ECONOMIC RESEARCH

The Bottom Line

THE LATEST VIEW ON THE ECONOMY

BMO Capital Markets

Don’t Rock the Boat

January 26, 2010

Dr. Sherry Cooper
Executive Vice President,
Chief Economist

1-800-613-0205

Now more than ever, the biggest risk to sustained recovery is the political response to the fallout of the financial crisis and its impact on consumer and business sentiment. Nowhere is this more evident than in the United States. The continued partisan bitterness in Washington has proven the Obama administration unable to get any of its major initiatives through the Congress despite a majority in both the House and the Senate. Republicans, for the most part, are unwilling to break ranks, and the Democrats have been in shambles well before the Massachusetts election drove many to fear for their political futures. Populist anger and scapegoating are cogent political forces everywhere. All incumbents are at risk of populist revolt, regardless of rational analysis.

This is much less the case in Canada, as the banks here have better weathered the crisis, and the economy, aside from the auto sector and manufacturing, has held up relatively well. Were it not for the recession in the U.S., the Canadian economy wouldn’t have suffered a contraction. Even so, Canadian pundits continue to debate the efficacy of the fiscal stimulus and the size of the structural deficit, but the virulence of the debate and the severity of the problems are minor in comparison to the damaging vitriol in the U.S., the U.K., the E.U. and Japan. Moreover, the recent tightening in China’s policy has sent commodity markets and materials stocks into a tailspin. Compound this with the uncertainty surrounding the Bernanke reappointment, the finger pointing at Treasury Secretary Geithner over the AIG bailout and the latest round of populist bank bashing, and it is not surprising that financial stocks have taken a beating worldwide as well.

With the Obama administration now focused on Wall Street and hatching new measures almost by the week—like the “Volcker Rule” last week, which would prevent commercial banks from trading on their own accounts, or the bailout tax the week before—the United States’ efforts may collide with reforms in other parts of the world. It is difficult to know where to begin in assessing this mess. Firstly, we must remember that the developments in the U.S. are political theatre at its worst and should not be taken too seriously by investors (rather than day traders). President Obama’s recent pronouncements, his State of the Union (SU) address proposals and his upcoming budget, will not be implemented unless they are passed by both Houses of Congress, of which the likelihood is de minimis. Right now, Obama is working against his own party in his most recent proposal to freeze the government’s discretionary spending, excluding security-related budgets for the Pentagon, foreign aid, the Veterans’ Administration and homeland security, as well as the gigantic entitlement programs that make up the biggest and fastest-growing part of the federal budget—Medicare, Medicaid and Social Security.

The idea of cutting government spending despite high unemployment and a fragile economy is certainly not going to fly. The payoff in budget savings, in any event, would be small relative to the deficit. Rather than make proposals that will actually tackle the long-term deficit in a serious way—either through future tax increases triggered by excessive deficits and/or through future entitlement spending caps triggered by excessive deficits—the Obama camp comes up with a proposal that does short-term harm to the economy in lieu of tackling the deficit in any serious and significant way. The major problem with the U.S. government's fiscal position is the mounting cost of health care. If this were dealt with, the rest would be relatively easy, but health care reform was muddied by Congressional add-ons by both parties that raised costs and watered down the real reform. Obama lost control of the legislative process and now with so many incumbent Congressional Democrats resigning or set to lose their re-election bids, none are willing to support the President on just about anything.

Bottom Line: With 17.3% underemployment, it is not surprising that Scott Brown won the Massachusetts Senatorial election or that financial populism reigns the day. However, a sustained recovery requires an environment in which businesses can develop sufficient confidence to open their order books and enlarge their payrolls. Banks must feel confident enough to expand their lending and consumers must have the income and confidence to open their cheque books. Widespread concern about the American fiscal predicament and uncertainty about the extent of government intrusion into the conduct of business is a massive obstacle to unleashing these private sector "animal spirits". Another obstacle to economic recovery and global financial stability is the risk that Congress will politicize the Federal Reserve and hazard its independence. In the end, I have to agree with the conclusion reached by Paul Krugman, Harvard economics professor and columnist for the New York Times. "*I favor his reappointment, but only because rejecting him could make the Fed's policies worse, not better.*" Changing horses midway for political reasons would raise the specter of debt monetization, inflation and a considerable further fall in the U.S. dollar. To be sure, qualified alternatives for Fed Chair exist, but the disruption and uncertainty that would ensue aren't worth the risk.