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Obama's Bailout

The Nobel Prize-winning economist says there's only one problem with the president's $787 billion stimulus plan: It isn't big enough

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If these were normal times, it would be ludicrous to issue a report card on the Obama administration's economic policies. Only a few weeks have passed since the new president was sworn in, and many important economic positions have yet to be filled. As some wags put it, we're still at the stage when officials are trying to find their way to the bathroom.

But these aren't normal times. Barack Obama took office in the midst of the worst economic crisis since the Great Depression, a crisis requiring immediate action. Indeed, some people, myself included, had hoped that the outgoing Bush administration would work with the incoming team, allowing Obama to take action *before* moving into the White House. But it soon became clear that as Obama tries to deal with the crisis, he will get no help from Republican leaders. Instead, he'll face obstruction and lies.

So our new president is on his own, scrambling to meet a crisis that is far worse now than it was when he won the 2008 election. How's he doing?

The short answer is, very well by any normal standard — especially when you compare it with what a McCain–Palin administration would have done. Indeed, not since FDR has a new president moved so aggressively on the economic front.

But the current economic disaster demands even more aggressive action than Obama has taken so far. What's truly scary is the breadth of the crisis. What began as a housing bust mutated into an implosion of the entire financial system. What began as a recession centered in the United States has gone global, with industrial production plummeting from Ukraine to Japan. Falling home and stock prices have wiped out a decade of savings, and consumers have slashed spending in a way they didn't in previous recessions. Losses from the housing bust and debt defaults have crippled the banking system; the resulting credit squeeze, in turn, has worsened the housing bust and fueled a sharp fall in business investment. And exports are plunging too, as the slump spreads around the world.

As a result, we're staring into the abyss: Without an effective response by the government, there's no telling how deep this slump might go. To promote more spending, the Federal Reserve has cut interest rates to almost zero and has vastly expanded its activities, financing everything from assets backed by credit-card debt to the operations of insurance companies. But while these efforts may have eased the credit crunch somewhat, they have been nowhere near enough to turn the economy around.

So now it's up to the Obama administration.

THE STIMULUS

There are, broadly speaking, three things the federal government can do to address this kind of economic crisis.

First, the government can offer help to victims of the crisis, with the goal of diminishing the suffering. This help can take a number of forms, from expanding unemployment benefits to rewriting mortgage terms.

Second, the government can act to support the overall level of spending in the economy, either by spending money itself or by giving money to individuals or businesses and hoping that they'll spend it.

Third, the government can step in to rescue and sustain key institutions crippled by the crisis — especially banks, whose continuing ability to lend is crucial to the economy.

These aren't mutually exclusive categories: To an important extent, the government can do well by doing good, and vice versa. Helping the unemployed can prop up consumer spending, helping homeowners can strengthen the banks, and a stronger economy reduces the number of victims.

The Obama administration has moved on two of these fronts. But it hasn't moved enough on either and has so far balked at the third.

The best of the policies announced so far is the homeowner–relief package. To reduce foreclosures, the administration will offer reduced rates on millions of mortgage loans made by Fannie Mae and Freddie Mac, the government–sponsored (and, since they were nationalized last year, government–owned) lenders. It will also offer subsidies and guarantees to private lenders who restructure mortgages.

Overall, this plan should help large numbers of people. But the arithmetic of the situation suggests that it will make only a minor dent in the overall economic problem.

The stimulus bill that was signed into law on February 17th is a much bigger deal: $787billion in economic support, most of it over two years — a huge measure by normal standards. In addition to helping support the economy, the bill will do a lot to aid the slump's victims: increasing unemployment benefits, helping unemployed workers maintain their health insurance and assisting state governments in paying for Medicaid and education — which will in turn help them avoid painful cuts in services that tend to fall hardest on the most vulnerable members of society.

Yet impressive as the stimulus bill is by normal standards, it's smaller than many economists were recommending. In my own pre-inauguration letter to the president ("What Obama Must Do," RS 1070), I called for a stimulus of $800 billion in the first year alone — more than twice as large as Obama's plan, which amounts to less than $400 billion a year. Furthermore, a relatively large share of the plan — almost 40 percent — consists of tax cuts. And cutting taxes yields much less bang for the buck than government spending, because a substantial fraction of tax cuts will be saved rather than spent.

Here's one way to see the trouble with the stimulus: The Congressional Budget Office predicts an "output gap," the difference between what the economy could produce and what it will actually produce, of $2.9 trillion over the next three years. A $787billion stimulus just isn't big enough to bridge that large a gap; even when you account for indirect effects, such as the fact that higher employment will lead to higher consumer spending, we'll be lucky if the plan closes a third of the gap.

