Print this page

VANITY FAIR

THE ECONOMY


The past as prologue? Lining up for food and water, Louisville, Kentucky, 1937. *By Margaret Bourke-White/Time & Life Pictures/Getty Images.*

# Reversal of Fortune

## Describing how ideology, special-interest pressure, populist politics, and sheer incompetence have left the U.S. economy on life support, the author puts forth a clear, commonsense plan to reverse the Bush-era follies and regain America's economic sanity.

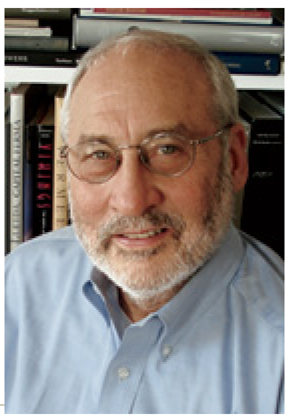
**BY JOSEPH E. STIGLITZ NOVEMBER 2008**

When the American economy enters a downturn, you often hear the experts debating whether it is likely to be V-shaped (short and sharp) or U-shaped (longer but milder). Today, the

American economy may be entering a downturn that is best described as L-shaped. It is in a very low place indeed, and likely to remain there for some time to come.

Virtually all the indicators look grim. Inflation is running at an annual rate of nearly 6 percent, its highest level in 17 years. Unemployment stands at 6 percent; there has been no net job growth in the private sector for almost a year. Housing prices have fallen faster than at any time in memory—in Florida and California, by 30 percent or more. Banks are reporting record losses, only months after their executives walked off with record bonuses as their reward. President Bush inherited a $128 billion budget surplus from Bill Clinton; this year the federal government announced the second-largest budget deficit ever reported. During the eight years of the Bush administration, the national debt has increased by more than 65 percent, to nearly $10 trillion (to which the debts of Freddie Mac and Fannie Mae should now be added, according to the Congressional Budget Office). Meanwhile, we are saddled with the cost of two wars. The price tag for the one in Iraq alone will, by my estimate, ultimately exceed $3 trillion.

**MORE STIGLITZ**



The $3 Trillion War, April 2008 (with Linda J. Bilmes)

The Economic Consequences of Mr. Bush, December 2007

This tangled knot of problems will be difficult to unravel. Standard prescriptions call for raising interest rates when confronted with inflation, just as standard prescriptions call for lowering interest rates when confronted with an economic downturn. How do you do both at the same time? Not in the way that some politicians have proposed. With gasoline prices at all-time highs, John McCain has called for a rollback of gas taxes. But that would lead to more gas consumption, raise the price of gas further, increase our dependence on foreign oil, and expand our already massive trade deficit. The expanding deficit would in turn force the U.S. to continue borrowing gargantuan sums from abroad, making us even more indebted. At the same time, the higher imports of oil and petroleum-based products would lead to a weaker dollar, fueling inflationary pressures.

Millions of Americans are losing their homes. (Already, some 3.6 million have done so since the subprime-mortgage crisis began.) This social catastrophe has severe economic effects. The banks and other financial institutions that own these mortgages face stunning reverses; a few, such as Bear Stearns, have already gone belly-up. To prevent America's $5.2 trillion home financiers, Fannie Mae and Freddie Mac, from following suit, Congress authorized a blank check to cover their losses, but even that generosity failed to do the trick. Now the administration has taken over the two entities completely, a stunning feat for a supposedly market-oriented regime. These bailouts contribute to growing deficits in the short run, and to perverse incentives in the long run. Market economies work only when there is a system of accountability, but C.E.O.'s, investors, and creditors are walking away with billions, while American taxpayers are being asked to pick up the tab. (Freddie Mac's chairman, Richard Syron, earned $14.5 million in 2007. Fannie Mae's C.E.O., Daniel Mudd, earned $14.2 million that same year.) We're looking at a new form of public-private partnership, one in which the public shoulders all the risk, and the private sector gets all the profit. While the Bush administration preaches responsibility, the words are addressed only to the less well-off. The administration talks about the impact of "moral hazard" on the poor "speculator" who borrowed money and bought a house beyond his ability to pay. But moral hazard somehow isn't an issue when it comes to the high-stakes speculators in corporate boardrooms.

## How Did We Get into This Mess?

A unique combination of ideology, special-interest pressure, populist politics, bad economics, and sheer incompetence has brought us to our present condition.

