

How to Fail to Recover

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Joseph Stiglitz



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Some people thought that Barack Obama's election would turn everything around for America. Because it has not, even after the passage of a huge stimulus bill, the presentation of a new program to deal with the underlying housing problem, and several plans to stabilize the financial system, some are even beginning to blame Obama and his team.

Obama, however, inherited an economy in freefall, and could not possibly have turned things around in the short time since his inauguration. President Bush seemed like a deer caught in the headlights—paralyzed, unable to do almost anything—for months before he left office. It is a relief that the United States finally has a president who can act, and what he has been doing will make a big difference.

Unfortunately, what he is doing is not enough. The stimulus package appears big—more than 2 percent of GDP per year—but one-third of it goes to tax cuts. And, with Americans facing a debt overhang, rapidly increasing unemployment (and the worst unemployment compensation system among major industrial countries), and falling asset prices, they are likely to save much of the tax cut.

Almost half of the stimulus simply offsets the contractionary effect of cutbacks at the state level. America's 50 states must maintain balanced budgets. The total shortfalls were estimated at \$150 billion a few months ago; now the number must be much larger—indeed, California alone faces a shortfall of \$40 billion.

Household savings are finally beginning to rise, which is good for the long-run health of household finances, but disastrous for economic growth. Meanwhile, investment and exports are plummeting as well. America's automatic stabilizers—the progressivity of our tax systems, the strength of our welfare system—have been greatly weakened, but they will provide some stimulus, as the expected fiscal deficit soars to 10 percent of GDP.

In short, the stimulus will strengthen America's economy, but it is probably not enough to restore robust growth. This is bad news for the rest of the world, too, for a strong global recovery requires a strong American economy.

The real failings in the Obama recovery program, however, lie not in the stimulus package but in its efforts to revive financial markets. America's failures provide important lessons to countries around the world, which are or will be facing increasing problems with their banks:

- **Delaying bank restructuring is costly**, in terms of both the eventual bailout costs and the damage to the overall economy in the interim.
- **Governments do not like to admit the full costs of the problem**, so they give the banking system

just enough to survive, but not enough to return it to health.

- **Confidence is important, but it must rest on sound fundamentals.** Policies must not be based on the fiction that good loans were made, and that the business acumen of financial-market leaders and regulators will be validated once confidence is restored.

- **Bankers can be expected to act in their self-interest on the basis of incentives.** Perverse incentives fueled excessive risk-taking, and banks that are near collapse but are too big to fail will engage in even more of it. Knowing that the government will pick up the pieces if necessary, they will postpone resolving mortgages and pay out billions in bonuses and dividends.

- **Socializing losses while privatizing gains is more worrisome than the consequences of nationalizing banks.** American taxpayers are getting an increasingly bad deal. In the first round of cash infusions, they got about \$0.67 in assets for every dollar they gave (though the assets were almost surely overvalued, and quickly fell in value). But in the recent cash infusions, it is estimated that Americans are getting \$0.25, or less, for every dollar. Bad terms mean a large national debt in the future. One reason we may be getting bad terms is that if we got fair value for our money, we would by now be the dominant shareholder in at least one of the major banks.

- **Don't confuse saving bankers and shareholders with saving banks.** America could have saved its banks, but let the shareholders go, for far less than it has spent.

- **Trickle-down economics almost never works.** Throwing money at banks hasn't helped homeowners: foreclosures continue to increase. Letting AIG fail might have hurt some systemically important institutions, but dealing with that would have been better than to gamble upwards of \$150 billion and hope that some of it might stick where it is important.

- **Lack of transparency got the U.S. financial system into this trouble.** Lack of transparency will not get it out. The Obama administration is promising to pick up losses to persuade hedge funds and other private investors to buy out banks' bad assets. But this will not establish "market prices," as the administration claims. With the government bearing losses, these are distorted prices. Bank losses have already occurred, and their gains must now come at taxpayers' expense. Bringing in hedge funds as third parties will simply increase the cost.

- **Better to be forward looking than backward looking,** focusing on reducing the risk of new loans and ensuring that funds create new lending capacity. Bygone are bygones. As a point of reference, \$700 billion provided to a new bank, leveraged 10 to 1, could have financed \$7 trillion of new loans.

The era of believing that something can be created out of nothing should be over. Short-sighted responses by politicians—who hope to get by with a deal that is small enough to please taxpayers and large enough to please the banks—will only prolong the problem. An impasse is looming. More money will be needed, but Americans are in no mood to provide it—certainly not on the terms that have been seen so far. The well of money may be running dry, and so, too, may be America's legendary optimism and hope.

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