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## False Profits: An Economics Primer About Americans "Going for Broke" and Nearly Making It

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# FALSE PROFITS

An Economics Primer  
About Americans  
"Going for Broke"  
and Nearly Making It



by  
**D.P. Diffine, Ph.D.**

**FALSE PROFITS -- An Economics Primer About Americans "Going for Broke" and Nearly Making It** deals with burning questions on Americans' minds about our global financial crisis. Did anyone see it coming? According to James A. Funk's haunting "Human Action Theory" (written in 1932), *"There is a mass psychological cycle which lasts approximately 50 years (three generations):"*

*Depression produces Thrift.*

*Thrift produces Confidence.*

*Confidence produces Investment.*

*Investment produces Activity.*

*Activity produces Prosperity.*

*Prosperity produces Easy Credit.*

*Easy Credit produces Overproduction.*

*Overproduction produces Fictitious Sales.*

*Fictitious Sales produce Fictitious Collateral.*

*And these produce Panic.*

*Panic produces Depression, and*

*the more things change,  
the more they are the same.*

Here's the paradox: If the original credit crisis and the housing bubble were caused by easy credit, too much leverage, and too few risk assessment sanctions by lenders, then why would we think that the solution to this carnage should be more of the same thing (but on a larger scale)?

The carnage is global. There is palpable risk of systemic failure baked into the cake: (1) *collapse of additional, bundled, derivative-based securities markets of questionable bond ratings (commercial real estate, insurance, reverse mortgages, student and auto loans), etc;* (2) *further loss in asset values;* (3) *investors being hammered;* (4) *more bankruptcies;* (5) *retail prices tanking;* (6) *worse job losses;* (7) *greater foreclosures;* (8) *state budgets bleeding;* (9) *a downward cycle of deflation;* and (10) *a protracted depression.* Please know this: Although, I am a short run pessimist, I am also a long run optimist.







# FALSE PROFITS

An Economic Primer  
About Americans  
“Going for Broke”  
and Nearly Making It

by D.P. Diffine, Ph.D.

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## DEDICATION

This book is dedicated  
to those individuals who,  
in addition to being responsible  
taxpayer/voter/investors, are willing to  
cultivate 21st century marketable skills,  
combined with the traditional core values  
of faith in God, private enterprise, and  
limited constitutional government.  
May they live long and  
prosper in yet another  
American Century.

*“Writing a book is an adventure. To begin with, it is a toy and an amusement. Then it becomes a mistress, then it becomes a master, then it becomes a tyrant. The last phase is that just as you are about to be reconciled to your servitude, you kill the monster and fling him about to the public. “*

-- Winston Churchill



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## **INTRODUCTION -- FROM BOOM TO KABOOM!**

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### **Keynote Presentation to 400 Money Managers Little Rock, Arkansas, March 11, 2009**

*Dear reader, consider this keynote presentation, over the next 25 pages, as an Executive Summary of sorts, previewing the major sections of FALSE PROFITS to follow.*

Is this a great country or what? “*Freedom of Speech*” and a captive audience! I told my son once when he was in college, “*America’s a privileged nation.*” He said, “*I disagree.*” I replied, “*That’s the privilege!*”

Our country has had some dark days, and yet some bright hours. It turns out that not only do we live in America, but America lives in us, doesn’t it, “*...crowned with good through brotherhood...*”?

I’m supposed to take your minds off your troubles and talk about the economy. Learning economics won’t make you a millionaire or keep you out of the soup line. It will give you a better understanding of how you got there.

My father-in-law, Arthur Hillman, is now 87 and very fit. Born in 1920, he has seen 16 presidents (and provided security for some of them, along with other heads of state and General Douglas MacArthur, in Hawaii). A lot of key legislation affecting and altering our economic lives also happened in his lifetime. The

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body of this presentation will, therefore, be built around those signal events.

An Economist is a guy who has one foot in oven, the other in freezer, and says, "*On the average, things are not too bad.*" Forecasting? You give people a number or a date, but not both. Not a Prophet, nor the son-of-a-prophet, I don't want to be an Optimist nor a Pessimist. Just being right is its own reward.

There has been too much "*Recession*" talk. The culprit? The national network media. They have predicted 17 of the last 10 recessions. If gloom and doom were nutritional, they could "*feed the world!*"

If, today, Edison invented the light bulb, the 10 p.m. national networks would shriek, "*Tragedy strikes candle industry!*" There have been about ten negative network stories for each positive one. I worry about Economists who are so young they think the Great Depression was cured by *Prozac*! Really!

Is this the 1930's all over again? *No!* It's the same answer in Spanish and English. There are many differences. Transfer payments create a purchasing power "*floor*," to keep recessions from becoming depressions. The Federal Reserve isn't "*imploding*" the money supply, as it did severely by one-third from 1928 to 1932.

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Unlike the 1930's, interest rates are low now. There are no five-year mortgages with a balloon payment. Investors are diversified with a 50% stock market margin requirement, not 10%. We don't have a highly prohibitive tariff. Today, only about 20% of our Gross Domestic Product (GDP) is especially vulnerable to the business cycle (mining and manufacturing), not 45%.

Sure, we all know some who aren't working. But most of them have jobs. There is a *silver lining*. We still have the "*Grossest Domestic Product*" in the world! Never forget -- we enjoy a standard of living beyond the dreams of kings. And for this, we owe a great deal of credit, to those who have extended us credit, to whom we owe a great deal.

Good news? Yes! We're in our third Revolution, one which provides computers to supplement our minds. Earlier, the Agricultural and Industrial Revolutions gave us machines to supplement our muscles. Dislocations occur whenever we alter production, distribution, and consumption.

Worry? Yes, I do a little to be sociable. We can be beneficiaries or victims. It's our choice. Global competition has brought down our "*wall*" of isolation. Additionally, we have weak neighbors to the north and south, along with fish to the east and west.

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We have been applying high-tech to low-tech industries. They are now smaller, leaner, stronger, potentially more profitable. It's not "*written in the stars*" that we have to lose markets to overseas competitors, or that their quality has to be better.

The lesson? "*Automate, Emigrate, or Evaporate.*" It has happened with the family farm, the mom and pop grocery, and the corner soda fountain. It's called economies of scale. Joint ventures are a growing trend, to reduce risk, build expertise, and penetrate markets.

The scorecard? With 4% of the world's population, we produce about 25% of the world's GDP (and use a similar percentage of energy). Only 2% grow enough food to feed 200% of us. Our poverty income is greater than the average Russian income. Our workweek is 30% shorter than in 1900. Over 90% of us are working.

50 years ago, incomes in the south were 40% the national average. Today, it's nearly 80%. Additionally, 70% of today's millionaires are first generation. They got it the old fashioned way -- they earned it! By the end of the 20th Century, more Americans were connected to the *Internet* than were connected to electrical power, a water source, or a sewer line 100 years earlier.

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Man, a year ago, I was bored and wondered what to write about (or speak about). Be careful what you wish for. Nobel Economist Milton Friedman, who was cited in *Fortune Magazine* in 2000 as “*Economist of the Century*,” once gave up a 1928 scholarship at Rutgers in Actuarial Science, because it was a “...*great time to be studying Economics (instead)*.”

What people want most from economists is a detailed forecast of the next 30 to 90 days. If I really knew, our new President would come to Searcy, Arkansas to find out. However, I wouldn't be here, but rather in Hawaii, which I would own by now.

As you must have suspected, there are two kinds of forecasters: (1) those who cannot forecast; and (2) those who do not know they cannot forecast. Among other things, I teach Economic History of the U.S. (*National Treasure*) -- especially the economics of those founding documents (*secret map*).

Before, say, 300 years ago, the future for most of mankind was grim: starve to death; freeze to death; or be eaten. In Columbus' day, if you owned a change of clothes and a simple chair, you were considered non-poor. Capitalism doesn't cause poverty. Capitalism inherited poverty from the Middle Ages, when life was grim, brief, miserable, (and everybody's babies were born naked)!

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*Pollyanna*? She was wrong in her excessive optimism. *Chicken Little*? He was also wrong with his abject negativity. Stock prices are certainly important, because they speak to confidence in future (profitability) progress. Keep that in mind, please.

Dr. Friedman and I were traveling across the country together in 1980-'81, the year of the Chrysler bailout. His comment was telling regarding the downside of loan guarantees, facilities misuse, low market share, etc. It was Friedman who popularized the saying, "*No Free Lunch*." That is, everything has a cost that must be paid for, by somebody, sometime, somewhere!

In all that we do, and especially our economic lives, we need to avoid "*Dumbth*" (it's on the test). "*Dumbth*" is willful ignorance. Don't make the same mistake twice (more than once). You don't want to be a loser? Watch what losers do. Don't do that.

During my 48-year career as an economist, the percentage of our National Debt owned by foreigners was traditionally no more than 15-20%. New federal debt from those record deficits is now approaching 50%, making it no longer similar to somewhat harmless, internally-held family debt.

As we sort this out, let's try to get something off the table: This present financial carnage has R & D causes, and it needs cooperative R & D solutions. By R & D, I mean nothing less than "*Republican and*

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*Democrat.*” Let’s get party labels off the table and try to examine things objectively.

Here are some “*Recession*” definitions. The Department of Commerce defines it as “*six months of no GDP Growth.*” That would put its starting point at approximately July 2008. The National Bureau for Economic Research’s (NBER) Wesley Mitchell coined the term “*Recession*” in 1952. (He didn’t want to scare people during a minor downturn with the “*D*” word).

The NBER triangulates dates of several indicators as production, employment, retail sales, and personal income and takes an average of the days they headed south, declaring that’s the official date the recession started. So, for the NBER, the recession officially started December 2007.

Here’s the definition of a “*Depression*”: two years of double-digit nationwide unemployment. In my lifetime, there have been no depressions and 10 recessions. Although not in textbooks, here are the “*Three D’s of Downturns:*” (1) *Depth* (how deep?); (2) *Duration* (how long?); and (3) *Dispersion* (how broad?). There have been six (6) financial panics since the Civil War. We recovered and prospered each time.

The thing is, however, that  $GDP = C + I + G$ . And, as you probably know, “*G*” (Government spending) can be artificially “*stimulated.*” When



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added to a flat “C” + “I” (Consumer spending and business Investment for capital stock), “G” stimulus signals “*rising GDP*,” even when no real growth in “C” or “I”(i.e., physical output) has occurred! Incumbents love to claim credit for such a “*recovery*.”

Twenty years ago, my accountant refused to advise me on investing (“...*a whole new set of liabilities*...”). So, I had to try to learn. Investing is always both offense and defense, as I learned early on.

I sincerely believe that watching one’s nest egg value go into the tank, while saying “...*the Lord will provide*...,” is unfair to both our Creator and the good sense He gave us, too. “*Free will*” must operate (or how shall we accept salvation?). In financial markets, both action and inaction have consequences.

Some economic history here. During, the panic of 1907, J.P. Morgan helped bail out a key, failing bank in New York City with, yes, his own money! More economic history now:

1911 -- *The 16th Amendment*: Income Tax -- 1% of income over \$3,000 was taxed. It was a flat tax (at first), although few paid it beyond professional people.

1913 -- *The Federal Reserve System Act* -- The Fed, our new central bank, was given vast powers. A banker’s bank, it performed many of the functions that

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banks do for you and me. The Fed issued the paper currency (Federal Reserve Note), could expand the money supply by approving loans, supervised member banks' capital accounts, reserves, and was charged to buy "good" debt (Treasury Bills).

1913 -- Henry Ford replaced two ten-hour production shifts and a four-hour maintenance shift with three eight-hour shifts (asking workers to do their own maintenance and cleanup). The workers got a 20% reduction in their work day and about a third more pay (\$5 a day). Henry made more cars and money than before, spreading those fixed costs over a larger production volume, etc. Win-win (unless you were a competitor)!

1913 -- *The Federal Trade Commission Act (FTC)* -- It held hearings and issued "cease and desist" orders in documented cases of unfair competition.

1921-22 -- Sharp downward spike in GDP. It was called the "*Primary Post-war Depression*." There was no government intervention; it was brief. Who has ever heard of it? Nobody.

1928 -- The Fed, fearing a Boom-Bust situation, triggered the Bust (opposite of "Boom" is "Kaboom!") by crunching the money supply by one-third from 1928 to 1932. Is there any way the macroeconomy (C, I, and/or G) or microeconomy (you and me) can keep going at the same level with one-third less money? Nay!

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Ever heard of Bernard Baruch, the investor? Observing the Fed's contraction, this "contrarian" pulled out of the stock market and sat on his cash, starting in 1928 (he was roundly criticized). Baruch then purchased (over the next decade) buildings, companies, commodities, etc. for 10¢ on the dollar. We hear of the millions who lost thousands, but rarely of the thousands who made millions.

1932 -- "*Secondary Post-war Depression*" -- The 1932 GDP was one-half the 1928 level (or equal to the GDP in 1900). Some 20% of banks had failed, and unemployment was 24%. The "*Great Depression*" was not "*great*" (except if you lived on Walton's Mountain). It was an election year, too. We threw the rascal out and got a new rascal.

1932 -- *The Glass-Steagall Banking Act* -- Important safeguards were levied on commercial bank activity, in the form of more strict sanctions; audits; supervision; capital accounts; reserve requirements; open market operations; fed funds rate; discount rate; consumer credit controls; etc.

1933 -- *The FDIC (Federal Deposit Insurance Corporation)* -- It is an insurance company with risk-based premiums. Because of "*trust*," each, say, \$1.25 (required minimum) in FDIC assets can "*insure*" each \$100 deposit. In 75 years, nobody has lost money from FDIC insured savings accounts.

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1935 -- *The Securities and Exchange Commission Act (SEC)* -- It amended the original Federal Reserve System Act, providing stock market margin requirements (down payments on stock purchased that were supposed to stabilize the market).

The SEC was supposed to halt inbreeding between financial community and regulators. Ask Martha Stewart or Bernie Madoff. Both were Board Members (NYSE and NASDAQ respectively) at the time of their downfall.

1935 -- *The Social Security Act* -- Providing pensions and medical care for the aged workers, their survivors, etc.; it is lesser known for setting up the state-run unemployment systems. Benefits are usually in multiples of 13 weeks, depending on the unemployment rate by state.

For example, in the 1981-82 recession lasting 16 months, benefits progressed from 26 to 39 to 52 to 65 weeks. Multiples beyond 26 weeks are usually federally funded. This makes the states feel very relieved.

1935 -- *The Wagner Act (National Labor Relations Act)* -- Employers must now bargain in good faith. The result? An increase of 500% in union membership between 1935 and 1947.

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1936 -- Election year! The Fed doubled the Reserve Requirement, the basis for loan creation. New taxes were levied by the Federal Government on the private sector, especially on business (to try to reduce the budget deficit). The result? A back-to-back, double dip depression. It was bad timing for such monetary policy and fiscal policy moves.

1937 -- *The Fair Labor Standards Act* -- Minimum Wage, hours, working conditions, etc., were sanctioned. Original minimum wage was 35¢. When I was a sophomore in high school in 1958 (*Happy Days!*), it went from 75¢ to \$1.00. Wow! A three figure income!

1938 -- *The Federal National Mortgage Association (FANNIE MAE)* -- a government-chartered corporation. “Affordable Housing” was the prime directive, because “better-citizens-own-homes” or is it verse visa, “people-who-own-homes-become-better-citizens”? That’s the debate. It still rages! Remember the movie, “*It’s a Wonderful Life*,” set in the 1930’s, George Bailey, and that passion of his for affordable housing?

1941 -- World War II (Now, we began to number them). The *Social Security Trust Fund* was borrowed by Congress in ‘41 to fight the war. The *Social Security System* has been an unfunded pyramid ever since. The System’s liabilities grew rapidly in the second half of 20th century: “*Disability*,” “*Medicare*,”

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*“Medicaid,”* gender neutral benefits (e.g. my dad), and the *Prescription Drug Benefits Program* (early 21st century, cobbled together, and significantly underfunded).

1947 -- *The Taft-Hartley Act (Labor Management Relations Act)*. -- This provided protections for business. Unions must now bargain in good faith, too. Secret ballots and 60 days notice on strikes were a part of the legislation.

1970 -- *The Federal Home Loan Mortgage Corporation (FREDDIE MAC)* was launched. As with FANNIE MAE, it was also government chartered, and “affordable housing” was still the prime directive.

1977 -- *The Community Reinvestment Act (CRA)* -- This “affordable housing” legislation (crafted in part by affiliates of the Association of Community Organization for Reform Now [ACORN]) was to serve full range of communities and of society, regardless of credit worthiness of households or the quality of loans by banks.

1980’s and 1990’s -- Compliance with the CRA was enforced by federal agencies, by disapproving banks’ requests for branches, acquisitions, etc. HUD and the Justice Department required hard data on CRA compliance, sometimes resulting in lawsuits against mortgage bankers.

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1999 -- *The Financial Services Modernization Act* -- Bipartisan, it gutted the main safeguard provisions of the *Glass-Steagall Banking Act* of 1932 by removing investment banks, mortgage brokers, and insurance companies from many of the former risk assessment-related banking regulations, capital accounts, reserves, supervision, audits, sanctions, etc.

Over many decades, “*Affordable Housing*,” pushed by lobbyists of community action affiliates and by some members of Congress, resulted, understandably, in greater political support from subprime neighborhoods. That’s why, in part, my profession was originally called “*political economy*” and/or “*social economy*.”

After the mid-1990’s, mortgages were increasingly securitized, that is, bundled collateralized debt obligations (CDO’s) with varying degrees of risk (tranches). They were often rated AAA erroneously by Moody’s, S & P, or Fitch (under pressure from Fannie and Freddie, and resulting in lucrative fees, etc.). Then, the CDO’s were marketed directly or through Fannie/Freddie to hedge funds overseas to spread risk. Man, did it ever!

In 2000, community action affiliates pushed for a goal of 50% of new mortgages being subprime by mid-decade (2005). We didn’t quite get there. In 2006, about 40% of new mortgages were subprime

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(up from 10% in 2001). Home prices doubled between 2000 and 2006.

The result? Houses, for many, became big automatic teller machines from which to suck out money every year and run up even more installment debt, in perpetuity (it seemed)! Beyond those brokers getting Originator's Fees, few cared about home loans' long term successes. Rarely were the mortgages carried on a bank's books (as in the old days) or even sold originally by a bank.

Selling prices were often inflated (as were appraisals) to cover the buyers' closing costs. Buyers were essentially renting for the first two years, before shocking ARM rates kicked in. Six months' interest prepayment on refinance and no equity made refinance impossible. Defaults, foreclosures, etc., followed, depressing housing prices.

Eminent former Federal Reserve Chairman Alan Greenspan was interviewed about all this (grilled by Congress and the media) in late 2008 and early 2009. He was astonished, and, trying to preserve his legacy, expressed *"...shock and dismay that all this could happen under the regulatory radar..."* In 2004, Financial regulators reported that Fannie Mae has over reported income by \$10 billion.

From 2000-2006, there was a rise in personal income of 1-3% per year vs. a rise in housing prices



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by, say, 8-12% per year compounded, again, doubling in housing prices in some places in 6 years (2000-2006). See why that house of cards could not have been maintained?

Remember the 1980's Savings and Loan (S&L) crisis motto of Resolution Trust Corporation (RTC)? *"Bury the Dead; Heal the Sick; and Marry off the Survivors."* Could we do this now? Yes! When to start? Preferably last year! Create another RTC. Liquidate bad debt. Move it systematically off financial institutions' balance sheets. But don't create zombie banks and companies, as Japan did in the 1990s.

Then came the *Emergency Economic Stabilization Act* of October 3, 2008. Economic Because of "...*systemic failure*..." risk, few questioned the new requirement on the Fed to now buy "*bad debt*" (in the trillions) and put it on, yes, the Fed's balance sheet. In fact, for months prior to October 2008, the Fed had also been quietly pumping hundreds of billions into central banks on several continents (think dominoes here -- systemic failure).

On September 15, 2008, Lehman Brothers failed. The U.S. Government, after observing a \$550 billion drawdown on the morning of September 18, 2008, promptly insured money market accounts, to avoid panic.

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President Bush, in signing that October 3, 2008 Emergency *Economic Stabilization Act* said (uncoached), *"We know the economy has come to a halt."* Leaders shouldn't say things like that! It wasn't true, either! November 2008: we threw the rascal and his party out; we got a new President and his party. Remember R & D here in both tandem problems and cooperative solutions.

I also believe that President Bush's early second term (February to April 2005) *"Private Accounts"* Road Trip (*"...I'm spending the political capital that I earned..."*) was ill-advised, actuarially. Voluntary private accounts? Yes! But compelling employers to take 2% of the 6.5% employees' Social Security Tax and throwing it into private accounts, accelerating Social Security System insolvency dates (2024) and bankruptcy dates (2042)? No!

Our new activist President Obama said this in a February 21, 2009 speech: *"We cannot successfully address any of our problems without addressing all of them."* We might all do well here to remember the *"No Free Lunch"* lesson, in the context of scarcity, too. What's possible and what's probable are two very different things.

Here's a paradox: If the original credit crisis and the housing bubble were caused by easy credit, too much leverage, and few risk assessment sanctions by lenders, then why would we think that the solution to

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this carnage should be more of the same thing (but on a larger scale)? Inquiring minds, like me, want to know.

Let the worst banks and businesses fail. The remaining, stronger banks, and businesses can buy their assets and operate them better for all stakeholders. On this, you should see “*Japan’s Lost Decade*,” by *U.S. News & World Report* Editor-in-Chief, Mortimer Zuckerman, July 13, 1998, who, by the way, recently lost \$30 million to Bernie Madoff (whom Zuckerman says he never met).

Do you know of any time in history when government could successfully spend private sector money (*by first taxing it*), borrow the difference (*deficit spending*), and crowd out private sector long run borrowing (*causing higher interest rates*) -- all to try to bring about private sector growth, economic recovery and stable prices? The question answers itself.

Should we worry that our new government’s ambitious spending plans could be like the proverbial drunken sailor squandering his paycheck on leave? At least it was his own money!

The “*other shoe*” has yet to fully drop (admittedly not an economic term). Circling overhead are more leveraged derivatives: *student loans; consumer credit; car loans; commercial real estate mortgages; even reverse mortgages*. All this could trigger more

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layoffs, mortgage defaults. Don't shoot the messenger.

The “*KABOOM!*” scenario (written and published September/October 2008 under the full title “*A Primer on the Housing, Credit, and Securities Bust*”) has concerned me since 2000, when I presented it to the Governor's Council of Economic Advisors (and every year since, at our semiannual meetings). It seemed like such a minority position to the others back then.

Having lost no money in my 403-b the last two years, it is alarming that others could have easily done likewise. Many just didn't care-to-know or know-to-care, about moving to the safety of the sidelines. A little poem (author unknown):

*Breathes there a man  
With soul so dead  
Who hasn't said  
When the market fell out of bed  
“Man! I wish I had quit  
When I was ahead.”*

“*DOWNDRAFT!*” (written and published November/December 2008 under the full title, “*The Economics of Deleveraging in Turbulent Times*”) is more about the stunning lack of capital preservation, and proactive free will, by and for our silver-haired citizens, many of whom have become like lemmings, marching over a cliff. Grim. Sad. Avoidable!

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Indeed, I have had running conversations over the last, say, three quarters, with many of my generation about lost nest eggs, outliving life savings, cancelled trips of a lifetime, moving in prematurely with kids, having to go on Medicaid in future, etc. I have yet to find one individual who had a type of “*Stop-Loss Order*” with a money manager at, say, 15%, etc. (that is halfway between a 10% technical correction and a 20% Bear Market), to preserve their principal.

Selling stock is not always wrong. Should we sell everything, when facing an awful, cataclysmic market? No. However, we can consider some approaches: (1) move some of our money to bonds; (2) leave some discretionary money in assets; and even (3) diversify into various sectors, even if it is the opposite of traditional poker-playing strategy.

