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Responding to an Historic Economic Crisis: The Obama Program
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Introduction

I am glad to be here. This morning I want to describe our understanding of the root of our current economic crisis, talk about the rationale for the Administration's recovery strategy, and connect our longer-term economic strategy to the central objective of sustained and healthy expansion.

Economic downturns historically are of two types. Most of those in post-World War II-America have been a by-product of the Federal Reserve's efforts to control rising inflation. But an alternative source of recession comes from the spontaneous correction of financial excesses: the bursting of bubbles, de-leveraging in the financial sector, declining asset values, reduced demand, and reduced employment.

Unfortunately, our current situation reflects this latter, rarer kind of recession. On a global basis, $50 trillion dollars in global wealth has been erased over the last 18 months. This includes $7 trillion dollars in US stock market wealth which has vanished, and $6 trillion dollars in housing wealth that has been destroyed. Inevitably, this has led to declining demand, with GDP and employment now shrinking at among the most rapid rates since the second World War. 4.4 million jobs have already been lost and the unemployment rate now exceeds 8 percent.

Our single most important priority is bringing about economic recovery and ensuring that the next economic expansion, unlike it's predecessors, is fundamentally sound and not driven by financial excess.

<u>This is essential</u>. Without robust and sustained economic expansion, we will not achieve any other national goal. We will not be able to project strength globally or reduce poverty locally. We will not be able to expand access to higher education or affordable health care. We will not be able to raise incomes for middle class families or create opportunities for new small businesses to thrive.

And so today, I will explain the rationale behind the President's recovery program and our strategy for long-term economic growth. Our problems were not made in a day, or a month or a year, and they will not be solved quickly. But there is one enduring lesson in the history of financial crises: they all end.

I am confident that with the strong and sound policies the President has put forward and the passage of time, we will restore economic growth and regain financial stability, and find opportunity in this moment of crisis to assure that our future prosperity rests on a sound and sustainable foundation.

The Crisis

First, I'd like to describe how best to think about this crisis.

One of the most important lessons in any introductory economics course is that markets are self-stabilizing.

- When there is an excess supply of wheat, its price falls. Farmers grow less and others consume more. The market equilibrates.

- When the economy slows, interest rates fall. When interest rates fall, more people take advantage of credit, the economy speeds up, and the market equilibrates.

This is much of what Adam Smith had in mind when he talked about the "invisible hand."

However, it was a central insight of Keynes' General Theory that two or three times each century, the self-equilibrating properties of markets break down as stabilizing mechanisms are overwhelmed by vicious cycles. And the right economic metaphor becomes an avalanche rather than a thermostat. That is what we are experiencing right now.

- Declining asset prices lead to margin calls and de-leveraging, which leads to further declines in prices.

- Lower asset prices means banks hold less capital. Less capital means less lending. Less lending means lower asset prices.

- Falling home prices lead to foreclosures, which lead home prices to fall even further.

- A weakened financial system leads to less borrowing and spending which leads to a weakened economy, which leads to a weakened financial system.

- Lower incomes lead to less spending, which leads to less employment, which leads to lower incomes.

An abundance of greed and an absence of fear on Wall Street led some to make purchases – not based on the real value of assets, but on the faith that there would be another who would pay more for those assets. At the same time, the government turned a blind eye to these practices and their potential consequences for the economy as a whole. This is how a bubble is born. And in these moments, greed begets greed. The bubble grows.

Eventually, however, this process stops – and reverses. Prices fall. People sell. Instead of an expectation of new buyers, there is an expectation of new sellers. Greed gives way to fear. And this fear begets fear.

<u>This is the paradox at the heart of the financial crisis</u>. In the past few years, we've seen too much greed and too little fear; too much spending and not enough saving; too much borrowing and not enough worrying. Today, however, our problem is exactly the opposite.

It is this transition from an excess of greed to an excess of fear that President Roosevelt had in mind when he famously observed that the only thing we had to fear was fear itself. It is this transition that has happened in the United States today.

What is the task of policy in such an environment?

While greed is no virtue, entrepreneurship and the search for opportunity is what we need today. We need a program that breaks these vicious cycles. We need to instill the trust that allows opportunity to overcome fear and enables families and businesses to again imagine a brighter future. And we need to create this confidence without allowing it to lead to unstable complacency.

