Research Reports

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RESEARCH REPORTS

AIER publishes over 100 articles per month that are distributed in digital form. Research Reports contains Business Conditions Monthly plus 10 of the most representative, chosen here for popularity, variety, and relevance. These articles are often reprinted in venues around the web, including Seeking Alpha, Intellectual Takeout, Mises Brasil, and dozens of other outlets. To read all of them, go to www.aier.org

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Business Conditions Monthly

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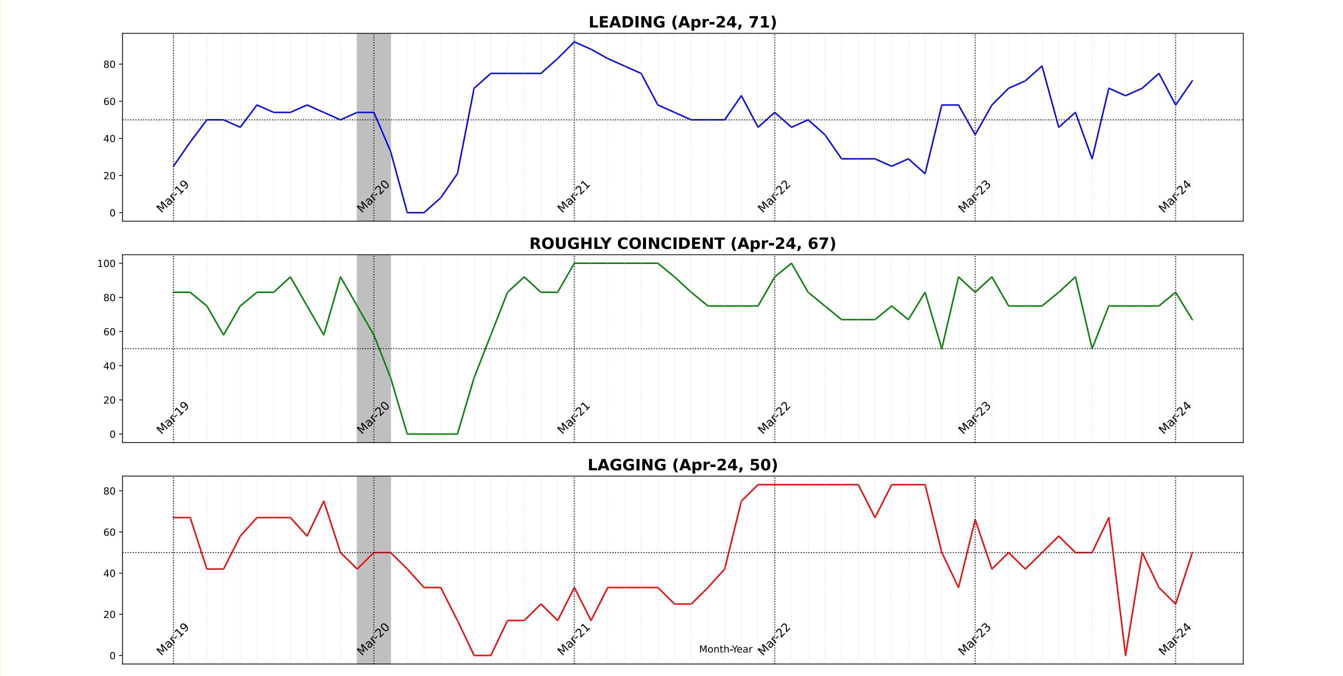
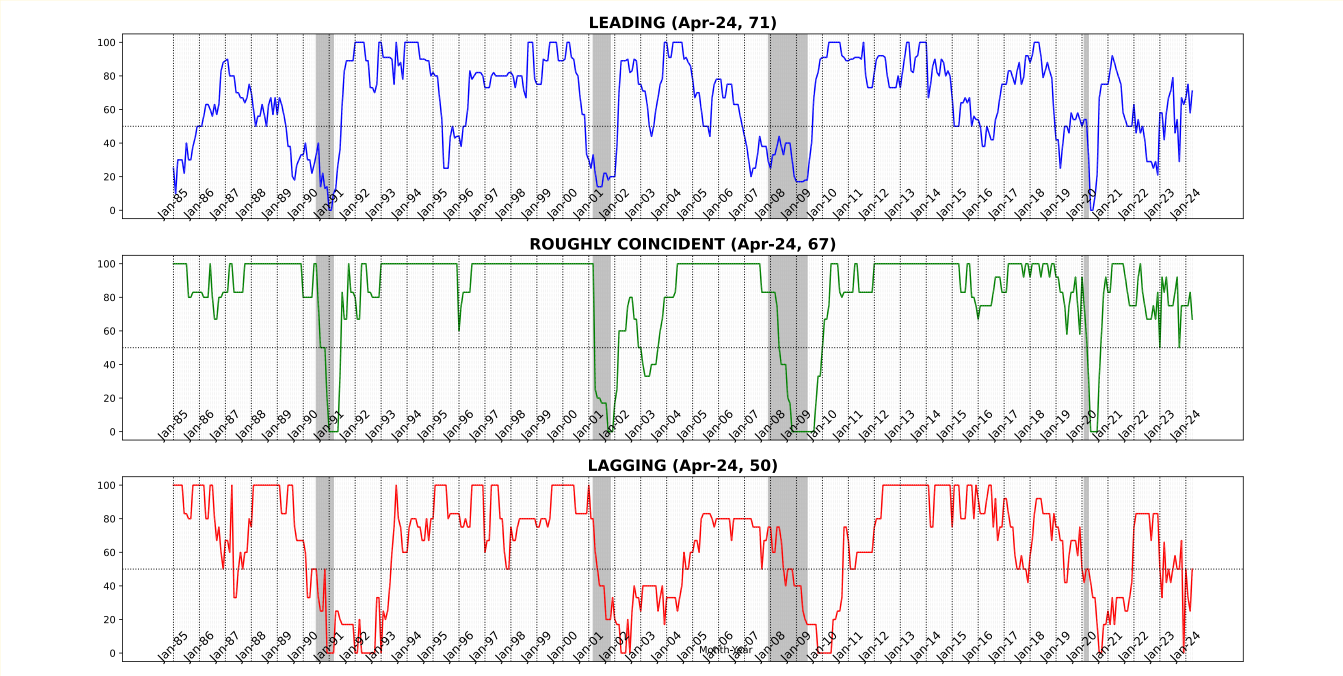
Senior Research Fellow

In April 2024, the AIER Business Conditions Monthly Leading Indicator rose back to the expansionary levels where it has lingered since November 2023 after declining to near-neutral levels (58) in March 2024. The Roughly Coincident Indicator declined to 67, its lowest reading in six months (back to October 23). And the Lagging Indicator rose to 50, returning to neutral levels after spending three of the last five months in contractionary territory, including the zero reading in December 2023.





(Source: Bloomberg Finance, LP)

Leading Indicator (71)

Among the twelve components of the Leading Indicator from March to April 2024: seven rose, two were neutral, and three declined.

The rising components within the Leading Indicator included the 1-to-10 year US Treasury spread (**31.4 percent**), United States Heavy Trucks Sales (**13.5 percent**), US Initial Jobless Claims (**5.9 percent**), US New Privately Owned Housing Units Started by Structure (**5.7 percent**)

the Conference Board US Leading Index Manufacturing, New Orders, Consumer Goods and Materials (**0.4 percent**), US Average Weekly Hours All Employees Manufacturing (**0.3 percent**), and the Conference Board US Manufacturers New Orders Nondefense Capital Good Ex Aircraft (**0.1 percent**). Adjusted Retail and Food Service Sales and the Inventory/Sales Ratio: Total Business were neutral. FINRA Customer Debit Balances in Margin Accounts fell by **1.1 percent**, as did the Conference Board US Leading Index of Stock Prices (**-1.1 percent**), and the University of Michigan Consumer Expectations Index (**-1.8 percent**).

The Leading Indicator indicates continued economic expansion, albeit with intermittent contractions. Beginning in mid-2023, growth was robust, followed by a dip but with a recovery towards the end of the year and into early 2024. The 71 level indicates the continuation of the upward trend in leading indicators of growth in April 2024.

Roughly Coincident (67) and Lagging Indicators (50)

The Roughly Coincident Indicator, which at 83 reached its highest level since September 2023. Three components rose, two were neutral, and one declined. The Conference Board's Coincident Personal Income Less Transfer Payments rose **0.3 percent**, its Coincident Manufacturing and Trade Sales were up **0.2 percent**, and US Employees on Nonfarm Payrolls increased by **0.1 percent**. Industrial Production and the Labor Force Participation Rate were neutral. The Conference Board Consumer Confidence Present Situation Index declined **4.2 percent**.

Meanwhile, the Lagging Indicator saw three rising and three falling components in April 2024. The Conference Board US Lagging Avg Duration of Unemployment, US Manufacturing and Trade Inventories, and the Conference Board US Lagging Commercial and Industrial Loans rose by 7.8, 0.3, and **0.3 percent** respectively, Both the Census Bureau's Private Construction Spending (Nonresidential) and US Commercial Paper Placed Top 30 Day Yields fell by **0.3 percent**, with the core CPI year-over-year felling **5.0 percent**.

The Roughly Coincident Indicator has seen sustained economic expansion over the 12 months from April 2023 to April 2024, despite a brief decline to neutrality in October 2023. Despite some volatility, the April 2024 of 67 suggests moderate but slowing expansion compared to the previous peaks. The Lagging Indicator, meanwhile, continues to depict volatile signals, with periods of stability around the neutral mark and sporadic shifts into contractionary and expansionary states. The significant dip in December 2023 to 0 indicates a sharp contractionary sign, even though followed by a return to neutral levels in April. It is difficult to extract meaningful information from swings in trailing markers of improvement and deterioration, especially when generally at odds with the Leading and Roughly Coincident Indicators.

Discussion

In May, consumers continued to exercise caution, limiting spending for the second consecutive month as high borrowing costs tightened budgets. Despite modest gains in retail sales, with a **0.1 percent** rise that fell short of expectations, shoppers increasingly turned to online deals to manage expenses. Notably, control-group sales rebounded by **0.4 percent**, reflecting a strategic approach to budget allocation, although spending on food services dropped by **0.4 percent**, indicating a strain on consumer finances. This trend suggests that, despite occasional spending boosts, the overall consumption leeway remains constrained by ongoing financial pressures.

In mid-June, consumer sentiment deteriorated as concerns over high prices persisted, with lower-income households feeling the most significant impact. The latest economic data indicates a pushback against price hikes, contributing to disinflation across various goods and services in May. The University of Michigan's preliminary consumer sentiment index for June dropped to a seven-month low of 65.6, below expectations. Both current conditions and future expectations saw declines, and while year-ahead inflation expectations remained steady at **3.3 percent**, long-term expectations increased slightly to **3.1 percent**. Middle-income consumers are also expressing concerns about tight budgets, highlighting ongoing financial challenges despite a strong labor market.

The Philadelphia Fed survey indicated minimal change in business activity for June, with the headline index dropping to 1.3, below expectations of 4.5. The survey highlighted growing inflation concerns as indexes for both prices paid and received increased. Future activity expectations also fell sharply to their lowest level since February. In contrast, the New York Fed's Empire survey showed an anticipated increase in business activity, suggesting regional differences in economic outlook.

After significant increases in the previous two weeks, jobless claims remained elevated during the survey week for the June employment report. We anticipate continued cooling in labor-market conditions due to a decrease in labor demand and an increase in the supply of available workers. Initial claims for unemployment insurance for the week ending June 15 decreased by 5,000 to 238,000, slightly above the consensus estimate. Non-seasonally adjusted claims dropped more significantly than expected, indicating fewer claims compared to the same period last year. Continuing claims rose to 1,828,000, with the insured unemployment rate holding steady at **1.2 percent**. We still project the U-3 unemployment rate to reach or exceed **4.2 percent** by September, with workers experiencing longer durations of unemployment.

May's jobs report revealed conflicting signals about the labor market, with the establishment survey showing significant nonfarm payroll gains while the unemployment rate, based on the household survey, rose to **4.0 percent**. We believe the household survey offers a more accurate picture, suggesting that the true pace of job growth is likely under 100,000 per month due to an outdated BLS model that overstates job creation amid rising business closures. Despite robust hiring in sectors like health care and leisure, the number of full-time jobs and the labor force declined, signaling deeper issues in the job market.

The divergence between the household and establishment surveys highlights the challenges in interpreting labor market conditions accurately. With jobless claims remaining elevated and the unemployment rate climbing, there are signs of increasing economic stress despite headline payroll numbers suggesting growth. The household survey indicated a significant drop in employment, underscoring the risk that nonfarm payrolls are overstating labor market strength. As a result, we expect the unemployment rate to rise, possibly reaching **4.5 percent** by year-end, which could prompt the Fed to consider rate cuts sooner than anticipated.

Wage growth accelerated in May, with average hourly earnings increasing by **0.4 percent**, primarily driven by gains in the services sector, such as leisure and hospitality. The jump in wages, alongside steady weekly hours, suggests a rise in aggregate labor income, providing some support for personal income growth. However, the overall increase in the unemployment rate and the decrease in labor force participation among older workers indicate a mixed economic outlook, with financial markets now adjusting their rate-cut expectations accordingly.

The Federal Open Market Committee's (FOMC) latest dot plot suggests a more hawkish stance, with many members believing that interest rates need to remain elevated for an extended period to curb inflation back to the **2 percent** target. While

Fed Chair Jerome Powell remains skeptical about the current policy being restrictive enough, he acknowledges that inflation is still higher than anticipated and that the labor market does not necessitate immediate rate cuts. Despite differing views, we expect economic conditions will lead to two rate cuts this year, in September and December, as growth indicators have been weaker than expected and consumer spending shows signs of faltering.

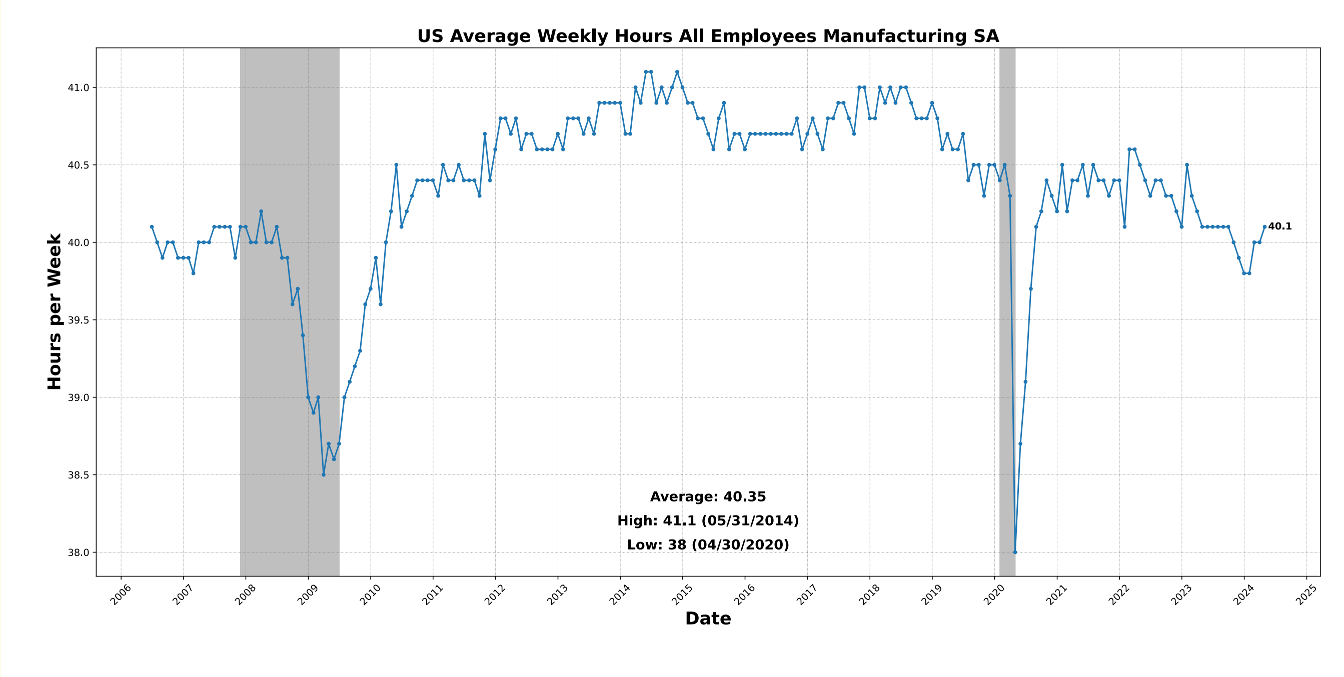
At the June meeting, the FOMC decided unanimously to maintain the target interest rate range at 5.25 to 5.**50 percent**. The policy statement indicated that price pressures are moderating, and while the committee now anticipates fewer rate cuts in 2023 than previously projected, there is a debate among members on the number of cuts required. Cleveland Fed President Loretta Mester's departure and her replacement's unknown stance add to the uncertainty. The upward revision in the neutral rate forecast reflects the committee's growing belief that current rates might not be as restrictive as needed, which could influence future rate decisions.

