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THE MULTIPLIER EFFECT OF RED FIELDS TO GREEN FIELDS

3 Channels to Consider:
1) The direct effect of fiscal policy & job creation.
2) The indirect effect on the banking system.
3) The indirect effect of real-estate credit stabilization (especially for small businesses).

As concerns about federal budget deficits continue to mount around the world, the search has continued for the best solutions to the financial crisis and its aftermath.

Numerous programs containing primarily financial solutions have been considered, and some have been implemented. But in mid-2010, with home prices again weakening and vacancy rates in commercial properties still elevated, it's tough to say that the problem created by real estate leverage has been "fixed".

Also worth considering now are programs that directly address the core physical problem – that there have been excesses created in real estate. As such, programs focused on purchasing and reconstituting distressed real estate are important. There are several economic channels worth considering when thinking about the benefits of such an approach: 1) what's the direct multiplier from creating jobs that give workers income to spend, etc 2) the monetary effect of freeing up the "zombie" banks to start lending again, and 3) the removal of a particular overhang on confidence and the U.S. economy from the downside risk to real estate prices. In this sense, solving the "physical" problem rather than the "financial" problem can make sense (phrases such as "extend and pretend" for bank real estate loans are again making headlines, which is inherently a "kick the can down the road" strategy rather than a solution)

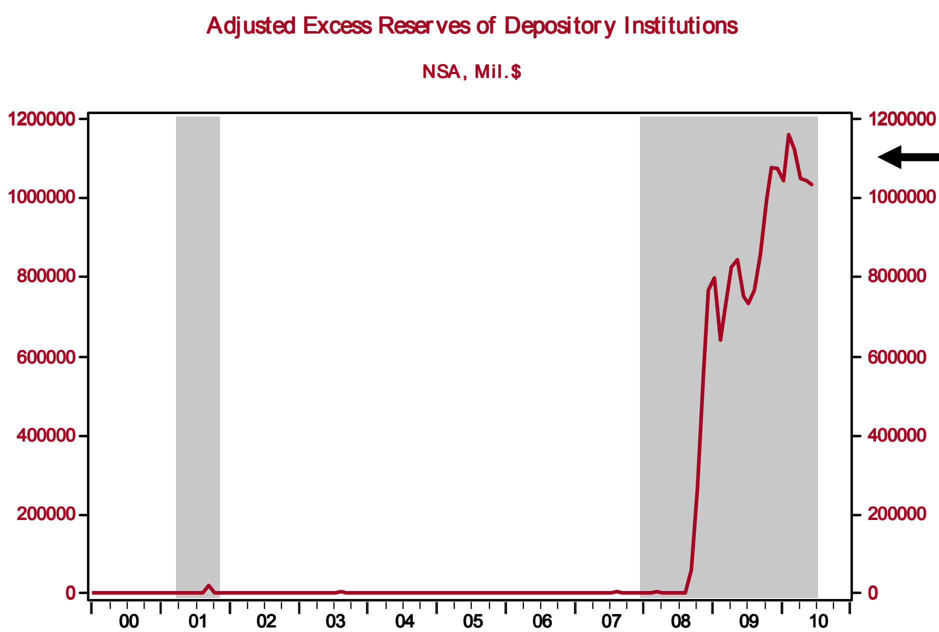
The direct fiscal multiplier for infrastructure spending is typically in the 1.5X range[1], which would be substantial, adding roughly 50% of "bang for the buck" (so a $230 billion fund could function as a larger $345 billion fund). These numbers are rough

[1] For instance, see: http://www.economy.com/mark-zandi/documents/Small%20Business_7_24_08.pdf

since they are generally estimated from large scale macro models, which are by construction very sensitive to the inputs and assumptions used.

