2013 Volume Issue 9
Economic Newsletter for the New Millennium
July 4, 2013

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THE CURRENT CACOPHONY OF MONETARY POLICIES THROUGHOUT THE MAJOR NATIONS

Since the quantitative easing began in December 2008, there have been a total of four rounds implemented (with QE 3 and QE 4 ongoing). The results of the Federal Reserve policy on stabilizing the financial markets and fostering growth have been two-fold: 1) increased the size of the Fed's holdings and be more accommodating in terms of expanding the availability of credit and reducing the cost for borrowers; and 2) lengthened the maturities of the Federal Reserve's security holdings to make it easier for them to control inflationary pressures in the event that the economy begins to experience a nice robust recovery – a recovery for which the Fed is now beginning to slowly sound the warning drums. This latter strategy would provide the Fed with the tools to address what former Chairman Alan Greenspan referred to as the now unforgettable term, *conundrum*. Recall where the Fed policy of managing the short term Fed Funds rate from 1.0% to 5.25% (June 2004 – June 2006; remaining at 5.25% until August 2007) had proved ineffective in achieving higher longer term interest rates.

Note:
Size of securities held outright…
In August 2007, the Fed's holdings totaled $791 billion; by June 2013, holdings had virtually quadrupled to $3.2 trillion.

Maturities of securities held outright…
In August 2007, 81% of the Fed's holdings had maturities up to 5 years: 51% less than 1 yr; and 30% less than 5 years.

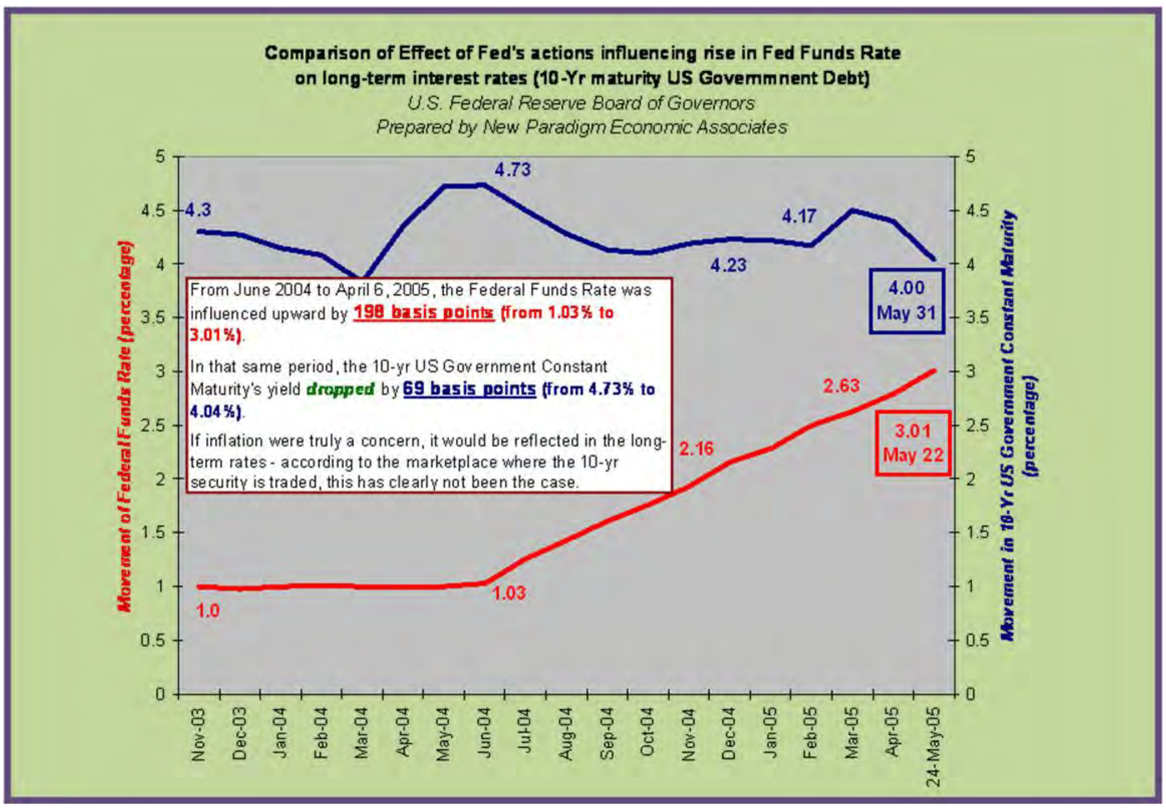
In June 2013: 17% of the Fed's holdings had maturities up to 5 years: 0.0% less than 1 yr; and 17% less than 5 years.

