QUO VADIS REDUX (PART II)

Earlier I discussed the factors leading up to our current economic turmoil. Foremost among them, were the Federal Reserve's policy of keeping interest rates too low for too long; the debased home mortgage lending standards introduced by President Clinton's housing officials and maintained by those of George W. Bush; and the system-wide failure to conduct proper risk assessment.

Events in the months since have confirmed my thesis that the bursting of the U.S. real estate bubble would result in pressures on capital markets which would, in turn, weaken financial institutions, which would then affect U.S. economy of employment, consumption, savings, home foreclosures, bankruptcies, etc. Left unchecked, these mutually-reinforcing factors in due course would have serious international repercussions.

I was concerned at: a) the high leverage of financial institutions in a period of declining asset value; b) the large number of AAA-rated loan portfolios consisting of mortgages to borrowers whose incomes were insufficient to cover debt service; c) the widespread confusion between a "liquidity crisis" and an emerging "solvency crisis"; d) the fear that a financially-exhausted public would be unable to maintain appropriate levels of consumption; and, e) that inflationary pressures would preclude the Federal Reserve from applying traditional "cheap money" actions to stimulate the economy.

No quick fix could prevent the turmoil from lasting longer than Ben Bernanke's forecast of an improving 2008 second half and a recovery in 2009.

Is the "end of the world" coming? No. As Adam Smith noted, "A nation has a lot of ruin in it"; an economy can take a lot of pounding and its citizens can absorb a lot of pain yet still function.

The U.S. economy has prodigious strengths, and our institutions and people are resilient. Our housing prices nationwide have already dropped substantially since the high—some 15%—although they still have far to go (perhaps another 10%) on the road back to sustainable values and market equilibrium. Of the estimated five trillion dollars of phony "value" created by the recent bubble, some $2 trillion has already evaporated.

The bull market in stocks that began in 1983, when the Dow Jones was at 1,163 continued until October of 2007, when the Dow Jones hit 14,198. No one could claim that, in the inevitable decline, the gains would all be given back.

Our strengths are a given; but our failure to anticipate and to forestall the economic trauma will cause anguish to many.

How long-lasting our problems are will depend on our reaction to them. In the 1990's Japan refused to acknowledge its difficulties (also triggered by a real estate crash) and they lasted for several years. U.S. officials were slow to understand what was happening; but when, in March of 2008, Bear Stearns notified the Federal Reserve Friday of its impending bankruptcy, our Fed and Treasury leaders worked throughout the weekend to arrange a buy-out of Bear Stearns by JP-MorganChase. The 'weekend improvisation' involved the Fed intervening with public money for a non-bank financial institution for the first time since the Great Depression. When an action is unprecedented, it establishes precedent; and 'moral hazard' is a legitimate fear. For example: Alan Greenspan has recently said, "There is no credible argument for bailing out Bear Stearns and not government-sponsored enterprises like Fannie Mae and Freddie Mac."

Fed Chairman Bernanke, who told a banking conference in June 2007 in South Africa that "the troubles in the subprime sector seem unlikely to seriously spill over to the broader economy" moved nine months later to forestall the failure of Bear Stearns which would have created an international catastrophe. Bernanke remembered the failure of Austria's Bank Creditanstalt and its role in the Great Depression.

Today, policy wonks quibble over whether we are in a 'recession' in a manner that recalls Bill Clinton's comment, "It depends on what your definition of the word "is" is."

U.S. consumer confidence is at its lowest level in 30 years; an estimated 10 million U.S. families have negative equity in their homes. Home foreclosures, auto loan and credit card defaults and bank failures are at frightening levels; and the Federal Deposit Insurance Corp. is at its most over-extended position since its creation in 1933. Sophisticated observers are convinced that after the November 2008 elections, the National Bureau of Economic Research will confirm the recession.

Will the recovery pattern be in the shape of a U, an L or a W? Only a few Panglossians have hopes of a swift V-shaped recovery.

What is to be done?

The answers lie in: a) short term governmental actions; b) medium to long term governmental actions; c) financial institution regulation; d) rating agency regulation; e) governmental housing policy; and f) bursting bubbles.

