The Fed Exit and the Role of BLOBS – Part 1

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Note to Readers: This is the first of a two-part commentary motivated by speeches and editorials from Federal Reserve officials about possible exit strategies from its current quantitative easing policies. We comment on some problems that the strategies may pose. We also identify subsidies in the Fed's current policies. In part two we comment on the Fed's own operating policies that may have played an important role in creating the too-big-to-fail problem. This last issue was overlooked by the Dallas Fed's Fisher and Rosenblum in their WSJ op-ed piece of September 27, 2009. They lamented the bottleneck that the concentration of banking resources now creates as the Fed attempts to exit its QE strategy. They fail to mention how the Fed's determination of primary-dealer status has contributed to the problem.

It is becoming increasingly clear from recent information coming from the Fed that its exit strategy from the crisis-induced injection of liquidity will rely upon two mechanisms. First, the Fed will try to sop up excess reserves by engaging in reverse repurchase (RP) agreements using accumulated mortgage and Treasury debt. Second, the Fed will attempt to adjust interest rates upward and perhaps sharply, as Governor Warsh recently suggested.

The Fed will attempt to sterilize the excess reserves that it has created and that have accumulated by raising the interest rate it pays on such funds that are placed with the Fed by banks. The Fed could also raise reserve requirements, although there is no indication they will pursue the reserve requirement course.

If the Fed follows the mechanism that is now used by many other central banks, the rate paid on excess reserves will set a floor, the discount rate will set a ceiling, and the targeted Federal Funds (FF) rate will be in the middle. The actual transaction-driven effective FF rate will fluctuate within that floor-ceiling corridor. At least that is the theoretical construction.

Presently, an apparent anomaly exists in the FF market. The interest rate the Fed is paying on excess reserves is 25 basis points, the desired target for the FF rate is defined to be a range of between 0 and 25 basis points (less than or equal to the excess reserve rate), and the discount rate is set at 50 basis points. The effective FF rate is trading roughly in the range of 14 to 16 basis points. The 25 basis points the Fed is paying on excess reserves, while consistent with the target, sets up a riskless arbitrage possibility for banks. They can borrow at 14-16 basis points in the FF market and immediately lend to the Fed at 25 basis points – they make 9-11 basis points risk-free.

Part of the reason the effective FF rate is below the upper range of the target is explained by the actions of Freddie and Fannie, who accumulate large volumes of cash payments from mortgages until required disbursements are made on mortgage-backed securities and they must deploy those funds on a short-term basis. The GSEs can’t hold deposits at the Fed or earn the interest on excess reserves that the banks are able to earn.

Because GSEs are not banks, they are faced with either earning a zero return on those funds by simply sitting on idle balances or they can lend the funds in the FF market, which they are doing at rates below what the Fed is paying on excess reserves. This arbitrage is a direct subsidy from the government (Freddie and Fannie are now under government conservatorship) and from the Federal Reserve to the banks, because it enables them to improve earnings and build their capital.

As long as the Fed wants to subsidize the banks, it will be difficult for it to raise interest rates with the FF rate trading below the rate paid on reserves. This pattern is particularly likely as long as Freddie and Fannie continue to pump funds into the market.

Interestingly, Sweden's Riksbank has actually been charging a negative rate on excess reserve deposits held with it, in an effort to induce lending. But with so much liquidity in the market, this isn't a feasible strategy for the Fed, since it would stimulate a rapid increase in the money supply and risk inflation. For a discussion of Riksbank's policy see: "Interest Rates go Negative: Compare Riksbank (Sweden) with our Federal Reserve" http://www.cumber.com/should-the-brussiaics-become-the-bics/.

As for the reverse RPs, some reports suggest that the Fed is exploring the establishment of relationships with money-market mutual funds (MMFs) to engage in reverse repos. The Fed would essentially sell securities overnight or perhaps on a term basis, to the MMFs, with an agreement to buy them back at a fixed price. The MMF pays cash, which has the intended effect of draining a portion of the excess reserves that had been pumped into the banking system. Those reserves would then be unavailable for credit expansion should the economy gain speed.

From the MMFs' perspective, this would be a risk-free transaction that would use the Fed's long-term securities as collateral and create a short-term asset for the MMFs, consistent with their investment strategy. This would be the equivalent, from a rate perspective, of a short-term Treasury, and superior to short-term commercial paper.

There are several implications of this strategy for interest rates and markets. First, given the large volume of securities that are involved, nearly all short-term interest rates would rise. This includes the rates on Fed Funds, Treasuries, and short-term commercial paper. Unless the Fed is extremely adept in coordination of this strategy within its interest-rate corridor strategy, the effective FF rate could push against and even exceed the discount rate (the supposed upper bound on interest rates). If this occurs, another risk-free arbitrage situation will be created and the discount-rate policy will have to be changed. The FOMC will find itself chasing its reverse RP policy as it sets the target Fed Funds rate. This “chasing the market” problem will likely be heightened the moment the Fed changes the language in its policy statement. Right now that statement says that rates will remain low for an “extended period.

Rational investors will assume, especially now that Governor Warsh has raised the possibility (although Governor Kohn expressed another view on Sept. 30th), that the FOMC might raise rates rapidly. That would be a departure from the Greenspan gradualism that characterized the last period of FOMC tightening.

Eventually, rates will begin to rise from their present near-zero level to what is expected to be an equilibrium rate. There is no present way to determine what that new equilibrium rate will be. And the start of a rate-hike sequence will be without regard to the timing or the Fed’s intended path for the FF rate. The point is that it is impossible to pursue a reverse RP liquidity mop-up strategy easily, without also affecting many other interest rates. Markets know that the rate movements might be quite large.

Secondly, there is also a potential important consequence for the commercial paper market. If the reverse RPs become more attractive investments to MMFs than commercial paper, because of their zero risk and guaranteed liquidity, then the supply of short-term money to corporations may dry up. This would likely occur just as the business expansion takes off, unless the Fed rejuvenates its special commercial paper facility. But of course, the objective in a tightening regime is to reduce liquidity, not increase it.

