Battered ~~but Not~~ and Beaten

J. Bradford DeLong

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Is This Really Our Proper Timeline?

This talk has turned out to be rather more of a self-therapeutic exercise—or perhaps a call for psychological help—than is appropriate for this conference. But you go to the conference with the talk you have, and not the talk you wish you had. So let me start.

These days I wake up. Bleary-eyed, I stumble down the stairs. And while I am eating my wheaties the macroeconomic situation hits me. And I stop, with the spoon halfway between the bowl and my mouth. I then find myself thinking: "This cannot be real. This has to be some horrible mistake, some dystopian alternate timeline—like that Star Trek episode with the transporter malfunction and evil-Spock-with-a-beard…" And then I stare unproductively at the wall for a while as I try to piece together how exactly we got here.

What I Was Saying Two Years Ago

Last week I went back and looked at all of my talks from the fall and winter of 2008. Back then I was ringing changes on three themes:

1. We are in substantial trouble: the collapse of the housing bubble triggered a mortgage finance crisis that snowballed into a general financial crisis and a flight to safety that would, if unchecked, produce the worst economic downturn since the Great Depression itself.

2. Normal stabilizing monetary policy tools cannot help us any more. The standard policy moves we use to stabilize demand and production and prevent or cushion downturns have already been used to the full and cannot help us any more.

3. Nevertheless, we are going to get out of this with only minor damage to the economy, for we do have (a) the technocratic knowledge, (b) the policy tools, and (c) the political will to escape from the trap.

And I was very confident about all three of those. I would have given 9-1 odds on all of them together.

The Impulse That Caused the Downturn

Indeed, we should not have been unable to escape from the trap. For one thing, the initial financial shock that set the downturn in motion was remarkably small.

We got irrationally exuberant about the demand for housing and the trajectory of housing prices. We built five million houses extra houses—largely in the swamps of Florida and in the desert between Los Angeles and Albuquerque—that simply should not have been built. Their cost of construction was to a first approximation covered entirely by mortgage debt. And on an average one of those five million houses the purchaser took out $100,000 in mortgage debt that simply will never be repaid: the buyer cannot afford it and the house is not worth it. That means that, as of the end of 2007, there were $500 billion of financial losses to be allocated: somebody's bonds and derivatives were going to pay off $500 billion less than people had thought.

Regulatory Forebearance & Arbitrage

Now in a global economy with $80 trillion worth of financial wealth, a $500 billion loss due to irrational exuberance and malinvestment should not be problem. Double it or quadruple it and it still should not be a problem. We have modern, sophisticated, highly liquid financial markets. We have originate-and-distribute securitization to slice, dice, and spread risks.

The purpose of these institutions and vehicles is to spread financial risk broadly across the whole globe so that nobody bears any significant part of and so is ruined by any idiosyncratic risk like mortgage defaults in the desert between Los Angeles and Albuquerque. The losses from the collapse of the dot-com communications-and-computers bubble were an order of magnitude larger than those from subprime. Yet they did not create anything like our huge current problems.

So where was the trap?

The thumbnail explanation is that the trap was set by regulatory—we call it “forebearance” to be polite, but the real words cannot be said at a family conference like this—and by regulatory arbitrage. Regulatory forebearance allowed investment banks to ramp up their leverage to unheard-of levels—30 to 1?—on the grounds that the financiers' had their fortunes at risk and knew their business. Regulatory arbitrage arose when investment banker said: “Hey! Look at these AAA CDO tranches! They pay 10 basis points more than Treasuries! We can hold them as Basel Tier I capital! That's free money!” And they never turned around and asked their own issue departments the natural question: “Just what dreck have you and your peers at other banks been persuading Moody's to rate as AAA these days, anyway?”

Or they asked and did not care about the answer, because their position would get marked to an overly exuberant market—or perhaps just marked-to-model—at the end of the year, they would collect their bonus, and then they would be gone.

Flight to Quality & the Financial Accelerator

So when the $500 billion loss hit, it hit the capital of highly-leveraged financial institutions and transformed all the liabilities of America's banks from safe, secure, and liquid high-quality assets to unsafe, insecure, and illiquid low-quality assets. Whenever anything was offered on the market it raised the natural questions: “Why are you trying to sell this? What is wrong with it? How little is it really worth, anyway?”