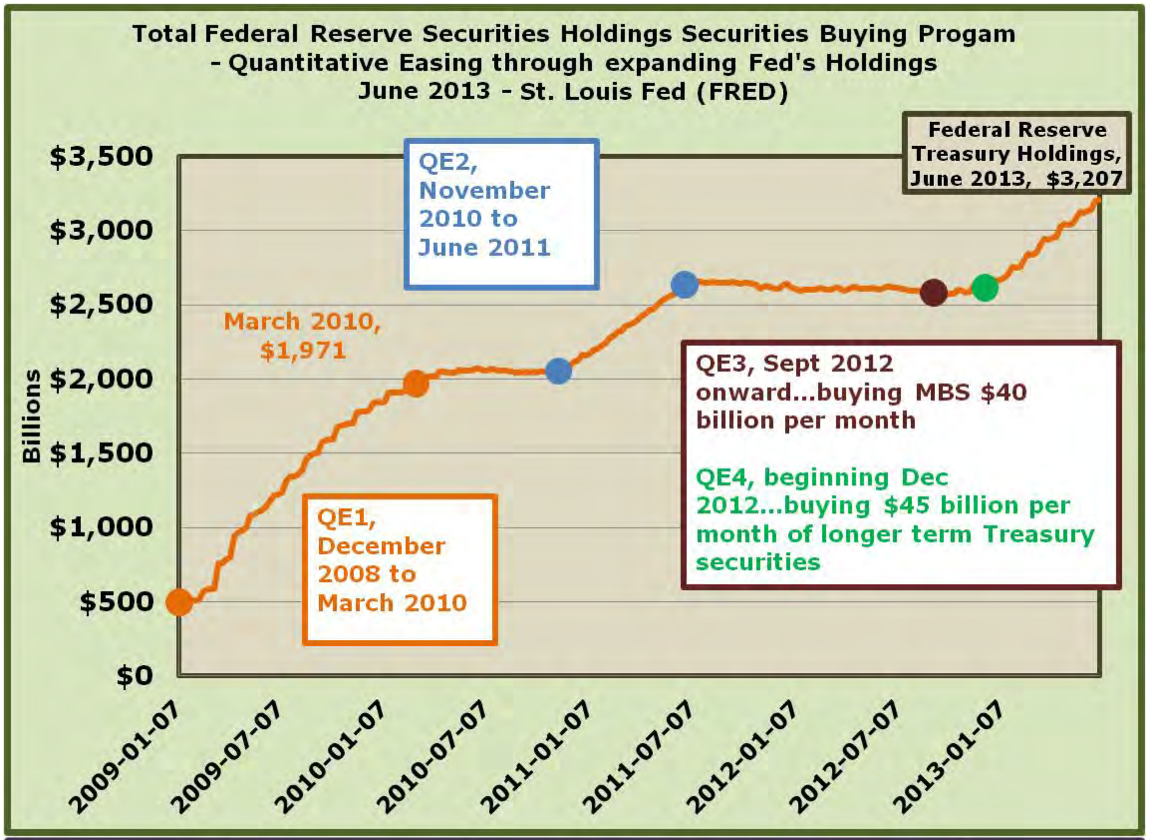
Keep in mind that the following newsletter cited was posted in mid 2005 in the midst of the Federal Open Market Committee's push toward the targeted 5.25% Fed Funds Rate...

http://byrned.faculty.udmercy.edu/2005%20Volume,%20Issue%202/2005%20Volume%20Issue%202.htm
May 31, 2005

Conundrum crisis – day 335

On June 30, 2004, the Fed began its drive to force up short-term interest rates; the longer-term rates (10-year) have [for the most part] fallen ever since.




