American Enterprise Institute for Public Policy Research

November 2008

On the Issues

The Honeymoon Is Over before It Begins

By Desmond Lachman

The economy is in a precarious state, and president-elect Barack Obama needs to throw his full support behind a new, well-designed stimulus package. He should abandon his distinctly left-of-center economic plans and present the country with a clear plan to stabilize the housing market and to strengthen the troubled financial system.

After his hard-fought election campaign, Obama will soon find out that winning the presidency was the easy part. Not since 1932, when Franklin D. Roosevelt won the presidency, has an incoming U.S. president been confronted with an economic and financial market crisis as urgent and as serious as the one we have today. This crisis will clearly not afford Obama with the honeymoon that is customary for an incoming president. It will also force Obama to put on the back burner much of the ambitious long-term agenda for economic change that he advocated so fervently on the campaign trail.

Over the past year, Obama mapped out for the country a distinctly left-of-center agenda involving bold tax initiatives and a larger role for the government in the economy. Among his specific proposals are raising taxes for businesses and for those in the top 5 percent income tax bracket, increasing government spending in many areas, and requiring employers to either provide health care for their workers or to pay increased taxes to fund health care. In addition, Obama proposed a far-reaching program to promote alternative energy sources that might wean the U.S. economy from its heavy dependence on foreign supply sources.

On the international economic front, Obama has struck the pose of someone who would be much more willing than President George W. Bush to cooperate with other international leaders on the global economic crisis. Counterbalancing such willingness, however, has been his ambivalent support for free and open international markets. This could prove to be problematic at a time when a world in recession so sorely needs decisive leadership to promote the benefits of globalization.

Now that he has won the election, Obama will soon realize that his long-term vision will have to give way to the more pressing task of stabilizing the U.S. economy. The economy is now in the grips of its worst asset price deflation and its most wrenching credit crisis in the postwar period. Over the past year, the fall in home, equity, and bond prices has already reduced household wealth by around eighty percentage points of GDP, while bank credit is now contracting at its fastest pace in fifty years. Worse still, it now appears that the financial market crisis has spread to the shadow banking system, as indicated by sharply increased redemptions from the hedge funds and growing signs of insolvency in the insurance industry.

The gravity of the economic situation that Obama will be inheriting is vividly illustrated by the speed and intensity with which Wall Street's woes are now affecting Main Street. While Obama's presidential campaign was entering its final phase, the economy appears to have hit the wall in October. Consumer confidence has dropped to new postwar lows, manufacturing production has

Desmond Lachman is a resident fellow at AEI. A version of this article appeared in the *Australian Financial Review* on November 6, 2008.

collapsed, and auto sales have plummeted to their lowest levels in over twenty-five years. Last week, on cutting interest rates to 1 percent, the Federal Reserve itself noted that all components of U.S. aggregate demand had weakened markedly and that the economy was now facing appreciable downside risks.

Obama's economic advisers, who include economic heavyweights such as former Fed chairman Paul Volcker and former Treasury secretary Larry Summers, have to be warning him that the economy and the financial markets cannot wait for major remedial attention until after the inauguration. Indeed, they have to be cautioning him about the very real danger that policy delays might result in intractable adverse feedback loops developing between a weakening real economy and worsening financial markets.

Fortunately for Obama, Congress is due to return to Washington on November 17 for a lame-duck session. One would hope Obama will be an important voice in crafting a new economic stimulus package that is commensurate in size to the economic challenges that the country now faces. One would also hope that such a package would include measures that are fast-acting and that get the most bang for the buck. Hopefully the package will include measures that favor aid to state and local governments, that directly help displaced workers, and that provide tax cuts for households with high spending propensities.

Beyond throwing his full weight behind a second economic stimulus package, well before the January inauguration, Obama must present the country with a well-articulated plan to stabilize the country's housing market and to strengthen its troubled financial system. If Obama is to have any hope of calming markets and allaying public fears, he will have to go beyond his lofty—and at times vacuous—campaign rhetoric. And judging by how quickly the economy is fading, he will need to do so soon.

Also by Desmond Lachman:

Article in the *Washington Times*

Deflation Bound

October 24, 2008

It is often said that generals tend to fight the last war. Judging by their continued pronouncements about inflation risks, one has to wonder whether the same might not be said of central bankers.

Despite ever-increasing signs that the global economy is in the grips of a vicious process of financial market deleveraging and asset price deflation, central bankers continue to fret about the threat of rising price inflation. They do so at the very time they should be worrying about the risk that a deep and prolonged recession could raise the specter of deflation of the sort that long plagued the Japanese economy after the bursting of its asset price bubbles in 1989.

Looking in the rearview mirror, there can be no doubt that over the last year inflation has risen to levels that must give rise to concern. Indeed, U.S. headline consumer price inflation has now risen to around 5 percent, or to a level not experienced in the last twenty-five years. Similarly, in Europe, headline inflation has ratcheted up to almost 4 percent, or to a level that is approximately twice the European Central Bank's inflation target of "close to but under 2 percent."

However, in gauging the risk that too high an inflation rate might now be taking hold in the United States and Europe, it is important to recognize that the rise in inflation over the last year was primarily the result of an extraordinary spike in international commodity prices. This spike has had the effect of raising U.S. headline inflation by around three percentage points above what central bankers refer to as the core rate of inflation, which excludes food and energy prices. Meanwhile, core price inflation in both the United States and Europe has remained relatively well-behaved, having inched up only very modestly over the last year. . . .

Read more at www.aei.org/publication28828/.

2008-63 #23679