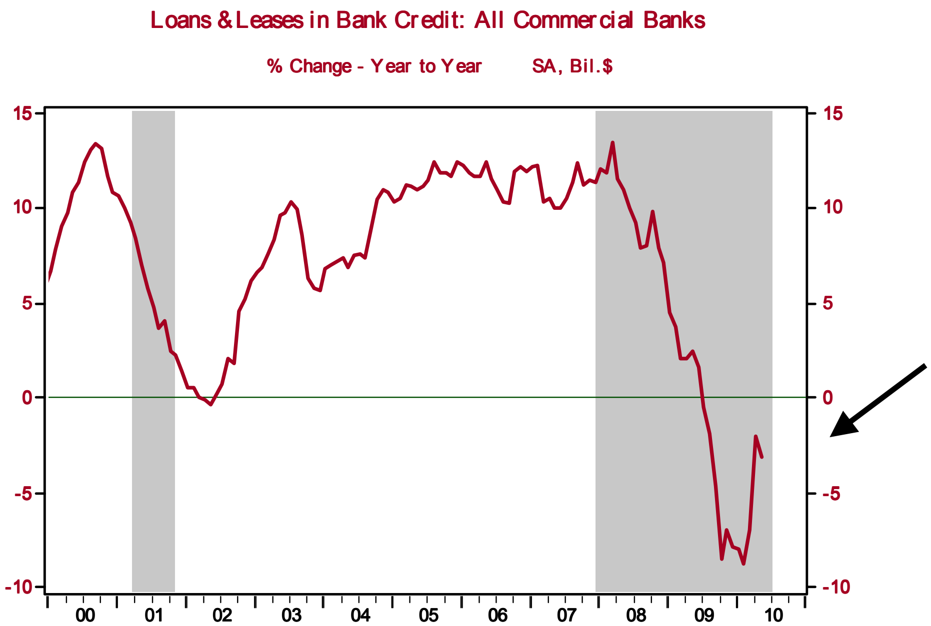
However, policies that help the banking system have an additional benefit in this current circumstance. The monetary effects are conceptually easier to think about, since the "money multiplier" is usually considered m = 1/RR where RR is the reserve requirement. With a banking reserve requirement of 10%, we would typically think of a money multiplier of 10 times. That is, bank lending can multiply narrow money into broad money by up to a factor of 10, i.e., an extremely powerful mechanism.

<u>There are already $1 trillion of **excess** reserves in the system, so right now it's like we've dropped money out of helicopters and it has all fallen into bank vaults</u>. Excess reserves get into the economy through bank lending – what "reserves" do is reserve against bank lending (which has not been growing). Freeing up the banks (which are behaving like "zombies" now in part because of the potential for additional asset impairment) to return to "normal" would open the door to this liquidity.



<u>**There's plenty of fuel already in the system. Now the question is how to use it.**</u>

So, the biggest "multiplier" value of the policy would probably be freeing up bank lending (which has remained anemic). <u>**Then the reserves already created could help the economy, with a monetary multiplier of 10 times.**</u> Efforts to get capital out of unnecessary real estate – and into productive investments – can make use of policies already in place to create an additional economic benefit, ie, a "two-fer" policy.



