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ECONOMIC NEWS UPDATE

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Where is Solomon when you need him?

“This too shall pass,” King Solomon’s advisers told him to engrave on a ring, and refer to it whenever he felt depressed. Or so the legend goes. Not a bad idea for bankers beset by still more dodgy paper to write off, for shareholders at loss-making Lehman Bros. and ailing Morgan Stanley (first quarter earnings down 58% year-on-year), and for homeowners as they watch the equity in their homes evaporate, or disappear. Some of our current crises will indeed pass.

But it would be a mistake to believe that once the current crises are over, the world will be as it once was. It won’t. For one thing, the entire system of regulation to which investment banks are subjected will be different. Ever since the Great Depression governments have recognized that large commercial banks cannot be allowed to fail, and that depositors had to be protected by insurance when banks did fail. But no one imagined that investment banks are too interconnected to be allowed to fail -- that the risks to the financial system of a failure by an investment bank are every

bit as great as the risks posed by a failing commercial bank. Bear Stearns put paid to the notion that if a big investment bank fails the next day will be just another day at the office for those who trade with it. So the Federal Reserve Board worked with the US Treasury to bail out Bear Stearns (paying \$10 per share for stock in a company headed to bankruptcy sounds like a bail-out to me), or at least prevent it from going bankrupt. Take the government’s guarantee against failure, and you are the government’s man: be too big or too interconnected to fail, and the government will regulate how you do business. Treasury Secretary Hank Paulson made that clear last week when he told an audience of Women in Housing and Finance -- or those who remained awake in spite of his, er, dry delivery style -- that some firms are indeed too big or interconnected to be allowed to fail, and that “We must ... define the scope of the Fed’s role in identifying and constraining risk-taking that can detrimentally affect the financial system.” In ordinary language, that means more regulation -- and this from

a former Goldman Sachs boss who is keenly aware of the moral hazard created by current Fed bail-out policy.

That won't pass. One highly knowledgeable observer tells me that the days of 30% and 40% returns on equity in the investment banking business are over. No longer will these institutions be allowed to leverage themselves as highly as they did in the past -- too risky for the taste of the Fed regulators. Investors will have to satisfy themselves with a 20% return on their equity, which as they say in New York, ain't chopped liver.

Nor will the dependence of America's banks on foreign investors pass. We are witnessing a massive transfer of wealth from American consumers to oil producers. The sovereign wealth funds set up by producers have more cash than they can reasonably invest in skyscrapers in their own cities. Their investments in America's financial institutions have proved a costly adventure so far, but these are long-term investors, the best kind from the point of view of the managers of our banks -- so long as they remain passive -- and so will remain key players in American financial markets.

The world of banking is not the only one that will never again be the same. The troubles of entire American industries will not pass, and they will be unrecognizable only a few years hence. The most obvious are the auto and airline industries. Oil prices might come down a bit, but General Motors' four shuttered SUV plants will not re-open and the 8,000 laid off workers will have to hope that the company can find jobs for them producing small vehicles and hybrids. Chrysler says it plans to "break some of the old paradigms", and Ford

speaks of a "transformation". Read, downsizing.

As for the airlines, they cannot even hope that their present difficulties will eventually pass, leaving them unchanged. Their business model is broken: some will disappear as the industry shrinks by at least 20 percent; others will introduce à la carte pricing to extract more money from travelers, and not merely by charging \$15 to check a bag; still others will continue paring schedules and finding new ways to make passengers sit in even closer proximity to their fellow-sufferers. But nothing they do will stop the shift from flying to teleconferencing, from hopping on a once-cheap flight on grandma's birthday to a congratulatory telephone call or family video conference. Yes, there will still be airlines a decade from now, but they won't look anything like the ones limping through America's skies in the days of \$40 or even \$80 oil.

Businesses are not the only institutions that will be changed forever by the current flow of billions from the treasuries of Western countries to oil producers and to the emerging Chinese and Indian nations. Governments also will have to adjust. Taxing consumers who are already experiencing downward pressures on their living standards as they fill 'er up, and heat and cool their homes, will become more difficult. So will taxing footloose corporations. Even politicians of the Left have learned that lesson, witness the fact that even tax-and-spend Barack Obama says he is considering lowering corporate tax rates.

There will be more unpleasantnesses that will not pass. It will take the wisdom of a Solomon to predict just where they will appear, and

how to cope with them when they do. My own guess is that the emergence of richer Chinese and Indians as competitors for the world's resources will mean a gradual decline in American and western living standards as more food, oil, iron, coal and other resources head for Asia and the Middle East. Unless.....

Unless the Western industrialized countries can figure out how to raise their games. Workers will have to produce more every hour, which means that their governments will have to provide some substitute for the current, failed state-run education systems and turn out better-educated workers. Western countries will have to improve their transportation facilities so that goods can move more cheaply. They will have to change their tax systems to encourage investment and discourage consumption. And America will have to figure out how to maximize use of its principal asset -- its entrepreneurial spirit.

Unfortunately, the number of Solomons serving in our congress is quite limited. So the outlook is less than bright.

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