Is this the time for bargain shopping, for bottom fishing? It could be too late to sell and too early to buy. Remember -- sell on fear, buy on hope. Most uninitiated investors buy high and sell low. Yikes! I know some who still think the S & P 500 is a car race!

The new fiscal Stimulus Bill being debated could be more fiscally sound. To me, it's back-loaded with too little tax cuts. It's front-loaded with too much entitlements and pork. On October 1, 2009, under existing law, taxes on dividends and capital gains are slated to rise from 15% to 20%.

## INTRODUCTION -- FROM BOOM TO KABOOM!

But then, we're asked to "*Invest in America!*" There is some irony there. Again, stock prices are important because they speak to confidence in future (profitability) progress. It's *Macroeconomics 201*: "*Anything you tax, you get less of. Anything you subsidize, you get more of.*"

This fiscal year, the '09-'10 *Omnibus Budget Bill* proposes more funding, in addition to the current 80-90% increases in agencies funding, already passed on October 3, 2008, the \$781 billion Emergency Economic Stabilization Act.

The money supply has increased dramatically since October 2008. Where is it? Mostly parked, waiting to return, and with it, inflation. Take a look at *TIPS* sometime -- *Treasury Inflation Protected Securities*. The investor receives the interest rate or the inflation rate, whichever is higher.

Presently, our new President Obama has been in office barely two months. Give him a break. President Reagan had all these warring factions, too, each with a constituency (and I'm just talking about his cabinet!). When, in an attempt to balance the budget, he tried in '82 to freeze COLA (Cost of Living Adjustment) for Social Security, he briefly lost his only natural constituency, the "*Grey Power*" folks.

What are the top priorities of our new Administration? Recovery Aid? Growth? Prosperity?

## INTRODUCTION -- FROM BOOM TO KABOOM!

Wealth Redistribution? Market Socialism? It's going to take more than two months to sort it all out.

Our new President is a great man. He came out of abject poverty, as did I. He will have to sort all this out. All taxpayer/voter/investors get impatient, especially every two to four years. It's an irony: we distrust government, and yet we expect more from it.

According to the *American Recovery and Reinvestment Act* of 2009, the \$787 billion economic stimulus bailout, signed into law by President Obama on February 17, 2009, each item has a constituency. Consequently, elected officials always sense a demand that is really greater than the general public's willingness to pay in more taxes.

Take, for example, my son, the doctor. The new Stimulus Bill includes EHR implementation funds. Starting in 2011, there will be \$44,000 paid over the following five years, if medical clinics adopt an electronic health record system. My son David would love it for his medical clinic, because he's been pushing it unsuccessfully for a decade.

On a CNBC, Monday, March 9, 2009, there was a special titled, *"Restoring Trust with Warren Buffet."* The *"Oracle of Omaha"* declared, uncoached, *"The Economy has fallen off a cliff."* That statement was the financial equivalent of standing up in a crowded theater and shouting, *"fire!"*

## INTRODUCTION -- FROM BOOM TO KABOOM!

CNBC Interviewer: *“Do you want our new President to pursue a free market solution or nationalization?”* Mr. Buffet’s reply: *“I want our President to take a clear stand, regardless what it is, to allay people’s fears. Then, we can all get behind him.”*

Oh, if it were only that sincerely simple. Frankly, by the end of the hour, it seemed that Warren Buffet was exhibiting a bit of *“diminished capacity.”* That’s something I’ve always tried to hide myself, as I age. I still think my mind is as sharp as it was 20 years ago. And I’ll tell you something else. I still think my mind is as sharp as it was 20 years ago.

Mr. Buffet, too, is a mere mortal. So, he purchased large blocks of Conoco/Phillips stock in 2008 when oil prices were very high and rising. And, after condemning derivatives as *“...ticking time bombs...”* in a 2002 stockholders meeting, he rolled the dice with derivatives last year. Berkshire Hathaway reported a 62% decline in net income for 2008.

Remember Margaret Thatcher? Can we learn from Lady Thatcher? *“The problem with Socialism,”* she said, *“is that, sooner or later, we run out of other people’s money.”* Why shouldn’t we cut taxes the most on those who pay the most taxes (dollars or percentages of total)? When was the last time a poor person ever gave you a job?



## INTRODUCTION -- FROM BOOM TO KABOOM!

Ancient proverb: *“He who rides on the back of another doesn’t appreciate how far off it is to the town.”* Why would we want to add to the number of people who do not even minimally support the body politic? It can warp attitudes. Remember this proverb!

In this regard, Theodore Roosevelt said, *“To announce that there must be no criticism of the President, or that we are to stand by the President, right or wrong, is not only unpatriotic and servile but is morally treasonable to the American public.”* Of course, he was a former president when he came to that conclusion.

Pioneers in commerce who have made great fortunes, men like Warren Buffett, along with Bill Gates, and predecessors Andrew Carnegie, J.P. Morgan, Leland Stanford, John D. Rockefeller, etc., predictably experienced altered approaches and attitudes as they aged.

Later in life, after power and wealth have been achieved (and were then little more to them than a way of keeping score of how well they are doing in their profession, serving the customer, consolidating industries, etc.), these individuals developed a different mindset. Many such *“Captains of Industry”* would then say, *“...beyond making it, and then giving it away, money has little use to me.”*

## INTRODUCTION -- FROM BOOM TO KABOOM!

They often respond to the allure of serving society through public service and/or philanthropy, by being magnanimous with their own and (sometimes) others' (taxpayer) money. Example? Warren Buffet, in that CNBC interview of March 9, 2009: *"The people that behaved well are no doubt going to find themselves taking care of the people who didn't behave well."* Really!

A seismic shift is in the works. For decades, government spending in the U.S. at all levels was 22-24% of GDP. This year, it will be nearly 40% of GDP. European Union governments' spending averages 47% of GDP. Welcome to *"market socialism,"* possibly on its way to *"state capitalism."*

You want one good, positive fix for American businesses to slow the carnage? Throw out the 2002 *"mark-to-market"* Sarbanes/Oxley Act provisions which updated the *"fair market"* requirement that companies must price assets at fire sale rates for their industry (e.g. Lehman Brothers collapsing affected other financial institutions which were conversely required by regulations to maintain viable capital accounts).

The consequences were devastating: sinking asset values, lowering bond ratings, spooking investors, sending stock prices south, bringing down other firms, industries. There are other accounting options on listing assets. The *"mark-to-market"* rule is

## INTRODUCTION -- FROM BOOM TO KABOOM!

an artificial accounting rule causing capital to collapse, because of discounted cash flow in these times.

As I understand it (in another life, I was a Junior Financial Accountant for our nation's largest public utility, Southern California Edison), that "*fair market*" requirement could be modified, while still providing disclosure and oversight, along with regulatory discretion. Allow financial institutions to list assets in, say, *Held to Material* accounts instead of *Available for Trade* accounts. Allow financial institutions to amortize bad debt over longer time periods, too.

You want more solutions? How about tax relief (all types)? It gives everybody a real pay raise, therefore a rise in the standard of living. There is a strong history, from President Kennedy forward to President Reagan, showing it works. That is, at lower rates, more money flows in as people prosper, although this gets visibly obscured by even greater surges in federal spending for social programs.

Control Federal budget deficits. Most state budgets are balanced, thanks to revenue stabilization budget laws and line-item veto authority. Congress could pass similar mechanisms. Adopt anti-fraud, anti-theft sanctions on federal and state spending, and aid, etc.

## INTRODUCTION -- FROM BOOM TO KABOOM!

Make corporate governance more transparent, especially in the financial sectors. Change our tax and trade laws to encourage research, development, and economic growth. Explore both proven and new energy technologies and infrastructure upgrades, where they can be cost-effective.

Conduct periodic reviews of government agencies, entitlement programs, paperwork requirements and regulations, with sunset provisions for those which have served their purpose.

America recently celebrated Abraham Lincoln's 200th birthday. Here are Lincoln's "*Economic Ten Commandments*" (distilled down from Lincoln's speeches by a clergyman named Boetcker in 1916):

1. *You cannot bring about prosperity by discouraging thrift.*
2. *You cannot strengthen the weak by weakening the strong.*
3. *You cannot help small people by tearing down big people.*
4. *You cannot help the poor by destroying the rich.*
5. *You cannot lift the wage earner by pulling down the wage payer.*
6. *You cannot keep out of trouble by spending more than your income.*
7. *You cannot further the brotherhood of men by inciting class hatred.*

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8. *You cannot establish sound security on borrowed money.*
9. *You cannot build character and courage by taking away initiative and independence.*
10. *You cannot help men permanently by doing for them what they could do for themselves.*

See, in the past, free, private enterprise has helped make America great. Free market capitalism can help rebuild America, if we all -- political leaders and citizen voters -- recognize the sentiment of Winston Churchill: *“Business is not a predatory tiger to be shot, or a cow to be milked, but the sturdy horse pulling the wagon.”*

Let's keep free enterprise in business, and watch the U.S. really grow. Support fundamental changes in our American Incentive System which could help unlock our creative energies, so the American economy can continue to prosper. And, then, those tax revenues can reduce budget deficits, too.

Included in this country's greatest assets are its creativity and imagination -- our entrepreneurial spirit. American enterprisers are not the enemy. If we genuinely love the poor, how can we ignore the economic system that has done more than any other economic system for them?

## INTRODUCTION -- FROM BOOM TO KABOOM!

America's business men and women know that the best way to reduce unemployment is to develop a dynamic, growing economy. America's entrepreneurs are also concerned about cost effective environmental sustainability.

Might we all then continue to participate in a cooperative R & D (again, Republican and Democrat) effort to protect and preserve our American Incentive System? If so, as citizen voters, let's ask our elected officials and their agents to focus in the near and distant future on major economic issues: full employment, stable prices, and economic growth.

Remember that classic movie, *"It's a Wonderful Life"*? If there is a moral to Frank Capra's movie, reminds Paul Greenberg, wouldn't it be the comment from *Clarence*, George Bailey's stumbling guardian angel-in-waiting? *"Strange, isn't it? Each man's life touches so many other lives, and when he isn't around, he leaves an awful hole to fill, doesn't he?...You see, George, you really had a wonderful life."*

Yes, just one so-called ordinary man, as *George Bailey*, can keep a *"Bedford Falls"* from becoming a *"Pottersville."* And let us not forget that special spouse, *Mary Hatch*, who made a world of difference in George's life, for sure. Did George ever make it to Europe? Nope. But would not going overseas really be so awful? To others, it would be their loss to never have made it to the United States.

## INTRODUCTION -- FROM BOOM TO KABOOM!

Again, dear reader, consider these 30 pages an Executive Summary. Want more interesting details about these things that go “*bump*” in the night? Read on. And worry not about occasional repetition; people who tell the truth do tend to repeat themselves.

## PART ONE

### A Governor's Economic Council Advisor's Perspective

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In 1998, I joined Governor Mike Huckabee's nine-member *Governor's Council of Economic Advisors* (GCEA). We met several times a year. They made us work and think, too. These are activities that tenured professors don't necessarily seek out.

Presently, I am in the middle of my third, four-year term in the GCEA, and with our new governor, Mike Beebe. We convene often, sometimes with the governor's staff, or some legislators on the Joint Committee for Economic Policy, and especially the staff of the Director's office of the *Department of Finance and Administration* (DFA).

GCEA members discuss the economic performance and general revenue outlook on a biennial basis for the state of Arkansas. There are wide-ranging issues on the current and expected economic performance of the state: *private and public investment, gross state product, employment, income, retail spending, monetary policy, industrial production and construction, banking, agriculture, and the state of economic development*.

We review the parameters that make up the annual economic and state general revenue forecast, property tax reform, income tax reform, along with a



## **A Governor's Economic Council Advisor's Perspective**

strategic plan for economic development rounds out our agenda.

There was a fear of the unknown before that first meeting in November of 1998. I kept thinking, "*What if other GCEA members find out I really don't know anything?*" (that I, too, once thought the S & P 500 was a car race).

And would you know, as we went counterclockwise around the room for everybody's best ideas, I was sitting on the Chairman's left, which made me the ninth and last speaker. Now, what original thoughts could I come up with that had not already been stated by the first eight people? I had been researching for months and months everything I could get my hands on.

However, the night before and for several hours after midnight, I decided to see what I could do to distill my concerns down to a one-page list. And following is that list, double spaced, and I laid it on all my other eight GCEA colleagues, because although their analysis was rigorous and their models were impressive, the fact is that no mortal knows what lies ahead.

We all think we know, because we reasoned it out with great care. However, there are those banana peels, as we call them in the profession, "*wild cards.*"

## **A Governor's Economic Council Advisor's Perspective**

A lot of these are purely in the category of what we will come to call “*exonomics*” (outside forces).

“*Exonomics*” also compounds the picture: significant, outside, unpredictable events exerting real influence over economic facts of life as we know them, such as financial crises, terrorism, third world debt default, changes in availability of resources, crop failures, national security issues, faulty statistics, etc.

What I find astounding over ten years later is that the many concerns I expressed then to our *GCEA* were viewed by our group as a minority opinion and not that compelling. Look at this list from yesteryear and tell me they are not compelling:

- *Record personal bankruptcies.*
- *Financial institutions' loan exposure, non-performing loans.*
- *Unstable economics, globalization of risk.*
- *Repatriation of funds (i.e., pulled out of our economy).*
- *Stocks: investing, speculating, or gambling.*
- *Near negative savings rate.*

## **A Governor's Economic Council Advisor's Perspective**

- *Hedge fund bailout contrary to our export version of capitalism (i.e., global free markets).*
- *Large amounts of short term external debt.*
- *Exporters hurt by strong dollar resulting in more layoffs.*
- *Manufacturing weakest sector of economy.*
- *Downsizing affects 4% in recession (2% in normal times).*
- *Baby Boomers piling on stock market at rate of 4,000,000 a year.*
- *Capital flight triggered by low rates of interest (returns more attractive elsewhere).*
- *Cascading currency devaluations -- shockwaves, domino effects.*
- *Major lenders who failed to appreciate dangers of hedge funds.*
- *No one knowing how much leverage was being deployed in global markets.*
- *Rising nationalism colliding with retreating global finance, resulting in less control, more fear.*

## **A Governor's Economic Council Advisor's Perspective**

- *Fragile young democracies and hidebound old regimes out there.*
- *Elaborate structuring of cash flow through securitization (bundling of loans into bonds) in financial sector.*

Do let the record show that I am not at all writing here to represent the views of the entire GCEA, or our Governor. Rather, I only point out that if we take a closer, Monday morning quarterback look, we'll see that now, a decade later, some of *"the chickens have come home to roost."*



## 1. Laugh or Cry -- Your Choice

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What's the difference between a whining dog and a whining economist at the back door? The dog quits whining when he is let in. Laugh or cry, the choice is yours.

Seriously, no mortal has been given perfect foreknowledge. Economists do well to name the variables, put them on the scales, and try to see which way they are tilting. The trend can be our friend, if we are careful.

According to James A. Funk's "Human Action Theory" (written in 1932), "*There is a mass psychological cycle which lasts approximately 50 years*" (two generations):

*Depression produces Thrift.  
Thrift produces Confidence.  
Confidence produces Investment.  
Investment produces Activity.  
Activity produces Prosperity.  
Prosperity produces Easy Credit.  
Easy Credit produces Overproduction.  
Overproduction produces Fictitious Sales.  
Fictitious Sales produce Fictitious Collateral.  
And these produce Panic.  
Panic produces Depression, and  
The more things change,  
the more they are the same.*

## Laugh or Cry -- Your Choice

GDP fell at an annual rate of nearly 6% during fourth quarter 2008 and first quarter 2009. For all of 2008, the S & P 500 fell 38%, the Dow 34%, the NASDAQ 41%. Foreclosures are projected to continue to stumble along at a rate of about 1.2 million per year through 2012. At mid-year 2009, unemployment was 9.4%, up from 5.6% a year earlier. A little poem has begun to circulate:

*The market's gone to pot;  
Outlook's not so hot;  
Don't cry for what is not;  
Give thanks for what you've got.*

In a year and a half, over \$10 trillion of paper gains in the stock market evaporated, reducing investor wealth by over 50%. Most of that occurred in late 2007 and through calendar year 2008. At this writing, American factories are operating at a record low of 68% of capacity.

Starting in 2007, and continuing presently, approximately 1,200,000 families per year lost homes to foreclosure. By some estimates, about 30% of available consumer credit evaporated in the last two years, as financial institutions attempt to clean up their balance sheets of unused lines of credit (liability to them). At the end of 2008, there were just under 800 billionaires in the world, compared to over 1100 in 2007. Life is hard. It always has been.

## **2. Compelling Social Action in the Marketplace**

From our Civil War to World War II, debt and credit schemes have blown up on six occasions. Today, nobody really knows how much the bundled, mortgage-backed securities (derivatives) out there are worth. We do know that being heavily leveraged globally with increasingly nonperforming debt, endangers financial institutions' capital accounts and asset values, not to mention customers, employees, and stockholders.

In a 2002 Berkshire Hathaway stockholder report, Warren Buffett referred to out of control derivatives as, “...*time bombs...*” that could “...*cause a chain reaction of financial disaster.*” Complicating things, those Mortgage Backed Obligations (MBO's) have tranches, different levels of risk categories.

Being an economic historian, among other things, I know that if we don't learn from history, we are destined to repeat it (next semester). On the 1930's New Deal premise that home ownership makes us better citizens, Government Supported Enterprises (GSE's) like the 1938 *Federal National Mortgage Association (Fannie Mae)* and the 1970 *Federal Home Loan Mortgage Corporation (Freddie Mac)* were chartered; more recently, they morphed into a classic case of co-dependency.

With good intentions, the 1977 *Community Reinvestment Act (CRA)* goal was to create social good through affordable housing. The CRA



## Compelling Social Action in the Marketplace

mandated increased oversight of financial institutions to be sure loans went to all segments of society, especially middle- and low-income people (or, as a penalty, bank mergers and branch requests would be disapproved).

The *CRA* specifically required that each depository institution's record be evaluated periodically by federal agencies, in helping meet the credit needs of its entire community. Contrary to these banks' fiduciary duty toward risk assessment in the past, non-compliance with *CRA* led to fines and affected adversely banks' applications for deposit facilities, acquisitions, etc.

Banks are not required to track *CRA* compliance as far as performance of sub-prime loans versus the entire loan portfolio. Major banks do. Presently, for Bank of America, 24% of the non-performing loans in their portfolio come from the 7% that are sub-prime in origin.

*The Association of Community Organizations for Reform Now (ACORN)* was a player at the table in helping to draft the *CRA* legislation. By one account, over the last 30 years, several hundred million dollars have been paid in fees to *ACORN* and affiliates, in part, for assistance with what are now commonly called "*NINJA*" loans -- realtor jargon for "*No Income, No Job, No Assets.*"

## **Compelling Social Action in the Marketplace**

I know first-hand, as a seller of investment property in 2006, that sellers have been happy to let the subprime house buyer, and the grade B mortgage broker, inflate the sale price by the amount of the buyer's down payment and the buyer's closing costs, since frequently the buyer had neither.

Somehow, the grade B mortgage broker seemed to have an out-of-town appraiser at the ready to ratify the higher amount. Everybody involved held their breath until closing was finalized. Subprime borrowers have been essentially renting.



### 3. Coveted Home Ownership

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The *Financial Modernization Act* of 1999 ominously opened the system to more “*affordable housing*,” by removing investment banks, mortgage brokers, and insurance companies from the legal rules of the road, commercial banking regulations (essentially gutting the federal oversight of the 1932 Glass-Steagall Act).

As a follow up to the 1999 *Financial Modernization Act*, a provision was inserted in the Commodity Futures and Modernization Act of 2000, which exempted from regulation the suspicious credit default swaps regarding derivatives. Now, the chickens have come home to roost.

The people we elected passed these laws and provided for enforcement, or the lack thereof. This decontrol and lack of sanctions became very similar to what caused the S & L economic crisis in the 1980's. “*Affordable Housing*,” pushed by some members of Congress, would understandably result in greater political support from those in subprime neighborhoods.

Undermining our traditional marketplace risk assessment, and with the sale of mortgages in the secondary market, nobody seemed to have an interest in the long term success of these subprime loans, that is, beyond originator's/broker's fee.

## Coveted Home Ownership

The resulting increased demand for houses, fed in part by Federal Reserve engineered low interest rates, led to the 2001-2006 housing bubble, a near doubling of housing prices in that period. Houses were treated by many owners as ATM machines from which to withdraw and spend money; as a result , some owners became “*upside down*,” owing more than the house was worth.

There was an even more ominous bipartisan bill proposed in Congress in 2005, to reduce trading and increase regulatory oversight of mortgage-backed securities by *Fannie* and *Freddie*. It did not pass, in part, due to intense lobbying against it by *Fannie* and *Freddie*. *Fannie* and *Freddie* spent \$170 million on lobbying between 1997 and 2007.

By 2006, 40% of new mortgages were subprime, up from 10% in 2001. Subprime mortgages were bundled as derivatives and sold to *Fannie* and *Freddie* and/or to hedge funds all over the world as mortgage-backed Collateralized Debt Obligations (CDO's), supposedly to spread risk. A perverse, opposite effect occurred.

After the subprime mortgage's first two years, it usually reverted to an Adjustable Rate Mortgage (ARM) which is several percentage points higher. This resulted in increased, and often unaffordable, house payments, up by sometimes 30-40%.

## **Coveted Home Ownership**

With a six month's interest prepayment penalty, it was difficult to refinance subprime mortgages, especially with falling prices and no equity. Subprime delinquencies and foreclosures glutted housing markets, resulting in lower prices and sending more people "*into the bucket*" (again, owing more than the house is worth). Therefore, more walked away.



#### 4. Bailout or Workthrough?

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The Federal Reserve System, the Fed, our central bank, was chartered in 1913 as a result of the financial panic of 1907. The Fed was charged to buy good debt (e.g. Treasury Bills, Bonds). The October 3, 2008 bailout legislation, the *Emergency Economic Stabilization Act*, an undoubtedly historically unprecedented intrusion into the private sector, allowed the Treasury and Fed to buy bad debt.

The bailout did little to alleviate the credit crunch. The Fed now becomes the lender of last resort, to try to alleviate the credit crunch in the commercial credit market. However, where are the reforms to avoid future bad financial policy decisions? All this is like taking a taxi to bankruptcy court and then asking the cab driver to come in as a credit reference. Welcome to market socialism.

Today, the Federal Government is the only organization big enough to buy up the bad mortgages. And the government may, in the long run, be getting housing worth more than the discounted mortgages (a possible money-maker for taxpayers).

The government may even buy 30 year mortgages in California and Florida (by far the worst states) to keep people in their homes (and the otherwise foreclosed homes off the market). The Fed has also created a special fund to buy commercial paper and the stock of select financial institutions. With Fed help, banks may discount mortgages to



## Bailout or Workthrough?

present value to assist homeowners. No bank wants to be stuck with a high-priced mortgage or an underpriced house.

Here's a further irony. It was about a hundred years ago that J.P. Morgan pulled off a rescue in 1907 of a troubled financial institution, for the same systemic reason: to remove falling dominoes that could have cascaded globally.

The difference? The J.P. Morgan financial consortium in 1907 used their own money, not the taxpayers'! The 2008 J.P. Morgan purchase of Bear Stearns occurred only after the Fed guaranteed \$32 billion of Bear Stearns' most risky nonperforming loans. Candidly, our financial capitol has been moved to Washington, D.C.

Although much more serious, this financial crisis is, in a way, similar to the S & L crisis of two decades ago. In the end, it was everybody's fault, therefore nobody's fault. The motto for the Resolution Trust Corporation (RTC) was this: *"Bury the Dead, Heal the Sick, Marry off the Survivors."* It took six years.

This financial crisis is much worse than even the proverbial drunken sailor on leave, squandering his paycheck. It was his own money he squandered, not ours! Go figure.

## 5. Always Follow the Money

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Investment firms bundled the mortgages and resold them as Collateralized Debt Obligations (CDO's), often incorrectly rated by Moody's as AAA. The hedge funds, or *Fannie* and/or *Freddie*, saw their profits evaporate as more defaults occurred and their asset base imploded.