Total Federal Reserve Securities Holdings Securities Buying Progam
- Quantitative Easing through expanding Fed's Holdings
June 2013 - St. Louis Fed (FRED)
Federal Reserve Treasury Holdings, June 2013, $3,207
QE2, November 2010 to June 2011
March 2010, $1,971
QE3, Sept 2012 onward...buying MBS $40 billion per month
QE4, beginning Dec 2012...buying $45 billion per month of longer term Treasury securities
QE1, December 2008 to March 2010
Billions
$3,500
$3,000
$2,500
$2,000
$1,500
$1,000
$500
$0
2009-01-07
2009-07-07
2010-01-07
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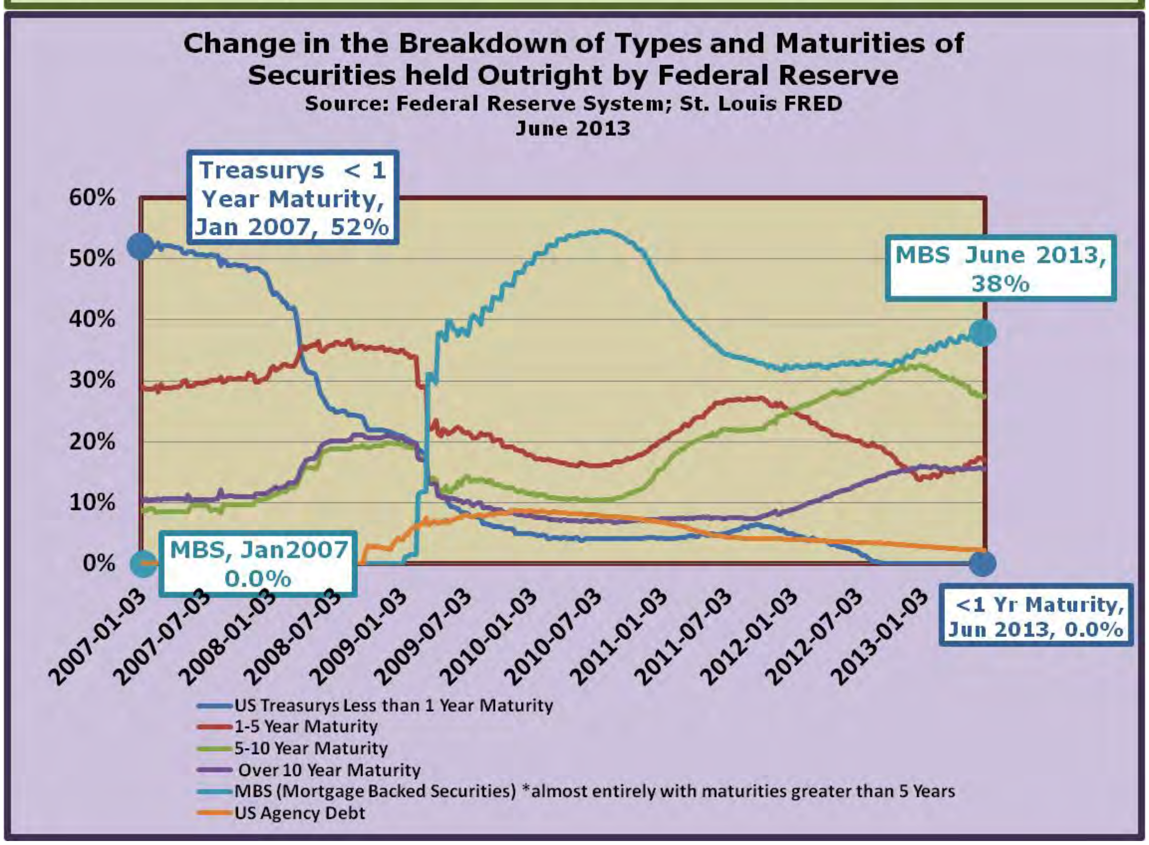
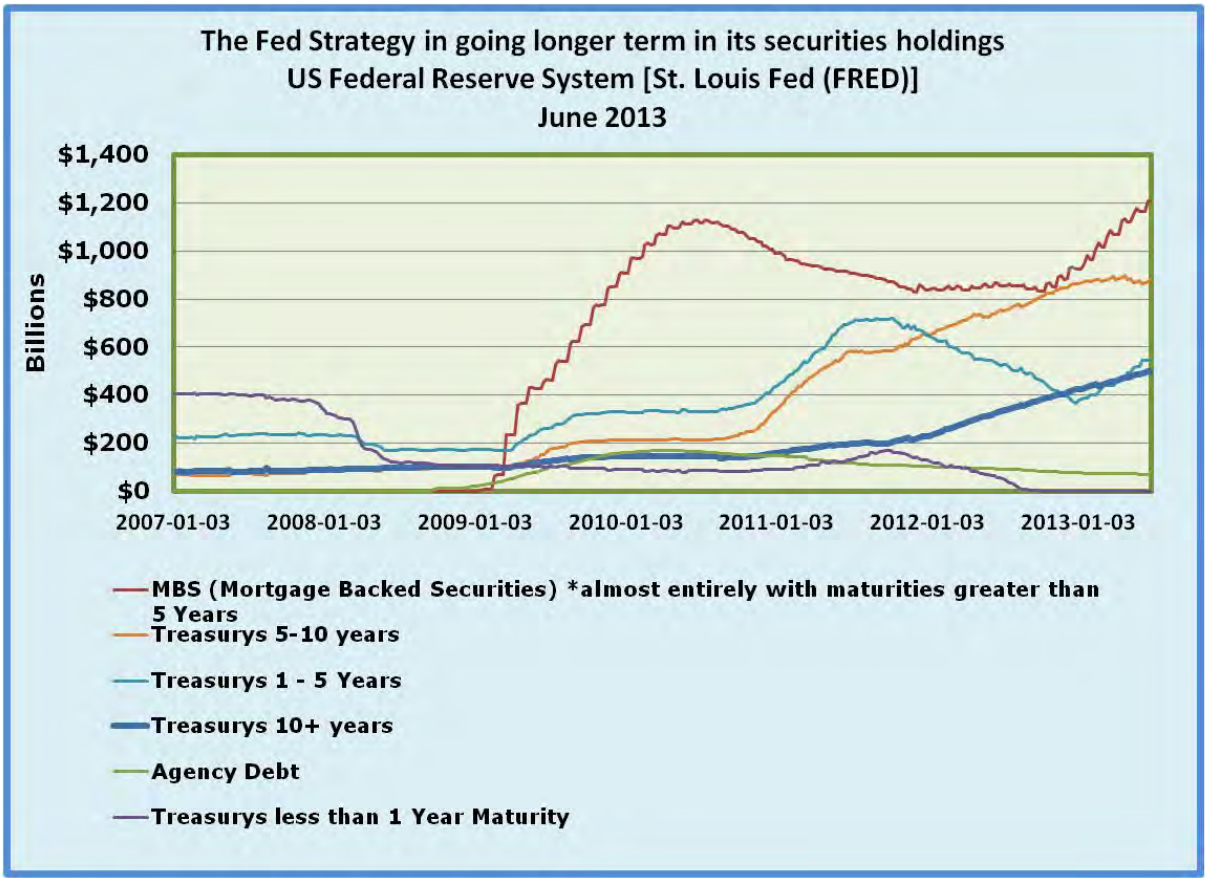

