Economic and Domestic Policy

Obama revealed:
A moderate Republican

America is mired in three wars. The past decade was the hottest on record. Unemployment remains stuck near 9 percent, and there’s a small, albeit real, possibility that the U.S. government will default on its debt. So, what’s dominating the news? A reality-television star who can’t convince anyone that his hair is real is alleging that the president of the United States was born in Kenya. Perhaps this is just the logical endpoint of two years spent arguing over what Barack Obama is — or isn’t. Muslim. Socialist. Marxist. Anti-colonialist. Racial healer. We’ve obsessed over every answer except the right one: President Obama, if you look closely at his positions, is a moderate Republican of the early 1990s. And the Republican Party he’s facing has abandoned many of its best ideas in its effort to oppose him.

If you put aside the emergency measures required by the financial crisis, three major policy ideas have dominated American politics in recent years: a plan that uses an individual mandate and tax subsidies to achieve near-universal health care, a cap-and-trade plan that attempts to raise the prices of environmental pollutants to better account for their costs, and bringing tax rates up from their Bush-era lows as part of a bid to reduce the deficit. In each case, the position that Obama and the Democrats have staked out is the very position that moderate Republicans have staked out before.

Take health-care reform. The individual mandate was developed by a group of conservative economists in the early ’90s. Mark Pauly, an economist at the Wharton School of the University of Pennsylvania, was one of them. “We were concerned about the specter of single-payer insurance,” he told me recently. The conservative Heritage Foundation soon had an individual-mandate plan of its own, and when President Bill Clinton endorsed an employer mandate in his health-care proposal, both major Republican alternatives centered on an individual mandate. By 1995, more than 20 Senate Republicans — including Chuck Grassley, Orrin Hatch, Dick Lugar and a few others still in office — had signed one individual-mandate bill or another.

The story on cap and trade — which conservatives now like to call “cap and tax” — is much the same. Back then, the concern was sulfur dioxide, the culprit behind acid rain. President George H.W. Bush wanted a solution that relied on the market rather than on government regulation. So in the Clean Air Act of 1990 he proposed a plan that would cap emissions of sulfur dioxide but let the market decide how to allocate the permits. That was “more compatible with economic growth than using only the command and control approaches of the past,” he said.

The plan passed easily, with “aye” votes from Sen. Mitch McConnell and then-Rep. Newt Gingrich, among others. In fact, as recently as 2007, Gingrich said that “if you have mandatory carbon caps combined with a trading system, much like we did with sulfur . . . it’s something I would strongly support.”

As for the 1990 budget deal, Bush initially resisted tax increases but eventually realized they were necessary to get the job done. “It was clear to me that both the size of the deficit problem and the need for a package that can be enacted require all of the following: entitlement and mandatory program reform, tax revenue increases, growth incentives, discretionary spending reductions, orderly reductions in defense expenditures, and budget-process reform,” he said. That deal, incidentally, was roughly half tax increases and half spending cuts. Obama’s budget has far fewer tax increases. And compared with what would happen if the Bush tax cuts were allowed to expire in 2012, it actually includes a larger tax cut.

The normal reason a party abandons its policy ideas is that those ideas fail in practice. But that’s not the case here. These initiatives were wildly successful. Gov. Mitt Romney passed an individual mandate in Massachusetts and drove the state’s number of uninsured below 5 percent. The Clean Air Act of 1990 solved the sulfur dioxide problem. The 1990 budget deal helped cut the deficit and set the stage for a remarkable run of growth.

Rather, it appears that as Democrats moved to the right to pick up Republican votes, Republicans moved to the right to oppose Democratic proposals. As Gingrich’s quote suggests, cap and trade didn’t just have Republican support in the 1990s. John McCain included a cap-and-trade plan in his 2008 platform. The same goes for an individual mandate, which Grassley endorsed in June 2009 — mere months before he began calling the policy “unconstitutional.”

This White House has shown a strong preference for policies with demonstrated Republican support, but that’s been obscured by the Republican Party adopting a stance of unified, and occasionally hysterical, opposition (remember “death panels”?) — not to mention a flood of paranoia about the president’s “true agenda and background.”

But as entertaining as the reality-TV version of American politics might be, it can’t be permitted to, ahem, trump reality itself. If you want to obsess over origins in American politics, look at the president’s policies, not his birth certificate.
Ezra Klein
A fiscal infection that can spread everywhere

It's easy to understand why the government will have more trouble borrowing if it fails to pay its debts. It's a bit harder to see why ordinary Americans, the city of Pittsburgh, hospitals in Iowa, or medium-size corporations will have more trouble borrowing. But they will. And their trouble borrowing is the primary way a default, or even something too close to it for the market's comfort, could deal a body blow to the economy.

It all comes back to U.S. Treasury bonds, which are the foundation of almost all other financial products — the base of the global financial pyramid. If the federal government's borrowing costs rise, so will everyone else's. Mortgages rates will jump, car loans will be harder to come by, universities won't be able to float bonds, cities won't be able to fund themselves. Treasuries are supposed to set the rate of "riskless return" — the price of lending someone money and knowing, with perfect certainty, that they'll pay you back, with interest. So when lenders decide how much to charge, they start with the riskless rate and then add to it to cover the risk that you won't pay them back, and the inconvenience of having to wait for you to pay them back. It's a practice called bench-marking, and it's everywhere: in your mortgage, your credit card, your car payments, the loan you took out to hire three new employees at your business. It's even common internationally. The fact that Brazilian loans tie themselves to the American government's debt just shows the high esteem in which the world holds us.

