No Return to Normal

Why the economic crisis, and its solution, are bigger than you think.

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Barack Obama's presidency began in hope and goodwill, but its test will be its success or failure on the economics. Did the president and his team correctly diagnose the problem? Did they act with sufficient imagination and force? And did they prevail against the political obstacles—and not only that, but also against the procedures and the habits of thought to which official Washington is addicted?

The president has an economic program. But there is, so far, no clear statement of the thinking behind that program, and there may not be one, until the first report of the new Council of Economic Advisers appears next year. We therefore resort to what we know about the economists: the chair of the National Economic Council, Lawrence Summers; the CEA chair, Christina Romer; the budget director, Peter Orszag; and their titular head, Treasury Secretary Timothy Geithner. This is plainly a capable, close-knit group, acting with energy and commitment. Deficiencies of their program cannot, therefore, be blamed on incompetence. Rather, if deficiencies exist, they probably result from their shared background and creed—in short, from the limitations of their ideas.

The deepest belief of the modern economist is that the economy is a self-stabilizing system. This means that, even if nothing is done, normal rates of employment and production will someday return. Practically all modern economists believe this, often without thinking much about it. (Federal Reserve Chairman Ben Bernanke said it reflexively in a major speech in London in January: "The global economy will recover." He did not say how he knew.) The difference between conservatives and liberals is over whether policy can usefully speed things up. Conservatives say no, liberals say yes, and on this point Obama's economists lean left. Hence the priority they gave, in their first days, to the stimulus package.

But did they get the scale right? Was the plan big enough? Policies are based on models; in a slump, plans for spending depend on a forecast of how deep and long the slump would otherwise be. The program will only be correctly sized if the forecast is accurate. And the forecast depends on the underlying belief. If recovery is not built into the genes of the system, then the forecast will be too optimistic, and the stimulus based on it will be too small.

Consider the baseline economic forecast of the Congressional Budget Office, the nonpartisan agency lawmakers rely on to evaluate the economy and their budget plans. In its early-January forecast, the CBO measured and projected the difference between actual economic performance and "normal" economic performance—the so-called GDP gap. The forecast has two astonishing features. First, the CBO did not expect the present recession to be any worse than that of 1981–82, our deepest postwar recession. Second, the CBO expected a turnaround beginning late this year, with the economy returning to normal around 2015, even if Congress had taken no action at all.

With this projection in mind, the recovery bill pours a bit less than 2 percent of GDP into new spending per year, plus some tax cuts, for two years, into a GDP gap estimated to average 6 percent for three years. The stimulus does not need to fill the whole gap, because the CBO expects a "multiplier effect," as first-round spending on bridges and roads, for example, is followed by second-round spending by steelworkers and road crews. The CBO estimates that because of the multiplier effect, two dollars of new public spending produces about three dollars of new output. (For tax cuts the numbers are lower, since some of the cuts will be saved in the first round.) And with this help, the recession becomes fairly mild. After two years, growth would be solidly established and Congress's work would be done. In this way, the duration as well as the scale of action was driven, behind the scenes, by the CBO's baseline forecast.

Why did the CBO reach this conclusion? On depth, CBO's model is based on the postwar experience, and such models cannot predict outcomes more serious than anything already seen. If we are facing a downturn worse than 1982, our computers won't tell us; we will be surprised. And if the slump is destined to drag on, the computers won't tell us that either. Baked into the CBO model we find a "natural rate of unemployment" of 4.8 percent; the model moves the economy back toward that value no matter what. In the real world, however, there is no reason to believe this will happen. Some alternative forecasts, freed of the mystical return to "normal," now project a GDP gap twice as large as the CBO model predicts, and with no near-term recovery at all.

