Economic Policy for the Incoming Administration

The incoming Obama Administration carries two, often-contradictory drivers in formulating its economic policy: its campaign rhetoric for "change" and the need for a pragmatic program to deal with a growing economic slump. To put it bluntly, Obama must fashion policies that deal with the current economic distress while not dashing the hopes for a vast reordering of economic and social priorities that his campaign engendered. This will not be easy since policies that address the economy's decline may not satisfy many of his campaign promises. Only a successful restart of the economy can lead to the promised changes.

What will it take to right the current economic nightmare? As yet, that is not clear. Only a few months ago, the Secretary of the Treasury asked for an unprecedented amount of financial power (some seven hundred billion dollars) based on the argument if he had adequate authority, he would have to use less of it (the famed "bazooka" metaphor). The combined actions of the Fed, the Treasury, and the FDIC have gone well beyond what was initially thought to be sufficient to restore confidence by investors and spenders. Yet, the underlying credit mechanism that governs financial flows in the economy remains in terrible shape.

Business loans are hard to come by. The interbank lending market has revived only through credit guarantees offered by monetary authorities here and abroad. The commercial paper market is functional only to the extent that the monetary authorities have buttressed it with substantial guarantees Financing of auto sales, retail sales, credit cards and even student loans is tenuous at best. Day to day business credit is largely paralyzed. Yield spreads in the corporate sector are at historically high levels and the IPO market for financing young companies is moribund. The Fed has driven the Federal funds rate to zero by resorting to quantitative easing to forestall any hint of a banking collapse. Still, these funds have not easily flowed into the household and business sector. Confidence has waned and business is now cutting back inventories and fixed investment, intensifying the collapse in consumer spending that diminished employment prospects have produced. The extent of the confidence collapse is perhaps best indicated by short term Treasuries with negative interest rates, aping the Japanese experience of a few years ago. Japan's credit collapse was once seen as a ***sui generis*** economic phenomenon, but perhaps it was only a forerunner of what can happen in a modern financial system? What was initially seen as a recession appears to

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be morphing into a much more serious economic downturn, perhaps approaching that of the 1930's.

A Steep Recession or Worse?

In a recent symposium held at the Kennedy Center at Harvard for incoming freshmen legislators, Professor Gregory Mankiw offered up a little known tidbit of economic history. In the early days of the Roosevelt Administration, the basic economic outlook was one of sharp cyclic decline, not a world-wide, decade- gripping depression. Yet, the period from 1933-1941 turned into the bleakest period in American economic history. Furthermore, despite a legion of New Deal reform measures, the U.S. did not pull out of the Great Depression before World War II took away most of our domestic policy options. The financial needs of the war obviated our choices between guns and butter. Policy was reduced to producing guns, rather than butter, with perhaps a little margarine thrown-in.

Today's prevailing consensus of economic opinion is that this recession is likely to be severe, perhaps the most severe economic setback of the post World War II period, but that another "great depression" is not the most likely outcome. The consensus could be wrong. As each wave of policy response falls short, the call for even stronger measures will dominate policy choice. In our view, the Obama policy team is more likely to recommend even more severe measures than what now appear in the offing for fear of "falling short." This has to mean a much larger hand for government in the management of economic affairs in the United States. It also means that defining an exit strategy from the current malaise will become both more difficult and more delayed. That environment will tend to make Obama's longer run economic strategy more difficult to predict.

Strategy in an economic emergency often resembles strategy in a military crisis and it often fails for similar reasons. First, a clear definition of the objective is required (goals). Then, a rational assessment of respective forces must be made (opposing forces). Next, the means of achieving the chosen objective (deployment) must be specified. Finally, a careful parsing of an exit strategy is required (the end game), as recent geopolitics has reaffirmed. As the calls for more Government assistance increase, the capability to define an exit strategy becomes more remote. Ignoring the need to clearly define an exit strategy has often meant snatching defeat from the jaws of victory in military affairs. It may be no different in this economic emergency.

It is surely the case that Obama-led policy measures will substantially increase the Federal Government's involvement in the economy dramatically. The dilemma for Obama policy makers is acute. First they must use enough government measures to stop the decline and resume growth. At some point, unless the economy is to be totally socialized, they must pull these measures back and allow markets to function once again. There is no clear science available to these advisors to tell them the precise amount of government intervention that can achieve restoration of economic growth. That has meant that discussion of an agreed upon course of action to return the economy to its primary market orientation is on a back burner and essentially absent from the public discourse. But, without a clear specification of the role of government in the economy going forward, what are we to make of the campaign promises to take care of the middle class?

