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No Depression This Time, Uncle Sam Has Got Our Back

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Global markets have not been reassured by the coordinated interest rate cuts of several central banks or by recent congressional action, but they should be. Our bet is that financial markets will return to normal in short order and that the U.S. economy will squeak by with a moderate recession. Recapitalizing the banks and working out mortgages will take time, but the financial system will not collapse — the government won't let it.

The markets, of course, seem to be factoring in some probability of collapse. Why is this wrong?

For starters, the biggest subprime mortgage gamblers have already failed, been nationalized or been married off, shotgun-style, to banks run by grown-ups. Yes, lots of small shoes may still drop, but the Paulson "buy-up bill and, ultimately, the Fed's ability to print money provides the Treasury and Federal Reserve all the tools they need. The media don't seem to have noticed, but Section 113 of the bill authorizes government capital infusions into the banking system as necessary — something the British government is now doing and the Swedish government successfully did in the recent past. That means any bank with a viable business will not be allowed to fail simply because it is temporarily undercapitalized.

Second, Uncle Sam (a.k.a. Treasury Secretary Hank Paulson and Fed Chairman Ben Bernanke) is doing precisely what's needed to avoid the mistakes of the 1930s. With credit markets drying up, he's turning on the faucet by recycling our panic dollars back into the financial market. The government is taking in our money (in exchange for Treasury bills) and using it to make mortgages and buy up the assets we're too scared to hold. It's doing this via the Treasury, the Fed, the Federal Deposit Insurance Corp., the Federal Housing Administration, the Federal Home Loan Bank, Fannie Mae, Freddie Mac and other appendages. It's starting to lend directly to large and small businesses whose usual sources of credit have become unavailable.

In short, Uncle Sam is becoming our new bank. He's also become our new insurance company with his effective purchase of the world's largest insurer — AIG. In the 1930s, nobody in the private sector could borrow, raise equity or sell insurance because everyone lost trust in everyone else. Uncle Sam stood on the sidelines and marveled at the chaos. But today Uncle Sam is saying, "Listen, if you households and firms are too scared to invest in each other or sell each other insurance, give us your money, and we'll do it for you. We'll pay you a sure return on the Treasuries and, if our investments and insurance sales do well, you'll benefit by paying lower taxes."

This may sound like socialism or state capitalism, but it's simply rearranging the financial furniture. As Americans have freaked out, Uncle Sam has stepped up. He'll continue doing so until we realize the sky is not falling. The \$700 billion rescue authorizes the federal government to keep doing what it has been doing for the past year to the tune of \$400

billion — buying distressed assets at bargain-basement prices and selling insurance at high premiums. If all works out, Uncle Sam will make a killing. This would be great, given our government's real problem — paying the long-term Social Security and medical costs of retiring baby boomers.

Point three is clear: This financial chaos has ruined our sleep but left our physical and human capital unscathed. We have the same productive capacity today that we had one year ago. And if our capital hasn't changed, we've suffered no overall capital loss. This means that our accounting, which has focused on financial losses, is missing lots of offsetting financial gains. The offsetting gains are accruing to current or prospective purchasers of the assets whose market values have dropped. Asset buyers, whether they are young people buying their first homes, middle-aged workers contributing to their 401(k)s, or billionaires such as Warren Buffett buying financial firms, can now acquire homes and stocks (claims to the same capital inside the companies) at a roughly one-third discount from a year ago. That's great for them, and lousy for the rest of us, but not a net economic tragedy.

The economic tragedy comes if we get hypnotized by the bad news, ignore the good news, fight about things we're already doing (e.g., having Uncle Sam buy and insure troubled assets), and pull our economic heads inside our shells. We Americans have lots of moxie. What we need is a strong pep talk and absolute assurance that credit will continue to flow, that insurance policies will continue to be honored, and that Uncle Sam is willing and able to invest directly in the private economy on our behalf.

So after scaring us half to death, this would be a good time for our other uncles — Hank and Ben — to make clear that we're heading for a safe landing and that there is no way in hell they will let this economy go down the tubes.

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