# Seeing things in their precise shape and color

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Commentary

The current economic situation, both locally and globally, is the most complicated the world has seen since the Great Depression In the midst of all this complexity it is imperative that we see things as they really are in order to properly diagnose the situation and to prescribe the correct course of action.

This crisis can be deconstructed into four components for analytical purposes. Let's take them in chronological order. First, Puerto Rico is suffering a severe fiscal crisis. This part of the problem is the result of bad decisions made over the last 20 or 25 years. The plain truth is that the government of Puerto Rico has been living beyond its means for decades, using accounting gimmicks, non-recurring revenues, and loans to make up for its uncontrolled spending. We may argue whether the problem consists of low tax revenues due to evasion or high spending due to a lack of expenditure controls, but the end result is the same.

Second, Puerto Rico is in the third year of a recession. The local economy decreased by 1.9 per cent during fiscal year 2007 and by 2.5 per cent during 2008. The forecast for the current fiscal year is for our economy to decrease by an additional 3.4 per cent. Some of the reasons for this anemic economic performance are cyclical in nature. Among others, we can point to (1) low consumer confidence, the result of higher local taxes, high oil prices, and increases in the cost of basic services; (2) weakness in the real estate sector, partly due to problems with the secondary market for mortgage loans in the United States, and (3) weakness in the financial sector, again closely related to the broader crisis in the U.S. capital and financial markets. In addition, other structural problems such as low investment levels, decreases in worker productivity, and outdated institutions have also affected the growth rate of the Puerto Rican economy over the last decade.

Third, there is a world-wide financial crisis. It is impossible to do a full accounting of the reasons underlying this crisis here but we can trace it to the huge amounts of capital that, seeking higher returns, flowed into the real estate sector in the United States after the rupture of the Internet bubble and the FED adopted an overly accommodating monetary policy after 9/11. This sudden inflow of capital allowed mortgage lenders to take greater risks in their search for ever-higher returns. The process culminated in the now notorious subprime and no-income, no-job application (NINJA) mortgages, loans that should never have been made.

Mortgage lenders sold these loans to investment banks, such as the recently disappeared Bear Stearns and Lehman Brothers. The investment banks mixed the bad loans with other good loans, much like a card dealer shuffles cards at a casino, and pooled them in packets called tranches. These packets were then sold to trusts that, in turn, issued bonds to investors all around the world. The return on these mortgage-backed securities depended solely on homeowners making the monthly principal and interest payments on their mortgages.

As we now know, that did not happen. Banks, insurance companies, and pension funds all over the world suddenly had millions of dollars worth of mortgage-backed securities on their balance sheets whose value was uncertain. Financial institutions stopped lending to each other, which created a liquidity crisis. The lack of liquidity, in turn, forced hedge funds and private equity funds, among others, to sell assets to avoid insolvency. The result was a crash of bond and stock markets around the world. The estimates of losses in the U.S. alone are staggering: total home equity has declined from $13 trillion in 2006 to $8.8 trillion in 2008; retirement assets, mostly 401(k) accounts, have declined from $10.3 trillion to $8 trillion; and other savings and investments have lost an additional $2.5 trillion in value. Taken together, these losses total $9 trillion.

Local banks, with the exception of Banco Popular's operations in the U.S., had very little exposure to subprime loans, but they over-lent to local housing developers. As a result, there is an excess supply of high-end housing in Puerto Rico and many banks are stuck with construction loans that have not been paid-off. In addition, local banks — just like their U.S. counterparts — are affected by higher funding costs and limited access to the secondary market for mortgages. The net effects are stricter underwriting standards, a local credit contraction, and a deepening of the local recession.

Fourth, the U.S. economy has been in a recession since December 2007. Economic growth for the last quarter of 2008 was -6.2 per cent and unemployment is currently at 7.6 per cent. More than four million jobs in the United States have been lost since the recession began. According to most economists this recession would probably be the longest and deepest since 1945. At this point in time it is impossible to determine whether the usual policy tools for stimulating economic recovery will be effective because banks, a key channel for both monetary policy and the Keynesian multiplier to work, are hoarding capital and not lending.

So, this is not your garden variety recession. The times call for cool heads and creative policymaking. But above all, we need to see the current situation clearly in all its gloomy complexity. William Herndon, who was Abraham Lincoln's law partner for seventeen years, believed that one of the keys to Lincoln's greatness was his capacity to see things in their "precise shape and color." Herndon attributed this capacity to Lincoln's melancholy temperament, what modern psychologists would call his "depressive realism" or the "sadder but wiser" effect.

Regardless of its cause, this ability allowed Lincoln to see clearly where the United States was headed and to be prepared to lead when war broke out in 1861. Similarly, we in Puerto Rico should take full account of our economic situation, without illusions or unrealistic expectations; roll-up our sleeves, and start rowing in the same direction.

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