MARKET PERSPECTIVE

by Claude Gruen

Do and Don't Worry

How to Stay Focused During the Current Economic Crisis

Abraham Lincoln's dictum that a house divided against itself cannot stand also applies to contradictory local and federal policies with regard to housing prices and debt regulation just as it does to slavery and freedom. Since the early 1970s, local governments in many fast-growing areas have been driving up housing prices by restricting entitlements for new development on vacant land and the redevelopment of existing structures.

Not coincidentally, since that same time, the federal government has been tearing down the banking restrictions that had been imposed to safeguard traditional mortgage lending and turned a blind eye to a host of new financial innovations that created vast new pools of credit for mortgage debt. When the financial tensions created by the opposing forces of local and federal actions with regard to housing lending finally cracked, only the federal government had the muscle to shore up the falling structure. At this writing, it appears that Congress is wimping out of that challenge.

The financial panic of 1907 was calmed when the actions of J.P. Morgan and a few top bankers restored confidence in the banking system. In what can be referred to as the "mark to market" confidence breaker of 2008, only Warren Buffett stepped up from the private sector to put his funds in the breaking dike of confidence in the financial sector.

The federal government started to repair the break in confidence by taking over Freddie Mac and Fannie Mae, sending a lifeline to AIG and brokering some takeovers of weak financial institutions. But at that point in the drama, political ideology and the paralyzing effect of the upcoming election seem to have won out over common sense in the chambers of the United States Congress. Unless Congress reverses its course, the U.S. economy will be left wallowing in the shallows of an economic recession.

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It is beyond the skills of even the wisest economist, let alone this writer, to predict how long the economic malaise will last. The best I can do is to suggest that at this point, the speed of that recovery will depend on how quickly businesses can respond to the secular changes that preceded the financial meltdown in confidence. I also suggest, below, what at this point is and is not worth worrying about.

What we should not worry about is the decline in housing prices that initially tripped the wire of the financial booby trap, setting off the credit crunch. Instead, we should encourage local land use regulators to take the actions needed to hold down the price of new as well as existing housing.

We should worry about and fight short-sighted and selfish local land use policies that restrict the supply of new construction on vacant land and sites encumbered by obsolete buildings. Our goal should be to keep housing affordable by encouraging competition, rather than trying to prop up effective demand with bad loans. Lower prices for new and existing houses will bring buyers back into the market, enabling more middle-income households to become homeowners without mortgage payments their incomes cannot sustain.

We should also worry about getting capital providers out of their panic-induced catatonia and back to providing mortgages to buyers who can afford to repay them, and financing to firms able to be responsive to local and international demands with cost effective, innovative products and services.

Another way to turn the bitter lemon of the near recession conditions into lemonade would be to accelerate our response to the secular change signaled by the recent run-up in the worldwide price of oil.

It makes no sense to respond to this only by intensifying U.S.–based oil and gas production. While it does make sense to increase drilling in places where it can be done safely, our domestic oil resources are simply not big enough to replace the more than 10 million barrels of oil per day that we are now importing.

While it may be true that on a worldwide basis there is enough oil under the ground to meet energy needs far into the future, the reality is that much of this oil is in places such as Venezuela, Russia, Nigeria,

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Iran, Iraq and Saudi Arabia. Continuing to rely on those countries to satisfy our oil gluttony is neither economically wise nor militarily or politically practical.

There are also critical environmental reasons for switching America's energy base away from oil. Therefore, contrary to what you may read in this morning's newspaper or heard from political candidates for the highest office, it is not good news that oil and gasoline prices have started down again.

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We should provide tax rebates to lessen the burden of high gasoline prices on low-income Americans. But high oil and gas prices are a good thing because they encourage switching to alternative sources of energy. One of the most beneficial ways to help turn the economy around is to invest now in more nuclear power plants, advanced coal burning plants that bury their pollution underground and the infrastructure needed to harness wind, wave and solar power where it makes economic sense to do so.

Because higher gas and oil prices today and, even more importantly, the expectation of higher oil prices tomorrow create incentives for employment-generating investment in alternative energy sources, we should not worry about high oil prices. What arguably is the most important thing we should be worrying about is the danger that the same kind of locally centered selfishness that constrained the supply of new housing in the regions where housing prices soared most will also stand in the way of switching to non-oil based energy.

Folks like those in Northern California's Mendocino County who are demanding more and more studies in order to stop attempts to harness wave energy, those who argue that nuclear energy is just too dangerous in spite of its excellent track record and continuing improvements in its safeguards, and similar NIMBY reactions to other alternative power projects may well keep the United States addicted to oil.

In the 19th century, San Francisco alone had eight refineries producing whale oil for light and energy. If the pioneers of electricity and gasoline had faced the kind of opposition local activists are giving those seeking to build a new non-oil-based infrastructure, you might be reading this with light powered by whale oil.

The current U.S. unemployment rate is about 6.1 percent. This unemployment rate will rise. But, it will head down again if we successfully tackle the job of responding to the challenges of the long run changes in economic geography, environmental conditions and resource availability.

By keeping focused on what matters, and maintaining a long-term perspective, investors will get through the economically tough times ahead. ❖

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