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ECONOMIC NEWS UPDATE

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Flexibility+Entrepreneurship=Resilience

Ben Bernanke will decide tomorrow whether the recent turmoil in financial markets, and the apparent slowdown in the “real economy”, warrant some action on his part -- or whether to stand pat and see whether his recent moves to break the credit logjam are working. Meanwhile, and perhaps more important, we have to decide whether to worry whether the credit crunch and, among other signals, the recent bad news from the jobs market foretell longer-term problems for the U.S. economy.

One clue to the answer is to be found in the economy’s performance after Islamic terrorists dealt what they thought was a lethal blow to American capitalism by bringing down the World Trade Center towers some six years ago, in the process wiping out important financial firms and forcing the closing of the New York Stock Exchange and other exchanges. Surely, Bin Laden had

demonstrated that his version of god trumped Mammon.

Not really. I remember lunching at a reopened Stock Exchange with Rudi Giuliani, and still have the souvenir hat emblazoned with “Let Freedom Ring”. Uplifting. But having been to ground zero shortly after 9/11, at the invitation of New York’s finest, I worried that the American economy might never bounce back.

Since that terrible day, our economy has demonstrated that a flexible, capitalist economy can survive and then prosper a blow that makes the current upset in financial markets look trivial by comparison. Consider these data, compiled for me by the Hudson Institute’s Andrew Brown.

Household employment has grown by about one million jobs, or 7%. The unemployment rate has dropped from 4.9% to 4.6%. Some three million more families own their own homes, and

even the current troubles in the mortgage market won't put much of a dent in that gain.

As for investors -- the crowd that is grumbling about recent declines in share prices and the reluctance of the Federal Reserve Board's monetary gurus to rush to bail them out -- they are far ahead of where they were when their world collapsed along with the twin towers. The day before the attack on the world's financial center the Standard & Poor's index of 500 stocks stood at 1092; when the exchange reopened a mere five days later, the index closed at 1039; six years after the attack, and after this tough summer for markets, it was at 1452, a gain of 40% from its low point.

Perhaps most startling, America's GDP has increased by \$2.5 trillion (adjusting for inflation). Look at it this way: since the attack on America, the US economy has *grown* by an amount that exceeds the size of the British or French economies.

There are many reasons why an economy as badly shaken as ours was on September 11, 2001 recovered so rapidly and completely. Certainly, the Bush tax cuts are in line for a share of the credit. Certainly, too, Alan Greenspan's Fed helped by pumping money into the system when a variety of external and internal financial shocks threatened to cause mayhem in the "real economy," a policy that Monday morning quarterbacks now say was mistaken. And surely the ready availability of immigrant labor helped by providing Silicon Valley with a crop of imaginative Indian CEOs, and the Salinas Valley with hands to pick the artichoke crops for which that part of Southern California is famous.

But there is more than that, which is the lesson that should be kept in mind as we appraise the consequences of the on-going turmoil in financial markets. The US economy is resilient because it is flexible. When cutbacks in defense spending caused widespread layoffs in California, unemployed workers moved to neighboring states in which jobs were plentiful. Americans go to where the work is, and there are no regulations to stop them.

Then there is American entrepreneurship, the willingness to take risks in the pursuit of very large gains. This has all to do with the current problems in financial markets. One of the advances of recent years has been the development of innovative financial instruments that dice and slice risk to fit the appetites of a variety of risk-takers. It is fashionable these days to complain about non-transparent "securitization of mortgage risk". But it is just that securitization that attracted many more players than otherwise would have made their capital available to finance, among other things, the home mortgages that allow three million more families to own homes than in 2001. Eliminate all these new, exotic instruments, and the flow of capital into mortgage and other markets will diminish more than would be efficient for the economy.

It is, of course, true that a bit more transparency, combined with a lot more common sense on the part of lenders and borrowers is in order. And no one can deny that a crackdown on some mortgage brokers would help to prevent exploitation of uninformed borrowers. But we must take care lest the benefits of some of the regulatory "reforms" being proposed exceed the long-run costs in lost availability of credit

and reduced innovation in financial markets.

When you hear daily whining about the dire situation into which the economy has plunged, keep this in mind: share prices have fallen by so little that they do not even meet the definition of a "correction" (a 10% decline), and remain well above start-of-year levels. About one-third of the dreaded foreclosures are of houses bought by investors gambling that the price of homes would continue to rise; they are hardly legitimate candidates for a bail-out. A portion of the other foreclosures will be on houses bought with no-money-down; those families have lost nothing by gambling to become home-owners, and will now return to the ranks of renters, which will ease their daily financial situations. Many of the others threatened with foreclosure are now negotiating with lenders to find repayment terms that will permit them to remain in their homes -- a program the President and Secretary of the Treasury Hank Paulson are persuading lenders is in their best interests.

Meanwhile, the credit markets might be tight, but they are not closed. True, the good old days of cheap and cheaper credit are gone, at least for now. But the Federal Reserve Board's discount window is open, it has plenty of room to ease if it chooses to do so today and in the months to come, commercial banks are not threatened with insolvency, and the extent of the damage to Goldman Sachs, Merrill Lynch, and other investment banks will soon be "transparent" when they have to file financial reports that reflect the new, lower -- or nonexistent -- value of some of their assets. My guess is that the damage to these firms will be less than

ghoulish financial reporters have been leading us to expect.

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