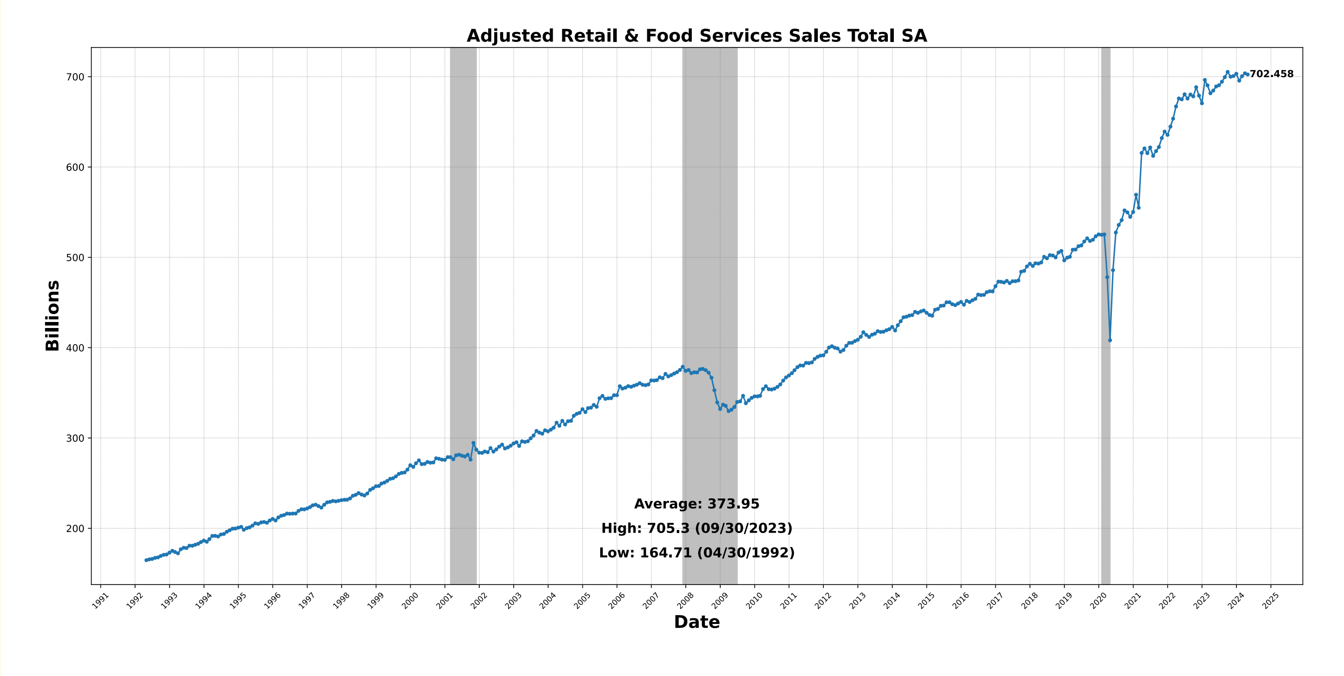
Economic projections from the FOMC show a modest upward revision in the inflation forecast for 2024, with core PCE inflation expected to be **2.8 percent**, slightly above previous estimates. Despite this, Powell's commentary at the news conference suggested a more dovish outlook, emphasizing the need to monitor upcoming inflation reports closely. The median FOMC member now foresees only one rate cut this year, with a more significant reduction anticipated in 2025. Markets continue to price in the possibility of rate cuts starting in September, indicating ongoing uncertainty about the economic trajectory and the timing of the Fed's response.

A brief word on US equity prices: after a rally to all-time highs in mid-June, US stocks experienced a brief pullback amid signs of buyer fatigue and concerns about overvaluation. The S&P 500 briefly surpassed 5,500 before slipping, although it remains above key technical levels. Despite bullish momentum, the market shows signs of near-term vulnerability due to overbought conditions and a narrowing leadership, with tech giants like Nvidia and Apple driving most of the recent gains. Equity valuations have moved into extreme levels on a historical basis, suggesting a limited forward return profile for new money. While the broader economy remains robust with optimistic earnings expectations, high valuations and concentrated market leadership leave equities susceptible to larger pullbacks if the economic backdrop weakens, particularly in employment, or should expectations for continuing disinflation be unmet. Gold has remained stable following the release of the aforementioned US economic data, which have clouded the six month- to one year-outlook on the degree and timing of a potential Federal Reserve policy shift to easing.

The May – June 2024 economic data suggests a continuing normalization from the pandemic period. The road ahead remains uncertain, though, with potential outcomes ranging from a slow, steady economic rebalancing to sluggishness or even a recession. The Federal Reserve, having kept rates steady in its recent meeting, remains cautious, forecasting fewer rate cuts for 2024 amidst mixed signals of slowing inflation and elevated unemployment. Our view of the economic outlook for the remainder of 2024 is similarly cautious, hinging on monetary policy (and relatedly, the near-term path of the general price level); the pace of flagging consumer wherewithal; the health of US labor markets; and growing trepidation around the November US presidential election.

Leading Indicators





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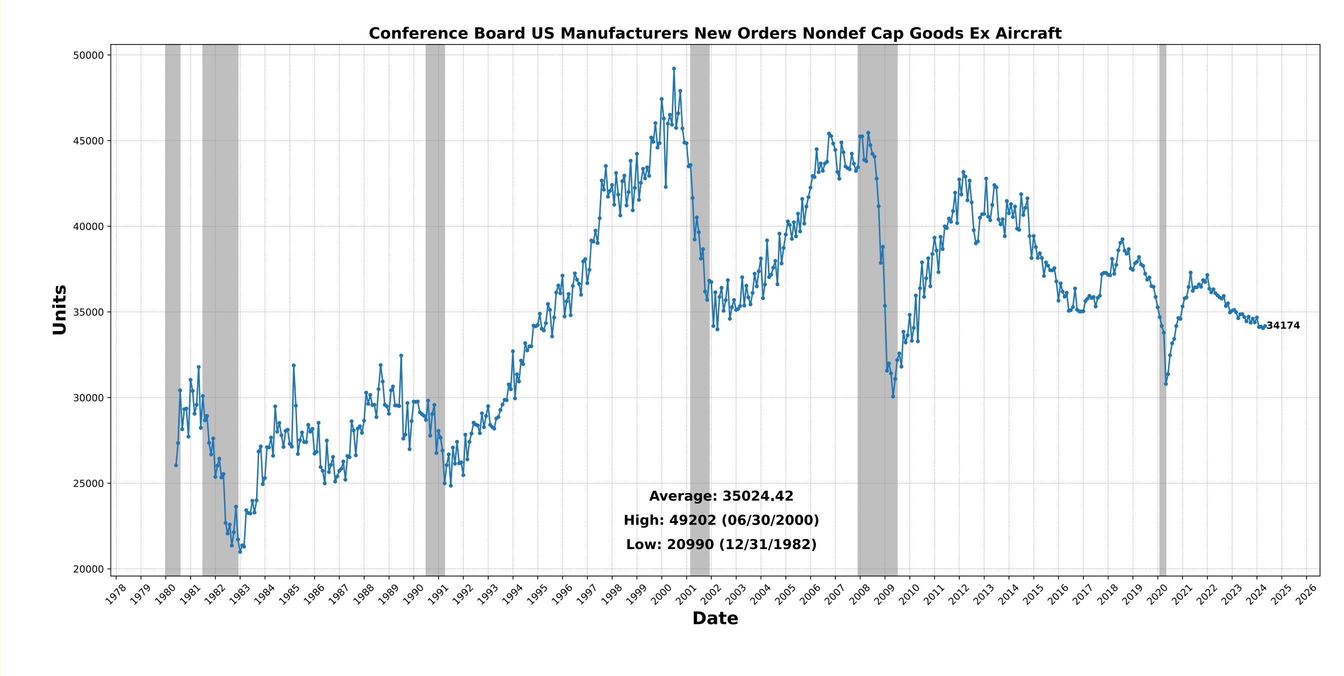

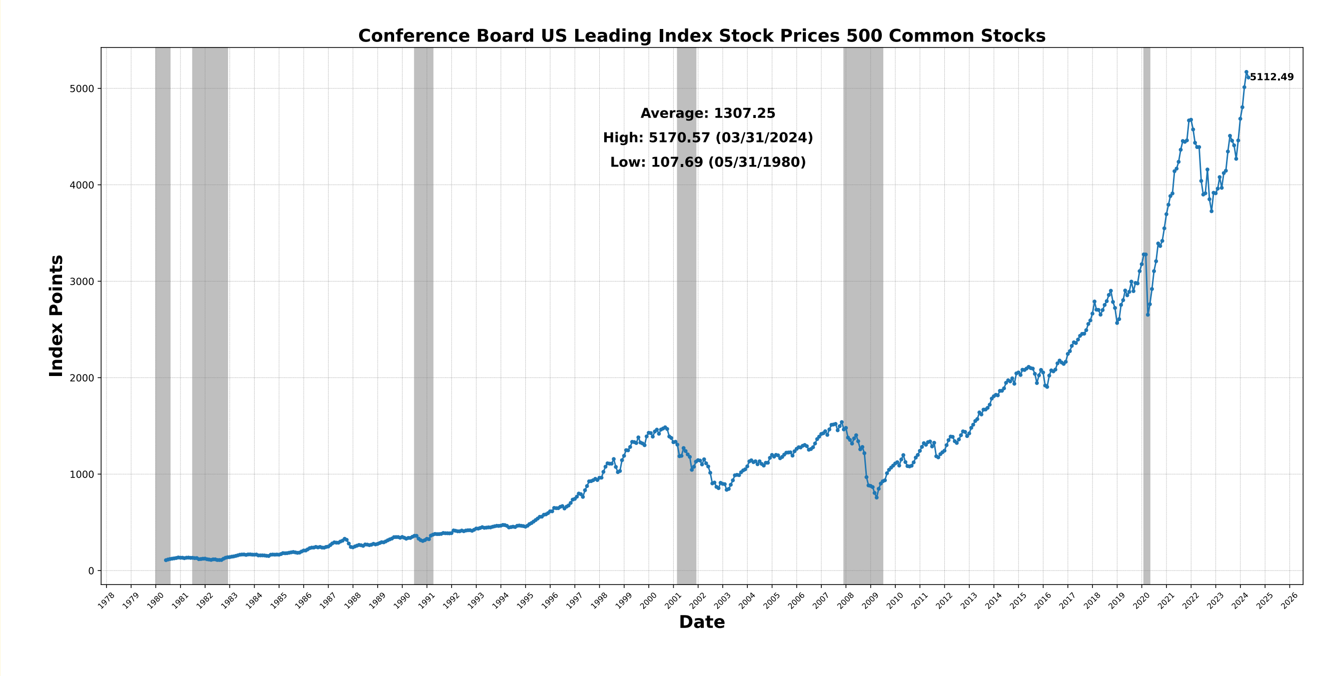

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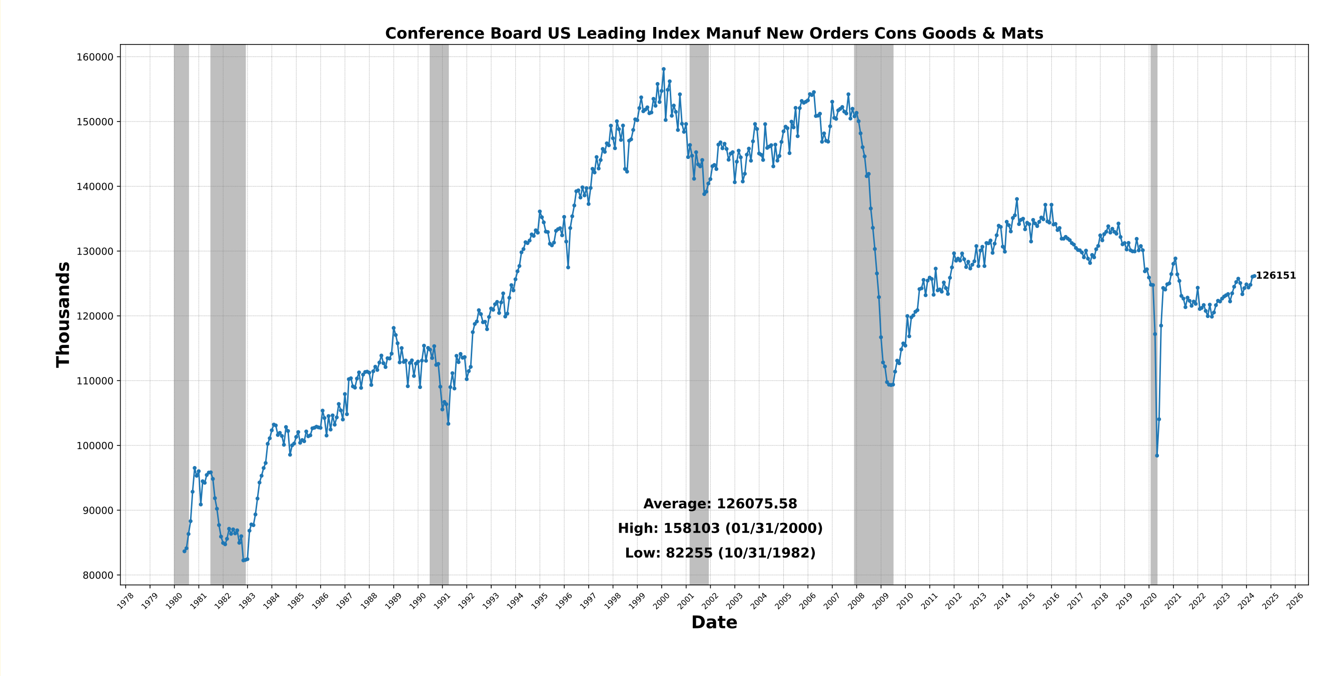

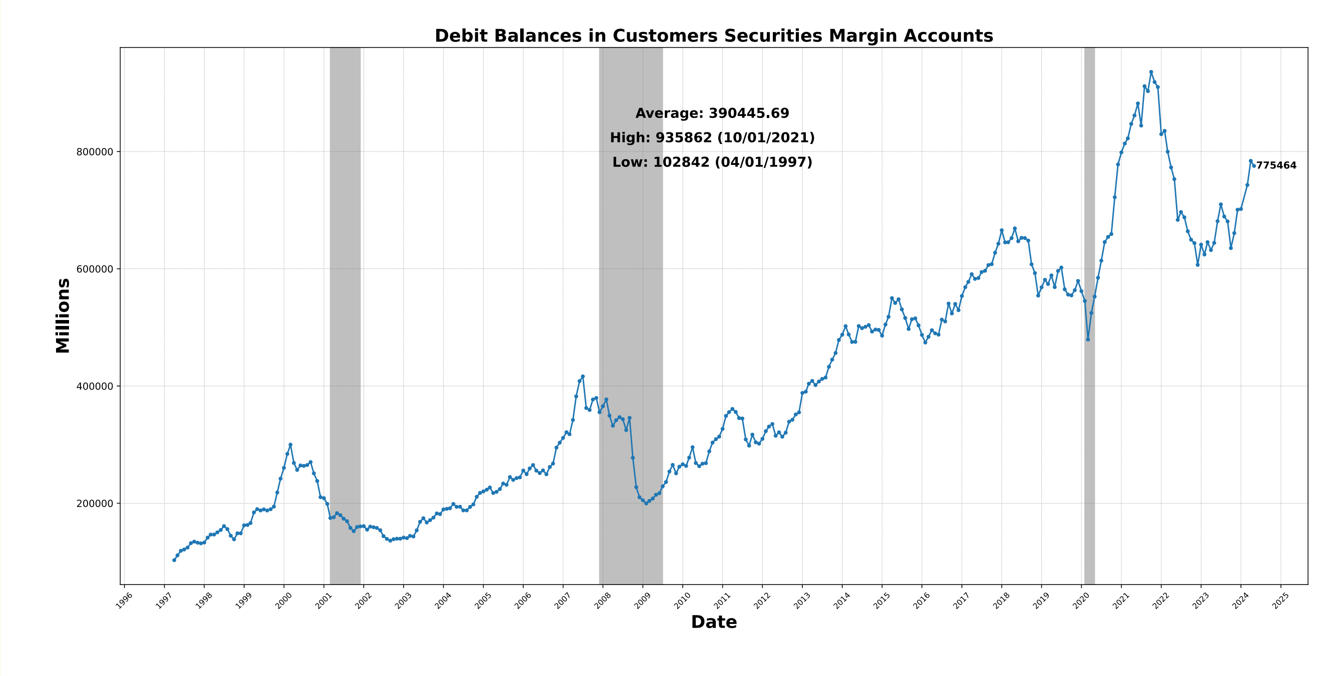

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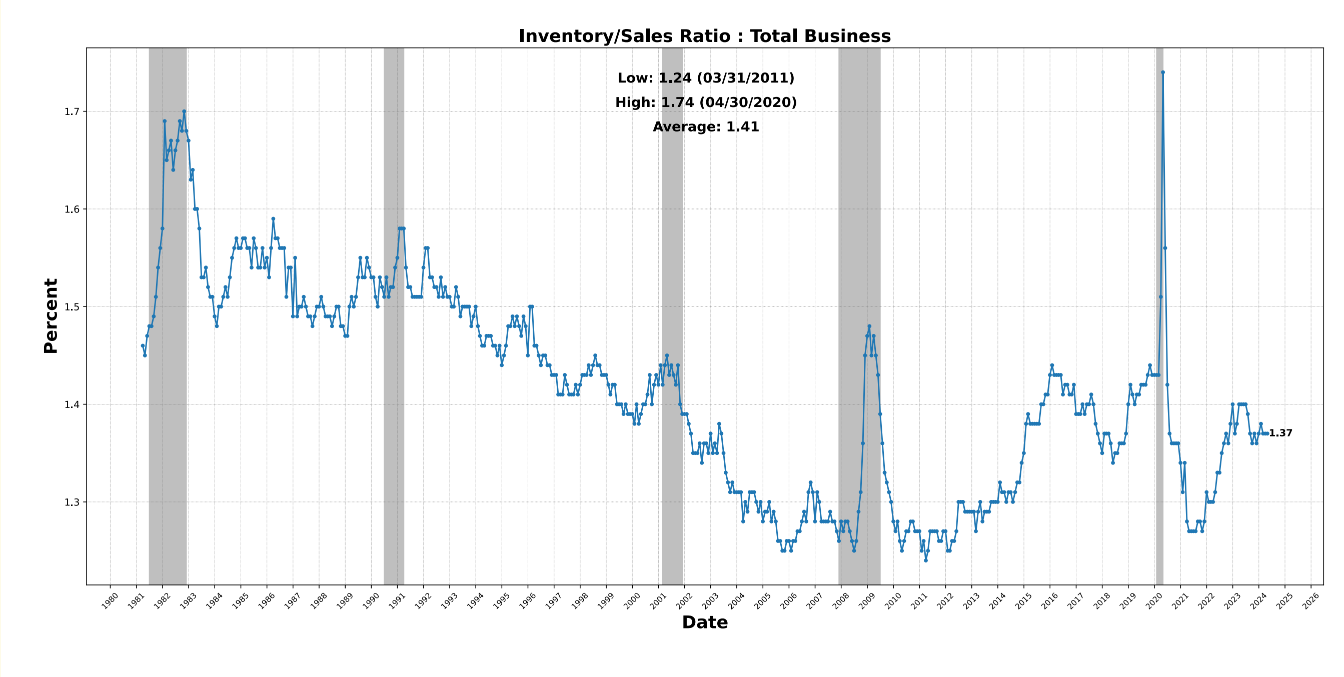