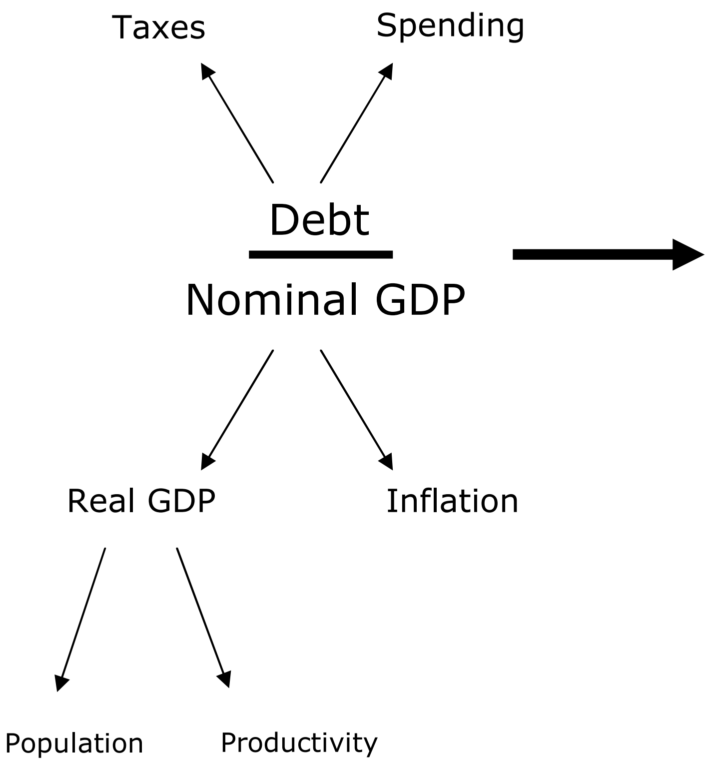
We are still missing the transmission mechanism for policy to help the economy as commercial bank lending remains impaired.

Additionally, there's the question of the demand for bank lending. With real estate prices remaining at risk (including the hiccup as the homebuilder tax credit has come to an end), both consumer and business confidence has remained under pressure. Without confidence, businesses have been reluctant to hire or take on new projects or capital spending initiatives. Initial claims for unemployment insurance remain elevated, for instance.

So, rather than broad deleveraging (the recent data have not been stellar – U.S. consumer credit fell -$9.1 billion m/m in May), there's an opportunity to see the stability in real estate prices that helps drive confidence and employment going forward, i.e., policies that address the core physical issues in this real estate crisis can be "three-fer" policies!

It has been possible to design purely financial solutions that addressed key concerns during the financial crisis. But as we have moved beyond the 2008 emergency, **future policies should likely be aimed at creating a legitimate solution to remaining problems**. The temptation with purely financial policies is the classic issue of relative pricing, i.e., there's some uncertainty associated with how to mark assets (other than to base prices off "near-by" assets). This uncertainty would likely be eliminated if there were actual transactions (i.e., properties were purchased), which would have the added benefit of providing an underpinning for confidence.

THERE IS A LIMIT TO WHAT CAN BE DONE, SO POLICIES NEED TO BE AIMED AT THE BEST SOLUTIONS.

