

ECONOMIC NEWS UPDATE

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**“The old order changeth, giving place to the
new.....”**

Tomorrow George Walker Bush will watch as Barack Hussein Obama is sworn in as the 44th President of the United States. Those who have been meeting with the 43rd see a man comfortable in his own skin, confident that history will vindicate his decision to wage war on terror, and proud of having foiled numerous plots to attack America. Listening to him talk about his planned return to his beloved Texas, one can't help being reminded of President Number 3, Thomas Jefferson, who reportedly remarked as his term ended, “Never did a prisoner,

released from his chains, feel such a relief as I shall on shaking off the shackles of power.”

It is those shackles that Obama will happily don. Bush says when the new President steps into the Oval Office there will be a moment in which he realizes the full weight of his new responsibilities. Perhaps that will come when he glances at his in-tray. He has promised to do a lot of things on “day one” -- start a new peace process in the Middle East, accelerate the withdrawal of troops from Iraq and ship thousands more to Afghanistan,

open a dialogue with Iran, close Guantánamo, replace “don’t ask, don’t tell” with a policy allowing gays to serve openly in the military, end the interrogation techniques that Bush and Dick Cheney credit with having prevented attacks on America, and repeal a host of Bush’s executive orders.

And that awesome list doesn’t include Obama’s top priority -- getting his stimulus package through an increasingly fractious congress. The incoming President wants to spend \$825 billion over the next two years to meet what he calls “a crisis not seen since the Great Depression.” Pause a moment for perspective: the unemployment rate is now 7.2%; it was 25% during the Great Depression. True, the jobless total is rising, but even the gloomiest Gusses don’t expect it to top 10% before the recovery takes hold. That’s more in line with experience during the 1982-1983 recession than with the Great Depression.

Not everyone is overjoyed. David Obey, the Wisconsin Democrat who chairs the House Appropriations Committee thinks the package is too small. Deficit hawks in both parties, fearful of a burst of inflation, think it is too large, given the

already-strained state of the federal budget. Some Republicans say that features such as the \$600 million to help television viewers convert to digital have nothing to do with a stimulus. Environmentalists are disappointed that few of their pet 80 infrastructure and transportation projects are to be funded -- never mind the billions headed for wind and solar power development. And more than a few Democrats don’t like the tax cuts: they would rather increase spending.

Now the horse-trading with Congress begins. Obama’s principal trader, Larry Summers, is not noted for his emollient style, or his sympathy with lawmakers being subjected to what The Wall Street Journal calls “the lobbying frenzy now under way,” or his patience with congressmen who want to make sure that money gets spent in their districts, no matter the social value of the project. And on the other side of the table are congressmen unhappy with the seepage of power from the legislature to the executive during the Bush years, and eager to re-establish their relevance. “I don’t work for Barack Obama”, announced Senate Majority Leader Harry Reid.

But in the end Obama will get most of what he wants. The Democrats dare not turn down their new president, and the minority Republicans don't have the votes to deny Obama a victory if it comes to a show-down vote in Congress -- besides, they are pleasantly surprised at the amount and type of tax cuts included in the stimulus package, and his courteous attention to their views.

Politicians pay attention to the polls they always contend they ignore. Obama's approval rating is over 80%, while congress's languishes in the low 20s. As for Reid, a majority of voters in Nevada now regret having sent him to the senate. In Washington, the politician holding the 80 beats the ones holding the 20 every time. And when it comes to the issue at hand, the stimulus package, 60% of those Americans with an opinion think it's a good idea.

No surprise, given mounting concern about the economy, and fears that unless the government does something, we are in for a long, deep recession -- even a replay of the 1930s. Every day brings more bad news. The latest survey of business conditions released by the Federal

Reserve Bank of St. Louis last week reported that "Overall economic activity continued to weaken" across the country, "retail sales were generally weak" "a general weakening of the labor market", "manufacturing activity continued to fall". And Jamie Dimon, CEO of JPMorgan Chase, says things will get worse this year as more consumers default on credit card debt. One way to understand the severity of the problem is to consider this: it's one thing when tired old companies such as Delta Airlines, General Motors and retailer Neiman Marcus announce layoffs, quite another when Google fires 100 recruiters because it expects to need fewer new workers this year, and Microsoft prepares substantial layoffs. The economy's growth engines are sputtering. The big engine that previously could, now can't.

Obama is doing his best to combine a show of confidence with warnings that it will take time to get the economy moving again. And to leave himself room for error. He has taken to citing Franklin D. Roosevelt as his recession-fighting mentor, a name more familiar to voters than the real father of his stimulus package,

John Maynard Keynes, the great British economist who contended that hiring the unemployed to dig holes makes sense. He points out that FDR continually experimented, and if one plan didn't work, he would scrap it and try another. After cartelizing the economy in a bid to end the depression by raising prices, FDR reversed field and called for a vigorous antitrust attack on cartels. And he spent money on roads, bridges, dams and other infrastructure projects, some that yielded long-term benefits to society, others that did not.

