THE LINNEMAN LETTER

This is an excerpt from the Winter 2010-11 issue of *The Linneman Letter*.

Volume 10 Issue 4

What Would We Do If…

By Dr. Peter Linneman, PhD
Chief Economist, NAI Global
Principal, Linneman Associates

What would we do if we were the President of the United States? We would announce that:

- business is a valued constituency, which creates our growth.
- we will repeal the misguided, expensive, and widely despised health-care bill.
- we will provide no further subsidies, under any circumstances, for businesses or individuals who overextended themselves.
- over the next three years, we will privatize the portfolios currently held by Freddie and Fannie via an RTC-like entity.
- Freddie and Fannie will no longer participate in mortgage markets after 2011.
- we will sponsor no further major legislative initiatives for the next three years.
- we will undertake no major changes of any regulations for the next three years.
- we support the extension of all current tax levels for three more years. (Two will do for now with the new tax legislation).
- we will freeze federal hiring for the next three years.
- we will freeze all federal salaries and benefits for the next three years. (Obama suggested a 2-year freeze shortly after this line was drafted).
- we will cut federal spending across the board by 3% for each of the next three years.

In short, we would announce that there will be no significant changes in the "rules of the game" for the next three years, other than to shrink government spending. This is not because the current rules are perfect (far from it). It is because the economy can flourish with predictable imperfect rules, but it cannot flourish with unpredictable imperfect rules. The most important element of a strong economic recovery is a predictable set of rules of the game.

Baseball is a game with highly arbitrary and imperfect rules. However, it works because people know that the rules will be applied honestly by imperfect umpires doing their best during the season, with minor rule tweaks post-season. The President needs to make it abundantly clear that the government will focus on efficiently applying existing rules, with minor tweaks only if backed by strong bipartisan support.

The President must also make it clear that business, not government, creates jobs, and that business is the player in our economy, while government is just an honest referee. Unfortunately, he believes the opposite is the case.

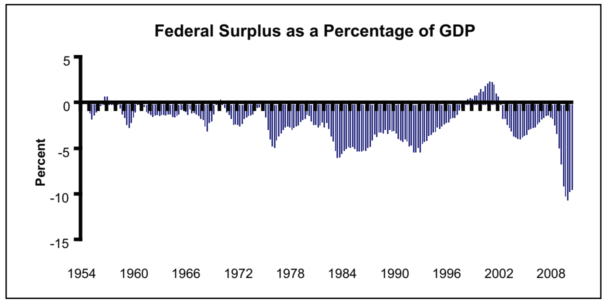


Table of Contents

Perhaps most importantly, the President must admit that he was badly mistaken in believing that he had all the answers, even though he had never run a business or met a payroll.

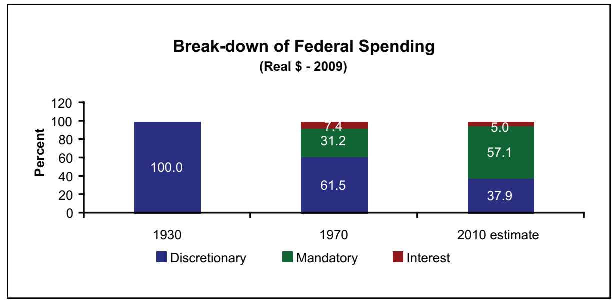
Freezing federal employment and federal wage levels for the next three years would amount to a decrease of 6-10% in real federal spending. Combined with an across-the-board 10% reduction in federal spending over the next three years, this would reduce an out-of-control federal deficit from nearly 12% of GDP to an almost manageable 5% of GDP.

