

ECONOMIC NEWS UPDATE

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“The Sibylline Books remain closed...”

Matthew D’Ancona

Lot’s wife looked back at a scene of devastation and was turned into a pillar of salt. Salt -- as in the salty tears we shed last week as we looked back on 2008, a year of deepening economic recession, and the worst for share prices since 1931. Worse: most forecasters are expecting an even bleaker 2009. The unemployment rate is expected to climb into double digits, output to drop by between five and ten percent, repossessions of homes to soar, protectionism to stalk the international economy, more firms to file for bankruptcy as they find

themselves unable to refinance the \$1 trillion in loans that Reuters Loan Pricing Corporation estimates are coming due in the next three years -- fill in your own predicted horror to round out the list. “Most major economies will remain in recession or at least in relative stagnation through most of 2009,” says John Greenwood, chief economist at Invesco.

Greenwood is only one of the many economic forecasters who are gloomy -- and he is far from the gloomiest, since he sees the possibility of a modest recovery in 2010. These

forecasters are admirable men and women who study their models of past behavior for a clue to the future in an attempt to meet the demands of clients and readers seeking help in peering through the fog of economic crisis. I fear I am not a member of that fraternity, but a mere guesser of what might be in store for us in 2009, a year in which government policies -- some new, some of unprecedented magnitude -- will drive events. As the estimable Robert Samuelson writes in The Washington Post, "The great lesson of the past year is how little we understand and can control the economy." Or as the equally estimable Matthew D'Ancona puts it in Britain's Sunday Telegraph, "The Sibylline Books remain closed. The crystal ball yields no secrets.... Almost nothing is certain about the next 12 months."

True, economic theory provides us with tools that are helpful in analyzing the possible impact of some of the policies at the top of politicians' and central bankers' agendas. But in the end we economists cannot, or should not, confidently predict the consequences of any policy -- after all, if economists could predict the consequences of pushing this or that button, the Soviet Union's economy, under complete control of central government and its economic

advisors, would still be with us, prospering and outstripping the United States, as our intelligence services confidently predicted it would. Humility should be the order of the day.

If you doubt just how little we know about what makes a modern economy tick consider this. Mortgage rates and home prices are at historic lows, but builders can't persuade anyone to buy their houses even though "affordability" is no longer a problem. The government is showering consumers and businesses with money and running up a huge deficit, but there is no sign of inflation: indeed, consumer prices fell in November at the fastest rate in 60 years. The Fed's decision to cut interest rates to zero was followed immediately not by a burst of joy on the floor of the nation's stock exchanges, but declines in share prices. As we say in New York, "Who'd-a-thunk it?" Certainly not Fed chairman Ben Bernanke.

The truth of the matter is that we have launched a massive experiment in economic management. Disciples of the late, great John Maynard Keynes believe that the deficit spending being undertaken by governments around the world will trigger an economic recovery. On their side are two groups who see the crisis as an opportunity, and Keynes an

iconic figure to use for their own purposes: they would have welcomed such spending even if we were not in recession.

One simply distrusts the market, dislikes the way it distributes incomes, and sees government bail-outs of banks, insurance companies, auto manufacturers and others as a small price to pay for greater control of the commanding heights of the economy. How delicious it is to control executive bonuses, tell auto companies to produce greener cars whether consumers prefer them or not, guide the lending policies of banks and other financial institutions. Power to the people, or at least to their elected representatives.

The second group of enthusiasts for a hefty stimulus package has long believed that John Kenneth Galbraith had it right when he referred to private opulence and public squalor -- underinvestment in infrastructure, over-consumption of baubles, bangles and beads. Now they have their chance. We have elected a president and a congress that favor increasing taxes on the rich to curb their ability to indulge themselves in planes, yachts, and expensive stiletto shoes. That money is to be redistributed to lower income groups and, supplemented by massive borrowing, used to build

roads, bridges, schools and whatever politicians can cram under the rubric "infrastructure".

The current recession/credit crunch provides an excuse for these groups to form a coalition with those focused exclusively on getting the economy moving again. Result: Barack Obama's plan to spend what will eventually turn out to be a few dollars short of a trillion (politicians here still fear a negative reaction to the T-word, so the Obama team is putting a price tag of only \$850 billion on its spending package) on infrastructure projects. Plus a new health care system, renewable energy projects, greener vehicles, better pay for teachers -- the list goes on. Indeed, the 11,391-item wish list of "shovel-ready" projects presented to the President-elect by the nation's mayors includes \$1.5 million to get prostitutes off the streets of Dayton, Ohio; a few hundred thousand to heat a swimming pool in Hawaii (average temperature something like 70 degrees); \$300,000 for "traffic calming measures" in Reno, Nevada; and a trifling \$80 million for loading docks at the Philadelphia Museum of Art.

