

The New
REPUBLIC

Published on *The New Republic* (<http://www.tnr.com>)

A Former Clinton Official on How Obama Isn't Doing Enough for the Economy

Robert Shapiro August 26, 2011 | 12:00 am



This article is a contribution to 'Is There Anything That Can Be Done? A TNR Symposium On The Economy.' [Click here to read other contributions to the series.](#)

The persistent sluggishness of the recovery here in the United States and in most of the world's advanced economies should underscore a stark lesson from economic history: Systemic financial crises are the products of deep economic problems, and they can't be solved by simply treating the after-effects of slow growth. It's long overdue that the United States and Europe directly address the deep market distortions that brought about the crisis of 2008 and 2009.

So far, all we've done is substitute large doses of fiscal and monetary stimulus for the hard work. We shouldn't have been surprised that once the stimulus played out, the same distortions reasserted themselves. We may technically be experiencing a recovery. But unless we're more forthright in our interventions into both the housing and financial markets—on both the international and domestic stage—we'll remain exposed to the possibility of a renewed crisis, one even more severe than the one that began three years ago.

These considerations don't drive policy, in part because so many economists still see the crisis as an anomaly, one that will be followed in due course by markets reasserting their natural optimality. This view, of course, ignores or slights the overwhelming evidence of how inefficiently and "sub-optimally" the financial and housing markets have performed for years. U.S. and European financial markets have systematically failed to reasonably price the risks of trillions of dollars of derivative securities; housing markets here and across much of Europe have sustained a classic speculative bubble and equally classic crash.

Our current predicament has as much to do with our own lame responses to the consequent crisis, as it does with the original crisis itself. Washington provided bailouts and virtually-free credit for financial institutions without applying requirements to how

that new-found money ought to be used. There also were new housing initiatives, but based on a fanciful view that a little federal money would be enough to convince bankers to extend new credit to people on the brink of default. Finally, there was a substantial fiscal stimulus cobbled together from the wish lists of hundreds of members of Congress.

The results are now clear in the data. Financial institutions amassed trillions of dollars without expanding business lending, mainly because the financial-market distortions that brought on the crisis are still with us. These institutions are still holding trillions of dollars in wobbly asset-based securities, whose risks even now they cannot reasonably price. So they sit on most of their new capital (after paying out their bonuses) in hopes of avoiding another bout of bankruptcy from those assets, should another crisis erupt. Yet, the prospect of new legislation to sustainably resolve those weak assets by pulling them off the books—as Sweden did in its early-1990s banking crisis, and we did in the S&L crisis of 1989-1990—is nonexistent.

The prospect of another imminent crisis on the horizon ought to put the necessary policies into relief. One initiative that cannot wait: President Obama should call an emergency G-8 meeting to help head off a new financial meltdown in Europe. The sobering fact is that many of Europe's largest banks are nearly insolvent. It's a legacy from not only the 2008-2009 meltdown, but also the EU's decision in 2007 to reduce bank capital requirements under the level set by the "Basel 2" accords. Americans benefited from the fact that our own banking regulators dawdled in making similar changes desired by the Bush administration, by which time even the Bush Treasury had doubts about cutting capital requirements. The result today is that the German and French banking systems in particular are in much worse shape than Wall Street.

Now these weak banks face additional, large-scale losses from the falling values of Italian and Spanish government bonds, a contagion from the now-anticipated defaults of Greek and Portuguese public sovereign debt. If this turmoil intensifies, it will probably pull down some of Europe's largest banks. And if institutions such as BNP Paribas and Deutsche Bank (the world's two largest banks) fail, the U.S. and global economies would probably follow. Moreover, this time, the consequences would be even more dire than in 2008-2009, since governments have already exhausted their fiscal and monetary policy options.

