

When The Fed Tightens

At some point the economy recovers enough to start worrying about the next economic catastrophe – rampant and uncontrolled inflation. The Fed is not going to allow this kind of inflation to develop if it has anything to say about it and, in fact, this is what the Fed was designed to control. The tools that are available to the Fed during a recession are pretty limited and most of the action is in fiscal policy; but when the issue is higher prices the Fed is well armed. This time the Fed has new tools as well. The economy doesn't seem to be threatened by inflation at this point but its arrival is nearly inevitable given all the fiscal steps that have been taken.

The major new weapon is that the Fed can pay interest on the reserves that banks are required to keep within the Fed system. This is called “interest on excess reserves” and the rate paid at the moment is .25%. The aim at the moment is to get the banks to lend as much money as practicable and thus the rate they get for leaving their money in the Fed is being kept low. As the Fed elects to draw more money out of the economy without stomping on the brakes through raising the Fed funds rate, they will be able to use this technique. It remains to be seen whether this is as effective as many assume as this has been part of the Fed's arsenal only since 2008.

A second major decision will affect the Fed's practice of buying up the mortgage backed securities that were at the heart of the housing sector meltdown. The Fed has committed \$1.25 trillion to buying these assets but the time is rapidly approaching when the Fed will exit that market and return to buying the securities that usually underpin their strategy. The purpose of the purchases was to stabilize the mortgage market and there is some fear that leaving will result in a dramatic spike in mortgage rates.

Finally there is the whole notion of communication. It has long been assumed that more communication was preferred to less but that isn't exactly how it has turned out. It appears that Fed predictability led to riskier decisions as the investors could assume they knew what the Fed would do with key decisions such as what the Fed Funds rate would be. It is now argued that the Fed needs to shock the markets from time to time to keep investors worried about risk and exposure. However, too many shocks and the markets start to waffle uncontrollably and that isn't a good thing either.

Analysis: The plan is for the Fed to start to discuss these exit strategies this week – at least as far as the overall strategy is concerned. There will be no action but the discussion should start to get investors and banks thinking about what comes next. The challenge for the Fed is that this strategic conversation should ideally be coordinated with fiscal policy but Congress has shown no signs of being able to organize around anything approaching a coherent plan. There are still many new rules and regulations that will apply to banks and these have all but stymied bank plans to get engaged in the economy. The effort to shift TARP funds to community banks so they loan to small business is a grand scheme but if the FDIC continues to demand dues be paid six quarters in advance and Congress demands that banks set back millions and billions in some sort of “living will”, this additional revenue will just be swallowed up by the new obligations.

Eurozone Contagion Continues to Rock Markets

As the US continues to contend with its own recession/recovery situation, it has been a little challenging to keep up with the mess that has engulfed Europe. But last week made it abundantly clear that what is happening with the PIIGs (Portugal, Italy, Ireland, Greece and Spain) will have a major impact on the US in the short and long term. The biggest part of the crisis is that the Eurozone has shown itself almost wholly incapable of addressing the crisis in anything approaching a coherent manner. This has opened up the possibility of defaults becoming contagious and eventually dragging down much of Europe. The reactions have been highly contradictory and there has been very little real leadership coming from any of the nations in the EU. The most consistent calls for response have come from Jean Claude Trichet and the European Central Bank but the ECB is limited in what it can do about this situation.

In a nutshell, the issue is unsustainable debt. Greece is the first to fall into this hole but there are others teetering on the brink and this is what has paralyzed the Europeans. If this were simply a matter of rescuing one smallish nation – such as Greece – the decisions would not have the implications they have and the challenge would not be nearly as great. But Greece is just the tip of this proverbial iceberg as there are at least six other nations that face very similar issues and could follow Greece into financial default.

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Analysis: There are only two options available to the EU and neither of them is very popular. The first and possibly the worst is to simply allow Greece to fail and default. There are many truly negative outcomes that stem from a strategy like this. The Greeks would have almost no way to repair the damage as long as they were part of the Eurozone and if the Greeks perceive that they have been abandoned by the EU at precisely the moment they need the help, there will be no incentive whatsoever to remain part of the organization. The Greeks would likely pull out of the Eurozone and return to their own currency so as to be able to devalue it and allow for recovery through a radically reduce currency value. This has been the mechanism that states have used for decades but thus has been a strategy that has been denied members of the Eurozone as they use a common currency. The implied trade was that countries would be able to turn to the EU for help if they needed it.

