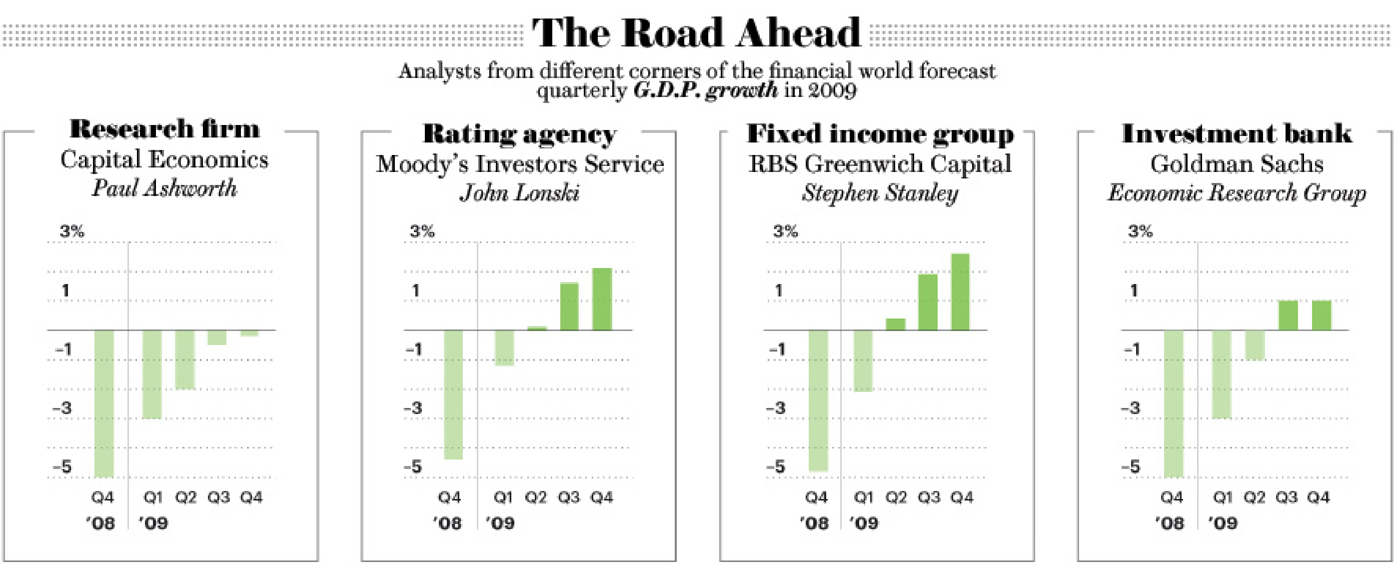
The Case for Optimism

by John Cassidy

It’s possible that this downturn could end quicker than anyone thinks.

When it comes to issuing gloomy warnings about the U.S. economy, I’ve established myself as something of an authority (or bore). Ten years ago, I was much exercised about the threat of a stock market bubble; in 2002, I wrote a piece saying that the next crash would come in real estate. Since then, I’ve produced numerous jeremiads, including ones for this column. But for the first time in my memory, I am less pessimistic than the conventional wisdom.

I wouldn’t say that I’m a heady optimist, but I think there is a danger of repeating the mistake that many of us made during the boom: extrapolating current trends to make decisions about the future, failing to take into account how rapidly economic circumstances can change. There’s a risk that we may again overshoot the mark: As the economy goes down, we could be overemphasizing the negative just as we exaggerated the positive on the way up. (Graphic showing analysts' predictions for 2009 quarterly G.D.P. growth.)



Yes, the short-term outlook is dismal and will remain that way for months. On top of a slumping housing market and credit crunch, we have soaring unemployment, an unprecedented fall in consumer confidence, daily corporate retrenchments, and a dramatic slowdown in the world economy, which is affecting even India and China. The U.S. recession, according to the National Bureau of Economic Research, began in December 2007, which means it's already the third-longest downturn since 1945. Come May, barring something completely unexpected, this recession will become the longest in postwar history.