"Change You Can Believe In"

The Obama campaign used the mantra of "change you can believe in" and that slogan encompassed a profound re-ordering of domestic and international economic goals. He made the needs of the "middle class" a top priority and he coded that priority by the hyperbolic distinction he drew between benefits to "Main Street" as opposed to "Wall Street." The distinction is confusing at best and disingenuous at worst. The distinction has the power to push the organization of the economy into paths from which it can never emerge. The immense loss of confidence that is readily apparent in credit markets and the flight to safety that has pushed treasury yields below zero will both tempt the application of even more severe economic intervention and may well delay the ability of the private economy to resume normal economic activity. There is a point down the road of government management in economic affairs where the path back to economic normality can be essentially blocked. Is an economy controlled by Government the likely outcome of this trial and error process?

It is clear that resumption of strong economic growth will require the repair of our financial system, but it is unclear how monetary and fiscal measures now deployed can be easily retracted and a return to a "normal" state of economic management resumed, that is to say with the primacy of the private economy. The Japanese case is illustrative in this regard. Despite a large application of quantitative easing that pushed short term interest rates to zero in early 1999 and kept them there for about six and a half years (excepting the famous seven month Hayami "interlude" where rates moved up a quarter of one percent). Deflationary forces remained, however, in the Japanese economy for more than seven years. Japanese economic growth never regained a sustainable upward trend, except in 2006, and recently has begun sliding downward once gain. Abstracting from the growth in Japanese exports, stimulated by the rise of China and growth in the U.S., there was little evidence of strong, domestic led growth in Japan throughout the past decade. The historical record in other advanced countries is also not exactly reassuring for those who hope that a kaleidoscopic restructuring in the roles of the government and private sector will not occur as a result of current government rescue efforts.

Main Street and Wall Street

The Obama policy team surely knows that without resumed economic growth, there can be no successful address to middle class issues that they have championed. Resumed economic growth will require a functioning credit system and it is impossible to see how the private credit system can be repaired without the efforts of Wall Street and other financial centers. Main Street and Wall Street are not, as the campaign rhetoric sometimes suggested, separate policy options. To repair Main Street will require the repair of Wall Street, unless we assume Government is going to be the central finance mechanism of the future.

Much of the criticism of Wall Street stems from the apparently high rewards earned by senior Wall Street executives, particularly during the evolution of the mortgage market fiascos of 2007/2008. To the extent that excessive risk behavior of financial institutions was the core of the problem, that risk posture was enhanced by a long period of easy credit in an (unfamiliar) environment of global finance, insufficiently restrained by suitable corporate governance. If and when the economy is restored to health, monetary authorities will have to address the moral hazards they may have unleashed during the past decade. That is neither a partisan issue nor is it one that Main Street will find easy to understand. Demonizing Wall Street excess will not help to understand needed corrections. Similarly, creating a better system of corporate governance is no easy task and one likely to fall to the bottom of a priority list devoted to restarting the economy. Pillorying Wall Street is not a step on the road to understanding the dilemma that full employment policies create. Corporate governance issues are not confined to Wall Street. We see them in Detroit and elsewhere repeatedly. For too long, American managerial capitalism has allowed risk boundaries to be set by managers unrestrained by active and thoughtful boards of directors.

Policy Moves Limited by International Considerations

Obama has been quite clear that he has a strong commitment to reorder the distribution of income and wealth in the U.S., using expenditure and taxation measures to further that redistributive aim. He has also evinced a nearly religious dedication to environmental issues---shorthand for confronting climate change. Efforts to confront climate change were tied closely during the campaign into his prescriptions on national energy, security, regulatory, as well as tax and expenditure policies. Environmental issues transcend national boundaries and cannot be remediated solely by domestic policy measures. Obama knows, even if the electorate sometimes forgets, that policies to slow down climate change will require an international consensus that does not yet exist. That will not happen in his first 100 Days, perhaps not even during the entire first term. Nations around the world do not agree on the priorities embedded in the Obama climate massage. Negotiations on these issues are likely to be lengthy and not entirely satisfactory. Because of the seriousness of the current economic situation, dramatic improvements in global environmental policies will surely rank behind restoring economic growth.

As he enters office, his economic policy agenda can no longer be mere political rhetoric. He has to deal with an economy that is declining rapidly while the world economy declines as well. Economic pundits who claimed that a decline in the U.S. did not entail declines in the emerging and fast growing markets of the world are now confronted with facts to the contrary. The "decoupling hypothesis" has turned out to be a myth. Interdependence rules in bad times as well as good. That recognition must inform the Obama administration if it is to avoid "beggar thy neighbor' policies which damaged recovery attempts during the Great Depression.