While the economy is falling far short today, perhaps a trillion dollars or more short, we should never lose sight of its potential. We have the most productive workers in the world, the greatest universities and capacity for innovation, an incredible amount of resilience, entrepreneurship, and flexibility, and the most diverse and creative population of any major economy.

One striking statistic suggests the magnitude of the opportunity that is before us in restoring our economy to its potential. Earlier this week, the Dow Jones Industrial Average, adjusting for inflation according to the standard Consumer Price Index, was at the same level as it was in 1966, when Brookings scholars Charlie Schultze and Arthur Okun were helping to preside over the American economy.

While there could be many ways to question this calculation, that the market would be at essentially the same real level as it was in 1966 when there were no PCs, no internet, no flexible manufacturing, no software industry, and when our workforce was half and our net capital stock was a third of what it is today, may be regarded by some as the sale of the century. For policy-makers, it suggests the magnitude of the gains from restoring sustained economic growth.

Producing recovery and harnessing these opportunities, however, will depend upon the choices we make now. This is what the President's program sets out to achieve.

Short-Term Recovery

Towards this end, the President is committed to an approach that moves aggressively on jobs, credit and housing, thereby attacking the vicious cycles I described earlier at each of their key nodes. In this effort, he has insisted that we all recognize that the risks of over-reaction are dwarfed by the risks of inaction.

Fiscal

The first component of the President's program is direct support for jobs and income to engage the multiplier process in favor of economic expansion. Increases in income lead to financial repair which supports further increases in income. Rising employment will lead to rising spending, which leads to further increases in income and employment.

The Recovery and Reinvestment Act is the largest peacetime economic expansion program in the country's history. It will inject nearly $800 billion into the economy, ¾ of it within the next 18 months. The Council of Economic Advisors' estimates suggest that the Recovery and Reinvestment Act will save or create 3.5 million jobs. It will at the same time do some of the work that the nation has needed done for a long time—doubling renewable energy capacity in the next 3 years, supporting middle class incomes, modernizing ten thousand schools, and making the largest investment in the spine of our national economy – the nation's infrastructure – since Dwight Eisenhower's investment 50 years ago.

Already, its impact is being felt by cops and teachers who would have been laid off but whose jobs have been saved—it may retain14,000 teachers in New York alone. It will, for most American workers, be felt in the coming weeks as withholding schedules are adjusted, in continuing unemployment insurance benefits and health benefits for hundreds-of-thousands of workers who already would have done without, and in contracting already underway with respect to tens-of-billions of dollars of infrastructure projects across the country.

It is surely too early to gauge the broader economic impact of the President's program. But it is modestly encouraging that since it began to take shape, consumer spending in the US, which was collapsing during the holiday season, appears, according to a number of indicators, to have stabilized.

Financial Stability Program

The second major portion of the President's strategy is the financial stability plan. It is directed at addressing the vicious cycles associated with de-leveraging and credit contraction. A strong flow of credit is necessary because factories need it to buy equipment, stores need it to stock their shelves, students need it to attend college, consumers need it to buy cars, and businesses need it to meet their payrolls.

The approach rests on two pillars: The first is a trillion dollars for financing or purchasing mortgages, student small business loans, and other financial instruments through the TALF (or what is now called the Consumer Business Lending Initiative), the GSEs, and public-private investment facilities that Secretary Geithner will be detailing in the weeks ahead.

Reactivating the capital markets is essential to realistic asset valuation, to restarting nonbank lending, and to enabling banks to divest toxic assets when they judge it appropriate.

The second pillar of the program is assuring that our banking system is well capitalized and in a position to lend on a substantial scale. The stress tests now underway will enable a realistic assessment of the position of each different institution and appropriate responses in each case to assure their ability to meet their commitments and lend on a substantial scale. And as the President said in his joint address to Congress, "When we learn that a major bank has serious problems, we will hold accountable those responsible, force the necessary adjustments, provide the support to clean up their balance sheets, and assure the continuity of a strong, viable institution that can serve our people and our economy."