The third implication concerns the structure of the markets for FOMC day-to-day policy actions. The idea of engaging in reverse RPs with MMFs is rooted in the fact that the current group of primary dealers is capital-constrained. They have been contracting their balance sheets for almost two years. They have limited capacity to invest in short-term reverse RPs and may not have enough to meet the Fed's policy needs.

This problem of the primary dealers is the subject of part two of this commentary. The issue has, in large part, been created by the NY Fed&'s Open Market Desk operating procedures and the Federal Reserve's rescue policies for large, complex financial institutions. We note that these facts were overlooked in the recent op-ed by the Dallas Fed's Fisher and Rosenblum, as they tussled with the problem of "too big to fail." We will discuss this in part 2.

The Pittsburgh G-20 – Does It Matter?

The second G-20 Summit meeting was held in Pittsburgh last week. There were no market-moving surprises in the outcome. The decisions taken were largely signaled by the preparatory meeting of finance ministers and central bank governors on September 4 and 5 in London. While the press accounts suggest the results were modest, perhaps because of the absence of big surprises or visible sharp disagreements, the accomplishments were, in fact, substantial and in some aspects unprecedented in the post-War history of international economic policy discussions. We agree with the September 28th *Financial Times* editorial on the G-20 outcome, when they state that "… it would be a mistake to indulge in cynicism. The G20 has shown a real will to act…"

The Leaders' Statement, which can be obtained at http://www.ft.com/cms/s/0/5378959c-aa1d-11de-a3ce-00144feabdc0.html , is unusually long and detailed for a text agreed by heads of state. These include not only the leaders of the most advanced economies, who have considerable experience in working together, but also the leaders of major emerging-market economies such as China, India, Brazil, and Russia.1 The list of decisions is too long to discuss here. It is the result of considerable preparatory work by central banks and finance ministries/treasury departments. We will discuss below just the central economic conclusions and the future prospects for policy coordination. Some of the other actions included commitments to strengthen financial regulation, via reformed rules on capital adequacy and the remuneration of bank employees; to reform the global institutional architecture, including a needed reallocation of quotas in the IMF; to phase out fossil fuel subsidies; to "bring the Doha round to a successful conclusion in 2010"; and to reach agreement in Copenhagen on climate change.

The leaders agreed that the unprecedented coordinated policy stimulus they had agreed at earlier meetings and subsequently implemented had worked to bring about a recovery in the global economy, which is now underway in most economies. They recognized, however, that the strength and durability of the recovery is still unclear. They agreed that all would avoid premature withdrawal of that stimulus. This possibly is the only element of the communiqué that has immediate market implications, as it is a further confirmation that policy interest rates will not be raised from their current very low rates, at least during the near term. This has bearish implications for the US dollar and the Japanese yen, which will continue to be used as carry currencies. There were no specific statements on exchange rates, an issue the leaders wisely left to finance ministers and central bank governors.

We give particular importance to the agreement of the G-20 leaders that they will plan together their eventual “exit strategies” and launch a “framework for strong sustainable and balanced growth.” That framework is discussed below. While some had been looking for more details on future exit strategies, such an action at this time evidently would have been premature. In any event we would expect any future statement by the G-20 on exit strategies to be worded pretty broadly, as individual central banks in particular will not wish to lay out future possible steps in much detail. The two important take-aways are the consensus that it is still too soon to start withdrawing liquidity from the global economy and that these countries and their central banks are committed to coordinate their eventual exit strategies.

This latter commitment was made in the context of the following statement, which marks a milestone in international relations: “We designate the G-20 to be the premier forum for our international economic cooperation.” The US and the governments of other advanced economies have finally and formally recognized that the global economy has changed, that in the 21st century it is no longer practical for the G-8 (the G-7 advanced economies plus Russia) to seek to “manage” the global economy. The G-20 is probably larger than ideal, but its inclusion of the major emerging-market economies is a critical plus. Particularly important is the evident commitment of China to this forum. The Chinese delegation to the Pittsburgh Summit was second in numbers only to that of the US and was reported to be highly sophisticated. We are seeing increasing evidence of the so-called G-2 (US and China) playing a leading role on the international stage.

We note also that the G-20 has taken over the Financial

Stability Forum, a G-8 creation, and has upgraded its status, increased its membership to that of the G-20, and renamed it the Financial Stability Board (FSB). G-20 has mandated the FSB to assist it by coordinating and monitoring progress in strengthening financial regulation.

The G-20 members have agreed to develop shared economic and financial policy objectives, set out their medium-term policy frameworks, and "…work together to assess the collective implications of our national policy frameworks for the level and pattern of global growth, and to identify potential risks to financial stability." This will be done through a process of "mutual assessment to evaluate the collective implications of national policies for the world economy." The IMF will provide analytical assistance to this process.

Some have questioned the value of this commitment of the G-20 governments to vet each others policies, citing the absence of sanctions in case a country does not heed the advice of the group. This writer's experience in the OECD, which has pioneered the approach of peer reviews in promoting economic reforms and monitoring international commitments, suggests such comments misjudge the power of moral suasion in encouraging international cooperation. Adding sanctions to such a process in the economic and financial policy area would never be acceptable to the US or the other G-20 members. All governments, including that of the US, are highly reluctant to circumscribe their national sovereignty. But they do respond to moral suasion to adhere to political commitments taken jointly in a group with agreed, shared policy objectives and principles. In the OECD, to take one example, such a process underpinned the lengthy but eventually fully successful process of liberalizing capital movements. Often, it was the pressure of other members that assisted governments in overcoming the resistance of vested interests to needed reforms. Time will tell if such a process will be successful within the G-20, but it is noteworthy to see countries like

China, India, and Brazil accept to have their policies vetted by the G-20 membership.

The next meeting of the G-20 leaders will take place in Canada in June 2010. By then we should have a considerably clearer view of the development of the "Framework," as well as progress on the many action items in the Pittsburgh communiqué, including notably the coordination of "exit strategies."

[1] The members of the G-20 are the finance ministers and central bank governors of 19 countries: Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, the U.K. and the U.S., as well as the European Union, represented by the rotating council presidency and the European Central Bank.

Iran, Nukes, War & Markets

Iran.

Remember the old story about the kid and cookie jar? "If you do that one more time, I will punish you," says the mom. This latest two-months so-called "line in the sand" is not the first, nor the second, nor the third time. The only thing different now is that the Brits (Brown), the French (Sarkozy), and the Americans (Obama) are collectively drawing it. Make no bones about it; it will be tested by the power in Tehran.

