

# THE ECONOMIC OUTLOOK GROUP



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## ECONOMIC TALKING POINTS

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### **The Umbrella Keeps Getting Wider --- and Heavier**

- Redefining the Role of Government. Just Where Is The Line in the Sand?
- August Housing Starts Were Dismal, But Home Builder Spirits Are Rising

Given all the recent convulsions in the financial markets, it is important to take a step back and appreciate the scope of the historic changes underway and its implications for the economy. What would normally take any other industry years to achieve such sweeping restructuring and consolidation has for financial industry been violently compressed into literally days, and in some cases hours. This face-flattening acceleration of major acquisitions, historic failures and unprecedented bailouts has caused much anxiety, confusion and for many investors a bad case of vertigo. But the picture becomes a bit more clear and coherent from 35,000 feet up.

First, nothing is as important to the day-to-day operations of the world economy than a well functioning financial sector. Whether it is currency trades, flows of capital, insurance, or derivatives, these financial transactions play an indispensable role in fostering world economic growth. The supply of credit is the critical jugular of the US and international economy. Any significant disruption in the availability of credit poses an immediately threat to global capital markets. So here's point one: It is NOT the cost of funds that can suddenly destabilize an economy, it is the inaccessibility to funds when

they're needed that can abruptly shut down consumer and business activity around the world.

Second, the paroxysm in the financial markets is the only way to quickly address the exposure to failing assets and deteriorating balance sheets. These ills are the prime reason for the tightness in credit right now. The process of rehabilitation, while hard to watch, should quickly sweep away those institutions that have been reckless in their risk management and careless in doling out loans, and bring forward a group of financial firms that will be healthier, better capitalized, more competitive and presumably more prudently managed.

The one question that still looms large is how will the government strengthen the discipline of risk management and thereby prevent the deterioration of moral hazard? Can a more definitive line in the sand be drawn that explicitly warns financial firms that beyond this point no government bailout will occur? This entire issue has bedeviled Washington policymakers for years but it now needs to be articulated. With most Americans now preoccupied about their own future and job security, the one thing they do not want to hear is how they will end up paying the bill for poorly managed companies. Remember, up until a year ago, the Federal Reserve was responsible for solely protecting the banking system. Then last March, that umbrella was widened to cover troubled investment firms too. Last night, the government stretched that umbrella beyond where anyone thought possible a day or two ago when it rescued an insurance company. Every time that umbrella widens, it gets heavier and heavier for those holding it up – which is the taxpayer. Thus, we believe that an essential part of the solution is for the government to redefine its relationship with the financial community as soon as possible. It is not politically acceptable or even economically wise to allow top executives and owners of a corporation to share in the profits when times are good, and have innocent taxpayers get stuck with the bill when stupidity and recklessness results in major losses.

Time is of the essence. The Great Depression gave birth to regulations that stabilized the financial industry and paved the way for seven decades of vibrant economic growth. We're now in the midst of the Great Financial Calamity of the 21<sup>st</sup> century, and this crisis demands that Washington act with speed to redesign a modern regulatory structure that will strengthen our financial system, which would provide the backdrop for sound economic growth in the decades ahead.

## Housing Starts

Shifting to today's numbers on housing starts, new construction activity plummeted to a near 18-year low of 895,000 annualized units in August. The pace of new homebuilding is now 33% below last year's depressed levels! The news on housing permits point to even less construction in coming months. Permits dropped by 8.9% to an 854,000 rate. Let me add one other statistic to the mix: The number of new homes completed last month came to 961,000, which turns out to be the smallest in more than

two decades. The dismal housing stats, along with declines in industrial production, consumer spending, and rising joblessness are symptomatic of an economy in recession.

We also looked at the latest weekly mortgage applications figures by the Mortgage Bankers Association, which showed new filings surged by more than 33% in the last week. Don't get excited, though. Most of it was to refinance existing loans, not to purchase a home. Refinancing applications jumped 88% last week, while applications to buy a home rose just 2.4%.

However, one leading indicator we do look at for clues on future home buying and construction is the index that tracks visitor traffic to homebuilder show rooms. The National Association of Home Builders noted yesterday, that confidence among homebuilders in September increased for the first time in seven months. Their September Housing Market Index rose to 18 in September, after two consecutive months stuck in the cellar at 16. Their traffic index also inched higher, to 14, after bottoming out at 12 and 13 in July and August, respectively. These are not significant moves, of course, and it remains to be seen whether they have any meaning. What did raise eyebrows, however, was the expectations index on sales of single-family homes over the next 6 months. That index bounced up to 30 in September, the highest in more than year. Since the survey was conducted prior to this week's upheaval on Wall Street, it will be interesting to see if homebuilder confidence can be sustained in the October survey.

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