As a result of government interventions in the financial markets, key credit spreads are already substantially narrower than they were last fall. There are some indications that the expectations of future actions have been a positive in reducing credit costs in a number of key areas. It is our hope and expectation that further support for capital markets, transparency with respect to the condition of banks, and infusion of capital into the banking system, will create virtuous circles in which stronger markets beget stronger financial institutions, which beget stronger markets, leading ultimately to financial and economic recovery.

Housing

The third component of the President's recovery strategy is addressing the housing market. The vicious cycle of rising foreclosures leading to declining home prices, leading to rising foreclosures – must be contained. This problem is at the heart of our economic crisis.

Through direct interventions, using the GSE's to bring down mortgage rates and make possible refinancings for credit-worthy borrowers who have lost their home equity as house prices decline, and through setting standards and providing significant financial subsidies for measures directed at payment relief to prevent foreclosures, we are achieving several objectives.

Housing wealth and its contribution to expenditures is being maintained. And critically lower mortgage rates mean more income for consumers, and function like tax cuts in support of consumer spending. Depending on market conditions the administration's program may save American households more than 150 billion dollars over the next 5 years.

Taken together, these steps to support incomes, increase the flow of credit, and normalize housing market conditions address each of the vicious cycles that is leading to decline.

With the passage of time, it will permit the re-engagement of the normal processes of economic growth: rising incomes and employment, greater credit flows, increased spending, a stronger US economy and a stronger global economy. They will reinforce crucial dynamics that will also operate to promote recovery.

For example, about 14 million new car sales are necessary for replacement and to accommodate rising population growth. Yet car sales are now running at an annual rate of about 9 million. New household formation requires something like 1.7 million new housing units a year and housing starts are now running about 400,000 a year. Once the inventory is worked off, investment will increase. Historical experience suggests that rapid inventory decline such as we have observed in recent months is followed by increased production to rebuild inventories.

Long-Term Investment

Of fundamental importance is ensuring that we do not exchange a painful recession for another unsustainable expansion. That would not only be irresponsible – it would be counterproductive. We have seen what happens when we pursue policies that produce short-term, instead of durable and sustainable growth.

We have seen housing prices reach unsustainably high levels and credit spreads reach unsustainably low levels in the middle of this decade. And we saw bubbles in technology in the late 1990s.

Bubble driven economic growth is problematic because of disruption and dislocation – affecting those who took part in the bubble's excesses and those who did not. And, it is not entirely healthy even while it lasts. Between 2000 and 2007 – a period of solid aggregate economic growth – the typical working-age household saw their income decline by nearly $2000. The decline in middle-class incomes even as the incomes of the top 1% skyrocketed has a number of causes, but one of them is surely rising asset prices and the fact that financial sector profits exploded to the point to where they represented 40% of all corporate profits in 2006.

Confidence today will be enhanced if we put measures in place that assure that the coming expansion will be more sustainable and fair in the distribution of benefits than its predecessor. That is why the President has priorities that go beyond the immediate goal of containing the downturn and promoting recovery.

Financial Regulatory Reform

An overhaul of our financial regulatory system is one such priority. In little more than two decades, we've witnessed the stock market crash of 1987, the Savings and Loan scandals, the decline of the real estate market, the rapid decline of Asian markets, the collapse of the NASDAQ telecom bubble, Enron, Long Term Capital Management, and today's crisis. This is roughly one crisis every 2.5 years. We can and must do better.

There is room for debate about how regulation should be enhanced, but not about whether we can stay with the status quo. Treasury Secretary Geithner will be laying out the Administration's approach in some detail in the coming weeks and the President is eager to take this issue up with his fellow leaders at the April G-20 meeting. While the discussion can get pretty technical quickly, some things should be clear:

- Regulatory agencies should never be placed in competition for the privilege of regulating particular financial institutions.

- Globally, the United States must lead a leveling-up of regulatory standards, not as has happened all too often in the recent past, trying to win a race to the bottom.

- No substantially interconnected institution or market on which the system depends should be free from rigorous public scrutiny.

- Required levels of capital and liquidity must be set with a view toward protecting the system, even in very difficult times.

- And there must be far more vigorous and serious efforts to discourage improper risk taking through transparency and accountability for errors.

