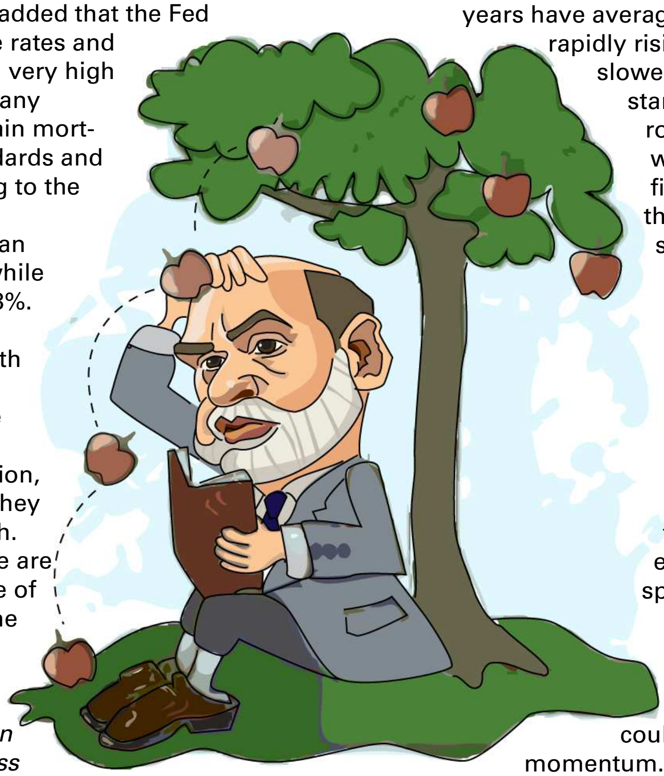
What Goes Up?

Sir Isaac Newton (1642-1727), the father of physics, developed the **Universal Law of Gravity** which states that every object exerts an equal but opposite force on every other object. This gravitational force is proportional to the mass or size of an object. Because the Earth has such a large mass it exerts a very large force and this is why we simply say, *"What goes up must come down."* The Laws of physics cannot be broken but central bankers around the world are trying to bend the rules to keep world growth on an upward trajectory. But the liability of debt keeps pulling down.

Here at home our Federal Reserve Chairman, Ben Bernanke has been fighting the gravity of personal, bank and governmental debt for the last five years. Bernanke just told Congress that the depressed housing market has been an enormous drag on the economy. He added that the Fed influenced, historically low mortgage rates and lower purchase costs have promoted very high levels of housing affordability; but many prospective homebuyers cannot obtain mortgages due to tightened lending standards and impaired creditworthiness. According to the recently completed Fed's Survey of Consumer Finances 2007-2010, median household income was down 7.7% while median household net worth fell 38.8%.



Banks here at home are still laden with debt from the **Toxic Asset Waste** created from the subprime mortgage meltdown. Back in 2008, these toxic loans thrust us into the Great Recession, reshaped our financial systems and they continue to depress economic growth. Sovereign debt fears in the Euro-zone are exacerbating the poor health of some of their banks, which not only caused the European recession, but also has dampened world growth.

Newton's first law of motion states *an object at rest will remain at rest unless acted on by an external force.* Europe's economy is at rest and motionless. According to Bernanke's testimony, the European Crisis is dragging down world exports, weighing on business and consumer confidence and pressuring world financial markets. European policymakers have taken many steps to curb the crisis trying to calm financial markets' fears about sovereign debt and come to agreement on a workable future arrangement among the European Union member countries. But more will be needed to exert enough force to drive Europe from its dormancy and lay the foundations for long-term economic growth.

Newton's first law also says that *an object in motion tends to stay in motion.* And here at home, the US economy is plodding along but at a fairly slow pace. The first quarter's real gross domestic product (GDP) came in at 1.9%, softening from the 3% growth in the last quarter of 2011. On average economists believe our future growth rate will be a little over 2%, appreciably less than our long-term average but nonetheless in motion. The Fed needs our economy to grow faster to get unemployed Americans back to work. Because of the significant downside risks due to the strains in the global financial markets which may stifle growth, the Fed extended their latest effort to hold down longer-term interest rates, Operation Twist. The Fed stands ready to exert additional external forces to counteract any weakness and to promote a stronger economic recovery.

Bernanke nagged Congress about the size of government debt and the ongoing deficits. He told Congress that government inaction is undermining corporate and consumer confidence. The federal budget deficits over the last three years have averaged 9% of GDP. He warned that rapidly rising levels of debt will lead to slower economic growth, reduced standards of living and mushrooming foreign indebtedness which could provoke another financial crisis. Everyone agrees that this unsustainable deficit spending must be curtailed, but no one wants to slow the momentum of future growth.

The conundrum that law makers face is to address our fiscal unsustainability but at the same time not impede the recovery. Bernanke warned that if Congress allows the temporary Bush tax cuts to expire and the automatic spending cuts to go into effect next year, global financial markets could be shaken and our recovery could be derailed. Political paralysis could be the force that stops our momentum. Bernanke in his own way pleaded for "a credible fiscal plan to put the federal budget on a longer-run sustainable path which could ... improve household and business confidence, thereby supporting improved economic performance today."

The deleveraging of our personal and bank debt along with efforts to balance the federal budget will be a long-term drag on our growth. Now, Congress must tackle the looming *"fiscal cliff"* before going home in December. The American people don't want them to test Newton's laws of physics.

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YOUR TRUSTED PARTNER
4940 Washington Blvd.
St. Louis, MO 63108