Change in the Breakdown of Types and Maturities of Securities held Outright by Federal Reserve
Source: Federal Reserve System; St. Louis FRED
June 2013
Treasurys < 1 Year Maturity, Jan 2007, 52%
MBS June 2013, 38%
MBS, Jan2007 0.0%
<1 Yr Maturity, Jun 2013, 0.0%
60%
50%
40%
30%
20%
10%
0%
2007-01-03
2007-07-03
2008-01-03
2008-07-03
2009-01-03
2009-07-03
2010-01-03
2010-07-03
2011-01-03
2011-07-03
2012-01-03
2012-07-03
2013-01-03
US Treasurys Less than 1 Year Maturity
1-5 Year Maturity
5-10 Year Maturity
Over 10 Year Maturity
MBS (Mortgage Backed Securities) *almost entirely with maturities greater than 5 Years
US Agency Debt

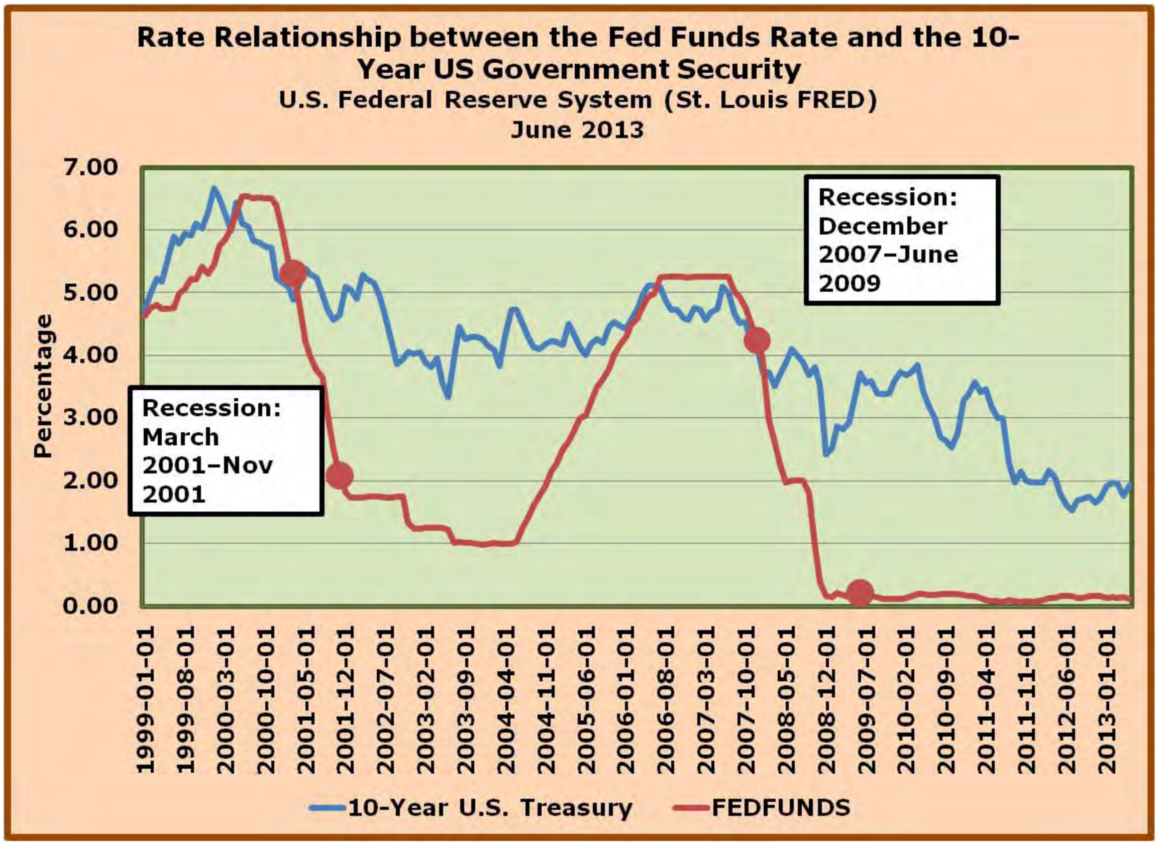


As we have pointed out in earlier newsletters, the central bank of the U.S., the Federal Reserve System (that we lovingly call the FED), had for a number of years concentrated its intervention on the short-term end of the yield curve by targeting short-term interest rates such as the Fed Funds rate. Other short term interest rates very quickly moved pretty much in unison with the short-term Fed Funds rate. The dominantly held theory of the term structure of interest rates (the graph of which is the yield curve) is the expectations theory. Simply stated, longer–term interest rates are the geometric averages of the expected short-term interest rates over the relevant time period. Usually, the market seemed to accept that the intervention of the FED in pressuring up the short-term interest rates was going to lead to averages of expected shot-term interest rates being increasingly higher over the relevant future time period and the longer-term interest rates fell (or rose if you will) into line.

What shocked FED Chairman Greenspan (during the years 2004–2006) was the failure of the FED's intervention to raise the longer-term interest rates by putting upward pressure on shot-term interest rates at the short-tem end of the maturity structure. Such a strategy seemed to have worked in the more recent past. The market must have smelled trouble "comin' round the mountain". The market's expectations of continued rises in the short-term interest rates did not materialize and hence the longer-term interest rates did not rise that time around.

Chairman Greenspan was caught by surprise and declared it a CONUNDRUM. The FED, at that time, did not have sufficient longer-term securities to sell as they do now thanks to the QEs. This would have afforded them the ability to drive down longer-term security prices, which, via the inverse relationship, would have driven longer-term interest rates up, market expectations notwithstanding. That is yet another reason why the FED's portfolio has shifted to such an extremely long term average maturity compared to a number of pre-QE years. Its purchases were biased heavily toward the longer-term maturities of debt as the graphs presented just above clearly show. This time around, the FED did not rely on expectations falling in line but directly intervened in a decisive manner by purchasing huge amounts of longer-term debt securities forcing their prices upward, and via the inverse relationship, drove long-term interest rates down. Examine the the following picture of the pattern of yields on the 10-year marketable U.S. Government security as an example of the effects of the FED's actions.