Considerations of timing also influenced the choice of line items. The bill tilted toward "shovel-ready" projects like refurbishing schools and fixing roads, and away from projects requiring planning and long construction lead times, like urban mass transit. The push for speed also influenced the bill in another way. Drafting new legislative authority takes time. In an emergency, it was sensible for Chairman David Obey of the House Appropriations Committee to mine the legislative docket for ideas already commanding broad support (especially within the Democratic caucus). In this way he produced a bill that was a triumph of fast drafting, practical politics, and progressive principle—a good bill which the Republicans hated. But the scale of action possible by such means is unrelated, except by coincidence, to what the economy needs.

Three further considerations limited the plan. There was, to begin with, the desire for political consensus; President Obama chose to start his administration with a bill that might win bipartisan support and pass in Congress by wide margins. (He was, of course, spurned by the Republicans.) Second, the new team also sought consensus of another type. Christina Romer polled a bipartisan group of professional economists, and Larry Summers told *Meet the Press* that the final package reflected a "balance" of their views. This procedure guarantees a result near the middle of the professional mind-set. The method would be useful if the errors of economists were unsystematic. But they are not. Economists are a cautious group, and in *any* extreme situation the midpoint of professional opinion is bound to be wrong.

Third, the initial package was affected by the new team's desire to get past this crisis and to return to the familiar problems of their past lives. For these protégés of Robert Rubin, veterans in several cases of Rubin's Hamilton Project, a key preconception has always been the budget deficit and what they call the "entitlement problem." This is D.C.-speak for rolling back Social Security and Medicare, opening new markets for fund managers and private insurers, behind a wave of budget babble about "long-term deficits" and "unfunded liabilities." To this our new president is not immune. Even before the inauguration Obama was moved to commit to "entitlement reform," and on February 23 he convened what he called a "fiscal responsibility summit." The idea took hold that after two years or so of big spending, the return to normal would be under way, and the costs of fiscal relief and infrastructure improvement might be recouped, in part by taking a pound of flesh from the incomes and health care of the old.

The chance of a return to normal depends, in turn, on the banking strategy. To Obama's economists a "normal" economy is led and guided by private banks. When domestic credit booms are under way, they tend to generate high employment and low inflation; this makes the public budget look good, and spares the president and Congress many hard decisions. For this reason the new team instinctively seeks to return the bankers to their normal position at the top of the economic hill. Secretary Geithner told CNBC, "We have a financial system that is run by private shareholders, managed by private institutions, and we'd like to do our best to preserve that system."

But, is this a realistic hope? Is it even a possibility? The normal mechanics of a credit cycle do involve interludes when asset values crash and credit relations collapse. In 1981, Paul Volcker's campaign against inflation caused such a crash. But, though they came close, the big banks did not fail then. (I learned recently from William Isaac, Ronald Reagan's chair of the FDIC, that the government had contingency plans to nationalize the large banks in 1982, had Mexico, Argentina, or Brazil defaulted outright on their debts.) When monetary policy relaxed and the delayed tax cuts of 1981 kicked in, there was both pent-up demand for credit and the capacity to supply it. The final result was that the economy recovered quickly. Again in 1994, after a long period of credit crunch, banks and households were strong enough, even without a stimulus, to support a vast renewal of lending which propelled the economy forward for six years.

The Bush-era disasters guarantee that these happy patterns will not be repeated. For the first time since the 1930s, millions of American households are financially ruined. Families that two years ago enjoyed wealth in stocks and in their homes now have neither. Their 401(k)s have fallen by half, their mortgages are a burden, and their homes are an albatross. For many the best strategy is to mail the keys to the bank. This practically assures that excess supply and collapsed prices in housing will continue for years. Apart from cash—protected by deposit insurance and now desperately being conserved—the American middle class finds today that its major source of wealth is the implicit value of Social Security and Medicare—illiquid and intangible but real and inalienable in a way that home and equity values are not. And so it will remain, as long as future benefits are not cut.

