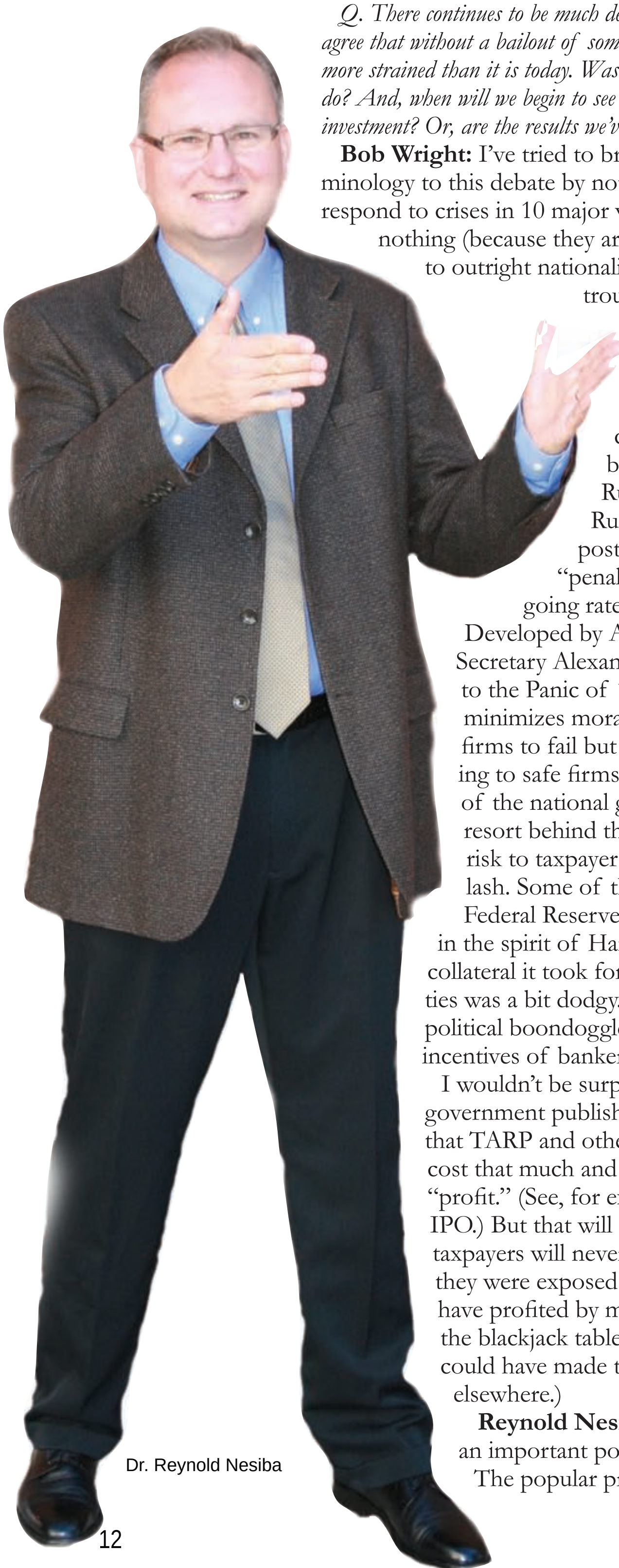
Q&A State of the Economy

While daunting challenges continue to haunt the U.S. economy, Augustana Economists Dr. Bob Wright and Dr. Reynold Nesiba offer their views on the (alleged) recovery and what the future holds.



Dr. Reynold Nesiba

Q. There continues to be much debate about "the bailout." Most agree that without a bailout of some kind, the economy would be more strained than it is today. Was the bailout the right thing to do? And, when will we begin to see some significant results from the investment? Or, are the results we've seen thus far all we will see?

Bob Wright: I've tried to bring some more precise terminology to this debate by noting that governments can respond to crises in 10 major ways, ranging from doing nothing (because they are incapable of responding) to outright nationalization of troubled companies or industries. Each can be an appropriate response under certain specific circumstances, but most crises will be best resolved by following Hamilton's Rule (formerly Bagehot's Rule): lend to all who can post undoubted collateral at a "penalty" rate greater than the going rate before the crisis struck. Developed by America's first Treasury Secretary Alexander Hamilton in response to the Panic of 1792, Hamilton's Rule minimizes moral hazard by allowing risky firms to fail but stops panic from spreading to safe firms by putting the full power of the national government's lender of last resort behind them. It also minimizes the risk to taxpayers and hence political backlash. Some of the actions taken by the Federal Reserve system were very much in the spirit of Hamilton's Rule, although the collateral it took for some of its lending facilities was a bit dodgy. TARP, by contrast, was a political boondoggle that likely increased the incentives of bankers to take large risks.