So where's the good news? In any serious downturn, a number of self-reinforcing processes—economists call them adverse feedback loops—start to take hold. To prevent a recession from turning into a depression that lasts for years and years, these feedback loops have to be thwarted on as many fronts as possible, with a variety of policies. Fortunately, these are now being put in place.

In the U.S., we have an energetic new president with a mandate to expand government spending and cut taxes. Equally important, we have the Federal Reserve, chastened by earlier errors, injecting money into the financial system at a rate never seen before. Overseas governments also are busy introducing stimulus packages, slashing interest rates, and propping up their banks. It's possible the pessimists are right, and all of these initiatives will fail to halt the downward spiral. But that would go against historical precedent. And during the most catastrophic slumps of the past—the Long Depression of 1873 to 1879, the Great Depression of 1929 to 1933, Japan's "lost decade" of the 1990s—policymakers failed to act decisively until it was too late.

The most visible adverse feedback loop is in the financial industry. Faced with mounting losses on housing-related securities and loans, banks and other institutions are curtailing their lending to preserve capital. Initially, the Fed responded to this problem by cutting interest rates and expanding its role as the lender of last resort to encourage banks not to sit on their capital. This strategy, which amounts to a finger in the dike, prevented a rash of collapses but did nothing to repair the financial industry's capital base, which has been massively impaired.

By injecting taxpayers' money into big banks on generous terms and agreeing to have the government take the hit on many of Citigroup's junky securities, Ben Bernanke and Hank Paulson are well on their way to addressing the problem; in essence, they're socializing the private sector's losses. From a political and philosophical perspective, this is an ugly process to behold—who likes bailing out Vikram Pandit and Robert Rubin? Nevertheless, it is probably the only way for the financial industry to move beyond the credit crunch and start over. The Obama administration is likely to expand assistance to the banks, possibly through the creation of a new Resolution Trust Corp., which would take on distressed assets from many financial institutions, perhaps in return for stricter limits on executive compensation and bigger equity stakes than the Bush administration demanded from Citigroup.

In addition, the Fed has agreed to purchase hundreds of billions of dollars' worth of such dubious securities as "triple-A"-rated mortgage bonds and credit-card receivables and allow financial institutions to swap even trashier paper for cash or Treasury's. The financial crisis is far from over, but with the federal government guaranteeing bank debts, dispensing practically unlimited amounts of credit at close to zero percent interest, and acting as the junk purchaser of last resort, it may well have seized the initiative.

Similarly aggressive moves may soon be under way in the housing market, where the self-reinforcing cycle is continuing into its third year. As prices keep falling, the number of foreclosures increases and abandoned homes flood the market. At the same time, home loans become more difficult and costly to obtain for almost all kinds of borrowers, so potential buyers decide to stay put, and prices fall further. The good news is that Obama appears to be serious about preventing more foreclosures.

One option is to follow the advice of Sheila Bair, the departing head of the F.D.I.C., and restructure millions of delinquent home loans, reducing the principal and lowering the interest charges. For this to happen, changes will need to be made to the bankruptcy code and laws regarding the disposition of securitized mortgages. A more radical approach would be to have Fannie Mae and Freddie Mac, the two government-sponsored mortgage companies—now effectively government agencies—offer refinancing to any homeowner with negative equity, that is, anybody with a home loan bigger than the value of his or her property. And to encourage home buying, Allan Meltzer, an economist at Carnegie Mellon University, has proposed making some down payments tax-deductible.

Unfortunately, even if Obama could wave a magic wand to mend the financial industry and stabilize the real estate market, the recession wouldn't end overnight. Thanks to another adverse feedback loop—dubbed the Keynesian multiplier, after the dead British economist who is all the rage these days—the trouble has already spread to the rest of the economy. Take Charlotte, North Carolina, a big regional financial center. As locally based companies like Bank of America, LendingTree, and Wachovia lay off thousands of employees, the area's restaurants, messenger services, and limo companies see their revenues plummet. These businesses, in turn, trim their operations and jettison staff, which reduces the need for produce, bicycles, and town cars. The original fall in demand generates a second-round effect, which generates a third-round effect, and so on. Imagine this happening in towns and cities all across America and you can begin to understand how a recession takes hold.