In addition, some of the biggest banks are bust, almost for certain. Having abandoned prudent risk management in a climate of regulatory negligence and complicity under Bush, these banks participated gleefully in a poisonous game of abusive mortgage originations followed by rounds of pass-the-bad-penny-to-the-greater-fool. But they could not pass them all. And when in August 2007 the music stopped, banks discovered that the markets for their toxic-mortgage-backed securities had collapsed, and found themselves insolvent. Only a dogged political refusal to admit this has since kept the banks from being taken into receivership by the Federal Deposit Insurance Corporation—something the FDIC has the power to do, and has done as recently as last year with IndyMac in California.

Geithner's banking plan would prolong the state of denial. It involves government guarantees of the bad assets, keeping current management in place and attempting to attract new private capital. (Conversion of preferred shares to equity, which may happen with Citigroup, conveys no powers that the government, as regulator, does not already have.) The idea is that one can fix the banks from the top down, by reestablishing markets for their bad securities. If the idea seems familiar, it is: Henry Paulson also pressed for this, to the point of winning congressional approval. But then he abandoned the idea. Why? He learned it could not work.

Paulson faced two insuperable problems. One was quantity: there were too many bad assets. The project of buying them back could be likened to "filling the Pacific Ocean with basketballs," as one observer said to me at the time. (When I tried to find out where the original request for $700 billion in the Troubled Asset Relief Program came from, a senior Senate aide replied, "Well, it's a number between five hundred billion and one trillion.")

The other problem was price. The only price at which the assets could be disposed of, protecting the taxpayer, was of course the market price. In the collapse of the market for mortgage-backed securities and their associated credit default swaps, this price was too low to save the banks. But any higher price would have amounted to a gift of public funds, justifiable only if there was a good chance that the assets might recover value when "normal" conditions return.

That chance can be assessed, of course, only by doing what any reasonable private investor would do: due diligence, meaning a close inspection of the loan tapes. On the face of it, such inspections will reveal a very high proportion of missing documentation, inflated appraisals, and other evidence of fraud. (In late 2007 the ratings agency Fitch conducted this exercise on a small sample of loan files, and found indications of misrepresentation or fraud present in practically every one.) The reasonable inference would be that many more of the loans will default. Geithner's plan to guarantee these so-called assets, therefore, is almost sure to overstate their value; it is only a way of delaying the ultimate public recognition of loss, while keeping the perpetrators afloat.

Delay is not innocuous. When a bank's insolvency is ignored, the incentives for normal prudent banking collapse. Management has nothing to lose. It may take big new risks, in volatile markets like commodities, in the hope of salvation before the regulators close in. Or it may loot the institution—*nomenklatura privatization*, as the Russians would say—through unjustified bonuses, dividends, and options. It will never fully disclose the extent of insolvency on its own.

The most likely scenario, should the Geithner plan go through, is a combination of looting, fraud, and a renewed speculation in volatile commodity markets such as oil. Ultimately the losses fall on the public anyway, since deposits are largely insured. There is no chance that the banks will simply resume normal long-term lending. To whom would they lend? For what? Against what collateral? And if banks are recapitalized without changing their management, why should we expect them to change the behavior that caused the insolvency in the first place?

The oddest thing about the Geithner program is its failure to act as though the financial crisis is a true crisis—an integrated, long-term economic threat—rather than merely a couple of related but temporary problems, one in banking and the other in jobs. In banking, the dominant metaphor is of plumbing: there is a blockage to be cleared. Take a plunger to the toxic assets, it is said, and credit conditions will return to normal. This, then, will make the recession essentially normal, validating the stimulus package. Solve these two problems, and the crisis will end. That's the thinking.

But the plumbing metaphor is misleading. Credit is not a flow. It is not something that can be forced downstream by clearing a pipe. Credit is a contract. It requires a borrower as well as a lender, a customer as well as a bank. And the borrower must meet two conditions. One is creditworthiness, meaning a secure income and, usually, a house with equity in it. Asset prices therefore matter. With a chronic oversupply of houses, prices fall, collateral disappears, and even if borrowers are willing they can't qualify for loans. The other requirement is a willingness to borrow, motivated by what Keynes called the "animal spirits" of entrepreneurial enthusiasm. In a slump, such optimism is scarce. Even if people have collateral, they want the security of cash.