"*Preference*," by the way, is a term now being discussed in legal circles. An example of "*preference*" would be a Chief Financial Officer (CFO) passing bonus money to his top executives, while knowing that the company is failing to disclose its increasingly precarious financial position.

If proven, that form of preference could be against the law. However, in the post-9/11 era, there has been a significant redeployment of FBI agents away from white collar crime toward counter-terrorism.

Insurance companies, involved in credit swaps insuring the nonperforming collateralized debt, saw their financial situation deteriorate. Stock prices of these firms spreading the risk headed sharply south, and many investors fled the stock market. The highly controversial SEC "*mark-to-market*" rule forced otherwise solvent financial institutions to artificially write down asset values to fire-sale prices created by failing institutions.

So, things happen fast in the deleveraging world. If you wait to read about it in the financial news, that

## **Always Follow the Money**

may be too late. All of this is very similar to the decade-long financial crisis and deflation Japan experienced in the 1990's. It's an R & D problem; the solution will be an R & D one. By R & D, I mean nothing less than Republican and Democrat. There's enough blame to go around.

Here is a sampling of Mortgage Bankers Association 90-day mortgage delinquencies in the early, dark days of the financial crisis and as of October 1, 2008:

*Subprime Adjustable rate -- 26.8%*

*Subprime Fixed rate -- 9.8%*

*Prime Adjustable rate -- 6.8%*

*Prime Fixed rate -- 1.3%*

How do you move defaulted home mortgages off the books of financial institutions and into government-created trust accounts? Painfully. Carefully. Gradually. It was a failure of government, trying to do "social engineering" with housing (*Fannie*, *Freddie*, and the CRA), and not a failure of capitalism, that gave us what economists euphemistically refer to as negative externalities (bad consequences of economic activity)!

The frozen credit markets have created a disconnect from free market fundamentals, and, in the process, there has been a partial flight from, say, money market funds to Treasury Bills. New "covered

## **Always Follow the Money**

*bonds,*” common in Europe, may now become popular in the United States. They can stay on the banks’ books, not be thrown onto trust accounts. Covered bonds, backed only by prime mortgages, are also paid off before FDIC claims.



## PART TWO

### Recession with Honor

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The individual investor should be informed that the little known *Securities Investor Protection Corporation (SIPC)* is charged with identifying, securing, and returning investment instruments to their rightful owners (up to \$500,000 per account), whatever the assets are worth after a financial institution fails. However, remember this: in many cases, we did this to ourselves.

Concern about risk aversion, after the fact, is false economy. There is no painless way out for all who believed that housing prices, and the wealth effect, would continue to rise in perpetuity. It would be like the young man who is about to be sentenced by the Judge for bumping off his parents, saying, *“But, your Honor, I plead for mercy -- I’m an orphan, you know!”*

All along, there has been too much *“Recession”* talk. The culprit? Mostly the national media, specifically the networks. They’ve predicted 17 of the last 10 recessions. As the saying goes: *“If gloom and doom were nutritional, they could feed the world.”*

If today Edison invented light bulb, the 10 p.m. national network news would blare, *“Tragedy strikes candle industry!”* Even in normal times, typically there are ten negative network stories on the economy for every positive one. If it bleeds, it leads.

## Recession with Honor

Let's deal with the big question on people's minds. Is this 1932 all over again? No! The answer is the same in Spanish and English. There are many differences. Transfer payments (entitlement money sent to people from government, not as a result of current year production) create a purchasing power "*floor*" to keep a recession from becoming a depression.

The Fed isn't "*imploding*" money supply today as it did by 30% from 1928-1932. There are decreasing rates of interest now. There are no 5-year mortgages today with a balloon payment at the end. Furthermore, investors today have been diversified.

There is a 50% stock market margin requirement now, not 10%. There was a highly prohibitive tariff in 1930 (*Smoot-Hawley*), triggering a trade war. Global competition has brought down our "*wall*" of isolation; we have weak neighbors north and south -- fish to the east and west.

Arkansas exports approximately \$10 billion each year to about 135 countries. It's 13% of Arkansas Gross State Product (GSP). For three decades, the U.S. has been applying high-tech to low-tech industries. They are now smaller, leaner, stronger, and more profitable.

Today, barely 20% of GDP is especially vulnerable to the business cycle (mining and

## **Recession with Honor**

manufacturing), not 44% as was the case in the 1930's. Sure, we all know some who aren't working, but most of them have jobs. There is a silver lining: we still have the "*Grossest Domestic Product*" in the world!

Never forget that we enjoy a standard of living beyond the dreams of kings. For this, we owe a great deal of credit, to those who have extended us credit, to whom we owe a great deal. So, here we are. Our money doesn't talk anymore; it just goes without saying.





## 6. Where Do We Stand?

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Here is my take on things. The October 3, 2008 relief package, which became the *Emergency Economic Stabilization Act*, was not initially presented well by then-Treasury Secretary Paulson and the Federal Reserve. Bailing out Wall Street made taxpayers/voters furious. Think Main Street, not Wall Street, regarding credit collapse -- not just mortgages, but also cars, consumer credit, student loans, with the deleveraging and credit crunch.

What about that \$155 billion in miscellaneous pork, add-ons for congressional districts back home, added to the October 3, 2008 bailout legislation? Be angry if you must; worry not. Those items would have been quietly passed anyway, before Congress went home. It's just that the bailout package took up so much time at the end, few felt like they would stay in session beyond that already late departure date (*"...have to get home and campaign for reelection!"*).

It's ok to be angry and resentful that some of the people who participated in the run-up to the speculative housing bubble (including former Goldman Sachs CEO Paulson) might be paid to create a Resolution Trust Corporation (RTC) type of organization to move these bad loans off lenders' books and into a trust in an orderly fashion.

Even though they made some bad decisions (and were rewarded for it) in reselling bundled bad debt to global hedge funds, and even though Moody's should

## Where Do We Stand?

never have rated them AAA, these people do know the financial markets better than we do.

Nevertheless, the bipartisan 1999 *Financial Services Modernization Act* allowed them (investment banks, mortgage brokers, hedge funds, etc.) to do these things. Taken away by the law was most of Federal Reserve, Treasury, and FDIC oversight, regarding several key concerns: 1) being heavily leveraged globally with nonperforming debt; 2) endangering their capital accounts, asset value, stockholders' investment, and 3) endangering employees' livelihood. Thus, the grim consequences.

This is very serious, and we need to look past elected officials' pandering to their constituents about how offended they are on our behalf. Again, it's important to think "*Main Street*," not just "*Wall Street*."

"*Exonomics*" also compounds the picture as well -- significant, outside, unpredictable events exerting real influence over economic facts of life as we know them: financial crises, terrorism, third world debt default, changes in availability of resources, crop failures, national security issues, faulty statistics, etc.

## **7. Dire Questions Abound**

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Will financial institutions' loan exposure (nonperforming loans) get better or worse? Will record personal bankruptcies continue? What direction will unstable economies and the globalization of risk go? Will there be a possible repatriation of funds (i.e., pulled out of U.S. economy)?

How low will consumer confidence go (and for how long)? How large are the amounts of short-term external debt? How badly have importers been hurt by a weak dollar? How long will it take the weakest sectors of manufacturing (autos and housing) to recover?

How much capital flight will be triggered by low interest rates? Are there prospects globally of cascading currency devaluations and systemic shockwaves? Do major lenders still fail to appreciate dangers of hedge funds? Does anyone fully know how much leverage is deployed in global markets?

What about rising nationalism colliding with retreating global finance (less control, more fear)? How many fragile young democracies and fragile old regimes are out there? Can businesses continue to structure cash flow through loans' securitization (bundling into bonds)? Was Moody's AAA rating of subprime mortgages grossly unmerited? Why did the financial markets believe it?

## **Dire Questions Abound**

We can always plan on election season policies to pander to taxpayer/voter/investors. Beyond that, credit rationing by banks will continue to neutralize, in part, any Fed easy money policy. What direction will oil prices go (most 2005-2008 production growth was in natural gas which is not feedstock for other petrochemicals such as gasoline, jet fuel, and diesel)?

Strong demand for oil by China and India (very large populations) suggests higher prices in the long run (\$4/gallon might actually be referred to as the "*good old days*"). There are stagflation possibilities (usually a long term phenomenon, so not yet).

## 8. Is Anything for Sure?

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Ever present geopolitical events, the Mideast turmoil, for example, hover over us. The weak dollar is only half the picture (it makes exporters more competitive). The weak dollar also creates upward bias on import prices, especially on petroleum prices.

Housing market inventories still hold at approximately 10 months, due, in part, to foreclosures. Shopped-out consumers are a drag on the economy. Conversely, quicker supply chain management adjustments by businesses have smoothed things out in recent decades, resulting in fewer, more shallow recessions.

Government spending, in general, and tax rebates, specifically, can result in a phantom increase in GDP growth statistics. What we produce and sell to each other in terms of real, physical goods could be flat or declining. However, if government spending is up, GDP figures show a rise. Incumbents love it!

Can we ever assume no further terrorist attacks? Are successful military campaigns a certainty? Is *“soft landing with successful war completion”* a realistic scenario? Will global energy markets be interrupted again? Will appropriate and timely monetary and fiscal policy applications be the key? Pay your money; take your choice.

Uncertainty is hard on markets; it's a difficult time to be a risk-taker. The domestic economy revival

## Is Anything for Sure?

could be later and slower than expected. There is only so much Fed leveraging that can be done with one major tool: interest rates. So, the Fed will throw everything possible at the problem.

It's possible that government bailouts, to try to ease the pain of the economy imploding, might, in fact, postpone a healthy recovery. Hear now the haunting words of Thomas Jefferson, "*The principle of spending money to be paid by posterity, in the name of funding is but swindling futurity.*" In that regard, we still live on the same planet. However, it is indeed a very new world.

## **9. Government Budgets Hammered**

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The word on the street: the unemployment rate (at this writing 9.4%) could bump to 12.0% if we experience a double dip recession. That would exceed the brief high point of the '81-'82 recession (10.5%). However, the labor force is 50% larger today, so that's significantly different in terms of the sheer numbers of people and families affected.

The tax base for many states has also been eroding for a decade. Unemployment figures and state revenues typically lag the economy. The federal government has not been reimbursing states for post-9/11 security costs. Every dollar spent on antiterrorism security by the states must come from other programs, creating a fiscal crunch.

Any cuts in Medicaid are also scary. Medicaid accounts for roughly 20% of our Arkansas state budget. Further, rising unemployment is sharply boosting demand for Medicaid. As a general rule, for every one dollar cut in state Medicaid spending, the state would lose another three dollars in federal matching funds.

Of concern is that when we talk about budget cuts and percentages of programs, these are dear to people's hearts and going unfunded in the Health and Human Services area. In Arkansas, we realize that, in times of revenue shortfalls, most of the cuts come from Category B priorities, after Category A programs are fully funded.



## Government Budgets Hammered

Every Arkansas Governor is no doubt very thankful for the *Revenue Budget Stabilization Act*. Some states, like Oklahoma, do seem to fare better in times of general revenue shortfalls by appropriating only 95% of anticipated revenues (rainy day fund), thereby protecting, in part, against shortfalls.

Then there is the issue of perceptions vs. reality. For example, in the mid 1990's, the Clinton administration won the budget cuts battle over the Republicans. While the Republican leadership talked about "*percentages, stats, deficits, and debt,*" the Democrat leadership announced adeptly that the Republicans wanted to "*toss Granny out in the snow.*" Guess what people remembered at the end of the day? Poor Granny! Game. Set. Match. The world operates not only on what is true, but also on what people believe to be true.

Most recent key assumptions of typical U.S. and Arkansas economic consensus forecasts are probably too optimistic. They hinge in great part on the consumer as the key, bank on Fed rate cuts, assume that no more terrorism will occur, that the war on terrorism will be successfully concluded, and that global energy markets will be undisturbed. However, there is good news out there.

## 10. The Scorecard

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In a broader sense, it is not “*written in the stars*” that we have to lose markets to overseas competitors, or that their quality is better. What’s the lesson? Automate, emigrate, or evaporate; it has happened to the family farm, the corner soda fountain, and the mom & pop grocery. Joint ventures are a growing trend, to reduce risk, build expertise, and penetrate markets, using the people and resources of many countries.

We are more interdependent now than ever before. With 4% of the world’s population we produce nearly 25% of the world’s GDP (and use about 25% of the world’s energy production). Barely 2% grow enough food to feed 200% of us; we export 50% of what we grow. Our poverty level income is greater than the average income in Eastern Europe.

Our workweek is 20% shorter than it was in 1900. Over 90% of us are working in the present economy. Some 50 years ago, incomes in the South were two-fifths the national average. Today, it’s four-fifths. And 80% of today’s millionaires are first generation. They got it the old fashioned way; they earned it!

Today, more Americans are connected to Internet than were hooked up to electrical power, a water line, or a sewer line 100 years ago. Our average lifespan has increased about 60% in the last 100 years (average age of death in 1900 was 48).

## The Scorecard

Thanks to better fuel economy and gains in per capita income, motor fuel would have to stay at \$4.00 a gallon to cost family budgets in real terms what it did 30 years ago (the early 1980's price spike). An average factory worker's pay today (approximately \$19.00) buys nearly five gallons of gas. Seventy years ago, it was three gallons. It is Eastern Europe that has been inefficiently consuming three times the energy per dollar of GDP.

Heavily subsidized ethanol, by the way, has ruined feed lot prices and global food prices, hurting the poor (2 billion people for whom food costs are 60% to 70% of their budgets). It makes little sense to expend petroleum at all those stages of farming, to try to distill food into fuel. Why should, say, 30% of our corn crop go to distill 3% of our fuel? Is it worth all that to salve our consciences for driving SUV's? The question answers itself. More on that later.

Alas, according to the Tax Foundation and U.S. Treasury statistics, and in terms of adjusted gross income, the progressive tax code is alive and well (like it or not):

- *The highest 5% paid 42.9% of all federal income taxes;*
- *The highest 10% paid 53.9% of all federal income taxes;*

## The Scorecard

- *The highest 25% paid 76.3% of all federal income taxes;*
- *The highest 50% paid 93.8% of all federal income taxes;*
- *The lowest 50% paid 6.2% of all federal income taxes; and*
- *The lowest 25% paid 0.9% of all federal income taxes.*



## **PART THREE**

### **A Reach Beyond Grasp**

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Might the Fed be reaching beyond its authority to help the economy avoid the dominoes falling -- systemic failures globally? Possibly. Few are complaining, because of the greater downside risk (global depression).

And yet, swings in commodity prices are also a consequence of global demand and supply and will not readily respond to federal monetary policy. Banks' credit rationing to customers has resulted, in part, from mortgage defaults and asset deterioration. Lack of credit robs the economy of the necessary lubricant to keep commerce moving without friction.

Therefore, the Fed is extending short-term bridge loans and taking some equity interest in some major banks. We will probably have to see at least an overall 30% drop (from the high in 2006) in housing prices, to put us back on the long run trend line of 2000. This double bubble, housing and credit, has been a long time coming; there are no quick fixes.

The Spring stimulus checks (really advance rebates on next year's tax filing on this year's earnings) went mostly into gas tanks. The weak dollar and rising speculation fueled, in part, the rising commodity prices, including petrochemicals. Remember, however, that exports of goods, services,

## **A Reach Beyond Grasp**

commodities, etc., thrive and are more competitive with a weak dollar.

Again, no one knows how much collateralized, nonperforming debt is leveraged globally. There is a scary disconnect here. So, central banks around the globe are throwing hundreds of billions of dollars, etc., out there. The great fear is a systemic failure (again, think dominoes), and banks conversely try to ration credit as asset values decline.

Inflation-linked Treasury Bills (TIPS) are an option for some during these times. The purchaser of TIPS at, say, the start of calendar year receives a fixed interest rate above inflation (CPI benchmarked semiannually). In deflationary times, par value at maturity or an inflation-adjusted principal is guaranteed with TIPS, whichever is greater. More on that later (see Appendix).

## 11. Where Do We Go?

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Is the worst still ahead of us? Possibly (don't shoot the messenger). Candidly, a new round of foreclosures could be triggered by rising unemployment, glutting the market, and depressing housing prices further, until they can get back to the long term trend leading up to 2000 (again, probably a 30-35% drop overall). Who knows the timetable? Not we mortals.

Many participants in the marketplace are in denial; it's not just a river in Egypt. Remember the Chrysler bailout/loan guarantees in 1981? Chrysler surprised everyone by paying back the loan early. *"Few remember that the Chrysler loan guarantees artificially put Chrysler ahead of the more creditworthy borrowers. Never mind the bad decisions and shrinking market share that led them to that point,"* Milton Friedman pointed out to me on one of our trips.

The 2009 GM bailout troubles me. The rule of law (contracts) must be preserved or else people won't want to invest. What I'm saying is that for the government to fire a CEO of a corporation probably violates contract law. If government feels the CEO has broken the law, the remedy would be in the courts.

Welcome to state-regulated capitalism. *"Too big to fail"* is the mantra now. It's all very interconnected, and yet there have been some systemic disconnects.



## Where Do We Go?

For example, Lehman's landlord in London had a renter's insurance with AIG.

Yes, I do wonder if the Fed used more power than it legally has. Someone speaking about the crisis recently said, *"The rascals snuck out the back way, ran around to the front, and joined the crowd demonstrating and shouting, 'Throw the rascals out!'"* Sadly, an untold number of innocent people have been hurt along the way.

## **12. The Raging Conservative-Liberal Debate**

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Many issues in life seem to have “*conservative*” (rightist) and “*liberal*” (leftist) spins to them. In election years, there may be more (or less) clarity on this, as each side is tempted to pander to the other’s base. Additionally, on either side of the barricade of issues are some who have neither understood nor cared. Confusing matters, few of us are consistently in just one camp or the other.

Winston Churchill put it this way (paraphrased): *“Anybody who is under 25 and not a liberal has no heart, because he can’t feel the pain and suffering of the people. Anybody who is over 25 and is not a conservative has no brains, because in 25 years he has not learned what people are really like.”* Ouch!

Conservatives believe that each person should be compensated according to his contribution to the marketplace, as valued by customers, and that capitalism has solved the poverty problem better than any other economic system. Liberals would not want a capitalism in which some are rich while others are poor, because wealth-causes-poverty, don’t you know? On budget deficit issues, conservatives push for spending cuts. Liberals opt for tax increases.

Conservatives are sometimes content to follow the plans their grandfathers made. Liberals may pass laws and then go on their way to pursue other noble causes with other people’s money. Conservatives believe that, in clashes between good and evil, duly constituted governments are ordained

## The Raging Conservative-Liberal Debate

by God to mete out justice to those who harm the public good.

Neither is for locking up criminals. Liberals claim it's society's fault, and conservatives say it costs too much money. Liberals say that country clubs should be more fully integrated and that prisons should become more like country clubs.

Complicating the debate, several recent studies confirm, often by self-reporting, that American academia and media members are, on balance, markedly to the left of center. Do unbiased scholarship and balanced news reporting become potential casualties? The question answers itself.

Conservative people of faith, who want to be “*salt*,” “*light*,” and “*leaven*” in this life, tend to actively participate in our representative democratic process by voting their cultural values. Some liberal people of faith believe that they should not take their personal convictions into the polling booth and in some cases even refuse, by abstaining from voting, to support the body politic.

Conservatives usually regard moral values as “*mainstream middle America issues*” in elections, and believe that religion can provide moral values that not only make a country great, but also that nations prosper when governments work well and honorably. Liberals often regard moral values as “*wedge issues*”

## The Raging Conservative-Liberal Debate

in elections, deriding those who are drawn to the polls by just moral or cultural issues.

The conservative jurist literally intends to “...*support and defend the Constitution of the United States...*,” by enforcing the Constitution and timetested laws passed by elected public officials. The liberal jurist tends to favor personal politics, activist social agendas, and sometimes interprets other countries’ founding documents into his own circuitous judicial rulings.

Well, what do conservatives and liberals have in common? They all want more laws. They have different goals; however, they both agree that they want to control the kind of power that can be wielded to achieve their respective goals. They live in blue and red states all across the map, states predominately blue around the perimeter in large, metropolitan areas and mostly red everywhere else.

This list could be longer; however, we get the idea. Two schools of thought are locked in battle, and that’s good. As history demonstrates, when there is no active political opposition, there is always the danger of the suppression of liberty in the name of liberty.

For example, the former Soviet government excused tyranny by saying that inasmuch as the Communist Party was the party of the “...*liberated*

## The Raging Conservative-Liberal Debate

people,” there would be no sense in having another party to oppose the “...will of the people.”

*“Opposition is so important, that I wish it would always exist, even for its own sake. It will sometimes be wrong, but it performs a valuable function nevertheless,”* said Thomas Jefferson (paraphrased).

As Disraeli put it, *“No government can long be secure without a formidable opposition.”* Opposition by the “outs” makes the “ins” careful to avoid actions that invite criticism and to promptly correct the mistakes that they do make.

How shall we all get together? John Milton penned it this way: *“When there is much desire to learn, there, of necessity, will be much arguing, much writing, many opinions; for opinion in good men is but knowledge in the making.”*

And sometimes, yes, being liberal or conservative comes down to the issue at hand and next to whom we are standing at the time. In the meantime, is this a great country, or what?

### 13. Moving Past It All

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Excessive and negative chatter about the economy is not wholesome, except to achieve clarity. Why all this self-flagellation? Why do the networks dwell on it? Horror movies attract large crowds. Nevertheless, there are some things that reasonable and prudent people just don't do. You just don't stand up in a crowded theater and yell "*fire!*"

It is possible to be a short term pessimist, and yet a long term optimist. That is where I find myself. In fact, one reason I became interested in capitalism is that, even flawed, it solves the problems of society better than any other economic system known, by solving the problems of the individual.

The application of freedom to the marketplace allows people to achieve much more than under other systems. When America's profit-incentive system is working well, profits (or business savings) provide steady jobs, higher wages, more jobs, worker benefits, better working conditions, safe and modern equipment, rising standards of living, opportunities for the future, and social progress.

Even right now, the dynamic triad of corporate restructuring, quality improvement, and spending on research and development are fortifying our economy during our financial crisis.

Losses also provide a valuable function in the American incentive system. Losses are the market's

## **Moving Past It All**

way of sending a signal to businesses to reallocate their resources more efficiently, according to the price- and quality-conscious customer's demanding standards.

Capitalism, therefore, contains its own built-in checks and balances. People are required to exercise sound judgment, or suffer the consequences of their own folly. The American incentive system doesn't carry any guarantee.

One risks failure along with the prospect of success. And if we are honest, we know that there are no real guarantees possible in life -- not in theory, not in reality.

## 14. Soldiering On

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According to Greek mythology, Pandora, the first woman on earth, was given gifts by all the gods. One gift was a box which they warned her never to open. Not being able to resist her curiosity, Pandora raised the lid and all of life's troubles, sins, vices, and diseases immediately escaped. Pandora quickly closed the lid, preserving only "*hope*," mankind's last refuge.

With worldwide bloodshed taking up most of the headlines, it's reassuring to ponder the words of historian Will Durant. "*Civilization*," he said, "*is a stream with banks. The stream is sometimes filled with blood from people killing, stealing, shouting, and doing the things historians usually record, while on the banks, unnoticed, people build homes, make love, raise children, sing songs, write poetry and even whittle statues. The story of civilization is the story of what happens on the banks.*"

Beyond the storm clouds, and in the economic recovery, the American economy will continue to be foursquare in the middle of a rebuilding binge that could run for two more decades. During this era of restructuring, implementing of new technologies, and yes, probably more regulation, we will, in both goods and services, continue to be able to compete with any other nation in the world.

One hundred years from now -- 50, 25, 10, 5, years from now -- America will remain the place to be.



## **Soldiering On**

People all over the world will still look to us for growth, stability, and the good life. We should love our country and yet fear our government.