Thus an enormous worldwide flight to quality. A $500 billion fundamental loss triggers a $20 trillion decline in global financial asset values with a financial accelerator of 40 as everybody tries to dump their risky and build up the safe assets in their portfolios. And, as John Stuart Mill knew back in 1829, whenever you have a large excess demand in finance it will be mirrored by a large deficiency in demand for currently-produced goods and services and labor: what John Stuart Mill and his peers called a "general glut"—unsold commodities in pretty much every branch of distribution and unemployed workers in pretty much every branch of production.

Could We Have Escaped the Trap?

Could this meltdown have been avoided?

Of course.

Proper financial regulation-or proper enforcement of existing financial regulations—or even proper control of their derivatives books by the senior managements of highly-leveraged financial institutions would have prevented it. If the originate-and-distribute securitization model had actually been followed the $500 billion in losses would have been spread out over the entire globe and not threatened the integrity of any piece of the financial system.

Putting into receivership housing finance in the winter or spring of 2008 would have prevented it. If the U.S. government had said at the start of 2008 that housing finance was a broken mess, and that Fannie Mae and Freddie Mac were now arms of the government that were going to buy up all mortgages and mortgage-backed securities—at a discount—and sort things out, there would have been no downturn. The U.S. government would probably have made money on the deal: it's cost of capital is low, and the universe of even subprime mortgages was not that impaired until millions of additional people began losing their jobs.

Putting into receivership as many banks as necessary in the spring, summer, and fall of 2008 would have prevented it. If the U.S. government had zeroed-out shareholders and options-holders in the process of rescuing each bank from a run as it happened, it would probably have had to have nationalized Bear-Stearns, Lehman, Fannie, Freddie, AIG, Citigroup, and a few others. But as long as it guarantees the liabilities of investment and commercial banks there is no general impairment of quality and no flight to safety and no financial accelerator. Admittedly, that would have required letting concerns about moral hazard out the window, but letting creditors off the hook is not the worst thing in the world if shareholders and option holders are completely on the hook. We wouldn't even have had to use legal process to nationalize or to completely take ownership. A simple rule by which government cash injections trigger equity issues at the then-current market price would have done the job.

And then with the U.S. Treasury as the majority shareholder of every single large leveraged financial institution in the United States, they would have been unable to lobby against financial reform.

But we did not do that. We did not do any of those things, Treasury Secretary Henry Paulson decided that it was time to take away the punchbowl, let creditors see what the consequences of not doing due diligence was, and allow Lehman Brothers to fail in an uncontrolled and unmanaged process—and then in 72 hours he reversed himself and made all of the creditors of AIG whole. That looked very bad indeed, as one of the biggest creditors of AIG was Henry Paulson's old firm, Goldman Sachs, and if AIG's failure had followed the pattern of Lehman Brothers the odds are that Goldman Sachs would not be here today.

And so the crisis came.

Consensus Expectations Before the Crisis

Back in the early and mid-2000s, when Federal Reserve officials, other policymakers, and academic onlookers were running scenarios for financial crisis management, the consensus was that even the largest crisis that irrationally exuberant financial markets could deliver would deliver would not be enough of a shock to push the unemployment rate to within kissing distance of 10%, let alone keep it there. The conventional wisdom was that the conventional policy tools of Federal Reserve open-market operations could do the job. The Federal Reserve could, if necessary, flood financial markets with nearly unlimited amounts of liquidity. If markets were liquid enough there would be no deficient demand for currently-produced goods and services. Rather, the excess supply of liquidity would be mirrored by an excess demand for currently-produced goods and services and the economic problem of the day would shift from unemployment to inflation.