Infrastructure is clearly in the eye of the beholder. But better this than to "To dig holes in the ground, paid for out of savings, [which] will increase, not only employment, but the real national

dividend of useful goods and services,” as Keynes contended, only partly tongue-in-cheek. Or to drop money from helicopters, as Federal Reserve Board chairman Ben Bernanke once proposed, again, only partly tongue in cheek. Unless, of course, you live where most Americans live -- in urban areas. The history of this sort of spending is that a disproportionate sum goes to rural areas, for nice smooth roads to nowhere that matters much, while the cities’ potholes remain large enough to swallow entire vehicles.

Economists have waited a long time to test Keynes’ theory that deficit spending can provide the stimulus to shorten or even head off recessions, and to resolve the debate over the efficacy of such spending by Franklin D. Roosevelt. Now we have a massive laboratory experiment to teach us just what such a program can do -- and one that is, according to Obama’s chief economic advisor Larry Summers, going to err on the side of too big to avoid the danger of being too small to get the economy moving.

If the economy does revive - - more on that in a moment -- the triumphant Keynesians will be virtually impossible to live with for the next decade or so. Except for two things. First, the monetarists will claim that it was zero interest rates, not government spending,

that turned things around. Second, both Keynesians and monetarists might decide to avoid claiming credit for the recovery if the worst fear of their critics is realized: inflation takes off.

The Treasury and the Fed are running the printing presses overtime. Billions of dollars are being created out of thin air to fund Obama’s spending, to buy toxic assets from financial institutions, to bail out auto companies and insurers. Already, after a strong run for most of the year, the dollar is showing signs of weakness, as investors begin to worry that the oversupply of greenbacks will drive down their value.

So what does all of this mean for 2009? Remember: this is a guess, not a forecast. It is difficult to see how all of the money that will be sloshing around the economy will fail to produce some sort of recovery. Here is a benchmark to use when confronted by those who say that similar policies didn’t work in Japan: Capital Economics reports that total bank reserves rose fivefold in the first year of Japan’s expansion of its money supply; U.S. reserves have already grown nearly fourteen-fold in just two months. Bernanke is determined to drive down the cost of mortgages and of corporate and interbank borrowing, and there are

signs that he is succeeding. The federal government is determined to shore up almost any firm that claims to provide a lot of jobs, or to be “too interconnected to fail”, and to rebuild the nation’s infrastructure, broadly defined. Consumers are skittish, and are borrowing and spending less, but government spending will more than make up the shortfall: economists at Goldman Sachs say that the “sharp retrenchment by the private sector” requires “the government to step in with fiscal stimulus”. Obama is glad to oblige. The wall of money stashed in low-paying Treasury IOUs will sooner or later wash back into shares and corporate bonds. The \$500 billion that Bernanke will use to buy up mortgage-backed securities cannot but help to loosen that part of the credit market, just as the bail-out of General Motors’ credit arm, GMAC will make it easier for less credit-worthy consumers to buy cars with no down payment and no interest charges. Moves such as that might be recreating the excess credit culture that brought us to this pass, but better than a prolonged recession -- so believe politicians for whom the 2010 elections are just around the corner, and Bernanke, whose claim to academic fame is his study of the causes of the Great Depression, and whose Fed has pledged to “take whatever steps

were necessary to support the recovery of the economy”.

It will be surprising indeed if all of these moves, many of which have yet to be fully implemented but nevertheless already have “measures of financial distress improving gradually, albeit unsteadily”, according to Goldman Sachs’ economists, don’t put the economy on the path to recovery by the end of the year. And on the path to a round of inflation that the Fed, with Larry Summers, by then in the chairman’s seat, and Obama’s other advisors feel they can pinch off by quickly draining excess liquidity from the economy by raising interest rates and -- you guessed it -- taxes.

Meanwhile, many Americans remain preoccupied with three things: their weight, their smoking habit, and their spending pattern. Diet, kicking the habit, and spending less top the resolutions that were solemnly made on New Year’s day. Fortunately, 60% of Americans declined to make any such resolution, so only a minority -- some portion of the 40 percent who believe they can change -- will be feeling guilty year hence.

More important, according to that same Marist Poll, 56 percent of Americans are optimistic about what 2009 has in store for us. Fifty percent of men and 62% of women “think good things are going to happen” this year, with

the young leading the way: 64% of Americans under the age of 45 “think the world will be a better place” in 2009 -- probably a reflection of their faith in the restorative powers of Barack Obama.

This, of course, contradicts still another poll: consumer confidence is at an all-time low, having fallen from an index level of 90.6 a year ago to a mere 38. So we are left to guess at the mood of Americans. My view is that we are a bit rattled by the state of the economy, and when asked about economic prospects, or to unsheathe plastic in a shopping mall, we respond with nervous gloom. But when asked more generally about the outlook for the nation, our natural optimism reasserts itself. It takes a lot more than a 40% decline in share prices, the prospect of double-digit unemployment and a recession to dim the optimism of most Americans -- and of the millions around the world who want to come here to seek their fortunes.

Let me thank those who have followed these pieces in the past year, and wish all a happier 2009.

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