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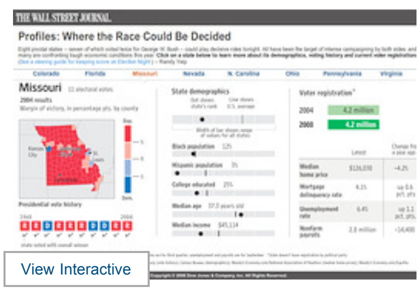
New Economic Ills Will Force Winner's Hand

Big Drop in Auto Sales, Factory Output Worsen Outlook on Eve of Election; Calls for Swift Action to Loom Over Next President

By BOB DAVIS, JONATHAN WEISMAN and TIMOTHY AEPPEL

WASHINGTON -- With a fresh blast of bearish news hitting just before the presidential election, Tuesday's victor will be under rising pressure to put his stamp on U.S. economic policy well before his Jan. 20 inauguration.

Election Guide



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On Monday, auto makers reported steep declines in U.S. car and light-truck sales for October, with General Motors Corp. reporting a 45% drop compared with the number of vehicles sold a year ago. Ford Motor Co. was down 30% and even once-mighty Toyota Motor Corp. was off by 23%. A senior GM executive said the company's results, when adjusted for population changes, represented "the worst month in the post-World War II era."

The auto industry's woes contributed to another drop in overall factory output, with the Institute for Supply Management reporting its manufacturing-activity index fell to a 26-year low in October. Meanwhile, troubled electronics retailer Circuit City Stores Inc. said it was closing one-fifth of its stores.

"We're dealing with a situation that could develop into another Great Depression, if not handled properly," says Daniel DiMicco, chief executive of Charlotte, N.C.-based steelmaker Nucor Corp., who spent an hour in line on Friday waiting to cast an early vote.

Few economists predict the world is in for a repeat of the 1930s. But the deepening problems -- rising joblessness and home foreclosures, falling consumer spending and tight credit -- are prompting calls from businesses and Congress for quick action by the next president to clarify, and begin working on, his economic agenda.

Senate Banking Committee Chairman Christopher Dodd (D., Conn.) says the president-elect should start by picking his Treasury secretary and economic team within days. With Congress planning a session this month to push through a second economic-stimulus package and discuss remaking the nation's financial system, lawmakers will look for direction from the future president. Mr. Dodd said he will bring the next White House team into the regulatory

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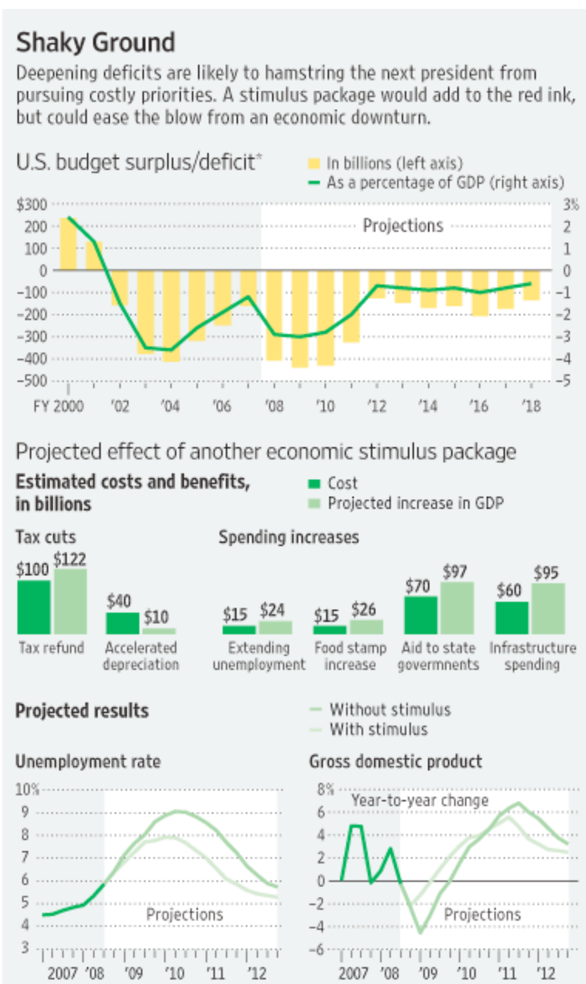
CLOSING ARGUMENTS: Sen. John McCain, left, and rival Sen. Barack Obama campaigned in Florida Monday as the economic outlook worsened just before the election. Twenty-seven electoral votes are at stake in the state.

