

Bailout bill defeat could cause painful recession

WASHINGTON (AP) — The fallout from the vote against a bailout package for the U.S. financial system may well dig deep into the economy.

The House's stunning defeat of a \$700 billion package urgently championed by President Bush, sent shock waves through Capitol Hill, the trading floors on Wall Street and the Oval Office on Monday.

Bush warned on Tuesday that the economic damage will be "painful and lasting" if Congress doesn't revive the package.

"An economic 9/11," warned Terry Connelly, dean of Golden Gate University's Ageno School of Business, of the potential fallout. As the package went down, panicked investors caused the Dow Jones industrials to nosedive nearly 780 points in their largest one-day point drop ever. Markets across Asia fell sharply Tuesday in the wake of the Wall Street downdraft.

Lawmakers defeated the legislation by a 228-205 vote, although Democratic and Republican leaders and Treasury Secretary Henry Paulson all pledged to keep working for a package acceptable to all sides. Vowed Bush: "This is not the end of the legislative process."

In the meantime, the economic wreckage that the administration and Congress have warned about — rising unemployment, shrinking nest eggs and prolonged recession — might not happen immediately, but that doesn't mean it won't happen at all.

"This is like the advice you get from the doctor who says you should quit smoking," said Robert Brusca, chief economist at Fact and Opinion Economics in New York. "You know he's right. But if you don't, you're not going to die tomorrow and you're not going to die next week. But at some time, it's probably going to get you."

For now, Treasury was expected to work with other government agencies, including the Federal Reserve and the Federal Deposit Insurance Corp., to deal with problems on a case-by-case basis.

"Our tool kit is substantial but insufficient" without a bailout, Paulson warned.

There are some steps the Federal Reserve can take to cushion damage from the worst credit crisis since the Great Depression.

The Fed, which has been providing billions in short-term loans to help banks overcome credit stresses, could keep expanding those loans in an effort to spur financial institutions to lend more freely again. And, it could keep working with other central banks to inject billions into troubled financial markets overseas.

Also, the Fed could make it easier for banks and investment firms to draw emergency loans from the central bank by expanding the type of collateral they pledge to back those loans.

And, if the credit crisis were to turn even worse, the Fed also has the power in extreme circumstances to

adequate credit from other banking institutions.

The Fed also could do an about-face and start cutting its key interest rate again. The Fed in June halted an aggressive rate-cutting campaign and has kept its key rate since at 2 percent.

While some Fed officials doubt that another rate reduction would do much to boost confidence and persuade banks to begin lending again, Brian Bethune, economist at Global Insight, insists a deep cut would pack a powerful punch. It would lower the prime lending rate, now at 5 percent, that serves as a benchmark for credit card rates and many other types of loans.

Even if the bailout were enacted by Congress and actually worked, many predicted the economy will probably shrink in the final quarter of this year and in the first quarter of next year, meeting the classic definition of a recession. If Congress doesn't act, analysts, who were scrambling to downgrade their economic forecasts, believe those contractions will be deeper.

The unemployment rate — now at a five-year high of 6.1 percent — is expected to hit 7 or 7.5 percent by late 2009, which would be the highest since after the 1990-91 recession. Some economists say the jobless rate could rise even more.

"Undoubtedly, both businesses and consumers will run for cover. They will clam up," said economist Ken Mayland, president of ClearView Economics. "The snowball hitting the economy will pick up speed and gather mass."

More banks could fail, too. In the second quarter that ended in June, the Federal Deposit Insurance Corp. estimated 117 banks and thrifts were in trouble, the most since 2003. The threat of more banks failing in the U.S. and abroad forced the government to act swiftly.

The tanking stock market and falling home values — the single-biggest assets for most Americans — have taken big bites out of people's wealth and their retirement accounts even as high energy and food prices are shrinking paychecks. Consumers are major shapers of the U.S. economy. If they retrench, the country will go into a tailspin.

The bailout plan was intended to revive jittery and fragile banks on Wall Street and Main Street by buying billions upon billions of their worst mortgage-related assets so that lending, the oxygen of the American economy, would flow freely again.

"People are going to go home and look at their 401(k)'s and not be very happy, and these are not just people from New York, but Iowa and everywhere else. This bill is meant for everyone — not just Wall Street but Main Street," said longtime New York Stock Exchange floor trader Theodore Weisberg.