I wouldn't be surprised if at some point the government publishes a study that concludes that TARP and other bailout measures didn't cost that much and may even have turned a "profit." (See, for example, GM's pending IPO.) But that will be misleading because taxpayers will never know how much risk they were exposed to. (Only fools think they have profited by making a 2 percent return at the blackjack tables in Las Vegas when they could have made the same much more safely elsewhere.)

Reynold Nesiba: Your question raises an important point in need of clarification. The popular press seems to conflate the $700 billion Bush-Paulson plan of 2008 with the $787 billion measure passed by Congress and the Obama Administration. The political conversation seems to "blame" the Obama administration entirely for "the bailout," when in fact it has been done by both parties.

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> **Associate Professor of Economics**

More importantly, I believe that both the Republican-led and Democratic-led measures were necessary — although clearly both could have been improved. In addition, our nation's central bank, The Federal Reserve, needed to do what it did. It aggressively expanded liquidity (by over a $1 trillion) and drove down short-term interest rates almost to zero.

All of these actions are consistent with what economists and policy makers refer to as "functional finance." This framework points out that government finance is not like household or business finance. Governments have the power to tax, to create money, and as long as the overall economy expands faster than the debt, it can run deficits indefinitely. Thus, advocates of functional finance would say that we should judge federal government spending, taxes, and monetary policy in light of economic performance. If the economy exhibits slow or negative growth and high unemployment, more expansionary policy is needed. So, if 9.5 percent of the workforce is unemployed, we should be spending more, lowering taxes, running larger budget deficits and providing more liquidity to the economy through the Fed. My biggest fear at the moment is the rising chorus of voices advocating cutbacks in spending and increases in taxes. Moving toward a balanced budget at this time will make this recession deeper and longer than it would have been otherwise. The President's recent proposal to spend $50 billion on infrastructure is a good one. However, I suspect that it will be far too small to address the enormity of our current crisis.

Q. Throughout 2009, we heard the phrase "economic crisis" every few minutes. Some say that the crisis is over – that the U.S. is officially in a period of recovery. What do you think?

BW: The crisis per se was over by the end of 2008. That is not to say that another crisis related to the first will not strike. If another crisis hits, it will likely be tied to the stress the first crisis put on government finances, as in the case of Greece, both in terms of decreased revenues and increased expenditures (for bailouts, social safety nets, etc.).

Recovery is a macroeconomic term that refers to the beginning phase of an economic expansion when per capita income returns to a former peak following a recession. We are certainly in recovery and have been since mid-2009. The recovery may falter, sending us into a so-called "double dip" recession but, so far, the economy has followed the classic pattern of expansion, bubble, panic/crisis, recession, recovery, expansion.

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Dr. Bob Wright
Nef Family Chair of Political Economy

RN: Economist-speak obscures the real issue here. As of Labor Day 2010, the U.S. economy had an unemployment rate of 9.6 percent.

If one adds in underemployment — those who want a job but have given up looking and those working part-time who want full-time employment — that rate rises to 16.7 percent. That is one-in-six workers in America who are unemployed or underemployed. That's more than 26 million people! To say we are in an "expansion" or to suggest that the economic crisis has passed is like a Norwegian farmer saying, "things aren't so bad," after a sixth of his wheat crop is destroyed by hail. It's accurate, but it takes a particular cultural context to understand what he really means.