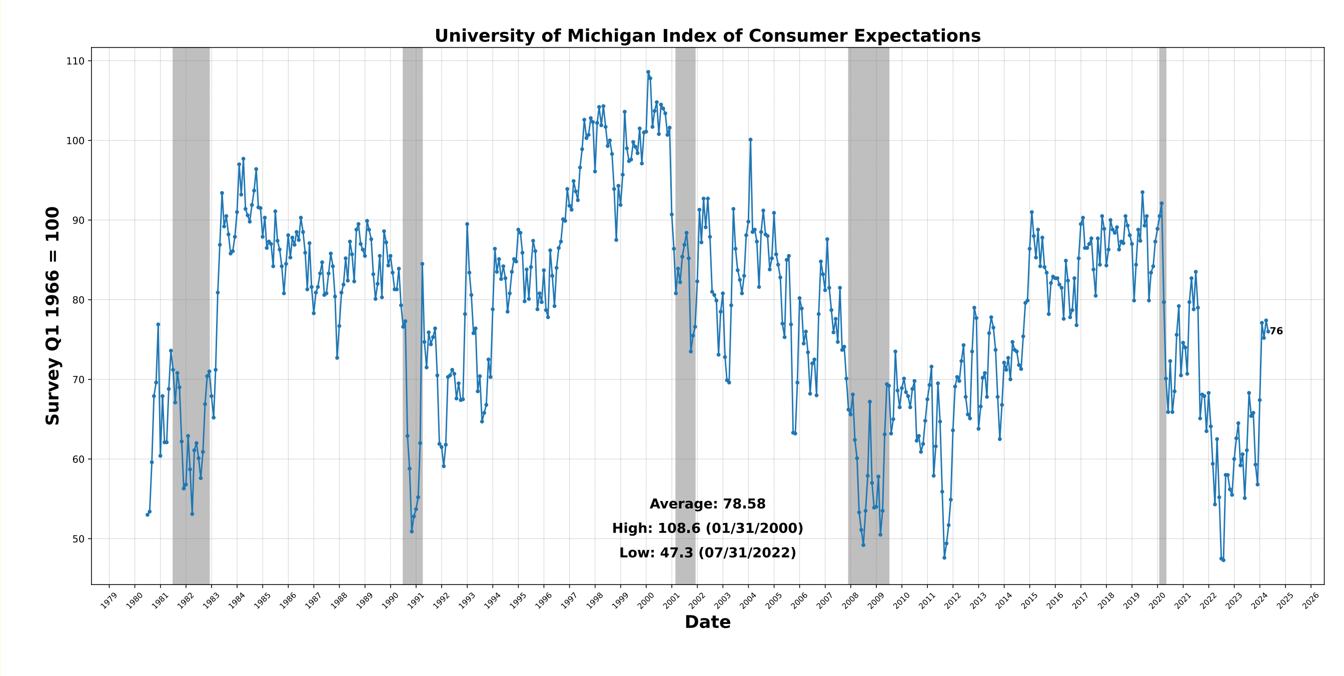

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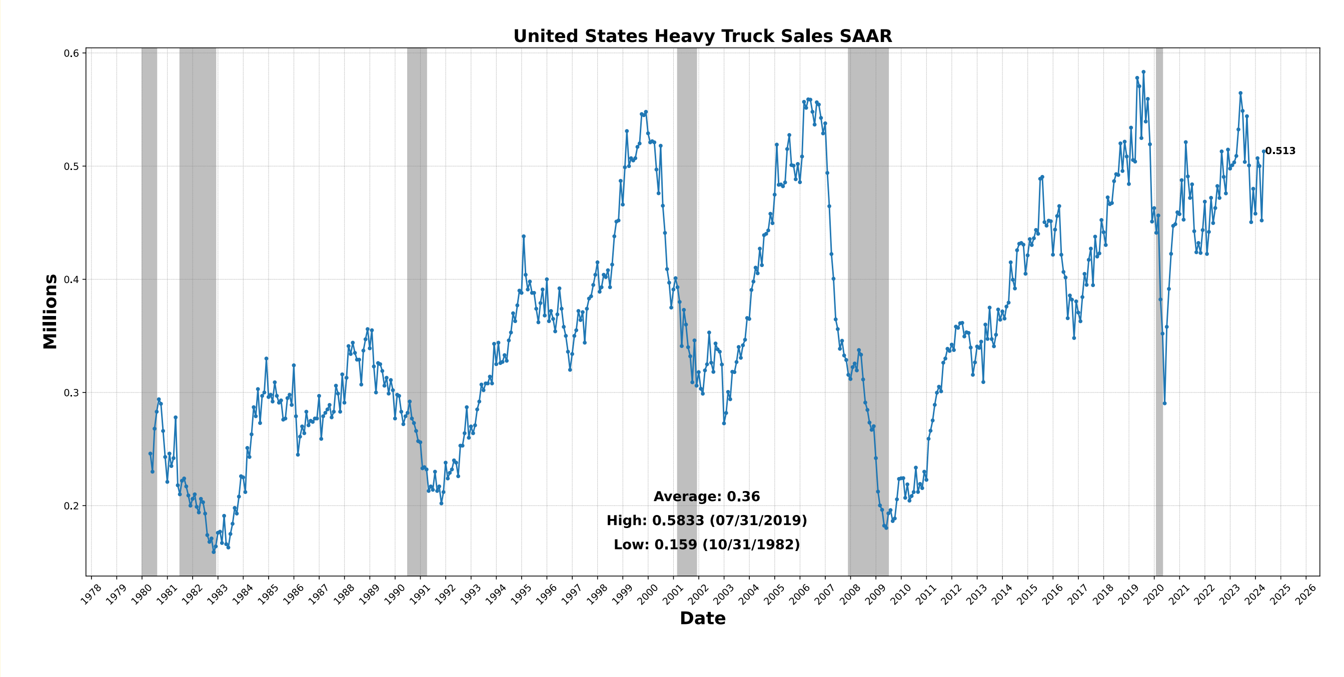

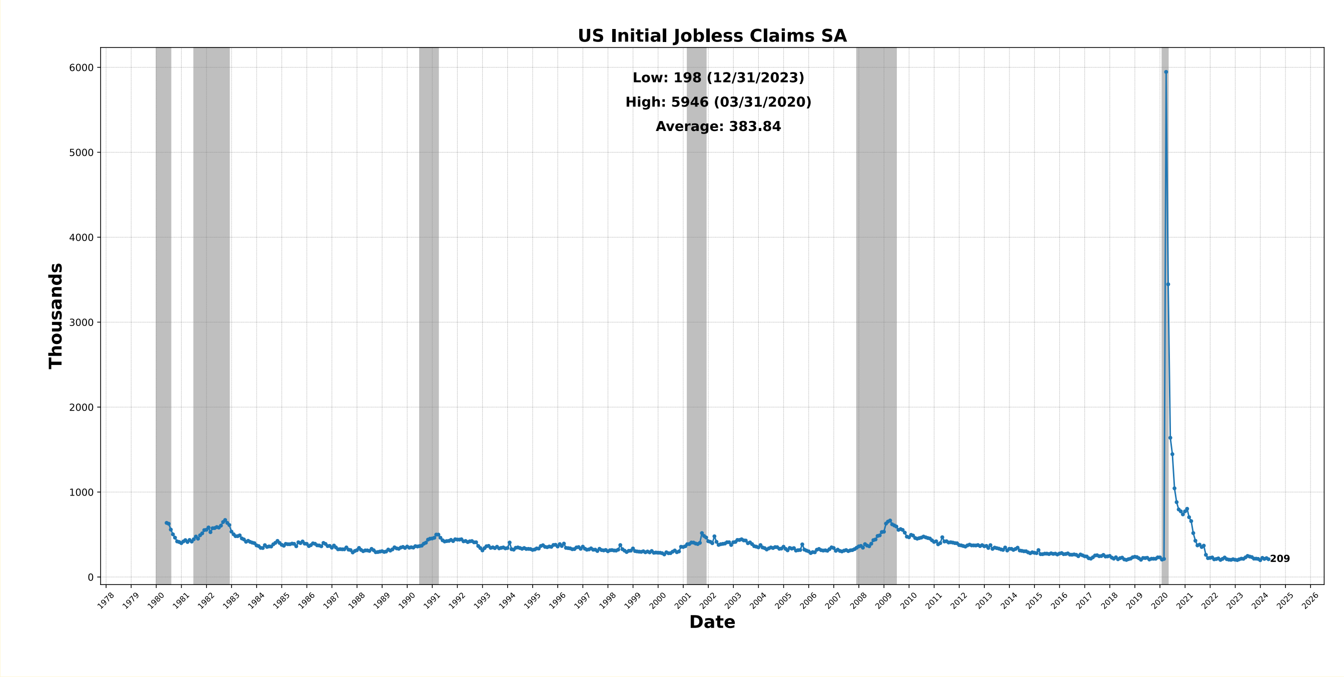

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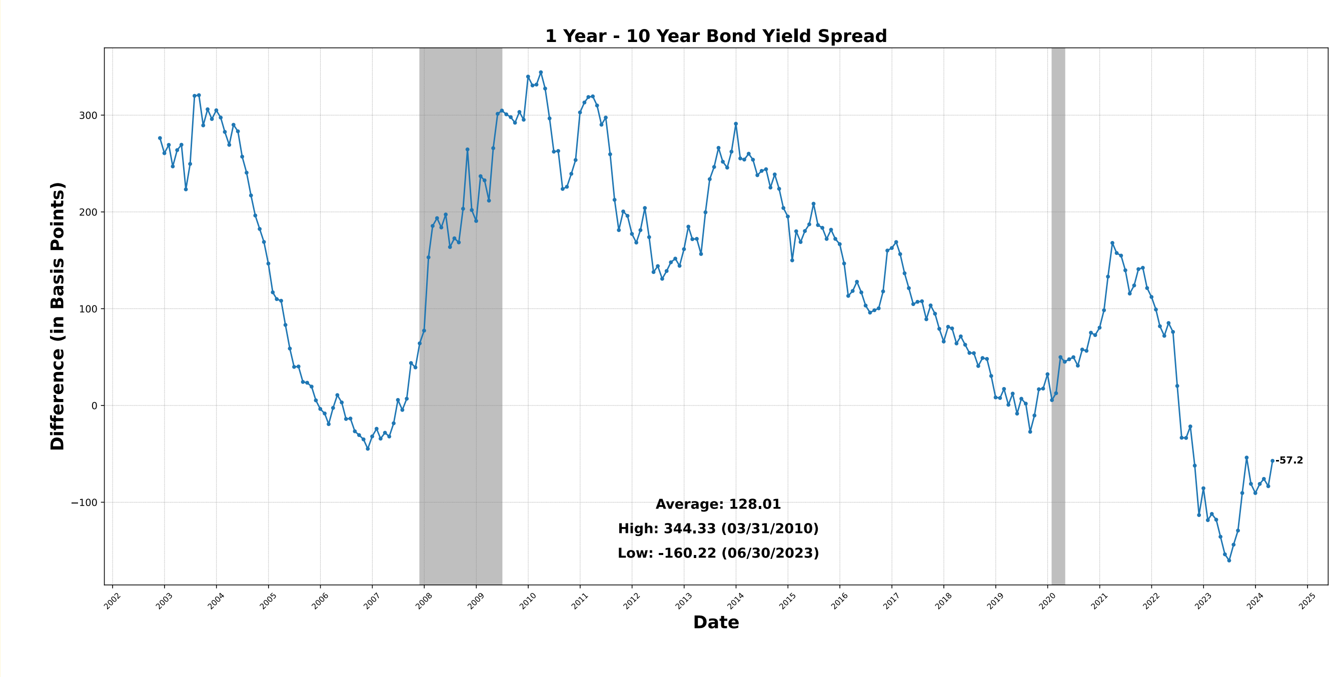
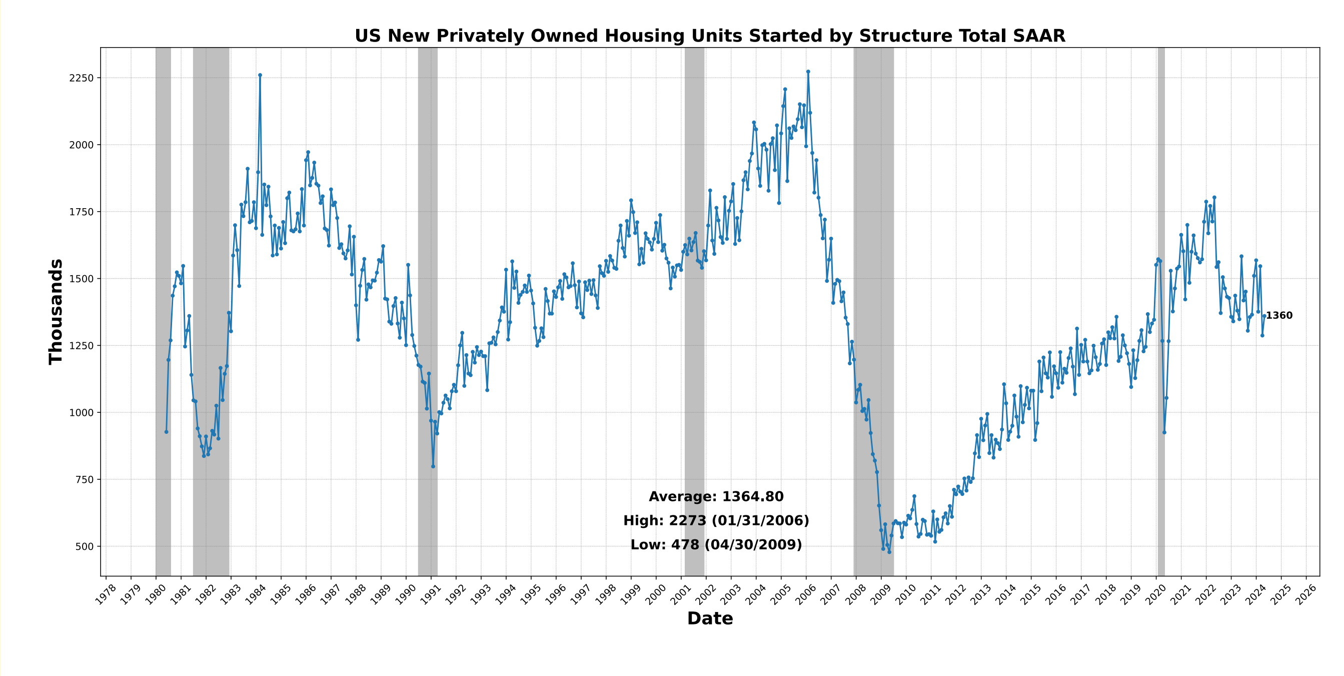
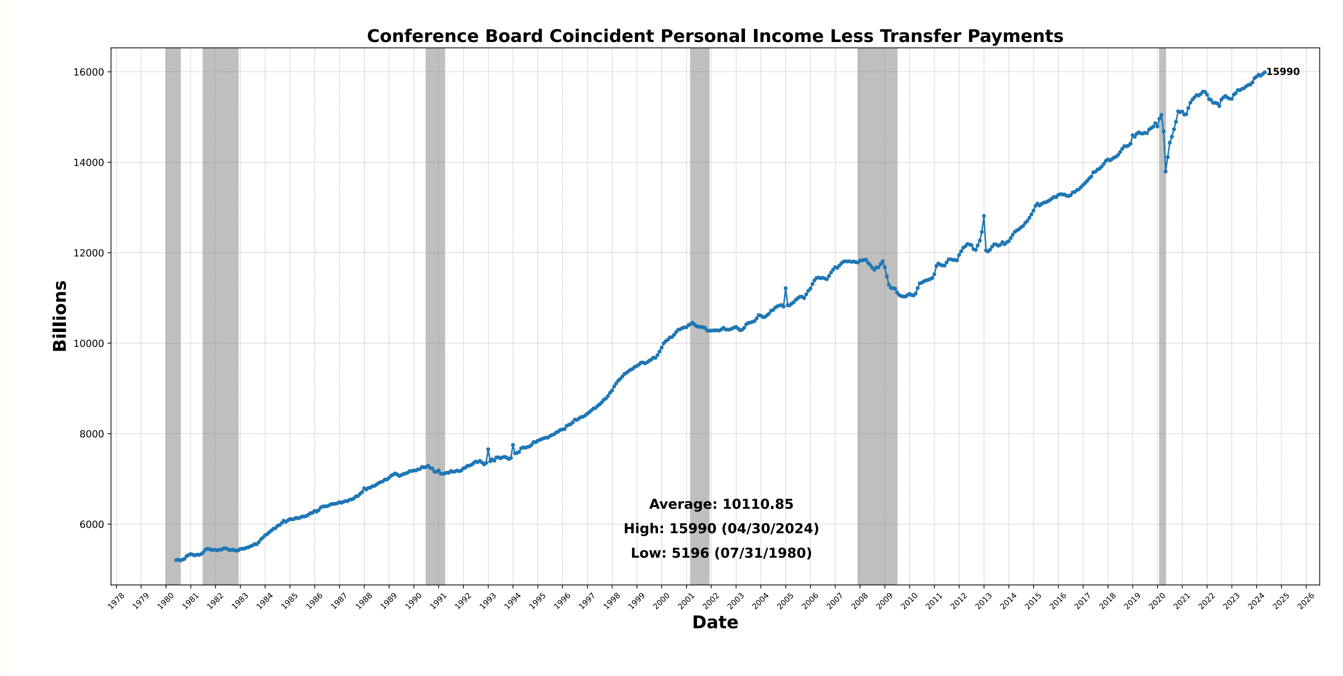
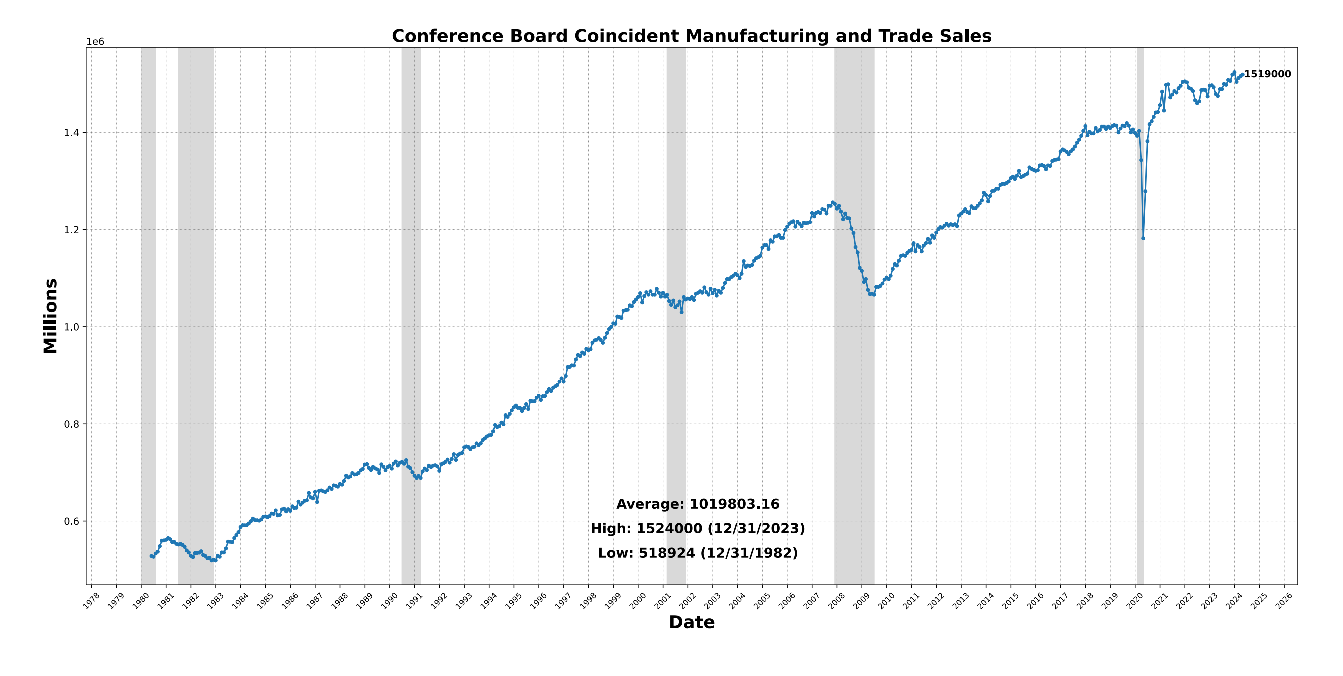




