Saturday, March 9, 2013

Policies and Economy: The Return of the "Bubble"

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It was to be another usual, uneventful Tuesday on March 5 at the New York Stock Exchange (NYSE). When business opened, no one expected anything sensational.

The squabbles among politicians were continuing in the face of mandatory spending cuts of US$ 82.5 billion which began from March 1, with ultimate total of US$1.2 trillion over 10 years. President Obama had warned of the harmful impact of cuts in government services ranging from education, vaccines for children and medical research to airline travel and aviation security. The Republican opposition led by Senator Mitch McConnell dismissed the warnings as empty threats: "I don't believe the world will end."

With the housing market improving, the stock market roared back: Enough is enough.

The unexpected finally happened during the later part of the day.

A single day record

New York's Dow Jones share index set a new all-time high record. In one day it wiped out the losses brought on by the global financial crisis in 2008. It was at its highest (14,285) during the day, smashing the previous record intra-day high of 14,198 in October 2007. The index more than doubled (the lowest was 6,550) in the depth of the crisis in March 2009.

It closed slightly lower at 14,256.

The Financial Times and London Stock Exchange (FTSE) index also closed on Tuesday at its highest, 6432. The rise was 68 percent from its lowest in 2009.

For a second day, on March 6, the Dow Jones Index climbed further reaching 14,296.

At the close of business in NYSE on Thursday, the Dow Index has set a closing record for the third straight day, finishing at 14,329.49.

Dow Index covers only 30 stocks. They include Coca- Cola, Microsoft, Wal-Mart and General Electric. The Standard and Poor is broader and Nasdaq is tech-heavy. They too rose, but not to the same extent.

Some exuberance is better than no exuberance!
It has yet to become "irrational" to move the economy!

Helicopter Ben

Efforts by the US Federal Reserve (the Fed) to pump in money under the unorthodox program of quantitative easing (QE) have shown some results.

The QE was compared to throwing money from the helicopter. That earned the Fed Chairman his nick name: Helicopter Ben!

The best results would have been a rise in credit flows.
Banks are hesitant although they are sitting on mountains of reserves.

The Fed added more than US$3 trillion of monetary stimulus and US$ 1 trillion of bailout loans to financial firms since the 2008 financial crisis.

Just a week earlier, in late February, Chairman Bernanke told the US Congress that he would continue the QE until the unemployment rate is brought down to 6 percent, "which would be around 2016."

The investors took the hint.

They decided to take out their cash from under their mattresses and buy stocks. Bond holders were dissatisfied with a poor yield of 1.9 percent on a 10 year bond. They switched on to stocks. Bond prices fell and equity prices rose.

The job market news too played a role. Payroll data survey of Fortune 500 revealed that companies added 198,000 new workers to their payrolls in February. It is likely the current unemployment rate would fall to 7.8 percent from 7.9 percent.

Accommodative monetary policy

Central banks all over the world follow expansionary monetary policies.

On Tuesday, Fiji's Reserve Bank announced no change in the overnight policy rate at 0.5 percent. Fiji's economy is marked "by weaker performances in tourism, sugar, gold and sluggishness in electricity and cement production" and supply-side disturbances, which included cyclones in late 2012.

The European Central Bank decided on March 7 to keep interest rate unchanged at 0.75 percent for the eighth month in a row. The Bank of England's rate is also maintained unchanged at 0.5 percent.

The hopes are now pinned on stock market.

Rise in stock prices will enhance the paper wealth, raising the value of collaterals. Borrowing by households will rise. Consumption and purchase of semi-durables will be up. The firms can raise more capital by issuing new stock at higher prices. The so called Tobin's "q theory" will speed up monetary policy transmission.

Will QE lead to inflation?

Chairman Bernanke told the Senate Committee: "It's our view that there's still a good bit of slack in the economy. I don't think the economy is overheating," he said.

The Fed will not pull away the punchbowl. It will be refilling the punchbowl for a very long time!

So we will have the much awaited return of the asset bubble.