In short, policy making for the Obama Administration can no longer afford rhetorical indulgence. Pragmatic efforts are required to arrest the economic decline and rekindle economic growth here at home. It is "the economy, stupid," to use that memorable phrase of his Democratic predecessor, that must command his utmost attention. How artful a politician he is will be measured by how successful he is in restoring this country to economic health while still holding onto to his mantra of "change." He has a very tough mission indeed.

Financial Crisis and Beggar Thy Neighbor Appeals

Clearly, the overriding theme of the present disturbance is a massive financial crisis that has left no financial market untouched around the globe. In a global context, 'beggar thy neighbor' remedies become more dangerous in spite constituent pressure to benefit the middle class. Trade policy provides a clear example. During the campaign there was much talk that trade agreements must be modified to encompass "fair" rather than "free" trade. Restricting international trade for domestic political concerns was tried by the previous Administration, but the Obama Administration would be wise to avoid this tactic. The fair trade--free trade dichotomy posits a false option for Obama policy makers similar to the Main Street-Wall Street distinction. Fair trade policies that punish foreign exports to the United States will surely trigger restrictions on our own export industries. Furthermore, as our financial system tries to rebuild, fair trade measures will undoubtedly redound to the disadvantage of our financial institutions. The Clinton years' focus on free trade was wise, and adoption of that same attitude will give Obama a larger purchase from which to rebuild international cooperation in foreign policy. Obama has already shown he can accommodate a Clinton in the new administration. Perhaps he will also shift gears to a more Clintonesque view on trade issues?

Ironically, for a country that has always led the fire brigade when financial contagion threatened to burn down the world economy, the current U.S. financial meltdown is now at the center of a world financial crisis. It is first and foremost a home fire and extinguishing it here will help the entire global economy. What started as malaise in the U.S. private housing market has now spread world wide into every financial market. The rest of the world has levitated to financial events here and will continue to do so for years to come. To gain traction in correcting financial issues here is paramount to resurrecting financial institutions abroad that are needed for a full global recovery. The danger is that the new government will forget this maxim and begin once again trying to hector others on their own economic domestic policies. That would be an unproductive tactic that will divert our attention from what we can do for ourselves. It creates the false illusion that only if others adopt our recommended policies for themselves, will it be possible for us to recover. That is a false model of the choices that are truly open to us.

A major case in point is our economic stance toward China. If we begin by attacking

Chinese exchange rate policies, we will weaken our connection to a major and financial trading partner. Publicizing them to the American electorate in order to demonstrate concern for the "middle class" will create risks on the slippery slope of economic nationalism. The Chinese are already aware of the problems that an overreliance on exports has created for their economy. Their exports are actually now declining. They may not see an easy route to correcting them by a rapid increase in domestic expenditures although such a plan has been promulgated. Banging the drum on Chinese exchange rate policy is a modality that Obama needs to avoid.

Policies for a Global Age

Whatever its ultimate outcome, this is the most global financial crisis since the Great Depression. In some ways, it is far more severe----at this stage of its development----precisely because world financial interdependence has grown so large. The share of traded goods in world output has grown markedly over the past sixty years, indicating that world trade has grown far faster than world output. Financial linkages have grown even faster than the markets for goods, and financial ties are now far deeper than ever before. Finance is global, for better or for worse, a fact that Obama's election mantra of paying close attention to the middle class cannot overcome. What Washington chooses to do on economic policy will affect the entire global economy. Likewise, what he chooses to do on international policy issues such as energy and the environment will be conditioned by the response of many other countries to his menu of economic policies.

To be successful internationally, then, he must begin to separate himself from the rhetoric of the campaign and become an effective spokesman for international cooperation. There is great power in this interdependence, but there is also great danger. If poor policies are chosen, policies that are fundamentally 'beggar thy neighbor' in their impact, whether because of inappropriate vision or for an inability to convince the Congress to move with the President, the consequences will be felt not only on Main Street, but on Every Street throughout the globe.

We do not know if we are at the abyss of another Great Depression, but this President cannot take the chance that current prognostications are once again wrong. Policy has to start from the presumption that this slump can get worse if not appropriately treated. Policy has to start from the knowledge that the bigger the slump here, the greater the impact around the world. Because the global economy is a fact of life which we cannot ignore, the Obama Administration needs to avoid framing the discussion or the policy alternatives in narrow, overly domestic terms. Narrowly framed policy, policy, focused only on the difficulties of America's Main Street, will ignore the truly international role played by this country in an interdependent, global economy. Narrowly conceived policy has its own malignant history, as the Smoot Hawley tariff once demonstrated. It is a mistaken road that we can only hope this 'domestically oriented' American President will not take. It is the policy equivalent of a "bridge to nowhere."