We can still head off a 1931 scenario if Germany and France will accept the inevitable and obvious: A common Euro currency requires that every member pledge its full faith and credit for Eurobonds to support the full faith and credit of everybody else. Otherwise, the failure of a small member (today, Greece and/or Portugal) can destroy confidence in the economic sustainability of much larger members (Italy and Spain). And then, everybody's goose is cooked.

The political catch is that the solution puts French and German taxpayers on the hook to bail out fiscally-inept Greece and Portugal. Chancellor Merkel and President Sarkozy have tried to avoid the political blowback from introducing Eurobonds by trotting out smaller options. It is a decision that hearkens to the Bush administration's attempts to avoid bailing out Lehman Brothers. Investors aren't buying it. So if Greece goes down now, Sarkozy and Merkel will be forced to rescue Italy and Spain—and perhaps France itself—at incalculably greater cost to everyone.

President Obama should not delay to call for a G8 meeting; Europe needs to hear that the United States considers its current course unacceptable, and that Washington would be ready to help fund IMF support for a broader solution that can head off another full-blown crisis.

If we intervened to put Europe back on course and thus managed to avoid a catastrophic global depression of the sort the world experienced in 1931, we still would be facing the prospect of a persistently slow economy. Preventing that kind of long-term stagnation would require that we finally address the distortions in the housing market by stabilizing housing prices. Policymakers' most promising avenue to that end would be to focus on bringing down foreclosure rates and keeping American families in their homes.

There is no doubt that housing prices are central to our current growth dilemma. People spend freely when their incomes are rising or their wealth is increasing. During the last expansion, and leading up to the current crisis, the incomes of most Americans stagnated. Instead, growth and business investment were driven mainly by the "wealth effect" created by fast-rising housing values. Now, the economy is caught in the flip-side, as four years of sliding housing prices drive a powerful negative

wealth effect that continues to hold down consumption.

The broad reach of these effects reflects how wealth is now distributed in the United States: According to Fed data for 2007, the bottom 80 percent of American households held 40 percent of the value of all real estate assets, compared to a miserable seven percent of the total value of all financial assets (and yes, that includes pensions). Home equity, in short, is very nearly the only real asset for more than half of all Americans. The decision to allow housing values to fall for four straight years—in contrast to the equity and bonds of large financial institutions—leaves the majority of American consumers growing poorer month after month. Just as people who grow richer spend more, people who find themselves poorer spend less. So, consumer demand and with it business investment will not recover until housing values stabilize.

To help make that happen, policymakers could establish a temporary loan program for homeowners whose mortgages are in trouble, to help bring down foreclosure rates and so begin to stabilize housing prices and stem the negative wealth effect. The program should not be a giveaway; if it were, it would create enormous moral hazard and enrage everyone who works hard to keep up their own mortgages. So, the loans would carry an interest rate above current 30-year mortgage rates, and those who take advantage of them would have to turn back to taxpayers a share of any capital gains earned later from selling their homes.

It's very important that we get this right. Unfortunately, the signs from Washington right now aren't promising. The Obama administration reportedly is considering a program to promote large-scale mortgage refinancings at the current, low fixed rates. If it worked, lower mortgage payments could free up an estimated \$85 billion for consumers. But since those whose mortgages are in trouble probably wouldn't qualify, the refinancing program would inject only a little stimulus without affecting housing values. That means it would leave intact the current, negative wealth effect.

Waiting for the markets to begin acting rationally again is a fool's errand. The economy will only right itself when housing values stabilize and distortions in Wall Street's and Europe's financial systems have been addressed. We will need to intervene actively, on both domestic and international fronts, to restore consumer demand and business investment—and with them, President Obama's prospects for reelection.

Robert Shapiro, former Under Secretary of Commerce for Economic Affairs under President Clinton, is the chairman of the economic advisory firm Sonecon, an advisor to the IMF, and the chair of the Globalization Initiative at NDN.

Source URL: <http://www.tnr.com/article/94233/shapiro-obama-housing-europe-economy>