ORCAM ALTERNATIVE PERSPECTIVES

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Z.1 Flow of Funds Analysis

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Every quarter the Fed releases the Z.1 Flow of Funds Accounts of the United States. This is one of the more detailed and insightful reports provided by the government.

The Importance of the "Flow" of Funds

The economy is a system of flows much like the human body is a system of flows. That is, the human body is healthy so long as there is a healthy flow of blood through the system. And ultimately, the quality of the nutrients and the way the system responds to this flow of nutrients determines the overall health of the system.

It's appropriate to think of the economy in the same manner. The economy is a system of payments that flow between users in the process of exchanging goods and services. The health of this system is not only due to the flow, but also the quality of the output that is produced during the course of this flow.

The Fed's Flow of Funds report gives us some insights into the health of this flow. So let's dive right in.

Unusual Times Continue....

We live in a highly unusual economic period. Our monetary system is designed in such a manner that the primary form of money is what I refer to as "inside money" or bank money. This money exists as a result of loans that create bank deposits. This can be thought of as the primary medium of exchange helping contribute

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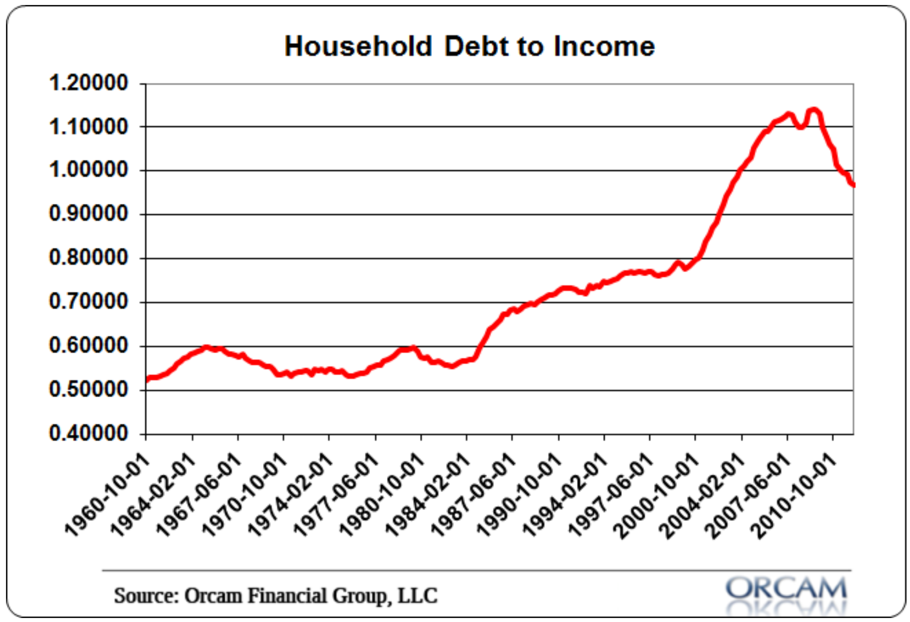
Long story short—The Flow of Funds shows a fragile private sector bolstered by government deficits.

to the “flow” in the economy. In a healthy economic environment the flow is strong as households borrow to purchase goods and services and business borrow to invest. As I’ve discussed often, a strange thing occurred in 2008 when the credit bubble burst. The flow in this type of money stopped. And when that flow stopped the economy stopped. The government’s response helped get the flow going again and served in many ways like an artificial heart that pumped blood through the system. But the recovery has been far from normal and nothing close to organic. That is, the private sector is still suffering from this massive heart attack it suffered and one of the primary things keeping the flow going through the system is the government’s deficit and various Fed policies (to a lesser degree).

