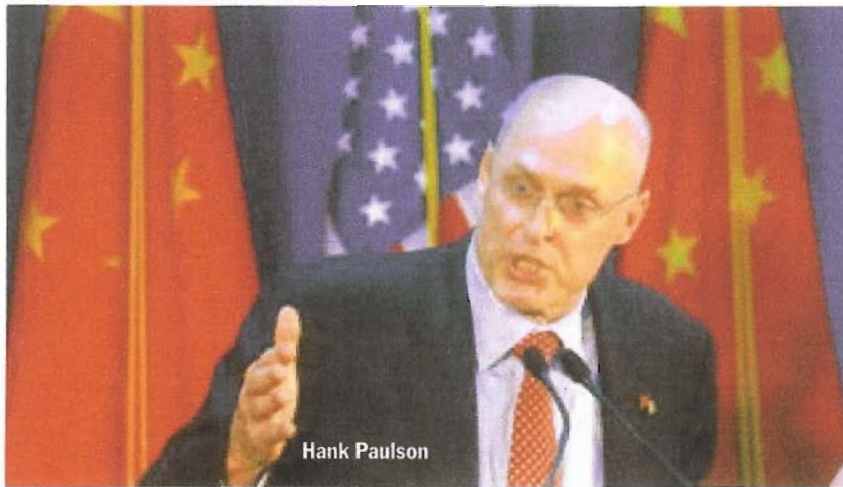


It's Still the Economy, Stupid

Nervous markets aren't the whole story.

BY IRWIN M. STELZER



A market spasm. Repricing of credit risk. Liquidity crunch. Those are some of the terms traders are using to describe the turmoil in financial markets. Frank Sinatra said it better, "The party's over." Note: Normal life resumes after a party, so Frank had it right.

The collapse of a third Bear Stearns hedge fund last week simply added to the unhappiness on Wall Street and most world financial markets, and gave reporters on CNBC an opportunity to shout "fire" in a crowded studio. Traders and investors are rediscovering that it is indeed risky to lend money to people who are unlikely to be able to repay their loans. They are learning that bundling high-risk loans into large packages does not somehow elevate the loans to AAA rating.

They are learning, too, that not every stock that looks like a takeover

candidate will be snapped up at a substantial premium by some private equity firm. The gusher of unlimited credit that flowed into the coffers of the private-equity firms has slowed to a trickle. Suddenly, some of the deals that the market had been anticipating are just too expensive to consummate profitably. So the premium built into the shares of takeover candidates disappears, and with it the hopes and dreams of those who bought their shares without regard to the fundamental earning capacity of the company.

All of this has rattled some consumers. Forget that the underlying economy is sound. Media tales abound of canceled vacations, home-buying deferred, ripples that will become waves and swamp families struggling to keep their heads above water in the age of \$3 gasoline.

Throw in tales of high-paying jobs lost to \$1-a-day Chinese laborers—never mind that Beijing's biggest problem is pollution from Mercedes and Rolls Royces—and the Bush

Irwin M. Stelzer is a contributing editor to THE WEEKLY STANDARD, director of economic policy studies at the Hudson Institute, and a columnist for the Sunday Times (London).

administration finds itself beleaguered on two fronts. On the foreign policy front it finds itself trying to persuade voters that the situation on the ground in Iraq is improving, and that the vacation bookings of the Iraqi parliament are irrelevant to the outcome of the war against al Qaeda.

At home, the administration seems unable to take James Carville's pithy slogan, "It's the economy, stupid," and hurl it back at the Democrats who are crying about tax breaks for the rich (of which there are some), and the plight of the poor (who are in fact becoming steadily better off). A new *Wall Street Journal*/NBC poll finds that nearly two-thirds of Americans think we are in the midst of a recession right now, or will be in such a downturn in the next year. True, the administration did assemble its economic team of Treasury Secretary Hank Paulson, Chairman of the Council of Economic Advisers Ed Lazear, Secretary of Commerce Carlos Gutierrez, and (departing) Director of the Office of Management and Budget Rob Portman to say before CNBC's cameras that all is well. But a daytime broadcast to a limited audience is no antidote to the drumbeat of gloom emanating from the multiple candidates for the Democratic presidential nomination. My guess is that far more people saw, and were affected by, images of John Edwards touring the poorer neighborhoods of America.

Why the administration can't get its story out is something of a mystery. Because it has a decent story to tell—not a perfect one, and not one that can show an economy without problems, but one that voters might, just might, find a reasonable offset to the bad news bears on the left.

Speaking of bears, let's spend a moment on the stock market—you know, the one that is in the process of imploding. Or is it? There is little doubt that problems in the subprime mortgage market are tightening credit. There is also little doubt that what Paulson calls "excesses . . . loans that have been done without traditional covenants" and other sillinesses are now being sweated out, and not without pain for the overly optimistic.

But before reaching for the panic button, consider this. The past disastrous week has driven share prices so far down that the S&P index of 500 stocks is "only" some 12 percent above where it was at this time last year. Much more important—and here we can rely on Paulson as a man who knows something about the real economy as well as its Wall Street reflection—is the strength of the underlying economy. Paulson, no shill for the administration, which needs him far more than he needs his current job, puts it this way, "I've received a fair amount of questions about volatility, market moves, those kinds of things, and I always start with looking at

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the underlying economic strength of the global economy and a very, very healthy U.S. economy."

The U.S. economy is proving to be a resilient, flexible machine. Despite the very real problems in the housing market, the economy is providing jobs for just about everyone who wants to work. The unemployment rate remains a low 4.6 percent, the economy created an average of 136,000 new jobs every month this year, and 40 of the 50 states have unemployment rates below the average for the '80s and '90s, according to the Bureau of Labor Statistics. The economy grew at the highly satisfactory rate of 3.4 percent in the last quarter. Workers' compensation has been growing in real terms, while inflation is contained, running at

2 percent or lower, and profits remain satisfactory. The world economy is growing at something like an annual rate of 5 percent. David Hale, an economic consultant, points out that the growth rates of 120 countries will exceed 4 percent this year; economist John Makin puts it more colorfully: "Since 2004, the global economy has caught fire." That development, long in coming, combines with a weaker dollar to stimulate exports and reduce our trade deficit.

And house prices are not collapsing, although you'd never know it from media reports. Yes, some borrowers are finding they can't meet the payments as interest rates on their adjustable rate mortgages move up. Yes, house prices seem to be softening, although data are too imperfect to permit firm conclusions. And, yes, we don't know when the housing market will recover. But prices have a long way to drop before all of the gains realized in the past four or five years are wiped out. Unless you think of a house as a commodity to be traded every day like pork bellies or oil futures, most home owners have no reason to lose sleep.

None of this means that there are not important policy issues that need attention, or that the economy might not slow as consumers make the desirable transition to a somewhat higher savings rate. America needs a tax structure that is efficient and allows our firms to compete with overseas rivals that are steadily cutting taxes; a system for allowing the deserving workers displaced by trade to retrain or retire; a health care system that increases the availability of care by detaching insurance from the job, and increases the range of individual choice and competition; and an energy policy that is more than a grab bag of gifts to vested interests.

As politicians like to say when they don't quite know how to solve the problems of which they complain, "There is work still to be done." One of those chores is to enable the American people to balance the daily doses of bad news with the larger fact of good news. Too bad the Bushies can't figure out how to do that. ♦