

Themes on the Economy®

Mesirow Financial™

October 15, 2008

Moving Beyond the Panic to Pain

By Diane C. Swonk, Chief Economist and Senior Managing Director

A Confrontation

"I see you, and if you kill me today, I will die with you knowing that I know who and what you are."

With those simple words, the old woman of Aboriginal descent managed to accomplish what the "authorities" either couldn't or wouldn't do. She temporarily silenced the mob of white supremacists looking for a kill.

She then turned to deliver a thermos of homemade soup to her grandson (my good friend), who was fighting a cold he had caught while documenting one of this country's darkest moments. He was an intern, working with ABC News deep in the South, at the height of the civil rights movement.

He said that he almost fainted of terror, as the crowd turned toward her. He was sure he would see this woman of great character shot down in front of him. Instead, she forced the mob to face their own demons, and for a moment in time, balanced the scales of justice.

Why should that story matter to us now? Because we are once again facing our own demons and must make a choice: We can bow to the fears of those who wish the world were still as it was, and do absolutely nothing; we can bow to the fears of those who think that the government didn't do enough, and intervene to the point of extinction of capitalism as we know it; or, we can move forward as we are, using the government to provide a bridge over these troubled waters that we traverse, but not as a long-term solution to the problems that we face. We have the most flexible,

*"Our problems are man-made.
Therefore, they can be solved by man."*

John F. Kennedy, April 10, 1963

innovative, and resilient economy that this world has ever seen. There is no reason to throw the baby out with the bath water, and give up on what we still do well.

NABE's 50th

Last week, I attended the National Association for Business Economics (NABE) 50th annual meeting in Washington, D.C. Much like the angry confrontation described above, economists and policy makers tried to confront the angry mob of investors rushing Wall Street, with a dose of reason. Meanwhile, the press and cluster of television cameras recorded the carnage from the sidelines.

The roster of speakers included: Federal Reserve Chairman Ben Bernanke, who virtually promised to ease monetary policy as he spoke; chair of the FDIC, Sheila Bair, who remained composed, despite the skepticism about her policies; current and former chairs for the Council of Economic Advisers for the White House, Ed Lazear and Martin Bailey, who shook their heads in disbelief at the degree of corruption and greed that triggered the events leading to the current crisis; two Nobel laureates, Edmund Phelps and Paul Krugman, whose insights into trade are helping us better understand the magnitude and reach of

Recession as a Reality

The U.S. economy grew at a revised 2.8% rate in the second quarter, despite some \$150 billion in tax rebates. Indeed, most of the gains (more than 90%) were attributed to an improvement in trade, rather than any pick up in domestic demand.

Moreover, conditions continued to deteriorate in the third quarter, as consumers were forced to cut back in the face of deteriorating incomes and rising unemployment. The end to tax rebates only exacerbated those losses, as consumers no longer had that extra cash to offset the crimp from higher prices at the pump. The decline in home buying and building started to dissipate, but remained negative, while orders and shipments started to falter. Even exports softened in response to slower growth abroad. The positive was inventories, which were not drained at quite the pace we saw in the second quarter. On net, the economy looks like it now contracted slightly in the third quarter.

Preliminary data on the fourth quarter is even worse. Unemployment rose and spending contracted as consumers who wanted to buy big ticket items, such as cars, couldn't get the financing to execute those purchases. Home equity lines were also scaled back, which limited the extent to which consumers could keep spending going in the face of a deteriorating labor market. The only bright spot is lower energy prices, which will help to keep food on the table this holiday season, but not put many more gifts under the tree. The primary strength remains trade, which is now improving more because of falling imports than rising exports. All totaled, real GDP is forecast to contract by 2.1% in the fourth quarter; its largest contraction since the first quarter of 1991.

Fed Remains Ready to Ease. The fed funds rate is expected to drop another half percent by the end of the year as policy makers now grapple with the reality of recession. Inflation has also abated considerably from its highs earlier this year, and should decelerate further before the end of the year, which should make an additional rate cut easier to sell among the more hawkish of FOMC members.

globalization; former president of the St. Louis Federal Reserve, Bill Poole, who is already writing the book on lessons learned from the crisis; and, former Treasury Secretary Larry Summers, who rose head and shoulders above his peers to deliver the best speech I have ever heard him give.

