The Economy: Cheerleaders vs. Reality

When MSNBC headlined the report that existing home sales surged by 7.4 percent in November (according to the National Association of Realtors), it suggested that such an improvement boosted "recovery hopes." Others jumped on the recovery bandwagon, including Treasury Secretary Timothy Geithner, and former Vice Chairman of the Federal Reserve Board Alan Blinder.

According to Geithner, it's now reasonable to expect "positive job growth" by spring and correct to assert that people should have confidence in an improving economy. "I think most people would say the economy actually is strengthening now," he added

Blinder, in a long article appearing in the *Wall Street Journal*, said essentially the same thing. While acknowledging "serious dangers to the nascent recovery," he said, "Let me offer instead, in a deliberately one-sided fashion, the case for optimism." While Blinder makes several interesting points, his case, upon closer examination, shows the fragility not only of the economy, but the usual Keynesian arguments supporting such a point of view.

He refers to the "slingshot effect" of driving certain sectors so far into the ground that some rebound is to be expected. Others refer to this phenomenon as "reversion to the mean." Housing starts is a good example, as he himself admits: "Home building is still in the doldrums — limping along at less than half the level of *1960*. [Emphasis added.] The only way to go is up."

He then refers to a "shocking" rate of growth of productivity in the business sector. Upon closer analysis, however, this productivity has resulted from fewer people doing the same work. He takes this as a positive, saying, "This means that employment may start growing sooner."

Blinder then said that "while payrolls continued to decline in November, it was by only a scant 11,000 jobs … which suggests that net job creation may be only a month or two away." He implies this optimism is additionally warranted because of the fact that not all of the "stimulus" money has been spent yet, and that a "second job-creation package looks to be in the works."

Finally, he refers to other interferences and interventions in the economy by the Fed (such as buying mortgage-backed securities to provide "vital support" to the mortgage market), which are allegedly designed to "get credit flowing again."

To be fair, Blinder does acknowledge that his arguments are weak and based more on theory than experience. He says that "serious downside risks remain." He admits that any "slingshot" and stimulus effect will in any event peter out in a few months. He says, "Banks are still failing and commercial real estate is a mess. So my optimism is guarded."

And so it should be.

The growth in sales of existing homes rose in November "to the highest level in nearly three years, reflecting an extraordinary level of federal support," according to MSNBC. New home buyers' $8,000 credit moved many to purchase homes sooner than they otherwise would have, creating a potential decline in the next few months if the credits are not renewed. However, Congress has decided to extend that credit, and expand it to others living in their home for five years or longer.

Which raises the question: What happens when the music (and the credits) finally stops?

The fanfare that greeted the housing starts announcement virtually disappeared when the Commerce Department reported that the economy grew at a lower than expected 2.2 percent annualized pace during the third quarter. The original estimate from the establishment economists was 3.5 percent, but that number was later adjusted downward to 2.8 percent instead.

The Commerce Department explained that several primary factors impacted the much lower than expected performance: Consumers didn't spend, commercial construction slowed, and business investment was "soft."

Ian Shepherdson, chief economist at High Frequency Economics, said, "The core problems for the economy — busted banks [not lending] and massively overleveraged consumer[s not borrowing] — have not gone away."

MSNBC stated that "foreclosure rates remain a strong drag on the housing market … and employers continue to cut jobs, which is not good news for the record 14 percent of homeowners [one out of every seven] with a mortgage that is either behind on payments or in foreclosure."

Buried in the report was the news that builders reduced spending on commercial real estate projects at an annualized pace of 18.4 percent in the third quarter, much "sharper than the 15.5% [decline] previously estimated."

On Wednesday, the Commerce Department reported that new home sales dropped more than 11 percent in November. Home builders have 235,000 homes for sale, the lowest inventory since April of 1971.

Classical economic theory holds the reasonable position that face of uncertainty producers don't produce, consumers don't consume, and investors don't invest. Until confidence in the future is restored, producers, consumers, and investors will continue to hunker down.

Here are some of the uncertainties they are facing:

1. *Banks are not lending:* Why should they? With short-term interest rates at zero, and two-year Treasury notes paying almost 1 percent, banks can make 1 percent with zero risk (and by using leveraged derivatives trading, these risk-free gains can be greatly multiplied). This is one of those "unintended consequences" of the Fed holding interest rates so low.

2. *Tax credits expiring:* Home buyers who are enticed to move up their timetable in purchasing a new home are merely borrowing from the future. Once the credits expire, the underlying weakness in the housing market will again manifest itself. This was seen following the end of the "Cash for Clunkers" program when new car sales sagged afterwards.

3. *Christmas buying will not jumpstart the economy:* In fact, the Associated Press just reported that 80 percent of gift buying this year is with cash. Using cash is not only a way to stick to a budget, but may also reflect maxed-out credit cards, or no cards at all. Besides, such spending represents less than 13 percent of the fourth quarter's spending.

4. Healthcare costs increasing: With more and more government intervention into the delivery of healthcare, costs (and premiums) will increase in the future.

5. Unemployment concerns: Even though job losses and layoffs appear to be slowing, the total level of employment is lower than it was before the economy entered the last recession in 2001. Put another way, all of the job growth over the past nine years has been virtually wiped out by the current recession. And when that last recession ended in November of 2001, it wasn't until February of 2005 that all the jobs lost in that recession were finally replaced. According to an MSNBC study, this time it will take more than six years to make up the losses from this recession. It will take years to restore consumers' confidence to the point where they will willingly add "convincingly to GDP [Gross Domestic Product]."

6. Jobless benefits in jeopardy: In another study, 25 states have already run out of unemployment money, and an additional 15 will run out in less than two years. This is resulting in some states cutting benefits while raising taxes on small businesses at the worst possible time. For instance, a Kentucky task force recommended cutting benefits by 9 percent and delaying payments to recipients by a week. And in Indiana, "There's immense pressure, and it's got to be faced," said state Representative David Niezgodski. "Our system [is] absolutely broke."

7. Medicare and Social Security: According to Gary North, both systems are currently running deficits, and will run out of money in the next few years.

8. Commercial real estate: This market is still headed down. New construction is not expected to rebound before 2011, according to Global Insight. And a credit crunch looms over the owners of commercial properties as they try to refinance mortgages secured during the bubble. With tenants either leaving at the expiration of their leases or demanding significant reductions in their current lease payments, owners will face increasing difficulties in meeting lenders' demands.

9. Alt-A and Option ARM resets: A "second wave" of defaults is just around the corner, according to Agora Financial, that would result in more write-downs and defaults by these mortgage holders.

What to do?

With "stimulus funds" not stimulating, and efforts to create new jobs not working, what should be done? According to a recent study by the National Bureau of Economic Research, based upon the experiences of most wealthy economies from 1970 to 2007,

> Fiscal stimuli based upon tax cuts are more likely to increase growth than those based upon spending increases…. The current stimulus package in the U.S. is too much tilted in the direction of spending rather than tax cuts.

In sum, government spending doesn't end recessions. Tax cuts and spending cuts do.