

The Uncertain State of the Economy
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One of the marvels of a free market economy is how the needs and desires of millions of people in the market are met by the mutual enterprise and labor of each person working to advance his or her own interest. Adam Smith called this confluence of self-interest that serves all needs the Invisible Hand. Much of the history of the twentieth century was a testament to the failure of other systems of economic organization to provide for the welfare and prosperity of its citizens, particularly the centralized, command systems of the Soviet communist states. The Invisible Hand of free enterprise in an open economy works. Other systems do not.

The current financial and economic crises, however, are a reminder that even open economies can fail to deliver the goods when key aspects of the economic system are unregulated or poorly regulated. Such has been the case recently with the system of supplying credit to the U. S. housing market. An abject failure to rein in rampant abuses in providing credit to home buyers and speculators has brought the U. S. economy and, with it, the global economy to a point where a major downward adjustment in output, income, and living standards is underway. The current contraction in the U. S. economy does not look to this observer to be temporary - quite the contrary. The contraction now underway is bringing about a recalibration of expectations that will result in a long-lasting change in the nature and level of economic activity and output in the U. S. Relative to its standing with the rest of the world and to its growth rate before the crisis, the U. S. will come out of the current crisis with a lower level of personal consumption, a lower level of real per capital GDP, and a higher savings rate. The implications for investors are that capital market returns will be more modest and equity returns, in particular, will be lower.

This is not a pessimistic outlook, but a realistic one. Those who are waiting for a resumption of the good times before the credit crisis will be waiting a long time. Those who are looking for a stimulus package to restore GDP to what it was before the collapse of the housing bubble are likely to be disappointed. Why? Because the bubble in the housing market boosted economic activity to a level that was artificially inflated and that can not be sustained by the fundamental forces of the Invisible Hand, by the real needs and interests of consumers.

In an August 12, 2005 *New York Times* op-ed article titled "Safe as Houses," Paul Krugman pointed to the problem. He told of a Russian émigré who wondered at how the country creates the wealth that is so evident to him. ". . . I never see anyone making anything. How does the country earn its money?" Krugman's answer was that "we make a living by selling each other houses." His article went on to explain how the housing boom was a source of significant job and wealth creation.

That was 2005. Now the housing boom, and the credit glut that fed it, are over. What's going to take the place of all the economic activity it spurred? Are we waiting like the investor in the cartoon for the next asset bubble? Even if another bubble were coming, however, none could have as large an impact as a housing bubble, because no other asset market is as large. Herein is the damning failure of the Fed and the banking regulators—to have failed to act to ameliorate the most damaging kind of asset bubble an economy can experience.

The fact is that nothing stands to replace the economic activity spurred by the housing boom. What are the needs and desires of Americans that we can turn to satisfying in place of a desire for our own homes, bigger and better and with new furniture and appliances? What will Americans buy on credit now that equity credit lines have been tapped out or shut off due to falling housing values. What will entice us to spend when we are figuring out how to shore up our battered 401-k plans or trying to build a savings cushion in case of a job loss?

This is the reality of the American situation, and it is different from what has prevailed over the past several decades. As Robert Shiller states in the introduction to his monograph *The Subprime Solution*, “this crisis has set in motion fundamental societal changes—changes that affect our consumer habits, our values, our relatedness to each other. From now on, we will be conducting our lives and doing business with each other a little bit differently. (page 1)” To this observer, it appears we are likely to consume less, borrow less, work longer, become more productive, and save more; but it will take time to assess all of the changes in values and behavior.

Some of the changes wrought by the current crisis are likely to make it difficult to increase economic output with traditional measures. Expanding the economy through credit expansion is pushing on a string. Neither business nor the consumer believes it to be in his interest to take on more debt. Trying to expand output through infrastructure investment will only have a permanent effect only to the extent that the infrastructure improves productivity or provides a service or convenience consumers do not already have. Much infrastructure investment will have only a temporary effect because it will fail these requirements—like Japan's efforts to recover from their lost decade of the 90s. And need we be reminded that Japan's lost decade was precipitated by a collapse in real estate values?

Are we in for a lost decade of declining asset values, price deflation, and zero interest rates? We could be. Although we should not discount the resilience of the U. S. economy and its capacity to find new ways to create value for the consumer, restoring economic output to pre-crisis levels will be challenging in the face of substantial declines in household wealth (from both housing values and investment values) and reductions in employment. It will require the creation of at least somewhere between \$350 and \$500 billion in real economic output annually—not just additional spending, but the creation of real products and services valued by consumers who will be reluctant to increase their

consumption. The alternative energy industry holds some promise here; but even in this case, it will be a challenge to create value (and jobs) with crude oil at \$40 per barrel.

The future is as uncertain as it has been in more than a generation, and even more so because the very caution consumers and business people feel today compound the uncertainty. The words Franklin Roosevelt spoke seventy-six years ago are true today as they were then: “. . . the only thing we have to fear is fear itself.” How we shall overcome our fears and anxieties remains to be seen. Our prosperity depends on doing so. But doing so involves more than solving an economic problem and more than solving a political problem. In the mean time, investors are well advised to moderate their return expectations.