## PART FOUR

### Pollyanna and Chicken Little

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Pollyanna was wrong in her excessive optimism; Chicken Little missed it, too, with his abject negativity. No mere mortal has been given perfect foreknowledge. We do well to name the economic variables in play, put them on the scales, and try to see which way it is tilting. It turns out that learning economics won't make you a millionaire or keep you out of a soup line. It will give you a better understanding of how you got there (or *there*).

Starting in the third quarter of 2008, and well into 2009, there have been very many unanticipated conversations with my silver-haired friends and associates in the autumn of their years. They exhibited wide-eyed fear.

Fear of what? The following: (1) *of not being able to retire*; (2) *of, having retired, outliving their retirement nest egg*; (3) *of that foregone trip of a lifetime*; (4) *of Kingdom work they were looking forward to financing*; (5) *of not having an estate to bequeath heirs*; (6) *of being compelled to choose between meals and medicine*; and consequently (7) *of being forced to go on Medicaid*.

One prominent individual of modest means stated that he, after his reading of it, made his wife read my “KABOOM!” monograph (usually with the things I write, once people put it down, they cannot pick it up).

## **Pollyanna and Chicken Little**

He then confided that he had lost over half a million dollars in the last half of calendar year 2008. Another individual told me of a 90% drop in her one-company (?) IRA in 2008.

They were, as many others have also expressed, distraught about money managers not having a program in place for older investors in advance, to be risk-averse and move these investors to the sidelines when a predetermined point beyond a downward technical correction (10%) in the stock market occurred. If there is anything sadder, it would be investors who don't know to care, and/or who don't care to know, either.

And these wonderful college students! Bless their hearts; they can be too trusting at times. Some young couples I know are signing up with for-profit debt consolidation companies and becoming ever-deeper in debt. These outfits make their money by fees and investing the victim's money (to earn interest for themselves), causing more problems (not fewer): *(1) late payments; (2) late charges; (3) worse delinquencies; (4) tanking credit scores; and, of course, (5) more emotional trauma on the home front.*

## 15. Little Faith and Free Will

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I have a strong religious faith, and yet I know that “*free will*” must operate. Otherwise, how shall we accept salvation? My concern is that some in recent times have said of the economy going into the tank, “...*Well, God is in control...the Lord will provide...*” Yes, indeed. God is still God, and we are His children. This is my Father’s world. He is in control as much as He prefers.

However, sometimes in an attempt to give God the credit, we shortchange Him. We pray, but we don’t spring into action and put feet to our prayers (i.e., the expression, “*Pray hard, but row away from the rocks!*”). With the hurricanes, floods, and earthquakes of late, I’m reminded of the story about a man who was stranded on his front porch by rising flood waters.

The rescuers arrived in a four-wheel drive vehicle, but he declined, saying, “*The Lord’s going to take care of me.*” Hours later, he was sitting on his roof as the rescue boat came by. “*No thanks,*” he said. “*The Lord is going to take care of me.*”

Late that night, he was sitting on his chimney, with the flood waters lapping at his feet. The rescue helicopter made one last attempt to get him to climb aboard, but noooooooo, “*The Lord is going to take care of me.*”

And Saint Peter, the story goes, in surprise, at seeing the man before “*his time,*” indicted him with

## Little Faith and Free Will

his reply, *“Man, the Lord sent you a four-wheel drive vehicle, a boat, and a helicopter -- what in the world did you want more than that?”*

Alas, over the years, I have occasionally known firsthand, through many years of benevolence work, some able-bodied people who had a distorted *“The Lord will provide”* attitude and would not (prepare themselves to) work or support their families. Innocent casualties were the result, as those families eventually went under and/or broke apart.

God’s sermon on this issue is quite brief and stern (II Thessalonians 3:10): *“If any would not work, neither should he eat.”* On this issue, there is a very plain duty set forth in the Scriptures (I Timothy 5:8): *“But if any provide not for those of his own house, he hath denied the faith, and is worse than an infidel.”* It hardly needs any commentary.

## 16. Friends or Foes?

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Let's put the financial mess question foursquare in front of us, before we put our snorkels on and wade in further. Our economics and our religion -- are they destined to be allies or enemies? It is a profound and perplexing topic which should be approached with great care, caution, and consideration.

Regarding our amazing American incentive system, it is possible that John J. Davis, author of Your Wealth in God's World, was right on the money as he boldly observed, *"When the dynamism of a society of free individuals is tempered and permeated by Biblical values, the resulting system would appear to be the best one attainable by imperfect individuals this side of eternity."*

What shall we discover? Whatever our findings, the purpose here is certainly not to sanction every action or deed committed down through the ages by individuals and enterprises in the name of capitalism. Nor is it the goal to give credence to all that has ever been written, said, or done by people of faith who have embraced the name of Christ.

On either side of the barricade are some who have neither understood nor cared. We may, in time, and with reason and good conscience, be able to demonstrate that, at their best, free markets and will tend to stand or fall together -- because both are deeply rooted in the servant leadership nature of man.

## Friends or Foes?

George Gilder, one of our American Studies Institute Lecture Series speakers and author of best-selling Wealth and Poverty, suggested this synergism: *“Our greatest and only resource is the miracle of human creativity in a relation of openness to the Divine.”*

Although no graphs, curves, or equations appear in God’s Word, the Scriptures certainly contain many statements of interest in an economist like me. The concept of *“opportunity cost”* (i.e., the best foregone alternative) and many other terms dear to the heart of an economist are not found, as such, in the Scriptures.

Or are they? Actually, *“opportunity cost”* looms before us in Mark 8:36-37: *“What shall it profit a man if he shall gain the whole world and lose his own soul...or what shall a man give in exchange for his soul?”*

Scripture references to matters of faith greatly outnumber those which deal with issues such as economic success. The Bible does, however, address every aspect of our lives, including the production, distribution, and consumption of wealth -- the subject matter of economics, too.

## 17. Do Well and Do Good

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Macroeconomics vs. microeconomics -- in these turbulent times, what can we know for sure? God created the world in which we live, that we must, of necessity, concern ourselves with the matter of toiling to provide food, clothing, and shelter for ourselves and our dependents; otherwise, we would be an unnecessary burden to others (II Thess. 3:6-13).

However, the irony about making a living is that we sometimes overindulge and go to excess -- buying things we don't always need, spending money we don't always have, and impressing people we don't always like. 'Tis a sad and seductive side of modern living. Nevertheless, we must concern ourselves every day with both the supply side (i.e., efficient allocation of the factors of production) and the demand side (i.e., the best use of goods and services).

Were the principles of supply and demand created by economists? Nay. Their origin reflects man's God-given nature and ability to sort through circumstances, weigh options, structure decisions, take action, and thereby maximize value and satisfaction.

Adam Smith would later attribute such providence to the "*invisible hand*" of the marketplace. Does the Bible provide the foundation principles to govern these economic areas of life? Indeed. Examples abound. Private property is recognized in the



## Do Well and Do Good

Scriptures. The book of Proverbs emphasizes and openly commends hard work and resourcefulness.

Many other references in Proverbs go on to mandate integrity, fair measurements, and quality workmanship. And of the conduct of the master and servant or employer and employee, what does the Bible say? Look into Ephesians chapter 6; we are to conduct ourselves “...as unto the Lord.”

What else can be found in over 2000 Scriptural references? Both testaments contain examples which condemn such vices (greed, oppression, lust, dishonesty, laziness, theft) which violate the charge over all things that man was given, as recorded in Genesis chapter 1.

Are there other admonitions? Yes, the Bible is also foursquare in favor of the noble qualities (hard work, honesty, generosity, fairness) which make for good living, good business, good economics and, of course, good sense.

Beyond that, the Scriptures describe good religion as a giving love for mankind, especially individuals (microeconomics) who have not been able to benefit from the general prosperity (i.e., the macro economy).

## 18. Stewardship and Prosperity

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As they are buffeted by the winds of economic uncertainty, many are now seeking refuge from the carnage by delving into the Scriptures. Does the word “*economics*” occur in standard translations of the Bible? No; however, our English word “*economics*” comes from the Latin, “*oeconomia*” which was derived from the Greek “*oikonomia*.”

Derivations of these terms are used over three dozen times in the Bible. The words are usually translated as versions of such words as “*stewardship*,” “*management*,” or “*administration*.” Stewardship of what, we might ask?

It could be stewardship of resources, property, talents, or souls -- quite a range of responsibilities. That stewardship is stated early (Genesis 1:26-28), as man, created in God’s image, is given the mandate to subdue the earth and to manage and develop his environment to the glory of its Creator.

Should Christians administer the affairs of God’s world according to the instructions of God’s word? Yes. The parable of the talents (Matt. 25:14-30), in examining business finance options, very sternly links degrees of responsibility and rewards.

Soundly practiced economics trains those who are faithful in small things to be found worthy for the responsibility of greater things in this life and the next (Luke 16:10, 11). In all of this, one may be wondering

## Stewardship and Prosperity

what a subject called “*Christian Economics*” is all about. Is the term perhaps an oxymoron?

Why does the term “*Christian Economics*” make us nervous? Typically, it has enough religious doctrine in it to make the secular folks uneasy; it has just enough technical economics to make people of faith uncomfortable.

Each group seems content to not confront the responsibility of examining the others’ perspective and then applying, yes, Biblical principles of economics. As economists often disagree on policy matters, so should Christians be tolerant on matters of opinion, while remaining firm on doctrinal issues.

Who knows? The result might be that each would be a little less confused than he was before. In the end, there will certainly be those who might conjecture that this book could have used more (or less) of either scripture or economic jargon.

*“Giving financial advice is a whole new set of parameters,”* my accountant told me years ago, as he declined my request for investment advice. So, in the name of, yes, stewardship, and exercising the God-given sense to do so, I began then and there to research such things.

## 19. Health and Wealth

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Think not that this is a topic on *“How to Get Rich.”* Nor is it a treatise on God’s plan of salvation, which is infinitely more important. Rather, it examines, among other things, possible areas of compatibility that could create a healthy, reinforcing balance between the two. Accordingly, it comes with a warning about balance and attitude that *“No man can serve two masters”* (Matthew 6:24).

I believe that *“Christian Economics,”* however, can be sound when it fulfills three criteria: (1) when it’s founded on Biblical principles; (2) when scholars agree upon it; and (3) when it makes common sense. Of course, if the first criterion is not satisfied, the other two don’t matter, do they? For the Christian, the prime directive is always to seek first the kingdom; the rest will follow (Matt. 6: 19-33).

It has been facetiously said that *“When it comes to money, people seem to be of the same religion.”* Is it really that simple? If you were a student in my economics class, I would candidly tell you that money should not be in first place in our lives.

Instead it should be in fifth place -- behind God, integrity, family, and country. If money is in first place in our lives, then we should have pronounced upon us that old Middle Eastern curse: *“May you make a million dollars -- may you spend it all on doctors.”*

## Health and Wealth

Example? A good friend and faculty colleague relates this true story: He was preaching a gospel meeting in a resort community. Attendance at the meeting was poor, so he asked one of the Elders, “*Why?*” The answer the Elder gave him was this -- “*Nobody wants to go to Heaven from here.*”

Our guest preacher said, “*I didn’t believe it,*” so he started asking people who should have been in attendance -- “*Do you want to go to Heaven?*” “*No,*” they replied. “*Well, then do you want to go to hell?*” “*No,*” came the grim answer; “*We just like the setup we have here!*”

Dear hearts and gentle people everywhere, we should weep for them -- and ourselves! We are all fighting this battle on some front. Balance is the key: “*I wish above all things that thou mayest prosper and be in good health, even as thy soul prospereth*” (III John 2).

## PART FIVE

### Vantage Point

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If those heavily invested in stocks had not exercised “*free will*,” at least in part in the fall of 2007 as the Dow peaked, and more extensively in the summer of 2008 (the S & P peaked that July), in moving proactively and selectively out of the stock market and into safety, they could have lost approximately 40% of their nest egg by year’s end.

Advice to nobody and information for all, here, from my limited perspective, is an observation (2008 notwithstanding): College Retirement Equities Fund (CREF), Treasury Inflation Protected Securities (TIPS) Average Annual Compound Rates of Total Return have often been about 35% better than CREF’s Bond Market Account and CREF’s Money Market Account, the latter not being insured by the government until September 19, 2008. CREF TIPS even outperformed the CREF Stock Account from 1997 to 2007.

Again, since September 2008, and as a result of those aforementioned numerous, spontaneous, private conversations with more colleagues and brethren, friends and neighbors, etc., in response to the aforementioned “*KABOOM!*” and “*DOWNDRAFT!*” monographs, I’ve become genuinely convinced that there were very few investors (especially silver-haired) who made such a move to safety.

## Vantage Point

Because of my economics profession, and in these times, I attract questions. When people understand why not everyone is traumatized as much as they are by scary economic events unfolding, there are sick looks, heavy sighs, and occasionally a *“Why-didn’t-we-do-some-of-that, too?”* look (or a comment) from one spouse to the other.

The private conversations were over, almost as quickly as they started (to be followed up the next day by a discrete request for more information). *“Woulda. Coulda. Shoulda.”* Investing is both an offensive and defensive activity, sure as the business cycle swings go up and down. You snooze, you lose.

It concerns me to hear about some money managers who could allow clients, especially our supposedly risk-averse elderly (with short time horizons) to hang on, as they watched the S & P 500 drop nearly 40% in calendar year 2008. Consider this stark financial proverb: *“When the tide goes out, you learn who is not wearing a swimsuit.”*

Leveraging is what we all (citizens, families, businesses, governments, etc.) did with a fistful of credit cards and other asset-inflated lines of credit: *“...went for broke...”* and almost made it. Deleveraging is the opposite of leveraging. It is reversing the process, probably without anybody giving us a loan to do it.

## 20. Sell It All?

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Selling is not always wrong. “*Buy and hold*” is not always right. Should we sell everything, when facing an awful, cataclysmic market? No. However, we can consider some approaches: (1) move some of our money to bonds; (2) leave some discretionary money in assets; and even (3) diversify into various sectors, even if it is the opposite of traditional poker-playing strategy.

The “*other shoe*” has yet to fully drop (admittedly not an economic term). The “*KABOOM!*” and “*DOWNDRAFT!*” scenario have concerned me since 2000, when I presented it to the Governor’s Council of Economic Advisors (and every year since, at our semiannual meetings). It seemed like such a minority position to the others back then.

Isn’t this perplexing? God is undoubtedly in control, as much as He chooses to be. Every so often in my career, as I would be handing out a test on exam day, I have had students announce that they wanted to “...*pray for a miracle...*”

My response has been as follows (paraphrased): “*If you exercised good stewardship of time and talents, i.e., (1) good class attendance; (2) reading the book before lectures; (3) taking notes; (4) reviewing; (5) asking questions; and (6) getting a good night’s sleep -- then you can pray in thankfulness to God for giving you the good sense and tender conscience to prepare, and for Him to add His blessing to your*



## Sell It All?

*efforts...If you didn't do those preparatory things expected of you, then you don't have (much of) a prayer!"* Again, it's a good object lesson about "free will."

Do we really want God to intervene in the trivial affairs of men, when miracles were for a specific purpose (that Jesus was the Christ) and ended 2,000 years ago, as far as we know? Again, how shall we accept salvation, if we cannot and/or do not exercise "free will"? Shall we sin all the more, that grace may abound?

Nay! Pain, even the financial kind, can sucker-punch us because of the unwanted uncertainty it places in our laps. However, despite our best efforts, we are not left without options as children of the King.

What then can we do? Try this: (1) *accept God's joy in the place of pain*; (2) *change our focus*; (3) *help create a better life*; (4) *let go and reach out*; (5) *set new personal goals*; (6) *appreciate the Grace of God*; (7) *plan for change*; (8) *let others bless us*; (9) *be grateful for new beginnings*; (10) *minister to others*; (11) *secure our future*; (12) *create a better life*; (13) *seek wisdom to make positive changes*; (14) *be grateful for comforting support*; (15) *claim the promises of God*; and (16) *pray for strength to finish the day and hope for tomorrow*.

## 21. Follow the Money

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These are amazing times. Each year, projected back to 1995 and forward to 2015, four million Baby Boomers turn 50. Overall, that's 80 million Boomers in a 20 year period. The affluent of this number have been piling on, paying more for stock than ever before (until the meltdown). Twice as many families were investing by 2008 than 15 years earlier.

Equities replaced houses as a family's largest asset (what goes up can come down). Some in the market failed to distinguish between investing, speculating, and gambling. There is great irony that these two sectors sink or swim together. Now, in the current climate, some investors are, therefore, on the sidelines. Others are bottom fishing and shopping for bargains.

As I tell my students, *"You may think that I am being humble when I say I am not a very good economic forecaster. However, I am being arrogant; although I'm not very good, I am better at it than you!"* There will be decreased consumer demand for years to come. Consumption in the future will, as it should, be income-driven, not asset-driven (inflated values) as in the past.

The drumbeat from many money managers during the Bear Market meltdown of late 2008 (appearing to roast marshmallows while Rome was burning) was this: *"Hang On! Don't Sell! Be in there to take advantage of the bargains in the next Bull*

## Follow the Money

*Market. Stay with dollar cost averaging!*” It is not at all that simple, especially for our silver-haired citizens with shorter time horizons.

“*Buy and hold,*” we frequently hear. What are they really saying? Could it be, “*Buy, and let me hold onto your money*”? Buying and selling slowly and at different levels (yes, dollar cost averaging) can be good, sound advice with discretionary funds.

It is generally true that as stocks fall, dividends rise. And, in that, dividends can limit loss. However, are the promised dividends safe? Can they be paid? Is there sufficient cash flow to do so? In the first half of 2008 the answer would probably have been, “Yes.” What about the last half of 2008? Possibly not.

There is, indeed, great risk in not knowing how all this financial crisis will play out. Nevertheless, we must (try to) secure our futures.

## 22. Compound Investment Factors

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Here is a partial list of other factors to consider: (1) *age*; (2) *retirement plans*; (3) *taxes*; (4) *income goals*; (5) *growth plans*; and (6) *risk-averse attitudes*. Why would some money managers be willing to lose transactions' fees in helping especially older clients sell equities early in a Bear Market (defined as greater than a 20% decline)? Could it be that if those investors moved to the safety of the sidelines, the brokers might not lose just fees, but also customers?

Many older investors ended up being steamed at some money managers (rightly or wrongly) for not staging the customers' position to be more risk averse along the way, say, through "*stop-loss*" orders in times of fear and panic (e.g. automatic sell order when stocks drop a predetermined percentage, say, 15%), etc.

When, beyond fundamentals, fear and panic trigger a meltdown, there is the ultimate loss of purchasing power. Ironically, uninitiated investors tend to show a tragic, historical pattern of buying high and selling low. Don't forget the basics: *buy on hope*; *sell on despair*.

There were some money managers who were willing to admit that, if older investors didn't flee to safety before (or early) in the equities market meltdown, those investors' chances and abilities to take advantage of a rally, after those huge losses,

## Compound Investment Factors

were somewhere between “*slim and none* (and *Slim* just left town).”

The individual investor should be informed that the little known *Securities Investor Protection Corporation (SIPC)* is charged by the government with identifying, securing, and returning investment instruments to their rightful owners, whatever the assets are worth after a financial institution fails.

Remember this: we did this to ourselves. Concern about risk aversion, after the fact, is false economy. There is no painless way out for all who believed that housing prices, and the wealth effect, would continue to rise in perpetuity. It would be like the young man who is about to be sentenced by the Judge for bumping off his parents, saying, “*But, your Honor, I plead for mercy -- I’m an orphan, you know!*”

## 23. I'm Rich! Wasn't I?

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*Breathes there a man  
With soul so dead,  
Who hasn't said  
When the market fell out of bed,  
"Man! I wish I had quit when I was ahead. "  
-- author unknown, wisdom eternal*

Is the worst still ahead of us? Possibly (don't shoot the messenger). There are potentially other wild cards out there. They would be globally leveraged bundles (i.e., securitized variable-risk derivatives) of the following: (1) *student loans*, (2) *consumer credit loans*, (3) *car loans*, (4) *commercial real estate loans*, (5) *insurance policies*, and even (6) *reverse mortgages*, popular with (bless their hearts) *the elderly*. Try to get loans to comfortably deleverage through this!

Candidly, a new round of foreclosures could be triggered by clearly rising unemployment, glutting the market and depressing housing prices further (presently 25% on average off their 2006 highs), until they can get back to the long term trend leading up to 2000 (probably a 30% drop overall). Who knows the timetable? Not we mortals. The United States is facing down a *"...lost decade..."* similar to Japan of the 1990's.

Can we compare this to the *"Roaring '20's"* and the consequent *"Great Depression of the '30's?"* Possibly. Housing and then stock market crashed,

## I'm Rich! Wasn't I?

followed by more financial sectors, and other basic industries. The five year interest-only mortgages, perpetually refinanced, were part of the house of cards. Today's crisis began gradually about 75 years ago, spurred on, in part, by well-intentioned legislation in the 1970's and 1990's that had some perverse consequences.

Forecasting? There are two types of forecasters: (1) *those who cannot forecast; and, (2) those who don't know they cannot forecast.* The cardinal rule is to give people a number or a date, never both. Not a prophet, nor the son of a prophet. I don't want to be an optimist or a pessimist. Just being right is its own reward. I do worry about Economists who are so young they think the Great Depression was ended by Prozac.

Fear and panic also drive the market, not just fundamentals. Beyond this yes, palpable cataclysm, rather than a V-shaped recovery, it may look like a U-shaped upturn (moving sideways for awhile) from this Bear Market. There is even the possibility of a W-shaped, double-dip recovery-inflation-tightening of monetary policy-recession scenario.

To avoid going full speed into the tank, or ending up living out our days at "*Shady Pines*" (trying to build a log cabin out of popsicle sticks), we'd better clean up our balance sheets. If all this carnage doesn't spin our wheel, then our hamster is already dead!

## **I'm Rich! Wasn't I?**

Nevertheless, while being short-term pessimists, we can be long-term optimists. In the end, *"Lassie will come home."*





## PART SIX

### Signs of the Times

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There are always “*signs of the times*,” if we look for them. Consider the Fall 1987 stock market meltdown (a mere speed bump by today’s standards), about which I wrote the following article, circa 1998:

#### *On Bulls, Bears, and Hogs*

by D.P. Diffine, Ph.D.

*It has been said that “A Bull can make money on Wall Street, so can a Bear, but not a Hog.” Read on for more details regarding possible performance parallels between the stock market situation 10 years ago and now (nothing written herein should be construed as financial advice for individual investors and/or specific investments).*

*Why the stampede into stocks in the first place (especially January-August 1987)? After 1982, inflation was much lower. Investors, whose refuge had been in savings and tangible assets (real estate, gold), moved into financial assets. Lower interest rates reduced yields on bonds and money market accounts. Investors thereby shifted into stocks.*

*The Fed had pumped significant amounts of money into the financial system. Wall Street had concluded that a recession was unlikely. A great*

## Signs of the Times

*number of new mutual funds poured billions into the stock market.*

*Profit margins increased dramatically as the business sector experienced a corporate renaissance. Takeovers, mergers, leveraged buyouts all greatly enriched shareholders, while there was a decrease of the number of shares available -- the classic definition of "inflation (too much money chasing too few stocks)." Then, interest rates went up (there were two increases in discount rate).*

*The Fed began pursuing a tighter monetary policy. Stocks were becoming overvalued relative to bonds. Growing business activity had increased demand for credit and absorbed liquidity. The Fed restricted credit to check inflation. The increased supply of stocks spread demand too thin. Over-optimistic investors had done all their buying and used up their cash.*

*The collapsing dollar further reduced liquidity, as foreign investors' gains were paid out in a depreciating currency. Between January and August 1987, the Dow increased 800 points (a runup one would normally not expect in a decade). Investing had become gambling. Our October 1987 stock market panic triggered selling waves overseas. We sneeze, and the rest of the world gets pneumonia.*

## Signs of the Times

*In the war between profit takers and bargain hunters, the profit takers prevailed and the Dow plunged. The major correction of the January-August 1987 runup was fed by headlines, fear, and hysteria. Program trading added to already wide swings in the market caused by uncertainty. Most individual investors took paper losses.*

*It was the institutional investors who panicked, many being too young to have seen a bear market. So, watch the headlines, such as "Investors Euphoric" about continued growth. Then consider moving to the sidelines.*

*Optimistic reports tend to trail (lag) the actual situation. Past bear markets began when average dividends fell below 3%. In August 1987, dividends were at 2.5% (lowest in history). Watch insider selling -- big patterns when the ratio is three sales to one buy. Insiders have a strong track record of getting out near the top.*

*One sign of the latter days of a Bull market is individual, uninitiated investors piling on as the professional, institutional traders move to the sidelines. Historically, when the stock market races ahead despite major warning signs, the runup is followed by a sharp decline.*

## Signs of the Times

*To lock in value, those who remain in stocks may place stop-loss orders; i.e., a selling floor at 10-20% below current value, as an insurance policy against a major meltdown. Some investors will get into Money-market mutual funds, COs, Treasury Bills, etc.*

*The sun continues to come up in the east and set in the west with great regularity; it is still a wonderful life after all.*

Keep in mind that if I really knew, in some detail, what was going on, and what will probably happen in the next 30 to 90 days, our U.S. President would make an appointment with me here in Searcy, Arkansas. But I wouldn't be here. I would be in Hawaii, which I would own by now.