The Iranians are caught in a fully disclosed lie. President Mahmoud Ahmadinejad (pronounced: Ach-pitoui MAD Jihad) proves himself the worst of his ilk in the political category. He is a thug like Chavez or Kim or Mugabe, but he has one thing that they do not have: he has a credible weapon in the making. And he has oil and money and is empowered by an oppressive political constituency (mullahs) that preserve him.

Prez A shows his true colors when he uses historical revisionism as a political tactic. That becomes the basis for distracting others within his country and for arguing policy abroad. Larry King's interview is worth watching for those who might disagree with this contention.

For me, this one is easy to call. I've walked through Auschwitz twice. That's right, an American Jew walked in and out of a crematorium; it's the one in the back of Birkenau that wasn't fully destroyed. I've visited the "white ponds" in the back where 800,000 souls have their ashen remains interned and where the gray color of the water is still there after a half a century and where you can still walk and kick the dirt and find a small fragment of a bone and wonder if it is a remnant of a Holocaust victim and not something deposited there by a stray cat.

The notion of a Holocaust denier holding the key to a nuke is frightening. He is a leader of an Islamic revolutionary state and has one mushroom cloud in the making. There is no choice for the Western world, in my view. Think about it: in 1981 the Israelis took out the Iraqi nuke weeks before it was about to be turned on. The location was Osirak. Google it if you are too young to remember this history. Imagine how the world would look if Saddam Hussein had gotten his nuke. Then close your eyes, think back further into history and imagine that the West had responded to Hitler with something other than Chamberlain's pacifism. Contemplate the silliness of failed sanctions and realize that they only empowered the regime that is targeted. Ask yourself if our sanctions on sales of helium (the Hindenburg used hydrogen) had any effect.

You want proof of intentions. Here is Iran's powerful speaker of parliament warning other countries not to provoke Iran and cautioning against moves that would "cost them heavily." Ali Larijani said that any countries trying to provoke Iran could pay heavily. He also recommended that Western nations consider the recent comments from UN nuclear-watchdog Chief Mohamed ElBaradei, who said Saturday that a strike on Iran would turn the Middle East into a "ball of fire." "We advise you to take Mr. ElBaradei's warnings seriously and not to be after provoking Iran. In that case, you will face our predestined action, and returning to interaction will become impossible for you," Larijani said in parliament in Tehran.

Until 1979, the US-Iranian nexus had one dominant family on the Iran side. America's counterparty was one ruler, Mohammad Reza Shah Pahlavi, who ascended the throne in 1941 and ruled until 1979. America and Iran considered themselves allies. The US supported the regime and got strategic location advantage in return. Remember: the Soviet Union bordered Iran. The US failed to see the changes coming in Iran as a generation raised under the Shah resented his monarchy.

The 1979 Islamic Revolution deposed the Shah; America and Iran became adversaries. Iran's strategic Persian Gulf location remains its current critical geopolitical source of power. Saudi Arabia sits opposite Iran on the Gulf. That summarizes the basis for the US-Iran relationship today. That is also why a nuclear weapon on an Iranian missile will change the entire regional and global balance.

Nukes.

Take this seriously. This is not North Korea's Kim, who is a sick and fake actor with a poor country and limited resources and is fully isolated and subject to close surveillance from above and nearby. Rather, in Iran you have the funding, the brains, and the formula. Thanks to a Pakistani who sold it to the world, in Iran you have the technology or, at least, enough of it to advance heavy water and form the basis for a weapon. Iran is not just developing peaceful usage of nuclear material for electric power; it is making weapons and it is setting up to deliver them on intermediate- and longer-range missiles. For excellent and independent research on this issue and others in the geopolitical sphere, see the commentary from Stratfor, at www.stratfor.com. George Friedman and his colleagues are doing superb intelligence work in this area. We subscribe to their service and find it very helpful. Our conclusion: if no action is taken to stop Iran, they will advance their program to full-blown nuclear weaponry.

War.

War is the ultimate act of diplomacy. It can happen by design or by accident. It is horrible and, regrettably, human behavior requires that it is still necessary. It changes form as technology evolves and as political systems are subjected to modernism.

In our present Western world, war is viewed as limited in human terms and extensive in technological terms. We in America have lost the sense of a draft and of broad-based citizen-manned military service. We therefore function with a two-class system for our soldiers. There are those who do and those who don't. A divide exists between them. Many of our political leaders never wore a uniform; their children don't either.

Thus their political decisions do not reflect the direct experience of military service. Vicariously obtained impressions drive viewpoints. They are no substitute for experience. This pains me and others whom I know well and who wore uniforms in their earlier years. Some of us still believe that all should serve our country in some form. Our society might be better off if they did; our leaders might make different decisions if that universal service was part of our national policy.

Political systems in the West do not permit large casualties, which his why the Vietnam era was the last of them. We replace mass casualties with more sophisticated and costly weapons. America dominates the world's air power and the seas so it can engage from distance.

Larger land war deployments like Iraq and Afghanistan become political albatrosses in the US. Sequential casualties quickly sink our presidents. Obama knows that fewer dead on our side is the driving force that makes the decisions; that is why the increased troop deployment in Afghanistan will likely not occur.

But Iranian nukes will introduce a new dynamic to the present system. The war on the Korean peninsula in the 1950s and the Vietnam War in the 1960s were fought under the no-nuke accord. In those wars it was understood that nukes would not be used.

In the jihadist world of suicide bombers, this assumption is not valid. Nuclear war and mass casualties are more of a risk now than they were a few decades ago. That is why Pakistan is a constant global worry. That is why Iranian nukes are a high risk gambit.

Markets.

In ancient times and in modern times, some market players like war. They willingly sacrifice another's life for money. This is one of the terrible tragedies that haunts human history. With nuclear war it may or may not be different. There may still be some who personally think they can escape harm and profit. More likely, in the jihadist sphere, is that there are actors possessed by what some of us would deem to be fanatical belief systems. But, as we learned from the Pakistani sale of nuke technology, money can motivate killer behavior without regard to the scale of the ultimate threat.