The bonus of these massive interventions that have come to be called the Quantitative Easings 1-4, is that now the FED can avoid future "Conundra" by selling from their massive portfolios of long term debt securities. Perhaps their new motto should be, "take nothing for granted when long-term interest rates are to be altered." An expression closer to the everyday vernacular would be, "never get caught again with your average portfolio maturity down."



If, and I would not recommend holding your breath until it comes – but if a robust recovery should break out soon, the FED is now well prepared to slow it down should inflation raise its ugly head. There will be no conundrum this time around in the event that a robust recovery breaks out triggering a movement toward seriously accelerating inflation. Again, the good news is that the FED now has the portfolio to go either way. Keep buying securities in the open market if the economic malaise continues, OR sell them if that talked about "prosperity is indeed just around the corner" actually occurs.

Like all panaceas, there are warnings that we must point out, in fact at least two of them. The first is that if that robust recovery should occur and trigger significant inflationary pressures, make no mistake, the FED will intervene in the open market and unload sufficient long-term debt securities to transform a robust recovery into a reasonable and much less inflationary rate of recovery. The shots across the bow by the various FED officials – however mixed are the signals, showed how sensitive the financial markets are to their pronouncements, no matter how innocuous they might seem.

To elaborate, the first danger is that the rising interest rates across the maturity spectrum as a result of the FED's debt security sales and via that cursed INVERSE RELATIONSHIP BETWEEN INTEREST RATES AND SECURITY PRICES, IN FACT TO ONE DEGREE OR ANOTHER, ALL ASSET PRICES INCLUDING GOLD, will tend to fall. Such sales drive the prices of debt securities down and interest rates up. Look out debt security holders. In fact, all assets prices will come under pressure to one degree or another, as required rates of return on investments tend to rise. Fortunately, the FED will bear much of the brunt of it due to the extent they still have massive holdings of debt securities even after substantial sales, if and when that FED action(s) should occur.

The second danger is that debt securities, unlike equity securities such as common stock, have a limited time to maturity (there are very few consol-like debt securities in the current markets, with a perpetual maturity). Their times to maturity continuously decrease toward zero on their maturity dates. Given enough time and an end to the QEs, the average maturity of the FED's portfolio will become increasingly shorter in average maturity and smaller in amount. This would decrease the monetary base even if the FED did not pursue massive sales of such securities. To neutralize this effect, the FED would have to buy additional debt securities at a rate sufficient to offset the existing ones in their portfolio as they reach maturity. If the FED did not do so, a prolonged period of upward pressure on interest rates would ensue until the FED shrank its portfolio to pre-QE levels or some other desired size.

It is almost analogous to addiction including addiction to a dependency on government largesse or a business hooked on "rent-seeking", a term recently coming into vogue which does a disservice to the economics vocabulary by further confusing the term rent now often referred to as producer surplus.

The U.S. Federal Reserve System (the FED), has been talking of easing out of the policy of Quantitative Easing before QEs 1, 2, 3 and 4 become QEs ad infinitum. Confusion reigned when Chairman Bernanke's statement of a few weeks back seemed to be a bit inconsistent with that of the minutes of the last FOMC meeting released shortly after the Chairman's statement of a few weeks ago. In an attempt to calm financial markets, some FED officials have been downplaying any talk of backing down from its bond-buying ways in the foreseeable future.

http://blogs.wsj.com/economics/2013/06/27/feds-lockhart-fomc-meeting-wasnt-major-shift-in-direction/

Wall Street Journal June 27, 2013, 12:34 PM

> ““Nothing has changed” in the Fed’s outlook toward tightening interest rates, Federal Reserve Bank of Atlanta President Dennis Lockhart said in a speech in Marietta, Ga. “The timing of the first move to raise the policy rate will depend on overall economic conditions, but I would estimate ‘liftoff,’ as it is called, to come sometime in 2015,” the official said.”

http://www.buffalonews.com/20130620/Stocks_extend_slide_fall_353_points_after_Fed_statement.html

Stocks Extend Slide; fall 353 Points after Fed Statement
June 20, 2013 Buffalo News

> “A Fed policy statement and comments from Chairman Ben Bernanke started the selling in stocks and bonds Wednesday [June 19, 2013]. Bernanke said the Fed expects to scale back its massive bond-buying program later this year and end it entirely by mid-2014 if the economy continues to improve.”

Bernanke’s statement on June 19, 2013, only added to the confusion as to the near future of the FED’s monetary policy. His decision not to seek another term as Chairman (at least that’s the latest word) did not calm the nerves of anxious investors. President Obama nominates his replacement and those nominations have not been doing well of late. The stock market dropped sharply over two consecutive days nearly two weeks ago. Of course with all the buying and then selling, guess who made out like a bandit? Of course it was the investment bankers who get you coming and going on your financial transactions and profit from good times and bad; preferably alternating frequently.