Instead of just placating the audience with reassurances, Larry challenged us to think beyond the crisis to the economic agenda of the next president. He was the old woman, as in the story above, who forced us to confront our own demons, abandon the relative safety of our ivory tower of theories, and to use our moral as well as our economic compasses of applied knowledge to tackle the challenges that we are facing.

He also temporarily silenced those with a vested interest in perpetuating fear and panic, who are more numerous than most people would like to think. There is a group of people who have figured out how to make money by perpetuating our fears rather than appealing to our reason as investors.

The remainder of this report will provide the highlights of Larry Summers' remarks, to the best that my note-taking ability.

Larry spoke eloquently and extemporaneously without a text or notes.

Evoking President Kennedy

Larry started his speech with a quote from John F. Kennedy's speech, given at American University on June 10, 1963—only four months prior to his assassination. As background, it is important to understand that Kennedy was trying to defuse the panic that was perpetuated by those hoping to ignite an arms race with the Soviet Union, by appealing to America's sensibilities rather than its fears.

In the same way, Larry used Kennedy's statement, "Our problems are man-made. Therefore, they can be solved by man," to inspire the audience (and financial markets) to rise above our fears and panic about the current situation, and realize the strength in who we are: the most flexible and resilient economy the world has ever seen.

A Multi-faceted Agenda

Larry went on to outline a multi-faceted agenda of issues that the next president must confront, regardless of his party affiliation.

Fiscal Stimulus

The next president will have to do something to limit the rise in unemployment and mitigate the losses associated with recession, regardless of the success and size of the current rescue packages targeted at credit markets and the banking industry. Unless, of course, a lame duck Congress doesn't do something first, which is entirely possible.

Essentially, Larry argued that it is cheaper to limit our losses up front, both in terms of the human toll associated with recession and the additional upward pressure a recession would put on the federal budget deficit, than to suffer the more severe consequences of doing nothing at all.

Most economists are forecasting a recession with a contraction in growth in the fourth and first quarters. Unemployment could rise as high as 9% by the end of 2009, if absolutely nothing is done to mute the additional blow to the economy created by the recent credit market seizure. That, of course, seems unlikely, given the global infusion of cash we have seen come into the banking system in recent days.

It would not be difficult, however, to see unemployment rise to 7.5% by the end of 2009, without any additional stimulus. That is not only a full percent and a half higher than it is today, but is the highest rate since the early 1980s, when the economy experienced the worst back-to-back recessions of the post-World War II period.

I personally favor a plan that focuses more on the infrastructure investments than on tax rebates. This would provide a much needed backstop for construction employment, which is expected to further soften in the face of a slowdown in commercial construction activity next year (many of the projects that were in the pipeline this year are coming to completion, while very few new projects were financed during the crisis). Moreover, it could provide a much needed leg up for state and local governments that are bearing the brunt of the collapse in housing—a drop in real estate tax revenues, in particular, has forced many of them to cut back on infrastructure spending.

Financial Sector Reform

The next president will have to start the process of financial sector reform. This will need to include regulatory as well as institutional reforms. Larry was especially critical of the structure of Fannie Mae and Freddie Mac, which allowed shareholders to privatize profits and socialize losses (e.g., taxpayers were put in the position of subsidizing profits at the two agencies, and simultaneously, were expected to absorb losses.)

Any reforms we see are also likely to include a consolidation of regulatory agencies from the state to the federal levels, and some coordination of regulation and accounting standards across country borders. A more standardized global regulatory system would not only limit financial arbitrage across country borders, but would instill more stability and transparency into the system. Wall Street law makers and financial firms are particularly concerned that any changes that we see in regulation don't give foreign firms an advantage in global financial markets over U.S. firms.

Separately, I have my own concerns about the European banking system and the fate of the Euro. Either Europe needs to step up to the plate and create the institutions necessary to support the European Central Bank and Europe's banking system (including deposit insurance) or abandon the concept of a common currency zone entirely.