War requires financing, and capital markets are the system to provide it. Here is America's weak underbelly. To fight war you need trained personnel and materiel and money. We may have enough of the first, because we have an abundance of the second. But the third is questionable in the eyes of the world because of the financial crisis and the huge ongoing federal deficits.

In Iran they are smart enough to see this side, too. Deficits cannot be enlarged forever, and that includes the financing of a preemptive military action against Iran. In Tehran they are counting on this economic aspect of the issue. They see America as weak enough that it may be challenged head on. They see the possible mining of Hormuz as their card to play.

We expect the Iran situation is introducing a risk premium in markets. It will reflect in a shift in pricing of certain sectors. It may change yields on some debt instruments. It is an added force impacting the US dollar. The volatility increase in the currency realm is already apparent.

Markets expect this US-Iran standoff to end in some form of diplomatic settlement. Markets are not pricing in a shooting war or military event or bombing of Iran's facilities or mining of the Persian Gulf or even gasoline sanctions. That is one tool that has power against Iran and that can threaten the present regime. Changing the Iran nuke policy requires changing their regime. The US could embargo Iranian gasoline imports; they do not refine enough for their own needs. But Russia holds the key to the success of gasoline sanctions. As George Friedman has so well explained, Russia could send in unlimited quantities of gas by truck if it chose to undermine American sanction policy.

In our view it is time to be thinking about scenarios where we would make major shifts in strategy. We're not making them yet but we are worrying about them and we do watch things very closely.

Geopolitical risk is rising. The global economic recovery is still fragile. Nukes, war risk and Iran have made things more problematic. We are holding a cash reserve in our US ETF accounts for the time being. We would commit it back to a fully invested position but only at lower prices.

When event risk is rising we want our clients to be compensated for it. We wish this caution were unnecessary but we must conclude that this is a very uncertain and dangerous world.

Pay or No Pay?

In a move that has become the typical Washington modus operandi, but one that has traditionally been un-Fed-like, word was leaked to the Wall Street Journal about the Federal Reserve's intention to regulate banker pay. This parallels the growing international focus on limiting executive compensation, because of its presumed role in inducing more risk taking by bankers.

We have been told that the Fed plan is still weeks from being finalized, but by floating vague dimensions of the plan, it becomes possible to elicit comment before the details are put in place. This leaves to one's imagination what mischief the proposal might cause. It is like going to a horror movie, where the sound and music builds to the point where the anticipation is worse than the actual scene. For example, some are already conjecturing how deep into an organization the controls might go, while others, predictably, are arguing whether the Fed has the authority to regulate pay. Parties are lining up for and against a proposal that has neither form nor substance.

Longer-run, going down the road of setting pay restrictions will inject the Fed even deeper into the day-to-day decision making and resource-allocation decisions of bank management. This is not a function that is appropriate for the central bank. Moreover, it will likely have severe unintended consequences.

Fed pay restrictions will simply generate incentives for management to devise methods to avoid them by structuring contingent contracts that pay off when certain goals are met. One can conceive of cleverly designed securities that could be given to employees which pay off when certain goals are achieved. Or they could simply induce key employees to form LLCs and contract separately with their companies as independent contractors as opposed to being bank employees. The possibilities are endless and as will be the regulatory creep that will surely ensue as the Fed seeks to choke off the regulatory avoidance activities that inevitable will arise.

Such drama and its approach to the compensation issue is unbefitting of the central bank and is not the way to handle the issues of financial and regulatory reform on the heels of a crisis. But it is another demonstration of how the Fed's independence has been eroded to the point where it now routinely plays the same games that the Washington politicians are playing: float or leak a vague plan, let the hue and cry determine what is or isn't acceptable, and then put together the specifics of a regulatory or legislative proposal that has a chance to fly politically.

Political acceptability may ultimately determine what financial reforms get put in place and what do not, but managing that process is the role of Congress and not the central bank. Making sausage is what politicians do, not central banks. What the Fed should do is to wait until its ideas have crystallized, make the case that restricting pay is a necessary but omitted tool in its regulatory tool kit, and put out justifiable proposals for public comment. Then let the political debate take place, where the central bank is above the fray.

What will all this mean for investors? There are several implications. Initially, the trial balloon process will only add uncertainty to the prospects for financial stocks. As the plan begins to be sorted out, the proposals will first be viewed as a negative for financial stocks, especially Wall Street firms that depend heavily upon bonuses to motivate performance. Finally, successful avoidance strategies will be put in place and there will be the realization that the restrictions were much about nothing. The real risk is that the avoidance activities will only generate another round of government interventions that inject it even deeper into the day-to-day micro-management of American business, from which an exit becomes increasingly problematic.

Tires, Chickens, and Trade – One Week Later

In the week following President Obama's imposition of tariffs on Chinese tires, some commentators expressed confidence that the resulting trade dispute would be well-contained by the two countries and argued that the President had to throw some "red meat" to his trade union supporters. Other, including this writer, expressed concerns that this move could be damaging to the Obama Administration, costly for the US, and risk triggering more significant protectionist actions. The pro-business British magazine The Economist was particularly forceful in the cover story of its September 17 issue, entitled "Economic Vandalism." The article begins with the following: "A protectionist move that is bad politics, bad economics, bad diplomacy and hurts America. Did we miss anything?" Some developments last week are encouraging, but others are not.

Starting with the negative, as was anticipated, workers in numerous US industries also suffering from competition with the Chinese have begun to clamor for similar relief. China, for its part, after threatening action against US chicken and automotive imports, has acted first in the services area, which also is covered by the World Trade Organization (WTO) and is of great commercial importance to the US. China has invoked "defense of public morals" to appeal a WTO ruling against restrictions on the distribution of US movies and other Western media, including the downloading of music. Chinese action against chicken and/or automotive imports may still follow as a result of the anti-dumping investigation China initiated.

The positive aspect of developments so far, including last week's referral to the WTO by China of its complaint against the US action on tires, is that both sides appear to be committed to keeping the dispute within the regulatory framework of the WTO. Thus far, they are following a contract that they both signed, as described below. If the dispute can be kept inside this mechanism, the chances for containing it are reasonably good. However, that will require cool heads on the shoulders of both leaders, in the face of heated nationalist pressures. It also is essential that other countries avoiding joining in with protectionist actions of their own.