Fiscal Discipline

An additional requirement for financial stability is that the government's own finances be stable. When I left Washington eight years ago, people were debating what to do when there was no more federal debt. That is hardly our problem today. I hope that all of those who participate in the debate over this year's budget, whether they agree or disagree with President Obama's priorities, will share his commitment to truthful and realistic budgeting and fiscal sustainability to ensure that after recovery, the ratio of the nation's debt to its income stabilizes.

Sources of Sustainable Growth: Exports, Healthcare, Energy, Education

If growth in the coming years is not to be driven by asset price inflation-induced consumption, other engines of growth must be identified. These forms of growth should be sustainable and shared by the majority of American households.

Stronger exports are one sound foundation for sustainable expansion. That is why along with strengthening financial regulation, the President will be working on the global growth strategy at the G20. Priorities will include spurring demand around the world and assuring the adequacy of funding for emerging markets.

These are issues both for global recovery - at a time when 2009 is likely to be the first year of negative global growth since the Second World War - and for a healthy, less debt-dependent US expansion.

But moving away from foreign debt-financed growth is only one component of ensuring a healthy expansion. An additional component is addressing our healthcare system. It is no accident that the period of the most rapidly rising wages for middle income families was the 1990s when healthcare cost inflation was relatively well controlled. Our ability to produce competitively in the United States will be enhanced if we contain healthcare costs. I have heard it said that GM's largest supplier is not a parts company or a tire company, but Blue Cross Blue Shield.

Containing healthcare costs help keep the economy sustainable and so does improving quality and access. A study I helped sponsor while at Harvard demonstrated that less than 1 in 4 Americans with hypertension had it under control. This means huge costs for treating strokes down the road as well as children who will never know their grandparents. By investing in healthcare now, we can make our economy, as well as our people, healthier. We will also increase confidence in the ultimate stability of the nation's finances.

An equally important engine of recovery can be investment in reducing our energy vulnerability and our contribution to climate change. That is why the Recovery and Reinvestment Act provided for doubling renewable energy and weatherizing 75 percent of federal buildings. It is also why the President's budget points toward strong action to implement a market-based cap-and-trade system, after the economy recovers, beginning in 2012.

Let's be realistic. Sooner or later we will have to reduce our dependence on foreign energy and contain our carbon emissions. As Federal Reserve Chairman Ben Bernanke's doctoral thesis demonstrated 30 years ago, unresolved uncertainty can be a major inhibitor of investment. If energy prices will trend higher, you invest one way; if energy prices will be lower, you invest a different way. But if you don't know what prices will do, often you do not invest at all. That is why we must move forward as rapidly as possible to reduce uncertainty and carefully create a new cap-and-trade regime.

There is another benefit as well. As many enlightened business leaders have recognized, the confident expectation that pricing policy will discourage carbon use in the future will spur a whole range of green investments in the present, when our economy can benefit from all the investment it can get. And in the long run, we believe this will create millions of new jobs. And the evidence is clear: we can choose to lead these industries, with all the commensurate economic and political and environmental benefits, or we can choose to lose out on these jobs and these opportunities.

Finally, while America's education system may not be directly implicated in the current economic crisis, it is surely the case that improving it is essential to the long-run growth of the economy and to ensuring that this growth is shared, lifting up more families who get the opportunities afforded by a better education and expanded access to college.

Conclusion

I've spoken in the language of economists and economic policy – budgets and prices, capitalization and interest rates. That is because I believe there is no substitute for careful analysis in setting economic policy. But as we debate these abstractions, we must always keep in mind that our economic policies affect real lives – and economic problems cause real pain.

The decisions we make will determine whether children will look to their parents with pride when they come home from work – or fear that their home will be lost. Whether families will experience the prosperity this nation is capable of producing, or the disruption and dislocation that too many have found instead.

President Obama inherited an economy in crisis. This is not a crisis we sought – nor is it one we created. But it is one, under the President's leadership, that we have answered. The Obama Administration is embarking on what I believe is the boldest economic program to promote recovery and expansion in two generations. No one can know just when its positive effects will be fully felt. No one can predict when this crisis will be resolved. But in resolution, I am confident there is enormous opportunity for both Americans and for the United States of America. We can and we will emerge more prosperous, stronger, wiser, and better prepared for the future.

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