Chicken Little: The Economy is Falling!

Deteriorating economic conditions have policymakers in Washington, D.C. running around like Chicken Little. As a result of the perceived falling of the sky, these same policymakers are scrambling to come up with a fiscal stimulus plan which, coupled with aggressive monetary policy action by the Fed, is intended to stave off a recession and calm jittery financial markets. Whilst these initiatives are well-intentioned, these efforts are an exercise in futility. There is little, if anything, that can be done to stop the economic downturn that is in progress and that is coming.

During the inflating of the real estate bubble, several important things happened. First, consumer and government spending spiraled out of control. The federal government ran up huge spending deficits that were financed by increased debt levels—most of which was and is held by foreigners. Consumers spent beyond their means—relying on home equity extraction and credit card debt that was relatively inexpensive whilst rates were low. Americans and America became a nation of dissavers, relying on others to fund their insatiable appetites for consumption. This is a trend that is unsustainable for the long-term. Second, Americans purchased real estate that was beyond their means in hopes of achieving the "American dream." This was a noble ambition but little regard was given to the consequences of the end of cheap money and cheap mortgage rates. Third, the buying frenzy fueled a real estate boom where valuations far exceed their fundamentals. At the time, however, no one was willing to admit that prices were too high. Finally, as a result of these factors, counterparty risk increased, despite the use of numerous derivative products and financial instruments aimed at reducing or eliminating such risk.

There is little doubt the current economic downturn was caused by the deflating of the real estate bubble and the mortgage crisis. This caused the banking system to clam up and become more restrictive in lending. This began a chain reaction which sent a systemic shock throughout the economy, causing a credit crisis that was particularly disruptive to financial institutions whose lending reluctance retarded liquidity and prompted some degree of panic in equity markets and in corporate boardrooms.

The Fed's actions in cutting the federal funds rate fifty basis points along with other policy actions in August was intended to

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build confidence and liquidity in the banking system and shore up struggling equity markets with a comforting "Bernanke put." Successive cuts along with the seventy-five basis point cut on January 22, 2008 were aimed at shoring up equity markets amid mounting turmoil and uncertainty over the magnitude and depth of the impact the housing contraction and mortgage crisis would ultimately have on the broader economy. After all, the Fed's actions could not possibly solve the banking crisis. This was a situation created by the banks that would only begin to be relieved by massive write-downs and massive capital infusions by foreign investors, namely Asians and Arabs, totaling in excess of $21 billion. To be sure, there is much more bloodletting to come at financial institutions who provided too much credit when interest rates were low with little apparent regard to attending risk of borrowers. The Fed shares a part of the blame for keeping rates much too low for much too long and in the process allowing the real estate bubble to inflate precipitously.

The magnitude of this may ultimately be over $100 billion as derivatives are revalued in the process to reflect current fundamentals and counterparty risks are reassessed. And there is more revaluation to come in the real estate markets as prices adjust to reflect true fundamentals. This is all a painful process that cannot be avoided forever.

This all suggests that the U.S. financial system ventured to the precipice of a meltdown. Whilst the possibility of such a meltdown is not totally eliminated, it is growing more remote. In response, policymakers now want to give taxpayers rebate cheques ranging from $300 to $1600 in hopes that these rebates will prompt consumers to continue spending and, thus, in the process revive the lagging economy. There is a problem with this. The federal government does not have this money to give away right now; we simply can't afford it. This will likely be funded through debt issuance. In all likelihood, either Asian or Arab investors will purchase this debt. Now we are in even more hock to these nations. And assuming consumers spend the money on goods produced in these foreign countries, the investors get their original money back! This hardly makes good sense. In addition, this fiscal stimulus does not address the mortgage crisis or rising consumer debt levels. More attention should be placed on financial responsibility and sound economic and financial decision-making by the government and individuals. Whilst the Fed's rate cuts have been protective puts for the equity markets, the proposed fiscal stimulus seems aimed only at bolstering the

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peoples' confidence that their elected officials are cognizant of the problem and looking to help their. To be sure, fiscal stimulus is good—but only at the right time. Throwing money at a problem, hoping it goes away, without addressing the fundamentals of the problem is wasteful and counterproductive.

But this is not to suggest that policymakers remain idle and twiddle their thumbs. To the contrary, action is needed. Now is the time to reassess the challenges facing the U.S. economy. A number of factors have resulted in the economy becoming less competitive. Wages are higher than in low cost countries. Manufacturing has moved overseas for cheaper labour. Government spending has grown dramatically. An entitlement program funding crisis looms. Corporate taxes are among the highest in the world. The tax code is complicated. Rather than the fiscal stimulus proposed, policymakers should consider making President Bush's tax cuts permanent, thereby eliminating a great and looming uncertainty. The limits on tax deferred contributions to retirement or 401k plans should be increased as a means of increasing savings. The corporate tax code should be reformed to make businesses domiciled here more competitive so that U.S. companies don't move offshore to avoid an onerous tax burden. The federal government should reduce spending so that debt levels do not increase significantly only to be further indebted to foreigners. Congress should give the President the line-item veto and restore pay-go rules as much as possible, even though this is difficult in times of war. Policymakers must begin the process of shifting to a consumption tax as opposed to an income tax so that taxation is equitable and so that even illegal aliens here pay their fair share of the burden. The Federal Reserve should increase the reserve requirements so that financial institutions are more judicious when it comes to lending depositors' money. This should help to avert another near financial system collapse which could, the next time, have more significant and more far reaching implications than the current situation.

Undoubtedly, policymakers are doing what they deem best. There is an old saying: The path to Hell is paved with good intentions. The Fed's efforts to cut rates and the policymakers' fiscal stimulus plan are aimed at helping avoid a recession or at least soften the impact. No one likes the thought of a recession, particularly in an election year. Recessions are not a necessarily bad phenomenon. All economies must undergo a cooling period. The longer and higher the rate of expansion, the sharper and deeper the cooling and contraction. These periods of cooling are healthy for an economy. They temper excess and help reign in moral hazards and excessive risk taking associated with speculative activity. They serve as a wake-up call to businesses, investors, and financial market participants.

But rushing to make fiscal and monetary policy decisions may only compound an already fragile situation. Now may be the time to show fiscal and policy restraint, even in the face of massive opposition. Fiscal stimulus and rate cuts won't help. The banks and mortgage market participants have to work this out for themselves. Shoring up their balance sheets with equity injections and write-downs is the only solution. To cut rates now may well be mistimed and prompt higher inflation in a period of lower growth. Sometimes it is best to bite the bullet and let things sort themselves out. Hopefully, policymakers will show better financial decision making skill than thus far. Going too far may open an economic Pandora's box. Once that happens, the sky may really be falling.

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