Some readers have requested a brief explanation of the legal background to this dispute. China's accession agreement to the WTO included, at the insistence of the US, a provision referring to Section 421, a pre-existing US law, under which, if the US government perceives a large increase in the imports of any Chinese product, sanctions may be imposed to limit the inflow of that product. The test is the following: if "such increased quantities and under such conditions cause or threaten to cause market disruption to domestic producers." Note that there is no requirement to prove that any unfair trade practices existed. We understand that the Clinton Administration gave assurances to the Chinese that the clause would never be invoked.

The process under 421 is the following: once the International Trade Commission (an independent US panel) determines that disruption, as defined by 421, has occurred, it is up to the US President to decide whether or not to impose remedies. Former President George W. Bush declined to impose remedies in the four cases that came to him. Barak Obama decided, on the contrary, to act on the first case referred to him, one where even the US industry in question, America's tire –makers, declined to support the application for import "relief."

This development does not bode well for the ability of the US to assume its usual and probably essential leadership role as champion of the global trading system. We may well see some negative fall-out in the coming days at the G-20 Summit in Pittsburg. Pledges there to avoid protectionist measures would sound pretty hollow. The Obama administration has thus far taken no action to reinvigorate the moribund Doha round of trade talks, nor the three free-trade agreements pending in Congress with three allies of the US, South Korea, Panama, and Columbia.

There also could be effects outside the trade area where the US needs Chinese cooperation and support, such as the climate-change negotiations, UN sanctions against Iran, and the negotiations with North Korea. Let us hope that those predicting the containment of this matter are correct. If events prove them wrong, the costs could be severe.

As portfolio managers, our greatest concern is the risk that this bilateral trade dispute spirals out of hand resulting in a trade war involving a number of countries. That would certainly drive the global economy back into a deep recession. It is difficult to overstate the importance to the global economy of the generally open trading system, the process of globalization, and the ongoing financial integration. Our current investment strategies are based on our view that the most likely outcome is that this trade dispute remains within the WTO and protectionism does not derail the global economy. Accordingly, we are bullish on the prospects for equities as the recovery of the global economy gathers steam. Our international portfolios currently are fully invested. We certainly will monitor the evolution of this dispute closely.

Did Policy Economists Get It That Wrong?

It has become fashionable for commentators to bash economists for having missed the financial crisis of 2007-2009. Nobel Prize winner Robert Lucas provided a recent rebuttal to critics in a guest article in The Economist of August 6, 2009. Unfortunately, it was a rather unconvincing effort.

More recently, Nobel laureate Paul Krugman, in his NY Times article of September 2, 2009 entitled "How Did Economists Get It So Wrong?" took his own shots at the profession. He essentially repeats two criticisms that were addressed in Lucas' article. The first is the profession's fixation on elegant mathematical models, and the second is its belief in efficient markets – the idea that market participants use all available information when making economic decisions and pricing securities. He claims that in the world of theory – which many economists tend to believe is the “real” world – markets are inherently stable and do not admit the possibility of “catastrophic failures in a market economy” like the current crisis. Should a problem occur then it could be easily corrected by appropriately administered Federal Reserve policy. Are these criticisms well-deserved and are they directed at the right people?

Krugman’s critique has brought forth a host of rebuttals from academic economists who defended their performance. Still, one has to concede that Krugman has some valid points. The first concerns the bias among theorists for stability and stationarity in their models. Models serve a useful purpose in all fields of physical and social science. In economics, the trend has been toward building models that exhibit stationarity and stability, so that they tend toward a fixed long-run equilibrium and naturally return to that equilibrium if shocked. Publish these types of models and you will advance your academic career. There has been relatively little interest in the contemporary academic profession in market imperfections or in models that may admit such properties.

However, what critics also fail to recognize is that academic economists are not engaged in the same activity as business and policy economists. Academics are not building forecasting and prediction models of the kind the critics seem to be demanding or expecting. Academic economists are mostly unconcerned and largely uninformed about the week-to-week data releases or the policy moves that the Federal Reserve makes and that fill time on CNBC, Fox Business, and Bloomberg TV. In fact, academia puts little value on forecasting. Once you have built a forecasting model, there is nothing more to be gained intellectually from the academician’s perspective by running the model week by week as new data becomes available. This is really the province of the Federal Reserve and other government agencies, economic consultants, the business economists that populate Wall Street and large corporations who have to make business and policy decisions based upon the outcomes of those forecasts.

The more relevant question, if one wants to criticize the profession, is to ask what the policy economists and forecasters were seeing and saying. If any group should have seen the crisis coming, for example, it was the economists at the Federal Reserve. After all there are a lot of them and they have the most sophisticated, large economic forecasting models that exist. What did they see? When did they see it? If they didn't see it, why not?

Although Krugman criticized former Federal Reserve Governor Rick Mishkin for some of the benign projections he had presented based upon the Fed's large scale model shortly before the crisis broke, one would not realistically expect a sitting Federal Reserve governor to be suggesting publicly that the economy or financial markets were about to collapse. As Lucas argues, Mishkin was talking about the likely paths for the economy, conditional on a crisis not occurring. We also need to recognize that forecasting and prediction models are only as good as the inputs and structure of the economy that the models capture. Unfortunately, existing models have been constructed without data from periods of economic downturn and severe crises, similar to what we have recently experienced. To expect that models would provide the kinds of precise out-of-sample forecasts the critics seem to be demanding is unrealistic. We will have to wait for the release of the FOMC Greenbooks and Bluebooks to get a better sense of the issues and what the inside view was of the crisis as it unfolded. Then, the second guessing will be more fruitful.

One of Krugman's other explanations for the failure to correctly predict the crisis has to do with economists' assumptions about human behavior and, specifically, that markets are efficient and people respond rationally to events. Instead, he suggests that in the future economists will have to deal with a messier world – one now inhabited by those interested in so-called behavioral economics and finance. This world is one that has concentrated mainly on demonstrating that people don't always act rationally in making economic decisions. However, Charles Kindelberger, in his classic book, Manias, Panics, and Crashes: A History of Financial Crises, sets out four alternative definitions of rationality, each with different implications for model structure. Some of these concepts are not inconsistent with the observed supposed deviations from rational behavior that have preoccupied the behavioral economists. Putting Krugman's objections to the side for a moment, there are other ways of thinking about this problem and whether the assumption of rationality is truly a flawed basis for structuring models.