Fiscal Discipline Must Return

The next president must restore some faith, in both domestic and foreign markets, that the U.S. will ultimately tackle its deficit problems. This may seem somewhat counterintuitive given Larry's first point, which is to stabilize the economy via fiscal stimulus, but it is actually quite sound. We can't even begin to think about the politics of deficit reduction if we don't do what we can to limit the size of the deficit as the economy slips into recession.

More importantly, we must rethink our tax and spending policies to reduce the deficit over the long haul, if we want to avoid what Larry referred to as "invisible" but tangible costs of returning to the large structural deficits of the past. These include everything from higher treasury bond rates to the crowding out of private sector investment that we saw in the 1980s. It also

includes an unbearably high tax burden for both our children and grandchildren.

Ultimately, dealing with the budget deficit means dealing with the hard choices associated with how we manage and distribute entitlements. The upward pressure on the deficits created by Medicare and Medicaid is particularly heavy as we age and spend more on health care.

Ruddy Penner, who is an expert on the federal budget and a Fellow at the Urban Institute, has also pointed out that we could make more near-term progress on tackling our deficit problems by changing the way in which we enforce the “pay-go” (pay as you go) rules for Congress. Currently, any shifts in tax or spending policy must be “paid for” (offset) by changes in either tax or spending elsewhere in the budget in the year in which they are proposed. This has limited negotiation over policy changes, and added to gridlock across policy lines. Instead, we would do better to allow changes in tax and spending policies to be paid for over a period of five years. This not only would allow for more flexibility and compromise on policy decisions, but already has a track record of working well in the 1990s.

Globalization is Under Siege

The next president must do something to stop the anti-free trade movement or we risk losing our chance at becoming a fully integrated economy. Our success in beating back the push toward populism and protectionism, however, will rely heavily on how we deal with a more fundamental problem, which is income inequalities.

Income Inequalities are a Harsh Reality

The next president must not only acknowledge, but begin to address the startling shift in income growth from the bottom 80% to the top 1% earners. This has not only left a vast majority of households feeling left behind in recent years, it goes to the heart of moving forward on globalization, free trade, and immigration. (It is no coincidence that the U.S. became increasingly protectionist and isolationist as income inequalities worsened during the years leading up the Great Depression.)

Readers of this report are familiar with the reasons for this shift in income, the most

notable of which is the shift from an industrial to a knowledge-based economy. A knowledge-based economy seems to reward the most educated of workers, because of shortages of the most skilled of workers, almost at the expense of the least educated of workers. An education policy alone, however, can't begin to deal with the magnitude of the problem in the near-term. It will take more than a generation to educate and prepare our workers for the kinds of jobs our economy is generating.

Healthcare Reform is Inevitable

One of the few places we can identify where working families are feeling the disparity in incomes the most is in health care insurance. Larry cited studies suggesting that poor quality health care has shaved almost two years from the average life span of low-income households relative to high-income households. Or, as Larry more blatantly laid out: Wealthy households are gaining an advantage in the quality of their health care coverage, which translates into an increase in life expectancy over their lower-income counterparts that is almost equivalent to that we would see if we were able to eradicate cancer from the face of the earth.

Moreover, he cautioned that work at Harvard suggests we are only about five years away from a simple blood test that can diagnose most of the chronic diseases that we are likely to get during our life spans. This innovation, although helpful in designing preventive care, could cut health care off entirely to whole groups of the population who are at the highest risk for the most expensive diseases. People who have chronic illnesses are already facing large hurdles to obtaining insurance in the private insurance market, which operates outside of employer-based health care insurance programs.

This is to say nothing of the role that escalating employer health care costs is playing in our general competitiveness as a nation. Indeed, most companies cited lower health care costs over lower wages as their reason for relocating out of the U.S. under the NAFTA agreement.

Energy Policy

The next president will have to deal with how we approach energy policy. The good news is that everybody seems to agree we

need to wean ourselves off of our dependence on fossil fuels, particularly foreign fuels. That consensus tends to unravel, however, once we try to discuss the attributes of a comprehensive energy policy.