Now the Japanese have had yet another go at quantitative easing. One top Japanese official is even calling for a return to the Samurai warrior spirit. He apparently has a non-historical mentality as well as failing to observe that China is far different now than in the 1930s.

http://online.wsj.com/article/SB10001424052748704443045756284031023379326.html
YUKA HAYASHI Wall Street Journal November 22, 2010

> “Japan's experience offers a case study in the possibilities and limits of quantitative easing, in which a central bank effectively prints money to spur economic activity.
>
> The BOJ began doing quantitative easing in 2001. It had become clear that pushing interest rates down near zero for an extended period had failed to get the economy moving. After five years of gradually expanding its bond purchases, the bank dropped the effort in 2006.”

http://online.wsj.com/article/SB10001424127887323873904578572793705332844.html

BOJ Deputy Governor Says Japan Is on Track - Hiroshi Nakaso Sees No Need for Further Easing
28 June 2013

> “Nearly three months after it began purchasing bonds on an unprecedented scale to pull the economy out of deflation, the Bank of Japan's Deputy Gov. Hiroshi Nakaso expressed confidence that the measures had improved economic conditions, and ruled out the need for further easing.”
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> “Mr. Nakaso is seen as of one the key players who led the central bank in April to depart from its incremental approach and introduce the bold easing steps. The BOJ has proceeded with massive purchases of government bonds—around ¥7 trillion ($70 billion) every month—to double the size of money in the financial system in a bid to achieve 2% inflation in two years.
>
> The 59-year-old career central banker reaffirmed his resolve to put an end to 15 years of price declines through an easing policy that the central bank describes as being on a "different dimension."”

The EU is exhibiting bipolar behavior in regard to monetary policy. The words Germany, Merkel, and austerity send riotous mobs into the streets of several EU member nations. Like the QEs, each EU bailout seems to beget new plans of more bailouts, as long as the ‘bailees’ will adopt policies of financial austerity. The EU looks like the rolling wave at athletic events as each of the beleaguered nations such as Greece announce their austerity packages and the demonstrators hit the bricks, so to speak. Such antics tempt one to laugh, but it is becoming no laughing matter. I expect that we will soon hear of Karl Marx's growing 'reserve army' as a result of the hidden unemployed buried in the fallen Labor Force Participation Rate (LFPR). Has an era of dependency descended upon us or are jobs that difficult to find both here and abroad?

The aura of corruption besmirches the high and the mighty including the top official of the IMF (not Dominique Strauss-Kahn, but Christine Lagarde). As economists have long said, there is no such a thing as a free lunch. It is just a question of sticking someone else – not so lunching, with the tab. The U.S. is not immune from such actions as a roll call of scandals rocks the Beltway. Apparently, the concept of transparency promised really means that the scandals will be made public.

Linking things together, historically…

History can be a great tool in analyzing the present and gaining a perspective on what the future might bring. A brief stroll through the years since the middle of the Great Depression will shed some light on this current and continuing cacophonic chorus of confusion in the realm of monetary policy.

Lord Keynes broke with the crowd in 1936 when his 'GENERAL THEORY' was published. Around that time there were many arguing that the worst was over and "prosperity is just around the corner". It sounds like many of the comments by our leaders today, does it not? The housing market has improved but manufacturing has not, we are being told.

'Prosperity is Just Around the Corner'
Carson Robison Trio - 1932

There is some timelessness and/or timeliness to the linked recording by the Carson Robison Trio from 1932…yes, 1932, not 2013.

Lord John Maynard Keynes wrote of the weakness of monetary policy in the attempt to resuscitate the Western World out of its financial and economic dilemma referred to as the Great Depression. He made the argument about the weakness of monetary policy in stimulating an economy in his 'Treatise on Money' (two volumes: Volume 1: The Pure Theory of Money; and Volume 2, The Applied Theory of Money).

Keynes spoke of a liquidity trap and of the equilibrium interest rate being negative due to the weakness of investment demand which in turn was partly related to the huge excess capacity of capital goods stock at the time. Like the pundits are currently pointing out, manufacturing then was not doing all that well. He offered an alternative theory of interest rates called the Liquidity Preference Theory in contrast to the Classical/Neoclassical Theory of Interest Rates, which eventually evolved into the modern Loanable Funds Theory of Interest Rates from its humble classical origins.

That bias against the belief in the effectiveness of monetary policy persisted for a long period of time in the writings of Keynes' followers. Their phrase for this weakness was 'pushing on a string' and a limp string at that. In the Keynesian tradition, fiscal policy was, and to a large degree still is, to the current followers of the Keynesian tradition, the 'King' of the economic policy castle.

Fiscal policies were to stimulate aggregate demand; this in stark contrast to the so-called fiscal stimulus of today, much of which is income redistribution policies intertwined with economic stimulus policies. Perhaps that is why massive federal budgetary deficits seem to be failing to cause a robust recovery.

Keynes argued that the behavior of aggregate demand determines the level of economic activity. This was in sharp contrast to the long standing Classical tradition of "Say's Law of the Markets" often said to mean that supply begets its own demand. With the publishing of Keynes "GENERAL THEORY", Demand Side macroeconomics was born, replacing the dominance of the Classical - Neoclassical tradition of Supply Side macroeconomics. Say's Law of the Markets was the security blanket of the neo-classical argument and bore the brunt of the attack by the Keynesian demand side argument.

