

ECONOMIC NEWS UPDATE

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Politics Trumps Economics in Driving the Economy

Bear trap. Dead cat bounce. The beginning of a bull run. Pick the animal that best describes your view of the recent upward move in share prices, and you will have company from at least some experts. The lack of consensus should be no surprise, for two reasons.

The first is the confusing nature of the incoming data. The housing market remains in dire shape. One in every nine Americans who has a mortgage on his home is behind on his payments, or in some stage of foreclosure. Contracts signed for the purchase of already-built

homes are declining at a rapid rate in this run-up to what has historically been the peak sales season. But sales of homes that have repossessed by the lenders are perking up, as bargain hunters buy the house of their dreams from owners to whom they became a nightmare.

The credit markets seem to be seizing up again, with the interbank lending rate (Libor) creeping up. But short-term commercial paper markets are in better shape than they were a year ago, and the interbank lending rate (now around 1.3%) is well below its October peak

of 4.8%, despite recent tightening.

The economy continues to contract, and the job market to shrink. But core retail sales -- excluding autos, building materials and gasoline -- increased by 0.5% in February after an upwardly revised 1.7% in January. "The increase appears broadly based as no single category is driving the increase," note economists at Goldman Sachs. It is anyone's guess whether improved sales will pull the job market up, or increased joblessness will pull sales down.

The more important reason that it is difficult to guess where the economy is headed is that the decision will be more about politics than about the usual economic indicators. Power has moved from Wall Street to Washington. It is here in the nation's capital that plans to save the housing market are being considered; that Treasury Secretary Tim Geithner is striving to regain the credibility shattered by his failure to come up with a plan to put the banks on solid footing; that a committee of experts will decide the future of GM and Chrysler.

Problem 1. Announcements don't necessarily mean action. In

November the Fed announced a \$600 billion program to support the mortgage market. Actual purchases of mortgage-related assets: a bit more than \$100 billion. More important, it turns out that a large portion of the \$787 billion stimulus package pushed through congress by the President is not going to be very stimulating. Instead, it will be spent on the Democrats' long-frustrated agenda, which means the money won't hit people's pocketbooks for several years, probably long after a recovery is under way.

Problem 2. President Obama is not a model of clarity and consistency, his obvious rhetorical skills notwithstanding. He calls for a new era of fiscal responsibility but then sends to congress a budget that takes the deficit to 12% of GDP, and projects deficits as far ahead as the eye can see. He calls for sacrifices from all but then proceeds to give 95% of American families a tax cut. He promises to revive the housing industry but then asks congress to reduce the deductibility of mortgage interest. He promises to fight the protectionists but then nominates a trade representative directed to crack down on unfair trading partners and tighten pending and

existing trade agreements. The gap between rhetoric and action makes it difficult to predict where the government is going.

Problem 3. The President is not in complete control of policy. Poor Geithner would like to get his hands on the \$2 trillion he needs to get toxic assets off the banks' balance sheets, but fears that a bailout-weary congress might not even give him the \$300 billion remaining in the TARP kitty. And Obama is not eager to challenge his own party, which sent him an interim budget (through September 30) that contains over 8,000 of the earmarks -- the pork congressmen carve out for their constituents -- that he repeatedly promised to veto. He signed. And the various congressmen who chair key committees have let it be known that they are going to fight the President's plan to reduce the deductibility of charitable contributions and mortgage interest, and will use their power to prevent him from loading billions in carbon emission fees onto the economies of the Midwestern states that produce much of the nation's coal. Worse still for the long-run fiscal outlook, congressional Democrats are

not prepared to consider the cuts in entitlements -- health care benefits, pensions and the like -- that the President is counting on to restore long-run fiscal balance. Which is why the Chinese are increasingly worried about the value of all those US IOUs it holds.

Problem 4. The President is convinced that the world is not doing enough to match his stimulus spending. "It's very important that other countries are moving in the same direction," he announced. He wants every country to spend 2% of its GDP in 2009 and 2010 on economic stimulus, and especially wants Europe to do more. But the EU is more worried about preserving the value of the euro than about the current recession, and will be telling Obama when he attends the G-20 meeting in London early next month that he can forget about stepped up deficit spending. Indeed, German finance minister Peter Steinbrück says that the EU is not even considering additional stimulus spending. And Jean-Claude Juncker, chair of the eurogroup of ministers, told the press, "The 16 finance ministers agreed that the recent American appeals insisting Europeans make an added budgetary effort were not to our

liking.” It bothered him and his colleagues not at all that insistence on spending only half as much relative to the size of their GDP as the US would not be to President Obama’s liking. The President will not leave London a happy man, and is unlikely to be cheered the next day when his NATO allies turn down his request for more troops for Afghanistan.

These problems make the word “cloudy” inadequate to describe the condition of forecasters’ crystal balls. Even Fed chairman Ben Bernanke, who ventures a guess that the recession will end later this year or early in 2010, is quick to add that his record is no better than that of Washington’s dismal, last-place baseball team.

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