We can put ourselves inside the mind of Alan Greenspan back in 2005, wondering whether he should take steps to try to curb the housing bubble. We can imagine what he thought:

> Raising interest rates to try to reduce demand for houses would raise unemployment, and since there are no signs of consumer-price inflation anywhere it would be a real shame to do that. Regulation... The subprime lenders want to lend and the borrowers want to borrow. Am I going to declare myself National Nanny, get in the middle, and tell then that they cannot strike the contracts they want to strike because Uncle Fed knows best? They will write to their Senators—both the lenders and the borrowers will write to their Senators. And then where I will be? Better to keep my powder dry and clean up the mess afterwards. I can do that. I did that in 1987, 1991, 1998, and 2001 after all. Defusing four financial crises in less than two decades and keeping any of them from having a large impact on production and employment is a sign that we really do have the tools we need…

By the end of 2008 it was clear that that was wrong.

The Federal Reserve had flooded markets with liquidity. It had pushed the price of liquidity down to zero: investors could not gain anything in return by trading their liquid reserve deposits at the local Fed away for longer-term Treasury instruments. Yet the deficiency in demand for currently produced goods and services was growing every day. The problem was that financial markets felt themselves short not of liquidity but of safety-of high-quality AAA-rated places to park their wealth where they could be confident it would not melt away while their backs were turned. Conventional monetary policy had done all it could to boost the supply of safe assets. It could not do any more. And we were in the eventuality that George Akerlof and Peter Diamond had warned me might come to pass back at the end of 2007—we had reached a point where the downturn was going to be huge unless the Federal Reserve took extraordinary steps and got extraordinary help from other branches of government.

What We Could Have Done at the End of 2008

But there were still plenty of things that could be done to help the Federal Reserve. Thus my personal confidence at the end of 2008: my strong belief that we were going to get out of this with only minor damage to the economy, for we did have (a) the technocratic knowledge, (b) the policy tools, and © the political will to escape from the trap.

What were the available policy tools even though conventional monetary policy open-market operations were exhausted?

1. Congress could act by pulling government spending forward from the future into the present and pushing taxes from the present back into the future. All increases in production and employment happen because somebody decides to spend their money faster—Milton Friedman's monetary policies work because when you give people more cash in their pockets they up their spending—and the federal government's money is as good at boosting demand and production and employment as anybody else's. Moreover, when the federal government spends and does not tax it borrows to finance it. That borrowing means that it issues bonds—and U.S. Treasury bonds are, now more than ever, high-quality safe AAA-rated financial assets. By expanding the supply of safe assets the government diminishes the excess demand gap between what the market wants to hold in the way of safety and what it can hold, and the reduction in the size of that gap reduces its mirror, the deficient demand for currently-produced goods and services.

2. The Federal Reserve could act in an extraordinary manner by engaging in "quantitative easing" policies. Such policies would not be aimed, as traditional expansionary open-market operations are, at increasing the amount of liquid assets on the market. They would be aimed at taking risk onto the Federal Reserve's and thus the government's balance sheet, thus decreasing the amount of risky assets the private sector had to hold and increasing the quantity of safe assets the private sector could hold. Such changes in the supply of risk and safety would almost surely be an

order of magnitude less effective in restoring balance to financial markets than conventional open-market operations are in normal times. But quantitative easing is not chopped liver.

3. The Federal Reserve could engage in open-mouth operations and state that it is raising its targets for the price level and the inflation rate. Such announcements would lead investors to expect that their holdings of safe high-quality nominal assets would be subject to a small inflation tax. That would diminish their demand for such assets in their portfolios—and as a consequence increase their demand for currentlyproduced goods and services instead. Once again, not as powerful as conventional open-market operations in normal times. But also not chopped liver.

4. The Treasury (and perhaps the Federal Reserve) could promise that the banks would not go bankrupt and stand behind that promise. Guaranteeing the debts of commercial and investment banks decreases the supply of risky and increases the supply of safe assets—but with obvious consequences for moral hazard, and for the incentives to avoid overspeculation and irrational exuberance in the future.

5. The Treasury could engage in targeted nationalizations to keep the inability of firms to get credit on usual terms from causing mass layoffs and bankruptcies and shutdowns that are unnecessary in the long run. The U.S. government did this with Fannie Mae, Freddie Mac, AIG, GM, and Chrysler—other financial bankruptcies were forcibly merged into stronger firms—but it could have done more.

6. The Treasury could use its resources to take private risk onto its balance sheet when it thinks markets have overshot and risky assets are undervalued—thus hopefully making money as the world's largest hedge fund and adding to the risk-bearing capacity of the market.