## **24. Good News and Bad News**

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Is there any good news? Yes! As we tiptoe further into our new millennium, there are more people connected to the Internet than were hooked up to water, sewer, or electricity 100 years ago.

In the last 25 years, we've grown about 75% in real terms on only 30% more energy. We've doubled vehicle fleet mileage. The equipment in homes and factories is 40-60% more efficient. We have had better efficiency gains than nearly every one of our Western trading partners. It is the former Socialist economies which presently consume three times the energy per dollar of GDP.

Applied science has brought renewal to our domestic economy. Information technology is changing the concept of industrial resources. Information is expandable; there are no obvious limits. Information is compressible; it can be concentrated, integrated, summarized, and miniaturized for easier handling. Information is substitutable; it can replace capital, labor or physical materials. Robots are an example.

What does that mean? For two decades, we have been applying high-tech to low-tech industries. Basic low-tech industries are now smaller, leaner, stronger, and more profitable. We have learned that it was not written in the stars that we had to permanently lose markets to overseas competitors or that their quality had to be better.

## Good News and Bad News

In the lifetime of today's college students, there is much to feel better about. The news in the public domain, if we would just keep our eyes open for it: (1) *emissions from major pollutants have been reduced*; (2) *a higher percentage of our lakes and rivers are fishable*; (3) *forest inventories, public and private, have grown*; (4) *auto death rates are significantly down, as are death rates from malignancies, heart disease, strokes*; (5) *we have won a majority of the Nobel prizes*; (6) *most of our children do live with both parents*; (7) *nearly 100,000,000 people attend church weekly*; and (8) *tens of millions of teens have never tried drugs*.

## **25. Progress Abounds**

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What is the record as things stand today? With about 4% of the world's population we create nearly 30% of the world's GDP. 2% of us grow enough food to feed 200% of our population, exporting as much as we consume at home.

Our poverty level income exceeds the average Russian income many times over. Our work week is 40% shorter than it was in 1900. There is a rise in entrepreneurship. At this writing, about 91% of us are working. In normal times, 5% are always between jobs, and 95% is considered full employment.

Looking around the world, don't we Americans have much to feel good about? Living standards have improved significantly. Some 50 years ago, 30% of the nation's homes had no running water, 40% had no flush toilets, 60% had no central heating and 80% were heated by coal or wood.

Regional poverty has been evaporating. Fifty years ago, average incomes in the Southern U.S. were about 40% of the national average. Today, Southern incomes have risen to near 80% of the national average.

Retirement, almost unknown early in the 20th century, due to poverty and shorter life spans, has become more the rule than an exception. Eighty



## Progress Abounds

percent of today's millionaires are first generation folks. How so? They got it the old-fashioned way; they earned it.

The late Nobel economist Milton Friedman, cited as *"Economist of the Century"* by Fortune magazine in 2000, also weighed in on the technology issue: *"The technological evolution makes it possible to produce products anywhere using resources from anywhere by a company located anywhere to be sold anywhere."*

Writing as an economic historian, I think it's good to remember that, timewise, it took nearly a half year for word of Christopher Columbus' discovery of the Americas to reach Europe. By contrast, barely 1.3 seconds elapsed for the world to witness on television the historic first step of man on the moon. Don't tell us we haven't made great progress, thank you very much.

## 26. The Way It Was

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The comforts most Americans enjoy today, shortly after the turn of another century, might make life over 200 years ago seem like hardship. Yet closer study shows that the colonists generally were a prosperous and contented people -- already turning America into the "land of opportunity."

According to the American Economic Foundation, by 1780, there were only 2.5 million Americans -- excluding Native Americans -- roughly the population of the state of Arkansas today. However, we were a different kind of people back in the 1780's. Nearly half the citizens were 15 or younger. Most people farmed the land for a living.

Life was rigorous and tough. Work was a sun-up to sun-down regimen six days a week. Little wonder that the average male could look forward to only about 38 years of life, compared with almost 75 years today. Only 1 in 1,000 had completed college in 1776, compared with 1 in 7 today.

Inflation was rampant during the War for Independence. By 1780, paper money authorized by the Congress was practically worthless and replaced by a new currency at an exchange rate of 40 to 1. Hence the expression "...not worth a Continental."

The ceiling price on turkeys was 9 cents a pound, on milk 9 cents a gallon, on rum 63 cents a gallon. Lodging at local taverns was frozen at 5 cents a night.

## **The Way It Was**

Two examples of typical wages were a maximum of 70 cents a day for carpenters, 42 cents a day for tailors. Barbers were prohibited from charging more than 3.5 cents for a shave. Top pay for a soldier or sailor was \$8.00 a month.

Average yearly income per person (measured in 1974 dollars) was \$634 in 1776. That's double the average yearly income in scores of Third World countries today. And the Gross Domestic Product came to \$1.6 billion in 1776, a tiny drop in the bucket compared with today's \$14 trillion.

It cost 10 cents to mail a letter, but that was good for delivery only within a radius of 100 miles. The fee rose to a maximum of 25 cents for a letter going 450 miles or more. And it was paid by the recipients. Wouldn't that put an end to junk mail!

Americans also plunged into privateering -- operating private commerce raiders, authorized by the Continental Congress. A group of merchants would fit out a heavily-armed schooner, each buying one or more shares. In keeping with the spirit of economic freedom, a man might own half the shares or only one-fiftieth. In addition to the shares, prize money went to owners and crews -- a true incentive system.

## **27. Privateers Sailing**

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For years during the American Revolution, the privateers thrived, taking some 2,000 British vessels and a vast amount of needed goods. But it was a high-risk business, and there was no guarantee a privateer would return at all, much less return a profit. Then, toward the end of the War for Independence, the British Navy swept most of our privateers off the seas. Many an owner suffered disastrous losses: high profits are often temporary, by their nature.

There are companies today that have been doing business since the founding of the republic. One notable example is the Pratt & Whitney division of Colt Industries Inc. Inventor Eli Whitney was father of the cotton gin, of modern high power gunpowder, and especially of accurate gauges for metal fabrication (think aircraft engines today).

American Bank Note, which has printed money for many nations, has been around since Washington's time. Curiously, two of the firms made pencils in George Washington's day and still make them, Koh-1-Noor Co. of Bloomsbury, NJ and Faber-Castell Co. of Newark, NJ.

As stated, the War for Independence brought new monetary difficulties. The Continental Congress, powerless to impose taxes, was forced to print massive amounts of currency to finance the war. This flood of paper money caused the Continental currency to rapidly depreciate.

## Privateers Sailing

America's first economist, Pelatiah Webster, warned that too much money being printed and issued resulted in useless currency. By 1777, the Continental Congress had imposed price controls to decrease the cost of feeding and supplying Washington's army. The result? Farmers refused to sell, except to the British, who paid in gold.

Hope for plenty at low prices resulted in scarcity and misery for the Continental army. General Washington sent very critical messages to Congress saying (paraphrased): *"troops are always to have two days provisions so when opportunity presents itself, they won't be continually obstructed. We have 2,898 men unfit, barefoot...unless something changes, the army will starve, dissolve, and disperse in order to subsist."*

Price controls were dropped by the Congress; supply and demand began to work toward natural, mutually-agreed upon market prices. Washington's army was supplied for the rest of the year and following winter. Good economics saved the day!

As Pelatiah Webster put it, *"Trade, if let alone, will ever make its own way best, and like an irresistible river, will ever run safest, do least mischief, and most good, suffered to run into its own channel."*

## PART SEVEN

### Still Our Amazing System

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It should be easy, even in these troubled times, to become interested in capitalism. It solves the problems of society better than any other economic system known by solving the problems of the individual. The application of freedom to the marketplace allows people to achieve much more than under other systems.

Freedom of enterprise is an attitude of responsibility, citizenship, pride, dignity and decency, and above all, it is an attitude of thankfulness. For too long, we who write and speak have mainly emphasized the free market's advantages, when perhaps we should also have been passing the word about its *"good news."*

In all of human history, only the free market has come to bear successfully on solving the age-old problems of scarcity and poverty. Through our American incentive system, we developed a superb track record of doing things that benefit people.

When America's profit-incentive system is working well, profits (or business savings) provide steady jobs, higher wages, more jobs, worker benefits, better working conditions, safe and modern equipment, rising standards of living, opportunities for the future, and social progress.

## Still Our Amazing System

Losses also provide a valuable function in the American incentive system. Losses are the market's way of sending a signal to businesses to reallocate their resources more efficiently, according to the price- and quality-conscious customer's demanding standards.

Capitalism, therefore, contains its own built-in checks and balances. People are required to exercise sound judgment, or suffer the consequences of their own folly. The American incentive system doesn't carry any guarantee. One risks failure along with the prospect of success.

And if we are honest, we know that there are no real guarantees possible in life -- not in theory, not in reality. The past is prologue. Just what is at stake for the future of our land? Josiah Bailey said it best long ago:

*The American Republic and American Business are Siamese Twins; they came out of the same womb at the same time; they are born in the same principles and when American business dies, the American Republic will die, and when the American Republic dies, American business will die.*

## 28. What's the Answer?

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We Americans work so hard. Often, when our candle flickers a little, especially in times of extraordinary financial stress, we pause to wonder about a basic question, *“What is the redemptive value of a lifetime of work and thrift we’ve incorporated into our lives?”*

What's the answer? *“How Do You Spell Relief?”* The answer is, and always has been, *“F-A-M-I-L-Y.”* Family is the past, present and future -- the closest thing to immortality this side of the grave. Be the best husband, dad, brother, son, and respectively, the best wife, mom, sister, daughter.

What can we all still do to truly make this our best century yet? We can each try to create a strong, loyal family, bound together and deeply rooted in faith and trust. Then we can work with purpose. Give them good memories of how to grow up as men and then gentlemen, and respectively, as women and then ladies.

Families are, indeed, the past, present, and future. Families take what we've accomplished and build on it. Families are for growing up in, for going away from, and for coming home to. The best Department of Health and Human Services is the family.

The world may not be entirely as we would like it to be. There have always been problems to be faced



## What's the Answer?

by individuals, families, business, and industry. Many problems are really conditions that eventually straighten themselves out in time in dynamic societies. Compared to other countries' problems, ours are just conditions.

In the perspective of previous decades, and looking at other countries, the American economy will emerge as superior. And we can take that to the bank. There is still a silver lining in economic storm clouds. We still have the "*Grossest Domestic Product*" in the world!

Never forget -- we enjoy a standard of living beyond the dreams of kings. For all this, we owe a great deal of credit, to those who have extended us credit, to whom we owe a great deal (a record level of debt -- personal, business and government notwithstanding). In the meantime, be the gift that keeps on giving -- a taxpayer.

## 29. Let Us Give Thanks!

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Why do we knock ourselves when we are the envy of the world? We have so much to be thankful for:

*(1) a country of truly unbounded beauty; (2) almost unlimited natural resources; (3) a standard of living beyond the dream of kings; (4) a judicial system that is the envy of the rest of the world; (5) food so plentiful overeating is a major problem; (6) food processing advances which give us all-season menus; (7) clothing that is more durable, longer lasting, and easier to maintain; (8) a press nobody can dominate; (9) a ballot box nobody can stuff; (10) churches of our choice; (11) 150 million jobs; (12) freedom to go anywhere we want, with the planes, cars, and highways to get us there; (13) automobile tires that last as long as some cars; (14) hybrid synthetics, metals and plastics that can even replace some body parts; (15) near-miracle drugs which can help us live longer and feel better; (16) unemployment insurance; (17) Social Security; (18) Medicare and Medicaid; (19) public and private schools; and consequently, (20) a proud economic history and track record.*

We are literally a people “free” to do anything we want if we have the “enterprise” to do it. The bottom line? Beyond making wise decisions to secure your future as much as possible, try to (at least partially) ignore the gloom and doom prophecies and get a life.

## **Let Us Give Thanks!**

Make your peace with your Creator on His terms, then live as to be neither ashamed of yesterday nor fearful of tomorrow. Yes, live long and prosper; however, also try to keep a balanced perspective. Always remember that despite all your accomplishments in life, the size of your funeral will be determined by the weather. If it is cold and rainy, don't look for me (only kidding)! Read on about the future.

### 30. Reinventing Ourselves Every Day

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It seems as if I am always giving advice to young people; they really are America's greatest natural resource. I like to catch them at the threshold of their careers. Often, that time comes as I have the chance to speak at commencement exercises. Commencement is a wonderful ceremony marking the beginning of a new life of "*freedom*" to support themselves.

The students are seated there at graduation thinking, "*Here I am world; I know my ABCs.*" And yet the world says, "*Come on out here, son or daughter, and we will teach you the rest of the alphabet.*" I try to make it a point to remind our young people that if they don't plan, their next summer job could be for the rest of their lives. Indeed, their first order of business should be to develop a marketable skill. Then they can become independent and self-supporting.

Consequently, they will never have to ask mother, father, brother, sister, church, or government to take care of them. You see, now is the time for all good people to come to the aid of themselves. This is practical economics. No "*onward and upward*" from me; they know the direction.

The world is not out there eagerly awaiting their talents; the world has gotten along just fine without them. All that our current graduates have is a one year head start on next year's graduates. And this new crop must make the most of it, for a year from

## Reinventing Ourselves Everyday

now there will be others after their job. It is so hard to convince young people of this old adage: *"You don't get more until you do more than you get paid for."*

There is a certain amount of fear of the unknown as our children grow up and graduate. There is always that concern and wonderment, *"Is there life after graduation?"* Very few people know the rules of life, and so they lay themselves open to pain. Time after time, they spend most of life as spectators on the sideline just observing the game.

The ideal vocation would be to pick something that we loved to do anyway as a hobby, if we were independently wealthy. Then, we can get really good at that and go out and find some organization that would be willing to pay us to do just that. Then, we would never really work another day in our life!

The story is related that one summer evening, when Thomas Edison returned home from his work, his wife said, *"You have worked long enough without a rest. You must go on a vacation."* *"But where will I go?"* he asked. *"Decide where you would rather be than anywhere else on earth, and go there,"* was the answer. *"Very well,"* promised Mr. Edison, *"I will go tomorrow."* The next morning he returned to his laboratory.

## 31. Post-Election Economics

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The fine line that any president walks includes the fact that, if he attempts too much too soon, he could short circuit the system and be patently unsuccessful. If he attempts too little, and doesn't take advantage of the honeymoon usually accorded to new presidents, a precious window of political opportunity would be lost.

American presidents also tend to develop the attention span of a hummingbird after a while. Our presidents have to keep alert to so many interest groups, with foreign and domestic agendas, which compete for the president's attention.

Every administration also has warring factions even within its own Cabinet. This tends to chew up American presidents, age them prematurely, and frequently throws us into a cycle of one-term presidents. Think about it; only four presidents in the last 60 years have been afforded the luxury of a second term: Eisenhower, Reagan, Clinton, and Bush.

In many ways America generally, and Americans specifically, are better off. In some other ways, both the country and Americans collectively are worse off. So, it has been neither “...*the best of times...*” nor “...*the worst of times...*,” Charles Dickens aside.

Frankly, on several fronts, the economy is not as bad as some made it out to be. Nor is it as good as we would like it to be. It's a bit like the economist

## Post-Election Economics

who, with one foot in the oven, and the other in the freezer, announced *"On the average, things are not too bad."*

Looking around the world, don't we Americans have much to feel good about? We are better off when looking at the reduced number of countries that are called Communist today. And yet, we still wonder how to get good government at a reasonable cost.

There will certainly be times when the winner of the 2008 presidential election, Mr. Obama, will say softly to himself, *"Why me?"* Conversely, there will also be times when the loser, Senator McCain, will privately exclaim, *"Could have been worse -- could have happened to me!"*

## 32. Questions and Answers

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The American economy is in the middle of a rebuilding surge that could run for two more decades. During this era of restructuring and implementing better technology, we will, in both goods and services, continue to be able to compete successfully with other nations at a profit.

Is business in a new age? Yes! The best and brightest graduates now graduate toward businesses which foster personal growth. Now, the manager's new role is that of coach, teacher, and mentor.

The top-down management style is yielding to a networking, people-style of management. Entrepreneurship is revitalizing companies from the inside out. Large corporations are emulating the personal and productive qualities of small businesses.

One hundred years from now -- 50, 25, 10, 5 years from now -- America, and especially the MidSouth, will be the place to be. People all over the world will look to us for growth, stability, and the good life. Our life expectancy is up 40% in the last 100 years alone. We can expect to live fairly long lives, relatively free of pain, and die in good health (your mileage may vary).

Today, there are many questions on our minds. Even our National Anthem seems to end with a question mark:



## Questions and Answers

*Oh, say does that star spangled banner yet  
wave,  
O'er the land of the free and the home of the  
brave?*

The answer is a resounding, "Yes." Here are the rest of the lyrics of the last three verses of our National Anthem, courtesy of Francis Scott Key:

*On the shore, dimly seen through the  
mists of the deep,  
Where the foe's haughty host in dread  
silence reposes.  
What is that which the breeze, o'er the  
towering steep,  
As it fitfully blows, now conceals, now  
discloses?  
Now it catches the gleam of the  
morning's first beam,  
In full glory reflected now shines on the  
stream:  
'Tis the star-spangled banner! O long  
may it wave  
O'er the land of the free and the home  
of the brave!*

*And where is that band who so  
vauntingly swore  
That the havoc of war and the battle's  
confusion*

## Questions and Answers

*A home and a country should leave us  
no more?*

*Their blood has washed out their foul  
footsteps' pollution.*

*No refuge could save the hireling and  
slave*

*From the terror of flight, or the gloom of  
the grave*

*And the star-spangled banner in triumph  
doth wave*

*O'er the land of the free and the home  
of the brave!*

*Oh! thus be it ever, when freemen shall  
stand*

*Between their loved homes and the  
war's desolation!*

*Blest with victory and peace, may the  
heaven-rescued land*

*Praise the Power that hath made and  
preserved us a nation.*

*Then conquer we must, for our cause it  
is just,*

*And this be our motto: "In God is our  
trust."*

*And the star-spangled banner in triumph  
shall wave*

*O'er the land of the free and the home  
of the brave!*

## **Questions and Answers**

Yes, we are the oldest living republic. However, let's remember that our Constitution doesn't guarantee a good life, prosperous life, a happy life, or even a long life. It only offers the protection of life. We make of our lives what we will. We should bet on the long run future success of American capitalism. If we don't have a future, nobody does.

## PART EIGHT

### Oil Pressure!

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This is a true story (adjusted for inflation). In the *late 1970's, the service station attendant implored me, "Fill it up?"* Reluctantly, I replied, *"Fill it up."* He opened the cash drawer and said, *"Fill it up."* I filled it up, emptying my wallet. Then he filled my gas tank, seeming to double the value of my old, gas guzzling car. Was this an emotional issue? Without question.

However, by the early 1980's, the pendulum had swung to the other extreme. I breezed into the service station in my new, fuel efficient model and happily challenged the attendant to *"fill it up."* He moaned, *"I haven't seen gas prices this low since it was put in the trolling motor of Noah's ark!"*

In more recent times, those high gas prices again make us feel as if we are *"paying through the hose."* Aside from trying to face any energy crisis with a sense of humor, the fact is that motor fuel is at least \$2 more per gallon in Canada -- \$3 to \$4 more in parts of Europe.

Examining the situation closer, and if we are open-minded, the news at the pump gets surprisingly better. In real terms, we have the least expensive gas in the industrialized world. In 1930, the average pay for an hour of factory work would purchase about three gallons of gasoline. Today, average factory worker hourly wages buy about five gallons.

## Oil Pressure!

What really drives petroleum prices? (1) *inventory levels and replacement costs*; (2) *refinery capacity and conversion schedules*; (3) *clean air fuel mandates*; (4) *zone price marketing formulas*; (5) *exchange rates*; (6) *global spot market prices*; (7) *geopolitical fear-risk premiums*; (8) *real and manmade disasters*; (9) *buyer-seller psychology*; and (10) *supply and demand*.

How can fuel prices at the pump vary upwards of 10% to 15% at any point in time? Emotions aside, it should not be a mystery. Retailers deal with many parameters: (1) *contractual cost structures*, (2) *marketing demographics*, (3) *volume strategies*, (4) *markup ranges in competitive urban versus rural areas*.

Prices elsewhere tend toward what the market will bear. Price elasticities operate as well. The rare, full-service station, with its loyal patrons, can charge more than the gas-and-go outlets (whom they correctly do not view as competitors). In fact, convenience store customers are probably more price elastic in their demand. As operators know, the tradeoff to higher prices at the pump is potentially declining sales of other items inside the convenience stores.

Ethanol is hyped as being right up there with apple pie, motherhood, and solar energy. More petroleum is consumed to plant, grow, harvest,

## Oil Pressure!

process, and distribute corn and its ethanol byproduct, than is saved.

Ethanol comes with a hefty, protective tariff subsidy over cheaper foreign ethanol imports. Corn prices have spiked, especially at cattle feed lots, the last three years. Prices of other food commodities have also risen, as production was pulled out of other crops in order to grow more corn.

Cutting down of the rainforests continued with abandon in order to bring more acreage under cultivation. Rising food prices are very painful to the near 2 billion of the world's poor who spend at least half their meager incomes on food to survive. Being "*renewable*" isn't without tradeoffs, is it?



### **33. Over a Barrel (Again)**

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Always a balancing act, in a typical year, it is standard operating procedure for American oil refineries to convert from the production of heating oil to the production of gasoline shortly after the New Year starts. Only by doing that conversion on a timely basis can the energy companies try to meet and anticipate the growing demand related to summer travel by Americans.

As with most things in economics, it all does come down to supply and demand. However, few experts before the Gulf Coast Storm disaster were predicting a petrocession, an energy shortage-induced recession, nor even a dramatic shift in consumer spending habits. Only after a sustained period of adverse economic signals, combined with chronic shortages and persistent record high prices, would we expect to see a petrocession.

Not to go unnoticed was the weakening of the dollar by approximately 35% against the euro between 2002 and 2004. Sellers of petroleum in 2005 reacted by raising prices. Is there wholesale price gouging in the works? American energy companies have not allowed motor fuel prices to rise as fast as crude oil prices have gone up at the wellhead.

Earlier in that decade, when crude oil prices ratcheted up from, say, \$20 a barrel to \$40 a barrel, the retail price of gasoline did not soar from \$1.50 a gallon to \$3.00 a gallon. Prices at the pump



## Over a Barrel (Again)

historically rise about 3.5 cents per gallon for each \$1 increase in crude oil prices.

