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Alaska better positioned to weather financial crisis

"Could George W. Bush be the Herbert Hoover of the 21st century? Hoover was the guy who happened to be president when the Great Depression unfolded in 1932. I don't think what's ahead for the American economy will be a repeat of the Great Depression: In key respects I think it may be worse." I wrote those words here in December 2004. It took a bit longer than I expected, but unfortunately the debacle seems to be playing out otherwise as predicted.

What does this turmoil mean for Alaskans? As an economist - not a financial adviser - I suggest Alaskans keep two things in mind:

• The mortgage meltdown is a symptom, not the problem.

• This is not the end of it. There is more to come.

American households and government have for years been using borrowed money to support a higher level of consumption than we could pay for. We're importing more than we export, using more government services than we pay for in taxes, and skipping investments in the future so we can live high on the hog today. Up to now the willingness of foreigners to loan us money has allowed this to continue.

The mortgage meltdown represents only a piece of the hole American consumers have dug for themselves. Wages haven't kept pace with rising prices, so real household income is falling. With the stock market in the tank and house prices down 16 percent from a year ago, Americans are turning to their credit cards to maintain the lifestyle to which they have become accustomed. As of July, consumer debt was growing about 25 percent faster than earnings. This growth has been possible because the banks that initially make these "revolving" loans have been able to bundle and sell the loans to others as "collateralized debt obligations," much the same way they did with mortgages. In the last couple of months foreign lenders have lost their appetite for this debt, so banks are sharply tightening the flow of consumer credit.

How that will affect consumer demand and the real economy remains to be seen. Despite the turmoil in the financial sector, the production of goods and services continues to grow, albeit slowly. But as Geoff Colvin, a senior editor at Fortune Magazine, put it last month, "it may be that the standard-of-living bubble finally has to deflate."

Policy makers face two challenges: They must maintain faith in the financial system we depend on to conduct our daily business, and keep the real economy from going backwards as Americans tighten their belts and buy less.

The government response has been to pump out money via stimulus payments and rescue packages. At this point that's the only response that can deter a financial panic. In a panic, sound institutions are swept away along with the rotten, leading to a cascading collapse of the payment system. Checks bounce.

Financing the massive infusion of government money with taxes is a political and economic non-starter, so the money has to be borrowed. Unless foreign lenders step forward, the Federal Reserve will finance this borrowing - by printing money. That would mean the sort of double-digit inflation we haven't seen in this country since the early 1980s.

What does this mean for Alaskans? The state government, so important to Alaska's economy, is generating huge surpluses. Those surpluses will end if oil prices drop below $75 per barrel, but even then the state can fall back on its bloated savings accounts. Fiscally, the state is in good shape.

Economically, Alaska is better off than most states. Inflation will weaken the U.S. dollar, improving the competitiveness of Alaska's private sector in foreign markets for tourism services, fish products, ores, and wood products. Our real estate market is reasonably sound.

In terms of personal investing, inflation is the biggest risk. Alaskans can protect against that by investing a share of their bond portfolio in inflation-protected securities. Certain stocks, like precious metal mining equities, are also said to be inflation hedges, and foreign equities hedge against the fall in the value of the dollar that would accompany domestic inflation.

But the most important advice is to maintain a reasonable allocation among classes of investments. That takes guts because it means buying stocks at the very time they are falling in relative value. As Peter Lynch, the author and former manager of Fidelity's Magellan fund has noted, in terms of investing, "the key organ in the body is the stomach, not the brain." Those with the stomach to stay the course are the most likely to come out of this intact.

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