Obama plans to do both - change course if necessary in pursuit of "whatever works", and spend money. Indeed, by some measures he will make FDR look positively parsimonious. Diana Furchtgott-Roth, an economist-colleague of mine at the Hudson Institute, has compared the magnitude of U.S. spending under Obama's planned stimulus with spending in Roosevelt's day. In 1934 government spending reached 11% of GDP in the fight against the Great Depression, while Obama plans to increase spending to 23% of today's GDP in 2009 in his effort to put the economy on a growth path. So even though Obama's

stimulus plan is not as large as Roosevelt's, relative to the size of the economy, it starts from a much higher base of government spending on programs that did not exist when FDR was deploying his personal jauntiness as a national anti-depressant.

In addition to stimulus funds, the new President will have available the second, \$350 billion tranche of the Troubled Asset Relief Program (TARP). As a courtesy, Bush asked congress to authorize that expenditure so the money will be available to Obama on "day one". Congress complied, but only after Obama promised to use between \$50 billion and \$100 billion for a foreclosure-prevention effort, and to place greater restrictions on recipients' use of the funds. Originally intended to fund the purchase of toxic assets from troubled banks, the first half of the TARP money ended up in the hands of the auto companies (\$19 billion), AIG (\$40 billion), Citigroup (\$25 billion) and sundry banks in exchange for preferred shares. Congress feels that it voted for one thing, and got another; Obama promises that won't happen again -- no more free ride for those bankers whose greed so offends liberal

congressmen and whose sheer incompetence so offends almost everyone else.

Obama knows one thing. He is inheriting George Bush' recession, but by year-end, or certainly by the end of 2010, he will own it. If the measures he adopts don't show signs of working -- unemployment no longer rising, credit flowing again in reasonable amounts, foreclosures down -- it will be Obama's recession.

That will put the small rump of anti-Keynesians on the spot, for they will be called upon to recommend their own remedies. No, a call for lower interest rates won't do, since the Fed's short-term rates are already zero. No, a call to increase the money supply won't sound plausible: it would be drowned out by the roar of the presses that are already turning out billions in new money. And no, a call for less regulation won't pass the laugh test, since the existing regime is already discredited.

Fortunately, it might not come to that. Credit markets are already responding to the measures taken by the Fed and the Treasury. The commercial paper market (a key source of funding for borrowers such as companies and banks) is showing signs of life, with the

portion of these IOUs that the Fed has been required to buy dropping precipitously. The market for mortgage-backed securities issued by Fannie Mae and Freddie Mac, the government-sponsored mortgage financiers, is improving. Risk premiums in the interbank lending market have dropped, as have those in the bond market. Investors have shown a willingness to take on more risk by buying the below-investment-grade ("junk") bonds offered by Cablevision Systems and El Paso Co. (a natural gas producer and pipeline operator) last week.

More surprisingly, some banks -- not many, but some -- have begun to raise private capital to reduce their obligations to the Federal bail-out program. The Financial Times summarizes all of this: "There is now compelling evidence that the authorities are not simply substituting for private activity in the markets in which they are intervening, but pulling in private capital as well." Problems in the credit markets are far from over, witness the need of Bank of America for additional billions of bail-out cash.

But Obama might just get lucky, and end the year with a recovery underway. Goldman

Sachs' economists are atypically cheerier than most. They "expect the unfolding massive stimulus to end the technical recession in the second half of 2009." But they also expect the unemployment rate to keep ticking up "through late 2010." Economists know that the unemployment rate is a lagging indicator, rising only after a recovery is well underway. Less well-trained voters, for whom the economy is all about jobs, now rate unemployment America's top problem (an unwitting testimonial to the effectiveness of Bush's program to prevent another terrorist attack). These voters don't deal in technicalities such as "lagging indicators", and so are less likely to hail Obama and the Democrats as saviors come the November 2010 congressional elections if unemployment is still headed up. That might put Obama in mind of Jefferson's first inaugural address in which the Virginian noted, "I have learned to expect that it will rarely fall to the lot of imperfect man to retire from this station with the reputation and favor which bring him into it." A lesson the departing President learned all too well.

Obama's willingness to consult them, the inclusion of

tax cuts in the stimulus package, the final shedding of the political liability that George Bush has become, and, if truth be told, the probability that Obama might come to "own" the current recession explain why all is not gloom in Republican circles as the inauguration of the new Democratic President approaches. In fact, most wish him well, and share with Obama's supporters the pride the country feels in seeing at least a portion of Martin Luther King's dream realized through a man President Bush described in his farewell address as one "whose history reflects the enduring promise of our land."

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