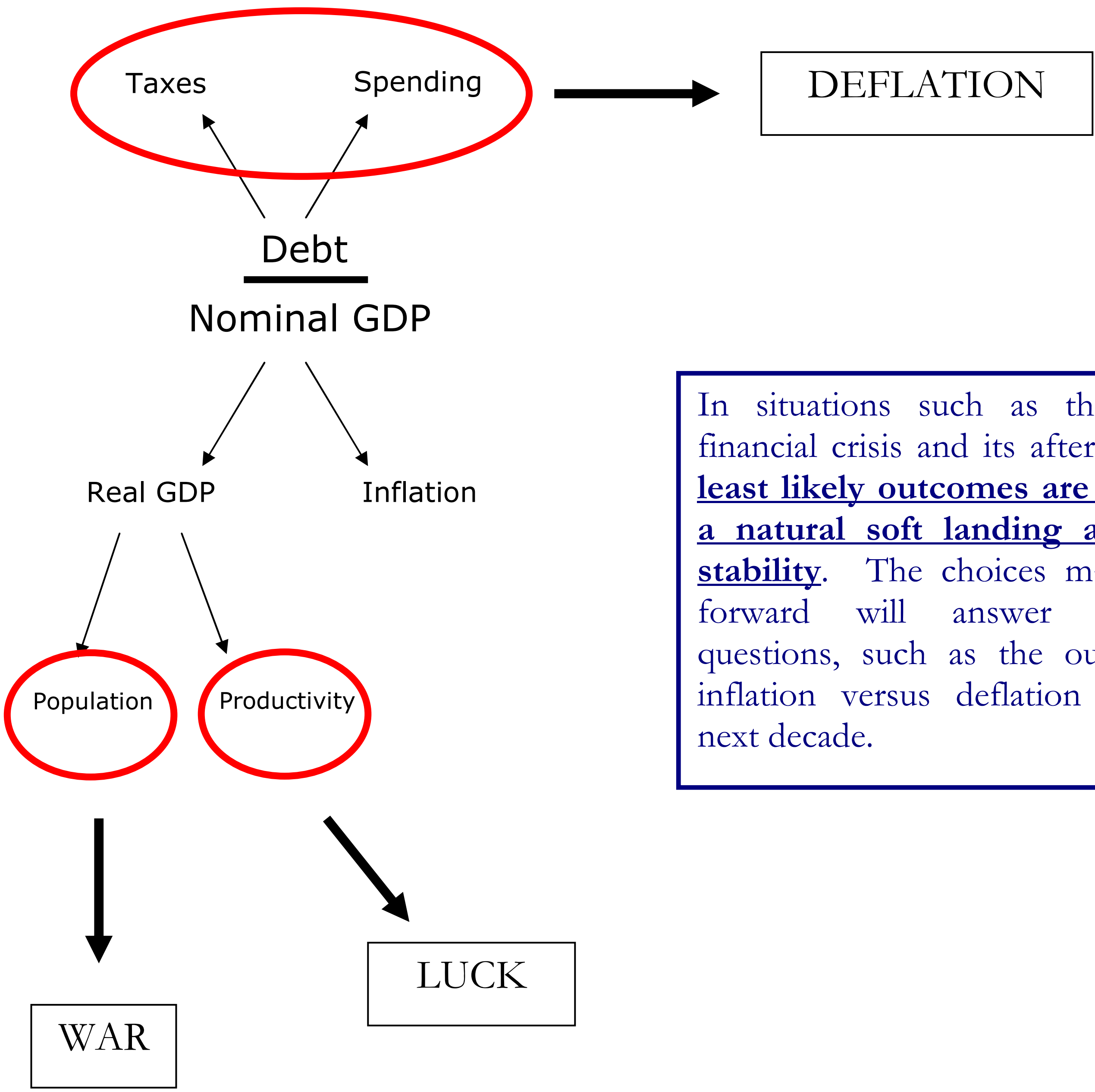


The ratio of government debt to GDP needs to move sideways long-term as a <u>definition of fiscal sustainability</u> (otherwise, interest costs would eventually consume the entire federal budget). With U.S. Treasury Secretary Geithner's reiteration this week that "businesses create jobs" rather than the government, national priorities appear to include both employment and long-run affordable policies. Now it's a question of how.

Barring a default, operating on the numerator to bring this ratio under control (using increased taxes or reduced spending) presents deflation risk, as we've seen from parts of Europe in the past several months. Operating on the denominator of this ratio is trickier. The solution until the mid-1900s was to increase population (i.e., through war).

Immigration policies and trade have been the preferred 21st century solutions, but these are often politically thorny issues. That leaves sustained productivity (which is basically the "luck" solution, ie, growing your way out) and inflation as options. The Fed, as an institution, is charged with preventing the latter option. There is certainly a role for borrowing and, when the government is the only sector with access to funds, there is a large role for intervention to help address problems in the markets. But it's hard to call ever increasing debt a long-run solution to fiscal problems, as the Japan experience of the last decade has demonstrated. Now it's a question of getting the best solutions.

U.S. DEBT/GDP MUST MOVE SIDEWAYS AS A DEFINITION OF FISCAL SUSTAINABILITY



In situations such as the current financial crisis and its aftermath, **the least likely outcomes are probably a natural soft landing and price stability**. The choices made going forward will answer important questions, such as the outlook for inflation versus deflation over the next decade.