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ECONOMIC NEWS UPDATE

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This Stool Has Four Legs

Is it possible that every part of President Obama's economic recovery plan is flawed, but the whole might prove greater than the sum of the parts? The short answer is that no one knows. But we now know enough to make some reasonable guesses.

The stimulus package, signed by the President in Denver last Tuesday, is a flawed mixture of tax cuts, spending, pork and, the special funding for congressmen's pet projects that Barack Obama had promised to consign to the dustbin of history. The spending-will-save-us Keynesians are over-joyed, and

the spending-will-break-us monetarists and conservatives are disconsolate, but neither really knows what the effects of the package will be. We do know that those effects will be late in coming: it will take two months to review bids for repair work on bridges and roads -- much longer for new infrastructure projects -- and an additional four months to get the work started and the pay checks cut.

With all its flaws, the stimulus package should add some pep to the economy. But that almost-instant gratification might come with the longer-term

pain of either higher taxes or inflation.

Most important, the stimulus package is only the first step in the President's overall recovery package. Obama chose to travel from snowy Denver to sunny Phoenix on Wednesday, and to use that venue, in which house prices have in places fallen by half, to announce a plan to help the housing market rise from the ashes. Again, only the brave or the foolish dare predict the effect of the President's proposal. One thing is certain: the President learned from the fiasco after Treasury Secretary Tim Geithner's no-details speech, and included in his announcement a mind-numbing list of details: estimated cost, as much as \$275 billion. Critics moan that the 92% of homeowners who are paying their mortgages will have to pick up the bill for the small minority that bought houses they can't afford. Defenders claim that the 92% of up-to-date payers will benefit from the reduction in the number of foreclosed houses hitting the markets and depressing the prices of all homes.

There are competing views on just how effective the programme will be. Lenders have already been renegotiating mortgage terms with delinquent borrowers, but because those borrowers have to play catch-up

on missed payments, their monthly payments often have risen, rather than fallen. Which explains why half of this class of borrowers has re-defaulted. Obama hopes to change all of that by providing lenders with incentives to reduce monthly payments to enable families to remain in their homes.

The third piece of the plan is the hardest: fixing the banks. President Obama led markets to believe that his Treasury Secretary had a fully formed plan. He didn't, and the markets are still reeling. But a plan there will be, and there is reason to believe that it will help. That reason: the much-maligned \$700 billion Troubled Asset Relief Programme (TARP), \$600 billion of which has already been spent, and actions by the Federal Reserve Board indeed eased credit conditions. The interest rates banks charge each other have come down. So have rates on short-term commercial paper, a key market for many firms. Issuances of investment-grade corporate bonds sold without government guarantees are rising.

And there are signs that words like "nationalization" no longer conjure up the sound of tumbrels rolling down Wall Street, as investors become resigned to the need for some radical move by the government to lumber taxpayers

with some of the toxic assets now resting on bank balance sheets. Even former Fed Chairman Alan Greenspan, free-market advocate extraordinaire, is reconciled to such a move. No one knows what the total cost will be, since we don't know the value of those assets (if they have any value at all), or what the government might be able to sell them for when markets are calmer.

So it is difficult to guess at the effect of any plan that might emerge from the Treasury. But experience with the effect of past efforts to ease the credit crunch suggests that financial markets just might respond to another set of interventions.

Politicians here like to talk about the three legs of the recovery stool: stimulus, a boost for the housing market, and a banking fix. They forget a fourth leg -- if stools can have four legs. There will be life after the current turmoil, and another programme will be needed to clean up the budget deficits now being generated, and the effects on the money supply of the Fed's decision to take lots of dicey assets onto its own balance sheet in return for cash.

The President has promised to address the first of these hangovers by putting Social Security, Medicare and Medicaid on a solid fiscal footing. Piled on

top of the recent spending splurge, entitlements as now constituted can bring the nation to ruin. Unless benefits are cut or new taxes levied, these programmes will send deficits up and drive the dollar into territory lower than it has ever explored. But if -- and this is a big "if" -- the President can convert his rhetoric into reality, and usher in an age of bipartisanship that includes more than friendly chats over drinks, entitlement reform just might be possible. Indeed, with the markets putting the possibility of a US government default at 6%, up from 1%, it's a good thing that Obama has called a bipartisan summit meeting at the White House on Monday to consider the looming entitlements bill.

Which leaves the Fed to drain excess liquidity out of the system. Late last week Chairman Ben Bernanke made clear that he intends to do just that, and has the tools with which to do it. He will sell some of the assets on the Fed's balance sheet, and lock the dollars re gets in return safely in the vault.

None of this means there is a free lunch out there. The stimulus package will waste billions. The housing programme creates serious moral hazard problems, and in the long run might make lenders more reluctant to make funds available to the

housing sector. The banking bailout invites politicians into the business of allocating the nation's capital among competing uses.

Anyone who professes certainty that the benefits of the recovery programs will offset those negative consequences is more ideologue than professional forecaster. As is anyone who takes the opposite position.

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