Or think of it in terms of jobs: The administration says that the stimulus will, at its peak late next year, create or save around 3.5 million jobs, which is nothing to sneeze at. But as of last January, the number of unemployed Americans had already risen by 4.1 million since the official start of the recession, and the economy was continuing to lose jobs at the rate of 600,000 a month. So while the bill will significantly reduce the eventual rise in unemployment, it won't even be enough to make up for the damage that has already happened, let alone the further damage to come.

Why wasn't the plan bigger, and why does it contain such a large proportion of tax cuts? Part of the explanation lies in the economics: Obama officials wanted public spending to focus on "shovel–ready" projects — that is, projects that could start employing workers and boosting the economy fairly quickly. But there is a limited supply of such projects: We can all think of major public investment projects that should be undertaken, but most of these would take years to get under way. As it is, more than half the "discretionary spending" in the bill (which means things like infrastructure projects) is expected to take place after September 2010.

But that's not as much of a problem as it may seem, because almost everyone expects the economy to remain depressed for years. The minutes of the latest Fed meeting, for example, tell us that "all participants anticipated that unemployment would remain substantially above its longer–run sustainable rate at the end of 2011."

And it would also have been possible to provide a lot more aid, both to distressed individuals and to hard– pressed state and local governments. Before the bill was passed, state governments were projecting deficits of $350 billion over the next two and half years — deficits that will have to be closed with spending cuts and tax increases, which in turn will reduce vital services and further depress the economy. The stimulus bill makes up about 40 percent of this shortfall — a significant help, but it could have done more.

The fact that the bill doesn't do more reflects politics — and, arguably, some important misjudgments on the part of the president and his advisers.

THE GOP ATTACKS

From the start, the Obama administration proposed a stimulus that was at the low end of what independent economists thought was necessary and was relatively heavy on tax cuts. This seems to have been done in the hope of gaining broad bipartisan support: According to news reports from early January, Obama aides hoped they might get as many as 80 votes in the Senate.

Instead, Republicans rejected Obama's overtures en masse. Not a single Republican in the House voted for the plan. In the Senate, 36 out of 41 Republicans voted for the DeMint amendment, which would have scrapped all of the spending provisions and replaced the whole thing with permanent tax cuts.

To listen to critics on the right, the stimulus was a terrible idea. First, they claimed that it was filled with pork — but in order to make that claim, they had to denounce things that were not, in fact, in the bill. An aide to John Boehner, the House minority leader, claimed the stimulus would spend $30 million protecting a marsh mouse near Nancy Pelosi's district; no such provision was in the bill. Boehner and other Republicans insisted it would spend $8 billion on a high–speed rail link between Los Angeles and Las Vegas; no, it wouldn't. In a way, the apparent need of Republicans to invent wasteful spending out of thin air was a demonstration of how clean the bill really is: They obviously couldn't find enough real waste to complain about.

Second, Republicans claimed that the bill will impose huge costs on future generations — that it's "generational theft," as Sen. John McCain put it. Now, the U.S. government does indeed have a long–term fiscal problem. Recent estimates by the nonpartisan Tax Policy Center put the long–run "fiscal gap" — the difference between spending and revenue under current policy — at between four and six percent of GDP. But the cost of the stimulus will add only slightly to that gap — around 0.12 percent of GDP. That's nothing compared to policy initiatives that Republicans in Congress enthusiastically supported over the past eight years. The Bush tax cuts will ultimately cost at least $2 trillion; the Iraq War at least $1 trillion. The stimulus will be a much smaller burden, especially when you bear in mind that by helping the economy, it will also raise tax receipts, offsetting at least a third of the measure's cost.

But anyway, all the stuff about burdening future generations is pure hypocrisy. The tax cuts in the DeMint amendment, which was supported by 36 Republicans — including McCain, the self–proclaimed opponent of "generational theft" — would have cost $3.1 trillion over the next 10 years. That's four times as much as the Obama stimulus.

One last line of attack was the claim that fiscal stimulus, in principle, simply can't work. You hear this from conservative "experts" like Brian Riedl of the Heritage Foundation, who declares, "Every dollar Congress injects into the economy must first be taxed or borrowed out of the economy. You're not creating new demand, you're just transferring it from one group of people to another." Borrowing from domestic lenders, the argument goes, cuts into the money available for investments; borrowing from foreigners curbs exports.

What's wrong with this claim? The answer lies in the very nature of our economic crisis. When the economy is at or near full employment, government spending does indeed come at the expense of private spending. But right now, we're suffering from a problem known as the "paradox of thrift" — everyone is trying to save more at the same time, even as investment demand is falling. Those vast quantities of potential savings — from consumers, corporations and institutional investors — have nowhere to go. By borrowing that excess money and using it to finance temporary budget deficits, the government can put it to good use, helping to sustain the economy. In a crisis like this, government spending is actually a way of getting unemployed resources working again.