(Source: Bloomberg Finance, LP)

Roughly Coincident Indicators





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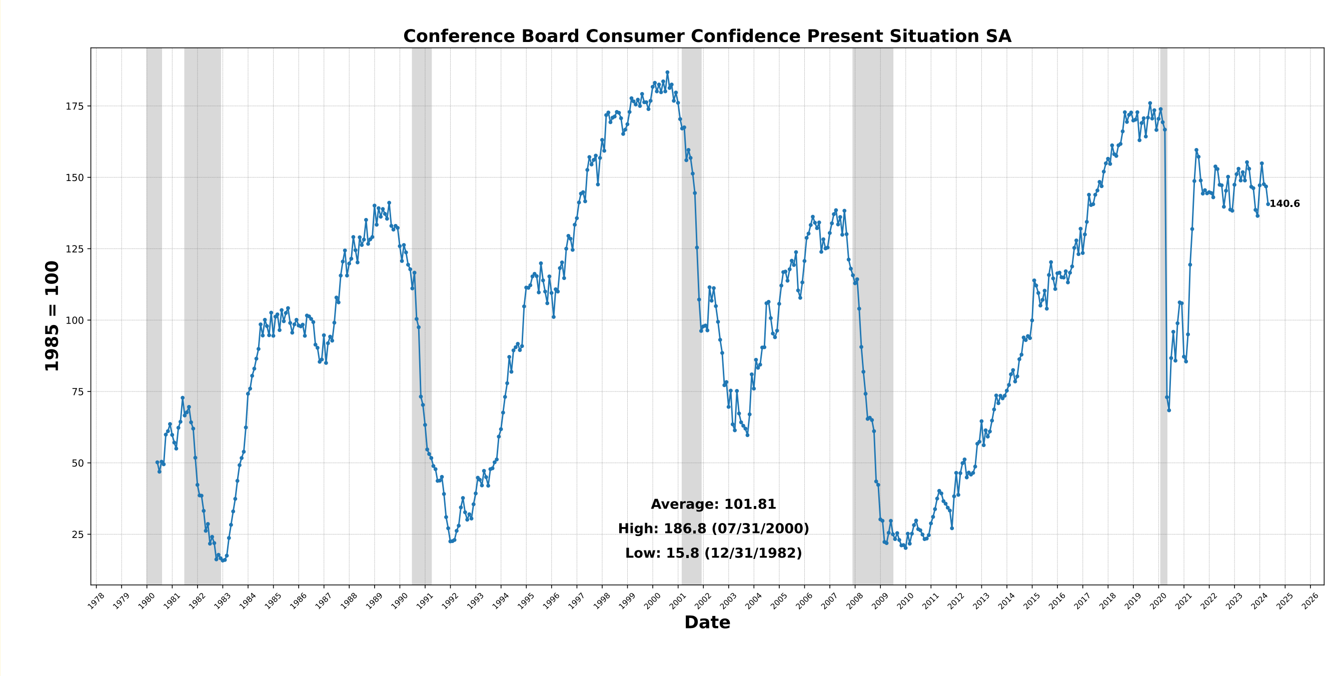

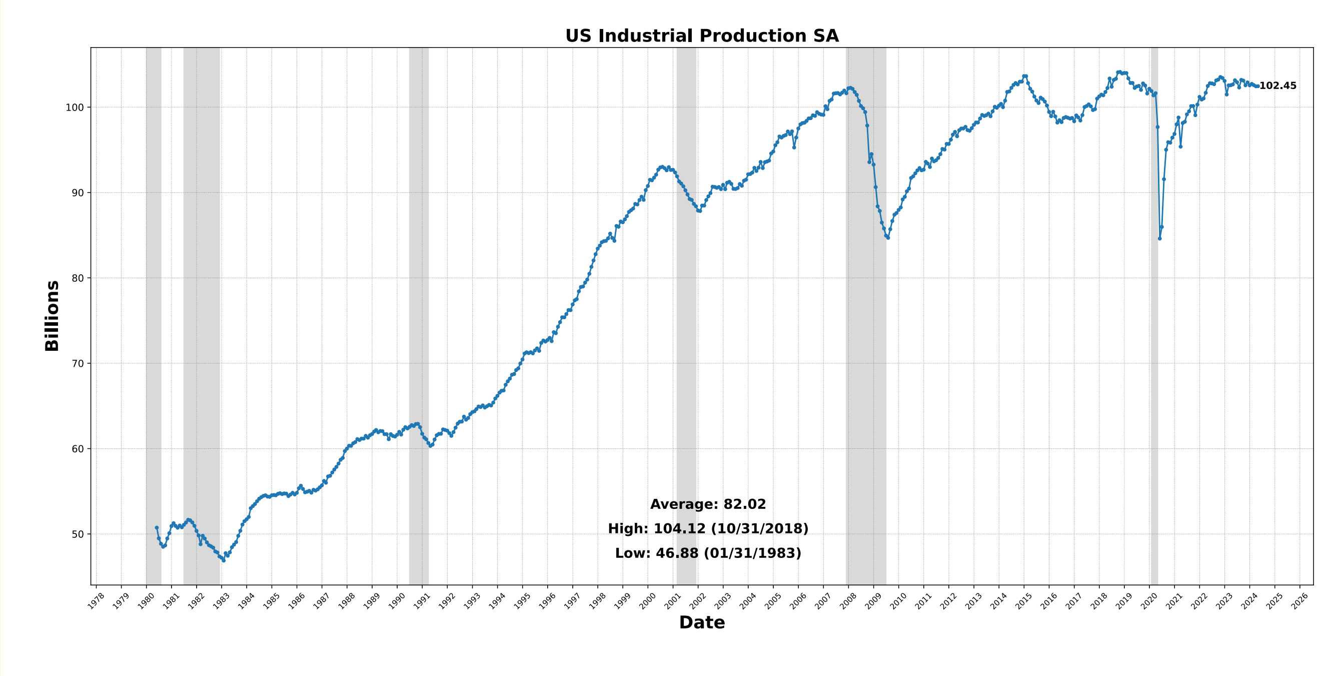

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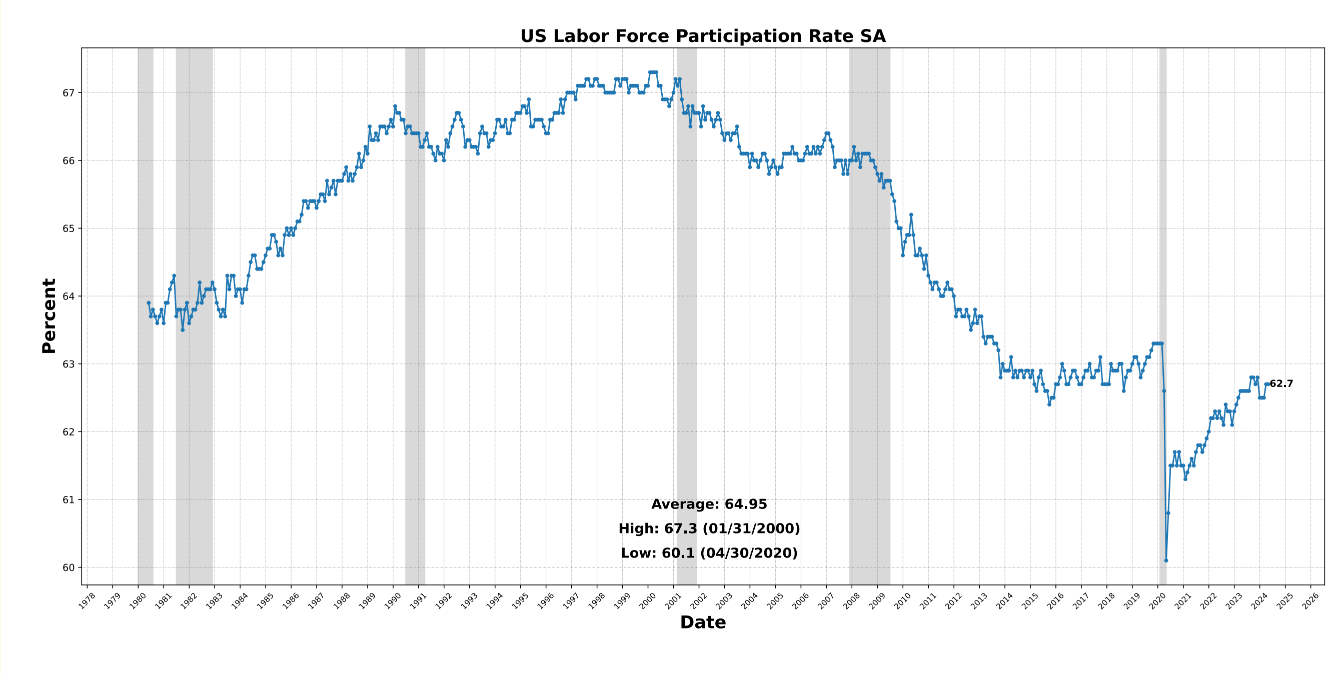

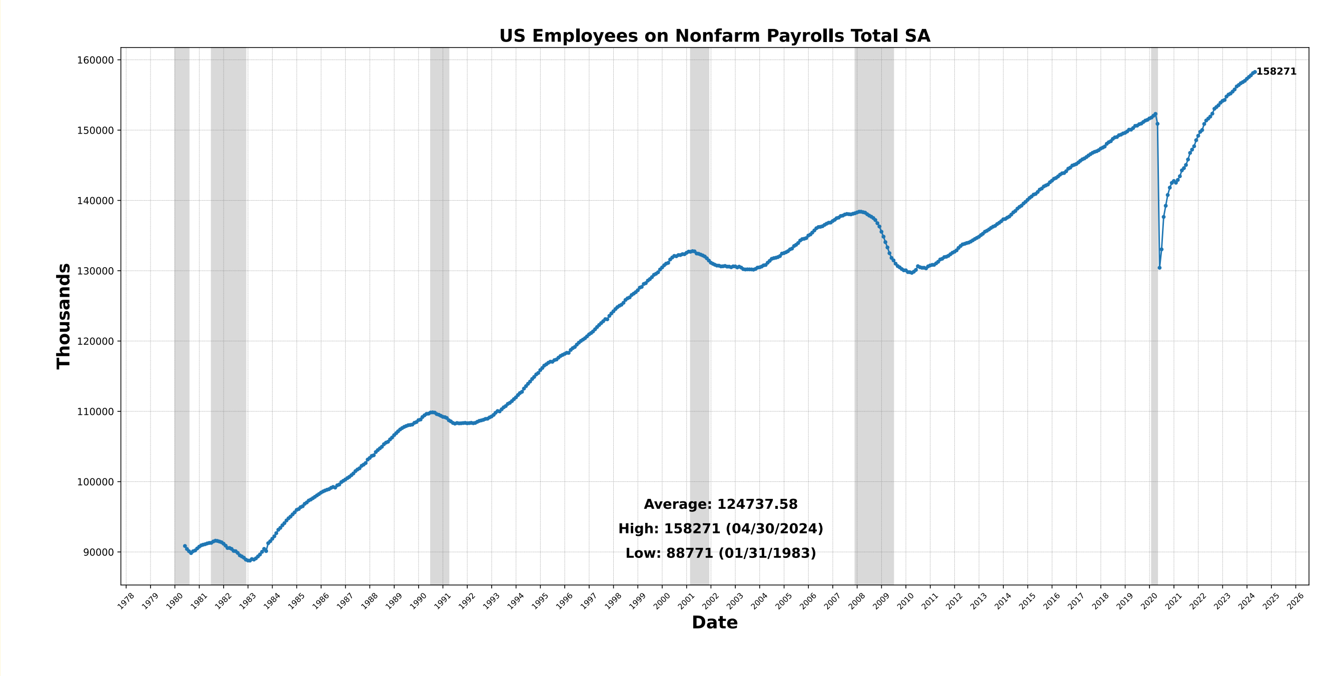

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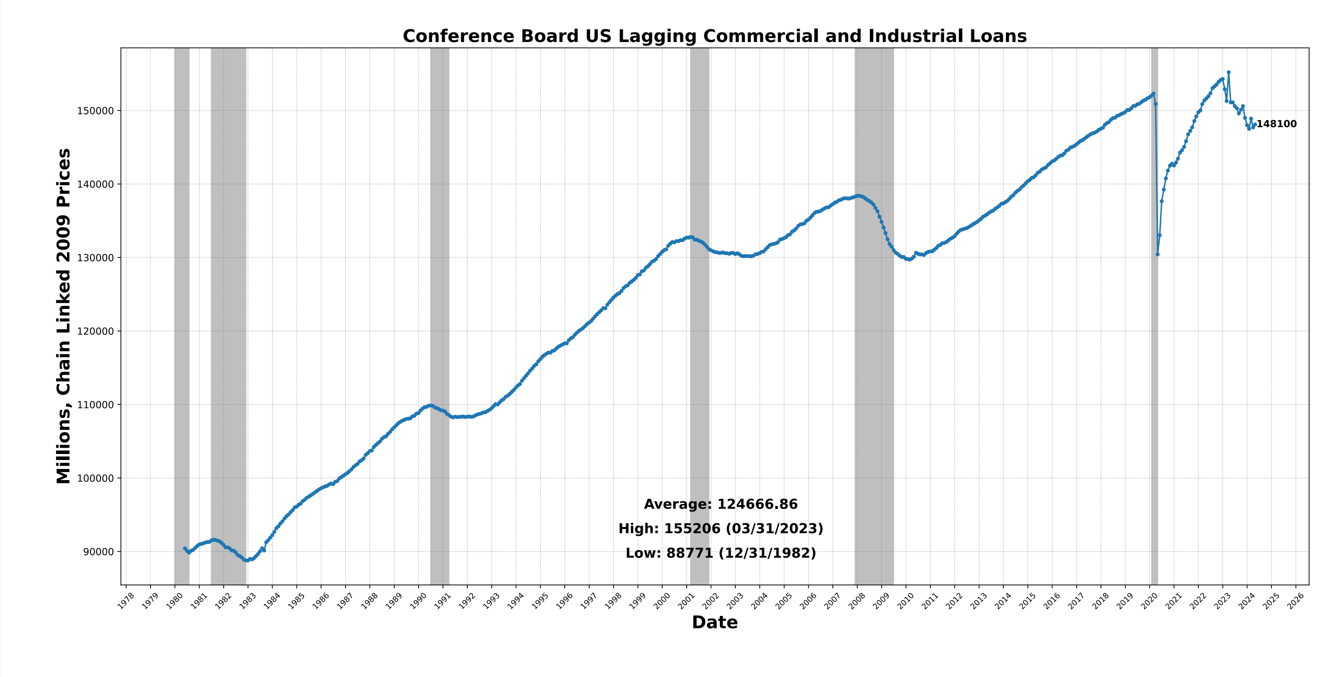
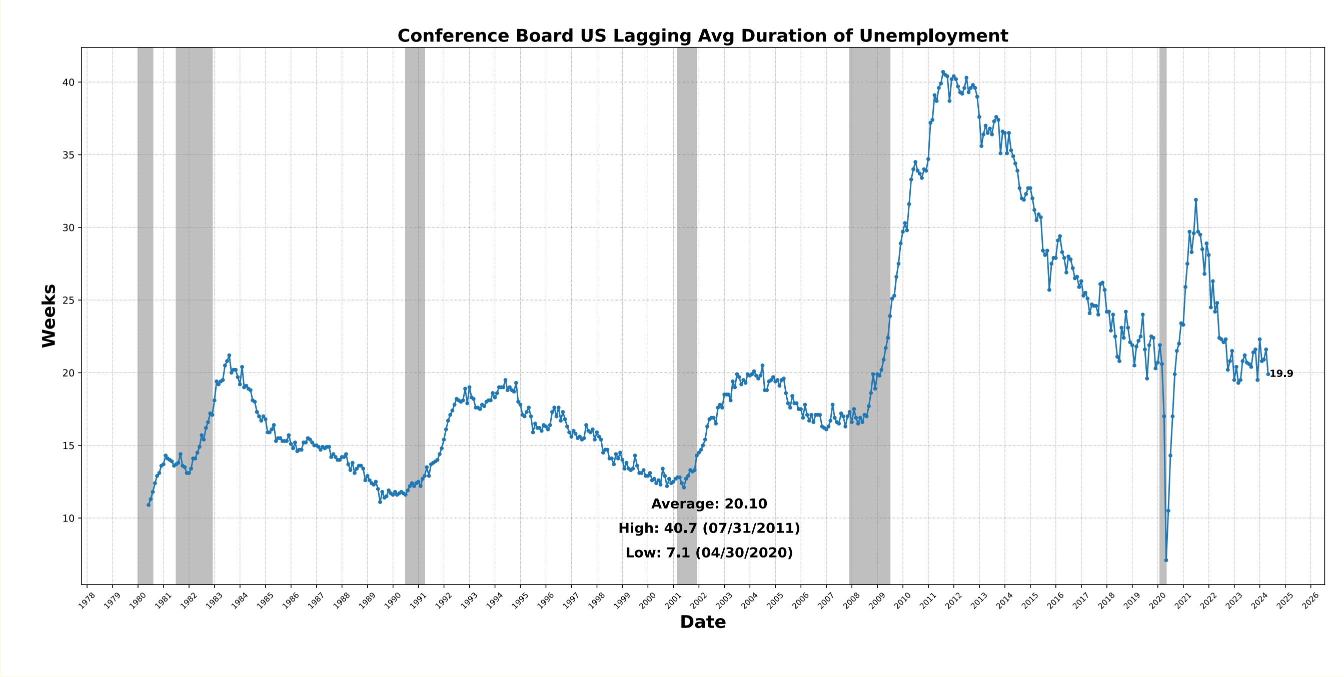
Lagging Indicators





