

THE ECONOMIC OUTLOOK GROUP



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ECONOMIC TALKING POINTS

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The \$700 Billion Bailout: A Bitter but Necessary Medicine for the Economy

There is palpable fury on both main street and in Washington now that taxpayers will have to foot the bill for a \$700 billion Wall Street rescue package. After all, most Americans are now besieged with their own problems as a result of a recessionary economy. Unemployment is at a five year high. Workers watch helplessly as their incomes fail to keep up with inflation, and households continue to see their wealth erode due to falling home values and stock prices. These are tough times for many.

Adding insult to injury, Americans are now being told they will also have to cover the cost of saving financial institutions that got into trouble largely because of reckless lending and poor risk management practices. The final outrage for taxpayers is that the CEOs responsible for making these disastrous decisions are able to walk away with millions of dollars in compensation and severance. Is it unfair? Yes. Absurd? Certainly. Taxpayers have every right to protest being dragged in to salvage such companies.

But when you come face to face with a financial crisis of this magnitude, there is an even larger issue to consider. Failure to act now would almost certainly trigger a 21st century depression, with much higher joblessness, an exponential increase in foreclosures, pensions being wiped out and with consumers and businesses frozen out of the credit market. That is what is at stake. So it was not a surprise to see the anger and

frustration and sarcasm displayed at today's Senate hearing as they grilled Bernanke, Paulson, Cox and Lockhart about the mother of all bailouts and how the country got into this mess. The Administration meanwhile is pressing Congress to move quickly to stabilize the country's banking system, making the argument that while stability may not be everything --- without stability, everything is nothing! The urgency is real. The nation has to address the threat that most endangers the US economy, which is the on-going paralysis of the entire credit-supply system.

It was a hard swallow for many Senators. The plan crafted by the Treasury and Federal Reserve gives the government authority to purchase \$700 billion worth of illiquid, immovable asset backed securities from banks, investment firms and even insurance firms. The goal is to cleanse the balance sheets of these institutions by removing the sludge that has clogged the financial pipeline. To do so, Federal Reserve Chairman Ben Bernanke said in Senate testimony today that most of the troubled assets will likely be valued on a mark to maturity pricing, and not on a mark to market basis. This means financial institutions will not have to write down as much on their balance sheets, and that allows them to recapitalize more quickly.

What it all comes down to is this: By taking over Freddie Mac, Fannie Mae, and now some \$700 billion in mostly mortgage backed securities, the Treasury is working to facilitate a recovery in the housing sector. We cannot lose sight of the fact that the depressed real estate market is at the core of the current financial crises. Once banks and other lenders have an opportunity to clean up their balance sheets and recapitalize, they will be in a stronger position to lend to home buyers. As the real estate market stabilizes and property values firm up, a significant chunk of those now toxic mortgage backed securities will rise in value and thus reduce (or possibly eliminate) the final bill that taxpayers will end up with.

But the Treasury and Congress will need to move quickly. Doing so will help accelerate the rehabilitation of the financial industry and hasten the recovery of both housing and the economy. A month ago, our forecast was for the economic activity to remain sluggish through 2009, with GDP growth a meek 1.5%. We expected no recovery until 2010. However, if the Treasury and Federal Reserve can come to terms with Congress and pass the rescue legislation in the next week or two, we could advance our expectations of a recovery with an economy approaching trend growth in the second half of 2009. Of course, we can't formally change our forecast until we see the details of the bailout plan, but it should have both a remedial and psychological impact on the financial markets and the real economy.

Once the program is enacted we'll be looking at several indicators in the months ahead to monitor how well the plan is working.

- The dollar. Foreign capital inflows will be necessary to help finance the swelling US deficits. A stronger dollar will reflect renewed confidence on the fundamental soundness of the US economy and its financial system.

- Bank stock prices. How share prices move for the major financial institutions will tell you if investors believe the bailout plan is working. Are banks taking the necessary steps to correct their balance sheets and return to profitability?
- National Association of Home Builders index of “traffic of prospective buyers.” Is the traffic to showrooms of home builders increasing? An increase in the showrooms index tells us home buyers are more confident about getting mortgages and are ready to take advantage of cheaper real estate prices.
- Mortgage Bankers Association. Does the weekly index show a sustained increase in new applications for mortgages to purchase a home?
- Inventory levels of New and Existing Homes. The critical number to track is the inventory sales ratio. Are we seeing a persistent decline in the number of unsold homes? Inventory levels have to come down by 40% before we see any price appreciation.

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