What may also happen, it has before, is that there could be sensational headlines, *“Oil Company Profits Soar 50 Percent.”* All it would take is the reporting that last year’s profits were, say, \$.06 on each dollar of sales and this year’s profits were \$.09 on each dollar of sales. Such swings, both up or down, occur in most industries.

On the other hand, with the Mideast a fragile powder keg, and recurring natural disasters hammering our coasts, might \$3 a gallon come to be referred to as the *“good old days?”* Absolutely. Will the reader find this writer expending his time and money, his opportunity cost of foregoing the next best use of his time and talents, driving from city to city comparison shopping and lamenting price differentials that obviously the aggregate marketplace willingly bears? Absolutely not.

Just think, if they all charged the same price, the Federal Trade Commission would scream, *“collusion!”* Most SUV drivers, weighing a number of factors beyond just annual fuel costs, will hang onto their prized chariots. To also gauge what a low price we pay for motor fuel, try pricing a gallon of drinking water. Milk is around \$4.00 a gallon.

### 34. Has America Acted Fuelish?

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Have we been “*fuelish*”? Not really. We have approximately doubled our real Gross Domestic Product (GDP) in the past 30 years; we did it with only about 60% more energy. Some would accuse us of being “*energy pigs*.” Americans are not “*energy pigs*” any more than our children whom we push to go on in school are “*education pigs*.”

Yes, we use about 25% of the world’s oil flow. We also produce (and sell to ourselves and others) nearly 30% of the world’s goods and services. Do we realize how far we’ve come? Our current model cars go twice as far on a gallon of gas compared to thirty years ago (29.3 vs. 14.2). Trucks have shown a 50% improvement in the same time period.

The equipment in our houses, cars, factories, and aircraft is 30% to 60% more efficient than 30 years ago. Total residential fuel bills have held steady for the last decade, despite an increase of 20 million dwellings (a 25% gain in total dwellings). Between 1980 and 2005, relative energy costs of American families fell by one-third. Additionally, low interest rates have helped consumers service other debt and obligations.

These improvements put us ahead of every major Western trading partner, and almost equal with Japan, in terms of energy efficiency gains. Japan has one-fifth the cars and a total land mass that would fit inside the state of Montana. Ours is a tremendous

## **Has America Acted Fuelish?**

achievement, considering the topographical size and diversity of our land and population. Oil now powers about 8% of our electrical energy, compared to 17% in 1973. We have come a long, long way in just 30 years.

Americans have been pumping oil domestically for 150 years. As a result, we are down to averaging about 20 barrels a day from our American wells, compared to approximately 260 barrels per wellhead each day in the Persian Gulf. So, where do we go from here? With environmental considerations, we may have to tap into our Western off-shore continental shelf for new, major oil reserves.

Beyond that, the sun is expected to shine for several billion years. Nuclear fusion creates its own fuel. The oil shale of the mountain states, petroleum in the tar sands of Canada, may rival the Mid East reserves. Recent discoveries in Venezuela and Nigeria have effectively doubled known world reserves.

Further, 100 billion barrels of oil are estimated to be in America's continental shelves. Oil, natural gas, gasoline, and methanol can be synthesized from coal, as was accomplished by Germany during World War II. Additionally, we are literally the Persian Gulf of coal. Coal accounts for 80% of American fossil fuel reserves.

## **Has America Acted Fuelish?**

If oil prices stay high, what would be the result domestically? New England will be hurt the most on heating oil costs. Texas, Oklahoma, Louisiana, and Alaska economies will pick up (Mexico, Nigeria, Canada, Venezuela, too). Price inflation could rise 0.5 to 1.0%, resulting more upward pressure on interest rates. U.S. exports could become less competitive with a stronger dollar, as those exports become more expensive.



### **35. When Peace Breaks Out**

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Like it or not, geopolitics weigh heavily on world oil production, delivery, and pricing. Two-thirds of the world's oil stock is in the Persian Gulf, as is one-fourth of the world's current flow of crude oil. Our lack of resolve to tap our own recoverable reserves, combined with our willingness to do business with a cartel, the Organization of Petroleum Exporting Countries (OPEC), has contributed to the power and pervasiveness of OPEC for three decades.

Oil reserves in Iraq and Kuwait alone are 200 billion barrels. We use 23 million barrels a day. Additionally, 13 million of the 23 million barrels must be imported. The world burns about 88 million barrels of oil a day. Crude oil consumption is expected to increase 50% by the year 2028. Domestic and foreign demand for petroleum (especially fast-growing China and India) has been surging to new records each of the last 10 years. An exporter of oil just a decade ago, China now imports six million barrels a day (projected to double by 2025).

What about those surging prices at the pump? Price increases for gasoline and heating oil may or may not continue to be as great as feared, or stay as high as those experienced during past oil crunches. Three decades ago, and as OPEC learned to flex its collective muscles, the price of OPEC crude oil surged 400% in 1973-74 and 300% in 1979-80.

## **When Peace Breaks Out**

A shocking three-fourths of known oil reserves are owned or controlled by their respective governments. Twenty-five percent of the world's proven crude oil reserves are within the borders of Saudi Arabia. The Saudis are the only OPEC producers who have significant idle capacity.

Some experts believe that the Saudi's claimed two million barrels a day idle capacity doesn't really exist. Rather, it may represent approximately how much wiggle room they are currently using to fudge on existing OPEC quotas. How reliable a supplier would Saudi Arabia be if the country was taken over by anti-western factions?

Further, changes in petrochemical strategy take time to work their way through the supply channels. Ten weeks must pass for crude oil to be refined into gasoline (and other petrochemical products) and delivered to the pump: six weeks to ship on super tankers; two weeks to refine; and two more weeks to move to storage depots.

Meanwhile, U.S. inventories of petrochemicals typically levels out at around 200 million barrels. Few new petrochemical refineries have been built since the 1970's. Post-Gulf Coast disaster pipeline and refinery circumstances are basically and structurally different today (but not necessarily better).

## **36. Wartime Petronomics**

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What would have happened in 1990 if Iraq, after invading Kuwait (and perhaps on its way into Saudi Arabia), had developed a monopoly on Persian Gulf oil? It could have held captive the world's economy and severely affected industrial output. By that time, it could have stifled the coalition's military power and will to resist. Was the 1990-91 war about cheap crude oil? No; more accurately it was about heading off a possible misuse of oil power.

We did not send coalition troops to the Persian Gulf just to hold oil prices at \$40 a barrel. The young men and women of western nations went there, in good measure, to keep expansionist Iraq from potentially controlling two-thirds of global oil reserves and from using that control to blackmail the industrial world.

The case for fighting in 1990-91 was, frankly, that Iraq (already possessing the world's fourth largest military) would be militarily, politically, and geographically harder to fight later. Remember, there was no peace treaty in 1991, only an uneasy armistice for the next dozen years thereafter. During that interim, shadowy terrorists without borders worked to form tenuous alliances with powerful enablers.

What we did in 1990-91 was a pragmatic attempt to maintain access to the oil on which the world depends. It was nothing less than an effort to sustain



## Wartime Petronomics

the well-being of billions of people on several continents. We still import more than half our petroleum, but even achieving self-sufficiency would not fully protect us from war in the Gulf. Our prosperity is heavily linked to countries that are also heavily dependent on Mid East oil.

When oil prices hover around, say \$80 per barrel, probably \$15 to \$20 of that is due to a *“fear factor* (about terrorist violence that could disrupt worldwide petroleum deliveries).” It’s a war-tax, if you will, against so-called *“weapons of mass disruption.”*

Additionally, when demand grows faster than supply, prices go up as they would in any seller’s market. This, by the way, also allows oil and gas companies to increase exploration and production expenditures. If they are smart, they will do so. Remember: oil companies do not set petroleum prices at the wellhead; the pricing action plays out in various countries’ mercantile exchanges.

Realistically, if we complain when prices go up, shouldn’t we also give thanks when prices go down? If the price were all that mattered, we could rely on the marketplace. Even for producers, excessively high prices don’t maximize profits. High prices can also affect buyers and sellers somewhat differently, by promoting conservation and inducing new oil production, respectively.

## **Wartime Petronomics**

Nevertheless, our economy cannot fully thrive except under peaceful conditions. The very foundation of our economic lives -- our freedom of choice to manage our individual, business, and national affairs -- is a direct result of periods of sustained peace in our time.



## PART NINE

### Connecting the Dots

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Is it a primary economic goal of the United States to try to guarantee western nations a stable supply of reasonably priced oil? To be sure. Again, two-thirds of the world's oil stock is in the Persian Gulf, as is one-fourth of the world's current flow of crude oil.

Our lack of resolve to tap our own recoverable reserves in Alaska, combined with our willingness to do business with OPEC, has contributed to the power and pervasiveness of OPEC for three decades. Again, we import over half our oil, but even achieving self-sufficiency would not fully protect us from war in the Gulf.

Will we have another spike in energy prices because we still import too much of our oil and are wasteful? No. The planet's chronic energy crisis is that oil provides 40% of the energy and that 65% of verified oil reserves are in the Persian Gulf, known by its shifting sands of strife for millennia.

Not to go unnoticed logistically, during Desert Storm in 1990-91, the only refinery in the entire Persian Gulf region that could produce jet fuel was in Kuwait. That country alone accounts for 10% of the world's oil production. We could not simply withdraw and cross our fingers that there would be no more such crises.

## Connecting the Dots

What happened in Kuwait in 1990 was a threat to the entire Arab world. Later, it could have become a threat to the rest of the globe. A year before the invasion of Kuwait, and at two Arab summits, Iraq's leader is reported to have argued that, by combining the OPEC quotas of the two countries, he could force oil prices up significantly, double his development budget, and still pay off his war debts in a few years.

Conjecture was that, in the process, Iraq's leader could expand his coastline from 37 miles to 225 miles and wind up with a deepwater port. All he seemingly had to do was take over Kuwait to whom he owed \$18 billion in loans from the Iran-Iraq war. His options were clear. Repay the loan, or he would rob the bank.

In 1990, Egypt's President reportedly told a U.S. Senator that Iraq's leader once took him aside and proposed a military coalition of Iraq, Egypt, Syria and Jordan to pool their weapons and carve up Kuwait and Saudi Arabia. On another occasion, Iraq's leader allegedly offered Yemen two of Saudi Arabia's southern provinces. Alas, so much friction over such a slippery substance.

### 37. Marketplace Petronoia

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Conversely, what was hoped for in the spring of 1999 ended up working all too well. That is, OPEC did cooperate in restricting the supply and flow of crude oil in early 1999, as part of an attempt to salvage sectors of the depressed American oil industry, when prices at the wellhead were then around \$10 per barrel.

The fix worked too well. Within one year's time, the marketplace responded with a swing from an earlier time of abundance and low prices to a new era of shortages and high prices. Economists refer to this perverse phenomenon as a type of "*Cobweb Theorem*": alternating high prices and surpluses with low prices and shortages.

Although domino theories have been less popular recently with the thaw in the Cold War, consider this sequence of events. A major oil cutoff would surely hobble energy-insufficient Japan and Europe. As major trading partners, their economic implosion could throw our economy into a free fall, jeopardizing jobs.

The loss of control of the oil fields in the Persian Gulf could shake the foundations of the international banking system. Why? There are scores of oil-importing, underdeveloped countries which owe tens of billions of dollars to overexposed major banks. A sharp, sustained increase in crude oil prices and those nations may not be able to service their debts.

## Marketplace Petronoia

The world's biggest and most vulnerable banks would take significant broadsides. If the banks are pushed to the edge, those who suffer won't just be bank stockholders. We, all of us, our enterprises, and our loved ones could also suffer, at least temporarily, due to financial deflation and confusion.

What would have happened if an Iraq with expanded territories had developed a monopoly on Persian Gulf oil in 1990? With Iraq's treasury rebuilt, it could have financed terrorism by stopping oil shipments sporadically to coerce Western support for its agenda. In fact, Iraq might have decided on a rate that suited its politics, even though it might not necessarily be profit maximizing.

For better or worse, Frederic Bastiat's expression in the 19th century applies: *"If goods do not cross borders, armies will."* And if it is in our national and international interest to assure a stable flow of oil from the Persian Gulf at reasonable prices then, alas, troops from western nations could be rotated into the Persian Gulf for many years to come.

### 38. Oil in the Family

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There have been many energy crises. In 1973, Arab nations, through the newly formed OPEC, refused to sell to Israel's allies, then tripled prices. In 1980, Iran's revolution and the Iran/Iraq war resulted in panic buying led by Japan. That caused world oil prices to spike to an all-time high of \$40 a barrel. In 1986, Saudi Arabia flooded the market, drove prices down to \$12 a barrel and effectively eliminated, for several years, some of our recoverable reserves.

Is oil merely "*another commodity*"? No, it powers the engine of our market economy and fortifies our national defense. We cannot have it both ways. We cannot have low-priced, offshore fuel from unstable foreign sources while we sacrifice our strategic defense capability and our own recoverable energy reserves.

Economists have long known that quantity available in the marketplace, both supplied and demanded, is always a function of price. It would be best to avoid the temptation of making energy predictions on the assumptions that our stockpile, technology, and environment are fixed. Throughout our history, various crises and technology breakthroughs have had a way of bringing new resources into existence while rendering old ones valueless.

Consider that for a thousand years, from approximately 900 A.D. until the 1860's, mankind's principal



## Oil in the Family

source of lubrication and lighting came from whale oil. By the time of the Civil War, the relative scarcity of whales and the tandem upward price spike of whale oil led to the development of refining processes for the then so-called non-resource crude oil, discovered in Pennsylvania in 1859. More on this later.

If economists know anything, it's that free markets, when allowed to operate in their own channels, have a way of resolving shortage and surplus conditions. Prices will respectively rise and fall in response to supply and demand conditions.

The 1990-91 Mid East crisis, and *Operation Iraqi Freedom* in 2003, removed the world's cushion of excess petroleum production. The global supply system has remained tight, fragile, and vulnerable to further shortfalls in volume and delivery (for example, the Gulf Coast disaster which hammered drilling rigs, pipelines, refineries, and storage facilities).

Although domino theories have been out of vogue lately with the thaw in East-West relations, consider again this sequence of events. A major oil cutoff would surely hobble Europe and Japan. As major trading partners, their economic implosion could throw our economy into a free fall.

One big winner in any short run spike in prices? Russia is a large oil producer. The break-even point for Saudi production is about \$11 a barrel. The U.S.

## **Oil in the Family**

breakeven point is \$14. For the Russians, it is approximately \$19 a barrel. The rise in oil prices partially rescues the Russian economy. Ironically, that could simultaneously impair Russia's primary customers: fuel inefficient Eastern Europe.



### 39. Creative Juices Flow

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Entrepreneurs with a good feel for applied science brought the Petroleum Age into full flower. We owe them much of our standard of living (labor saving products), our material comforts (heating and cooling), our transportation (cars, planes, trains, etc.), and our longevity (medicines from petroleum bases). Only when we try to bypass ordinary market processes and throttle creative juices, do we then face possible prolonged and protracted energy crises.

Before the mid 1800s, the principle sources of energy in the U.S. were wood, coal, and whale oil. Around 1829, the demand for whale oil was so great, and the cost of hunting whales so high, that prices increased over 400%. The only other oil available was kerosene made from petroleum that had seeped to the surface.

Crude oil sold for \$42 a barrel in 1850 dollars. Then, using data provided by a Yale chemist, a group of New Haven investors drilled for oil. On Aug. 27, 1859, near Titusville, PA, they struck oil, and a new industry was born.

Our supply of fossil fuels is finite; however, we are certainly not in the last days of the Petroleum Age. Curiously, at frequent intervals over the last 140 years, various government bodies (the Revenue Commission, the Bureau of Mines, and the Department of Interior) have respectively and oft declared the end of our reserves to be 10 to 20 years

## Creative Juices Flow

hence. Then, new reserves would be discovered, often exceeding all previously known reserves and all oil pumped out of the ground to that date. Examples abound from Texas, Oklahoma, and Louisiana 100 years ago to the more recent and major finds on the North Slope of Alaska and in South America.

Margin-rich oil fields, that is, seemingly tapped out but paid for, have been known to respond very well to secondary techniques of injecting steam or the dreaded  $\text{CO}_2$  to break loose formerly unrecoverable reserves, tripling the original output to date.

Again, there is a price at which shale and oil could be extracted from tar sands, liquefied coal. Come what may, we will have the energy we need, and we will pay for it at rates that, in the short run, may seem like a *“gold arm and a platinum leg.”*

No doubt we will end up with far more energy at lower prices in the long run if we can avoid so-called quick fix solutions. Such was the case with the abortive price controls attempted in past decades. Those controls attacked symptoms, were cosmetic, obscured root causes, aggravated shortages, curtailed buyer-seller freedom, masked true market costs, encouraged wastefulness, and discouraged exploration.

Government policies have often kept the price of domestic oil and gas well below world market values.

## **Creative Juices Flow**

This has discouraged conservation because the public simply hasn't considered it necessary to skimp on a low cost commodity. Legislative controls on prices at the same time discouraged exploratory drilling that would have led to increased supplies.



## **40. Energy Facts of Life**

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So, what are the energy economic facts of life? Those who lobby against coal-fired power plants, nuclear energy, off-shore drilling in our own backyard, exploration of mineral rights on federal lands will need to consider being more reasonable, or we may have to shut down the economy in its present form and return it back to our Native Americans.

How can we fight back against the painful swings in world oil prices? One approach could be to implement a countervailing tariff whenever the price drops below, say, \$60 a barrel. If the price falls to \$55, the fee would be \$5. When, and if, the price goes up above \$60 again, this variable import fee disappears.

The revenue generated can be used to refill our 700 million barrel Strategic Petroleum Reserve (SPR) stored in underground salt caverns (30 days supply). If and when world oil prices surge on the spot market, oil could be released from the SPR to dampen the price increase. In effect, we would buy low and sell high, at the expense of the Mid East oil cartel.

America's energy dilemma is serious and real, but much good can come from it as has been the case with past crises. There are no simple solutions. Although we long for much lower fuel prices, the downside to the macroeconomy would be to increase demand and thereby our dependence on imported oil. Price spikes? Yes, they will occur from time to time.



## **Energy Facts of Life**

But there is no shortage of energy reserves waiting to be identified and commercially developed. Then, the 21st Century can also be known as the "*American Century*," and, yes, we can take that to the bank.

## 41. Crude (Oil) Humor

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In energy crises, each of us has a role to play. The problem is, nobody wants a walk-on part. Should we look to more small cars as the answer for everyone? Some of those new models are so small now that when you take one to a car wash, you have to wait for a full load. Make our cars any more compact, and they will be afraid to come out of the garage whenever there's a hawk in the sky.

At best, severe conservation measures might cut in half our growth in energy usage requirements. Such was the case in one hotel in 1979 which posted small signs beside wall switches, *"Oh say, can you see by the dawn's early light? Then turn off this switch!"*

It really does come down to a choice between laughing and crying. In that regard, there is a prediction afoot of a shortage of humor by 2009, and the cost of a barrel of mirth could go as high as \$95. Six years ago, a barrel of crude laughs was selling as low as \$35, and it was difficult to give the stuff away.

By raising the price of a barrel of mirth to \$95, we might wake people up to the fact that, unless strong conservation methods are taken, we could run out of humor by the year 2015. In fact, the price of refined laughter could go as high as \$120 a barrel. We'll have to live with it. We can't have recession and inflation and expect cheap humor to boot.

## Crude (Oil) Humor

Abe Lincoln said it best, *“You can ‘fuel’ all the people some of the time, and you can ‘fuel’ some of the people all of the time, but you can’t ‘fuel’ all the people all the time.”*

As we pull ourselves together and hang loose, are there worse things than an energy crisis? Sure. Having an *“identity crisis”* and an *“energy crisis”* at the same time: not knowing who we are and being too tired to try to find out!

Have courage, dear reader. When we do have recessions, at least we’ll use less gasoline going downhill. Laugh or cry. Pay your money. Take your choice.

## PART TEN

### Champion of Capitalism

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With the passage from this life of Nobel laureate Dr. Milton Friedman, in November 2006 at the age of 94, we take special note of both a diminutive giant and a pugnacious gentleman who, at the turn of the millennium, was cited in Fortune Magazine as *“Economist of the Century.”*

Following his 1980 American Studies Institute (ASI) presentation at Harding University, promoting his new book and video series, Free to Choose, Dr. Friedman and I flew together across a portion of the southeastern U.S. in a small, general aviation aircraft. Upon boarding, he eagerly volunteered to ride up front with the pilot. Ever the mentor, he announced, *“Did you know that the clock and watch-making industries in the United States were subsidized by the government in the 1930s?”*

*“No,”* I replied. *“That surprises me. Of course, we weren’t as good as the Swiss or the Germans...Oh, I get it. We feared another world war and did not want to be cut off (embargoed) from the technology that made the gauges, navigational instruments, bombsights and so on.”* Friedman replied, *“Exactly, and for a while I actually worked in the factory that made these gauges for the aircraft consoles.”*

## Champion of Capitalism

In 1982, one of my students and I won cash prizes and a free trip to the West Coast to meet and dine with Professor Friedman at the Bonaventure Hotel in Los Angeles. Friedman was Chairman of the blue ribbon panel of judges for that First Annual National Essay Contest on freedom applied to the marketplace. We had won First Place.

On that occasion, we received our prizes, posed with Professor Friedman, and presented him with a copy of our *"FREE MARKET ALMANAC -- A Daily Chronicle of Enterprise."* He chided me for one quote on the January page: *"Ask not what your country can do for you, but what you can do for your country"* (President Kennedy at his Inaugural). Honorably pursuing self-interest will result in the social good - this was Friedman's frame of reference, not the other way around. Adam Smith would agree.

We corresponded now and then over the years. This delightful letter arrived in the Fall of 1983 (please forgive the lack of humility on my part for printing this):

*Dear Don:*

*Your activities in spreading the free enterprise message certainly deserve a great deal of praise. Each of the times I have heard you speak, you have been effective, persuasive, and humorous.*

## Champion of Capitalism

*I am sure that must be the reaction of most people who hear you speak. It is a real tribute to you that you are able to inject humor into a serious subject and at the same time to get across an important message. I wish you luck in your activities.*

*Sincerely yours,*

*Milton Friedman  
Senior Research Fellow  
Hoover Institute  
Stanford, California*



## 42. Interesting Time to Study Economics

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Friedman was a child of working class immigrants from eastern Europe. His mother worked as a seamstress in the New York City garment district, and his father died while Friedman was still in high-school. Friedman arrived in 1928 at Rutgers University with a rare and coveted scholarship in mathematics.

Friedman was wanting to become an actuary, but then decided that it was a fascinating time to be studying economics, as the Great Depression was unfolding. He turned down his scholarship, changed his major to economics, and took on several part-time jobs (clerking, waiting tables).

One account has it that, on the eve of our Great Depression, Friedman took his first economics class by accident, taught by Arthur Burns, future Federal Reserve Bank Chairman. After that semester, Friedman was addicted to what I like to call, *“The Only Game in Town.”*

Graduating from Rutgers in 1932, Friedman stated later that, *“Under the circumstances, becoming an economist seemed more relevant to the burning issues of today than becoming an applied mathematician or an actuary.”* So, off he went for graduate work in economics at the University of Chicago, followed by post-graduate work at Columbia University.



## **Interesting Time to Study Economics**

Early in his career, Friedman was a staff economist at the Treasury Department. He lobbied hard for wartime tax increases and price controls, all in the name of efficiency, he felt at the time. Later in life, he would profess that he had blotted out those early memories as they came from an era when he was a pro-Keynesian fiscalist in his thinking.

### 43. Passion for Market Forces

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Friedman had a passion for replacing the military draft with an all-volunteer military. And that landed him on a key commission after the Vietnam War. Obviously, with an all-volunteer military, you get a more committed, productive GI who has a higher retention rate and is therefore less costly to train and replace. Conscription is inefficient and it restricts freedom. The logic of it all is inescapable. He remarked to me more than once that some of his best and most serious students were the GIs who went to college on the GI bill after WWII.