Short term governmental response.

A U.S. public with little personal savings, seriously declining home values, heavy credit card and auto loan debt, and increasing fear of unemployment, is unlikely to spend cash grants from the government. That is why the $168 billion government stimulus program had so little impact, with only 10% to 20% of the rebate cash being spent, the rest going into savings or debt reduction.

Had that same money been allocated to states and municipalities for immediate expenditure on mothballed infrastructure projects, not only would the economic stimulus impact have been greater, but instead of more garden furniture, cosmetics and sports equipment, we would have had improved roads, bridges, water levees, airports and so forth to show for the money.

Yes, we need "Son of Stimulus," but for public capital projects rather than personal consumption. The U.S. Department of Transportation estimates that every $1 billion in highway investment creates 47,500 new jobs and generates more than $2 billion in economic activity. Plus a safer, happier country.

MEDIUM AND LONG TERM GOVERNMENT RESPONSE.

The U.S. economy (public and private) has focused on borrowing and consumption rather than on savings, investment and production.

This is not sustainable, and the sooner we face that, the less painful will be the transition.

To generate major economic activity in the medium and long term, we must turn to infrastructure and alternative energy sources. This means massive governmental expenditures to maintain, restore, improve and create the public physical facilities that underpin our national well-being. Highways, bridges, dams, airports, harbors, water levees, mass transit programs, new energy facilities of various kinds—public investment in all of them is needed to stimulate the economy and to improve our quality of life.

Across the country, there are some 600,000 bridges of which 25% are in below acceptable state, according to the Federal Highway Administration. The American Society of Civil Engineers has put price tags on the necessary repair bills, but points out that America today invests only 2.4% of our GNP in infrastructure compared with Europe's 5% and China's 9%.

Given our clogged ports, our airline flight delays that cost at least $15 billion each year in lost productivity, and the hours wasted in rush hour commuting, public support for infrastructure programs should be enthusiastic. Congestion on roads costs $78 billion annually, in the form of 4.2 billion lost hours and 2.9 billion gallons of wasted gasoline, according to the Texas Transportation Institute.

Historically, we have clear precedent, from Thomas Jefferson's support for canals and roads in 1808 and the national railroad mania in the mid-19th century to Dwight Eisenhower's Highway Act of

1956, which created our interstate system. Today, the rest of the advanced world is building high speed trains, but our only version runs between Boston and Washington on an outdated and inadequate track.

The case for investment in alternate energy sources needs little comment. The U.S. consumes one quarter of the world's oil while possessing less than 3% of its oil reserves; we spend $700 to $800 billion a year importing the difference. Cutting consumption and producing alternative sources of energy like solar, wind, hydroelectricity and biofuels are no longer optional, but mandatory.

Seventy-seven percent of France's electricity today comes from nuclear power, and the United States must rethink the nuclear question.

Infrastructure spending and alternative energy spending can supplement consumer spending in the short to medium term as engines for economic growth; in the long term, our helping to meet the consumer needs of the growing Chinese and Indian middle classes will keep our economic engines running.

In the U.S., personal consumption constitutes 70% of GNP; in China it is below 40%, but in time it will certainly rise. That will help us.

When the Chinese buy more cosmetics, for example, they will probably buy more American brands.

Financial Institution Regulation

The U.S. competitive free market financial and economic system has demonstrated its dynamism and its flexibility. To continue to function well, however, it requires public support and participation that are only gained by embracing the concepts of disclosure, transparency, accountability, and fairness.

The investing public has little idea of its exposure to risk because of institutional 'off balance sheet' transactions and the degree of leverage prevalent in the financial community. The public has little comprehension of the risks of the derivative instruments it owns, directly or indirectly; and it understands little about the workings of hedge funds.

Our government officials have been remiss in permitting opaqueness throughout our financial system. Fresh regulations are overdue in balance sheet and risk disclosure, required liquidity and capital-to-loan ratios; we need more effective disclosure rules about self-dealing and short-selling.

Government regulation of non-banking institutions is now front-burner, since the 'too big to fail' premise implies possible government bail-outs; bailout responsibilities should include regulation.