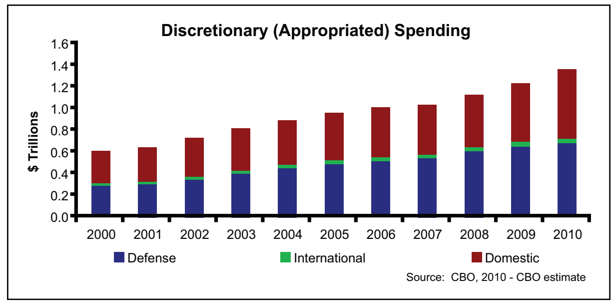
The federal surplus that was run during the dot-com bubble caused our huge federal deficit. Tech stock options generated capital gains taxes, while inflated salaries generated income tax revenues. Congress and President Bush spent the revenues, but as the revenues disappeared, the deficit exploded. We now have the third largest budget deficit in the history of the U.S. when measured as a percent of GDP. The first was during the Civil War (ok, it was the "War Between the States" or "Northern Aggression"), the second was during World War II, and the third is now.

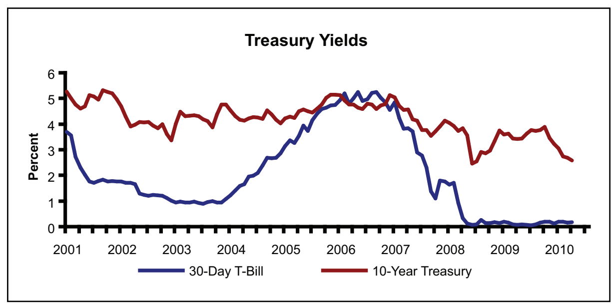
It is interesting to note that as the federal budget deficit exploded, first under the Bush administration and then even further under the Obama administration, citizens realized that they were not getting their money's worth. Nothing upsets people more than the feeling that they are being ripped off. The continual out-of-control budget deficits yielded nothing in terms of economic stimulus, and mortgaged our future for redistributive pork spending. The 2008 and 2010 elections said not that the citizenry (particularly independents) wanted Democrats or Republicans, but rather that they were sick of being ripped off by the out-of-control spending by both parties.

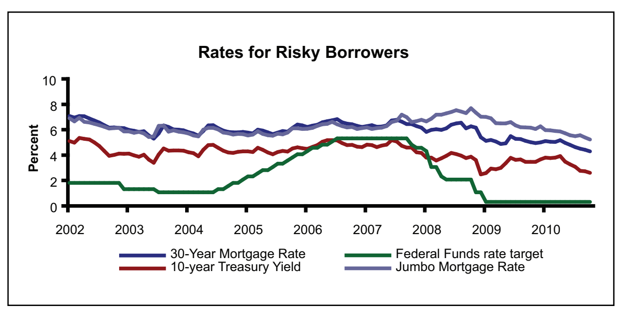
Unfortunately, the Obama administration and the Democrats badly misread their electoral victory in 2008. They interpreted the electorate as saying "we want to become France," and proceeded to ram through low-priority and unpopular legislation initiatives that are part of the French political fabric. They failed to understand that independents did not "hire" the Democrats; they "fired" the Republicans for failing to give people their money's worth. But instead of creating an environment of stability and value, the Obama administration and Pelosi-led Congress created an ever changing anti-business environment and gave even less value for money spent. They spent as if the independents who elected them wanted them to spend even more, when what they really wanted was better spending. The Democrats were so far removed from reality that they failed to grasp that the independents who control national election outcomes were saying, "Enough, give us some stability and our money's worth." For their mistake, the Democrats have suffered a stunning electoral rebuke.

We hope that the newly elected Republicans do not interpret their victory as a Republican victory, when it is merely the same independents "firing" the Democrats for their failure to deliver either stability or value. It is essential that the Republicans understand: people want a transparent government that provides stable and predictable rules with a









minimal level of corruption, and that gives value for money spent. They want a government that understands that the government works for the people, not the other way around. Hopefully, both Republicans and Democrats will finally grasp this simple message, if only briefly.