Recipient of the Presidential Medal of Freedom in 1985, Friedman was such a great communicator that his listeners would often react with, *“That makes sense. Why haven’t our leaders thought of that?”* He was acknowledged pioneer and scholar in the fields of monetarism, price theory, business cycles, privatization, personal investment accounts, inflation and price controls, school vouchers, all-volunteer military economic growth, freedom and property, etc.

Friedman and his wife, Rose, were a rare breed: both husband and wife were economics majors. She co-authored many of his books. The other husband and wife economist combo I know of first hand were Sam and Helen Walton, she graduating from Columbia College in Missouri and he from the University of Missouri at Columbia. Can you imagine the great conversations these couples must have had over the decades?

## Passion for Market Forces

I have heard accounts over the years of Dr. Friedman's receiving an honorary doctorate at the Hebrew University in Jerusalem. Asked if it was possible to summarize any theory of economics into a single phrase, Friedman reportedly responded, *"There is no such thing as a free lunch. That is the sum of my economic theory; the rest is elaboration."*

In his prime, Dr. Friedman was known for accepting one out of every ten speaking engagement invitations, for a maximum of three a month at a speaker's fee in the mid-five figure range. He was most well known in recent decades for his advocating of school vouchers, thereby encouraging competition and giving parents a choice to shop around, among and between different types and qualities of schools.

Dr. Milton Friedman and Dr. John Kenneth Galbraith, both of whom passed from this scene last winter, made very successful careers of going around the country debating each other on college campuses. It was quite a sight: conservative economist Friedman at 5'2" tall and liberal economist Galbraith at 6'7" in height. Champion of Capitalism Friedman with his logic, facts, and examples, could absolutely debate Galbraith under the table.

## 44. Social Responsibility

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Do I have one favorite quote from Milton Friedman? Yes, indeed:

*There is one and only one social responsibility of business -- to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say, engages in open and free competition without deception and fraud.*

To elaborate, some say that the bad done by business would fill a book. In some cases that is true. In this country, it is rare enough as to be newsworthy. However, the good done by most business people -- jobs, new and better products and services, a rising standard of living, economic growth, even taxes -- would fill a library. To me, that's the good news of our American incentive system.

On another occasion, as we were driving across a portion of the mid-south, Dr. Friedman was taken with my ten-year-old, 1965, mint condition, Buick LeSabre. It turns out he had one just like it at the time. He kept it on his mountaintop retreat in Vermont, for those six months of the year when he wasn't at the Hoover Institute at Stanford University in Palo Alto, California.

During that driving trip, I asked Friedman to name the top post-graduate programs in Economics across the country. He absolutely nailed it with a superb list

## Social Responsibility

of those which were both intellectually and technically competent. Don't forget: he was also a first rate econometrician.

Was Milton Friedman a giant in his profession? Indeed! He owned the second half of the 20<sup>th</sup> Century, just as English fiscalist John Maynard Keynes (1883-1946) owned the first half. Keynes was also keenly aware of the legacy which comes to those in the vanguard:

*The ideas of economists and political philosophers...are more powerful than is commonly understood.... Practical men, who believe themselves to be quite exempt from any intellectual influence, are usually the slaves of some defunct economist.*

Here is a pop quiz: Who grew up in a household where Milton and Rose Friedman were frequent house guests, was briefly a student of Friedman's, went on to earn a Ph.D., and also has a quick wit and a penchant for writing? Give up? It was Herbert Stein's (Chairman of Economic Council of Advisors for Nixon and Ford) son, Ben!

## PART ELEVEN

### Let Free Choice Reign

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*As an undergraduate economics major in a rigorous program at California State University at Long Beach, and in the mid-1960's, it was my good fortune to be assigned to read and critique Milton Friedman's new book Capitalism and Freedom.*

*A good title, or brand name for that matter, should describe the contents of the package. Friedman adeptly wove together the case for private enterprise and personal initiative as some of the key ingredients for prosperity.*

*The following text through page 191 contains the text of a presentation by Dr. Milton Friedman, Keynote Speaker of the American Studies Institute (ASI) Lecture Series, Harding University, in 1976, the year he received his Nobel Prize in Economic Science from the Royal Swedish Academy:*

My theme is, as I see it, the major problem which faces this generation of Americans, which faces the young people who are here in Harding now as undergraduates and those who will come after them.

It is wisely believed that the growth and size of government is inevitable. It is taken for granted that somehow the growing complexity of the world, increasing technical developments and sophistication

## **Let Free Choice Reign**

and growing numbers of people make it necessary for government to grow and that what we have been observing in recent years is simply a continuation of a trend running back for centuries. That is false, historically.

This country was founded in 1776. The present form of constitution came some 13 years later. In the first century and a half of this country's existence (1790 to 1930), there was no tendency whatsoever for the government to grow. On the contrary, the size of the government, both federal and state, stayed roughly the same throughout that whole period except during the war of 1812, the Civil War, and World War One.

Today, governments at every level -- local, state, and federal -- spend a sum of money which is equal roughly to 40% of the national income. That is to say that if I add up what our cities and our states and our federal government are spending, they are spending 40 cents out of every dollar of your income for you.

In the period I spoke of, from 1790 to 1930, excluding the great wars, spending by the federal government was never more than 5% of the total income (3% in 1929). In that whole period, spending by state and local governments was always larger than spending by federal government.

## **Let Free Choice Reign**

Spending by state and local governments in 1929 was about 9%, mostly for education. Taken together, local, state and federal governments had a total spending equal to about 12% of the national income. And at no time in the prior 150 years did it reach 15%. There was no tendency during that period for government to grow and grow and grow.





## **45. Origin of Government's Growth**

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The growth of government dates from roughly 45 years ago. It dates from the beginning of the New Deal, after the Great Depression of 1929 to 1932. The origin of the growth of government is to be found in the post-depression period. In the 40 years from then to now, we have seen the government's spending grow from 12% to something like 40%.

It started very rapidly. Already by 1936, federal spending was greater than state and local government, and the growth of government has gone along with a shift in the power from state and local communities to the federal government. Today, the federal government spends about 26% of the national income and state and local governments about 14%, or half as much as the federal level.

And the size of spending by the federal government understates the role and the importance of the government. That is not the only way in which the government impinges upon you and me.

The first question to be asked is, why is this a problem? Doesn't this merely mean that people are getting what they want? These expenditures by the federal government, the taxes to pay for them and the inflation which has accompanied them have been produced by the people you and I have elected and sent to Washington, by the people you and I elected and sent to the state chambers.

## **Origin of Government's Growth**

Why is this a problem? Is it not the reverse? Does it not mean that our democracy is really working -- that our government is giving us what we want? I think the answer is very clear.

Even if you could suppose we were getting our money's worth for every dollar that government is spending, government of this size is a serious threat to our individual and personal and political freedom. There is a sense in which government is giving us what the people want.

And indeed, the reason for talking about the problem is to try to get people to recognize what have been the consequences of their wants, to recognize that perhaps they have been wrong in what they have urged upon government, and to see what the further consequences of these developments are.

So, even if we are getting our money's worth, the growth of government would threaten our freedom. It is impossible to have a free society if government is too big. It is impossible for there to be simultaneously an all-powerful government and a free and individual society.

## **46. No Freedom of Speech**

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Let me ask you a question. Is there a business person in this country today at any important and responsible position in business who has freedom of speech, who can say in the press, over the radio, or on any public podium what he really believes? I can assure you that there is no top level businessman who will say he has freedom of speech.

Before he says anything anywhere, the business person will look over one shoulder and see what the Internal Revenue Service is doing and over the other shoulder to see whether maybe an antitrust suit isn't coming his way. And I guess he must have three shoulders now because he must look to see what will happen to his allocation of oil.

And this is inevitable. It is not because of any malicious or evil people in Washington. It is because, if you have power, power will be used. If you have a governmental body that spends 40% of the income of the community, if you have government so powerful and so strong, it will inevitably use that power.

But let's put aside the threat to freedom, even though from my point of view I believe that it is the most fundamental problem we face. Are we getting our money's worth? It seems like belaboring the obvious to discuss that issue.

## **No Freedom of Speech**

Is there really one among you in the audience who will say that the 40% of his income which is being spent for him by government -- state, local, and federal -- is giving him his money's worth compared to the other 60%? Are you really getting your money's worth? Is anybody getting his money's worth?

Some years back, in discussing the situation in New York City, John Kenneth Galbraith said there was no social problem that couldn't be solved by an increase in New York City's budget. In the period since he spoke, New York City's budget has tripled, and so have the problems. Did the problems get worse because the budget didn't quadruple? No!

The problems got worse because the budget increased. How can anybody say such a silly thing? How can it be that you get less for more money? The answer is that it is an illusion to believe that you had more money. Where did the city get the money to spend? It got it from the citizens of the city of New York. What happened was the government had more to spend, but the people had less to spend.

Now is it any surprise to you that governmental civil servants spending someone else's money are likely to get less value per dollar spent than people spending their own money will get for those same dollars? In my opinion the problems of New York

## **No Freedom of Speech**

became as bad as they are because government spending went up while private spending went down.

Instead of money being spent by people who were careful with their money, money was spent by people who had no interest in how efficiently it was spent. They spent much of it to create problems instead of solve them.



## **47. More Problems Exist**

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Now the next question we want to ask is, “Why has government grown?” Why have we had this tremendous growth? Clearly, if you accept my view that the increase in spending and the growth in government has not solved problems but has left us with more problems, you cannot say government has grown because there were some problems that had to be resolved.

The fundamental reason why government grew is because of a basic change in philosophy that was institutionalized by the New Deal. It wasn’t produced by the New Deal. The basic change in philosophy had been going on for a long time. If you look at what was happening in intellectual circles between 1890 and 1920, you will see a great shift in philosophy.

It was a shift from a belief in the government as umpire and peacemaker, to a view of government as Big Brother. It was a shift in philosophy away from the doctrine that each individual responsibility and the doctrine that each individual must be responsible for himself to a doctrine that some amorphous entity called society was responsible.

If a man did wrong, it wasn’t because he failed himself, but because somehow or other society had failed him. This change in philosophy which occurred over a long period might not have been effective exactly and as early as it was, except for the Great



## **More Problems Exist**

Depression which was itself produced by government mismanagement.

That Great Depression undoubtedly was the occasion for this shift in philosophy becoming embodied in actual governmental policy. It was the occasion for the acceptance by the public at large the view that all blessings flow from Washington. If there is a problem, we should turn to Washington to solve it. It is a view which unfortunately has not diminished very much over the years.

## 48. Opinion Leaders the Key

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To cite again the example just given, if you only look at the mass of nonsense which is being spoken about the oil crisis, about the gasoline problem at the moment, there seems to be a problem. What is the cry that goes up? Have Big Brother in Washington do something about it. It is that change in philosophy which fundamentally accounts for the growth of government.

This change in the role of government was midwifed by two very different groups that did the most to bring about the change and make it effective in government. They were, on the one hand, my fellow intellectuals, and on the other hand, the businessmen of this country.

Every intellectual believes in freedom for himself. Ask him whether he wants the right to speak freely, ask him whether he wants somebody to choose his research topics for him, or whether he wants somebody to tell him what job to take, and there is no doubt what answer you will receive.

But on the other hand, when it comes to other people, that is a different question. Intellectuals have been on the forefront of the groups producing an increase in the importance of government, because of their desire to limit the freedom of others.

Businesspeople, while preaching free enterprise and free markets, have in many, many cases been among

## **Opinion Leaders the Key**

the major forces which have undermined free enterprise and led to the growth of government. As I say, while believing in freedom for other people, each one thinks that he himself is indeed a special case.

## **49. Stopping Big Government**

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Time and again, you have had this unholy coalition of the do-gooders on the one side and then the supposedly hard-headed businessmen on the other, getting measures enacted which would strengthen government and reduce the area of freedom.

It really comes full circle back to my original question. Do we really have as much government spending as we have because people want it? The answer is, no. The answer is that our political institutions are so structured that there is a bias in what happens.

If somebody comes before Congress for a special program, there is a small group of people who have a very strong interest who will testify in favor of it. On the other hand, if you and I, as taxpayers, are concerned about it, which one of us is going to go to Washington to make a great effort to stop it?

Now I ask the question, can government be stopped? Can we stop this continued growth of government, this continued extension of government into a greater and greater part of our lives. The answer is, yes, it can be. How can it be? In order to stop it, we need a change of philosophy.

It cannot be stopped by complaining about wastefulness or bureaucracy. That will not stop it. It cannot be stopped by grumbling when we pay our

## **Stopping Big Government**

taxes. It can only be stopped as a result of a change in fundamental philosophy.

It can only be stopped as a result of emergence, again, of a philosophy of individual responsibility and a change in our attitude toward government, by recognizing that government is not the benevolent Big Brother. It is, on the contrary, a major source of danger to our freedoms and our liberties.

And if we have that change in philosophy, Big Government could be stopped. Again, how could it be stopped? It cannot be stopped by fighting the individual measures. You are beaten every time there. If you try to say we are going to stop it by trying to get Congress to vote against a particular tariff, for example, you are going to be beaten on this.

You cannot stop it piecemeal; you can only stop it by establishing limits to government in a constitutional form which will limit the scope and the power of government.

## 50. Rays of Hope

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If you are going to reform that income tax, you have to do it through a constitutional amendment which will change the income tax amendment, so as to say that Congress may enact an income tax provided that no deductions are permitted except strict occupational expenses and a personal exemption, and provided that the maximum rate cannot exceed the minimum rate by more than two to one.

I could go down a long list, but my main point is that we could stop government, if we have a change in philosophy, and if we proceed by adopting such self-denying ordinances.

But finally, will Big Government be stopped? Doubt it. I am an innate optimist, but I am not that optimistic. I think there are many signs of decadence and decline in our society. We note through history that golden ages have been brief; they have tended to last about 75 years, and then they have declined. We may very well be at the end of our golden age.

But there are a couple of rays of hope. Indeed, the one thing that gives some hope is the incredible inefficiency of government. That is the great saving grace. People complain about so much of that 40% going down rat holes.

I say that you should praise that, because if that 40% of our income were really being spent efficiently,

## **Rays of Hope**

our freedom would have been gone long ago. It is only because so much of it is wasted, because we get so little for our money, that it does as little harm as it does.

The other ray of hope is the spreading disillusionment with standard liberal remedies throughout this country. There is nobody who believes anymore in the standard remedies. The liberal philosophy is literally bankrupt. That is not an expression of hope; it is a statement of fact which will be granted by almost every liberal in this country.

There is not one liberal who will not agree with that statement, but although the inefficiency of government and the spreading disillusionment with standard liberal remedies are rays of hope, there is very little sign, unfortunately, that they are producing the hope of slowing down the government.

## 51. Remedy the System's Flaws

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In recent Harris polls -- the fraction of the population that thought Congress was doing a good job was even lower than the fraction that thought the President was doing a good job. Yet, what lesson do they draw? Do they draw the lesson that maybe we should give Congress less to do? Not at all.

The lesson that is drawn is that we ought to kick the rascals out and put another set of rascals in. But the people who are in are not rascals; they are good, decent people but they are operating in an environment, in institutions, and under circumstances where they are inevitably driven to pass bad laws.

What's wrong is not the men. As Karl Marx said in a different context, *"What is wrong is the system."* What's wrong is a system in which we assign the powers and the rights to government to attempt to solve the problems. What's wrong is the acceptance of the view that it is possible to solve the problems of this world with somebody else's money.

I have often said that if I could add an 11<sup>th</sup> commandment to the Ten Commandments, that 11<sup>th</sup> commandment would be a very simple one. It would be this: *"Everyone shall do good with his own money."*





## SUMMARY

### Market Socialism

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Each of us must be our own personal economist, especially in troubled financial times. We must try to understand all we can, and then try to secure our future. Let's first deal with this financial crisis on a microeconomic level for investors. *"You have a zero chance of recovering* (that is, your lost fortune in stocks) *if you sell,"* is what some brokers said repeatedly to people who wanted to move to safety, to the sidelines into Treasuries, etc., especially in the awful fourth quarter of 2008.

What those money managers were not saying, especially for the senior citizens, is that it was the money that investors would not have lost in the first place, if they had been allowed to move to safety early in the economic downturn. Investors, nobody is going to watch your money better than you. Read the fine print in contracts. What the big print giveth, the small print taketh away. *"Buy and Hold"* is seldom right in a volatile climate.

Demand explanations in writing from financial advisors as to how they plan to preserve your principal (perhaps a *"stop loss"* order at a certain percentage of decline in stocks value). A technical correction is a 10% decline in the market. A bear market is a 20% or greater decline. So, a 15% *"stop loss"* order is plausible.

## Market Socialism

If possible, invest with a company, not an individual. Check [sec.gov](http://sec.gov) or [sec.net](http://sec.net) to find out who are the rogue traders. Insist on transparency and independent, outside audits. Keep asking questions. Remember Rudyard Kipling's observation: *"I had six honest, serving men. They taught me all I knew. Their names were Where, What, When, Why, How, and Who."*

The current CEO of TIAA-CREF, and former Vice-Chairman of the Federal Reserve, stated in the Wall Street Journal last fall that *"While we expect stocks will eventually recover, we should take time to rethink how Americans achieve lifetime financial security -- and the mechanisms in place to help them do it."* Did he not strongly hint at the importance of the use of some form of *"stop loss"* orders, among other things?

The issue of energy prices has been given significant coverage herein. Let's take another brief run at the issue, before focusing more on recent developments in the global financial crisis. Frankly, those who understand well this complex situation could give thanks, rather than throwing a tantrum.

Examining the situation closer, and if we are open-minded, the news at the pump is not bad. In real terms, we still have the least expensive gas in the industrialized world. In 1930, the average pay for an hour of factory work would purchase about three

## Market Socialism

gallons of gasoline. Today, average factory worker hourly wages buy about five gallons.

Again, what really drives petroleum prices? (1) *inventory levels and replacement costs*; (2) *refinery capacity and conversion schedules*; (3) *clean air fuel mandates*; (4) *zone price marketing formulas*; (5) *exchange rates*; (6) *global spot market prices*; (7) *geopolitical fear-risk premiums*; (8) *real and manmade disasters*; (9) *buyer-seller psychology*; and (10) *supply and demand*.

How dare they have fuel prices at the pump that vary upwards of 10% to 15% at any point in time! Emotions aside, it should not be a mystery. Retailers deal with many parameters: (1) *contractual cost structures*, (2) *marketing demographics*, (3) *volume strategies*, (4) *markup ranges in competitive urban versus rural areas*. If all the gas stations charged the same price, the Federal Trade Commission would scream, “*collusion!*”

Will the reader find this writer expending his time and money, his opportunity cost of foregoing the next best use of his time and talents, driving from city to city comparison shopping and lamenting price differentials that obviously the aggregate marketplace willingly bears? Absolutely not. And, realistically, if we complain when prices go up, shouldn't we also give thanks when prices go down?

## Market Socialism

Now, on a broader macroeconomic level, and observing the global economic carnage, starting in the third quarter of 2008, the federal government had numerous options to try to jump start the economy (many are already under way):

1. *helping banks discount refinanced home loans to current owner occupants;*
2. *buying up foreclosed property;*
3. *making direct loans to homeowners;*
4. *partially taking over private companies;*
5. *tax cuts (business and personal);*
6. *injecting more money into the system;*
7. *part ownership of some U.S. banks;*
8. *broader bank insurance coverage;*
9. *compelling Fannie/Freddie to buy back, refinance subprime mortgages (they are familiar with the procedure);*
10. *direct loans to homeowners facing foreclosure;*
11. *having patience and waiting for the medicine to kick in*

Recessions aggravate federal budget deficits. Tax revenues fall as people are out of work and companies are losing money. Additionally, entitlement spending surges as the transfer payment checks go out to these individuals as unemployment benefits, etc. Forced early retirements lead to stress on the Social Security system and Medicaid, too.

## Market Socialism

Will the economic recovery be a “V” (sharp upturn), or perhaps “U” (slow, lateral ebb and flow with chronic unemployment for a few years before the upturn), or, more likely, a “W” (a recovery in the very near future which triggers a scary round of inflation which would then cause monetary authorities to raise interest rates and put a clamp on money and credit, perhaps triggering another downturn)? Time will tell.

According to the Associated Press, the new administration’s budget will have to borrow fifty cents for every dollar it spends this year. The latest stimulus package is about 70% in the form of new spending programs for, say, infrastructure. About 30% of the recent stimulus package is in the form of tax relief.

Currently, 16.5% of personal income comes to Americans from some level of government, the highest level since records were kept starting in 1930. In the early summer of 2009, the White House has estimated a current fiscal year budget deficit of \$1.8 trillion dollars. That’s an overrun of nearly 50%, and certainly a record. That projected \$1.8 trillion deficit exceeded the 2008 record deficit by 350%.

These record deficits, and the enormous increase in the money supply by the Fed in the past nine months, could, in a worst case scenario, be a compelling case of what some would call fiscal and monetary child abuse. Our children and

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grandchildren may have to pay the piper. We are, as perhaps never before in our history, creating a cauldron of inflationary pressure that is smoldering just below the surface.

In just the last year, the Fed has, among other actions, committed itself to over \$3 trillion in debt, lending funds to troubled financial institutions. Justification? Whatever it takes to avoid a deflation scenario as the 1930's Great Depression! Perhaps significant idle factory capacity and a global glut of goods can save our bacon on the inflation front.

It is true that the United States went rapidly and heavily into debt during World War II. However, that was only public sector debt. It was not compounded by a meltdown of significantly leveraged private sector debt in key housing and consumer credit markets.

In an attempt to generate more liquidity, the Federal Deposit Insurance Corporation (F.D.I.C.) is now guaranteeing broader forms of deposits -- transaction accounts of businesses (used for payroll, payables, etc.). The U.S. Comptroller of the Currency has also approved a new type of bank charter, to make it easier for private sector investors to purchase troubled banks.

Presently individual bank accounts are insured up to \$250,000, instead of the former \$100,000. Brokerage accounts are insured by the SIPC, the

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Securities Investor Protection Corporation, up to \$500,000 per customer. That doesn't guarantee the value of any financial instrument held by the failed brokerage, but rather, facilitates the investor getting these financial instruments back, whatever they are worth at the time.

It is not well-known, however, there is also an obscure organization, the Pension Benefit Guarantee Corporation (PBGC) that insures shortfalls in company pension plans that are hammered by, for example, business bankruptcies.

It ought to make us especially nervous that the Federal Reserve is spending hundreds of billions of dollars to purchase mortgage-backed securities that are supposedly guaranteed by *Fannie Mae* and *Freddie Mac* (which were, themselves, bailed out by the government last fall).

All total, the Federal Reserve, dealing with the most severe downturn since the 1930's, has a strategy to pump over one trillion dollars into our monetary system, in addition to purchasing another \$800 billion worth of mortgage backed securities. All this is designed to jumpstart an economic recovery. And it probably will. The wildcard nature of it is a potential for raging inflation beyond anything we've seen in our country's history (too much money chasing too few goods, and prices go up).



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Not everyone has bought into the ambitious stimulus package of the new administration. The U.S. Chamber stated in the Spring of 2008, *"It appears to move in exactly the wrong direction. More taxes, heavy-handed regulations, and command and control government will not hasten recovery. You do not build a house by blowing up its foundation."*

The national debt (a consequence of accumulating annual budget deficits) for the last several decades has been about 65% of each year's Gross Domestic Product (GDP). Presently, our national debt is around \$13 trillion, compared to a GDP of about \$14 trillion. The Treasury Department estimates that by 2025, our national debt will be equal to our annual production.

One of life's ironies is that the government, in an effort to pursue full employment, crowds out corporate borrowing for research and development, expansion, and consequent job creation purposes, as a result of excessive deficit spending by the government. This ties up the long-term money markets and pushes up interest rates, discouraging corporate borrowers who are attempting to create real growth and more jobs.

Let us remember that, with good cause-and-effect thinking, we should realize that the money that comes to people from government was first taken by the government from the people (less a service charge).