To come out at the end of this dark passage, the U.S. cannot afford to use too little economic weaponry nor can it fail to set sensible ground rules for the longer term financial health of the nation. Those ground rules must include a defined exit strategy. The main presumption of the Obama policy team is that fiscal policy is the ***sine qua non*** for economic recovery. Some economists disagree that the only way out is a strong fiscal response, believing that aggressive monetary policy, particularly quantitative easing measures, will ultimately restore our credit economy. There is an added virtue in using monetary measures in that they can be scaled back as recovery occurs without leaving a permanent imprint on the financial sector. Unfortunately, that argument is now probably moot. The predominant view of the Obama policy advisors is that a vast expansion of fiscal measures is required to restore adequate aggregate demand. Our own history during the 1930's should caution us over the efficacy of this view, but it probably will not. The fire alarms are ringing and the engines are already racing out of the station.

Even if it is assumed that fiscal measures are required, if the goal is sustainable economic growth, then permanent changes in tax policies are likely to be far more effective than transitory assistance to personal disposable income. If government expenditures are deemed necessary to confront sagging aggregate demand, the Obama team needs to be quite clear what they are wishing for: an expansion in demand or a selected set of bridges to finance! Once fiscal action, particularly expenditure moves are set, they are very hard to reverse.

This President also wishes to use tax policy as a redistributive force. That is likely produce not only more of the same tinkering that has made a shambles of any rational tax policy, but in addition it is likely to concatenate the goal of tax reform and tax fairness to the detriment of both objectives. The root issue, which often escapes serious policy debate, is that the U.S. income tax code is a scandal in its own right. It is the result of constant pressure from separate interests to gerrymander the fiscal regime for their own benefit. The result is tax policy that is both inconsistent and counter-productive.

What is needed is a tax policy focused on consumption, rather than taxes on factor income. This would be a monumental change in the American economy that has significant upsides. Moving there, however, would mean giving up various shibboleths of Democratic Party tax policies of the past. It would mean treating the corporation for what it was, a legal fiction, and focusing on the detrimental aspects of the corporate tax.

Most economists, including the bevy of talent recruited by this Administration, are aware that the corporate tax falls significantly on labor (roughly in the proportion that labor makes up in total value added or approximately 70%). The candidate of “change” could use the Bully Pulpit to make a strong effort to educate the population about the fallacy of the burden of the corporate income tax. It falls most heavily on that “middle class,” which has elected this President. It mistakenly taxes the “good guys,” although it is always portrayed as just the opposite, and it illustrates in the extreme why policies that try to excoriate the “rich” and be “fair” to the poor, often result in just the opposite outcome. We think that is extremely unlikely.

By the same token, but perhaps easier to understand, taxing labor at the payroll level may be an ingenious way of collecting taxes, but it creates perverse incentives for an economy wishing to add employment. The fairest tax regime would be to abolish both the income tax and the payroll tax (for employees as well as employers) and move straight to a consumption tax. That tax can be made progressive, if demands for ‘fairness’ require it, but the key is to make it totally broad and totally inescapable.

Finally, because the long term fiscal health of this country does indeed depend upon raising total national savings, abolishing the capital gains tax and becoming totally dependent upon a consumption tax regime, would be a huge change for the better, but one we are not likely to see. Capital gains are associated with the “rich,” even if we now have the largest participation in the stock market by individuals in the history of the country.

The financial crisis of 2007/2008 has resulted in a decimation of American private wealth. Personal household savings, pension plans, 401k's, equities, bonds and real estate have all been severely damaged. It will take years to cure these losses. Ending taxes on capital gains would immeasurably help that recovery and should be applauded by teachers, firemen, farmers and special interests of every kind. To do that would take a truly raw act of political courage and require a vast education of the voting public. Is such a change in the wind? We doubt it, but the scope of the current crisis does bring forth opportunities for drastic change. The question is whether there is sufficient leadership to support it?

Regulation or Enforcement

That brings us to the regulatory agenda and the legacy that the rhetoric of the campaign has left. The critique of many has been that a vast expansion in regulation is needed because the predecessor Administration ignored any serious attempt at regulation. It did not regulate mortgage-making that has caused so much trouble. It did not regulate the activities of commercial and investment banks that have now become the poster children for the finance bazooka wielded by the Treasury. It did not regulate insurance companies that took unheard of risk with little in the way of sufficient capital adequacy. And, as the latest manifestation of this crisis reveals, the Madoff Affair proves that the SEC was completely blindsided while the public was traduced. The real issue is, however, whether we need more regulations or do we need clear enforcement guidelines that are adhered to regardless of political consequences?

