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VELOCITY (AND TAXES) HOLD THE KEY

BY: Jay Bowen*

As we enter the new year and face an impending stimulus package proposal poised to become the most prominent issue of debate for both the new Administration and Congress, it is an opportune time for both our public policy officials and business community to assess what policies might be implemented to foster job creation and economic growth and pull us out of our current state of deflationary economic contraction. We are witnessing an extraordinary period in our economic history, and the policy responses must be aggressively bold on both the monetary and fiscal fronts to put us on a path to recovery. Over the past few months, the Federal Reserve Board has demonstrated their determination through both conventional and unconventional measures to do whatever is necessary to prevent a deflationary spiral from taking root; and the numbers are staggering, a quantitative easing extravaganza, resulting in a balance sheet that has expanded over \$1 trillion in 5 months and a monetary base growing at a 1,400% annual rate. However, it is important to note that while the Fed can control the quantity of money, they cannot control the velocity, or turnover, of money. This is of crucial importance because a vigorous recovery cannot take place until the velocity of dollars increases. This was painfully demonstrated both in the depression era U.S. in the 1930's and during Japan's lost decade of the 1990's. In both cases, velocity fell sharply, and sustained recovery never materialized. Of particular interest was Japan, where an almost tripling of the money supply resulted in a decade of stagnation, from an inflation, economic growth, and stock market standpoint. It is important to note that at some point in the future, when velocity begins to pick up steam and the recovery takes hold, it will be crucial for the Fed to begin to unwind their aggressive easing agenda and act in an expedient manner to withdraw excess liquidity from the system in order to prevent inflationary forces from taking hold. However, this is a problem for another day, as the pressing matter continues to be anti-growth deflationary forces.

Thus, it is imperative that the extraordinary measures that the Fed has implemented on the monetary front be matched by equally bold actions on the fiscal front in order to pull us out of the current deflationary doldrums, raise the velocity of money, and prevent the U.S. from securing her own "lost decade." Monetary policy alone cannot solve our economic ills. It is again instructive to examine the depression era U.S. and Japan of the 1990's to determine what policies not to pursue. In both these cases, there was an aggressive expansion of the size and scope of government, with public works programs and infrastructure spending playing a dominant role. In both instances, federal spending, as a share of GDP, and the unemployment rate surged, which is not the correlation public policy officials were hoping for, while the velocity of money and economic growth rate stagnated. Arthur Laffer has done great work on this subject by demonstrating that the benefits of government spending stimulus net out to zero

or are potentially negative because of decreased output, increased debt levels, and increased future tax liabilities.

So the Fed has provided us with the bullets but no weapon; and now we need fiscal policy to provide us with the gun to make the ammunition potent, thus raising the velocity of money, not the fiscal policy of the depression era U.S. or 1990's Japan, but one based on growing the private sector's share of the economy through increasing incentives for work, risk taking, capital formation, and investment. This can be done by reducing the tax burden on corporations, individuals, and capital. To achieve their desired impact from an incentive standpoint, the reductions should be across the board and not targeted toward those who have no federal tax burden via a refundable tax credit. The best way to help these workers would be to implement a payroll tax holiday, which would raise after-tax incomes. If the federal government is going to use its balance sheet in an attempt to spur economic growth, priority should be given to reducing the tax burden and growing private sector payrolls, as opposed to expanding the government's share of GDP through public works programs.

	FEDERAL OUTLAYS AS A % OF GDP	UNEMPLOYMENT RATE
	<u>U.S.A.</u>	
1930	3.4%	8.7%
1940	9.8%	14.6%
	<u>Japan</u>	
1990	31.6%	2.1%
2000	38.3%	4.7%

Economic history is replete with examples of policy responses that resulted in unintended consequences and did not solve the underlying problems for which they were designed. Our monetary authorities are already way out ahead of the mistakes made by the Federal Reserve Board during the Great Depression and the Japanese central bank during the 1990's, and are moving above and beyond a zero interest rate policy. It is now time for our fiscal policy authorities to step up to the plate and deliver a powerful growth-oriented blow that will raise velocity, private sector job growth, real incomes, and economic growth.

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