First, I was always taught that economics and finance were the study of human and firm behavior and decision making. If this is not the case, and only "behavioral economics and finance" are focused on "real decision making," then it isn't clear what nonbehavioral (or regular) economics and finance have been studying for all these years.

Second, proponents of so-called behavioral finance have yet to offer significant theories that systematically describe human behavior or that yield better predictions than current approaches. Simply demonstrating that a particular set of assumptions doesn't always hold, is not a substitute for a new theory, nor does it provide the basis for a new discipline. Put another way, in science and social science, it takes a better theory (model) to beat an accepted theory (model). If it is not possible to put forward an alternative, which behavioral finance and economic theorists have not yet done so, then proponents of behavioral finance and behavioral economics are effectively suggesting that human behavior is random and/or irrational. This means that it may not be possible to build a systematic theory to describe nonrational decision making. It implies that the fields of economics and finance may not be legitimate fields of study – leaving only the field of abnormal psychology.

Third, as mentioned previously, it is not true that economists failed to predict that a crisis or significant market adjustment was approaching. Many in the profession correctly foresaw that trouble was brewing in the mortgage market because they saw the perverse effects that subsidies and government interference were having on the effective functioning of markets. Chairman Greenspan warned about the risks, for example, that Freddie and Fannie posed, long before their collapse. Economists have also demonstrated that government subsidy policies designed to indirectly support housing in the ’60s and ’70s were at the heart of the S&L crisis. Perverse subsidies reared their heads again through the actions of Freddie and Fannie and related governmental housing-support activities that were at the heart of the explosive expansion of the housing market and the run-up of real estate prices. Again, these issues have been pointed out time and time again. To be sure, the exact timing of the crisis was not pinpointed, but certainly many micro and regulatory economists saw the problem. This includes not only many of us at the Fed who published warnings on the issues, but also members of the Shadow Financial Regulatory Committee, and many others as well.

Fourth, there is an alternative and more plausible explanation for the crisis other than it flowed from presumed irrational behavior on the part of market participants. Building on the previous point, government policies have long combined to create a substantial set of incentives for rational people to invest in real estate and to take on mortgage debt. Mortgage debt and local real estate taxes are tax-deductible, which encourages leverage and lowers the relative cost of mortgage debt (and, hence, home ownership). Interest rates were held extremely low coming out of the 2001 recession, and mortgage rates were at historically low levels for several years. Both the Clinton and Bush administrations had the encouragement of home ownership as a key policy objective. Congress created Freddie and Fannie and continually encouraged them to expand their portfolios and to invest and support “affordable housing” for low- and moderate-income people. Freddie and Fannie were forced to expand significantly their portfolios of subprime loans. HUD set goals in 2000 that envisioned 50% of the dwelling units financed by Freddie and Fannie would be for low- and moderate-income families. Furthermore, at least 20 percent would be for “very low-income families.” Freddie and Fannie traded on the market perception that they were the beneficiaries of government guarantees should they get into financial difficulties. This enabled them to leverage themselves to dangerous levels, and when they collapsed the implicit guarantees were in fact honored. The Community Reinvestment Act encouraged banks to channel funds into low- and moderate-income areas, and regulators lowered capital requirements on mortgage loans compared with other loans. Even if borrowers found themselves unable to meet their mortgage payments, relaxation in the bankruptcy statutes made it more accommodative for borrowers to declare bankruptcy and walk away from their mortgage debts. It has been argued that those who got into mortgages they couldn’t afford did so rationally. Why? Because even if they were forced to default, in the short run their cost of living (i.e., housing) was lower than it would have been had they simply rented.

In summary, where do we stand when it comes to criticism of the economics profession? Once one recognizes that the academic side of the profession is not primarily engaged in activities designed to either identify or predict recessions, depressions, or economic collapse, it is understandable that these economists would be defensive. Whether the profession is focusing on the right questions or whether its approach to modeling is correct or useful is another matter and deserves their close attention.

Should those engaged in economic forecasting have done a better job of anticipating the downturn? That's a tougher question. We don't yet have the available evidence to know, for example, whether the Federal Reserve economists did anticipate it or not. The preliminary evidence from perusal of the minutes of FOMC meetings suggests that they may not have, but we'll have to wait for the transcripts and release of the Bluebooks and Greenbooks. What is abundantly clear is that there were plenty of other economists who pointed to the growing risks in the housing sector, who pointed to the role that government policies and subsidies played in stimulating the housing sector, who were concerned about the systemic risks posed not only by Freddie and Fannie but by other large institutions, and who pointed to the problems of resolving the failures of large cross-border financial firms. All of these warnings were ignored by policy makers.

The Drunk and The Liquor Store

A few thousand miles of flying gives one a chance to catch up on some research reports. In this case the stack was about the debt-to-GDP ratio and what it means.

It is clear that the United States is on a borrowing binge. And also clear that the Nancy Pelosi-led US Congress has no will to restore any discipline to its spending habits.

Now we all know that borrowing at increasing rates cannot go on forever. And we also know that it can go on for a long time. And history shows that the adjustment process is nonlinear. In other words, there is a period when the increased borrowing in order to finance consumption seems to be painless. We are in that period now.

This usually is followed by a shock. What triggers the shock? When does it occur? These are the types of questions we wrestle with each day as a money manager. And these are exactly the questions without easy answers. A bunch of research reports has proven that to these tired eyes.

Here is what we do know. The total of all government debt in the US has now breached the 100% of GDP level. We get this number courtesy of Ned Davis and by tallying up all the debt of the federal, state and local governments. This ratio has not been this high since World War II. It is climbing in a vertical fashion and can be projected to set a new record each and every foreseeable month.

Unlike World War II, the US debt explosion is not due to military and interest expense. Ned Davis has calculated the spending to GDP ratio without interest payments or defense. Again we are at an all-time high in the post World War II period. We cannot blame the spending spree on the army.