If the EU elects to help the Greeks, this will mean a massive financial bailout and that creates issues of its own. The first is practical and the second is philosophical. The EU is not exactly flush with cash after almost two years of recession and the member states are in no position to divert significant additional funds from their own economic resurgence. The other objection is that Greece has been warned for years that corruption and fiscal mismanagement would create this situation and the governments in Athens simply dithered and delayed until the moment of truth arrived. The Europeans are in no mood to suffer without making Greece suffer far more. The fear is that bailing them out too soon will mean that Greece will delay the decisions it is required to make.

On top of the basic concern about Greece is the fear that this situation will rapidly become contagious. The other states that are in trouble include some much bigger economies than that in Greece and they will be far harder and more expensive to bail out. The notion that Spain and Italy would require a massive bail out is enough to cripple the financial future of the EU for years to come. The Germans have been especially reluctant to turn to this option and there hasn't been much consistent enthusiasm from the French either – although Nicolas Sarkozy is more aggressive in preserving the institutions of the Eurozone and EU.

There have been some who suggest that the Greeks be turned over to the IMF as it is asserted that this is what the IMF does best. While this is certainly true and the IMF does have loads of experience in this kind of fiscal rebuilding, there are some factors that would make this approach very dangerous. The IMF has tools that it normally uses to help countries dig out of their crisis and these are not available to them with Greece. The comparison has been made between Greece and Argentina and some have asserted that this is a very similar situation – one the IMF helped the Argentine government work through. The difference is that Argentina was able to lower the value of the peso to record levels and thus stimulated a significant boost in export activity. The Greeks don't have that option for at least two reasons. The first and most intractable is that they can't lower the value of their currency as they use the Euro. Either the Euro itself would need to be reduced drastically or the Greeks would need to pull out of the Eurozone and possibly the EU altogether. The other problem is that Greece has nothing like Argentina's export capability. The Argentines could export beef and other agricultural commodities, the Greeks have very little to sell outside the country as most of their national income comes from shipping and other services.

Critics have also pointed out that allowing the IMF to take control of this situation would expose the EU as weak and incapable of taking care of its own issues. The advantages of being in the Eurozone would start to fade and more nations would begin to consider whether they would be better off on their own. The euro experiment may well be facing its biggest test and thus far it seems to be failing. The US has a stake in all this as the euro is dropping in value against the dollar every day. That is going to hamper the US economic recovery as this makes US exports more expensive in Europe and that remains one of the key markets for most US sellers. It also means that European products are cheaper in the US and that puts additional pressure on US producers and competitors.

Unemployment Rate Falls as Factories Start to Hire Again

The resurgence in the manufacturing sector started to take hold in December as evidenced by the recovery in GDP numbers, the rise in the PMI and other factors. The data had started to suggest that many manufacturers were slowly adding people to beef up production and when the latest employment data came out, the rate of joblessness had fallen back to 9.7%. This is good news but there are several notes of caution to sound. The first is that the rate may very well climb again in the weeks and months to come as the gain in jobs may provoke those who had stopped actively looking to get back in the job market again. Once they are back in, they are going to be counted and the rate may rise.

Analysis: The other factor of note is that many of these new jobs are somewhat contingent on the second half of the manufacturing rebound. Right now the gains are being made on the basis of inventory replenishment in anticipation of better demand news in the future. There is nothing suggesting that this demand is ready to manifest quite yet and until the consumer gets untracked, there will be some vulnerability with these jobs. The gains could be lost as quickly as they came if the manufacturers aren't able to sell their newly established inventories. The other problem with the latest data is that there has yet to be a big surge in service sector jobs and that is crucial for an economy that relies on the service sector for 80% of job growth. The best news is that most of the improved job picture has come due to the hiring by small business.

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STRATEGIC GLOBAL INTELLIGENCE

February 8, 2010

Orange Revolution has been Reversed

The elections in Ukraine are over but the political war has only just started. As the polls had been suggesting for weeks, the victor in the second run-off election was the former President Victor Yanukovich. It is a stunning comeback given the fate of his first Presidency. It was Yanukovich who was ousted by the Orange Revolution in 2004. That episode marked one of the high points of transition in the former USSR. The horribly mismanaged Ukraine was facing a seminal election and the polls had all suggested that there would be decisive win by the reform candidate – Victor Yushchenko. In the weeks before the election there was evidence of massive Russian interference and at one point Yushchenko was the victim of a poisoning attack designed to force him to drop out the race. His soup was laced with dioxin but it failed to sicken him enough to withdraw, instead the poison scarred his face horribly and added to his reputation as a martyr for the cause. The election was clearly rigged in favor of Yanukovich and that prompted a massive reaction by the Ukrainian people. For weeks they stood in protest in the bitter cold and forced the election to be nullified. It looked as if Ukraine would finally shed the ineptitude and cronyism that had held it back for so long. That was not to be.