7. The Treasury can reorganize mortgages by providing liquidity and a little up-front cash in exchange for principal writedowns—thus making the riskiest part of the financial asset structure less risky.

Bagehot's Rule

All seven of these tools are applications of Walter Bagehot's rule: the principal that the way to deal with a panic in which nobody is sure if contracts will be honored is for the government to make sure that contracts are honored by lending freely to anybody who asks. (But, Bagehot wrote, the lending should be "at a penalty rate"—financiers should never profit from the fact of government assistance to stem the panic. That is the second part of Bagehot's rule.)

Back at the end of 2008 I was confident that the government would do as many of these seven supplements to standard monetary stabilization policy as necessary to keep unemployment low. 10% unemployment seemed, to me, politically unthinkable. 10% unemployment for any substantial period of time seemed, to me, doubly politically unthinkable.

Expectations

That was the general expectation at the end of 2008. The incoming Obama administration's belief was that, with the fiscal stimulus of the Recovery Act and the appropriate support from the Federal Reserve and the Treasury, the unemployment rate was most likely to kiss 8% in mid-2009 and then start down. The most likely scenario and central case, they thought, was that the unemployment rate would be down to 7% by the end of 2010 and then down to 5.4% by the end of 2012. And serious private-sector forecasts painted the same picture as the incoming Obama administration.

The Outcome

But that is not the outcome that we got.

Current forecasts as of late 2010 see the unemployment rate still kissing 10% late in 2011 before, finally starting to decline. Its level at the start of 2012 is currently forecast to be at least three percentage points higher than what was expected for the start of 2012 back at the end of 2008.

What Went Wrong?

Why have things turned out so much worse than expected when the Obama administration took office?

Some of it is that the Bush Treasury hobbled itself. Bush Treasury Secretary Henry Paulson did not believe in all of that “penalty rate” stuff. He believed that you could not charge banks a high interest rate for support in the financial crisis because the banks were not just illiquid but, at then-current crisis fire-sale market prices, insolvent. In such a situation the Bagehot rule says that if you cannot charge high interest rates on loans you require options to give the government most of the upside: the essential principle is that the financiers not benefit from the situation that required government support. But Paulson was not interested in taking any form of an equity stake in the banks that the Treasury and the Federal Reserve were helping—that, he claimed, would be socialism. So government policy in the crisis got off on the wrong inadequate foot.

And, of course Obama administration initially underestimated the magnitude of the problem: its Plan A was too small given how much damage the late-2008 financial crisis did to the real economy.

However, it was clear by February 2009 that the situation was much worse than the plans made in November and December 2008 had reckoned. By February 2009 it was time for a Plan B. But the Obama administration put forward no Plan B. And then there was no Plan C. And there has been no Plan D: policies on a scale to restore the economy to normal levels of employment and capacity utilization in less than half a decade have simply not been put forward by the Obama administration.

The overall impression I get is of policy that was many days late and many dollars short. This is especially distressing since the Obama administration appeared to be aware of this danger: remember Lawrence Summers writing on December 28, 2008: "In this crisis, doing too little poses a greater threat than doing too much..."

Why?

Let us look, first, at our seven tools. How have they been used?

Congress did, indeed, enact the $800 billion Recovery Act, containing about $600 billion of useful stimulus over three years. Thus expansionary fiscal policy was used, albeit on an inadequate scale. Since then, however, the difficulty of assembling 60 votes in the Senate—the Republican senators, plus Blanche Lincoln, Ben Nelson, and Joe Lieberman—have prevented any further use of this tool.

The Federal Reserve took risk onto its balance sheet in late 2008. As soon as the crisis began to ease, however, it stopped. It never took any steps to raise or even declare that it was going to try to meet its inflation target. It may begin to pursue quantitative easing on November 3, 2010—but market expectations are that this stimulus policy will, again, be on an insufficient scale.

The U.S. Treasury Department did guarantee that it would recapitalize banks if necessary and did guarantee their liabilities by announcing that they had passed the "stress tests." And the Treasury's takeover of most of the auto industry in early 2009 was a step toward targeted nationalizations. However, it was not a big enough step to have serious macro consequences. Moreover, many more nationalizations would have been needed for the Treasury to demonstrate that it was serious about achieving the "penalty rate" part of Bagehot's rule.