Ideology proclaimed that markets were always good and government always bad. While George W. Bush has done as much as he can to ensure that government lives up to that reputation—it is the one area where he has overperformed—the fact is that key problems facing our society cannot be addressed without an effective government, whether it's maintaining national security or protecting the environment. Our economy rests on public investments in technology, such as the Internet. While Bush's ideology led him to underestimate the importance of government, it also led him to underestimate the limitations of markets. We learned from the Depression that markets are not self-adjusting—at least, not in a time frame that matters to living people. Today everyone—even the president—accepts the need for macro-economic policy, for government to try to maintain the economy at near-full employment. But in a sleight of hand, free-market economists promoted the idea that, once the economy was restored to full employment, markets would always allocate resources efficiently. The best regulation, in their view, was no regulation at all, and if that didn't sell, then "self-regulation" was almost as good.

The underlying idea was, on the face of it, absurd: that market failures come only in macro doses, in the form of the recessions and depressions that have periodically plagued capitalist economies for the past several hundred years. Isn't it more reasonable to assume that these failures are just the tip of the iceberg? That beneath the surface lie a myriad of smaller but harder-to-assess inefficiencies? Let me venture an analogy from biology: A patient arrives at a hospital in serious condition. Now, it may be that the patient has simply fallen victim to one of those debilitating ailments that go around from time to time and can be cured by a massive dose of antibiotics. In this case we have a macro problem with a macro solution. But it could instead be that the patient is suffering from a decade of serious abuse—smoking, drinking, overeating, lack of exercise, a fondness for crystal meth—and that it has not only taken a catastrophic toll but also left him open to opportunistic infections of every kind. In other words, a buildup of micro problems has led to a macro problem, and no cure is possible without addressing the underlying issues. The American economy today is a patient of the second kind.

We are in the midst of micro-economic failure on a grand scale. Financial markets receive generous compensation—in the form of more than 30 percent of all corporate profits—presumably for performing two critical tasks: allocating savings and managing risk. But the financial markets have failed laughably at both. Hundreds of billions of dollars were allocated to home loans beyond Americans' ability to pay. And rather than managing risk, the financial markets created more risk. The failure of our financial system to do what it is supposed to do matches in destructive grandeur the macro-economic failures of the Great Depression.

Economic theory—and historical experience—long ago proved the need for regulation of financial markets. But ever since the Reagan presidency, deregulation has been the prevailing religion. Never mind that the few times "free banking" has been tried—most recently in Pinochet's Chile, under the influence of the doctrinaire free-market theorist Milton Friedman—the experiment has ended in disaster. Chile is still paying back the debts from its misadventure. With massive problems in 1987 (remember Black Friday, when stock markets plunged almost 25 percent), 1989 (the savings-and-loan debacle), 1997 (the East Asia financial crisis), 1998 (the bailout of Long Term Capital Management), and 2001–02 (the collapses of Enron and WorldCom), one might think there would be more skepticism about the wisdom of leaving markets to themselves.

The new populist rhetoric of the right—persuading taxpayers that ordinary people always know how to spend money better than the government does, and promising a new world without budget constraints, where every tax cut generates more revenue—hasn't helped matters. Special interests took advantage of this seductive mixture of populism and free-market ideology. They also bent the rules to suit themselves. Corporations and the wealthy argued that lowering their tax rates would lead to more savings; they got the tax breaks, but America's household savings rate not only didn't rise, it dropped to levels not seen in 75 years. The Bush administration extolled the power of the free market, but it was more than willing to provide generous subsidies to farmers and erect tariffs to protect steelmakers. Lately, as we have seen, it seems willing to write blank checks to bail out its friends on Wall Street. In each of these cases there are clear winners. And in each there are clear losers—including the country as a whole.

## What Is to Be Done?

As America attempts to work its way out of the present crisis, the danger is that we will listen to the same people on Wall Street and in the economic establishment who got us into it. For them, our current predicament is another opportunity: if they can shape the government response appropriately, they stand to gain, or at least stand to lose less, and they may be willing to sacrifice the well-being of the economy for their own benefit—just as they did in the past.

There are a number of economic tools at the country's disposal. As noted, they can yield contradictory results. The sad truth is that we have reached the limits of monetary policy. Lowering interest rates will not stimulate the economy much—banks are not going to be willing to lend to strapped consumers, and consumers are not going to be willing to borrow as they see housing prices continue to fall. And raising interest rates, to combat inflation, won't have the desired impact either, because the prices that are the main sources of our inflation—for food and energy—are determined in international markets; the chief consequence will be distress for ordinary people. The quandaries that we face mean that careful balancing is required. There is no quick and easy fix. But if we take decisive action today, we can shorten the length of the downturn and reduce its magnitude. If at the same time we think about what would be good for the economy in the long run, we can build a durable foundation for economic health.