And it is precisely because they want cash that they will not deplete their reserves by plunking down a payment on a new car.

The credit flow metaphor implies that people came flocking to the new-car showrooms last November and were turned away because there were no loans to be had. This is not true—what happened was that people stopped coming in. And they stopped coming in because, suddenly, they felt poor.

Strapped and afraid, people want to be in cash. This is what economists call the liquidity trap. And it gets worse: in these conditions, the normal estimates for multipliers—the bang for the buck—may be too high. Government spending on goods and services always increases total spending directly; a dollar of public spending is a dollar of GDP. But if the workers simply save their extra income, or use it to pay debt, that's the end of the line: there is no further effect. For tax cuts (especially for the middle class and up), the new funds are mostly saved or used to pay down debt. Debt reduction may help lay a foundation for better times later on, but it doesn't help now. With smaller multipliers, the public spending package would need to be even larger, in order to fill in all the holes in total demand. Thus financial crisis makes the real crisis worse, and the failure of the bank plan practically assures that the stimulus also will be too small.

In short, if we are in a true collapse of finance, our models will not serve. It is then appropriate to reach back, past the postwar years, to the experience of the Great Depression. And this can only be done by qualitative and historical analysis. Our modern numerical models just don't capture the key feature of that crisis—which is, precisely, the collapse of the financial system.

If the banking system is crippled, then to be effective the public sector must do much, much more. How much more? By how much can spending be raised in a real depression? And does this remedy work? Recent months have seen much debate over the economic effects of the New Deal, and much repetition of the commonplace that the effort was too small to end the Great Depression, something achieved, it is said, only by World War II. A new paper by the economist Marshall Auerback has usefully corrected this record. Auerback plainly illustrates by how much Roosevelt's ambition exceeded anything yet seen in this crisis:

> *[Roosevelt's] government hired about 60 per cent of the unemployed in public works and conservation projects that planted a billion trees, saved the whooping crane, modernized rural America, and built such diverse projects as the Cathedral of Learning in Pittsburgh, the Montana state capitol, much of the Chicago lakefront, New York's Lincoln Tunnel and Triborough Bridge complex, the Tennessee Valley Authority and the aircraft carriers Enterprise and Yorktown. It also built or renovated 2,500 hospitals, 45,000 schools, 13,000 parks and playgrounds, 7,800 bridges, 700,000 miles of roads, and a thousand airfields. And it employed 50,000 teachers, rebuilt the country's entire rural school system, and hired 3,000 writers, musicians, sculptors and painters, including Willem de Kooning and Jackson Pollock.*

In other words, Roosevelt employed Americans on a vast scale, bringing the unemployment rates down to levels that were tolerable, even before the war—from 25 percent in 1933 to below 10 percent in 1936, if you count those employed by the government as employed, which they surely were. In 1937, Roosevelt tried to balance the budget, the economy relapsed again, and in 1938 the New Deal was relaunched. This again brought unemployment down to about 10 percent, still before the war.

The New Deal rebuilt America physically, providing a foundation (the TVA's power plants, for example) from which the mobilization of World War II could be launched. But it also saved the country politically and morally, providing jobs, hope, and confidence that in the end democracy was worth preserving. There were many, in the 1930s, who did not think so.

What did *not* recover, under Roosevelt, was the private banking system. Borrowing and lending—mortgages and home construction—contributed far less to the growth of output in the 1930s and '40s than they had in the 1920s or would come to do after the war. If they had savings at all, people stayed in Treasuries, and despite huge deficits interest rates for federal debt remained near zero. The liquidity trap wasn't overcome until the war ended.

