DESPERATE HOUSEWIVES- 21ST CENTURY ECONOMIC HOUSEKEEPING

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AS THE WORLD TURNS

The 2007 advent of the international economic crisis ushered in dark and terrifying times. As financial fears increased- and especially as equity and real estate prices plummeted, central banks, finance ministries, and political corridors around the globe passionately responded. Their impressive and sustained rescue responses include slashing policy interest rates such as Federal Funds, money printing (quantitative easing), and enacting multi-billion dollar stimulus packages.

In the economic garden, arguably more than anemic green shoots sprouted. The International Monetary Fund predicts rather a sunny 2011, with worldwide real GDP growth of 4.2 percent following on the heels of 2010's 4.8pc. In 2011, the GDP of advanced economies will increase 2.2pc, with that of emerging and developing economies 6.4pc. ("World Economic Outlook", October 2010, Table 1.1, p2).

Scan the American scene. Are stocks representative of "the economy"? Anyway, **equity prices blossomed, with the S+P 500 up 82.9pc from the March 6, 2009 bottom at 667 to the 4/26/10 high around 1220. Note the spike in US corporate profits**. Nominal (annualized) after tax corporate profits jumped up 50.8pc year-on-year in 1Q10, with those of 2Q10 leaping 37.7pc year-on-year. These current corporate profit levels slightly exceed the peak year of 2006. (Federal Reserve, Z.1, Table F.7). The Case-Shiller composite housing index has rallied 6.9pc from its April 2009 low.

Our worthy financial guardians should congratulate themselves and go home for the night, right? Or at least take a welcome nap. Why not reverse the accommodative monetary policies? They can always set their burglar alarms in case vicious intruders disrupt our neighborhood.

Yet the current landscape is not the best of all possible worlds. Certainly in many regions, it does not appear to be a very happy one. Worries continue, both in regulatory pastures and in the playgrounds of the so-called real world. **Recent growls from economic watchdogs and noises from diverse corners of the statistical garage suggest that further thrilling and chilling episodes remain in the worldwide economic crisis.**

The long-running ABC television series, "Desperate Housewives", offers an archetypal title for our devoted central bankers and their allies in their epic and frequently frantic saga to promote prosperity. This widely-watched show does not confine itself to its crew of leading actresses. The economic domain likewise contains a wide cast of characters.

Why shouldn't television inspire the production of a mini-series of essays analyzing dramas on the economic stage? Part of this perspective should chronicle and assess the words and actions of the Federal Reserve, their friends, and other marketplace players. So let's continue this pilot essay. Subsequent chapters will focus on specific yet intertwined topics in commodity, foreign exchange, interest rate, and equity dens.

RAISING THE CURTAIN

ABC's website for Desperate Housewives tells us that in the town of Fairview, Wisteria Lane is "the perfect suburban fantasy". Nevertheless, "behind every picket fence there are secrets."

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A survey unveils worrisome scenes.

The World Economic Outlook (October 2010, "WEO", Executive Summary, p. xv) warns that **"downside risks remain elevated"**. "Risks to the growth projections are mainly to the downside (ch. 1, p19). The IMF's "Global Financial Stability Report" (October 2010, "GFSR", ch.1, p1) stresses: "substantial downside risks remain".

The US consumer balance sheet remains scarred. It sacrificed $15.4 trillion (yes, trillion) in net worth from end 2007 to end 1Q09. (Federal Reserve, Z.1, Table B.100). This is greater than full year nominal GDP ($14.6 trillion 2Q10, annualized). As of end 2Q10, American consumers grabbed only $4.7 trillion of that money back. Thus they remain about $10.7tr down from the blissful Goldilocks era. Weak consumer confidence and mediocre consumer spending consequently may persist for an extended stretch.

The OECD states that its composite leading indicator for August 2010 reinforces signals of a slowing economic expansion (10/11/10). To what extent can growth in China and other developing nations alter such OECD developments?

In the US and other advanced economies, despite the medicinal efforts by regulators and politicians, **mournful unemployment numbers continue**. The September 2010 headline official number for the US is 9.6pc, with the broadest measure 17.1pc (Bureau of Labor Statistics, Table A-15).

United States real estate marketplaces remain weak. The Case-Shiller composite housing index as of July 2010 still lingers almost 28 percent beneath the July 2006 ceiling. Currently foreclosed homes equal 25pc (twenty-five!) of all home sales (US Secretary for Housing and Urban Development, Huffington Post, 10/17/10). The IMF's "GSFR" underlines: "The stabilization of U.S. real estate prices remains fragile and negative macro-financial spillovers could cause a double dip in real estate." (Ch.1. Box 1.3, p20).

The worldwide fiscal situation is unhealthy now, and may become increasingly sickly as time passes. According to the IMF (WEO, ch3, p1):" In advanced economies in 2009, budget deficits averaged about nine pc of GDP in advanced economies, up from one pc in 2007. By end 2010, government debt is expected to reach 100pc of GDP, the highest level in 50 years. Looking ahead, population aging could create even more serious problems for public finances." The US federal budget deficit reached 9.9pc of GDP in 2009. The 2010 vista is unpleasant- it has a 9.1pc deficit. The 2011 deficit of 7.0pc is hardly appealing (US Congressional Budget Office, August 2010).