Soon the simple Keynesian (Samuelson) cross or aggregate demand, 45-degree model gave way to a more integrated IS-LM model, a concession to those still having some faith in the efficacy of monetary policy. Eventually, the macroeconomic scissors evolved with the Aggregate Demand-Aggregate Supply Model. Analogous to Alfred Marshall's developing the microeconomic scissors of supply and demand in the disaggregated microeconomic markets.

With the rebound of international trade and finance from its very low levels in the late 1930s, we now have an Internal Balance-External Balance Model as championed by economists such as Roy Herrod, John R. Hicks (1937) and Meade (1951) and later by others, including Mundell (1962), moving from the IS-LM Model and AD-AS Model to the Internal Balance-External Balance Model.

The development of these more recent models in macroeconomics has escaped many of the more ideologically inclined policy makers. The *Policy Making Gap*, as we here at the New Economic Paradigm Associates like to call it, does not end there.

Since the high-water mark of the ascendancy of Monetarism (modernized version of the classical tradition's Quantity Theory) was reached in the late 1960s and early 1970s, its credibility has fallen significantly as the theoretical basis for monetary policy in combating price level instability (inflation and deflation). In short, monetarism is the theory that is used to argue that a rapid and persistent growth in money, defined in various ways by it proponents, will lead to inflation.

In the late 1970s and into the early part of the year 1980, the U.S. experienced an inflation rate that was rapidly accelerating toward an annual rate of 20% in very early 1980. This caused the market behavior to move from being close to that of Complete Illusion to approaching that of Rational Expectations (passing through an Adaptive Lag behavior pattern along the way) in respect to the public's reaction toward rapidly accelerating inflation.

For a walk through the preceding, take a look at the following write-up on the Fisher Effect…
http://byrned.faculty.udmercy.edu/2003%20Volume,%20Issue%203/Fisher%20Effect.htm

The financial markets responded with a virtual cascade of new products and processes to aid in the public's search for protection from inflation (which also significantly increased the incomes of investment bankers). Processes such as securitization and swept balances and products such as money market deposit accounts and zero coupon rate debt securities experienced very rapid growth rates. The innovation syndrome has continued on with the rapid growth of such things as collateralized debt obligations or CDOs including mortgage backed securities or MBSs. They were in no small way contributors to the financial crisis that began to surface in 2007. Some of these new derivative products fill the FED's asset portfolio to the brim as a result of the QE policies.

Fed bond-buying could be more aggressive than new timeline: Dudley
http://www.reuters.com/article/2013/06/27/us-usa-fed-dudley-idUSBRE95Q0SX20130627
Reuters - June 27, 2013

> "Pushing back hard against market concerns over the withdrawal of quantitative easing, William Dudley stressed in a speech that the newly adopted timeline for reducing the pace of bond buying depends not on calendar dates but on the economic outlook, which remains quite unclear.""
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> ""Economic circumstances could diverge significantly from the FOMC's expectations," Dudley told reporters at a briefing at the New York Fed's headquarters in downtown New York.
>
> "If labor market conditions and the economy's growth momentum were to be less favorable than in the FOMC's outlook — and this is what has happened in recent years — I would expect that the asset purchases would continue at a higher pace for longer," he said.
>
> Following a Fed policy meeting last week, Bernanke surprised markets by saying the central bank expected to reduce the $85-billion monthly pace of bond buying later this year and to end the QE3 program altogether by mid-2014, if the economy improves as expected."

In deference to the growing credibility of monetarism in the 1960s and early 1970s and the various emphases placed on different monetary aggregates whose behavior were deemed the causes of price level instability, the FED increased the number of monetary aggregates they defined, measured, reported and targeted from 2 to 5 culminating in M-1 through M-5. These were dutifully measured, reported and used as targets for the FED's monetary policies back in that time period.

As the rapid growth in the financial processes and products mentioned above exploded, so did the link between the monetary aggregates and nominal GDP. This linkage is termed the velocity of the monetary aggregate in question. The reliable predictability of the behavior of these velocities over the targeting period is absolutely critical to their use as effective tools of monetary policy. That predictive reliability of such velocities disappeared with the roaring inflation and the explosive growth of the financial processes and products. The walls of separation between the monetary aggregates became porous sieves. The credibility of Monetarism collapsed as a result.

The FED has now gone back to measuring, reporting and sometimes using as targets, only M-1 and M-2. Much of the targeting now focuses on various interest rates such as the overnight Federal Funds rate. The High Priest of Monetarism was Milton Friedman. In one of his last interviews on television, I heard him say that he wanted to be remembered for his contribution to microeconomic theory and not monetary theory. “Be kind to others on your way up as you will meet them again on the way down”

As I read the minutes of the last FOMC meetings, I heard arguments from a few of its members’ that were reminiscent of Monetarism and at times even some of its predecessors of Monetarism, reflecting some form of the older Quantity Theory. There are also statements by members reflecting older versions of Lord Keynes’ legacy in macroeconomics.

A few hint of a desire for a quick return to a fixed exchange rate system such as the gold standard. Of course any fixed exchange rate standard involves a surrender o a significant part of a nation’s monetary sovereignty. The knowledge of this loss has kept the U.K. from adopting the Euro to replace its Pound. The UK’s reservations are increasingly joined by critics from other EU nations.