The debate is most heated when it comes to fundamentally reducing our dependence on fossil fuels. Even Democrats, who tend to worry more about global warming and how we deal with that issue as a nation, have acquiesced in recent months to the desire for quick fixes to the current surge in energy prices, and advocated increased drilling. This is despite the overwhelming evidence of global warming, the lack of actual reserves to tap, and seven year lead times it would require to get fields in Alaska and untapped reserves in the Gulf of Mexico up and running.

This is to say nothing of the externalities (obstacles to private sector firms investment) surrounding renewables that must be overcome for them to become viable alternatives to fossil fuels.

A Leader for Troubled Times

Finally, Larry concluded by pointing out our need for leadership to guide us through these troubled times, and in his own way, illustrated what we needed most.

Larry can be brilliant, pedantic, and arrogant. Ask anyone who had to work with him when he was treasury secretary in the late 1990s. But, that was then and this is now. He showed NABE that he could be self-deprecating, humble, and wise. He showed us he could be a good leader, something that has been missing from the political arena for some time.

The next president will have to have the strength of character and trust of the masses to lead us through some of the toughest decisions that we have had to make about our economy since the Great Depression. He will have to hold fear mongers at both ends of the political spectrum at bay, and allow us to do what we do best, reinvent ourselves for the better.

The next president should also have the foresight to appoint a cabinet that can help him get that job done. Larry Summers has risen to the occasion, and has my vote as the next treasury secretary, regardless of who wins the election in November.

Mesirow Financial Economic Forecast (Numbers as of October 15, 2008)

	2007(A)	2008	2009	2008:1(A)	2008:2(A)	2008:3	2008:4	2009:1	2009:2	2009:3
National Outlook										
Chain-Weighted GDP	2.0	1.4	0.4	0.9	2.8	-0.2	-2.1	-0.2	1.5	1.8
Personal Consumption	2.8	0.5	-0.4	0.9	1.2	-1.7	-3.6	-0.3	1.2	1.7
Business Fixed Investment	4.9	3.7	-3.0	2.4	2.5	4.5	-4.0	-6.7	-3.3	-4.1
Residential Investment	-17.9	-20.3	-6.8	-25.1	-13.3	-14.4	-18.4	-10.3	1.1	9.7
Inventory Investment (billions)	-2.5	-35.5	-16.1	-10.2	-50.6	-44.7	-36.6	-33.7	-22.6	-12.1
Net Exports (billions)	-546.5	-389.7	-328.4	-462.0	-381.3	-369.1	-346.6	-332.0	-328.6	-327.5
Exports	7.5	9.6	3.8	4.5	16.3	11.5	1.1	2.0	1.9	1.9
Imports	1.7	-1.7	0.6	-2.0	-7.1	7.4	-3.7	-0.7	2.5	3.0
Government Expenditures	2.1	2.6	2.4	1.9	3.9	2.9	2.6	2.5	1.9	1.8
Federal	1.6	4.4	3.1	5.8	6.6	2.1	3.4	3.6	2.5	2.3
State and Local	2.3	1.6	2.0	-0.3	2.5	3.4	2.1	1.8	1.6	1.6
Final Sales	2.4	1.7	0.2	0.9	4.4	-0.4	-2.4	-0.3	1.0	1.4
Inflation										
GDP Deflator	2.7	2.5	2.2	2.6	1.1	5.3	2.2	2.1	1.6	1.5
CPI	2.9	4.5	2.1	4.3	5.0	7.1	-0.1	1.1	2.0	2.0
Special Indicators										
Corporate Profits*	-2.0	-2.5	6.2	-1.5	-8.3	-2.3	-2.5	-2.7	3.5	-0.2
Disposable Personal Income	2.8	1.4	1.3	-0.7	11.9	-8.1	1.4	4.2	1.0	0.6
Housing Starts (millions)	1.34	0.95	0.91	1.05	1.03	0.90	0.82	0.83	0.86	0.92
Civilian Unemployment Rate	4.6	5.7	7.2	4.9	5.3	6.0	6.4	6.8	7.1	7.3
Employment	0.8	-0.8	-1.2	-1.5	-0.6	-1.2	-1.8	-1.5	-1.1	-0.5
Vehicle Sales										
Automobile Sales (millions)	8.0	7.2	7.7	7.5	7.7	6.6	6.2	6.4	6.6	7.5
Domestic	5.5	4.7	5.2	5.0	5.0	4.3	4.3	4.4	4.5	5.2
Imports	2.5	2.5	2.5	2.4	2.7	2.3	1.9	2.0	2.1	2.3
Lt. Trucks (millions)	8.6	6.3	5.3	7.9	6.6	6.3	5.4	5.7	5.7	5.8
Domestic	7.1	5.1	4.2	6.5	5.3	5.2	4.8	4.7	4.6	4.5
Imports	1.5	1.2	1.2	1.4	1.2	1.1	1.0	1.0	1.1	1.3
Combined Auto/Lt. Truck	16.6	13.5	13.0	15.4	14.3	12.9	11.6	12.1	12.3	13.3
Heavy Truck Sales	0.4	0.3	0.4	0.3	0.3	0.3	0.2	0.3	0.4	0.4
Total Vehicles (millions)	16.9	13.8	13.3	15.6	14.6	13.2	11.8	12.4	12.7	13.7
Interest Rates/Yields										
Federal Funds	5	2 ¹ / ₄	1 ¹ / ₈	3 ¹ / ₈	2 ¹ / ₈	2	1 ¹ / ₂	1	1	1
10-Year Treasury Note	4 ⁵ / ₈	3 ³ / ₄	3 ¹ / ₂	3 ⁵ / ₈	3 ⁷ / ₈	3 ⁷ / ₈	3 ³ / ₄	3 ³ / ₈	3 ¹ / ₄	3 ¹ / ₂
Prime Rate	8	5 ¹ / ₄	4 ¹ / ₈	6 ¹ / ₈	5 ¹ / ₈	5	4 ¹ / ₂	4	4	4
Corporate Bond AAA	5 ⁵ / ₈	5 ⁵ / ₈	5 ¹ / ₂	5 ¹ / ₂	5 ⁵ / ₈	5 ⁵ / ₈	5 ³ / ₄	5 ¹ / ₂	5 ³ / ₈	5 ³ / ₈
Exchange Rates										
Yen/Dollar	118	105	101	105	105	108	104	103	101	100
Dollar/Euro	1.37	1.48	1.33	1.50	1.56	1.50	1.38	1.36	1.35	1.32