Otherwise, the Treasury initiatives have been failures. The HAMP program has failed to reorganize any appreciable share of the mortgage market. The PPIP program has not involved a large enough swap of risky for safe assets to have any noticeable macroeconomic impact.

Obama's Biases

The Obama administration tends to blame the Republicans in the Senate (plus Democratic Senators Joe Lieberman, Blanche Lincoln, and Ben Nelson) for the too-small size of Plan A. And they tend to say that given gridlock in the Senate the administration has no levers to use to enact a Plan B, or a Plan C, or a Plan D.

The small size of the Recovery Act is indeed the fault of the Republicans in the Senate (plus Blanche Lincoln, Ben Nelson, and Joe Lieberman). But the fact that a minority of senators could and would block legislative action was very predictable, and was predicted even before Obama took the lead over John McCain in the national opinion polls. There are two modes to the Senate. The first is to have individual senators commit themselves to voting for what they regard as good policies for the nation without concern for party loyalty. Then the procedural obstacles of the Senate may perform a useful task: shouldn't a deal of national import be struck in such a way that at least 60 senators think that it is good policy. The second mode is to have rigid party loyalty behind a program aimed not at passing legislation but rather to embarrass the president of the other party by making him or her appear a failure. In this case the procedural obstacles of the Senate are dangerous and destructive.

President-Elect Barack Obama should have sent Vice President-Elect Joe Biden to talk to the Republican senators in November 2008. Would they commit to putting partisan advantage below the public interest? Or did Biden need to get ready, the moment he took the chair and began to preside over the Senate, to cut back the procedural underbrush as rapidly as possible? Biden never had that conversation. The Obama administration's placing the blame on Senate procedures raises the question of why they never lifted a finger to try to change those procedures.

The Recovery Act in particular and expansionary fiscal policy in general, however, are only one of the seven tools to promote macroeconomic expansion. The other six tools do not require congressional action. The President appoints the Federal Reserve Chair and the Treasury Secretary (albeit with the advice and consent of the Senate).

Barack Obama reappointed Ben Bernanke as Chair of the Federal Reserve. And so Barack Obama's own choice as Federal Reserve Chair has let the quantitative-easing levers that the Federal Reserve controls sit idle for two years. Moreoever, it took more than a year for Obama to make more than one nomination to the Federal Reserve Board. For practically all of the time since his inauguration, Dan Tarullo has been the only person Obama has added to the Federal Reserve's Open Market Commitee.

Similarly, Tim Geithner is Obama's Treasury Secretary. And Tim Geithner's failure to make macroeconomically-relevant successes of the PPIP and the HAMP program are owned by Obama: the cossacks work for the czar. Now it is very difficult for a new Treasury Secretary to gain control of the Treasury building and get it to do much. And it is next to impossible for a a new Treasury Secretary to gain control of the Treasury building without confirmed deputies. But the Senate does not have to confirm deputies—that is what recess appointments are for.

A President Obama who valued policies to reduce unemployment rather than extending the hand of comity one more time to Republican senators would, I think, have gone about staffing the administration in a very different way.

Some blame for the current situation should, I think, properly fall on Barack Obama's economic advisors. It is true that he did not ask for a Plan B, or a Plan C. But they should have unified and provided him with one. Instead, as best as I can tell the economic policy advisors split in the second half of 2008. Peter Orszag called for putting the budget deficit on a downward path to restore business confidence and boost private investment. Lawrence Summers called for a large stimulative infrastructure investment program. Jared Bernstein thought that a payroll tax cut was the best road. Christina Romer favored aid to states to head off the then-forthcoming and now in-progress large state fiscal contraction. Timothy Geithner called for a bunch of little fiscal stimulative programs each of which would be dear to the heart of a different senator number 60, but which together would have wound up to something macroeconomically significant.

Without a common platform and a common set of priorities, they were defeated in detail. None of them, as best as I can tell, was happy with the drift of policy. But their unhappiness did not lead to action on the part of the administration.

