Tea Leaf

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Your guide to understanding today's economy and financial markets

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Deficit Plunge

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Progress continues to be made in reducing the U.S. government's income versus spending imbalance, commonly known as the annual budget deficit. Additional progress from this point, however, may be more difficult to come by.

The federal budget deficit for fiscal year 2007, which ended on September 30, registered \$163 billion. The number resulted from government spending of a mind-boggling \$2.73 trillion (\$2,730,000,000,000) versus revenue of \$2.57 trillion (\$2,570,000,000,000).

One would think that having more than \$2.5 trillion to spend over 12 months might be enough…

…not the case

Still, good news saw the deficit decline by 34% versus the \$248 billion shortfall of the prior year, and down more sharply versus deficits of \$318 billion and \$413 billion of the two prior years.

Versus GDP

More relevant is the deficit as it relates to the size of the U.S. economy. The \$163 billion deficit represented 1.2% of GDP, roughly *half* the average deficit of the past 40 years.

One would also like to think that recent budget deficits have been declining because members of Congress and the Administration have taken a more responsible approach as to how they spend our money…

…also not the case

American voters removed Republicans from Congressional control last November because they saw too many spending excesses…too many pork barrel spending projects…too much waste.

Democrats took control with promises of greater spending (and pork) transparency…

…what a disappointment!

New Art Form

By some measures Democrats and Republicans have taken pork barrel spending to a new art form. With White House approval, for example, the U.S. Army Corps of Engineers requested \$4.9 billion for various water projects. The Senate passed a bill providing \$14 billion, and the House passed a different bill authorizing \$15 billion in spending.

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When House and Senate conferees got together to compromise…a total of \$23.2 billion was approved. It seems that each and every possible pork barrel project was included in the bill, with more than 900 special-interest boondoggles attached *(The Wall Street Journal).*

With other spending bills also laden with pork, the question arises as to how the budget deficit has been moving in a desired downward direction (say that three times quickly). The easy answer is powerful growth in tax revenues, in part tied to tax cuts of the past few years.

Tax Cuts…*More* Revenue

I argue that when you cut tax rates, especially on incomes, capital gains and on dividends, you simply generate more tax revenue. When you boost tax rates, you simply generate less revenue. History is replete with one example after another.

People are intelligent. They make rational decisions as to their investments. For example, they elect to recognize capital gains when tax rates are lower, and sit on possible capital gains when tax rates are higher. The government has never figured this out.

Overall tax revenues climbed by \$785 billion since tax rates were cut in 2003, the largest four-year revenue gain ever. Individual tax receipts have jumped more than 46% over the past four years, with the wealthy paying *most* of the additional taxes.

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Interest Rates

The general public's basic misunderstanding of the role played by the Federal Reserve in the conduct of monetary policy continues. In the days following the Federal Reserve's aggressive one-half percent cut of its important federal funds rate on September 18, I was called no less than 500 times (that might be a bit of a stretch) regarding how that Fed rate cut would impact mortgage interest rates.

Who Determines Short-Term Interest Rates?

The Federal Reserve is the sole determinant of the level of short-term interest rates in the U.S. economy. The federal funds rate, the rate at which commercial banks and other financial institutions lend excess funds to other commercial banks on an unsecured overnight basis, is the most important short-term interest rate of all. Every other short-term interest rate—including the prime lending rate, commercial paper, U.S. Treasury bills, and short-term bank certificates of deposit—is closely aligned with the Federal Reserve's federal funds rate.

The Federal Reserve has historically been associated with the discount rate. However, in today's financial world the discount rate has become largely irrelevant. If the Federal Reserve were to announce tomorrow that it was discontinuing use of the discount rate, nobody would care. The conduct of open market operations—which focus on the federal funds rate—is now front and center.

Who Determines Long-Term Interest Rates?

Long-term interest rates are determined by the "market"—individuals and institutional buyers and sellers of long-term fixed-rate U.S. Treasury, corporate, mortgage-backed, foreign, "junk" (excuse me, high-yield), and tax-exempt bonds. Just as buyers and sellers determine the price of IBM or Intel stock, or the value of the U.S. dollar in global financial markets, so do market participants determine the price (and corresponding yield or return) of long-term, fixed-income securities and mortgages.

Mortgage rates are indirectly tied to the yield on 10-year U.S. Treasury notes. The traditional rule of thumb has been to take the 10-year U.S. Treasury note yield and add 1.5 percent to 1.7 percent in order to roughly determine the current rate on 30-year fixed-rate mortgages.

Fed Action?

Following the Federal Reserve's aggressive cut in its federal funds rate on September 18 to 4.75% from 5.25%, the Fed made it clear in the accompanying policy statement that it stood ready to cut rates again if needed. A return to higher stock prices and declining global credit market anxiety from late September to around October 12 had trimmed expectations that the Fed would cut the federal funds rate again on Halloween.

However, a return of global financial market anxiety regarding the credit crisis, combined with a sharp decline in U.S. stock indices last week, strongly suggested by the end of the week that another rate cut, most likely 0.25%, was a sure bet on Halloween, with the likelihood of another 0.25% rate cut on December 11.

U.S. stock price gains on October 22 & 23 lessened the federal funds rate cut likelihood a bit. One of the best clues as to whether the Fed will cut its key rate again next Wednesday will be stock price performance between now and then.

At the same time, the 10-year U.S. Treasury note has largely replaced the 30-year U.S. Treasury bond as the key benchmark long-term security. This change is in line with the norm around the global marketplace.

Jeff

"TEA"ser

Ever wonder who closes the door to the bus when the bus driver gets off?

—submitted by *Tea Leaf* reader Janna Roberts

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