A= Actual

Quarterly data are seasonally adjusted at an annual rate. Unless otherwise specified, \$ figures reflect adjustment for inflation.

*Corporate profits before tax with inventory valuation and capital consumption adjustments, quarterly data represents four-quarter percent change. Totals may not add up due to rounding. In 2005, GDP was \$10,989.5 billion in chain-weighted dollars.

For additional information on Mesirow Financial, please visit our Web site at www.mesirowfinancial.com.

The Mesirow Financial name and logo are registered service marks of Mesirow Financial Holdings, Inc. © 2008, Mesirow Financial Holdings, Inc. All rights reserved. The information in *Themes on the Economy*® is the proprietary and copyrighted material (the "Copyrighted Material") of Mesirow Financial. The Copyrighted Material, or any portion thereof, may not be reproduced, retransmitted, or posted on any Web site aside from www.mesirowfinancial.com without the express written consent of Mesirow Financial. Statistical information contained herein has been obtained from sources believed to be reliable but such accuracy cannot be guaranteed. Any opinions or statements contained herein are purely the author's and may not reflect those of Mesirow Financial Holdings, Inc., or any of its affiliates and subsidiaries. The opinions or statements expressed are for informational purposes only and are subject to change without notice. This release should not be construed, considered or followed as investment advice, or anything related thereto. Mesirow Financial does not provide legal or tax advice.

For more information, contact:

Diane Swonk
Chief Economist
312-595-7122
dswonk@mesirowfinancial.com

Olga Camargo
Director of Economic Communications
312-595-7128
olcamargo@mesirowfinancial.com


Mesirow Financial[™]
Independent Minds.
Innovative Solutions.