Walking on Eggs

Economic Recovery Still Needs Federal Government Nurturing

Market Perspective

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The Troubled Asset Relief Program (TARP), the emergency Term Asset Backed Securities Loan Facility (TALF), and the bailout of companies deemed too big to fail have worked. These, and related ongoing actions, have kept the U.S. banking system from collapsing under the weight of residential mortgage defaults and the realization that financial institutions were under-capitalized and overly exposed to under-priced risks.

The decline in real Gross Domestic Product (GDP) that started in December of 2007 and decreased by 6.4 percent in the first quarter of 2009 has probably already been halted by the $767 billion fiscal stimulus program and the purchase by the Federal Reserve Bank of over $1 trillion in Treasury debt. The official GDP numbers for the third quarter are not out yet, but the betting is that output will show a slight gain in that quarter.

When measured exclusively by output or GDP performance, there is a good chance that the size and speed of Washington's one-two punch may have ended the recession. But the "output gap," which measures the distance between current output and the level of GDP required for full employment, has widened. While this lessens the danger of inflation, the size and persistence of this gap suggests that employment recovery is not yet in sight.

A new mood of thrift has infected consumers, driving the personal savings rate to 5.2 percent of real disposable personal income in the second quarter. Given this mood, there is little chance that consumer spending will rise enough to close the output gap as it has in the past.

Further, while the banking system has avoided collapse, it is a long way from closing the output gap with loans to businesses. Ominously, the other shoe of defaulting loans is about to drop in the form of the more than $814 billion in commercial real estate (CRE) mortgages maturing between now and 2011. Additionally, at the end of June this year, $292 billion in CRE construction loans were outstanding, including many loans on condominium developments. *Foresight Analytics* was quoted in the September 5th *New York Times* as estimating that of the twenty cities with the most construction loan delinquencies, only one has less than a 10 percent delinquency in such loans.

The output gap also continues to be propped up by productivity increases. Employment and the ability of consumers to spend are being significantly decreased by state and local government tax increases and cutbacks in jobs and expenditures.

These responses to the recession from entities that can't print money are offsetting portions of the federal government's stimulus spending. We may have won the first inning, but it is too early to count the recession down and out. Yet that seems to be the position of those who are arguing against further stimulus spending. Those players say it is now time for Washington to balance its budget, and for the Federal Reserve Bank to cease increasing the money supply and keep interest rates low. These are worthy goals, but for the time being, we should heed Saint Augustine's prayer about worthy goals: "Lord, give me chastity and continence – but not yet."

We have yet to reach the proportions of government debt to GDP that motivated the pitch for savings bonds during World War II. So for now, the White House should hold off on encouraging consumers to save more by buying government bonds.

The push from Washington to force the banks to bulk up the capital portions of their balance sheets now also strikes me as premature.

Fortunately, the Accounting Institute has issued FSP-FAS 157-4 with the imposing title, "Determining Fair Value When the Volume and Level of Activity for the Asset or Liability Have Significantly Decreased and Identifying Transactions that are Not Orderly." What this pronouncement wisely recognizes is that many CRE markets today are not orderly, making it inappropriate to rely on comparable sales as the primary measure of value. When most transactions are the result of distressed sales, basing estimates of market values on such sales can only lead to a downward spiral of more distress and further declines in alleged market values. Unless borrowers are incompetent or criminal, lenders should be encouraged to roll over maturing loans on properties with sufficient net operating income to cover interest payments. For the time being, banks should be encouraged to value properties based on reasonable discounted cash flow forecasts, rather than current comparables, and pay more attention to debt coverage ratios than loan-to-value ratios.

The country still has great need for infrastructure. Examples include a dangerously outmoded air traffic control system, unsafe bridges and highways, and in-school art and music programs that have been dropped for lack of funds. Alleviating such needs is where fiscal stimulus could do real good, while boosting a still limping economy. Private business, and this includes the real estate sector, must retool for the new, highly competitive, technologically advanced and urban-centered economy that is emerging quickly in the twenty-first century.

China is a country that has accepted the challenge of using governmental stimulus to lift its economy back into employment and output growth, while it simultaneously reinvents its public and private infrastructure in line with the demands of the emerging new world economy. Concentrating on the short run remedies for market and governmental failures is much easier for a dictatorship than a democracy.

If U.S. policymakers are to complete the job of putting the economy and its regulatory framework back on track, they will have to tread a very delicate path through a political minefield. But the future vigor, if not the survival, of democratically-regulated capitalism is what's at stake.

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