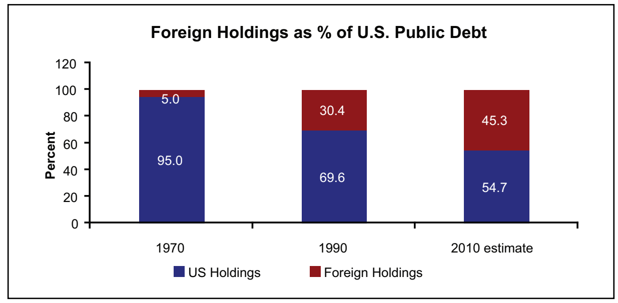
As to "reforms" of the financial sector, the rules should clearly be that if you lose money, you bear all of the losses. And if (as is the case with commercial banks) an institution only attracts money because of an FDIC seal on the window, then it must be subject to regulations that highly limit the risks it can take. The simplest regulation is that if an institution is FDIC-insured, it can pay no dividends, nor can salaries and bonuses exceed prescribed levels, unless the financial institution has lots of cash on hand and very little debt. That is, if a bank relies on a federal guarantee to attract funds, it should be subject to federally mandated pay scales. If it does not want to be bound by such pay scales, it can scrape the FDIC seal off its window and attract funds purely on the basis of its investment track record. An FDIC license is not a license to run a hedge fund with insured deposits.

What would we do if we were in control of the Federal Reserve? We would announce that:

- we will not monetize federal deficits by purchasing government bonds associated with federal deficits; that is, no quantitative easing ("QE2"). (Query: Why do they call it "QE2" rather than "printing lots of money"?)
- our target is to increase base money supply by 5% per year, so as to create a stable monetary environment.
- we will raise the Fed funds rate by 300 bps over the next two years on a transparent, pre-announced schedule.
- we are only humans and we will stop pretending that we are deities who magically know what the "right" interest rates are.

Price establishment by government mandarins did not work for the USSR, and works no better when done by Fed officials. The Fed has kept interest rates at artificially low levels for two years. This has created an enormous bubble in Treasury prices and artificial increases in the prices of other relatively safe assets, as people search for yield in the face of negative real returns on safe short-term investments. The combination of serial gimmickry, with QE2 as the latest example, and the ongoing uncertainty of when rates will be increased, is undermining the economic recovery. While we applaud the fact that the Fed injected liquidity into the system in late 2008, they have tinkered far too long and far too extensively.

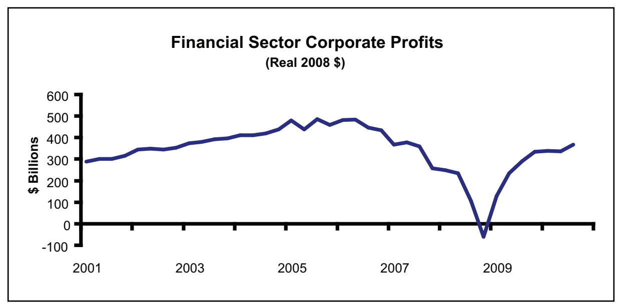
QE2 is a huge error. It pretends that creating money – and eventually inflation – creates jobs. But there is no theoretical or empirical reason to believe this conjecture. It is nothing more than the Fed saying to the Treasury, "You can run deficits $800 billion above the norm without raising taxes or going to the market to float your bonds, as we will buy them with newly printed money." This has pushed up long rates in the short term, as it will lead to inflation. This is pure political accommodation on the part of the Fed, de facto making the Fed a branch of the Treasury.