The usual way to counter a fall in demand in one part of the economy is to boost it in another. This is the principle behind stimulus programs like the one Obama has proposed, which could involve up to a trillion dollars in new expenditures and tax cuts. The arithmetic behind this enormous figure is strikingly straightforward. Since the start of 2007, about $10 trillion in real estate and stock market wealth has been wiped out. If, for every dollar American households have lost, they cut back their expenditures by, say, 5 cents—an assumption that jibes with historical evidence—the total spending shortfall in the economy will be $500 billion a year, or $1 trillion over two years, the likely duration of the stimulus package.

This emergency measure will eventually have to be paid for—as will all the recent bailouts—but the middle of a recession isn't the time to obsess about budget deficits. A more pressing concern is making sure that additional government outlays are spent rather than saved. It turns out that much of the $150 billion worth of tax rebates authorized by the Economic Stimulus Act of 2008 wasn't spent. So the 2009 stimulus will be targeted at cash-strapped states, the unemployed, and other recipients who won't let the money collect dust in their savings accounts. It may be too much to hope for that the package by itself will revive overall spending. However, combined with the $250 billion in consumer savings that the recent drop in gasoline prices will deliver this year, it could well prevent another downward lurch.

As in any deep recession, the ultimate key to recovery will be restoring the confidence of business executives, investors, and consumers. When times are good, most people you meet are upbeat, and it's easy to dismiss the warnings of worrywarts and cranks like yours truly. As unemployment increases, the odds of running into somebody who was just fired, or whose best friend was just fired, rise exponentially. Gloom spreads like a virus. Eventually, the few remaining optimists are the ones who start to seem crazy.

Breaking this psychological feedback loop is Obama's toughest task. Luckily, he comes equipped with impressive oratorical skills, a calm and reassuring demeanor, and the rare ability to make Americans feel good about themselves and their country. If, after leveling with the public about what has gone wrong, he can outline a credible and fair strategy for recovery, including the establishment of a tougher and more scrupulous regulatory structure, he could buck up what Keynes referred to as the economy's "animal spirits"—the optimism that goads entrepreneurs into action.

The model for Obama, inevitably, is Franklin D. Roosevelt, who took office in March 1933, a time when one in four people was out of work and the banking system was in a state of panic. By no means did all the policies that Roosevelt introduced in his famous "hundred days" work out perfectly. But he stabilized the financial system; convinced Americans that, at last, something serious was being done; and conveyed a sense of confidence. Bernanke, a Republican fan of Roosevelt's, likes to remind people that one of the stock market's best years of the 20th century was 1933. During Roosevelt's first term, the inflation-adjusted gross national product expanded more than 25 percent.

It would be wishful thinking to expect such a vigorous upturn between now and 2012. Before we can hope for a sustainable recovery, we have to deal with yet another adverse feedback loop—deflation—which is a recipe for Japanese-style stagnation. As prices start to fall throughout the economy, borrowing money and servicing debt costs more in real terms, putting even more strain on borrowers and financial institutions.

Bernanke is determined not to let deflation gain a foothold. Between September and December, the monetary base—notes and coins in circulation, plus bank reserves at the Fed—jumped by about a third. Without announcing it publicly, the Fed has adopted a policy known as "quantitative easing," which basically means that it's flooding the economy with cash. With central banks around the world adopting similar policies, it's hard to see a global fall in prices persisting for very long.

By the end of this year, if all goes well, there could be tentative signs of an upturn. How seriously do I take this rosy scenario? Recently, I moved some of my savings from cash into stocks. If the past two years have taught us anything, it's that popular economic wisdom is often mistaken. In venturing into the stock market, I am taking out a long-term call option on the possibility that the doomsayers, my normal self included, are mistaken. I hate to sound like a shill for Wall Street, but in my mind, this is simply sensible diversification.