Total credit market debt to GDP in the US is a record 373% as of June 30th. In the UK it is 233%. In Japan it is 225%. We have become the most profligate borrower of the large countries in the world.

Private sector and household debt is not the problem. In the last two months the household debt declined by a huge $37 billion. Non-financial corporate debt is also not the problem. It is barely increasing.

The problem simply is government. It is borrowing at all levels and without restraint.

From Japan we learned that increasing borrowing can continue for a very long time. And that we can get it without much inflation and with persistent very low interest rates. The reason is that borrowing is a way of loading a debt burden on the economy. The larger the debt burden the slower the economy will grow. This is especially true when the borrowing is for consumption purposes. That is the current condition of the United States.

We borrow from ourselves when we have savings. That is the case today as the savings rate has risen due to an after shock of the financial crisis.

We borrow from others when they are willing to lend to us or when they are motivated by other than economic returns. The Chinese loan to us because that is the way they can maintain their currency peg. They need to do that in order to keep their export prices very low. We buy the stuff cheaply and trade our debt to them in return for their cheaply produced goods.

They are motivated by internal politics. They have an estimated 50 million workers making stuff to sell to us and the rest of the world. (Source: China online) It is better to have those workers earning some income than it is to have them idle and looking to foment civil unrest. We have about 500,000 workers making stuff we sell to China. Our stupid protectionist policies will not change this. Bashing China or placing tariffs on their goods will not create any new jobs in the US. Politicians who tell us that knowingly lie to us.

China is motivated by internal politics. So they finance us in an unprecedented way. We may as well enjoy it for as long as it continues.

All this debt has a deflationary characteristic. That is a serious worry for the economy. It also means that longer maturity bonds are still worthwhile investments. They have rallied meaningfully and still have more to go in some of the sectors. This is not true for Treasury bonds. It is true for spread product. Those are the bonds that are performing well and will continue to do so until the spreads return to some new level of normalcy. We do not know what the new normal will look like. But we have every reason to believe it will be narrower spreads and not wider ones.

My friend and Brandeis professor Catherine Mann uses metaphors to characterize the interdependence surrounding the China-US debt relationship. I once heard her describe it as similar to the relationship between the alcoholic and the liquor store. They need each other. They can sustain the relationship for a long time. It only ends when the drunk runs out of money or when the liquor store runs out of inventory. In this case the drunk is getting credit and the liquor store is booking the sales on the accrual method and carrying a big receivable. Some day it will have to be paid.

When I think more about this I listen to the advice of sage Art Cashin. It is time to stop for the day and wet some ice cubes with a night cap. We're back after four flights, 8000 miles, 4 hotel nights, two rental cars, etc. And, we must admit, we did it all on credit. Good night.

Kicking Tires, Playing Chicken: a Misstep on Trade

Last Friday, September 11, President Barack Obama signed an order to impose a duty of 35% on Chinese tire imports, on top of the existing 4% tariff. This was the first major trade action of the new administration, following a campaign marked by strong statements on trade that generated concerns about protectionism and assurances that the candidate really was committed to open markets. As must have been expected, China reacted sharply over the weekend, starting anti-dumping procedures against chicken and automotive imports.

We will not get into here the international legality of these moves. Nor will we defend China's trade practices. Rather, we will argue that this was both a cynical and dangerous move by the Obama administration. As Charles Freeman pointed out in the September 13 Financial Times, the President's decision was cynical because it has little prospect of offering relief to the depressed and internationally uncompetitive US tire manufacturing industry. If the move dissuades the Chinese from exporting tires to the US, other foreign low-cost tire producers will step in to fill the demand. The move looks clearly like a sop to the trade unions just several days before Obama's scheduled Tuesday speech to the annual meeting of the AFL-CIO. If it was a bid to get labor to moderate their opposition to multilateralism, the moribund Doha round, and pending free-trade agreements with Korea, Panama, and Columbia, past experience suggests it is very unlikely to succeed.

The "danger" in the trade action is the possibility of escalation into a full-scale trade war between the US and China, with others joining in. In his speech to Wall Street on Monday, the President stated, "Make no mistake, this administration is committed to pursuing expanded trade and new trade agreements. It is absolutely essential to our economic future." He continued, "But no trading system will work if we fail to enforce our trade agreements. So when, as happened this weekend, we invoke provisions of existing agreements, we do so not to be provocative or to promote self-defeating protectionism. We do so because enforcing trade agreements is part and parcel of maintaining an open and free trading system."

China's contrary view is reflected in their filing of a complaint with the World Trade Organization. There is a positive aspect of this development, in that China is seeking thereby to undertake US-China discussions on the issue, which could be seen as an effort to contain the matter. However, other depressed US industries are likely to clamor for similar "safeguard" actions by this administration, including in cases where the previous administration decided it would be prudent to avoid taking such actions. How such a situation could deteriorate into a serious global decline was demonstrated in the aftermath of the Smoot-Hawley Tariff during the Great Depression. Obama's economic advisors are no doubt well aware of this serious risk, but we have moved one step closer to that slippery slope.

We have to hope that cooler heads in the US and China do prevail and this tempest remains contained. At the least, it is going to be a difficult G20 Economic Summit for Obama next week in Pittsburgh. Recall that at the previous Summit in London in April, the US President joined the Leaders' Statement, in which they reaffirmed their commitment to "… refrain from raising new barriers to investment or to trade in goods and services…"

The escalating trade tensions between the US and China reverberated across global markets on Monday. Commodity markets were hit, as were Asian and European equity markets. Sentiment was negative also at market opening in the US, but as the trading day progressed the US market turned around and attention moved to other issues. Certainly, if the trade row should escalate, the market effects will be more significant and longer lasting. We will be tracking this situation closely.

It is interesting that the domestic Chinese equity market closed up on Monday, apparently shrugging off the trade dispute.. Readers of our Commentaries will recall that at the end of July we noted that the Chinese market had risen too rapidly since its low in early March and was due for a correction. (See "[Is it Bubble Time in China Again?]"). We also said that “We do not question the strong growth of the Chinese economy going forward.” In August the Shanghai market Domestic A-Share Index did experience a -23% correction. The index for China H-shares (shares of Chinese company shares listed in Hong Kong and freely available to international investors) also adjusted but by much less, -6.7%.