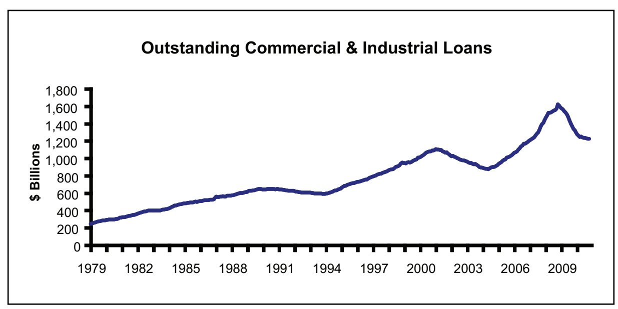
Foreign Holdings as % of U.S. Public Debt

Foreign Holdings of U.S. Treasuries

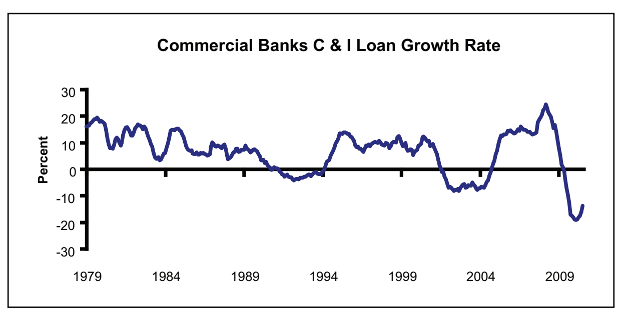
Country	U.S. Treasury Holdings	Holdings as a % of Public Debt
Mainland China	$868	9%
Japan	$837	9%
United Kingdom	$448	5%
Oil Exporters	$227	2%
Brazil	$165	2%
All Other Countries	$1,668	18%



Financial Sector Corporate Profits
(Real 2008 $)



Outstanding Commercial & Industrial Loans



Commercial Banks C & I Loan Growth Rate

THE LINNEMAN LETTER

Volume 10 Issue 4

The Fed has re-capitalized big banks at the expense of non-defaulting borrowers and savers seeking low-risk returns. Such savers are receiving zero return even though they are taking notable investment risk. This is a non-legislated taxation. The result is that core U.S. savers, particularly retirees, have been deprived of hundreds of billions of dollars of interest payments, which they would have received but for the Fed's de facto taxation. Why should these citizens be responsible for subsidizing the banking system? And why should the Fed set U.S. tax policy? Core savers have lost income, resulting in reduced consumer confidence, which has stalled the economic recovery.

Banks have received huge injections of federal funding, but have not passed those dollars through to their borrowers in the form of either lower rates or increased credit. In fact, banks have reduced credit availability to corporate borrowers, with commercial and industrial loans falling by $380 billion over the past two years, and real estate loans declining by $140 billion over the past year and $50 billion over the past six months. And consumer loans have fallen by some $20 billion, even as bank holdings of U.S. Treasuries have risen over $200 billion during the past year.

Japan did this not via its central bank, but rather via its control of the Japanese Postal system, which controls Mom and Pop money. Instead of printing new money, they mandated that private money purchase the new debt. This has kept rates down, de facto taxing Japan's Mom and Pop population via almost no return on their savings for nearly two decades. This de facto tax has meant no growth, as it has misallocated capital from the private sector to pork (oops, "stimulus" government spending). But since no money was printed, they have no inflation.

But we have no such mechanism, at least not yet. Imagine what would happen if all pension funds and 401k plans were required to hold a lot of Treasuries. The Fed will short-circuit the bond market via their artificial purchases with newly printed money. This will result in inflation within 18-30 months. This is particularly true given that half of our debt is bought by foreigners. This inflation will transfer wealth from creditors to debtors, and will harm those with nominal assets.

Why is this Bernanke's desired path? Because political accommodation is attractive and his philosophy is, "I will keep giving extremely high doses of chemo to dying cancer patients until they survive, because otherwise they are dead; and if there are side effects, we will deal with them later." But the U.S. economy is not a dying cancer patient. This is a serious misdiagnosis. One does not administer high doses of chemo to someone who does not have cancer.

Banks have only recently begun to reduce their lending standards, so far reducing the $1.1trillion excess reserve position to just under $1 trillion. One hundred billion dollars with a 7x multiple is a tremendous amount of money starting to trickle into the system, creating an enormous inflationary bias.