

ECONOMIC NEWS UPDATE

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Soul Trying Times

That light at the end of the tunnel: a glimmer of hope or, as President Bush's former chief economist, Larry Lindsey, sees it, an onrushing train? That jump in share prices: start of a recovery from a market bottom, or a "dead cat bounce" typical of bear markets?

It is trying to answer questions such as these that put me in mind of Tom Paine's characterization of the dark days of the American Revolution. "These are the times that try men's souls'Tis surprising to see how rapidly a panic will sometimes run through a country."

Some 232 years later the chairman of the Federal Reserve Board and the Secretary of Treasury find themselves fighting

a different sort of panic, while ordinary investors find themselves in soul-trying straits as their net worth declines for the first time in decades, and volatility serves as a backdrop for the financial reporting of the 24-hour financial news channels.

Fed chairman Bernanke pulled no punches when he gave his semi-annual report to congress last week. "Sizable losses at financial institutions ... financial headwinds ... inflation has remained elevated ...declining house prices, a softening labor market... deteriorating performance of subprime mortgages ... turbulence.... Decline in the...value of the dollar." There's more, but you get the idea: a Fed chairman who has

deployed every weapon at his command, and manufactured new ones in his fight to right the economy, and is not certain he has succeeded.

It just might be that Bernanke, with an assist from Treasury Secretary Hank Paulson, has been more successful than he dares dream, and that the panic that has been running through the country has been contained. Not that we will soon see the boom times that investors remember so fondly, or that homeowners can soon look forward to double-digit annual increases in the value of their homes. But it is possible -- not certain, but possible -- that the woes that have beset the housing and financial sectors, and the damage inflicted on consumers by rising petrol prices, are about to be contained and mitigated. At minimum, given that good economic news has been as scarce as favorable media reports on the McCain campaign, it is worth considering what might be going right -- other than the economy's continued if slow economic growth.

Start with housing. Falling prices, inventories of unsold homes, slowing construction and rising foreclosures have combined to shake mortgage-writing financial institutions to their foundations.

But sales of existing homes seem to have stabilized this year at an annual rate of close to five million units, with gains in the Northeast and Midwest offsetting declines in the South and West. Inventories of new single-family homes are down 21 percent from their 2006 peak. Nation-wide average house prices continue to decline, but whereas in March only two of the eighteen markets covered by the much-watched Case-Shiller Index recorded increases, in April prices rose in six regions. And, as Barron's points out in an article run under the title, "Home Prices Are About To Bottom," price figures are biased downward by the overweighting of sales of homes with subprime mortgages. Chip Case -- the Case of the Case-Shiller Index -- believes that homes are now more affordable and that, barring a recession, home prices "may well stabilize" and begin to recover by year end. Barron's Jonathan Laing concludes that "the scary dive in home prices soon will be over."

Improvements in housing would, of course, translate into improvements in the banking sector. The prompt intervention of the Federal Deposit Insurance Corporation, protecting deposits of up to \$100,000 per depositor, prevented the failure of IndyMac, the third largest bust in US

banking history, from starting a panic. Meanwhile, Merrill Lynch announced that it is increasing its excess liquidity pool to record levels, and raising \$4.5 billion by selling off its 20% stake in Bloomberg (which means the New York mayor is worth \$22 billion, and as vice presidential candidate running mate to whichever presidential candidate rings him first spend \$1 billion on ads, etc. while earning enough to end the year ahead of the game); several investment houses reported earnings that, although off from last year, beat the market's expectations; Citigroup reported better-than-expected although far from happy results; and by the end of last week shares in Fannie Mae and Freddie Mac began to recover some of the huge ground lost recently.

It was the precipitous drop in the shares of Freddie (a client) and Fannie that shook investors. These are government sponsored enterprises (GSEs) that finance about half the mortgages in the US. Never mind that through all the turmoil over their share prices, these enterprises continued doing what the government wants them to do, and their former enemies, the President and Paulson only recently prayed they would continue doing -- keep mortgage money flowing. True, to offset some of the panic caused by

declines in their share prices, Paulson and Bernanke decided to make explicit the implicit message always sent to investors in Freddie and Fannie -- these enterprises are too big to be allowed to fail. So this month both were able to borrow money at attractive rates, and to continue business as usual, writing perhaps \$50 billions in new mortgages as Fannie announced it is unlikely to need government aid and Freddie filed with the SEC in preparation for an eventual move to raise new capital.

It is too early to say that all is calm in the financial sector. More bad loans will be written off, several banks are in less than robust health, and the FDIC has already committed 10 percent of all its funds to IndyMac depositors, meaning it might have to call on taxpayers for additional funds should failures become widespread. Many banks still need to raise equity capital, and will probably dilute existing shareholders in order to do so.

Finally, there is oil. Students of the impact of oil prices know that the rapidity of an upward movement has more effect on the economy than the level of prices. Or at least as much. We cannot predict the course of prices with any certainty, since this market is cartel-ridden, affected by "resource nationalism" that inhibits

new investment, and has other features that make thumbing through “The Wealth of Nations” not very useful. But it does seem that the higher prices are destroying demand at a more rapid rate than economists anticipated, which might, just might, hold back further price increases, or sustain last week’s downturn in crude prices.

Perhaps most important, the flexible American economy so far - - and the “so far” is important -- seems to be doing better than the troubled housing and financial sectors. “The economy has continued to expand, though at a subdued pace.... Personal consumption expenditures have advanced at a modest pace..., generally holding up somewhat better than might have been expected.... Growth is expected to pick up gradually over the next two years,” says Bernanke. Imports are adding perhaps a full point to GDP, offsetting all or most of the housing-related decline.

And financial markets are being restructured. Paine wisely noted that “panics, in some cases, ... produce as much good as hurt.... They bring things and men to light, which otherwise have lain forever undiscovered.” So inept CEOs have found, and regulators have learned.

There is, then, light at the

end of the tunnel. Let’s hope it’s that glimmer of hope rather than the onrushing train that Lindsey, one of the nation’s best forecasters, sees in his crystal ball.

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