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Will Fall in Stocks Resume?

By Richard W. Rahn

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What do you think would happen to stock market prices if President Obama announced he was no longer going to push for increased taxes on capital gains, dividends, Social Security, small business, death and energy?

The easy bet is stock prices would rise, but unfortunately just fixing the fiscal side of the economy may not be enough to reverse the downturn. Fiscal policy refers to government tax, spending and regulation policy. Monetary policy refers primarily to the actions of the Federal Reserve in controlling the growth of the money supply.

There is plenty of blame to go around for the current mess, notably:

- The Federal Reserve, whose initial mistakes set off the crisis.
- The Bush administration for failing to adequately control government spending.
- Congress for encouraging irresponsible lending by Fannie Mae and Freddie Mac, passing a series of destructive regulatory measures (including the Community Reinvestment Act, Sarbanes-Oxley, etc.), and engaging in wasteful spending.
- And now, the Obama administration, which has already made a boatload of bad decisions, including the tax increase proposals mentioned above, an irresponsible and counterproductive "stimulus bill" - aptly referred to as "a dog's breakfast" by the economic historian Niall Ferguson - the new "omnibus" spending bill, and a host of destructive trade and regulatory proposals.

Members of Congress continue to advocate counterproductive proposals, which will do great damage to the U.S. and world economy. For instance, Sens. Byron Dorgan and Carl Levin have proposed a couple of anti-tax haven bills, which will actually drive more U.S. companies to foreign countries and diminish the amount of foreign investment in the U.S., just when the U.S. needs more investment to fund the additional debt. These senators are typical of those in Congress who seem incapable of understanding the second order effects of their actions, which is why we are in the current mess. (Note: The core problem was not greedy bankers - they suddenly did not become more greedy.)

Those in the Obama administration blame the Bush administration for the mess. As noted above, they are partially correct, but the markets have continued to fall since President Obama was nominated (S&P down 48 percent), elected (down 28 percent) and assumed office (down 15 percent). Worse yet, the markets are down to less than half the level they were when the Democrats took over Congress two years ago. The markets are clearly registering a vote of "no confidence" in the Democratic Congress and the Obama administration. Markets are leading indicators, and so it is only a matter of time before the general public registers its vote of no-confidence in the Obama administration.

Even if the administration and the Democratic Congress reverse course and introduce pro-growth policies, the recession could drag on because the "balance sheet" problem of financial institutions still has not been reversed.

It is desirable for individuals, and necessary for businesses and financial institutions, to have more assets than liabilities. The problem for individuals and businesses alike is that as asset prices fall, the ratio of debt to equity increases. When the economy is functioning normally, there is usually no problem for a profitable business to use some of its earnings or sell some assets to pay down its debt. However, when a large number of businesses, and particularly financial institutions, are all trying to sell assets to pay down debt, it becomes a self-defeating, deflationary spiral.

To sell assets, the institutions have to reduce prices (whether the assets are real estate, other real property or securities). These price reductions, in turn, reduce the value of the holdings of all of those with similar assets, forcing more of them into distressed selling of their assets. As was seen in the Great Depression of the 1930s, a deflationary spiral can cause prices to drop sharply for long periods until the value of assets is worth a small fraction of their prices at the top of the previous boom.

There is a way out of this dilemma, and that is for the Federal Reserve to step up its asset purchases. If the Fed accelerated its purchase of government-guaranteed (and perhaps other) assets, it could stop the downward spiral. It has been slow to do so because of arguments about how to do it within the Fed, criticism from members of Congress and the public about bailing out the private sector, and fear of criminal prosecution and/or congressional censure if it makes mistakes as to what assets to buy and the even more difficult problem of eventually selling them without insiders getting wind of the intention.

Rep. Barney Frank, chairman of the House Financial Services Committee, is on a witch hunt to find people in government and the private sector to threaten and blame, which is ironic, given that Mr. Frank was, and continues to be, a major part of the problem. He, like many others in the Washington political establishment, cannot seem to understand that the problem of too much debt and leverage cannot be cured by adding more government debt, which will ultimately result in sub-prime government debt.

We are left with a world where the same people who caused the recession and financial crisis are largely the ones who have been given the responsibility for stopping it. The

road to recovery is being delayed by those who continue to implement counterproductive policies. The sooner the body politic understands this, the sooner it will finally demand change in the right direction.

Richard W. Rahn is a senior fellow at the Cato Institute and chairman of the Institute for Global Economic Growth.

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