

# THE ECONOMIC OUTLOOK GROUP



**475 WALL STREET**  
**PRINCETON, NEW JERSEY 08540 TEL: 609 - 529 - 1300**  
[WWW.ECONOMICOUTLOOKGROUP.COM](http://WWW.ECONOMICOUTLOOKGROUP.COM)

## ECONOMIC TALKING POINTS

Bernard Baumohl  
Chief Global Economist & Managing Director

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### **From Crises to Catastrophe?**

Grab the money, mattress and food. Pack up all the survival gear, and head for the hills! There is panic in the streets, or at least on Wall Street, and perhaps later Main Street as well.

It is remarkable how quickly the mood in Washington can turn overnight. Most of us thought Congress was close to a done-deal on a financial bailout plan. Then last night, the whole plan suddenly and dramatically unraveled as a small but influential group of Republicans in Congress slammed their foot down and refused to go along. Their argument? Instead of going ahead with a taxpayer financed plan, create a private insurance fund to cover mortgage-backed securities, with the financial industry coughing up the premiums. Just keep the taxpayers out of it, they insisted. Whether their proposal is doable is hard to say since we know so little of how it would work. But their obstruction of the initial plan stunned Democrats as well as the White House, which supported the \$700 billion taxpayer plan.

Let's start with the obvious. The financial industry is now on life-support, kept alive by massive emergency injections of liquidity from the Federal Reserve. We've already seen Bear Stearns, Fannie Mae, Freddie Mac, AIG either go belly or be taken over by the government. Now comes word the country's largest S&L, Washington Mutual, has failed. On top of those extraordinary events, Congress, the Administration and the

Federal Reserve came up with a financial rescue package that is the most expensive in US history. Add all this to the fact we are only 40 days away from a Presidential election where the race has been close and heated and the result is a very explosive brew where everyone is engaged in brinksmanship. This is democracy at its messiest, chaotic, and most unproductive. It is a time when partisanship ascends to a priority higher than the national interest.

Though the Democrats have the votes to pass this bill, they do not want to be identified as the sole party that approved the largest taxpayer bailout ever. Some key Republicans and the White House are willing to support the Paulson plan. But other House Republicans either fundamentally disagree with it, or they see this crises as an opportunity to boost McCain's popularity by aligning him to a program that doesn't involve taxpayers. To be sure, many Americans hate the idea of "bailing out Wall Street executives." As one Congressman described the calls he was getting from his constituents, 50% yelled "No!" and the other 50% screamed "Hell No!"

Whether this is a bailout plan to rescue McCain, Wall Street or the economy, the real danger is the perception that Washington is paralyzed. If they fail to act, the financial crises will certainly snowball into a global economic catastrophe.

Indeed, this morning we got a report telling us that, were it not for trade, the US economy would now be in recession. GDP in the second was revised down from 3.3% to 2.8%. Of that 2.8% growth, however, trade contributed 2.93 percentage points. With US and foreign economies markedly slowing down, we will not be able to rely on trade much longer to keep the economy afloat. One statistic that reflects demand only in the US is "gross domestic purchases." It contracted to minus 0.1% in the second quarter, after inching up 0.1% in the first quarter and a minus 1% in the fourth. In other words, domestic spending in this country has not increased at all for the last nine months. Clearly, the US economy is at risk of suffering a deep recession, especially with the credit markets so dysfunctional. There is no way economic activity will rebound if the banking sector is unable or unwilling to finance consumer and business activity.

The core issue in the whole debate right now is whether taxpayers should foot the entire bill, part of the bill or have no liability at all in the rescue plan. Until that issue is resolved, the economy is at risk of a 21<sup>st</sup> century depression, where the only hot selling items are going to mattresses.