So given all the objections to the stimulus, was Obama wrong to seek broad bipartisan support? That depends on how you interpret the endgame. To get the 60 Senate votes needed to override a filibuster, Obama had to make concessions to a few Republican "moderates" — and those concessions made a somewhat weak plan significantly weaker, stripping out spending, especially aid to states, and replacing it with tax cuts. Obama aides, notably Rahm Emanuel, claim that this showed that the Obama plan was the strongest possible. But I'd argue that the moderates would have demanded a pound of flesh from whatever Obama proposed, and that he guaranteed a too–weak bill by aiming low.

Whatever your interpretation of what happened, however, the result was a stimulus bill that is much better than nothing but one that will at best mitigate the slump, not cure it.

THE BANK BAILOUT

So far, obama has taken sensible action on homeowner relief, and sensible but probably inadequate action on fiscal stimulus. What about the third type of action, rescuing financial institutions? At the time of writing, the Obama administration had announced what it said was a plan — but nobody knew what it meant. And thereby hangs a tale. Banks, broadly defined — which include many institutions that don't have big marble buildings and rows of tellers but nonetheless fulfill banking functions — play a crucial role in the economy. Yet major U.S. banks have suffered heavy losses in this crisis, leaving them severely undercapitalized if not insolvent. What that means, in English, is that big banks don't have enough assets to be sure of paying their debts — which in turn means that nobody wants to deal with them, for fear that they won't be repaid. As a result, our financial system is half–crippled.

To help the economy, the government needs to get the banks back on their feet. But how should that be done? Some proposals call for having the government buy troubled assets, like mortgage–backed securities, from the banks — but this only helps the banks if the government pays much higher prices for these assets than private investors are willing to offer, which means that taxpayers get a raw deal and the banks get a huge windfall. Or the government could guarantee the banks against large losses — but this, again, is a raw deal for taxpayers and a gift to the banks. And we're talking about a lot of money here: Some estimates put the losses of U.S. banks in this crisis at more than $1.5 trillion.

There is one more option, however. The government could put money into the banks in return for a commensurate share of ownership. What that would mean in practice, for at least some of the biggest banks, would be nationalization. Think of it this way: Citigroup and Bank of America probably need hundreds of billions of dollars in additional capital, yet as of February 26th, their combined stock–market value was less than $40 billion — and even that figure was inflated by the lingering hope of receiving a government handout. There's really no way for the government to inject the capital these banks need without either providing that handout, on a grand scale, or taking ownership itself.

A number of people have followed this line of thought to its natural conclusion — including some people whose names might surprise you. Maybe it's no big deal that Sen. Chris Dodd of Connecticut has said that temporary nationalization may be necessary, but so has Sen. Charles Schumer of New York, usually a defender of the investment industry — and so has none other than Alan Greenspan.

At the time of this writing, however, the Obama administration still wasn't willing to go there. On February 10th, Tim Geithner, the Treasury secretary, purportedly laid out the administration's bank plan — but nobody understood what, exactly, he was proposing, probably because the administration itself hadn't decided what to do. Even Obama has been cagey about the matter, praising the "Swedish model" (Sweden nationalized some major banks in the early 1990s) but suggesting that the United States is different.

Why the hesitation? The bankers themselves, not surprisingly, insist that a government takeover would be a terrible idea. And then there are the cries of "socialism" coming from the usual suspects, along with assertions that governments do a very bad job of running banks. Actually, as many of us have pointed out, the lesson of the past few years is that bankers do a very bad job of running banks — it was the private sector, not the government, that lost all that money. And in an important sense, the banks are already socialized: They're getting lots of government money, and the government has made it clear that they won't be allowed to fail. In effect, the government already owns their possible losses; why shouldn't it own their possible gains?

But anyway, talk of socialism deliberately misses the point. Nobody involved in the rescue plan wants the government running banks on a permanent basis. The idea, instead, is to do what is routinely done with smaller banks when they go bust and are seized by the FDIC: The government takes them into temporary receivership and cleans up their balance sheets — taking over their bad assets and paying off enough of their debts so that what's left is a viable enterprise. Then the bank is re– privatized, and the government gets the best price it can for the troubled assets. That's what Sweden did in the early 1990s, in what is widely regarded as a success story. It's also what we ourselves did with failed savings–and–loan institutions at the end of the 1980s; the Resolution Trust Corporation, which took over the troubled assets, is almost always cited as a good example of how to resolve a banking crisis while getting the best possible deal for the taxpayers.

Maybe it's a problem with words: Some have suggested, in fact, that we stop talking about "nationalization" and call the process "pre–privatization." Yet, whatever you call it, the Obama administration is still hesitating. Why?