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Well, we have to consider the times and the agenda of our new administration. It is quite progressive. President Obama said in a speech in February 2009 that *“...we cannot successfully address any of our problems without addressing all of them...”* Candidly, that is not possible for any country, any economic system, any leader, in a world of scarcity, trade-offs, opportunity costs, etc.

Similar to FDR's *“Three R's” (Relief, Recovery, Reform)*, former Secretary of the Treasury Paulson said last fall that *“I've always said that stability is our first priority, then recovery, then repair.”* That does make some sense.

China is the key both to our recovery, our fiscal problems, and our inflation concerns. China has the money to buy machines, chemicals, steel, cement -- all of which they need. More importantly, China needs to know that the United States will keep inflation in check, or they won't buy our government debt (which we might have to pay off with cheaper dollars in the future).

Worst case? Major foreign investors, especially China, Japan and other Pacific Rim nations, decide they do not want to continue to purchase large quantities of our government debt. A deficit-triggered surge in inflation in the U.S. could result in them being paid back by us in depreciating dollars. That is a great concern to them (and us)!

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The financial crisis is an R & D problem, and the solution must be an R & D one. By R & D, I mean Republican and Democrat. At some point, we'll have to put our faith and trust in Fed chairman Bernanke, as his training has been intense in the area of analyzing financial panics and depressions, both in cause and cure. Then, candidly, why would our government throw everything possible at the financial crisis?

The carnage is global and there is a great risk of systemic failure: (1) *economic and political collapse*; (2) *a protracted depression*; (3) *a protracted downward cycle of deflation*; (4) *further loss in asset values*; (5) *investors being hammered*; (6) *retail prices tanking*; (7) *more bankruptcies*; (8) *greater foreclosures*; (9) *worse job losses*; (10) *more farms failing*; (11) *collapse of additional bundled derivative-based securities markets of questionable bond ratings (commercial real estate, the insurance industry, the reverse mortgages sector), etc. -- all baked into the cake!*

In speaking at trade association conventions, stockholders' meetings, chamber banquets, graduations, etc., if there is any one question people ask, here it is: *"Is this going to be as bad as the 1930's?"*

I always qualify my answer: *"For us, this is still 1930. Certainly we have not seen the economy of*

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*1932 -- 20% of banks failed; unemployment at 24%; GDP half what it was in 1928 (i.e., equal to what it was in 1900!). However, the causes of this global crisis are far worse than the causes of the 1929 crash and 1930's depression."*

Most economists do agree today that the Fed, in 1928, then just a teenager (born in 1913), either did too little too late, or worse, fearing a boom-bust situation, actually created it by drastically shrinking the money supply by one-third between 1928 and 1932.

Therefore, when our leaders, elected and appointed and of either party, throw everything but the kitchen sink at the problem to avoid further carnage, we have to assume they know how great the downside risk is.

In the end, if you are in a place of leadership for our country, and you worry about things getting down to a populist backlash rising up against the economic implosion, with citizens fighting in their front yards for their neighbor's last piece of beef jerky, then future inflation prospects don't look so bad in that light.

In times of idle factory capacity, depressed commodity prices, swollen inventories, chronically high unemployment, etc., those mega-budget deficits can be pushed through without triggering a significant round of inflation (yet).

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The late humorist, Will Rogers, once observed this of President Roosevelt during the proactive New Deal: *“If the White House burned down, people would at least cheer FDR for getting a fire started!”* Nevertheless, have we taxpayer/voter/investors forgotten those axioms about government that we were weaned on in school?:

*That government that governs best governs least. Government is the fallacy that everyone plans on living off everyone. Your subsidy is my tax. Government is like your stomach. When it works well, you hardly know you have it. When it doesn't work well, watch out. Government starts out like Santa Claus and ends up as Frankenstein.*

As stated earlier, but worth repeating here, America recently celebrated Abraham Lincoln's 200<sup>th</sup> birthday. Here are Lincoln's *“Economic Ten Commandments”* (distilled down from Lincoln's speeches by a clergyman named Boetcker in 1916):

- 1. You cannot bring about prosperity by discouraging thrift.*
- 2. You cannot strengthen the weak by weakening the strong.*
- 3. You cannot help small people by tearing down big people.*
- 4. You cannot help the poor by destroying the rich.*

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5. *You cannot lift the wage earner by pulling down the wage payer.*
6. *You cannot keep out of trouble by spending more than your income.*
7. *You cannot further the brotherhood of men by inciting class hatred.*
8. *You cannot establish sound security on borrowed money.*
9. *You cannot build character and courage by taking away initiative and independence.*
10. *You cannot help men permanently by doing for them what they could do for themselves.*

The perennial third party candidate, Norman Thomas, said in a speech in 1944, as he represented the Socialist Party of America, *“...American people will never knowingly adopt socialism, but under the name of ‘liberalism,’ they will adopt every fragment of a socialist program, until one day America will be a Socialist nation without knowing how it happened.”*

Welcome to *“Market Socialism,”* possibly on the road to *“State Capitalism.”* Pay your money; take your choice. Remember, if we don't learn from history, we are destined to repeat it (next semester). If Adam Smith, Abe Lincoln, and Milton Friedman were alive today, would they be rolling over in their graves? There's hardly any clearer answer since Noah said it looked like rain.

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Alas, I have known some unhappy, rich people who loved only money. I have also known some fine and decent rich people who enjoyed money, spent it, invested it, and kept making more -- all for the love of the game, not for the money itself. Other things than money were important to them.

If we keep money in perspective, earning it honestly, sharing it with the less fortunate, contributing it honorably to good causes, and investing our money to create jobs and business, then can our money be a blessing to us and others? Yes; otherwise it can corrupt us and give us great misery.

And if by hard work, study, and good judgment, we prosper others and ourselves by investing our money, shouldn't we be congratulated? Whether or not our fortune is tainted depends on how we got it and how we used it. As virtue can be its own reward, so, with a proper attitude, reward can, in some ways, be its own virtue.

We must be honest with ourselves regarding earthly riches and keep things in perspective. Then, what is the moral to all this getting and spending which consumes our lives? Here it is: *"Be Ye Careful."*

The following quotation makes this point and is titled *"WHAT CAN IT BE?"*:

## Market Socialism

*WHAT MAKES\$ U\$ RI\$E AT BREAK OF DAY,  
GULP DOWN A MEAL AND RU\$H AWAY,  
AND AT A DE\$K TILL EVENING \$TAY?  
WHAT I\$ THE GLA\$\$ THROUGH WHICH  
WE \$CAN EACH DEED, EACH PROJECT  
AND EACH PLAN, EACH \$TRUGGLE OF A  
FELLOW MAN? FOR WHAT DO WE \$ET  
HONOR BY; GIVE UP A LOVE WITHOUT A  
\$IGH; ENDURE THE HI\$\$ING AND THE  
CRY? AND WHAT, WHEN LIFE'\$ POOR  
LAMP I\$ BURNED AND TO THE \$HADOW  
WE HAVE TURNED, BECOME\$ THE  
CHEAPEST THING WE'VE LEARNED?*

The message? If the “S” is messed up on your computer, get it fixed now!

Put your financial house in order. Clean up your balance sheet (see Appendices). Do your best to secure your future. Live long and prosper; however, also try to keep a balanced perspective. Love your country; fear your government. Make your peace with your Creator on His terms, then live as to be neither ashamed of yesterday nor fearful of tomorrow. Watch. Wait. Pray.

And remember, if we adapt to change, our name will be “*Beneficiary*.” If we do not adapt to changing circumstances, our name will be “*Victim*.” It’s up to us. Worry? You can if you want. I worry a little, just to be sociable. Ben Franklin once observed that, “*If*



## Market Socialism

*a man saw ten problems coming down the road toward him, nine of them would probably fall in the ditch before they got to him.”*

So, lighten up, and keep moving; don't give the buzzards a place to land. And, always remember that despite all your noble accomplishments in life, personal and financial, the size of your funeral may be determined by the weather. If it is cold and rainy, don't look for me. We are all in this alone.

## EPILOGUE

### A Prayer to the God of Our Fathers

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Twenty years ago, I told my college-age son, “*America is a privileged nation.*” He said, “*I disagree.*” I replied, “*That’s the privilege.*”

Former Chaplain of the U.S. Senate, Peter Marshall, once delivered this Independence Day prayer. Consider his perspective:

*God of our Fathers, whose Almighty Hand has made and preserved our Nation, grant that our people may understand what it is they celebrate. May they remember how bitterly our freedom was won, the down payment that was made for it, the installments that have been made since this Republic was born, and the price that must yet be paid for our liberty.*

*May freedom be seen not as the right to do as we please, but as the opportunity to please do what is right. May it ever be understood that our liberty is under God and can be found nowhere else. May our faith be something that is not merely stamped upon our coins, but expressed in our lives. To the extent that America honors Thee, will Thou bless America and keep her as Thou has kept her free, and make her good as Thou hast made her rich.*

And all the people said, “*Amen!*”



## APPENDICES

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### Friedman's Way

By Wythe Walker, Jr., then-publisher

Arkansas Business, April 20, 1992

*After a 15-year hiatus, it was good to visit with Wythe Walker again recently. He was thrilled to know that I read his Arkansas Business article to my microeconomics students every semester, as Free to Choose is a supplemental text that is half their final exam. Wythe's article is reproduced below with permission. It is especially interesting and relevant, as Wythe's undergraduate work was primarily in humanities and psychology, not in business and economics.*

Midway through this political season, the state of the economy is all the rage. Yet, none of the candidates seem to be offering any answers. Perhaps that is why I spent last week-end watching a videotape series drawn from economist Dr. Milton Friedman's book, Free to Choose.

Friedman offers a straightforward analysis of why America continues to struggle with exploding health care costs, poor public education, overregulation and onerous federal deficits. His conclusions are simple and classically conservative: *"Let the free market work and the little people will have the most freedom and the most prosperity."*

## **Friedman's Way**

Violate these rules, let government interfere in the working of free markets, and invariably consumers won't get what they want. Their individual liberties will diminish, and big business will align with big government every time.

I find these conclusions inescapable. They match my experience as a reporter covering politicians and businessmen for the past six years. They match my experience as a publisher running a small newspaper.

Although theory never matches reality in the social sciences, Friedman's principles are as sound as those that shaped the Constitution. They focus on individual responsibility and individual liberty.

## **The Great Sea Change**

If you're under 50 like me, you don't remember the Depression, but you've felt its impact. You've grown up in a world where government has been cast in the role of the ultimate caretaker. You've assumed that Social Security, Medicare and Medicaid, and all the other paternalistic government programs are as integral to democracy as the Bill of Rights.

You probably believe that the collapse of the United States economy during the Great Depression of the 1930s was the fault of a free market economy and the greed of the monied classes. Wrong on all counts.

## **Friedman's Way**

American capitalism collapsed in the 1930s in large part because the newly created Federal Reserve monetary system (the Fed was born in 1914) tightened, instead of loosened, the money supply in the face of one banking run after another.

Big business, not big government, got the blame. Big Brother was born as a result. Before 1929, spending by government at all levels had never exceeded 12% of the national income. Federal spending averaged just 3%. Today, the total amount of government spending is 40%, with the federal government spending two-thirds of that total.

Thomas Jefferson never envisioned the federal government as a modern day father figure. Jefferson and the original framers of the Constitution were concerned about the dangers of centralized power and appropriate taxation.

Their goal was to curtail, not enhance, government power. What would they think of total government taxation that garners an average of 40 cents of every dollar earned and still runs a \$400 billion deficit?

## **Karl Marx and Me**

Karl Marx said a man's work determines his point of view. If so, then my arrival at the free market

## Friedman's Way

doorstep of Dr. Friedman is no accident. Since I became publisher of *Arkansas Business* 10 months ago, I have been thinking more and more like a businessman.

It's no surprise that I should find Friedman's paeon to the free market making all the sense in the world. Friedman's focus is on individual liberty, individual responsibility, and the role big government plays in curtailing individual liberties.

Months ago, I read Free to Choose the first time through. Next came the rereadings, the underlinings, and the note taking. A rabid Friedmanite, I am now in favor of free trade, a bare bones government structure, a Federal Reserve that keeps its hands off the economy and a tax system without loopholes, giveaways and a myriad of incentives.

Friedman is a patron saint to economists in eastern Europe. They have experienced firsthand the inefficiencies of the command economy and the psychological misery of the all-powerful state. Too bad we can't see our economic reality as clearly.

In America, we are like Britain in the 1960s, slipping further and further into socialism with the continuing growth of regulatory agencies and inflation indexed benefit programs.

## **Friedman's Way**

We complain about lower productivity growth, yet we are unwilling to take the free market steps to let the economy really grow. Asking politicians to make wild promises certainly isn't the solution.





## **50 Valuable Actions You Can Take Right Now to Make Your Enterprise Leaner, Stronger, and More Successful Than the Competition**

**by D.P. Diffine, Ph.D.**

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*Managers who take these 50 Valuable Actions will come out of any economic downturn and into the recovery stronger, leaner, and, yes, more profitable than the competition.*

1. Manage the details of the business each and every day.
2. Stay nimble and flexible; do study the competition -- they're watching you.
3. Become prepared to respond quickly to competitive opportunities.
4. Conduct business impact analysis for operational continuity.
5. Create partnerships with customers and suppliers, remaining in close contact.
6. Collaborate with other business owners on purchasing strategy.
7. Consider an acquisition of another company with a strong cash flow to the bottom line.
8. Keep costs under control, especially before times are bad.
9. Have a new respect and passion for liquidity and working capital.

## **50 Valuable Actions...**

10. Lock in credit lines early and often; be on the lookout for new capital sources.
11. Make bankers information partners and part of a strategy-making process.
12. Treat vendors as a type of banker; aging payables can improve cash position overnight.
13. Keep your legal counsel well informed at all times. Listen and learn.
14. Concentrate on markets in which you have a distinct advantage.
15. Think long and hard about both product abandonment and product development.
16. Take advantage of small company agility to enter and exit markets.
17. Develop market segments that your larger competitors consider too small.
18. Do everything possible to be a hero to your customers.
19. Boost sales to existing customers through offering add-ons.
20. Use after-sales service to solidify your relationship with customers.

## **50 Valuable Actions...**

21. Develop contingency plans for a significant reduction in sales.
22. Keep sales revenue profitable; the goal is profits, not market share.
23. Eliminate excessive inventories through just-in-time manufacturing; don't over-do it.
24. Carefully implement pricing strategy with an eye toward ongoing cost-benefit analysis.
25. Be sure that investment in info-tech doesn't lag behind, even for old-economy companies.
26. Trim those insurance costs by eliminating overlapping coverage wherever possible.
27. Cut travel costs by instituting a per diem travel allowance incentive plan.
28. Analyze and pare back utility costs, without sacrificing the mission.
29. Initiate a capital audit to learn where idle capital is tied up in the business.
30. Stop capital projects unless operational efficiency or cost reduction would be greatly impaired.
31. Depreciate assets aggressively and to the maximum allowed by accounting methods.

## **50 Valuable Actions...**

32. Sell underused assets, refunding proceeds to shareholders through stock buybacks.
33. Convert your budget process from a bottom-up to a top-down, fast-tracking the outcomes.
34. Review the company's tax planning strategies in light of a weak economy.
35. Improve your cash flow by consistently annualizing estimated taxes.
36. Take advantage of government-sponsored employment incentives for business.
37. Get out of a bunker mentality, and get more involved than ever.
38. Make sure to communicate the CEO's presence and commitment to any plan.
39. Communicate to employees in a climate of mutual respect and consideration.
40. Regularly ask your people for advice, and follow through whenever possible.
41. Encourage and reward new ideas and suggestions from your employees.
42. Integrate your key personnel directly into company operations and strategy, to reduce turnover.

## **50 Valuable Actions...**

43. Keep confidential list of employees ranked by contribution. Categorize A, B, or C. Tough decisions may await you.
44. Keep a list of past applicants who would have been hired if openings had existed.
45. Never lay off people in any department who are key players in customer service.
46. Fully staff key positions to give added strength to compete.
47. Shorten the work week, to warehouse a trained work force for the coming recovery.
48. When absolutely necessary, make salary reductions across the board, to try to keep morale from deteriorating.
49. Provide stock option plans for effective and loyal employees who tough it out.
50. Never underestimate what your employees can do for you or to you.

**Remember -- Do not ever forget these 50 Valuable Actions during the next round of good times!**



## Some Good Tips

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*Nothing contained herein is to be construed as advice for the individual investor whose circumstances merit advice and counsel from trusted investment professionals, tempered with issues of age, safety, growth plans, income goals, risk-averse attitude, time frame, retirement plans, taxes, etc. -- D.P.D.*

Treasury Inflation-Protected Securities (TIPS), especially in a TIAA/CREF context (explained earlier), can be one option for some during times of uncertainty:

1. TIPS are inflation-linked Treasury Bills guaranteed by the U.S. Government.
2. Sources of TIPS earnings (returns) are typically as follows:
  - Semi-annual interest payments;
  - Inflation adjustments (CPI-linked); and
  - Price appreciation/depreciation due to changes in “real” interest rate (i.e., removing effects of inflation or deflation).
3. Historically, when many other securities fall, Treasury Bills rise.
4. TIPS, a valuable tool, are specifically designed to provide a substantial rate of return in inflationary times.



## **Some Good Tips**

5. Somewhat unique regarding time horizons and safety concerns, TIPS is designed with the specific goal of long-term gains keeping pace with inflation.
6. The U.S. Treasury guarantees TIPS' published rate at purchase, plus the inflation rate which is Consumer Price Index (CPI) adjusted semi-annually.
7. Predictably, TIPS interest earnings fluctuate based on inflation-adjusted principal.
8. Deflationary times do not reduce TIPS principal payments.
9. In deflationary times, TIPS principals remain at par value until maturity.
10. Over their life, TIPS have consistently constant coupon rates.
11. The probability of protracted deflation, which could reduce TIPS yields, is low.
12. Regular purchases over time (dollar-cost averaging) can reduce uncertainty about short-term CPI swings over time.

## **Some Good Tips**

13. Changes in real interest rates drive the valuation in TIPS' principal (inverse relationship).
14. TIPS real, after-inflation returns are guaranteed, as principal is adjusted to changes in CPI.
15. TIPS are exempt from state and local taxes (unlike similar corporate offerings).
16. Investors can count on TIPS to pay interest semi-annually.
17. TIPS were first launched by College Retirement Equities Foundation (CREF) in 1997.
18. They are the only CREF-sponsored bonds that CREF offers, amid a sea of equities.
19. The CREF TIPS Fund track record has been significantly better than Teachers Insurance and Annuity Association (TIAA) Traditional (e.g., Treasury Bills) Accounts.
20. Only 10% per year of TIAA Traditional Bonds can be moved out of TIAA and into, for example, CREF Accounts.

## **Some Good Tips**

21. CREF TIPS are not bound by TIAA restrictions regarding shifting or withdrawals.
22. With an openly “easy money” Fed policy (pushing more “liquidity” into and through the system), TIPS could be of increasing interest to investors.
23. TIPS are sold by the U.S. Treasury in \$100 increments.
24. Maturity wise, TIPS are sold in increments of 5-, 10-, and 20-year bonds by the U.S. Treasury. For more information, see [www. publicdebt. treas.gov/sec/sectrdir.htm](http://www.publicdebt.treas.gov/sec/sectrdir.htm) or 800-722-2678.
25. A direct purchase of TIPS without a fee can be done from the U.S. Treasury ([www.treasury.gov](http://www.treasury.gov)). Fund families with TIPS-related accounts are growing.

**Remember: Investigate Before You Invest!**

## ACKNOWLEDGEMENTS

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This book is a logical consequence of a 48-year professional career in economics, America's financial crisis, and recent monographs on the ever-changing carnage, written in *The Entrepreneur* by the author: "KABOOM: A Primer on the Housing, Credit, and Securities Bust" (October 2008) and "DOWNDRAFT: The Economics of Deleveraging in Turbulent Times" (January 2009).

*The Entrepreneur* itself is a quarterly journal addressing contemporary economic issues from a moral perspective. One may not agree with every word printed therein, nor should he feel he needs to do so. It is therefore hoped that the reader will think about the points laid out in the book, and then decide for himself. Hopefully, the material herein will motivate people to further study and also toward a greater understanding of God's will on life's stewardship issues here on Spaceship Earth.

In this book, as in the expository monographs, many sources have been consulted in the preparation of this material. The References section enables those who desire further study to consult these sources. If any such acknowledgements have been inadvertently omitted, the author would appreciate receiving information, so that proper credit may be given in any future printings.

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Care has been taken to trace the details of specific events and fast-moving trends. Every effort has been made to include only reliable information and trends, and yet present it in a way that will not quickly date this book. The author would welcome knowing about any possible errors in content. Otherwise, enjoy!

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## ABOUT THE AUTHOR

Dr. Don Diffine is currently Professor of Economics at Harding University in Searcy, Arkansas, and Director of the Belden Center for Private Enterprise Education. Senior Research Associate of Harding University's American Studies Institute, Dr. Diffine is listed in the Heritage Foundation's Guide to Public Policy Experts. He has 11 books and 23 monographs in print.

Dr. Diffine has provided Congressional testimony on business problems, economic impact statements, and inflation-recession dilemmas. He is a three-term member of the Governor's Council of Economic Advisors (1998-2011). Also a member of the International Platform Association and an economic humorist, he is a frequent speaker for conventions, management clubs, stockholders' meetings, trade associations, and chambers of commerce.

The recipient of the 1981 Leavey \$7,500 Freedoms Foundation Principle Award for Excellence in Private Enterprise Education, Dr. Diffine has received 16 additional Freedoms Foundation awards in the categories of Non-profit Publications, Economic Education, Public Affairs-Advertising, Public Address, and Published Works. He is the 1982 faculty winner of a \$1,000 First Place prize in a national essay contest judged by Nobel Economist Dr. Milton Friedman.

He received the "Champion of Enterprise" award in 1995 from the Students in Free Enterprise Hall of Fame in Kansas City. The First Annual Distinguished Scholar Award was also presented in 1998 to Dr. Diffine in Cleveland, Ohio, by the Association of Private Enterprise Education. In 2000, Diffine was inducted into the Samuel Moore Walton Free Enterprise Hall of Fame.

Dr. Diffine's wife, Dion, is from Kailua, Hawaii. She is a retired math teacher, Searcy Public Schools. The Diffines have two children: David, a medical doctor; and Danielle, an accountant. Four wonderful grandchildren -- Katie Elizabeth, Ridge Tyler, Lillie Ann, and Piper Dion -- round out the family tree and give him both a reason to live and a heightened focus about the long run future of our American incentive system.

## False Profits

An Economics Primer About Americans  
"Going for Broke" and Nearly Making It

America's present financial carnage has "*R & D*" causes; it needs cooperative "*R & D*" solutions. "*R & D*," means "*Republican and Democrat*." Let's get party labels off the table and examine things objectively. There is plenty of blame to go around.

Has there been any time in history when government could successfully spend private sector money (*by first taxing it*), borrow the difference (*deficit spending*), and crowd out private sector long run borrowing (*causing higher interest rates*) — all to try to bring about growth, economic recovery, jobs, and stable prices? Should we worry that our government's ambitious spending plans could be like the proverbial drunken sailor squandering his paycheck on leave? At least it was his own money!

Will America's economic recovery be a "*V*" (sharp upturn), or perhaps "*U*" (slow, lateral ebb and flow with chronic unemployment for a few years before the upturn), or, more likely, a "*W*" (a recovery in the very near future which triggers a scary round of inflation which would then cause monetary authorities to raise interest rates and put a clamp on money and credit, perhaps triggering another downturn)? Time will tell.

Worst case? Major foreign investors, especially China and Japan, decide they do not want to continue to purchase large quantities of our government debt, as a deficit-triggered surge in inflation in the U.S. could result in them being paid back by us in depreciating dollars. That is a great concern to them (and us)!

Remember Margaret Thatcher? "*The problem with Socialism*," she said, "*is that, sooner or later, we run out of other people's money...*"

D. Diffine