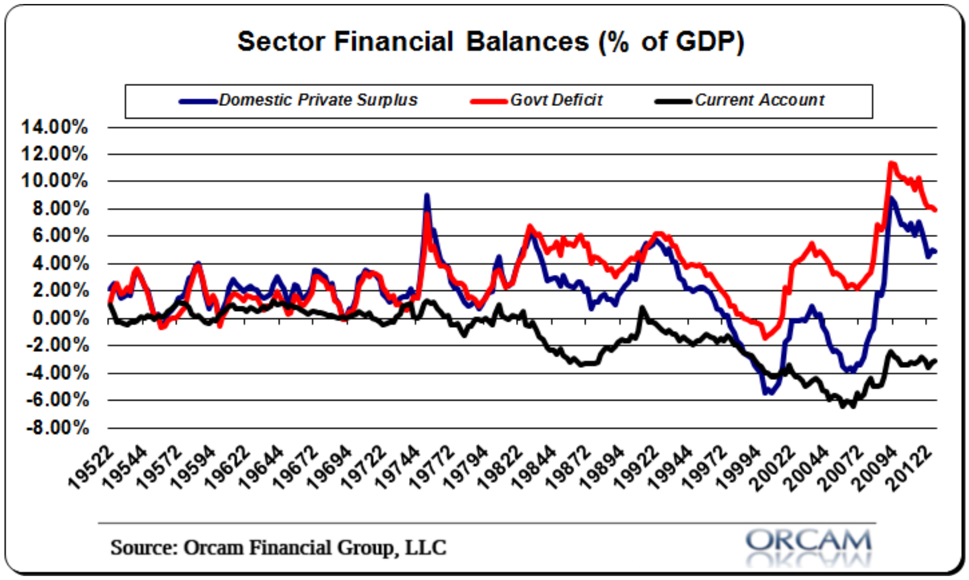


The good news is the private sector is slowly healing as it pays down debt and gets to a position that is more sustainable from a debt accumulation level. The current household debt to income ratio (in the chart to the right) is at 0.92. This is far from the pre-bubble levels in the 0.8 range, but well off the highs. Most importantly, this shows that incomes relative to debt have normalized to some degree. I estimate that this level will continue to heal and will likely reach 0.85 by the middle of next year. That’s good news as it means the de-leveraging cycle is healing and we are slowly reaching a point where credit accumulation can play its normal role in the economy.

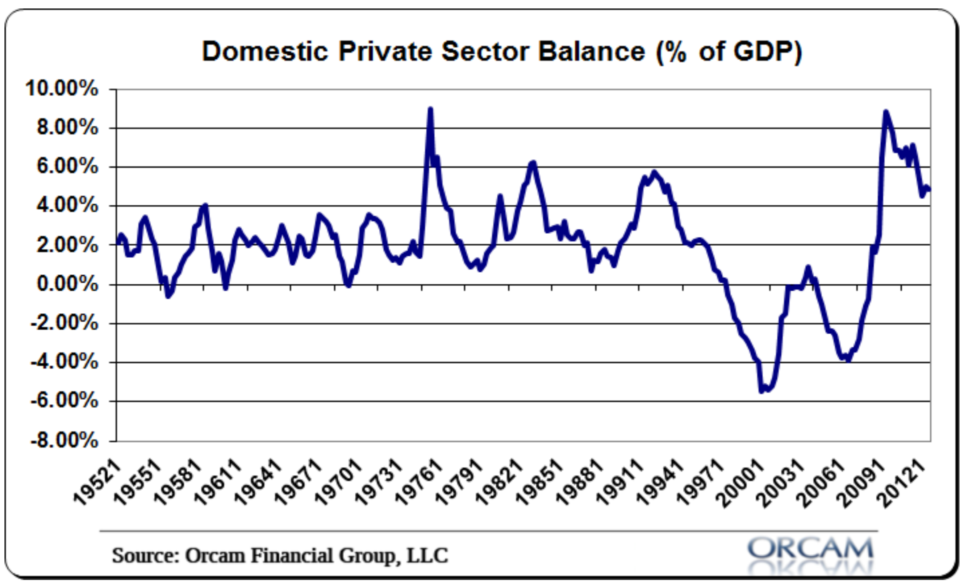
The Fed’s Flow of Funds rounds out this picture. Today’s data dump showed the substantial impact of the government’s deficit on the private sector. If you look at the first chart on page 3 you’ll notice the historical flows of the public sector, private sector and foreign sector as a % of GDP. The three sectors sum to zero. In econ wonk talk, that’s:

$$(S-I) + (T-G) + (M-X) = 0$$

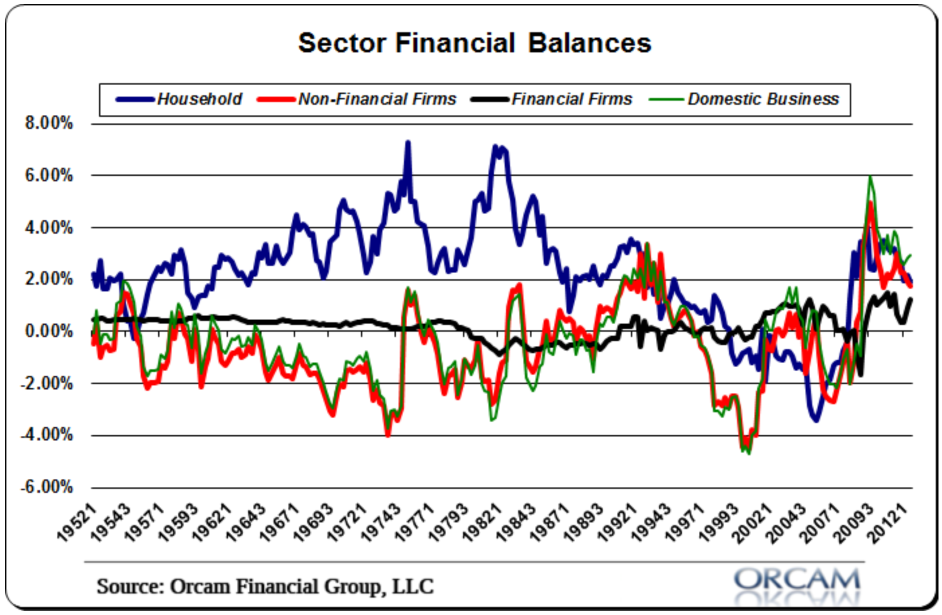
So the crucial thing to understand is how the government's spending is the non-government's income. In other words, when the government spends more, a whole bunch of American citizens obtain more income that can then be spent on goods and services. Of course, this says nothing about the quality of the spending or the "nutrients", but that's a talk for a different time. The important thing for us to understand is that the private flow dried up when the credit bubble burst. And that spike in the red line you see in 2009 resulted directly in the spike in the blue line. In other words, the government's spending turned up the "flow" and got income and revenue flowing through the economy at a time when the private sector was unwilling to do this on its own.



This can be seen in a bit more detail in the chart below. This is the domestic private sector on its own. The fragility we see in the early 2000's was only sustained due to the massive increase in household debt as the housing bubble exploded higher. And when the asset price adjustment occurred the destabilization occurred and the private sector flow turned into a drip.



It's important to break this down even further though. Within the private sector the flow of credit is contingent upon the relationship between households and businesses. The chart at the right shows the more complete relationship here. This shows the flows as a % of GDP by private sector breakdown.



The latest FoF report shows that the government's -8% budget deficit is helping to offset the foreign sector's -3% deficit which results in a net saving position of approximately 5% for the private sector. Within this 5% piece the household sector is saving 2% while the business sector is saving 3%. This is down just marginally over the last few quarters, but it's important to note that this positive saving position is the result of the government's deficit. In other words, the private sector is able to save AND de-leverage because of the government's deficit position. This has been crucial to the current recovery and continued at a healthy clip in the most recent quarter.

Luckily, the business sector remains moderately healthy relative to households who are deeply indebted and de-leveraging still. This has resulted in a substantial positive contribution to GDP from the private investment position. What we're waiting on is the private household sector to make a complete comeback. I don't think we're there as the first figure on page 2 showed. I think household de-leveraging is healing, but won't turn definitively positive until some point in 2013. That means the government's deficit will be needed to continue holding up the economy as the private sector "flow" gains momentum. The big risk to this outlook is obviously the fiscal cliff and a substantial decline in the deficit, but I don't see that happening. So the 30,000 foot view here remains moderately constructive so long as 8% deficits are in store for 2013.

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