It was the war, and only the war, that restored (or, more accurately, created for the first time) the financial wealth of the American middle class. During the 1930s public spending was large, but the incomes earned were spent. And while that spending increased consumption, it did not jumpstart a cycle of investment and growth, because the idle factories left over from the 1920s were quite sufficient to meet the demand for new output. Only after 1940 did total demand outstrip the economy's capacity to produce civilian private goods—in part because private incomes soared, in part because the government ordered the production of some products, like cars, to halt.

All that extra demand would normally have driven up prices. But the federal government prevented this with price controls. (Disclosure: this writer's father, John Kenneth Galbraith, ran the controls during the first year of the war.) And so, with nowhere else for their extra dollars to go, the public bought and held government bonds. These provided claims to postwar purchasing power. After the war, the existence of those claims could, and did, establish creditworthiness for millions, making possible the revival of private banking, and on the broadly based, middle-class foundation that so distinguished the 1950s from the 1920s. But the relaunching of private finance took twenty years, and the war besides.

A brief reflection on this history and present circumstances drives a plain conclusion: the full restoration of private credit will take a long time. It will follow, not precede, the restoration of sound private household finances. There is no way the project of resurrecting the economy by stuffing the banks with cash will work. Effective policy can only work the other way around.

That being so, what must now be done? The first thing we need, in the wake of the recovery bill, is more recovery bills. The next efforts should be larger, reflecting the true scale of the emergency. There should be open-ended support for state and local governments, public utilities, transit authorities, public hospitals, schools, and universities for the duration, and generous support for public capital investment in the short and long term. To the extent possible, all the resources being released from the private residential and commercial construction industries should be absorbed into public building projects. There should be comprehensive foreclosure relief, through a moratorium followed by restructuring or by conversion-to-rental, except in cases of speculative investment and borrower fraud. The president's foreclosure-prevention plan is a useful step to relieve mortgage burdens on at-risk households, but it will not stop the downward spiral of home prices and correct the chronic oversupply of housing that is the cause of that.

Second, we should offset the violent drop in the wealth of the elderly population as a whole. The squeeze on the elderly has been little noted so far, but it hits in three separate ways: through the fall in the stock market; through the collapse of home values; and through the drop in interest rates, which reduces interest income on accumulated cash. For an increasing number of the elderly, Social Security and Medicare wealth are all they have.

That means that the entitlement reformers have it backward: instead of cutting Social Security benefits, we should increase them, especially for those at the bottom of the benefit scale. Indeed, in this crisis, precisely because it is universal and efficient, Social Security is an economic recovery ace in the hole. Increasing benefits is a simple, direct, progressive, and highly efficient way to prevent poverty and sustain purchasing power for this vulnerable population. I would also argue for lowering the age of eligibility for Medicare to (say) fifty-five, to permit workers to retire earlier and to free firms from the burden of managing health plans for older workers.

This suggestion is meant, in part, to call attention to the madness of talk about Social Security and Medicare cuts. The prospect of future cuts in this modest but vital source of retirement security can only prompt worried prime-age workers to spend less and save more today. And that will make the present economic crisis deeper. In reality, there is no Social Security "financing problem" at all. There is a health care problem, but that can be dealt with only by deciding what health services to provide, and how to pay for them, for the whole population. It cannot be dealt with, responsibly or ethically, by cutting care for the old.

Third, we will soon need a jobs program to put the unemployed to work quickly. Infrastructure spending can help, but major building projects can take years to gear up, and they can, for the most part, provide jobs only for those who have the requisite skills. So the federal government should sponsor projects that employ people to do what they do best, including art, letters, drama, dance, music, scientific research, teaching, conservation, and the nonprofit sector, including community organizing—why not?

Finally, a payroll tax holiday would help restore the purchasing power of working families, as well as make it easier for employers to keep them on the payroll. This is a particularly potent suggestion, because it is large and immediate. And if growth resumes rapidly, it can also be scaled back. There is no error in doing too much that cannot easily be repaired, by doing a bit less.