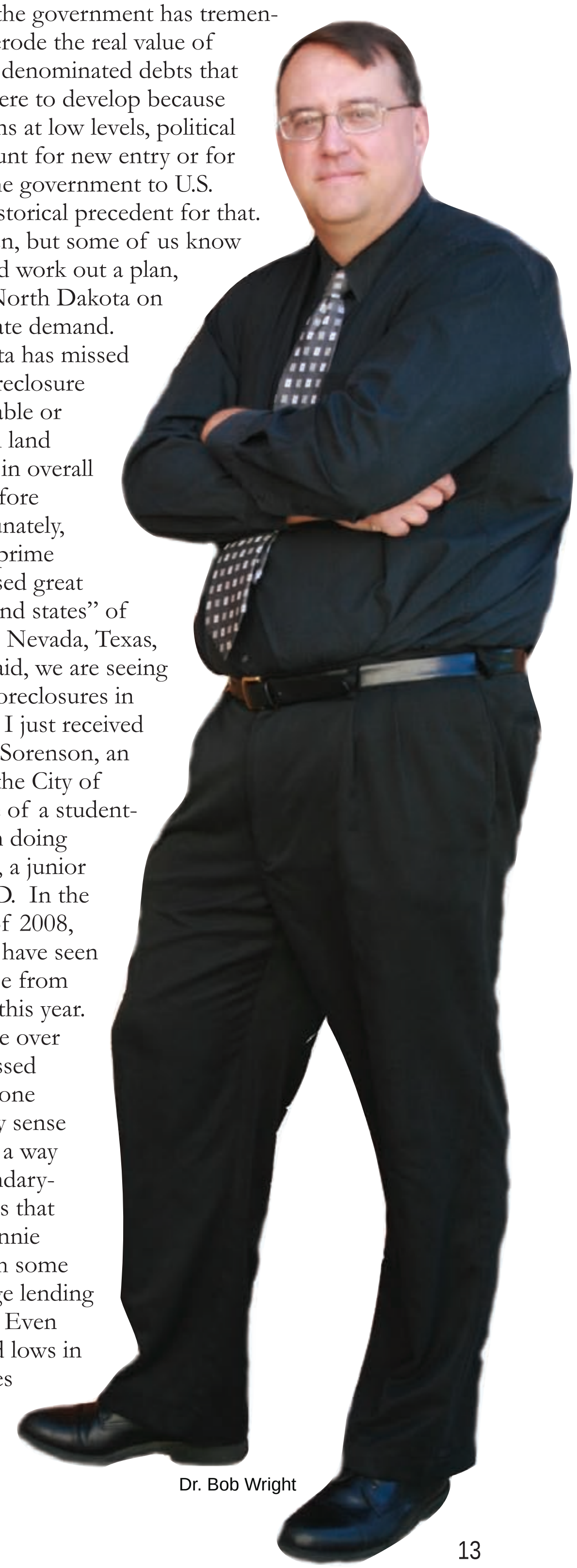
According to the Economic Policy Institute, the U.S. economy would need to add about 290,000 jobs every month for five years simply to get us back to the 5 percent unemployment of December 2007. In August we saw job growth of about 60,000. (And that's if we overlook the fact that the census shed 114,000 additional temporary workers.) While this high unemployment persists we can expect to see a continued slowing in the rate of growth in wages. So we might be in an expansion, but for ordinary working people, times are tough and whatever gains are being made are painfully slow.

Q. Staggering foreclosure numbers continue to make headlines throughout the U.S. While we've been somewhat isolated from the housing crisis here in South Dakota, other parts of the country have seen neighborhoods – and the lives of the families who once called them home – turned upside down. Will the housing market ever come back?

BW: That depends on what you mean by "come back." Will we ever see housing become so unaffordable again? I hope not. Will nominal house prices rise to and beyond their previous peak? Of course, so long as the Fed hits its positive inflation target range.

Some fear that we may be entering several decades of economic funk like that experienced by Japan after its big real estate (and stock market) bust circa 1990. I don't think that's a big threat here in the U.S.A. because the government has tremendous incentives to erode the real value of the huge nominally denominated debts that it owes. If a funk were to develop because bank lending remains at low levels, political pressure would mount for new entry or for direct loans from the government to U.S. citizens. There is historical precedent for that. It is largely forgotten, but some of us know the details and could work out a plan, sort of a Bank of North Dakota on steroids, to rejuvenate demand.

RN: South Dakota has missed the worst of the foreclosure crisis because of stable or increase agricultural land values, little run-up in overall real estate prices before the crisis, and, fortunately, a dearth of the subprime mortgages that caused great problems in the "sand states" of California, Arizona, Nevada, Texas, and Florida. That said, we are seeing sharp increases in foreclosures in Sioux Falls in 2010. I just received a report from Russ Sorenson, an Urban Planner for the City of Sioux Falls, because of a student-research project I'm doing with Drew Doshier, a junior from Rapid City, S.D. In the first eight months of 2008, 2009, and 2010, we have seen foreclosures increase from 142, to 147, to 209 this year. So, this year we have over $29 million of assessed valuation that has gone into foreclosure. My sense is that until we find a way to replace the secondary-market in mortgages that Freddy Mac and Fannie Mae used to fill with some alternative, mortgage lending will continue to lag. Even now we have record lows in new home purchases although mortgage interest rates are at historical lows.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