Both campaigns declined to comment on any specific post-election plans. However, Democratic Sen. Barack Obama would likely come under pressure to assure investors that he won't increase income taxes on the wealthy during a recession -- as he hinted during the campaign -- or boost capital-gains taxes during a market slump. For Republican Sen. John McCain, one challenge would be explaining how he'd work with a Democratic Congress after a bitter presidential battle.

The central issue now, says McCain economic adviser Douglas Holtz-Eakin, "is the reality that so many Americans believe that the institutions they rely on -- banks, Wall Street, Washington -- have failed them. Those failures are the source of the lack of confidence."

Three economic challenges are apt to dominate the early days of the new presidency: mending the economy; reshaping the battered financial industry; and crafting a policy for China, America's biggest creditor and an economic rival.

The slumping economy is the top issue. Many economists forecast that the U.S. will fall into its deepest recession since the early 1980s, with some predicting unemployment above 8% by 2010, up from 6.1% today. Former Reagan economist Martin Feldstein, a McCain adviser, recently endorsed a stimulus plan of as much as $300 billion.



Sen. Charles Schumer, the New York Democrat who is chairman of the Joint Economic Committee, says an Obama win would mean the Democratic Congress will take up a small stimulus package in a lame-duck session soon and a bigger one in January after inauguration. Even if Sen. McCain were to win, Sen. Schumer says, expected Democratic gains in Congress will help the party leadership push through a package in November.

The last stimulus package of $168 billion, including about $105 billion in rebate checks, didn't do much to help. The money boosted spending in the second quarter of 2008, but not beyond, as the pain of $4-a-gallon gasoline offset the extra cash consumers received

*Projections don't include the cost of a new stimulus package.
Sources: Congressional Budget Office (surplus/deficit); Moody's Economy.com; Labor Department; Bureau of Economic Analysis (stimulus analysis)

from the government.

Now, stimulus advocates -- mainly Democrats -- are focusing on infrastructure projects, extension of unemployment-insurance benefits, and increases in food-stamp payments. State and local governments would also be targeted. Twenty-seven states have announced budget shortfalls for fiscal year 2009, which began in July, totaling $26 billion, according to Moody's Economy.com, an economic consulting firm.

Constituents are sure to weigh in with lawmakers. Kokosing Construction Co. in Frederickton, Ohio, laid off 300 of its 3,000 workers in the past year, and may delay the purchase of $35 million in new equipment. If Congress pays for several new dams and other projects that have been held up for lack of funding, Kokosing's chief executive, Brian Burgett, says he could rehire many of his former employees. Roughly 3,000 infrastructure projects are "ready to go," according to a survey by the American Association of State Highway and Transportation Officials, meaning that they could be put out to bid immediately.

Associated Press

Voters lined up early in Alexandria, Va.

A large stimulus package wouldn't forestall a recession, though it could accelerate a recovery. Moody's Economy.Com analyzed the effect of a $300 billion stimulus program tilted heavily toward spending. The unemployment rate in a post-stimulus economy would hit 7.7% in 2010, the firm estimates, compared with 8.9% without any stimulus help.

But a stimulus plan has drawbacks. One is the possibility that the spending becomes permanent, adding to the mounting U.S. debt and undermining U.S. finances as baby boomers begin to retire and government outlays for them rise.

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Deeper debt also means heavier borrowing. The Treasury is expected to sell about $2 trillion in debt next year, about twice last year's record, Goldman Sachs estimates, largely because of government borrowing to prop up financial institutions. While long-term Treasury rates have so far remained low, at around 4%, heavier borrowing could drive up general interest rates and "cancel all the stimulus," says Robert Litan, a former Clinton administration budget official, who is now a senior fellow at the Brookings Institution, a liberal-leaning Washington, D.C., think tank.

Another big challenge to face the president-elect is deciding how big a role the government should play in the economy, including picking winners and losers among companies competing for federal dollars, and sharpening financial regulation. Bush Treasury Secretary Henry Paulson is preparing rooms at the Treasury for a transition team to assure smooth coordination. Many decisions being made now will bind the next administration, especially how to spend the $700 billion rescue budget. While the presidential candidates talked generally about financial regulation during the campaign, they didn't propose specific solutions.