To go back to that patient in the emergency room: we need to address the underlying causes. Most of the treatment options entail painful choices, but there are a few easy ones. On energy: conservation and research into new technologies will make us less dependent on foreign oil, reduce our trade imbalance, and help the environment. Expanding drilling into environmentally fragile areas, as some propose, would have a negligible effect on the price we pay for oil. Moreover, a policy of “drain America first” will make us more dependent on foreigners in the future. It is shortsighted in every dimension.

Our ethanol policy is also bad for the taxpayer, bad for the environment, bad for the world and our relations with other countries, and bad in terms of inflation. It is good only for the ethanol producers and American corn farmers. It should be scrapped. We currently subsidize corn-based ethanol by almost $1 a gallon, while imposing a 54-cent-a-gallon tariff on Brazilian sugar-based ethanol. It would be hard to invent a worse policy. The ethanol industry tries to sell itself as an infant, needing help to get on its feet, but it has been an infant for more than two decades, refusing to grow up. Our misguided biofuel policy is taking land used for food production and diverting it to energy production for cars; it is the single most important factor contributing to higher grain prices.

Our tax policies need to be changed. There is something deeply peculiar about having rich individuals who make their money speculating on real estate or stocks paying lower taxes than middle-class Americans, whose income is derived from wages and salaries; something peculiar and indeed offensive about having those whose income is derived from inherited stocks paying lower taxes than those who put in a 50-hour workweek. Skewing the tax rates in the other direction would provide better incentives where they count and would more effectively stimulate the economy, with more revenues and lower deficits.

We can have a financial system that is more stable—and even more dynamic—with stronger regulation. Self-regulation is an oxymoron. Financial markets produced loans and other products that were so complex and insidious that even their creators did not fully understand them; these products were so irresponsible that analysts called them “toxic.” Yet financial markets failed to create products that would enable ordinary households to face the risks they confront and stay in their homes. We need a financial-products safety commission and a financial-systems stability commission. And they can’t be run by Wall Street. The Federal Reserve Board shares too much of the mind-set of those it is supposed to regulate. It could and should have known that something was wrong. It had instruments at its disposal to let the air out of the bubble—or at least ensure that the bubble didn’t over-expand. But it chose to do nothing.

Throwing the poor out of their homes because they can’t pay their mortgages is not only tragic—it is pointless. All that happens is that the property deteriorates and the evicted people move somewhere else. The most coldhearted banker ought to understand the basic economics: banks lose money when they foreclose—the vacant homes typically sell for far less than they would if they were lived in and cared for. If banks won't renegotiate, we should have an expedited special bankruptcy procedure, akin to what we do for corporations in Chapter 11, allowing people to keep their homes and re-structure their finances.

If this sounds too much like coddling the irresponsible, remember that there are two sides to every mortgage—the lender and the borrower. Both enter freely into the deal. One might say that both are, accordingly, equally responsible. But one side—the lender—is supposed to be financially sophisticated. In contrast, the borrowers in the subprime market consist mainly of people who are financially unsophisticated. For many, their home is their only asset, and when they lose it, they lose their life savings. Remember, too, that we already give big homeowner subsidies, through the tax system, to affluent families. With tax deductions, the government is paying in some states almost half of all mortgage interest and real-estate taxes. But many lower-income people, whose deductions are meaningless because their tax bill is too small, get no help. It makes much more sense to convert these tax deductions into cashable tax credits, so that the fraction of housing costs borne by the government for the poor and the rich is the same.

About these matters there should be no debate—but there will be. Already, those on Wall Street are arguing that we have to be careful not to "over-react." Over-reaction, we are told, might stifle "innovation." Well, some innovations ought to be stifled. Those toxic mortgages were certainly innovative. Other innovations were simply devices to circumvent regulations—regulations intended to prevent the kinds of problems from which our economy now suffers. Some of the innovations were designed to tart up the bottom line, moving liabilities off the balance sheet—charades designed to blur the information available to investors and regulators. They succeeded: the full extent of the exposure was not clear, and still isn't. But there is a reason we need reliable accounting. Without good information it is hard to make good economic decisions. In short, some innovations come with very high price tags. Some can actually cause instability.