There are issues of the span of control of the president, and there are issues of priorities. The job is hard. Bandwidth is limited. Macro recovery cannot take up all of your time. Financial reform, climate change, health care reform, international affairs, and so forth grab for time, and policy development time is scarce because the major tasks of the presidency are to explain what your policies are and to pick personnel, back them, and referee fights between them.

There are only 98 possible working hours in a week. A third of those have to go to coalition maintenance and ceremonial appearances. Another third have to go to explaining what you are trying to accomplish. That leaves a maximum of 30 hours a week to do policy.

There are huge numbers of priorities in addition to macroeconomic recovery. There is financial reform—which is not quite the same thing. There is climate change. There is health care reform. There are all the international affairs issues There is everything else. A president can spend only three hours a week on macroeconomic recovery, and there is not that much time in the legislative calendar and there is not that much time on the evening news.

Why Is Macro Recovery Moved to the Back Burner?

Nevertheless, it seemed at the time and seems even more so today extraordinarily strange that macroeconomic recovery was moved to the back burner after the passage of the Recovery Act. Even putting aside the question of the national interest as requiring quick action on those issues that genuinely will not wait, even a small concern for political survival and the ability to implement an agenda in 2011 and 2012 would have called for keeping macroeconomic recovery on the front burner throughout 2009 and 2010. The correlation between economic growth and electoral success not just at the presidential level but at the congressional-midterm level is well known. The correlation is strong. The difference between a rapid recovery and a jobless one is worth 20 seats in the House of Representatives in midterm elections.

Every pollster knows about the correlation between economic growth in the two and three quarters before an election and electoral success in it. So if there is one thing that the policy and the political and the message staffs in the White House should be able to all agree should not fade to the backburner, it is the macro recovery situation.

Yet it did.

Five Hypotheses

I simply cannot understand why the task of macroeconomic recovery was moved to the back burner in the Obama administration so very quickly.

This is the part of the talk where I go from simply needing therapy to actually asking for therapy. I am at a loss, All I can do is to throw out hypothesis. What pushed macro recovery to the bottom of the White House's agenda for so much of the past 28 months since the passage of the Recovery Act?

I do, however, have five hypotheses. All of these are speculative. I have no confidence that any of them are correct.

First, over the past generation the union movement in America has collapsed. This collapse of unions means that members of congress, executive-branch appointees, journalists, and other opinion makers rarely see people representing the interests of or even knowing much about what is going on in the bottom 90% of the American income distribution

My second hypothesis is like the first, but it focuses not on unions per se but on the general disconnection of Washington from the country. These days, it is said, the only place where it is hard to walk into a restaurant and immediately get a table is within a mile of Capitol Hill. The Washingtonians are prospering: for them and for the financiers of New York "recovery summer" is a reality. Their absence of close connection or even sustained contact with what is going on out in the periphery of the country means that they feel no sense of urgency about the macroeconomy at all.

My third hypothesis is that the failure to lend at a penalty rate broke confidence in the government's ability to do anything constructive at all, and greatly magnified the obstacles to further action. But it is hard to see how this influences the climate of opinion around Obama—and it is the climate of opinion around Obama that has led him to put macroeconomic recovery issues on the back burner that I want to explain and understand.

A fourth hypothesis is that Obama and his political advisors do not have a great deal of confidence in what their own economic advisors recommend because they see that the economics profession is badly split over a lot of crucial issues about how to generate a recovery. And it is certainly true that a great deal of the economics profession in America has behaved very badly indeed since the start of the financial crisis. They have helped to create a climate of ignorance, in which action to make things better requires that one start by rolling mammoth boulders uphill.

Here at Berkeley we are outraged at the Robert Lucases and Richard Posners claiming that Christina Romer must be corrupt for saying that the Recovery Act was likely to boost employment. Neither Lucas nor Posner has ever been able to elucidate any even half-plausible reason for why expansions in government spending would not boost demand. Both believe that expansionary monetary policy works because more money in people's pockets induces them to step up the pace of their spending. Why is a boost to the pace of the federal government's spending supposed to any worse at this than anyone else's? They have no answer because there is no answer.

Our reaction to Lucas and Posner is thus contempt and scorn.