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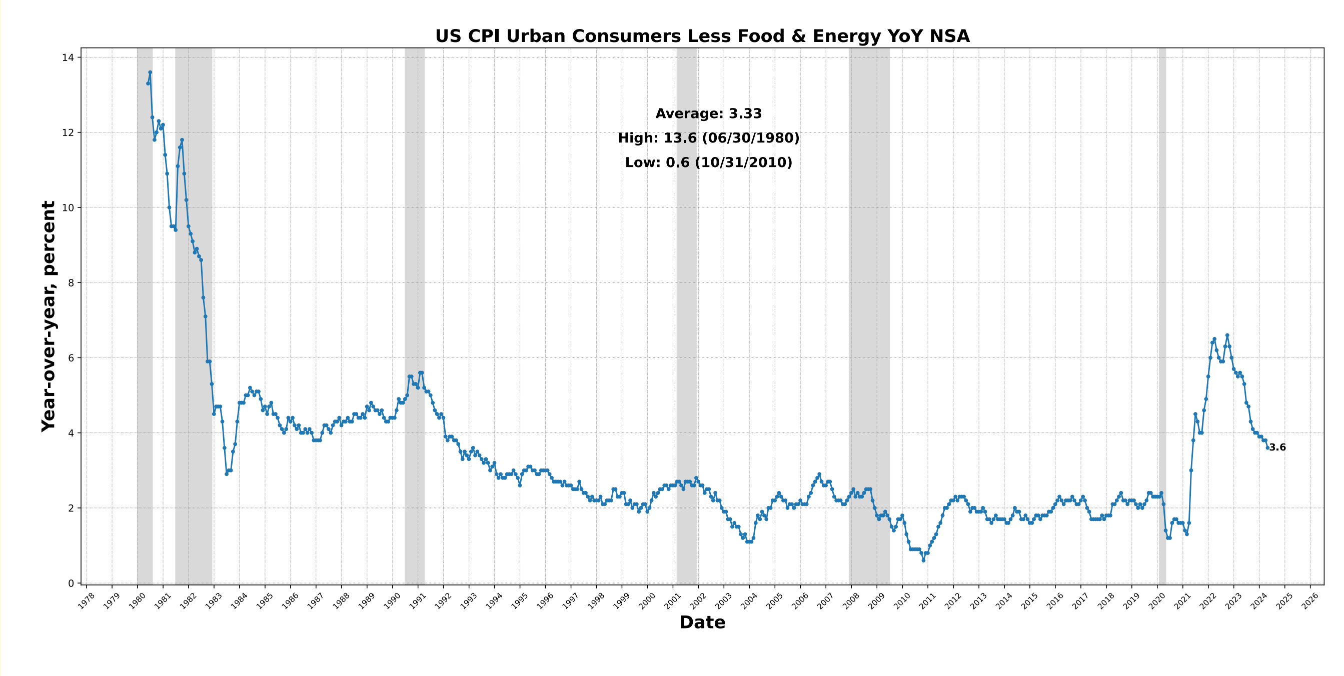

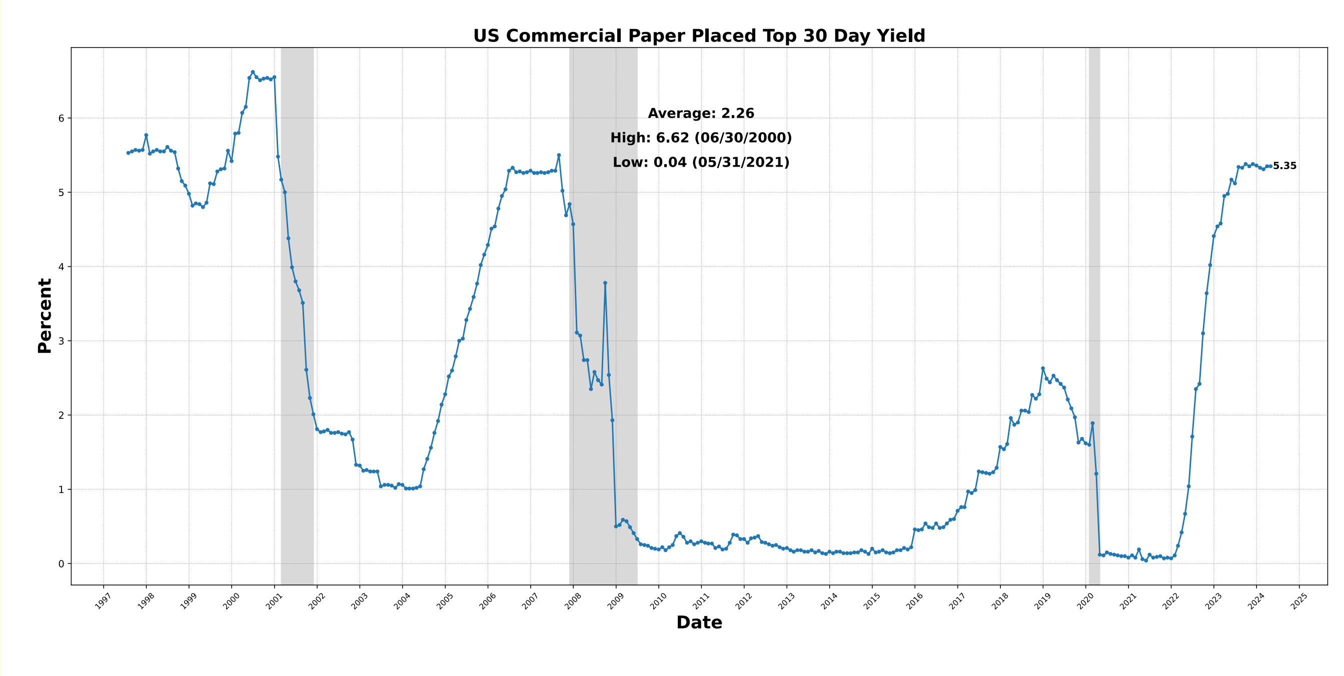

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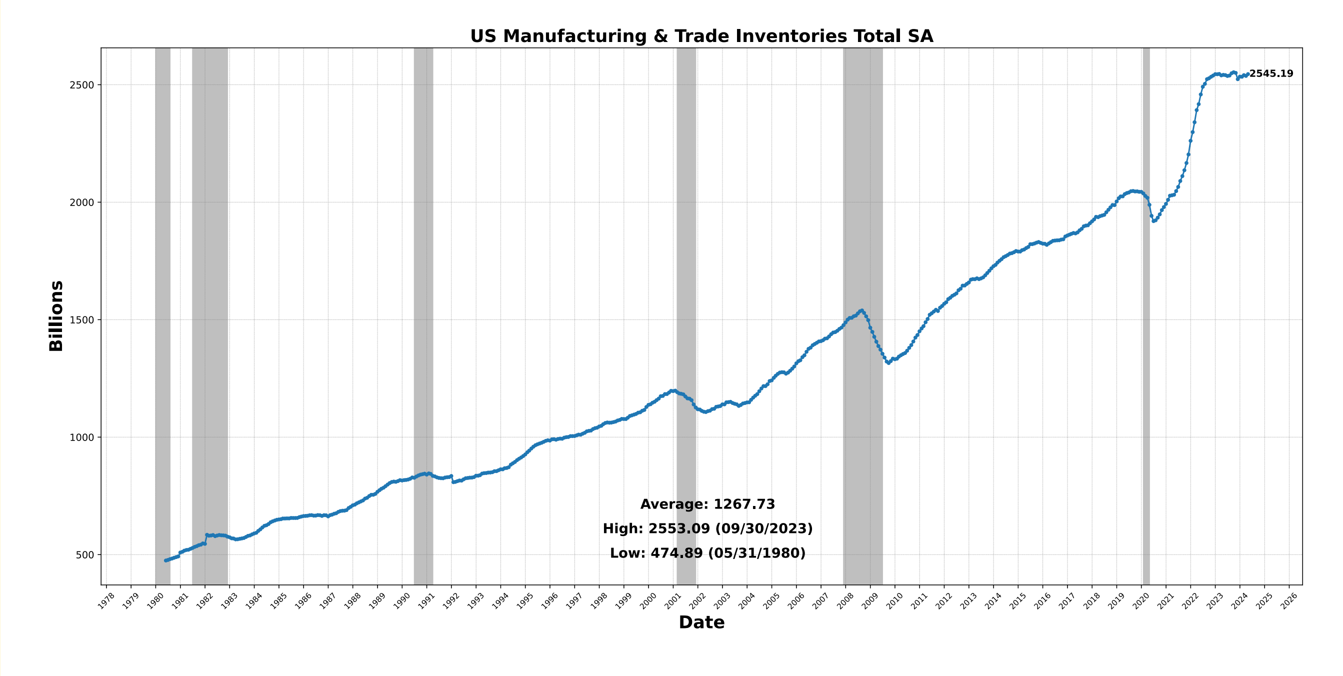
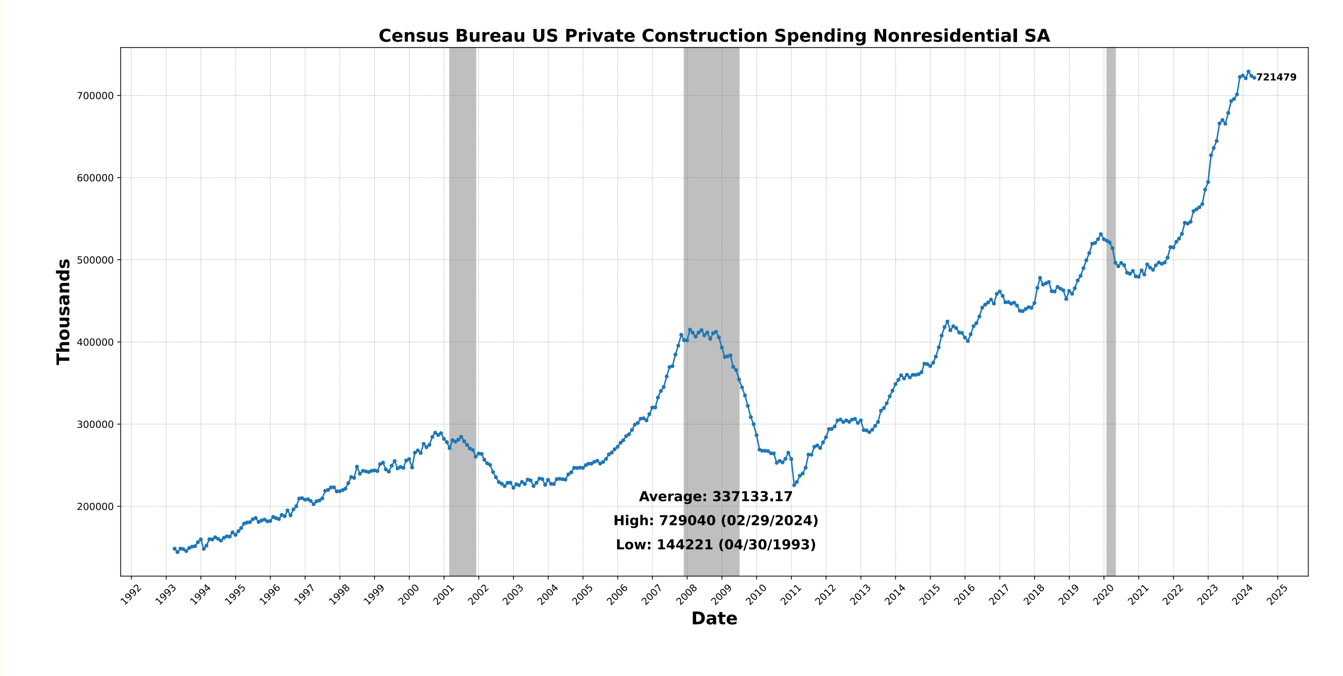




(Source: Bloomberg Finance, LP)

Capital Market Performance

Ticker		Short Name	%1M	%3M	%1YR	3 Year Annualized	5 Year Annualized	10 Year Annualized
SPR		S&P 1500 Composite Index	+2.93%	+6.06%	+23.35%	10.0931	15.0221	12.3811
SPXT	d	S&P 500 Total Return	+3.34%	+6.66%	+26.01%	10.7432	15.4952	12.6760
SPX	d	S&P 500 INDEX	+3.47%	+6.56%	+24.44%	10.7233	15.4763	12.6606
MID	d	S&P 400 MIDCAP INDEX	-2.89%	+.38%	+13.53%	4.7441	10.6841	9.7216
RTY	d	RUSSELL 2000 INDEX	-3.33%	+.06%	+8.02%	-2.7013	7.1021	7.6271
SXXP	d	STXE 600 (EUR) Pr	-1.52%	+2.20%	+10.33%	7.2454	9.6238	7.7341
TLT US	d	ISHARES 20+YR TR	+3.48%	+2.06%	-7.83%	-10.7149	-4.3722	.1173
QLTA US	d	ISHARES AAA - A	+.99%	+.73%	+.51%	-3.0612	.4608	1.8127
CRY	d	TR/CC CRB ER Index	+.66%	+2.94%	+9.14%	12.7796	10.9242	-.5127
XAU		Gold Spot $/Oz	-3.94%	+7.84%	+19.44%			
XAG		Silver Spot $/Oz	-7.13%	+18.05%	+23.39%			
ILMBNAVG		Bankrate 30Y Mortgage Rates Na	+.41%	+2.81%	+4.57%			
ILMINAVG		Bankrate 15Y Mortgage Rates Na	-.74%	+1.51%	+4.84%			
MB301ARM		5 Year ARM	-2.27%	+1.10%	+9.32%			
ILA3NAVG		Bankrate 30Y Fixe Mtg Refis Na	+1.28%	+1.02%	+9.22%			

Why Does the Federal Government Borrow?

Thomas Savidge

(*Research Fellow*)

Recently, White House Council of Economic Advisers Chair Jared Bernstein was featured in a viral clip in which he appears to flub a basic question about his job. The interviewer asked, "Like you said, they print the dollar, so why does the government even borrow?" Here's the clip of his answer.

In all fairness to Mr. Bernstein, he was asked a loaded question. The interviewers phrased the question to make it sound like the institution that issues debt and the institution that prints money are one in the same. That is *not* the case. The US Treasury borrows while the Federal Reserve prints money. The separation of these two institutions is designed to prevent the government from using the money printer to pay for government spending and the inflationary consequences that come with it.

As my colleague Thomas Hogan noted, advocates of Modern Monetary Theory (MMT) intentionally blur the lines between the Treasury and the Fed. For example, in Stephanie Kelton's *The Deficit Myth*, she claims, "Both the US Treasury and its fiscal agent, the Federal Reserve, have the authority to issue dollars." This claim stems from the Bureau of Engraving and Printing, within the Department of the Treasury, having the authority to print our paper currency. What Kelton omits, however, is that those notes are distributed by the Fed through its network of regional banks.

It's important to note that the relationship between the Treasury and the Fed is far from total independence. Throughout its history, the Fed has succumbed to political pressure from elected officials on both sides of the aisle, bureaucrats, and academics. The Fed currently operates under a policy of "constrained discretion," where Fed officials to stick to rules during "ordinary" times while giving them the ability to act with discretion during emergencies or crises. It's during emergencies where interest groups can most easily exert influence over monetary policy. For example, during the COVID-19 pandemic, the Fed opened numerous facilities to allocate credit, which ultimately blurred the line between fiscal and monetary policy. The policy of "constrained discretion" has led to the mess we're seeing now.

Advocates of MMT want to blur the line between fiscal and monetary policy even more than what we have now. If they accomplish this, it will spell disaster for the American people.

What Happens When Government Uses the Money Printer to Finance Spending?

This question has been asked and answered throughout economic history. Adam Smith discusses this point in Book V of The Wealth of Nations:

> *It occasions a general and most pernicious subversion of the fortunes of private people; enriching in most cases the idle and profuse debtor at the expence of the industrious and frugal creditor, and transporting a great part of the national capital from the hands which were likely to increase and improve it, to those which are likely to dissipate and destroy it.*

Smith comments that attempting to pay down debt with newly printed money is a "juggling trick" used to avoid default. This trick comes at the expense of everyday citizens, as the inflation brought about by money printing destroys the purchasing power of the money they hold.

George Selgin made similar warnings in his book The Menace of Fiscal QE. Fiscal QE refers to the policy of the Federal Reserve purchasing assets and expanding its balance sheet to support government spending. Selgin notes that while Fiscal QE is extremely tempting it casts doubt on the central bank's independence and creates an unaccountable back door for spending.

This question was also explored in a 2021 research paper by AIER Senior Fellow Joshua Hendrickson, titled "What Happens When Governments Pay for Spending with Money Creation? Lessons from the Early Riksbank" In the paper, Hendrickson discusses a historical example of mid-1700's Sweden when the Swedish parliament controlled both the government budget and the central bank (known as the Riksbank), bringing both fiscal and monetary policy decisions under one governing body. Results from Hendrickson's research as well as others show that the government was able to finance its spending using money creation but at the cost of rising inflation and no impact on inflation-adjusted economic activity. The government gained at the expense of the people. Economists cite similar results in Germany following World War I, Argentina over the past 25 years, and Turkey under President Erdoğan. The clear takeaway is that just because a government *can* finance spending with money printing doesn't mean it should.