The free-market fundamentalists—who believe in the miracles of markets—have not been averse to accepting government bailouts. Indeed, they have demanded them, warning that unless they get what they want the whole system may crash. What politician wants to be blamed for the next Great Depression, simply because he stood on principle? I have been critical of weak anti-trust policies that allowed certain institutions to become so dominant that they are "too big to fail." The harsh reality is that, given how far we've come, we will see more bailouts in the days ahead. Now that Fannie Mae and Freddie Mac are in federal receivership, we must insist: not a dime of taxpayer money should be put at risk while shareholders and creditors, who failed to oversee management, are permitted to walk away with anything they please. To do otherwise would invite a recurrence. Moreover, while these institutions may be too big to fail, they're not too big to be reorganized. And we need to remember why we're bailing them out: in order to maintain a flow of money into mortgage markets. It's outrageous that these institutions are responding to their near-monopoly position by raising fees and increasing the costs of mortgages, which will only worsen the housing crisis. They, and the financial markets, have shown little interest in measures that could help millions of existing and potential homeowners out of the bind they're in.

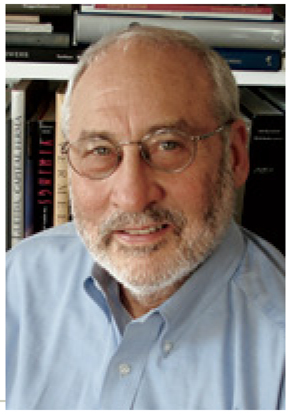
The hardest puzzles will be in monetary policy (balancing the risks of inflation and the risk of a deeper downturn) and fiscal policy (balancing the risk of a deeper downturn and the risk of an exploding deficit). The standard analysis coming from financial markets these days is that inflation is the greatest threat, and therefore we need to raise interest rates and cut deficits, which will restore confidence and thereby restore the economy. This is the same bad economics that didn't work in East Asia in 1997 and didn't work in Russia and Brazil in 1998. Indeed, it is the same recipe prescribed by Herbert Hoover in 1929.

It is a recipe, moreover, that would be particularly hard on working people and the poor. Higher interest rates dampen inflation by cutting back so sharply on aggregate demand that the unemployment rate grows and wages fall. Eventually, prices fall, too. As noted, the cause of our inflation today is largely imported—it comes from global food and energy prices, which are hard to control. To curb inflation therefore means that the price of everything else needs to fall drastically to compensate, which means that unemployment would also have to rise drastically.

In addition, this is not the time to turn to the old-time fiscal religion. Confidence in the economy won't be restored as long as growth is low, and growth will be low if investment is anemic, consumption weak, and public spending on the wane. Under these circumstances, to mindlessly cut taxes or reduce government expenditures would be folly.

But there are ways of thoughtfully shaping policy that can walk a fine line and help us get out of our current predicament. Spending money on needed investments—infrastructure, education, technology—will yield double dividends. It will increase incomes today while laying the foundations for future employment and economic growth. Investments in energy efficiency will pay triple dividends—yielding environmental benefits in addition to the short- and long-run economic benefits.

MORE STIGLITZ



The $3 Trillion War, April 2008 (with Linda J. Bilmes)

The Economic Consequences of Mr. Bush, December 2007

The federal government needs to give a hand to states and localities—their tax revenues are plummeting, and without help they will face costly cutbacks in investment and in basic human services. The poor will suffer today, and growth will suffer tomorrow. The big advantage of a program to make up for the shortfall in the revenues of states and localities is that it would provide money in the amounts needed: if the economy recovers quickly, the shortfall will be small; if the downturn is long, as I fear will be the case, the shortfall will be large.

These measures are the opposite of what the administration—along with the Republican presidential nominee, John McCain—has been urging. It has always believed that tax cuts, especially for the rich, are the solution to the economy's ills. In fact, the tax cuts in 2001 and 2003 set the stage for the current crisis. They did virtually nothing to stimulate the economy, and they left the burden of keeping the economy on life support to monetary policy alone. America's problem today is not that households consume too little; on the contrary, with a savings rate barely above zero, it is clear we consume too much. But the administration hopes to encourage our spendthrift ways.

What has happened to the American economy was avoidable. It was not just that those who were entrusted to maintain the economy's safety and soundness failed to do their job. There were also many who benefited handsomely by ensuring that what needed to be done did not get done. Now we face a choice: whether to let our response to the nation's woes be shaped by those who got us here, or to seize the opportunity for fundamental reforms, striking a new balance between the market and government.

**Joseph E. Stiglitz,** a Nobel Prize–winning economist, is a professor at Columbia University.