Recall the sovereign debt crisis in Europe earlier this year (for example, Greece). **Look at the lofty heights for gross general government debt as a percentage of GDP** in other key nations. Japan's in 2010 is 225.5pc, with the 2015 baseline 250.4pc. As for the US, it hovers at 92.7pc, with the 2015 estimate at 110.2pc. (GSFR, ch.1, Tables 1.1 and 1.2 at p6 and p39).

Anyway, the IMF prescription cries: "fiscal adjustment needs to start in earnest in 2011. Specific plans to cut future budget deficits [in advanced economies] are urgently needed now to create new room for fiscal policy maneuver." (WEO, "Executive Summary", p. xv).

However, solving the ravenous deficit probably offers no free lunch. Cutting spending may slow growth and boost unemployment. The IMF oracles offer hints on this topic.

For advanced economies, fiscal tightening by one pc of GDP typically causes a one pc fall in domestic demand (consumption and investment) after two years. About half of the effect on real GDP is usually offset by higher net exports (); the unemployment rate edges up by .3pc in this process (WEO,ch.1, pp17-18; ch.3, p2). So all else equal, and assuming no other policy measures, picture the near term economic- and political consequences if substantial budget discipline occurred in the current environment in the United States, many European nations, Japan, and elsewhere. Quite a dilemma. Perhaps policy rates would fall due to this retrenchment. Yet policy rates such as Federal Funds in America and elsewhere already are near zero, so they cannot be cut much further. A real dilemma.

Moreover, the IMF adds: **"repair and reform of the financial sector need to accelerate to allow a resumption of healthy credit growth."** (WEO, ES, p. xv). **And how strong are banks?** The IMF estimates (WEO, ch. 1, p6; GSFR ES, p.viii); that the final economic crisis bill will include bank write downs and loan provisions of around $2.2 trillion. Though much of that sum has been put to rest, about $550 billion of that total awaits recognition.

The US equity rally since March 2009 may not reflect robust, sustainable economic strength. The Dallas Fed Pres notes ("To Ease or Not to Ease? What Next for the Fed?", 10/7/10) that the late 2009 and early 2010 US growth primarily resulted from inventory adjustment (accumulation). Inventories equaled about 61pc of the three pc real GDP growth over from 2Q09 to 2Q10. He adds that little near term growth should be expected from net US exports or government purchases.

Also, stock buybacks have assisted price rallies in many American equities. Net buy backs by nonfinancial corporate business occurred at substantial rate from 4Q09 through 2Q10, thus resuming a net buyback trend for that sector of prior years through 1Q09. The average net buybacks for that sector (annualized rate, based upon the past three quarters) is $230.4 billion. (Federal Reserve, Z.1, F. 213).

The Fed has become more and more agitated regarding economic growth, deflation risks, and high unemployment. The Fed Minutes (9/21/10) indicate reduced projections on growth for the rest of 2010 and 2011-12 (p5). It says that "many" participants spoke of the need for additional monetary policy accommodation if economic growth was too slow to sufficiently reduce the unemployment rate or if inflation was too low (p7). Concerns regarding deflation and unemployment have been underlined (see the NY Fed President's wailing in "The Outlook, Policy Choices and Our Mandate", 10/1/10). Chairman Bernanke ("Monetary Policy Objectives and Tools in a Low-Inflation Environment", 10/15/10) suggests that current inflation is too low for the Fed's mandate; an inflation rate around two pc or a bit below is desirable. There may be a need for lower short term real interest rates than the current minus one pc Fed Funds level; perhaps it should be a negative three to four pc between now and end 2012 (Chicago Fed President, "Monetary Policy in a Low-Inflation Environment: Developing a State-Contingent Price-Level Target", 10/16/10).

Given damaged US consumer balance sheets, enormous budget deficits, questions regarding the sustainability of substantial US corporate profits, a still healing banking sector, interest rates already in the basement, further US quantitative easing (money printing) looms. Given globalization, this should worry both American dwellers and their neighbors around the world.

Central banks of course are not all alike. The European Central Bank in general is less concerned with unemployment (is more price stability oriented) than the Federal Reserve. Some nations may decide to raise interest rates to slow economic growth or lending. China increased its rates for the first time in three years (10/19/10). But if Chinese growth slows significantly, isn't that worrisome to the West?

The Fed has not embarked on a substantial new round of in the quantitative easing game yet. But all else equal, how does such money printing spark real (sustainable) growth? All else equal, does it really (and permanently) boost consumer and business confidence over time? If much of the rest of the world does not follow the leader/US, what does that presage for the US dollar?

How much dollar weakness is the US prepared to endure relative to current levels? What about foreign holders of dollar denominated assets? The broad real trade weighted US dollar in September 2010 averaged 87.00, quite a distance from its February 2002 peak at 113.04. It is not far from major support around 84.00. Recall the April 2008, July 1995, and October 1978 troughs. How long will the Fed be able to keep its policy rates low if it engages in a money printing party? US melodies about its love of a "strong dollar" do not necessarily inspire everyone to sing along. Also, what will holders of US securities do if the dollar depreciates quite a bit at a fairly rapid pace, and especially if that weakness occurs alongside a noteworthy increase in US interest rates? See "Goldilocks, Green Shoots, and the US Dollar" (9/7/10).