In the case of the United States, where the US dollar is currently the world reserve currency and the US Treasury security is the global reserve asset, we'd still see similar results despite what the advocates of Modern Monetary Theory (MMT) claim. The "world reserve" status depends on investors' faith in the US government to keep its promises. If policymakers were to openly embrace MMT, it would face all of the knowledge problems that other attempts at government intervention have faced before. Ultimately, the knowledge needed to organize an economy is decentralized and not easily quantified, because much of it is contingent on time and place. The closest the US came to this arrangement was during the late 1960s and early 1970s when the Fed funded deficits using expansionary monetary policy, resulting in stagflation.

Furthermore, there would be rampant cronyism if the federal government were to openly embrace MMT. The logic of collective action would play out. Politicians, eager to win political support, would promise to use the money printer for small, vocal groups seeking to concentrate benefits for these groups and disperse costs among the American people. When inflation results from this policy, don't be surprised when politicians blame it on corporate greed, price gouging, and anything else besides themselves.

So Why Does the Government Borrow? Look at the Incentives!

If the government can't use the money printer to spend, why borrow instead of raising taxes? This is another point Adam Smith discusses in Book V of The Wealth of Nations,

> *The government of [a commercial state of society] is very apt to repose itself upon this ability and willingness of its subjects to lend it their money on extraordinary occasions. It foresees the facility of borrowing, and therefore dispenses itself from the duty of saving.*

Smith's discussion of devaluation and inflation above as well as his comments on public debt here show that there's nothing new under the sun. Policymakers have an incentive to finance spending with money printing and debt to hide the cost of spending from taxpayers. These costs cannot be hidden forever, though, as inflation and tax increases to pay for yesterday's unproductive spending will eventually follow.

You don't need to read Adam Smith to understand that raising taxes is politically unpopular. A politician's top two priorities are to get elected and then get reelected, so raising taxes on their voters is to be avoided at all costs. At the same time, voters also love to be the recipients of government money. Government debt offers a politician the ability to win over voters with increased spending and put off the sting of tax increases until later. Politicians also can rest assured that the government has willing lenders that are happy to purchase government debt knowing that they'll be paid back with interest.

As my colleague Peter Earle and I noted, the government taking on debt has a two-fold effect. In the short term, private capital is diverted away from the productive private sector and into the unproductive public sector. As economist James M. Buchanan put it, spending that is funded by debt is "in effect chopping up the apple trees for firewood, thereby reducing the yield of the orchard forever." The second effect, Buchanan also noted, is that debt-financed spending also shifts tax burdens from present to future generations. While bond investors trust that their loan will be paid back with interest, future generations will bear the cost of the government spending undertaken today.

Don't be fooled by anyone saying there is no cost to printing money or that deficits and debt do not matter. History has clearly shown that when the government decides to finance spending by printing money or taking on massive amounts of debt, it is the average person who is bound to get hit the hardest.

– May 30, 2024

Inflation Continued to Decline in April

William J. Luther

(*Director, AIER's Sound Money Project*)

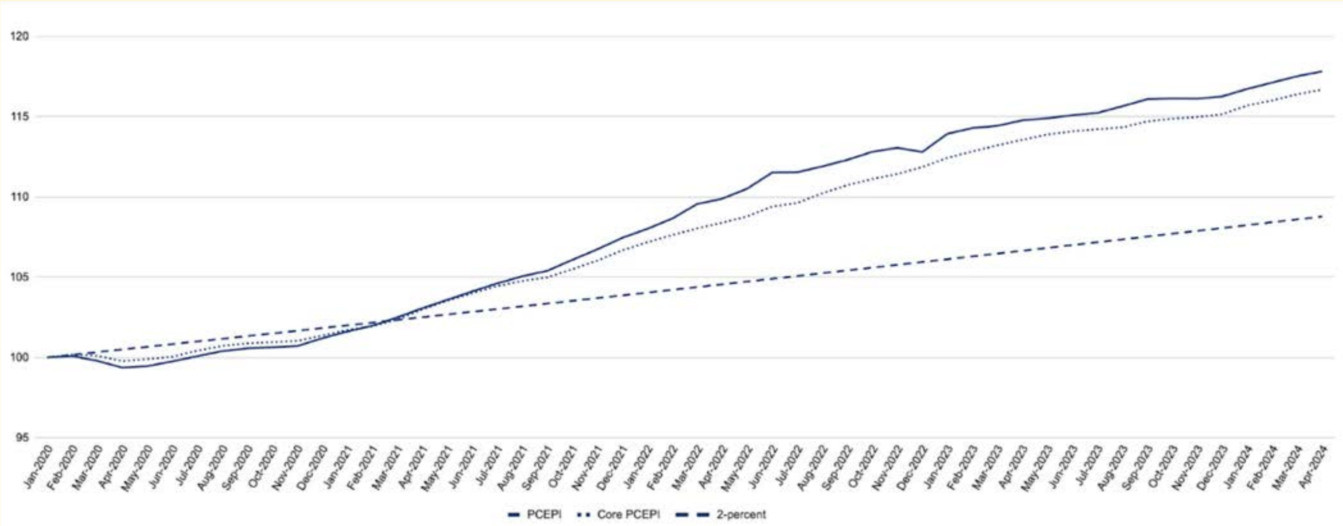


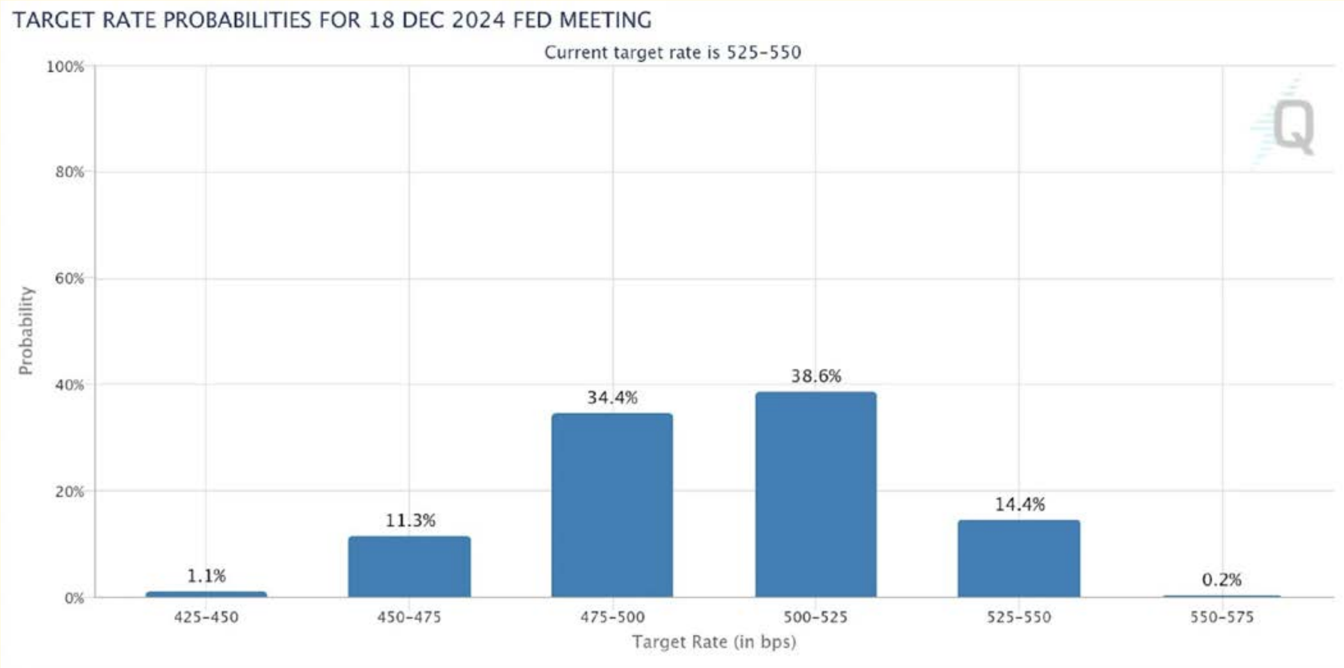
Figure 1. Headline and Core Personal Consumption Expenditures Price Index with 2-percent Trend, January 2020 – April 2024

Inflation ticked down further in April, according to new data from the Bureau of Economic Analysis (BEA). The Personal Consumption Expenditures Price Index (PCEPI), which is the Federal Reserve's preferred measure of inflation, grew at a continuously compounding annual rate of **3.1 percent** in April, down from **4.1 percent** in the prior month. It has grown at an average annual rate of **3.7 percent** over the last three months.

Inflation has typically exceeded the Fed's average inflation target since January 2020, with thirty-eight of fifty-one (**74.5 percent**) months registering inflation above **2 percent**. Prices today are **16.4 percent** higher than they were in January 2020 and **9.0 percentage** points higher than they would have been had they grown at an annualized rate of **2.0 percent** over the period.

Core inflation, which excludes volatile food and energy prices, has also declined. Core PCEPI grew at a continuously compounding annual rate of **3.0 percent** in April, compared with **4.0 percent** in the prior month. It has grown at an annualized rate of **3.4 percent** over the last three months.

While inflation is declining once more, members of the Federal Open Market Committee (FOMC) have suggested rates would need to remain high for longer than they had previously projected. In the minutes of the most recent FOMC meeting, released last week, members "noted disappointing readings on inflation over the first quarter and [...] assessed that it would take longer than previously anticipated for them to gain greater confidence that inflation was moving sustainably toward **2 percent**." Some members even "mentioned a willingness to tighten policy further should risks to inflation materialize in a way that such an action became appropriate."



In March, the median FOMC member projected that the federal funds rate target range would decline to 4.5 to 4.**75 percent** by December 2024, which would amount to three twenty-five basis point cuts this year. It seems likely that they will revise that projection when they meet again in June. The CME Group currently puts the odds that the federal funds rate target will fall at least that low at just **12.4 percent**. There is a **34.4 percent** chance that the target range will be 4.75 to **5.0 percent** in December and a **38.6 percent** chance that it will be 5.0 to 5.**25 percent**. There is a very slim chance (**0.2 percent**) that the FOMC will have a higher target come December.

FOMC members will almost certainly vote to hold their target rate constant at June's meeting. Absent an incredible decline in inflation, real output, or employment, they will probably hold the target rate constant in July as well. The CME Group gives a slight edge (**54.9 percent**) to a lower target rate following the September meeting, though November looks more likely (**67.8 percent**).

When the Fed will begin cutting rates — and how quickly it cuts once it starts — will ultimately depend on the incoming data, and how much confidence the incoming data gives FOMC members that inflation is finally back on track. For now, one should expect interest rates to remain high for some time.

– June 1, 2024

Trade Deficits: Accounting Masquerading as Economics

David Hebert

(*Senior Research Fellow*)

For 2023, the year for which we have the most current data, the total US trade deficit fell from $951.2 billion to $773.4 billion. What does this mean, and should we actively pursue reducing it further?

Trade deficits are one of, if not the, most misunderstood concepts in all of economics. The Build America Buy America Act, which this month celebrates its second anniversary of taking effect, seeks to reduce trade deficits by restricting the use of imported goods for certain infrastructure projects. Last month, President Biden suggested reducing our trade deficit with China by "tripling the tariff rates for both steel and aluminum imports from China." Former President Donald Trump has stated that he also seeks to reduce trade through aggressive tariffs, floating a "**10 percent** tariff on all imports, and a more than **60 percent** tariff on Chinese imports" to create a "ring around the country." The former President and his advisors have even gone so far as to suggest devaluing the US dollar as a means of reducing trade deficits. The misunderstanding of the effects of trade deficits on economies pervades Washington, DC. It is time to correct this misunderstanding.

A trade deficit is merely an accounting identity, not an economic identity.

Despite this truth, policymakers of all stripes fundamentally treat trade deficits as if they were a source of economic harm to the nation. To understand what a trade deficit is, we must first take a slight detour to understand a related concept: gross domestic product (GDP).

At its core, GDP is a measure of the total value of all the economic output produced in a country in one year. Conceptually, it is broken down into four components: consumption (C), investment (I), government spending (G), and net exports (NX). Because of this, we can say:

$$GDP = C + I + G + NX$$

Net exports is the source of the concept of "trade deficits" and the source of much confusion. We define net exports as "the total value of exports (E) minus the total value of imports (M)." If imports exceed exports, then net exports will be negative, and we experience a trade *deficit*. If exports exceed imports, then we will be experiencing a trade *surplus*. We can rewrite the above equation as:

$$GDP = C + I + G + E - M$$

The "minus M" term would imply, to the untrained, that imports *reduce* GDP within a country. The logic goes that if we could somehow reduce imports, we would increase GDP by the same amount of the reduction. This logic has been used by elected officials and Washington bureaucrats of both stripes for decades. It has even pervaded popular culture and news commentary.

Unfortunately, this logic has a flaw.

Remember: GDP seeks to measure the total value of all the economic output produced in one year *within a country's borders*. Counting exports as a positive makes clear sense: Exports are economic goods produced *domestically* and sold *internationally*. Because they were produced in the US, they count toward the US's *domestic* product.

Subtracting imports, though, seems strange — why not just ignore them entirely and not include them in our definition of GDP at all?

Consider the following truism: US consumers purchase many items each year, some of which were made in the US and some produced abroad for import. But consumption spending (C) includes *all* consumption spending that US consumers engage in, and therefore includes spending on both domestically produced goods and services *and* foreign-produced goods and services. We can use similar logic to break Investment and Government Spending down into their domestic and foreign components.

Since GDP is supposed to be a measure of only *domestic* production, the domestic spending on consumption, investment, and government spending on foreign goods and services should not be included. Since it already is, we must subtract it from our total. To do this, we must realize something very clever. If we were to add together all the foreign consumption spending, the foreign investment spending, and the foreign spending by the US government, that would account for all the import spending, since those are the only categories into which any spending must fall.

So why do we subtract imports from GDP? Because they have been added elsewhere in our calculation for GDP, and need to be subtracted. By the very definition of GDP, we must subtract imports from whatever figures to arrive at an accurate number. To not subtract imports would be tantamount to counting other countries' production as our own, which is clearly not true.

What would happen if, for example, Biden or Trump were successful in reducing imports of, say, legwarmers? All told, the US imported about $4.2 million worth of legwarmers in 2023. Because consumers purchase legwarmers, there would be $4.2 million worth of consumer spending (C). Because the legwarmers were produced abroad and purchased here, there would also be $4.2 million worth of imports (M). If we were to successfully prevent the importation of legwarmers, we would add $4.2 million fewer dollars to consumption and we would subtract $4.2 million fewer dollars of imports. The total effect of this would be zero. While legwarmers might seem like an absurd example, the same logic works for all forms of spending in the US on imported goods. Reducing imports by any amount of dollars would reduce consumption, investment, or government spending by an equal amount, as well, for a net effect on GDP of zero.

From this, we can plainly see that reducing "imports" would not, in fact, increase GDP at all. At best, doing so would leave GDP unchanged since we would be adding less to consumption, investment, and government spending while subtracting equally less from imports. More likely, it would reduce GDP, since we would have to produce more goods and services ourselves instead of benefiting from international trade and increased specialization.

Policy makers and the would-be-intelligentsia of both the American Right and the American Left who carp on about the trade deficit and use it as a means of speaking authoritatively on the state of the US economy reveal one thing: a stunning lack of understanding about which they speak. Trade deficits are merely an accounting number, nothing more and equally, nothing less.

– June 10, 2024

The Dollar and its Domestic Enemies

Peter C. Earle

(*Senior Research Fellow*)

Upping the ante following the initial weaponization of the dollar in 2022, the United States and a number of allied nations have agreed in principle to begin distributing profits on seized Russian assets to Ukraine. Interest payments on securities in which hundreds of billions of dollars worth of Russian foreign exchange reserves were invested, including US, European, and other sovereign bonds, would thus be transferred into a trust account accessible to the Ukrainian government. The US assertion of this undertaking was codified as the Rebuilding Economic Prosperity and Opportunity (REPO) for Ukrainians Act, signed into law by President Biden on April 24, 2024.

It is another in a series of unprecedented actions not only intensifying economic pressure on Russia but also signaling a shift in the economic dimension of current geopolitical conflicts. And it raises questions as to whether the entirety of those seized assets might be turned over to Kyiv should their reportedly declining war effort continue to weaken. (The legality of such a measure is beyond the scope of this writing, but discussed in full here.)

Expanding legal justifications for foreign asset confiscation, in addition to currency militarization, is accelerating an intense search for dollar alternatives among US rivals and certain allies as well. Recent data indicates that the process of dedollarization is occurring, albeit at a very gradual rate. The lethargy is to be expected given the global economy's long standing reliance on the US dollar for international commerce. Barriers to transitioning away from the dollar are considerable owing to deeply entrenched financial infrastructures including technology, accounting systems, long-established settlement practices, and ingrained customs. Those factors collectively reinforce dollar dominance in global trade networks. Unsurprisingly, innovation is underway.

Also, global reserve currencies have historically been subject to change. The US dollar supplanted the British pound sterling, which displaced the Dutch guilder, which replaced the Spanish real ('piece-of-eight'), and so on.

The Chinese renminbi is not a feasible substitute for the dollar for several reasons. Yet a significant movement away from dollar and dollar-denominated exposure is underway. In the first quarter of 2024 China sold a record $53.3 billion in US Treasurys and agency bonds. Explanations for the declining appetite for US debt include attempting to bring balance between the weakening renminbi and the strengthening dollar, which has surged owing to aggressive US monetary policy. Another is risk mitigation, as China (like all other nations) needs to balance its own foreign policy interests against the growing vulnerabilities associated with US dollar use.

But today the dollar's centrality is threatened as much, if not more, by domestic than foreign actors. One cause can be found in the Biden administration's March 11, 2024 General Explanations of the Administration's Fiscal Year 2025 Revenue Proposals. A notable footnote on page 80 contains the following statement:

> *A separate proposal would first raise the top ordinary rate to 39.6 percent (43.4 percent including the net investment income tax). An additional proposal would increase the net investment income tax rate by 1.2 percentage points above $400,000, bringing the marginal net investment income tax rate to 5 percent for investment income above the $400,000 threshold. Together, the proposals would increase the top marginal rate on long-term capital gains and qualified dividends to 44.6 percent.*

Currently, the top marginal US long-term capital gains tax rate ranges from 20 to **33 percent** when combining state and federal taxes. The FY 2025 budget proposal would increase this combined tax burden to over **50 percent** in many states. This would significantly raise, and in some cases double, the tax rates in key corporate hubs such as California (to nearly **60 percent**), New Jersey (to over **55 percent**), and New York (to over **53 percent**). It would establish the highest US capital gains tax in US history.

