The king is naked, but healthy

Some useful lessons are going to be acknowledged after the present financial volatility period settles, particularly in the US. The most important one will be the divergence between the real economy and the perceived one, the dissociation between short and long term equilibrium values and Wall Street.

Real activity in the US is certainly decelerating, and will continue in that trend next year. Late Federal Reserve monetary policy decisions centered on the aggregate liquidity, though necessary, will have no impact in the short term. Real GDP growth rates of 3,6% in 2004, 3,1% in 2005, 2,9% in 2006 and 2,5% in 2007 will continue going down in 2008. Current employment creation of 1,1 million new jobs annually is already 40% down from its peak at the end of 2005 and beginning of 2006, and below civilian labor demographic growth. Third quarter corporate profits were 20% down from last year's, after double digit growth rates in all previous quarters.

Can we really think that this picture is due to the present mortgage mess? If anything, it is just a consequence of a wider phenomenon, but not its cause. It is like blaming the monetarily caused 1929 crisis to changes in shares values and insider trading plots. The most probable cause lies also in a too restrictive domestic monetary policy that has seen no growth in monetary aggregates since mid 2005, predating this current mortgage related confusion: today's M1, the most liquid and meaningful one – US$ 1,37 trillion in a US$ 14 trillion economy -, is almost identical to that used by a vigorous US economy two and a half years ago. As Milton Friedman quite clearly explained long ago, even with "long and variable lags", consistent monetary growth below or over nominal money demand gets reflected in downward pressure over prices and activity, or inflation. The US is just getting the first one.

Present risk free long term real interest rates are close to 2%, below the historic average of 2,5%, under contained inflationary expectations. Monetary aggregates should respond in kind, finally increasing, and Federal Reserve additional measures besides efforts to lower short term interest rates seem pointed to get that objective. Further monetary impulses do not seem to be warranted; what is just needed is some patience to recognize their impact.

As for an additional US dollar devaluation, the case for it is not convincing at all. Foreign trade figures have been rapidly reacting to a US dollar historically undervalued on a real trade weighted basis, with exports growing at 12% and imports at 5%, annually. At present rates, in 5 years there would be a balanced trade, but given the previous monetary restrictive environment, that balance will be attained much faster. Considering real exchange rates from 1973 to this day, the US dollar is now 10% below that long term average. It is time to bet on this currency, not against it.
In other words, monetary corrections are under way and US foreign trade is responding with a rapidly decreasing deficit. And the rest of the world is nicely growing, particularly underdeveloped nations. Capital markets should at the end of the day reflect this and return to normalcy, separating a deceleration growth process with corrective measures already taken from noisy financial past decisions that are finally being internalized.

What is intriguing is that this essential story is not the one being touted in Wall Street. There the problem lies and is being caused by subprime mortgages, CDO's and SIV's. It is apparently now that they are learning that there is a rate of return and a corresponding risk that cannot be consistently broken; that usually what one party loses is being gained by someone else in a redistribution game, as Goldman Sachs can testify, reducing aggregate losses; that there is an optimal size and

business amplitude for any economic unit, including financial ones like Citigroup that have been clearly operating beyond their efficiency point; that the road to economic decay is full of good intentions, such as freezing the price of money; that a capital market seriously working under these very questionable assumptions is an unreliable one; that a financial system operating as of today damages the monetary transmission mechanism and the Federal Reserve ability to introduce liquidity into the system.

Let us hope that monetary authorities do not fall under this cloud of misinformation and light decision making. Liquidity centered decisions will all go in the right direction, as they have been doing for the last three months. What is missing is a message from the government and presidential candidates that for the long term health of the US economy, free market policies are the solution. That means opening the gates to immigration, getting out of outdated GSE's and their implicit insurance from the Treasury, being serious about limited and efficient government spending and approving free trade agreements, among others.

In other words, there is no magic. Otherwise, you are still living under the Wall Street spell.

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