Dog Days Arrive Early. Ancient Greeks and Romans believed that the position of Sirius, the “Dog Star” was responsible for the heat and the evil things happening during these days.

The weather has been exceptionally warm over much of the nation. And the economy hasn’t been doing too well either (going to the dogs?) Job growth continues to disappoint. Stocks have been listless. The news from Europe and Asia deepens the downside risk here and abroad. As November approaches, it is looking increasingly like the political parties will wait until the last moment before dealing with the expiration of tax cuts and implementation of massive spending cuts scheduled to hit just when we ring in 2013! And there’s not much the Federal Reserve seems to be able to do to stimulate the economy.

However, there are some bright spots. U.S. car sales are well above recession levels. Home prices are rising in much of the country.

Out of Ammo? Send the helicopters! At its June meeting, the Federal Reserve announced that it would continue “Operation Twist.” This is the sort of dance a central bank does when it is running out of monetary tools. Some are now betting that the Fed will resume its Quantitative Easing (QE) program.

Having pushed short term-interest rates to zero in December 2008, the Fed can no longer use traditional “Open Market Operations” to reduce money costs further. It faces the dreaded “zero lower bound.”

As a result, Quantitative Easing was introduced during 2008 to reduce long-term yields on Treasury and mortgage-backed securities. By buying these, the Fed helped drive the yield on the 10-year note to an all-time low of 1.5 percent by this year.

The Fed bought more than $2 trillion of securities from banks by simply crediting the sellers’ accounts with the proceeds. It paid for these securities by just making up the credits. Most of the proceeds from QE have ended up in “idle reserves” where the banks earn 25 basis points (a quarter of a percentage point).

“Operation Twist” differs significantly from QE. When the Fed sells short-term paper in order to purchase long-term bonds, it is changing the maturity composition of its existing portfolio with the hopes of holding down long term rates. Short-term borrowing costs could rise, but so far this hasn’t happened because the banking system is awash in liquidity and loan demand is still weak.

The main reason for “doing the twist” is because the simultaneous selling and buying does not enlarge the Fed’s portfolio – in contrast to Quantitative Easing. There has been considerable Congressional opposition to further expansion because it represents growth in the role of government and may pose inflation risks. Proponents worry that further Quantitative Easing will have little beneficial effect on long-term yields because they are already so low.

So what can the Fed do if there’s a melt-down in Europe or another recession around the corner? Ben Bernanke can still act as lender of last resort and keep the financial system from going under. However, it would be hard-pressed to stimulate the economy through lower interest rates.

In a speech back in 2002 about combating deflation, newly appointed Fed Governor Bernanke said that a central bank always had the option of printing money if all else failed! This earned him the nickname “Helicopter Ben” even though the idea of using helicopters to sprinkle cash liberally was actually put forth earlier by Milton Friedman simply to make a point about the Fed’s powers.

More recently, Nobel Laureate and New York Times columnist, Paul Krugman has been arguing that the Fed should be doing massive Quantitative Easing to get the economy rolling and drive unemployment down. Maybe this won’t bring interest rates down, but it should raise inflation expectations! That’s right, Krugman and others argue the Fed – and the European Central Bank – need to create more inflation, or at least expectations of more inflation! Real interest rates measure

Musings & Amusings: Paul Harvey

Golf is a game in which you yell “fore,” shoot six, and write down five.

I am fiercely loyal to those willing to put their money where my mouth is.

If there is a 50-50 chance that something can go wrong, then 9 times out of 10 it will.
borrowing costs after subtracting out inflation, more accurately, expected inflation. Stated simply, people and businesses will begin to borrow to finance purchases of homes, autos, equipment, etc., if they believe they can pay the loans back in cheaper dollars.

Controversial? You bet! But there may be few alternatives left in a world where the more conventional monetary options are used up and where fiscal/budget policy is being held captive by ideological disputes.

The rest of the story. Do you remember Paul Harvey, the radio commentator? He’d start with a teaser and before finishing, say “Stay tuned for the rest of the story.” He hoped this would keep people listening during the commercial break so they wouldn’t miss the story.

Back in 2008, there was surprisingly little furor when the financial press revealed that some big banks were understating their borrowing costs for the purpose of calculating of LIBOR. Maybe the story was overshadowed by the huge financial crisis that was then unfolding.

LIBOR stands for the London Interbank Offered Rate. It is what banks supposedly charge each other for short-term loans. LIBOR has become the global reference rate for as much as $900 trillion in financial contracts such as adjustable rate loans.

Now it seems that not only were some banks under-reporting what they had to pay for loans to make themselves look less shaky back in 2008, but some had been manipulating the rate to benefit their trading positions for quite a few years. Recently, a major international bank was fined heavily by British and American regulators for these activities. And this only seems to be the beginning of the prosecutions which could affect a couple of dozen of the world’s largest banks with fines and lawsuits running into hundreds of billions of dollars! Some individuals may even face jail time.

The problem starts with the fact that LIBOR is not an observed market rate. Instead, it comes from a daily survey that asks 15 or so very big banks what they expect to pay for loans that day. Unlike the U.S. Treasury bill rate, it is not calculated from actual market transactions. Hence, there were opportunities for some banks to misstate up or down.

Where do we go from here? There will certainly be more fines and firings. There will also be plenty of business for the lawyers in trying to figure out who sues who. Some experts worry that legal battles could gum up financial markets at precisely the time we need them to be functioning well.

There may even be some further tarnishing of financial regulators. Some of them may have looked the other way or even encouraged the deception – at least during 2008 when the world financial system seemed to be at the edge of collapse.

Stay tuned!

House Prices are rising again. During the New England recession of the early 1990s, I told this joke. The good news: housing had become more affordable. The bad news: it was your house!

One major price series is the Federal Housing Finance Agency’s House Price Index (HPI). It is a “repeat sales” index which tracks the value of homes as they get sold and resold. It covers the large number of homes financed by “conventional” mortgages, i.e., those meeting the criteria for sale to Fannie Mae and Freddie Mac. Unlike the Case-Shiller index, it does not include foreclosures.

Nationally, the HPI fell about 20 percent since the peak in April 2007. During the same period, the Case-Shiller index dropped more than 30 percent, partly because it includes foreclosed properties.

The HPI has started to rise again – not everywhere, but in more than half the states through Q1. Connecticut and Massachusetts should start showing increases with the second and third quarter data. The increases of recent months are especially welcome news. For one thing, they indicate that housing may, at long last, be turning the corner. Rising prices will not only stimulate new construction activity, but they’ll help repair household balance sheets. For the typical household, the equity on their home is the most important component of household net worth.

Surveys of economists show continuing – but modest – increases on the order of magnitude of 2 to 2 ½ percent during each of the next couple of years. Of course, this assumes that the overall economy manages not to slip back into recession. We still have a long way to go for prices to get back to the lofty levels of 2007.

### HOUSE PRICE INDEX 2012 Q1 % CHANGE

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*FHFA. Seasonally adjusted.*