. As a result, the entire interest-rate structure in the financial market tends to shift downward almost immediately.

Let us recap: Fiscal Policy implemented through Congress works slowly while Monetary Policy executed by the Fed works quickly. A combination of these two types of policy works optimally when one hand knows what the other hand is doing. As an exemplar analogy, let us consider the winter sport of Curling (see second opening quote). Similar to shuffleboard, players slide a stone on a sheet of ice towards a target area at the far end. The path and speed of the stone may be influenced by two sweepers with brooms. Accompanying the polished granite as it slides down the lane, these sweepers use their brooms to alter the state of the ice in front of the stone. A great deal of strategy and teamwork is involved in choosing the ideal path and placement of a stone. The skills of the curlers determine where the stone will come to rest in relation to its target.

In this analogy, Congress takes the role of the player who launches the slow-moving stone along its path. Once Congress releases the stone (Fiscal Policy) it becomes powerless to control its path and distance. However, the Fed acts as the players with brooms. Moving quickly and frequently (Monetary Policy), the Fed can guide the stone along its path to the desired destination at target center. In this way, Congress and the Federal Reserve work together in order to manage their mix of Fiscal and Monetary policies.

In conclusion, let us bring our discussion of Federal policies back to our local level. As financial markets, credit-flow, and interest rates operate globally, the actions taken by the Fed have a direct impact on borrowers and lenders in Southeast Michigan and far beyond. However, Congress can focus Fiscal Policy with a degree of precision. Specific spending and taxation-relief programs can be bundled and directed to Metro Detroit and other enclaves around the country. Such aid materializes as a matter of political savvy. In this respect, many mayors have paid opportune visits to the White House and in so doing have "brought home the bacon." Recently, Detroit Mayor Mike Duggan met with President Barack Obama. Afterwards, the Mayor stated that the President is very interested in plans to bring jobs to Detroit. Obama requested a written plan from the Mayor within ninety days. Duggan stated that he presented the President with some very specific economic strategies in order to create more jobs. In respect to this proposal, the Mayor mentioned a submitted request for more buses in order to carry people to these jobs. Duggan's plans also include support for the economic revitalization of Detroit. These plans include initiatives for innovation and for bringing opportunities to the City. In future columns, we will delve more into the myriad of economic topics as they present themselves with relevancy to the long road of recovery upon which Detroit and Southeast Michigan must travel.

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