Some lawmakers want to require more lending from banks in which the U.S. invested. But twisting arms could be counterproductive. "If you bang on them to make loans they don't want to make, they could lend to people who aren't qualified," says Mr. Litan. "That's how we got into this problem."

Sen. Schumer warns hedge funds and other largely unregulated private-investment firms that they too will soon face federal oversight and rules requiring them to disclose their operations -- even though heavily regulated banks that loaded up on risky securities have been at the heart of the financial crisis. Richard Baker, president of the Managed Funds Association, a hedge-fund trade group, says that it would be difficult to meet disclosure rules because "markets move so quickly that by the time information is made public, it may not be relevant."

A big fight is sure to arise over saving firms considered "too big to fail" -- meaning that their demise could lead to a broader economic collapse. The Bush administration and the Fed used that rationale to save investment bank Bear Stearns Cos., mortgage giants Freddie Mac and Fannie Mae and insurer American International Group Inc. Indeed, the one time the government let a major investment firm fail, Lehman Brothers Holdings Inc., credit markets around the world froze. Neither Sen. Obama nor Sen. McCain has said in detail how he would address this issue.

"As a nation, we need to figure out who's a 'toobtof,'" says Bob Atwell the chief executive of Nicolet National Bank in Green Bay, Wis., using his acronym for too-big-to-fail. Those firms need to be clearly defined, he says, and then taxed and regulated separately so they pay for what amounts to federal insurance. Otherwise, they would provide unfair competition for banks like Nicolet, with $600 million in assets, making them so small the government would be unlikely to bail them out if they fell into trouble.

But clarity might actually worsen the problem, some economists argue, because big firms would remake themselves to fit into the must-be-saved category. The protected firms would have an incentive to take extra risks. "It would be like playing with Uncle Sam's credit card," says Peter Wallison, an economist at the conservative American Enterprise Institute.

Another battle will focus on who should be responsible for looking at the soundness of the system as a whole. A plan by Treasury Secretary Paulson would give that role to the Federal Reserve. Morgan Stanley economist Stephen Roach would amend the Fed's charter to add "financial stability" to its mission of promoting full employment and price stability, so the Fed would focus more on identifying asset bubbles and deflating them gently before they burst.

A third challenge is trade with China, an issue over which Sen. McCain and Sen. Obama have sharply disagreed. Sen. McCain is an avid free trader; Sen. Obama argues that trade agreements have been written to help the wealthy, not average Americans, and has urged that a number of them be renegotiated.

Neither candidate focused on trade during the general election. But the calendar will force the issue on the White House. After a set of textile quotas on China expires on Jan. 1, industry lobbyists will press the new administration to renew them or make them tougher. Then, around May 1, the new president must decide the longstanding question of whether China manipulates its currency to keep it below market value -- and thus give Chinese exporters an edge for products priced in dollars.

The new administration's decision will be complicated. Since July 2005, when China delinked its currency from the dollar, the yuan has gained about 20% in value against the dollar. In recent months, the yuan has also appreciated against the currency of Europe, China's biggest trading partner, making it even tougher for China to compete with Vietnam and other lower-production-cost countries. Already, thousands of Chinese factories have been forced to close or move elsewhere in the past year because of weakening demand, rising costs and the stronger yuan.

If the U.S. pushes China to further boost its currency, it would deepen China's woes. That would further rile China, which holds nearly $2 trillion in foreign-exchange reserves, the majority in dollars. Beijing's willingness to continue lending to Washington by purchasing Treasurys is hugely important while the U.S. is on a borrowing binge.

"If China buys fewer Treasury bonds from the U.S., it will not be good for the U.S.," says Shi Yinhong, a professor of international relations at Renmin University in Beijing. He doubts relations will get that bad: If the dollar tanked, so would China's vast holding in dollars.

But others are hedging their bets. Harry Kazazian, chief executive of Exxel Outdoors Inc., a maker of outdoor clothing and sleeping bags in Haleyville, Ala., is preparing to move much of his apparel production from a large plant in China to Bangladesh. "I have to cover my bases if the government decides it needs to punish China," he says.

—Jason Dean, Kelly Evans and Easha Anand contributed to this article.

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