Main Street and Wall Street
by
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The Dow Jones Average is now 3,000 points below its level six months ago and is 5,000 points below the level reached 18 months ago. The loss of wealth is in the trillions of dollars. That loss directly affects consumer spending. Consumers have seen their accumulated wealth – their savings – significantly damaged in their pension plans, 401 (k) plans, mutual funds, 529 plans for their children's education and, of course, in the value of their homes. Fifty million workers alone have 401 (k) plans; fifty-three million American households own mutual funds. Tens of millions of others own individual stocks. The number of households directly or indirectly invested in the equity markets is almost equal to the number of households paying taxes.

These losses are far greater than any tax refund, employment benefit or infrastructure program can offset. The damaging effect to public confidence will not be offset by legislation to forgo tax increases for the upper 5% of the population. Nor will the middle class be comforted by $1,000 in lower taxes when their pension funds have lost 10 to 100 times that amount. The incremental advantage of long term infrastructure projects, while valuable, will not be felt for a long time. Taxpayers simply will not spend and, indeed, cannot spend until they have made up a good portion of the losses of their savings. And if they don't spend, corporations will be hurt and unemployment will rapidly increase. Economists call it the "wealth effect." Pollsters measure it by the "Consumer Confidence Index"—currently at its lowest level ever. It is the reality that consumer spending – our economy – is primarily driven by a population, largely middle class, which directly or indirectly has significant investments in the equity markets.

What can be done? First, our government officials might reject publicly the notion that it might be necessary to nationalize financial institutions. They have let that view circulate and it has caused great damage. It has driven down the value of equity in financial institutions so that they cannot now raise capital, as investors are afraid, not without reason, of adding equity support. The balance sheets of financial institutions are bad enough – they have made serious mistakes – without the government adding to the problem by scaring off potential investors with the threat of dilution of shares at low prices or nationalization. Investors believe that the federal government is indifferent to the equity value of financial institutions.

The largest financial institutions are reluctant to lend except under conditions that only a few individuals, corporations and businesses can endure. It is not likely there can be a recovery in the overall equity markets until credit loosens up for corporate and small business, and weak performing assets currently held by both financial institutions and other investors are either taken off their books or made more liquid – in short – until financial institutions are looked upon with favor. They have led the decline in overall market values and the weakened economy. They will have to lead us out.

Investors are savvy. They know full well that depositors in financial institutions have little to fear and will be protected. They know also that government ownership of equity will not make borrowers more likely to meet their obligations – it will probably do the opposite. Unfortunately, they also hear loud and clear officials who trumpet their disinterest in what happens to shareholders as if shareholders were separate and distinct from middle class taxpayers. Those shareholders are not likely to add capital (or buy shares in the market) when they are afraid they will be wiped out by nationalization. They are concerned that Congress is paralyzed for fear of a public sentiment decrying a "bail-out" of banks –even though it is that same public which has defaulted on their obligations to financial institutions. The fact is, like it or not, at this stage in our economy, a recovery package in which government takes "toxic" assets off the books of financial institutions and distributes any losses to the wider base of all tax payers is necessary and wise public policy.

Second, our society would be well served if Congress were to encourage guarantee programs, credit enhancement, or the establishment of floor prices for mortgage backed securities rather than capital infusions. Increasing capital does little to rid financial institutions of assets with uncertain performance. Moreover, if government purchases illiquid mortgage-backed securities, depending on the price it pays, it is likely to receive interest and principal payments over and above the price it pays to financial institutions. Would it not be wiser, therefore, if government, rather than purchasing such assets, guarantees a price floor rather than putting such investments directly on the taxpayers' balance sheet.

For those who argue that guarantees and purchases of "toxic" assets are a continuation of a "bail-out" of financial institutions, I would note that more banks have failed or are now essentially under government receivership over the last year than in the previous eight years. Their shares are worth zero. There are many other financial institutions which have been taken over or merged at a few dollars a share. The shares of Bank of America have gone from $50 to less than $8 a share. CitiCorp is down 90% from its levels three years ago. Wachovia Bank shares have declined from $40 to where they are now valued at the equivalent of a few dollars per share after its merger with Wells Fargo. The value of Washington Mutual has declined from $40 to almost zero following its takeover by J.P. Morgan. Overall, the share price for larger banks and S&Ls has declined almost 70%. That is not a bail-out. Moreover, if Congress were to legislate a vibrant support program, the benefit would go not only to financial institutions but to 401 (k) plans, other pension plans, mutual funds, state and local government retirement systems – in short – the American taxpayers who have a direct interest in those assets. And, if we believe that would result in too much benefit for the "rich," or for wrongdoing by overpaid management, then raise their tax rates and start regulating their activities. But don't act as if "Main Street" is indifferent to what happens in "Wall Street."

Third, there is a mortgage crisis, and it is painful to those who have not met their mortgage obligations and are subject to foreclosure. But, it pales in economic significance to the crisis in the housing market. Home values have declined dramatically, often below their mortgage obligation. The building of new homes has declined dramatically. There is a significant backlog of unsold homes on the market. Builders can't get credit or find customers. Given the importance of home building and its exponential effects in other industries, the U.S. economy will not improve until the back-log of unsold homes is cleared and builders can obtain credit and start building again. It would be wise, therefore, for the government to consider as part of any stimulus package a substantial program to provide a significant tax benefit for individuals and businesses that buy homes or move into newly built quarters over, say, the next six months. It will affect home prices. It is a targeted stimulus which would address a particular segment of the economy that is crucial to our economic well being. It would create a substantial incentive which, in turn, would lead builders to build as the oversupply of empty homes and space begins to diminish.

There is little doubt that a combination of circumstances and events had a domino effect in producing the current crisis, though even now it is difficult to separate cause and effect. The perfect storm was a combination of many factors: tremendous leverage by financial institutions; failure of senior management to understand the risks taken by their firms; an extravagant and asymmetrical compensation system which encouraged mindless risk taking; the issuance of complex, illiquid and non-transparent instruments which were difficult to value; highly aggressive and unrealistically low valuations by accounting firms that marked securities well below their fair value; a failure of regulatory agencies to even understand let alone regulate derivative markets; a reluctance by the Federal Reserve and the U.S. Treasury to constrain that market for fear that a constraint on derivatives or leverage would make it difficult to finance the U.S. deficit; substantial pressure from Congress on Fannie Mae and Freddie Mac to facilitate homeownership virtually irrespective of the creditworthiness of borrowers; unregulated short selling; a run on banks to pull out deposits; the failure to provide support for Lehman Brothers or provide timely funding for institutions in trouble because of public panic.

Though there are many culprits, public policy should not scapegoat any one of those factors. The focus now should be to stem the decline in public confidence and permit credit and equity markets to stimulate the economy.

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