An intrin*sic* part of the dollar's appeal as a reserve currency owes to liquid, deep, and broad capital markets including government securities, equities, corporate bonds, and a vast array of other investment vehicles. Governments and large corporations with substantial dollar holdings abroad frequently invest them in US Treasury bills and notes to earn a return on those reserves. The current weighted average maturity of US Treasury debt is approximately 71 months (5.9 years). Significantly altering the tax code for long-term investments is likely to impact investor behaviors; the imposition of the highest capital gains taxes in over a century conveys an unequivocally hostile stance toward investors.

On the other side, the dollar faces threats from economic advisers to former President Trump, who have reportedly discussed punitive measures against nations moving away from using the US dollar. Saleha Mohsin of Bloomberg reported last week that discussions have included imposing trade restrictions, tariffs, and penalties typically associated with currency manipulation against dollar defectors. Like proposals for soaring capital gains taxes, an open discussion of punitive measures against nations increasingly wary of dollar-based commerce suggests a troubling and profound lack of awareness.

Recent revelations pertaining to Biden advisor Jared Bernstein reinforce the view that the dollar has internal as well as external enemies. In op-eds as far as a decade back and recent presentations, Bernstein has hinted at purposeful dedollarization policies as a means of fostering reindustrialization within the United States. The purpose would be to reverse the nearly five decades in which China transformed into a manufacturing behemoth, a period during which the US deindustrialized, offshoring most of its industrial economy to become an uber-financialized, service-based economy. It is an objective facilitated in part by taking weak dollar policies to an extreme.

Even setting aside the vast ideological (and practical) gulf between spending lavishly on green energy projects while pursuing a return to a smokestacks-and-ironworks America, it is a shift more easily envisioned than accomplished. Rebuilding America's manufacturing base, whether accomplished via programs associated with the left (collectivism), the incipient right populism (National Industrial Policy), or a not-at-all inconceivable marriage of the two would quickly result in significant misallocations and crowding-out alongside cascading opportunity costs. But all of that would come only after an all-out assault on the dollar's value was joined. Or rather, continued; the most facile means of eroding the dollar's exchange value are stalwarts of the current and recent policy agendas: an inflation bias, debt accumulation, widening deficits, trade interventionism, and so on.

As both sides of the proverbial aisle have made abundantly clear for several decades, incentives for curtailing spending have fled Washington DC altogether. But as with a vision of America's industrial future that seems to feature higher inflation in the service of wind farms atop coal-fired power plants, here too is a hitch. Ratcheting up Federal spending requires issuing more US government debt, which pushes Treasury yields higher. But if dedollarization becomes a policy goal, falling use of dollars saps a portion of the demand for US Treasuries, reducing the US government's borrowing capacity. And this, as debt service costs steadily ascend.

The oft-heard argument that there are no substitutes for the dollar echoes hollowly in an era of stablecoins, cryptoassets, expanding commodity markets, and central bank digital currencies. The recent bull market in gold has largely been driven by central banks diversifying away from the dollar and bracing for geopolitical uncertainty.

Russian commodity dealers are increasingly turning to stablecoins, such as Tether (USDT), to execute financial transactions with Chinese counterparties in circumvention of traditional payment systems. At least two major unsanctioned metals producers have started using stablecoins and other cryptocurrencies for cross-border transactions, with settlements often processed through Hong Kong. The transition highlights the lasting impact of international restrictions following the 2022 invasion of Ukraine on the Russian economy, especially for companies trading commodities like metals and timber, which have faced challenges in receiving payments and purchasing equipment despite not being sanctioned.

The increased use of cryptocurrencies underscores the complications even in countries like China, which did not join international sanctions but have tightened compliance measures due to threats of secondary sanctions from the US Treasury. Stablecoins offer a quick and cost-effective alternative to currency-based cross-border transactions, reducing the risk of frozen or seized bank accounts. This trend reflects a broader adaptation within Russia, with the central bank showing a more open stance towards crypto in international transactions and lawmakers considering fully legalized stablecoin use. Additionally, some Russian commodities firms–in a throwback to methods employed by the Council for Mutual Economic Assistance (CMEA) during the Soviet era–have resorted to barter deals, circumventing international financial transfers altogether.

China is increasing its gold reserves, which now comprise roughly 5 percent of its total reserves. This is gold's highest share of the Chinese reserve base since 2015. That accumulation reflects not only a response to dollar strength and trade tensions, including new tariffs on Chinese goods, but also a broader effort to diversify away from dependence on the dollar. Central banks worldwide have been purchasing gold and opening foreign currency accounts in local/regional banks which heretofore they have not, insulating themselves from the prospect of monetary predation.

The greatest threat to the soundness and utility of the US dollar, and in turn to the financial health and prosperity of American civil and commercial life, comes not from shadowy figures in faraway lands, but from unremarkable apparatchiks carrying out the edicts of US officialdom. Political capacities for destroying monetary fundamentals in the pursuit of short sighted, ill-conceived and self-serving policies dwarf what elites in outlying capitals dare dream of, let alone accomplish. The flight from the dollar–still in its nascent stages, and likely reversible with economically coherent, consistently applied policies — was spurred on by poor judgment, opportunism, and arrogance. Slower and at times quickly, dedollarization will proceed until the fundamental values and policies that positioned the dollar as the anchor and lodestone of global commerce are restored.

– June 7, 2024

Government Failure in One Lesson

Michael Munger

(*Visiting Research Fellow*)

Public Choice originated as a heterodox corrective to a misguided focus on "market failure," a central concept in the welfare economics literature of the 1950s. The orthodox work compared real-world markets with the "ideal" allocation of resources that would be selected by an omniscient, benevolent despot.

Opponents argued that government also faces the "knowledge problem," and state employees are not immune to incentives. Real governments are neither omniscient nor benevolent, and so state action is not always better than markets. Sometimes, relying on government may make things much worse. In fact, it has been estimated that the total "killing by the state," or total death toll from democide, exceeds 250 million since 1800.

Still, unless you are an anarchist, you accept that some government is necessary. But how much? Doing what? James Madison, primary author of the US Constitution, argued that (1) if *people were angels* no government would be necessary, and (2) if people were *governed by angels* then no constitutions would be necessary. But government is necessary, and constitutions are necessary, so market failure has reasonably to be compared to its doppelganger, "government failure."

In deciding whether to use markets or the state, the real question is comparative: Which imperfect system solves the problem of ordering society *relatively* better, in a particular context, addressing a specific problem? In analytic terms, more mundane government failures can be divided into two types: failures of substance and failures of procedure.

1. Substance

Since (almost) any political order is better than the Hobbesian state of nature, failed states are the clearest examples of substantive government failure. The failure to keep order, to maintain property rights (including collective control to solve commons problems), to maintain a reasonably efficient and fair judicial system, and to maintain both the value of the currency and the ability to borrow by avoiding excessive debt, are all examples of substantive government failure. By these standards, many US municipalities are astonishing failures, and have been for years.

At the national level, there is a list of substantive government failure in the US over the past three decades:

- the regulation of the financial system
- the availability of a reliable, independent (not politicized) system for adjudicating disputes
- the stability of the currency
- the ability to control the expansion of debt, to secure modest interest rates on borrowing
- the incapacity to provide the basic state function of controlling the border

The presence of these substantive government failures need not be taken as a need for expansion of the market sector. They are instead *per se* failures of ba*sic* government functions. Nonetheless, this panoply of failure does raise the question of whether the scope of state action should be restricted to the functions listed above, with an eye toward improving the function of the state by restricting its charter; This approach is characteristic of "state capacity libertarianism."

2. Procedure

The fundamental political problem is the choice among Pareto optima. The reason is that any decision that is Pareto-improving will — in principle — be chosen by unanimous consent. But there are often two, or more, alternatives to the status quo, both of which are Pareto improvements, but which differ in those who would benefit from the change. Or, what amounts to the same thing, the existing situation is a Pareto optimum, and an alternative Pareto optimum has been proposed. By definition, the alternative will make some people better off, but some people will be worse off.

Which of the alternatives is "better," in the sense that it would be chosen by an omniscient, benevolent despot? You might think that's a ridiculous standard, but remember that is how "market failure" is measured. William Keech and I argued that government must somehow choose the "best" Pareto optimum, meaning that the utilitarian problem posed by the Kaldor-Hicks-Scitovsky paradigm will yield the maximum gains to the gainers, which must be larger than the losses to the losers.

One caveat: It is possible to argue that the entire welfare economics approach is nonsense, because no one could identify the "best of all possible worlds" that way. Fair enough. But we conducted our analysis by analogy to the market failure paradigm, where the optimal outcome is known. *Even then*, conceding the dubious claim about knowing the correct solution, government fails to choose the optimal Pareto optimum, because government must use a procedure to decide. And all procedures are flawed.

A simple example might be a decision to build a dam for flood control over a large region. The dam will be financed out of general tax revenues (each of the N citizens pays 1/N of the cost). The status quo, A, is the current world, with no dam. The alternative is B, where the dam is built. Which is better?

Many people will benefit if the dam is built, but some people will be harmed, because they have to leave the farms, homes, and villages where their families have lived for generations. A (no dam) is a Pareto optimum, and B (build dam) is a Pareto optimum. Which one is better?

Procedurally, governments have two main ways of answering the A vs. B question: democracy or technocracy. Will either deliver the "best" solution?

Suppose there are five citizens making the decision. Three of them would like for the dam to be built, but–given the tax costs of building — their preference is only slightly in favor of B. Two citizens, who would lose their homes, oppose the dam fiercely.

Process 1: Majority Rule

If we could account for the values the citizens place on the dam, three slightly in favor and two fiercely opposed, we would not build the dam. But that is not how democracy works. Instead, we take a vote, using majority rule, outcome B wins 3-2, and the dam is built.

B is Pareto inferior to A, however, because the two citizens opposed to the dam suffer harms that exceed the slight benefits to those who favored the dam. Using majority rule, or any voting mechanism, is a procedural government failure, because it almost certainly fails to choose the Pareto optimal outcome.

Process 2: Cost-Benefit Analysis

Experts should be able to solve this problem; all they need is accurate information about how each citizen values alternatives A and B, and they can "add up" the utilities, just like Kaldor, Hicks, and Scitovsky claimed. But there is a knowledge problem: when the bureaucrats ask the citizens which alternative they prefer, there is an incentive to exaggerate the "value" of whichever outcome is preferred. If I prefer that the dam be built, I will claim that I value it very highly, since my reported value has no effect on the cost I pay. Again, B is built, even though A "would be better" if there were an omniscient, benevolent dictator.

And that was our conclusion: the problem is not that *markets* fail, but rather that there is no omniscient, benevolent dictator. Keech and I considered a total of five possible procedures for choosing among Pareto optima, and showed that each of them fails to reliably identify the optimal Pareto optimum.

The actual argument is rather technical, and excessively detailed for this forum. I wanted to look back on our effort from ten years ago, to remind those who (correctly) see problems in market processes and immediately advocate for state action to "fix it."

Perhaps the easiest way to explain government failure in one lesson is to remember that there is no such thing as "the state." Instead, essential decisions about resource use will be made by political actors. This suggests what I have called "The Munger Test." If someone says, "I believe that government should make decisions about what information is true in an emergency, and what should be censored!", then you should make a simple suggestion: Take out the word "government," and replace it with "Trump" (or "Biden," I'm not making a partisan point).

See if the person still believes their argument, with that amendment. They probably won't. That's the "one lesson": government is made up of people, using a process of discovery — voting or bureaucracy — that fails compared to an imaginary standard of omniscience and benevolence. In truth, results are rarely so bad in private life that government meddling can't make things much worse.

– June 11, 2024

How Nations Defeat Poverty

Jon Miltimore

(*Senior Writer*)

Phung Xuan Vu was just eight years old when he accompanied his brother to the food distribution center. His belly hurt from hunger, and he was anxious—filled with worry that he would lose his food voucher or be chastened by the officials distributing food.

"The officials were not friendly. They were bossy and had power," Vu recalled decades later. "We felt that we had to beg for food that was rightfully ours."

Vu's family was poor, but not by local standards. They owned a bicycle, something not all families in Vietnam could say. Yet waiting for hours for food was difficult.

In the book The Bridge Generation of Viet Nam: Spanning Wartime to Boomtime, Vu recalled how schoolchildren, weak and thirsty, would wait hours on end in the heat for food rations only to get cheated by officials, who would mix rocks in with the rice to fool the scales.

"That made us angry, but we could not fight or argue with the officials," Vu told authors Nancy Napier and Dau Thuy Ha. "What could we do, as children?"

How Vietnam Became the Poorest Country in the World

Vietnam is a country most people know, but for many the knowledge of its history stops in 1975 — the year Saigon fell, two years after the withdrawal of US troops.

Though President Ho Chi Minh had promised in 1969 that defeating the Americans would allow socialists "to rebuild our land ten times more beautiful," the postwar period was marked by economic decline. Vietnam was primarily an agricultural economy, and collectivization of farming had achieved results that were little different from previous collectivization attempts by the likes of Stalin and Mao.

In its Second Five-Year Plan (1976–1980), Vietnam had set aggressive goals in annual growth rates for agriculture (8 to **10 percent**). Instead, agricultural output increased by just **2 percent** annually, in large part because communists had collectivized nearly **25 percent** of the farms in what had been South Vietnam.

The results were catastrophic. Rainer Zitelmann, author of How Nations Escape Poverty, points out that by 1980, Vietnam, once an exporter of rice, was producing just 14 million tons of rice annually, even though it required 16 million tons to feed its own population.

Planners also instituted aggressive policies to nationalize industries in Vietnam. Though these plans initially aimed to nationalize only foreign-owned companies, they eventually expanded to encompass all enterprises in Vietnam. Price controls — particularly rent control policies, which are notoriously destructive — also played a key role in Vietnam's economic decline.

"The Americans couldn't destroy Hanoi," Vietnam's Foreign Minister Nguyen Co Thach told reporters in the late 1980s, "but we have destroyed our city by very low rents."

The policies did great harm to Vietnam's economy. By 1980, Vietnam was the poorest country in the world — poorer than Somalia, Ethiopia, and Madagascar — a distinction it would hold for an entire decade. Throughout the 1980s and even into the 1990s, hunger was omnipresent for many Vietnamese people. As late as 1993, **80 percent** of Vietnam's population lived in poverty.

But unlike so many countries, Vietnam did not *stay* poor.

Today, in one of the most remarkable stories in modern history, poverty in Vietnam stands at roughly **4 percent**, according to the Asian Development Bank.

How Not to Defeat Poverty

Before exploring how Vietnam was able to escape poverty, it's important to understand how nations do *not* escape poverty.

Vietnam's story was the exception. Though other countries have made great strides in reducing poverty in recent decades, most have not.

In fact, many of the poorest countries in 2024 — Burundi, Central African Republic, the Democratic Republic of the Congo, Madagascar, Somalia, and others — were among the world's poorest nations a quarter-century ago. These countries also tend to receive the most foreign aid (no doubt because they are so poor).

While many people — and organizations such as the United Nations — argue that foreign aid is key to alleviating poverty, others disagree.

In his 2006 book, The White Man's Burden: Why the West's Efforts to Aid the Rest Have Done So Much Ill and So Little Good, NYU economist William Easterly argued that decades of international aid initiatives were far better at feeding bureaucracies than alleviating poverty.

One example Easterly cited was Tanzania, which received billions of dollars to improve its road system over a period of many years. Two decades later, Tanzania's roads were still a disaster — but its bureaucracy had swelled.

"Tanzania produced more than 2,400 reports a year for its aid donors, who sent the beleaguered recipient 1,000 missions of donor officials per year," Easterly wrote.

This is the problem with trying to alleviate poverty through top-down solutions. Planners believe they have sufficient knowledge to solve complex economic problems, but the evidence (and economic theory) shows they do not.

Zitelmann shares a colorful anecdote from German author Frank Bremer who spent half a century in more than 30 countries fighting poverty as a developmental aid worker. In the conversation, a local villager is trying to convince an expert that his people are in desperate need of a dam. But the expert keeps telling the villager he doesn't need a dam; what he really needs is a well. And better analytical tools. And more training for workers. And a more inclusive workforce.

It's a comical exchange, but it's based on Bremer's decades of experience in the international aid field, which attempts, year after year, to apply top-down solutions to alleviate poverty.

In her book Dead Aid, Zambian-born economist Dambisa Moyo makes the case that the $1 trillion in aid African countries received from rich countries over the last half-century didn't just fail to alleviate poverty in Africa; it exacerbated it.

"The notion that aid can alleviate systemic poverty, and has done so, is a myth," writes Moyo. "Millions in Africa are poorer today because of aid; misery and poverty have not ended but increased."

How Vietnam Defeated Poverty

Vietnam's experience was in multiple ways opposite to the African one.

For starters, aid to Vietnam was drying up in the 1980s and early 1990s. Because the Soviet Union was suffering its own economic collapse, billions of dollars in aid that would have gone to Vietnam were not sent.

Meanwhile, collectivist policies continued to destroy productivity. One of the many mistakes Vietnam planners made was to ignore economic incentives, which are much more aligned with economic needs in a market economy.

Napier and Ha interviewed Bach Ngoc Chien, who recalled that his mother, like all farmers working in cooperatives, was compensated based on the number of days worked. The quality of the work or the amount of food produced didn't matter.

"This encouraged members to slack off, be sloppy, or to arrive late at their jobs," Claudia Pfeifer explained in her book Confucius and Marx on the Red River.

Such policies caused great harm to Vietnam's economy. But, as its economy sputtered and then collapsed, something amazing began to happen in Vietnam in the late 1970s and early 1980s: an entirely new economy began to emerge.

Suffering under a system a bit like Lenin's "War Communism," the Vietnamese began spontaneously to create their own market economy to survive. State officials increasingly turned a blind eye to price control-violations and unauthorized contracts (*khoan chui*) between families and collectives. The practice, known as "fence-breaking" (*pha rao*) is just one example of the market economy (sometimes black, sometimes gray) that was emerging under the heavy hand of socialism in Vietnam.

In response to this burgeoning economy, socialist leaders did something else quite extraordinary: they embraced the market economy and admitted their own "mistakes."

The Sixth Party Congress of 1986 is regarded as a turning point in Vietnam's history for two reasons. First, party leaders announced its policy of Đổi Mổi ("renovation" or "renewal"), a series of free-market reforms designed to embrace the grayish market economy. Second, party leaders engaged in what Zitelmann described as a process of "radical self-criticism," admitting to the failure of previous five-year plans that achieved next to no economic growth.