Almost from the start, the two leaders of the Orange Revolution fought. Victor Yushchenko turned out to be the cautious and stolid bureaucrat he appeared to be and he was wholly incapable of building a political base. He placed all his hopes and aspirations with the western nations but they failed to deliver the kind of support he needed. Meanwhile his erstwhile ally – Yulia Tymoshenko – proved to be adept at building a power base but was wholly corrupt and incapable of attending to anything other than her political ambitions. She set about destroying Yushchenko with the assumption that he was her only rival for power. To say that they came to hate one another is an understatement.

Analysis: The two reform candidates squandered every opportunity and left the vast majority of their fervent followers disillusioned and depressed. The number of people who support a pro-western, pro-Ukrainian regime is large and fully capable of electing a government that takes that position but they are either split between the two candidates or they have become so disgusted with the ineptitude and greed that they no longer bother to vote. Victor Yanukovich is back on the strength of the Russian voter he represents. They make up scarcely a third of the total population in Ukraine but they now carry the day. The Russians played a more low key role in this election but there is elation in Moscow as their man is back in power and until the reformers purge Lady T, there is no threat to the Yanukovich forces in the future. The collapse of the Orange Revolution is sobering as this was thought to be the turning point in this region. The spate of reform governments that emerged in the early parts of this century have all fallen victim to inside squabbling – the Cedar Revolution in Lebanon is no more, the would-be reformers in Central Asia have been routed and now Ukraine.

Costa Rica Elects First Female President

The election of a woman to run a Latin American state is no longer all that unusual and that is a tribute to the involvement of women in the politics of these nations over the past few years. The latest member of this club is Laura Chinchilla. She joins women like Chile's Michele Bachelet. Panama's Mireya Moscoso, Argentina's Cristina Fernandez, Nicaragua's Violeta Chamorro and Janet Jagan in Guyana. Chinchilla is more akin to Bachelet as she has risen through the ranks without the help of a powerful husband. She is a protégé of the popular former President Oscar Arias and has already edged to continue the pro-trade and pro-business policies he espoused. The nation has long had a reputation for stability and this is what she campaigned over. She had been the Vice President under Arias and the assumptions that she will carry on the traditions set by his government.

Analysis: There will likely be some differences in the two administrations however – at least that is the assumption given what she was involved in as Vice President. She is a big supporter of education and especially that of women. She has been an advocate of the programs that empowered rural women and she will likely continue to push these efforts. She is more socially conservative than her predecessor and she has established a strong pro-business position as well. She was reputed to be the pragmatist in the Arias administration and makes no secret of her intention to keep consulting him.

Indian Economy on Verge of Returning to Boom Growth

The economy is surging in India and the expectation is that growth will hit close to the boom levels set in 2006 and 2007. The expectation is that growth will soon hit 8% again – perhaps by the end of this year or early in 2011. This expansion has been due to a number of factors – solid exports at the top of the list. But perhaps more important is the expansion of the domestic market and the Indian consumer. This is now driving a great deal of the new growth and will for the next few years.

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Are We All Saints Nation Today

The winner of the Super Bowl is the New Orleans Saints and this is the culmination of a most remarkable story. The Saints have been in the league for 43 years and had registered exactly two post season wins in that history until this year. This was their first appearance in the Big Game and they won it. The city that was so battered by Katrina now has its team on top of the NFL and they did it by beating the team that was supposed to walk away with the trophy behind the best quarterback in the league. Now comes the analysis and the symbolism. Is this the kind of weird rallying point that a downtrodden economy needs? Maybe. Stranger things have provoked change in national attitude. Plus there is the adage that Super Bowl winners predict the performance of the stock market. When the National league wins, the market pops up and when the American league wins the market declines. If this prediction holds true the market will be bullish this year.

Analysis: The best news is that the Saints have won prior to the start of Mardi Gras. If you thought the parties were good in the past – just wait till this year. The country has been in a funk for a while and part of the consumer equation is emotional. Perhaps now is the time for a real party to break out and no city does this better than the Big Easy. Let's all hope that "Who Dat" is the rallying cry for the 2010 economy!



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