Solidarity Plea: 'Germans Always Looking out for Own Interests'

http://www.spiegel.de/international/europe/three-prominent-europeans-challenge-germany-to-fix-euro-crisis-a-907729.html

> “Three influential Europeans from Luxembourg, Spain and Poland call on Germany to lead the euro zone out of the crisis without pursuing its own interests.”
>
> Luxembourg
> “The Germans, says Asselborn, should not forget what they owe the European Union and the euro: that Germany is now the only large country in the euro zone still experiencing economic growth. But according to Asselborn, one should also imagine Germany as a

locomotive that is no longer pulling a train. It is this image that is causing resentment in Europe."

Spain
"Felipe González, 71, has a word for the austerity demands imposed on his country: "austericide." And he leaves no doubt as to who is administering this deadly medicine to Spain. "Europe is expected to do Germany's bidding," says González."

History shows that whenever a nation faces serious problems, such as winning a war or running out of international reserves (part of which is gold), or continuing domestic policies that seem incompatible with other nations' goals, the often restrictive fixed exchange rate systems (including a single currency system such as that based on the Euro) have frequently led to abandonment of such standards. This has been the case EVEN IF THERE WAS A GOLD STANDARD! The U.S. did so under the '[watered down gold standard]' brought back by FDR. Over the years, even the link of the gold backing to the currency portion of M-1 money was gradually reduced. After WWII when the U.S. sponsored a form of a gold exchange standard referred to as the [Bretton Woods IMF Fixed Exchange Rate System] and when the U.S. began to experience significant balance of payments deficits, the gold price of the Dollar was altered (increased, i.e., the Dollar was devalued which is a form of depreciation in respect to gold) to avoid austerity policies to eliminate those deficits causing the outflow of gold.

The Bretton Woods IMF Fixed Exchange Rate System was a very close cousin to the gold standard. The U.S. dollar was the key currency in that system and currencies of member nations were pegged to the U.S. dollar. If member nations accumulated more Dollars than desired, they could convert Dollars into gold at the U.S. Treasury at the agreed on fixed price, at least that was the agreement on paper. As persistent and significant U.S. balance of payments deficits led to large gold outflows from the U.S., such a situation occurred. Nations such as France sought to exchange Dollars for gold and the U.S. became increasingly reluctant to lose its gold stock and finally refused to exchange Dollars for gold. The system collapsed and a floating exchange rate system of sorts replaced the Bretton Woods fixed exchange rate system.

Back to the Present…

What is happening to the U.S. is not very different than that of the European Union except that the EU has been experiencing it for a longer period of time. As income redistribution rises on the list of political priorities for the U.S., fiscal or budgetary responsibility gives way to programs seeking redistribution of income. Fiscal deficits become less a stimulant to economic recovery and growth and instead stimulate a growth in dependency. This growing reliance on dependency flourishes in an environment that finds employment difficult to maintain and even more difficult for individuals addicted to dependency on the safety net programs to return to the ranks of the employed. The EU has become the poster child of this economic condition. Will the U.S. of A. replace the EU as the poster child? Never say never!

As we have pointed out on this website, the best economic policy to achieve a higher per capita standard of living, i.e., achieving the economic welfare condition of efficiency as well as that of equity in the income distribution, is through more competition. The more competitive are both the product markets for goods and services and the productive resources markets such as labor and capital, the closer the economy moves to achievement of the optimal economic welfare conditions of equity and efficiency on a microeconomic level and high employment and a reasonable degree of price level stability on a macroeconomic level.

Monetary and fiscal policies are no substitute for the fostering competitive markets if the economic welfare of the nation is the goal. Ignorance is not bliss. It leads to misery and dependency and riotous waves of demonstrators as we have been witnessing in much of the EU.

Achieving economic welfare for society…

http://www.econnewsletter.com/173001.html
The Income Distribution…
May 15, 2013

> "The goals to be achieved for an economy to reach optimality are efficiency and equity on a microeconomic level and high employment and a reasonable degree of price level stability at the macroeconomic level."

“The Optimal Conditions of Theoretical Welfare Economics…

Efficiency is achieved when the per capita average levels of production and income are at their maximum. The economy would be producing the most out of the scarce productive resources available and the given level of technological ability it possesses.

EQUITY is achieved when productive resources (conventionally categorized as labor, capital, entrepreneurship, and land) receive as their reward for participating in the transformation process of production, just enough to bring them into employment and keep them employed. They are earning their opportunity cost level of income, i.e., just enough to bid them away from their next best COMPETITVE alternative employment. This would be true for not only labor but for every category of productive resources.

HIGH EMPLOYMENT is the labor market condition that occurs when those markets are cleared. Neither labor nor the firms that employ them have any market power and the quantity supplied of labor equals the quantity demanded. The level of the total compensation rate is that which causes every labor market to be cleared or reach its equilibrium. There is neither a shortage nor a surplus of labor in any market.

A REASONABLE DEGREE OF PRICE LEVEL STABILITY occurs when all markets are perfectly competitive and in long term equilibrium. This implies that neither suppliers nor demanders in any market possess any market or price power. When productive resources experience increases in their physical productivity, their marginal revenue products (the demand for productive resources such as labor) will rise as their productivity increases, all else equal. This will increase their opportunity costs. As long as their nominal compensation rates rise equal to their physical productivity rates, there will tend to be NO upward pressure on firms’ costs and prices charged to buyers. To the extent that some of the physical productivity gains are not attributable to specific productive resources, unit costs will fall and competitive pressures will put downward pressure on the product prices. Hence, a very mild deflation rate would tend to occur.”