It may be the same kind of political caution that led to a too–weak stimulus, although it's hard to see why that caution persists now that so many mainstream figures have accepted the possible need for nationalization. (Who would have expected to find Alan Greenspan taking a position to Obama's left?)

It may also reflect the character of Obama's economic team, which is smart but perhaps too conventionally minded. I had no problem when Obama chose familiar faces like Larry Summers and Tim Geithner to be in charge: The urgency of the crisis means that there's no time for a learning curve, so you have to appoint people who know where the bodies are buried (but preferably people who weren't personally responsible for any of the burials). But perhaps the very familiarity of the economic team with Wall Street is making it reluctant to lower the boom on bankers, even when they deserve it.

This could all change quickly. One part of Geithner's plan that seems comprehensible is his call for a "stress test" on major banks: Government auditors would study their books to determine whether they are viable. This could be turned into a Claude Rains moment, in which the Obama administration declares itself shocked — shocked! — to find that several giant banks are insolvent, leaving no choice except temporary government receivership.

But so far, at least, Obama is trying to finesse the crisis; he's looking for solutions that are less radical than temporary nationalization. On February 23rd, the administration floated a complex plan to convert some of the $45 billion in preferred shares it currently holds in Citigroup into common shares, while avoiding taking a controlling interest. Nobody outside the administration seems to think this would make much difference — it sounds as if Geithner is rearranging the deck chairs on the Titanic, while hoping the iceberg melts.

The truth is that there aren't any non–radical solutions to the banking crisis. The only way to resolve the crisis without nationalization would be a huge giveaway of taxpayer money, and that's impossible both fiscally and politically.

So the result of the Obama administration's caution is that the banking crisis remains unresolved. As long as government aid is perceived as a handout to bankers (because it is), that aid will be deeply unpopular. The result will be a banking system that, while being kept by government aid from outright collapse, has too little capital to provide the economy with the credit it needs. That's what people mean when they talk about "zombie banks" — they're still walking around, but they're too crippled to fulfill their proper role. And we know from Japan's experience in the "lost decade" of the 1990s that zombie banks can stifle economic recovery, even if the government spends heavily on fiscal stimulus.

LOOKING AHEAD

So far, at least, the administration's recovery plans seem to be based on the belief that the economy will somehow heal itself within five years. The official projections for the stimulus bill assume that even without it, the unemployment rate, after peaking at nine percent next year, would begin a steady decline back to five percent by 2014. Because the effects of the stimulus plan will fade out over time, this long–term return to normal levels of unemployment depends on unspecified natural forces of recovery.

In reality, however, it's hard to see where that recovery is supposed to come from.

The closest parallel in modern times to our current crisis is Japan's "lost decade." As the name suggests, this slump went on for much longer than the slump assumed in the administration's projections. And when Japan finally did recover, the revival was led by booming exports to China. With the whole world now caught up in economic crisis, the United States can't count on that kind of economic rescue.

Our own Great Depression, of course, also lasted more than a decade and was brought to an end only by a gigantic war — not something we want to emulate. Now, it would be wrong to suggest that there are no forces that will lead to recovery, given enough time. The revival of private saving will, gradually, boost consumer wealth. Home construction is now running at its slowest rate in half a century, which will create a pent– up demand for new homes. Auto sales are so low that at current rates it would take 27 years to replace the existing fleet; as cars wear out, sales will surge. In the long run, the U.S. economy will indeed recover even without government support.

But as John Maynard Keynes famously declared, in the long run we are all dead.

Here's what I think will happen: At some point, probably later this year, the Obama administration will realize that what it has done is not enough. (The economic team is very smart and intellectually flexible; if they were on the outside, they would probably offer an analysis quite similar to the one you're reading now.) At that point, the administration will devise a more ambitious plan, one designed not just to provide a cushion against the slump, but to lead the way to full recovery. That will almost surely involve nationalizing several major banks on a temporary basis and pumping in a lot of cash to get them running effectively.

Can such a plan be passed, when the administration was barely able to scrape up enough Senate votes to get the original stimulus through? I think so, for three reasons. First, as the economy deteriorates, more Republicans may see the need to do something sensible. Second, Al Franken will eventually be seated, meaning Obama will only need to win over one Republican to avoid a filibuster. And third, the next phase of the stimulus won't necessarily need 60 votes: The administration can use the budget process to increase spending or reduce revenues by a simple majority — something Obama can easily obtain.

Whatever the legislative maneuvering required, much more must be done. Right now, there's a strong chance that the unemployment rate will go into double digits — which means 15 million or more Americans seeking jobs but unable to find them. Millions more could lose their homes, even with the new housing plan. And worst of all, this could last for a long time: At this point, America is following right in the tracks of Japan's "lost decade."

When it comes to fixing the economy, President Obama has only begun his work.

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