An alternative is not to let institutions get "too big"; today, giant entities like UBS and Citigroup are considering "restructuring."

Creative destruction, the great insight of Joseph Schumpeter, should not be forgotten. Recessions—and the financial failures and bankruptcies that follow—are part of the mechanics by which a free market system revives itself.

Direct government intervention should be rare, and only used where public interest is the over-riding consideration; it should include financial penalties and loss for the shareholders and company officers; and it should require "pay back" provisions for the return of public funds on the model of the Resolution Trust Corporation of the 1990's.

Fannie Mae and Freddie Mac shareholders and officers should not benefit from government bail-outs, and public policy should be firmly against 'private benefit, public loss.'

One problem is the disparity in accounting standards and disclosure and trading practices around the world. Financial globalization will demand accounting standardization, and appropriate solutions are long overdue.

RATING AGENCY REGULATION.

The AAA bond ratings given to toxic subprime mortgage packages should excite outrage.

Only after unwary lenders suffered severe losses from reliance on defective ratings did the Security and Exchange Commission take notice. In July 2008, the SEC released a scathing 37-page report charging that major rating firms flouted conflict-of-interest guidelines and considered their own profits when rating securities at levels higher than risk exposure justified.

"Who shall guard the guardians?" asked the ancient Romans; there is no easy answer.

Individuals of character and professional expertise (Paul Volcker and Gerald Corrigan come to mind) should be impaneled to recommend changes that will not stifle the financial industry, but will protect the public.

GOVERNMENT HOUSING POLICIES.

The belief that housing values would invariably rise underlay 100% home mortgages to borrowers whose income was insufficient to cover debt service.

With the encouragement of the Clinton and Bush administrations, the percentage of U.S. families owning homes rose from the traditional 62% to 64% to nearly 70%; when the housing bubble burst, some 10,000,000 families found the equity value of their homes was below zero. The majority of those homes had mortgages written in 2005, 2006 or 2007, with little or no down payment required, with unverified borrowers' income and with "teaser," below-market interest rates that were not sustainable.

Now that the chickens have come home to roost, we must realize that not everyone can afford to own a home and that some should rent instead.

Canada has had no subprime debacle because Canada requires substantial down payments from mortgage borrowers and solid indications that borrowers can pay debt service.

Denmark requires that mortgages remain on the balance sheets of the issuers, eliminating the moral hazard of selling off the risks to others. The moral, says George Soros, is that when your own money is at risk, you tend to be more careful.

BURSTING BUBBLES.

Thirty-five years ago an economist named Hyman Minsky (who believed that free markets are inherently unstable and crisis-prone) described five stages of a credit cycle: displacement, boom, euphoria, profit-taking and panic.

Minsky, his disciple Charles Kindleberger (author of *Manias, Panics and Crashes: A History of Financial Crises*) and Kindleberger's disciple, Yale Professor Robert J. Shiller (author of *Irrational Exuberance*) all understand the role of emotion and psychology in economic decision-making, unlike conventional wisdom, which holds that economic decision-making is rational, markets are efficient, and the Tooth Fairy arrives on schedule.

Those wishing to understand how our system operates should be familiar with concepts like 'discounted future value,' 'price elasticity,' 'bond yield curves' and the like. But they should also be familiar with the works of Minsky, Kindleberger, Schiller and their predecessor, Charles Mackay, author of the classic *Extraordinary Popular Delusions and the Madness of Crowds*.

The American model of a competitive, free-market, loosely-regulated economy has shown the world how it can stimulate the energy and creativity of a dynamic public. The tightly- controlled, rigidly-planned economies of Joseph Stalin, Mao Tse- Tung and Fidel Castro pale by comparison and are now, in Trotsky's phrase, "in the dustbin of history."

An exploding Chinese economy, however, indicates that in the 21st century we may see competition between democratic capitalism in the West and autocratic capitalism in the East.

Over time, each of these pragmatic societies may take on some of the trappings of the other, with more individualism, privacy and free choice in the East and more large scale government intervention in the West.

How will the game play out? As Chou En Lai said in the 1960's of the impact of the French Revolution, "It's too soon to tell."

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