

Thoughts from the Edge of the Abyss
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Literally, everywhere I go I am asked the same four questions: How did it happen? How bad is it? What can we do about it? And when will it end? The “it” of course is the near paralysis of the U.S. economy. It started with the bursting of the housing bubble in 2007, which led to the collapse of U.S./global financial systems in 2008, and now leaves us with massive layoffs, a rising unemployment rate, and most likely the longest and deepest recession since the Great Depression of the 1930’s. If I truly knew the answers to each of these questions I would probably have been summoned to Washington long ago to help deal with the problem. Given that I have not been escorted to D.C., the following responses to these questions are offered as “thoughts, observations and opinions” which you are free to accept, change, challenge, or ignore entirely.

First, this is not a traditional recession triggered by rising interest rates designed to cut off an inflationary boom. Rather it was caused by a prolonged period of post-9/11 low interest rates that led to a massive housing boom which put many families into homes they could not afford. The brilliant financial engineers on Wall St. combined the unaffordable mortgages along with other types of loans into trillions of dollars of incomprehensible financial instruments. This debt was sold by greedy brokers, bankers and financial charlatans, who operated with little or no oversight or supervision, to high return hungry domestic and global investors. If the investors expressed concerns about the risks inherent within these opaque debt instruments they were told not to worry because they were all rated as “AAA” by the independent rating agencies. And if that wasn’t enough to calm your fears they were all backed by default insurance written by AIG. Some were even implicitly guaranteed by the U.S. government in the form of informal backing for Fanny Mae and Freddy Mac. Who realized that the entire process was actually put together and run by the descendants of the HAL computer from “2001”?

When housing prices stopped rising and began to fall in early 2006, homeowners couldn’t refinance their mortgages to get out from under the exploding interest rate reset. The speculators who greedily fueled the home price inflation but couldn’t “flip this house” just mailed in the key. But starting one by one, followed by millions more, individual families defaulted on their mortgages, cutting off the flow of payments on the opaque debt. This left thousands of banks, insurance companies, and the entire range of financial firms, including the one managing my 403(b), with assets of declining value. The DOW index fell from 14,000 plus to under 8,000. Losses on investments triggered reductions in bank capital that was necessary to support bank loans. Some investment banks failed (Lehman Bros), or were forced to merge (Bear Stearns, Merrill Lynch), or became commercial banks (Goldman Sachs, Morgan Stanley). Most commercial banks either tightened their lending standards or stopped lending altogether, thereby cutting off the flow of credit to each other and Main ST. businesses alike. The credit freeze and structural upheavals in the financial system struck mortal blows to the overall economy causing production to fall and jobs to be cut.

The financial system froze up so tightly in September and October of 2008 that the U.S. Treasury and the Federal Reserve had to step in and effectively buy AIG, Fanny Mae and Freddy Mac. Congress created and passed the \$700 TARP fund, half of which has been used to provide capital infusions that kept over 100 commercial banks afloat. This rescue included the ones that help cause the problem with the 14 largest being regarded as “too big to fail”. Lastly, the Federal Reserve has provided well over \$1.5 trillion of credit to all range of firms in an ongoing attempt to re-liquefy the domestic and global financial system.

And still the economic hemorrhaging continues. The recession officially began in December 2007. Since then, the nation has lost 3.6 million jobs with some estimates placing the potential job lost as north of 5 million. The unemployment rate is 7.6%, with peak projections of a 9% seeming to be reasonable. Job losses and rising unemployment rates are expected to continue through the end of 2009 and most likely into at least early 2010. Production, which fell in the last half of 2008, is expected to show some growth in the second half of 2009 in response to the massive \$800+ billion stimulus package. But will the package be enough to rescue the U.S. and global economies?

In my opinion, the stimulus package should accomplish three things in addition to the actions being taken by the U.S. Treasury and Federal Reserve programs. First, it should provide immediate assistance to individuals and families who are facing severe economic stress from job cuts, loss of health care benefits, and foreclosure. Second, it should have substantial, targeted, high value, spending programs aimed at putting people back to work. And third, it should have additional spending aimed at supporting a self-sustaining economic expansion.

Also in my opinion, while the package as originally constructed is a good start, it runs the risk of eventual failure for the following reasons. First, it is too small. The U.S. economy had a nominal GDP of just short of \$14 trillion in calendar 2008. A package of at least \$1.2 trillion+ would be needed to alter the course of a ship that large. Second, it has too short a spending focus. The plan should be in effect for at least four years not two. To spend \$800 billion in two years could easily result in hasty, wasteful expenditures that will undermine public confidence in the entire effort. And you can count on the myriad of talk show hosts as well as the *Wall Street Journal* to point out every spending misstep.

Third, the plan relies too much on tax cuts for households and businesses. Now I fully admit to wanting my share of the tax rebates along with everyone else. However, when times are tough and the future is uncertain people tend to save money rather than spend it. Or if they spend it they spend it on necessities at retail outlets such as Wal-Mart. While I have no special axe to grind against low price stores like Wal-Mart, upwards of 70% of the items for sale in these stores are produced outside the country. Therefore, it's a great place to spend money if you want to stimulate the economies of China, the Philippines, and the like but a poor place to stimulate U.S. production and jobs. Better you should go to movie, have dinner out, or have your teeth cleaned at your family dentist. Spending on domestic services generally yields a much larger bang for the buck.

Fourth, the plan has too little direct spending to create an immediate stimulus and far too little spending to support 21st century job creation that will trigger a self-sustaining economic expansion. President Obama and his economic team have come to realize that the list of “shovel ready,” investment worthy, public works projects is a lot smaller than they originally thought. As a nation, we need upwards of \$1 trillion+ of spending on roads, bridges, water pollution control, school, electric grid and other infrastructure projects that will contribute to economic growth over time. However, they can’t be contracted for and build in just two years. Welcome to the real world of public spending Mr. President. Hence, his excessive reliance on the tax cuts mentioned above, but which may not get the stimulus job done. We also need the package to trigger the creation of wide range of 21st century jobs and private entrepreneurial opportunities in alternative energy, energy conservation, green technology, automotive efficiency, mass transit, medical technology and general science among other fields. The spending here is way too small and can’t be made within a narrow, 24 month time frame. Moreover, these types of jobs will help the financial system to reconstruct itself as it channels new funds into the hands of private entrepreneurs who will take advantage of the new technology.

Lastly, the combined rescue package from the Congress, Treasury and the Fed needs better coordination, better public explanation, and simultaneous global cooperation from other governments and central banks in both Europe and Asia. The global economic collapse is not just a U.S. problem, although our financial system clearly played the leading role. If the U.S. goes it alone then even the multi-trillion dollar combined package will not be enough to jolt the global financial system out of its self-reinforcing set of fears and liquidity constraints. The Davos meeting really missed an opportunity to emphatically underscore the need for a global response to a global problem. So much for bringing together the “smartest guys in the room”.

At this point, there is no Plan B. The Obama package has to work or we risk of triggering only a weak recovery, with lots of debt that does little to solve the problems of rising job cuts, unemployment, and an increasing number of foreclosures. It may seem ironic that while the problem was caused by excess spending and too much credit creation, the Obama package actually calls for even more spending and credit creation as a way to solve it. As we go down this road, the real threat is that the package will be too small and might just leave us little better off in the long run.

By the way, did I mention anything about the potential for substantial inflation as a long run reaction to this much money creation? Don’t worry, the great architect of government deficit spending to counter a recession, John Maynard Keynes, had an answer for that one too when he noted that “in the long-run we are all dead”.

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