We are annoyed at the Greg Mankiws saying that a tax-heavy Recovery Act would have been effective but the actual Recovery Act was not. Does he not know that the Recovery Act was 40 percent tax cuts? Does he not know that the multipliers he says he favors predict that the Recovery Act would been twice as effective at boosting employment as the multipliers the Obama administration used predict?

We are puzzled at the Niall Fergusons saying that there is nothing that ex-construction workers can do that is productive because they have no useful skills. We point out to him that employment held up absolutely fine for 18 months after the peak of the construction boom. As construction employment collapsed the workers shed from that industry had no problems finding other jobs, It is only after collapse of Lehman Brothers and the financial crisis that employment crashes—that is a sign that what we have is not structural unemployment but deficient demand unemployment.

And we are horrified when Barack Obama goes off message too, saying that because the private sector is cutting back the government needs to cut back too—therefore, Obama said, he is calling for a three-year freeze on non-security discretionary spending.

I complained about this last to Peter Orzag—who said that it did not matter substantively, that the tax side and the mandatory spending side of stimulus dwarfed whatever happened on non-security discretionary. He is correct. But from the perspective of building and maintaining a coalition to support Obama's policies it is disastrous, and inept.

Things could be worse. Obama is not Cameron or Clegg or Osborne. Bernanke is not Trichet. We are, I think, in much better policy shape than Europe—although in worse shape than East Asia ex-Japan.

Nietzschean Ressentiment

Let me mention one last hypothesis—one that may get my economist union card revoked and get me transferred to a department of rhetoric, or perhaps cultural studies.

Friedrich Nietzsche talked about the losers, or about those who thought they were the losers. He discussed their tendency in various ways to transvalue their values—to say that what was thought to be bad was in fact good precisely because it was thought to be bad.

Three weeks ago I was talking to some activists from the California Tea Party. I was trying to explain the Keynesian perspective: Shouldn't we keep public employment from falling," I said, "because right the government can borrow at such extraordinarily good terms, and if we keep our teachers at work then they educate our students and our students can earn more in the future—and if teachers have incomes they spend money and that employs more people in private sector?

And they said no.

They said: we have lost our jobs in the private sector. It is only fair for those who work in the government to run some risk of loosing their jobs as well. They are unionized. They have pensions. It is not fair that they should have jobs too. They need to lose their jobs as well.

Thus unemployment becomes something to be valued. The fact that government austerity will increase unemployment becomes a transvalued virtue of the policy

Or take mortgages. Right now a great deal of mortgages are underwater. The people living in the house and controlling its maintenance thus do not have a financial stake in the enterprise. When we used to talk about situations in which decision makers did not have a financial stake—well, we used to call that "socialism," and we used to think that it was bad. The capitalist thing to do is to write down the value of underwater mortgages. That is the way to get back to a situation in which the decision makers have a financial stake in their decisions. If we do not do that, then there is a gulf between the deciders on the one hand and the people who bear the costs on the other. Then we look forward to a future in which underwater homeowners pull out the copper pipes from the walls of their houses and sell them on eBay while West Nile virus breeds in the untreated swimming pools.

Here, once again, the response was: no. We lost our money when the stock market went down. We lost our money because the house we bought is worth less; we bought it at the peak. It is only fair that underwater home owners lose their houses. It would not be fair if they get to write down the value of their debts just because they owe more on their houses than they're worth.

Once again a transvaluation: we are bankrupt, and so more people need to become bankrupt to keep us company.

This Nietzschean hypothesis is the last that I have.

The Outlook

Let me conclude by saying that the future looks bleak.

The last two recessions before this one—the early 1990s and early 2000s recessions—both had a financial crisis component.

And after those recessions there were no visible signs of the magic of the market returning the economy to full employment through the economy's natural processes, at least not until something else new came along. In the case of the 1990s the new thing that came along was the dot-com bubble and the technology explosion. In the case of the 2000s the new thing that came along was the housing boom and the coming of mortgage securitization.

Thus I can see no reason to believe that there will be substantial private sector forces to push the employment-to-population ration up anywhere toward normal over the next several years. And we have shot ourselves in the head with respect to expansionary government policies. I see no possibility for any such on a large scale for the next two years, and possibly for longer.

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