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THE LIGHT IN THE TUNNEL: HEADLIGHT OF ANOTHER ECONOMIC TRAIN WRECK?

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The final third-quarter GDP estimates indicating that the economy grew at an annual rate of 2.2 percent, though much lower than the 3.5 percent increase reported at first, confirm for those who see the glass as half-full that recession is over. Others who see the glass as half-empty are not convinced. To change the analogy, is the light at the end of the tunnel the daylight of an economic recovery or the headlight of another economic train wreck?

It is simply too early to know with certainty what that light indicates. To change the analogy once more, what we do know is that the patient has been very sick and recovery will take a long time. In the more than 60 years that the Bureau of Economic Analysis has been estimating GDP on a quarterly basis, the current recession is unique in that it is the first time that GDP, beginning in third-quarter 2008, has declined in four consecutive quarters.

A corollary issue relates to effect of the $787 billion stimulus package approved by Congress and signed by President Obama shortly after his inauguration. Here the glass appears to be less than half-full for all except his staunchest supporters. Nondefense spending on the part of the federal government contributed only 0.17 percentage points to the 2.2 percent increase in third-quarter GDP, exactly matching the contribution from the financial services and insurance sector. The main driving force during the quarter was an increase of 1.96 percentage points in personal consumption expenditures. The largest single source of GDP growth was the motor vehicles and parts sector which contributed 0.81 percentage points.

Indicators that the economy may be heading toward another train wreck, perhaps not as severe as this one, include the following.

Driven by a weaker dollar, exports increased by nearly 18 percent between the second and third quarters adding substantially to economic growth. A stronger dollar which depends importantly on whether the Federal Reserve raises interest rates – they can't go any lower -- in order to ward off inflation would dampen exports and slow the economy.

Banks continue to fail. A total of 50 FDIC insured banks failed in the third quarter. With two weeks left before the end of the fourth quarter, another 45 have failed. The FDIC reported that at the end of September there were 552 insured institutions on its "problem list," more than at any time in the last 16 years.

At 3.4 percent the third-quarter default rate for commercial real estate mortgages on office, industrial, hotel, and retail properties is higher than at any time in the last 16 years.

A mortgage in default is defined as one in which payment is past due for 90 days or more. Real Estate Econometrics states that this rate could climb to 7 or 8 percent next year.

Small business contributes substantially to economic growth. More importantly, however, it is the entrepreneur who is the dynamic factor in business enterprises of all kinds, including small businesses. The entrepreneur is the one who introduces new goods and services, penetrates new markets, finds new ways to produce goods and services more efficiently, pioneers the use of new resources in the production process, develops new business models. Small businesses prosper when entrepreneurs are successful and grow when their successful innovations are more than passing fancies. However, entrepreneurs are dependent on banks for the financial support necessary to implement their innovational plans. Innovation and economic growth are stalled when financial institutions do not have the wherewithal to make loans, the wisdom to tell the difference between a strong prospect and a weak one, and the willingness to assume the risk in backing what at that stage is an untested idea.

American entrepreneurs in general are regarded with respect and admiration. In many instances bankers, especially investment bankers, are viewed with suspicion and contempt. Like it or not, it is one of the harsh realities of a capitalist system that you can't have one without the other. Slamming bankers for the current economic mess may satisfy the few who revel in class warfare but it is one way to increase the odds that light in the tunnel is a headlight.

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