As these measures take effect, the government must take control of insolvent banks, however large, and get on with the business of reorganizing, re-regulating, decapitating, and recapitalizing them. Depositors should be insured fully to prevent runs, and private risk capital (common and preferred equity and subordinated debt) should take the first loss. Effective compensation limits should be enforced—it is a good thing that they will encourage those at the top to retire. As Senator Christopher Dodd of Connecticut correctly stated in the brouhaha following the discovery that Senate Democrats had put tough limits into the recovery bill, there are many competent replacements for those who leave.

Ultimately the big banks can be resold as smaller private institutions, run on a scale that permits prudent credit assessment and risk management by people close enough to their client communities to foster an effective revival, among other things, of household credit and of independent small business—another lost hallmark of the 1950s. No one should imagine that the swaggering, bank-driven world of high finance and credit bubbles should be made to reappear. Big banks should be run largely by men and women with the long-term perspective, outlook, and temperament of middle managers, and not by the transient, self-regarding plutocrats who run them now.

The chorus of deficit hawks and entitlement reformers are certain to regard this program with horror. What about the deficit? What about the debt? These questions are unavoidable, so let’s answer them. First, the deficit and the public debt of the U.S. government can, should, must, and will increase in this crisis. They will increase whether the government acts or not. The choice is between an active program, running up debt while creating jobs and rebuilding America, or a passive program, running up debt because revenues collapse, because the population has to be maintained on the dole, and because the Treasury wishes, for no constructive reason, to rescue the big bankers and make them whole.

Second, so long as the economy is placed on a path to recovery, even a massive increase in public debt poses no risk that the U.S. government will find itself in the sort of situation known to Argentines and Indonesians. Why not? Because the rest of the world recognizes that the United States performs certain indispensable functions, including acting as the lynchpin of collective security and a principal source of new science and technology. So long as we meet those responsibilities, the rest of the world is likely to want to hold our debts.

Third, in the debt deflation, liquidity trap, and global crisis we are in, there is no risk of even a massive program generating inflation or higher long-term interest rates. That much is obvious from current financial conditions: interest rates on long-maturity Treasury bonds are amazingly low. Those rates also tell you that the markets are not worried about financing Social Security or Medicare. They are more worried, as I am, that the larger economic outlook will remain very bleak for a long time.

Finally, there is the big problem: How to recapitalize the household sector? How to restore the security and prosperity they've lost? How to build the productive economy for the next generation? Is there anything today that we might do that can compare with the transformation of World War II? Almost surely, there is not: World War II doubled production in five years.

Today the largest problems we face are energy security and climate change—massive issues because energy underpins everything we do, and because climate change threatens the survival of civilization. And here, obviously, we need a comprehensive national effort. Such a thing, if done right, combining planning and markets, could add 5 or even 10 percent of GDP to net investment. That's not the scale of wartime mobilization. But it probably could return the country to full employment and keep it there, for years.

Moreover, the work does resemble wartime mobilization in important financial respects. Weatherization, conservation, mass transit, renewable power, and the smart grid are public investments. As with the armaments in World War II, work on them would generate incomes not matched by the new production of consumer goods. If handled carefully—say, with a new program of deferred claims to future purchasing power like war bonds—the incomes earned by dealing with oil security and climate change have the potential to become a foundation of restored financial wealth for the middle class.

This cannot be made to happen over just three years, as we did in 1942–44. But we could manage it over, say, twenty years or a bit longer. What is required are careful, sustained planning, consistent policy, and the recognition now that there are no quick fixes, no easy return to "normal," no going back to a world run by bankers—and no alternative to taking the long view.

A paradox of the long view is that the time to embrace it is right now. We need to start down that path before disastrous policy errors, including fatal banker bailouts and cuts in Social Security and Medicare, are put into effect. It is therefore especially important that thought and learning move quickly. Does the Geithner team, forged and trained in normal times, have the range and the flexibility required? If not, everything finally will depend, as it did with Roosevelt, on the imagination and character of President Obama.