Incoming General Secretary Nguyen Van Linh promised to correct the economic mistakes that had resulted — according to the party's own report — in high inflation, a collapse in labor productivity, a decline in manufacturing, massive unemployment, and widespread corruption.

"They did not try to blame other external factors," Zitelmann told me in a recent interview. "It would have been very easy to do so."

Importantly, after the watershed meeting in 1986, political leaders continued to push free-market reforms. In 1987, a new investment law was passed that showed Vietnam was open for business. The law promised that the state would not expropriate or nationalize foreign property or capital.

In 1988, a series of measures was passed to reduce or eliminate government barriers to economic activity. They included the following:

- eliminating price controls and subsidies
- abolishing domestic customs checkpoints
- allowing private companies to hire up to 10 workers (a cap that was later increased)
- slashing regulations on private companies
- deregulating the banking system
- returning businesses that had been seized during nationalization to private owners

The early 1990s saw legislation that introduced a legal framework for LLCs (Limited Liability Companies) and the introduction of Article 21 in the 1992 Constitution, which recognized certain private property rights (and other liberties, including freedom of religion).

Though in December 1991 Vietnam lost its primary benefactor and trade partner, the Soviet Union, it responded by expanding trade with capitalist countries, such as Australia, Taiwan, South Korea, and Japan. A trade agreement with the United States was completed in 2001, and in 2007, Vietnam joined the World Trade Organization.

Today, Vietnam is one of America's top-ten trading partners. The nation's primary exports, which were once coffee and coconuts, are computers, mobile phones, and other electronics.

It was one of the most miraculous economic transformations in history, and it achieved amazing results. From 1990 to 2022, per capita GDP in Vietnam increased more than fivefold, surging from $2,100 to $11,400 (in 2017 dollars).

'Peace, Easy Taxes, and a Tolerable Administration of Justice'

Vietnam's success didn't happen overnight, of course. Nor is it the only country to escape poverty in recent decades. China, India, and Poland have similar stories.

What these stories all have in common is that these nations rose from poverty by embracing a common formula: more economic freedom and free trade. And just like these other nations, Vietnam's success was not the result of international aid or central planning.

Much like China, whose own economic transformation was spearheaded by mass privatization, Vietnam's success stemmed from an admission that central planners couldn't run an economy. So they stopped trying and largely got out of the way. The earliest steps of ***Đổi Mới*** merely recognized the legitimacy of the shadow economy that had already emerged.

None of this is to say that Vietnam (or China) is a capitalist utopia. On the contrary, Vietnam ranks 59th in the world in economic liberty, according to the Heritage Foundation's 2024 Index of Economic Freedom, slightly above France but below Belgium.

Nor is Vietnam the richest country in the world. With a per capita GDP of $15,470, it's roughly in the middle, slightly higher than Ukraine ($15,464) and slightly lower than Paraguay ($16,291), according to *Global Finance* magazine.

What's important to understand is that Vietnam was the poorest country in the world through the 1980s but transformed itself by abandoning socialism and embracing an approach more congenial to free markets. In doing so, it lifted tens of millions of people out of poverty.

This economic miracle was achieved not through international aid or other top-down solutions, but by simply allowing the invisible hand to work. The term, Adam Smith's famous metaphor for the spontaneous order that occurs in market economies, brings to mind something else the Scottish economist wrote.

"Little else is required to carry a state to the highest degree of opulence from the lowest barbarism, but peace, easy taxes, and a tolerable administration of justice," wrote the *Wealth of Nations* author, "all the rest being brought about by the natural course of things."

Vietnam is proof that Smith had the formula right. Free markets, not international aid, are the key to defeating poverty. And it doesn't take an economist to see it.

"Commerce — entrepreneurial capitalism — takes more people out of poverty than aid," the Grammy-winning U2 frontman Bono noted more than a decade ago.

Bono is right.

And if humans are serious about preventing hundreds of millions more from going through what Phung Xuan Vu did — waiting for hours on end for a single scoop of rice — they should acknowledge the power of free markets, and recognize that international aid can't achieve anything close to what economic freedom can.

This is something Easterly recognized nearly two decades ago.

"Remember, aid cannot achieve the end of poverty," he wrote in *White Man's Burden*. "Only homegrown development based on the dynamism of individuals and firms in free markets can do that."

Decades of evidence shows he's right.

– June 17, 2024

Don't Let a Crisis Go to Waste in 2025

Vance Ginn

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As 2025 draws near, America teeters on the brink of a fiscal abyss. This impending fiscal cliff, marked by the end of tax cut provisions and a spending crisis, calls for immediate and decisive action by Congress to avert a worse economic situation than the one Americans feel today.

The national debt from excessive government spending is on track to surpass $35 trillion soon, a stark increase of nearly $10 trillion since 2020. This level of debt per citizen exceeds $100,000; per taxpayer, it is nearly $267,000.

Such figures are not just numbers but represent a looming burden that future generations will bear — a burden that transcends mere fiscal policy and ventures into the realm of ethical responsibility. The gravity of this debt is exacerbated by the interest payments it necessitates, which have soared to over $1 trillion annually, surpassing what the country spends on national defense.

This situation illustrates a troubling scenario where the government, to manage its debt, resorts to issuing more debt, a practice unsustainable by any standard measure of sound budgeting. The economic repercussions of this cycle of debt are profound, leading to higher interest rates, likely increased inflation, and a misallocation of resources that stifles productive private sector activity.

Amidst these challenges, the Tax Cuts and Jobs Act (TCJA) provisions, set to expire in 2025, play a pivotal role.

These tax cuts have been instrumental in supporting economic activity across all income brackets by reducing their tax burden. If these cuts expire, they could reverse the economic gains achieved, reducing disposable income, dampening savings and investment, and contributing to an economic downturn in an already fragile economy.

The cessation of these benefits would particularly impact families who have benefited from the near doubling of the standard deduction and enhancements to the child tax credit. Furthermore, the expiration of the $10,000 cap on state and local tax (SALT) deductions could have mixed effects; while it may benefit taxpayers in primarily blue, high-tax states, it complicates the fiscal landscape significantly.

A balanced approach would be to maintain the increased standard deduction while simplifying the tax code further by eliminating complex provisions like the SALT deduction and the child tax credit, promoting a flatter, more equitable tax system with one low tax rate for everyone. This would also support more economic growth that, combined with spending less, can quickly get our fiscal house in order.

This fiscal predicament is further complicated by President Biden's commitment not to raise taxes on those earning less than $400,000 annually. This promise will be difficult to keep if the TCJA provisions expire without appropriate legislative adjustments, further imperiling his dwindling reelection hopes in November. This situation and recent tariff impositions that affect all income levels would represent a double blow to American taxpayers, dampening economic prospects.

As we face these fiscal upheavals, the discretionary spending caps and the debt ceiling, due to expire in 2025, add complexity to an already challenging budgetary environment. The US risks a severe budgetary crisis without thoughtful reform, particularly in the so-called "entitlement programs" like Social Security and Medicare, which consume a substantial portion of the federal budget. These areas must be addressed because both will be essentially bankrupt over the next decade, and millions of recipients will face substantial cuts in benefits.

Given all these challenges, fiscal and monetary rules are paramount.

Congress should implement a fiscal rule after cutting federal spending to at least the pre-lockdown level in 2019. Implementing rules like the Sustainable American Budget, which caps federal spending based on population growth plus inflation, could provide a sustainable path forward. This approach, supported by Americans for Tax Reform along with the economic insights of Alberto Alesina and John Taylor, advocates for austerity focused on spending restraint and economic growth rather than tax hikes, as some on the "new right" have recently advocated.

Regarding a monetary rule, the Fed should return to a single mandate of price stability, cut its bloated balance sheet to at least the pre-lockdown level in 2019, and adopt a strict rule that ideally would be on the growth of its monetary base. These steps would help reduce persistent inflation and remove the extraordinary distortions throughout asset prices and the production process because of years of quantitative easing and low interest rates.

Combining these monetary and fiscal rules would provide the necessary checks and balances to give the economy time to heal from massive government failures and help support a stronger institutional framework for economic growth and individual flourishing.

Moreover, the regulatory environment has grown increasingly burdensome under the Biden administration, with an estimated $1.6 trillion in new final rules imposed since President Biden took office through May 2024. These rules have been applied across the economy, including financial decisions based on ESG factors influencing the energy sector to increase car emission standards influencing the auto sector. But these ultimately influence producers' and consumers' costs of many goods and services. Removing the burden on Americans would unleash economic growth, helping with the fiscal and economic headwinds.

The bad policies out of DC have created a dire fiscal and economic situation moving into 2025. If the Trump tax cuts expire, excessive spending will continue unabated, and corrective monetary policy will not happen. Uncertainty and expectations alone will result in a hard landing in the economy, job losses, and elevated inflation. Given the last four years of declining purchasing power for millions of Americans, this result is unacceptable, and the idea of raising taxes to attempt to solve this is naive.

Instead, the US must leverage this crisis as an opportunity for sweeping reforms. By returning to principles of fiscal responsibility and market-driven activity, America can navigate away from the fiscal abyss and toward a future of economic stability and prosperity. Though fraught with challenges, this moment offers an unparalleled chance to reshape America's fiscal landscape, ensuring a legacy of growth and stability for future generations.

– June 18, 2024

There's No Good Reason to Raise the Inflation Target

Alexander W. Salter

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The Federal Reserve has a 2-percent inflation target. Central bankers are supposed to conduct monetary policy such that the long-run trajectory of the price level follows a 2-percent growth path. Most policy-focused macroeconomists think this is a reasonable way to achieve price stability and predictability without running the risk of deflation. But some economists want the Fed's inflation target to be higher. They think something like a 4-percent inflation target would give the Fed more wiggle room to ease policy, should recessionary pressures emerge.

These economists are wrong. They misunderstand the nuances of monetary policy, as well as the ba*sics* of how the market price system works. There's no good reason for the Fed to raise its inflation target. Competent economists should work to discredit this idea as quickly as possible.

Supporters of a higher inflation target claim that it would give the Fed some extra ammunition. The key is the link between interest rates and inflation. From the Fisher equation, we know that the nominal interest rate equals the real (inflation-adjusted) interest rate, plus anticipated inflation. In the long run, inflation usually doesn't affect supply and demand in capital markets, so the only permanent effect of a higher inflation target is higher nominal rates. Suppose the equilibrium nominal interest rate under a 2-percent inflation target is **5 percent**, implying a 3-percent real return with 2-percent anticipated inflation. If the Fed were to increase its inflation target to **4 percent**, the equilibrium nominal interest rate would increase to **7 percent**, with the real return unchanged.

Higher rates supposedly give the Fed more room to maneuver. To loosen monetary policy, modern central banks reduce their nominal interest rate target. But nominal rates can't fall much below zero, since one can always hold cash to avoid a negative interest rate. Thus a bigger gap between the "effective lower bound" and the neutral policy rate (again, a nominal variable) means the Fed has a wider scope for stimulative policy.

Why not give the central bank a wider berth, if it helps to stabilize the economy? Because it doesn't actually help. Interest rates are a distraction. To loosen monetary policy, the Fed must boost nominal spending. It can do that even if interest rates are at the effective lower bound. Furthermore, inflation doesn't help the economy. It's really a drag on the economy.

As I've written before, the Fed can't control the real interest rate. The most it can do is help the economy adjust from one real interest rate to another as economic fundamentals change. In the wake of a recession, interest rates usually fall. The Fed's job is to nudge dollar-denominated variables in the right direction. Monetary policy is much more like recalibrating the economy's barometer than flooring the economy's gas pedal.

Of course, expansionary policy (printing money to purchase securities) can help fight recessions. But the reason isn't that interest rates are lower. Rather, it's that the Fed, as the monopoly supplier of high-powered money, can provide the needed liquidity when the economy faces an aggregate demand shortfall. It's proper to grow the money supply in response to a sudden and unexpected increase in money demand. The textbook effects on interest rates are downstream from this fundamental task.

When we stop thinking in terms of interest rates and start thinking in terms of the supply of and demand for money, we see that there's nothing special about a 2-percent inflation target. The Fed's goal is based on consensus and compromise, not any hard and fast rule about how markets work. Remember the dynamic version of the equation of exchange: effective money supply growth must equal total nominal spending growth. Provided market expectations mesh with actual Fed behavior, we can have a full employment equilibrium at 2-percent inflation, 4-percent inflation, or even 0-percent inflation. What matters is the credibility and predictability of policy.

So what's wrong with higher inflation? In brief, full-employment equilibria are not created equal. High rates of inflation reduce productivity, which means we produce fewer goods and services than we would at a lower rate of inflation.

Inflation throws a wrench in the economy's gears. Markets are good at creating wealth when prices correctly signal relative resource scarcities. But market prices are denominated in money. Tinkering with money introduces noise in the pricing process. While it's theoretically possible to have a high, but perfectly neutral, inflation rate, meaning there are no effects of inflation on relative prices, in practice this never happens. More inflation means more variability in how monetary policy affects supply and demand in particular markets. Faster price-level growth almost certainly weakens the market allocation process.

Furthermore, market actors often engage in privately beneficial, but socially costly, behaviors to avoid the effects of inflation. A weakening dollar is a tax on holding cash and other highly liquid assets. The obvious incentive is to economize on these assets as much as possible. But that makes transacting more difficult than it otherwise would be. Likewise, higher inflation rates encourage more frequent contracting, which increases uncertainty as well as the cost of contracting. Inflation is an underappreciated source of transaction costs.

Finally, although I previously wrote that inflation doesn't *usually* affect supply and demand in capital markets, there is an important exception: in the US, capital gains taxes are not indexed to inflation. Since asset prices tend to rise when all other prices are rising, inflation pushes investors into higher tax brackets. They forfeit more wealth to the government despite the fact that, in terms of real resources, their portfolios have not appreciated. This is a major disincentive to save and invest, and hence a drag on economic growth.

The campaign for the Fed to adopt a higher inflation target makes no sense. It's not supported by policy best practices, or by ba*sic* economic theory. Instead, it's a symptom of the "Great Forgetting" currently plaguing the economics profession. Let's hope we can put a lid on this misguided idea before it does any real harm.

– June 24, 2024

Trump, Tariffs, and Income Taxes

David Hebert

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In a recent trip to Washington, DC, Donald Trump proposed an "all-tariff" federal revenue system that would "replace the income tax" to Republican policymakers.

Finding additional sources of revenue is one way to reduce the current national debt, which at present stands at a staggering $34 trillion (about $100,000 per person in the US) of on-budget liabilities. To this we should add, as Thomas Savidge writes, another $80 trillion i.e., about $250,000 per person in the US) in off-budget, unfunded liabilities at the federal level and even more at the state level.

Paying for government can be tough. On the one hand, as Oliver Wendell Holmes once said, "taxes are the price we pay for a civilized society." This quote currently adorns the IRS building in Washington. On the other hand, it has been said that "the best tax is one that someone else pays." This latter consideration underlies the question, "how many pages long is the US tax code, anyway?" The answer is difficult to know. Estimates range from as few as 6,871 to over 75,000.

But if the best tax is one that someone else pays, would it not make sense that the best tax for US citizens is one that non-US citizens pay, e.g., a tariff?

The economist Alexander Salter has written about Trump's proposal, and how it would require us "to find a way to generate tariff revenue in excess of **150 percent** of what we spend on all imports." This sentence bears explication. Salter is not saying that we need a **150 percent** tariff on imports. He is saying that whatever tariff we set, it would need to generate revenues equal to **150 percent** of what the US currently spends on all imports.

Tariffs, like all taxes, come with the pernicious side-effect of raising prices for domestic (i.e., American) consumers, regardless of whether that tax is placed on the consumer or the producer. Economists call this the economic incidence of a tax,.It refers to the "split" of the tax between consumers and producers, with each paying at least some portion of the tax. For consumers, this means higher prices per unit. For producers, this means less revenue per unit.

The first law of *demand* teaches us that, at higher prices, consumers will purchase fewer of the now relatively more expensive good. The less-talked-about first law of *supply* says that, at lower revenue per unit, producers will produce less of the now relatively less profitable good.

If we suppose that foreign producers are only able to pass one half of the tariff to consumers in the form of higher prices, the price to Americans of imports would increase by **75 percent**. Further, this assumes that Americans would not change their spending habits *at all*, despite this new tariff.

It seems unlikely, to put it mildly, that American consumers would continue to import the same amount at a **75 percent** higher price. But with fewer imports, there would be less of a tax base from which to raise revenues, which means we would have to raise tariffs on the remaining imports even higher. That way, you would quickly end up on "the wrong side of the Laffer curve."

It is similarly unlikely that foreign producers — who pay **75 percent** of the tax — would continue to export to the US if they were only able to earn **25 percent** of what they were previously earning. Instead, they would almost certainly shift their export activities away from the US. But if they are not exporting to us, then we cannot import from them. Thus, once again, the tax base is eroded and the revenues from tariffs subsequently fall.

Most frustratingly is that Mr. Trump knows all of this. In 2018, the self-proclaimed "Tariff Man" applied tariffs to aluminum and steel imports to try and protect American factories and jobs. This effort failed. Indeed, it could only have succeeded if the tariffs had discouraged Americans from buying foreign produced goods and encouraged the purchase of domestically produced goods. The truth, however, is that tariffs only result in higher prices for Americans, not higher incomes. These higher prices were borne by the overwhelming majority of Americans not currently employed by the aluminum and steel industry.

Perhaps Trump's goal is simply to eliminate the federal income tax. If so, then he should advocate for doing that and *only* that. Eliminating the income tax would, in fact, make Americans richer in after-tax dollars. An added benefit would be that it would allow all Americans to be paid in dollars, instead of taking compensation in a myriad of non-pecuniary forms in order to secure certain tax advantages.

Imagine that health insurance was no longer a privileged form of income that could be purchased with pre-tax dollars. Or retirement contributions. Freeing Americans to be paid in dollars would simplify so much of our lives and would simultaneously close many of the loopholes in our current and bloated tax code that so many of us complain about.

Of course, this would also require a drastic reduction in total government spending, lest we contribute to our national debt. "Starving the beast" has not been an effective budgetary strategy in recent years, primarily because doing so has only starved the beast *of resources*. For this strategy to be effective, we must also starve the beast *of responsibilities* — especially those that lie outside of the scope of responsibilities best left to the states, local communities, or charities.

Regardless, replacing the current income tax with an aggressive tariff is pure nonsense. Ignoring the litany of problems with it from the standpoints of ethics and economic well-being, it makes no sense from a ba*sic* public finance perspective. Even attempting to do this would be bad policy and policymakers of all stripes should avoid doing so.

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