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Rational indifference and The Great Recession

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It's been over two years since the Credit Crisis and nearly three years since the start of The Great Recession. Although the recession officially ended in June 2009, most parts of the country are still waiting for some signs of life in the economy.

Recently the Fed announced it would purchase \$600 billion in U.S. bonds and notes over the next eight months in an attempt to jump start growth. Although it has pushed short-term rates to near zero, the Fed feels that purchasing treasuries will allow long-term rates to trend lower, thereby encouraging homeowners and businesses to borrow, resulting in increased economic activity. By increasing demand for government securities, yields will decline; long-term rates should settle and investors will be driven to stocks and corporate bonds to achieve higher yields.

While this sounds good, it's not likely to be very effective for a number of reasons.

First, consider these facts: There are roughly \$770 billion in negative equity in the U.S. housing market; approximately one-third of all homeowners are upside down in their mortgages, and; there are more than 14 million unoccupied houses in this country. Long-term interest rates could fall to zero and the impact on demand for mortgages would be insignificant. Banks will not refinance mortgages as long as property values continue to decline.

Second, although businesses that sell goods and services abroad may benefit from a devalued dollar, most are not likely to spend or produce more in the absence of a clear increase in demand. Consumer spending represents 65% to 70% of gross domestic product. Unemployment is frozen at 9.7% (with underemployment in the mid-teens). Demand will not increase until unemployment declines.

Third, the Fed just bought \$1.7 trillion treasuries and mortgage-backed securities between December 2008 and March 2010. By last summer, whatever positive effects it had on the economy had worn off and GDP was again flirting with negative numbers. Now the Fed's going forward with a similar program that's one-third the size of the earlier program. Many economists believe that for quantitative easing to be effective, purchases in the vicinity of several trillion dollars would be required.

Fourth, the only way to avoid a Lost Decade (similar to what Japan experienced during the 1990s) requires a combination of fiscal and monetary actions. The republicans only want to balance the budget; the democrats only want to stimulate the economy. Do we need to balance the federal budget? Absolutely. But if we put the brakes on too fast or too hard, we will find ourselves in the Lost Generation. We need to combine short-term stimulus with long-term reduction in spending.

Finally, it's all about demand, stupid. Tax breaks for business to encourage hiring when manufacturing companies are operating at only 72% of capacity make no sense. The economy added only 43,000 private-sector jobs in October. We need to be adding four to five times that

number just to reach 5% unemployment by 2017!

What's the answer? A one-time national debt holiday. Every household would be eligible for up to \$50,000 in debt forgiveness. This would result in a large number of households going from upside down to right side up overnight. Homeowners could refinance at lower rates and begin spending again. True, the banks and mortgage investors might not be too pleased, but the banks weren't complaining when Congress doled out \$700 billion from the TARP either.

I know, the chance of this being approved by Congress is like the democrats and republicans working together for the good of the country.

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