By reducing some of the speculative pressures that were building up, these corrections have likely strengthened the case for a further sustained advance in China equities during the remainder of 2009. Our expectation of a growing momentum in the Chinese economic recovery has been substantiated by recent economic reports. Thus far in September both the A-Share and H-Share markets have resumed their upward trends, advancing by 16% and 6.2% respectively. In Cumberland’s international ETF portfolios we have moved back to overweight positions in ETFs that invest in China H-Shares listed in Hong Kong and ADRs listed in the US.

Reflection on 9/11

It has been two pensive days. Somehow the words won’t come. Difficult for me since I write 100 times a year.

I sit staring at the keyboard. No words.

Everyone is/was so busy with 9/11. Public moments of silence, ceremonies, TV filled with remembrances, talk shows, websites, commentaries, footage of planes and fires and people. Nice, polite, respectful mostly, but very busy.

Shhhh, I thought. Just sit with it. Sit in solitude. Then some words started to form. Softly, very quietly. Shhhh. Go slow. Sit with it. A few more words are now coming. But only a few.

This was last years "reflection." http://www.cumber.com/september-11th-reflection/. Here's the lead paragraph: "After seven years, these closed eyes still see the jumpers as vividly as I did that morning. I counted five in the few minutes between the time I first turned around to look at the smoldering North Tower and the time the second explosion rocked the South Tower. The couple holding hands and flinging themselves out of an uppermost floor right below the "Windows" restaurant are framed on my inner eyelids."

The rest is there if you want to read it. For the curious, let me confess that I close my eyes and still see them jumping. No, that's not true. I see them right now and my eyes are actually wide open and I'm looking at the screen while typing these few words at four o'clock in the morning.

But there is no more crying now. Pain has given way to ache and now to calm which has replaced fear. Is it a numbing calm? Or is it a calming numbness? How can one know the answer to that?

Shhhh. Softly. Just think about it. Let it wander in and around on the inside.

Just ponder the imponderables.

It's okay to affirm life. We don't celebrate the attack, but we don't have to live in fear of a repeat.

Anger is still permitted. After 8 years we see it as a useless loss of life. What did the Jihadist fools accomplish?

And we pray that there is some just eternity and that Bin Laden and his ilk will rot in hell for the better part of it.

For us, just affirm life. And reflect with solitude and respect. Shhhh. Softly. Just sit with it.

More on Gold and the CUMB-E Index of Federal Reserve Policy Flexibility

Notice to Readers: Cumberland will be discontinuing publication of one of the two CUMB-E indices of Federal Reserve Policy Flexibility. Specifically, we will no longer maintain the CUMB-E (Gold) Index. What follows is a detailed explanation for this decision.

On August 24th, we introduced the CUMB-E Index of Federal Reserve Policy Flexibility (http://www.cumber.com/introducing-cumb-e-index-of-federal-reserve-policy-flexibility/) The purpose was twofold: to highlight the interest-rate risk associated with lengthening of the duration of the Federal Reserve's assets, and to begin to monitor the implications for the Federal Reserve's capital account. This is especially important as the Fed considers exiting from the current quantitative easing strategy through the sale of the long-dated assets or execution of other strategies to deal with heightened inflation risks. There is no indication in any of the recent discussions of policy changes or exit strategies that there has been any consideration of what a change in interest rates might mean for how the Fed values its assets. (See for example Robert L. Hetzel, "Monetary Policy in the 2008-2009 Recession," Economic Quarterly, Federal Reserve Bank of Richmond, Vol. 95, No. 2, Spring 2009).

The analysis suggested that the Fed would have very little flexibility to sell assets. Under current accounting practices, should the Fed sell assets at prices lower than their historical acquisition costs as part of its exit strategy, it would have to recognize the loss. An even modest increase in interest rates would effectively wipe out the Fed's book capital. In an effort to explore alternatives for the Fed to bolster its capital, it was suggested that the Fed could revalue its holdings of gold certificates, which were currently carried on the books at $42.22 per troy ounce, to reflect the current value of gold of nearly $1000 per troy ounce. The resulting capital gain from such a revaluation would significantly increase the Fed's flexibility to engineer an increase in interest rates.

An astute reader questioned the feasibility of such a revaluation. His reasoning was that the gold certificates were issued to the Fed in 1934 when the US confiscated gold from US citizens and the Fed, and he suggested that the certificates didn't give the Fed the actual right to the gold. As it turns out, the commentator was essentially correct. Under the Emergency Banking Act of March 9, 1933, the Secretary of the Treasury was granted authority to confiscate gold and to pay for it with other forms of coin and currency (source: Encyclopedia of Banking and Finance (9th edition), by Charles J. Woelfel; and the Par Value Modification Act). This authority was exercised on December 28, 1933 and January 15, 1934. Under the Gold Reserve Act of 1934 all of the Federal Reserve's gold was transferred to the US Treasury in return for specially issued gold certificates. The original certificates were carried on the Fed's books at $20.67 per troy ounce, and price was then revalued on January 31, 1934 to $35 per troy ounce. The gold has been revalued twice since then by the Par Value Modification Act (P.L. 92-268), which set its value at $38 on May 8, 1972. The act was amended again a year later (Par Value Modification Act, P.L. 93-110), on September 21, 1973, when the value was set at its current level of $42.22 per troy ounce.

Whenever the certificates are revalued, the Treasury holdings are monetized and the increase in the price of gold is reflected in the Treasury’s deposit account at the Federal Reserve and does not accrue to the Federal Reserve. An official at the Federal Reserve has confirmed that under current law any revaluation of the gold certificates on the books of the Fed would result in a debit or credit to the account of the US Treasury. Unless the law were changed, it does not appear that the Fed has the authority to revalue its gold certificates; and if they were revalued, the gain, if marked to the current market price of gold, would accrue to the Treasury and not the Fed. For this reason, then, we are discontinuing maintenance and publication of the gold version of our index, CUMB-E (Gold).

I am indebted to an astute reader and to officials at the Federal Reserve Bank of New York, the Federal Reserve Bank of Atlanta, and the Board of Governors for their willing cooperation and help in clarifying the issues surrounding the Federal Reserve’s gold certificates.