In our view, the typical call for more regulation is based on a canard of high order that more regulation will prevent financial scandal. The predecessor regime created an extensive regulatory apparatus (Sarbanes-Oxley) for the public securities industry. What failed was not sufficient regulation but sufficient enforcement. The regulations already on the books would have prevented much of the malaise we are currently experiencing, but that would have required regular and systematic enforcement by the relevant regulatory agencies of the government. Rather than adding to regulatory complexity with new laws, never well understood, this Administration could easily just make it a national policy to uniformly enforce the regulations already on the books. That would apply to the prime regulators: the SEC, the bank regulators (at the Fed and at the Treasury) and the other regulatory agencies that have abandoned the enforcement of their own statutes. A good policy would be for the new President to explain just what it means to enforce the law and then to demand that his new appointees create an enforcement agenda that is widely publicized and widely followed.

In the process of a growing determination by the Fed and the Treasury to put out the financial fires, the U.S. has created a nearly nationalized banking system; it has created a national credit guarantee program; and, it is now setting mortgage interest rates by intervening directly in the mortgage market. If the auto company bailout proceeds, the government will at the least be overseeing one of this country's largest industries with consequences for our entire productive structure as well as the financial underpinning of auto production and distribution in the U.S.

For an institution not known for managerial capability, the U.S. government will now become the world's largest economic manager. That is not clearly a prospect to be welcomed. Running the Post Office as a monopoly supplier of first class mail has shown no evidence that Government operates either efficiently or profitably in the business sector. Yet, that is what the incoming Administration will now inherit and seems likely to expand. A viable plan for exiting these extreme measures would be a tonic for the economy as it would create a blueprint for returning our financial institutions to the private sector where they belong.

Fiscal Policy Dangers

During the campaign, Obama put forth a series of income tax proposals that centered on what appears to be a tax cut for broad swaths of population while adhering to some sort of 'budget balancing' desire by raising taxes at the upper end of the income distribution. To do that, the Bush tax cuts of 2002 would have to be terminated and tax cuts implemented for all families below some arbitrary level (the campaign focused on $250,000 annual income). In addition, current corporate tax rates were to be raised, along with increases in the capital gains tax. That was then, but the circumstances now may dictate no increases in taxes currently. In our view, the most likely course of the new Administration will be to create a sizeable tax cut for the "middle class," that may involve a payroll tax holiday combined with a lower of income tax rates below some threshold level and to largely ignore for the time being the resulting deficit expansion. That would combine both 'transitory" and "permanent" measures. The payroll tax rebate or holiday would generate substantial disposable income gains, which while transitory, would at least allow households to both consume and save more simultaneously. The change in the rates would be needed to lessen the transitory savings that is likely to result and create an environment more conducive to a higher level of consumption. The "equity" side of that change might well be to let the Bush tax cuts expire under their own timetables.

Similarly, the campaign focused on claimed needs for additional expenditure on infra-structure, on schools, on promotion of alternative energy measures and on health care. In order to confront the current recession beginning from January 20, 2008, it is simply not practical to think that each of these policy areas is staffed for a vast increase in expenditure. If Obama is serious in attempting to put more government expenditure to work, it is almost mandatory that this be done through block grants to states and municipalities that already have designated projects that are now tabled due to declining state and local tax resources.   Because many states and localities already have 'balanced budget' legal machinery, any increase in their expenditures must be funded. What better source than Federal grants?

There is a downside to such a policy that the Obama planners need to consider. State expenditure plans are rife with state political pork and the lobbies that support them. While increased state and local expenditure may give a fillip for the economy, they will enshrine those political lobbies with a permanent call on Federal financial support. State and local political constituencies will clamor for funding going forward and are likely to become permanently installed as pigs at the trough. It may seem easy for Obama administrators to turn on the water, but it will much more difficult to turn the spigot of Federal funding off if the economy regains traction.

The Obama economic team is well versed in macroeconomic theory, but the choice is not essentially one of economics. It is the choice over the role that Government is to play in the economy of the future. Given the rhetoric of the campaign, catering to those who elected this Administration will be a powerful force. Obama's mandate will likely never be greater than it is now, so in the first "100 Days," markets would be well advised to adopt a cautionary stance on what will ultimately prevail. There appears to be no concern with developing an exit strategy from the huge intervention now underway, not even a minimalist attempt to set some guidelines for the future. We are rushing into a strongly interventionist future. Now is the time to be careful about what we wish. We may indeed get it.