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ECONOMIC NEWS UPDATE

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Noisily Flows the Red Ink

While politicians debate the identity of the “pig” at whom Barack Obama took a poke, the nation has stored up another problem for whichever candidate is unfortunate enough to inherit the White House come 2009. Hank Paulson did what he had to do, or at least what he thought he had to do, when he ordered a government take-over of Freddie Mac (a client) and Fannie Mae. Unless the government made explicit its guarantee of the two agencies’ debt, foreign holders of their IOUs would dump them. Indeed, in recent weeks Asian central banks sold off \$27 billion of these agencies’ securities.

The two Government Sponsored Enterprises, GSEs as they are best known, support about 80% of the mortgage market. If they could not borrow to make new funds available, the housing and credit markets would most likely have seized up, exacerbating our current economic woes.

So Paulson was probably -- not certainly, but probably -- right to cap his career as a successful private enterprise investment banker by presiding over a nationalization so large that even Lenin might have hesitated. The bill will come due long after President Bush has returned to his

job of clearing brush at his Texas ranch, and Paulson has returned to his favorite past time, bird watching.

He is unlikely to see the vultures circling, but circle they will. The Congressional Budget Office (CBO) says that falling receipts from corporation tax, the cost of the recent economic stimulus package, and the likely cost of meeting obligations of Freddie and Fannie have forced it to increase its estimate of the amount of red ink that will be poured across the government's books in coming years.

I won't bore you with the precise deficit estimates since they are always subject to major revision, moving up when the economy slows, and down when there is an uptick in economic activity and hence in corporate profits and personal incomes. What we do know is that although the deficit is headed up, in relation to the size of the economy it will be manageable for a few years, say in the range of 3% of GDP. But in the longer term the entitlements programs, mostly Medicare and Medicaid, if unchanged will drive it to levels that will make Italy look like a fiscally prudent country. There is talk of deficits that reach 6% of GDP and more. In the past, we have managed to survive deficits that came to 6% of gross national

product, but that was when expectations were that the deficit was headed down, not up.

We know something even worse than that. Two things, actually. The first is that several of the foreigners who have been financing our deficit by buying our government's bonds, are getting nervous, and are willing to pay increasing premiums for insurance against a default by our government. Think of it -- people who lend money to the United States are willing to pay increasing amounts to insure them against a default by our government. After all, by adding the \$5.4 trillion in Fannie and Freddie liabilities to the government's balance sheet, we have in effect doubled the national debt. It will never come due, of course, since not all of the Freddie and Fannie mortgages will default. Still, lenders are nervous.

The second thing we know is that neither candidate has the vaguest idea how to get the budget under control. Barack Obama wants to raise taxes on wealthier families, which will surely discourage the investment we need to get the economy rolling again. And he has great plans for spending huge sums on social programs and shoring up the national infrastructure. John McCain wants to cut spending, but other than "earmarks" -- remember, one man's pork is

another's important social program -- he won't say which programs he would axe. Ronald Reagan solved that problem by putting in a figure for such cuts, followed by an asterisk, guiding the budget reader to a footnote advising that the programs to be cut would be named at an unspecified future date. They were never named and by and large never cut. McCain might have to dust off that old dodge, while Obama tries to get his Democratic colleagues to reduce entitlement spending. Neither prospect is sufficiently bright to relieve the budgetary gloom that has been deepened by the Freddie and Fannie takeovers.

There is one bit of light somewhere in this dark tunnel. If the economy resumes the sort of growth of which it is capable, revenues might increase to bring the budget deficits down to sustainable levels. Alan Greenspan now says that house prices might bottom out later this year or early in the next, and there are signs that he is right: sales of new homes are beginning to exceed new construction. Mortgage rates have dropped significantly. America continues to attract foreign investment, in part because states are wooing new plants with promises of everything from new roads and worker training, to tax cuts. Productivity of the work force is rising. Inflation is

likely to come down as commodity prices ease, enabling the Fed to keep interest rates low.

None of these bits of cheer is likely to offset the downdraft that is ripping through the economy right now. But if they are harbingers of a recovery sometime in 2009, or even in 2010, the flood of red ink might, just might, slow to a trickle. Absent that, we will have to rely on the wisdom and courage of our political class. If you believe such wisdom and courage exists, I have a bridge in Brooklyn I would like to sell to you.

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