But if the rate on 10-year Treasuries rises, it means rates rise for everything else, too. That's why economists consider the Federal Reserve's power to affect interest rates — a power it has virtually exhausted during this crisis — so potent. If you can move the basic interest rate, you can move the whole economy.

"There's a whole credit structure," says Pete Davis, president of Davis Capital Investment Ideas. "Think of it as roads and bridges, but it's finance, it's all connected, and it's all on top of Treasuries. ... So when you shake the basis of it, everything on top of it shakes, too."

Some sectors of the economy, of course, will be shaken harder than others. Benchmarking is just the most common way that the smooth function of the Treasury market affects everything else; it's not the only way.

On Wednesday, Moody's warned that it was putting the U.S. government credit rating on review for a downgrade. But it didn't stop there. Another $2 trillion of debt products that are "directly linked to the U.S. government or are otherwise vulnerable to sovereign risk" were also put on review for a possible downgrade. That's about $130 trillion worth of debt. If America tumbles, so do they.

These are bonds that rely on payments from the federal government. Naomi Richman, a managing director in Moody's Public Finance division, puts it bluntly: "There are certain kinds of municipal bonds that are directly reliant on Treasury paying or some other direct payment. If those bonds don't receive their payment, they have no other source of revenue." If the federal government can't pay its bills, down they go.

But Moody's wasn't done. An unknown amount of "indirectly linked" debt is also getting reviewed. That's debt from state governments, local governments, hospitals, universities and other institutions that rely, in some way or another, on payments from the federal government. If Medicaid stops paying its bills, all the hospitals that rely on Medicaid's payments become less creditworthy. If we stop funding Pell grants, then all the universities that enroll students who pay using financial aid become less creditworthy. And since the federal government passes one-fifth of its revenue through to the states, and the states pass that revenue through to cities, all of those governments would suddenly be in worse financial shape if the feds stopped paying their bills.

This is how a default gets into the rest of the economy: It destroys the fundamental trust that allows the financial markets to operate. Running in the background of every day's trading is the accumulated wisdom of an almost endless number of calculations: How much money does J.P. Morgan Chase have? How likely is Des Moines to pay its bills? What will interest rates be next year? How many people will buy homes in 2013? These calculations undergo incremental updates almost constantly. That's fine. Occasionally, they need to be drastically updated. That's manageable. But if they all need to be updated at once, and if no one really has the information to update them because Treasuries are suddenly unreliable? That's catastrophe.

It was one thing to have forgotten that this sort of thing could happen in 2008, when America hadn't seen it for 70 years. But we just went through it with the financial crisis, which was all about building a mountain of debt on a flimsy, subprime foundation. If we go through it again, the Federal Reserve, which has pushed interest rates as low as they can go, and Congress, which has vastly expanded the deficit, has a lot less ammunition left for a response.

Are we likely to get to that point? No, of course not. But between here and there are worlds where the economy doesn't crash, but the federal government panics the market, interest rates rise and the economy slows.

In a recovery this weak, that would be a disaster. And it would be entirely of our own making.
The dangers of misinterpreting Keynes

I f you ask economists what went wrong during the Great Depression, you’ll often hear “We hadn’t read Keynes yet.” That’s John Maynard Keynes, author of the “The General Theory of Employment, Interest and Money.” After the crash, his description of economic crises — and how to get out of them — became so widely accepted that, in the 1960s, President Richard Nixon said, “We’re all Keynesians now.”

Well, we’re not all Keynesians now. When you hear “Keynesian” today, it’s usually with “ObamaCare” and “socialists.” It’s Republican shorthand not only for the economic theory that governed the Obama administration’s response to the crisis but also for the general Democratic outlook. And it’s not a compliment.

“The president’s team were fervent believers in the theories of a British economist called John Maynard Keynes,” Majority Leader Eric Cantor (R-Va.) wrote in his election-year manifesto, “Young Guns.” He’s right about that. Lawrence Summers, the former director of the National Economic Council, and Christina Romer, the former head of the Council of Economic Advisers, were two of the most influential Keynesian economists in the country. Obama didn’t just have a team of Keynesians. He had the Keynesian all-star team.

Perhaps the president’s team should have better explained their theories to Cantor. In his book, Cantor goes on to describe Keynesianism as the theory that “government can be counted on to spend more wisely than the people.” He’s wrong — and wrong in a way that’s making it harder to recover from this crisis, and could make it harder to respond to the next one.

“I think Keynes miscalculated his book,” Summers says. “The correct title would have been A Specific Theory of Collapsing Employment, Interest and Money.” What his book really was about was the proper understanding of the convulsive downturns to which a free-market economy is intermittently prone.

The idea, in other words, is not about whether the government spends money better than individuals. After all, a lot of the policies advocated by the Keynesians, like the Making Work Pay tax cut, put money into the hands of individuals so that they can spend it. The idea is that the government has a role to play when, because of a “convulsive downturn,” a crisis begins feeding on itself.

Keynes — and others who later elaborated on his work, like Hyman Minsky — taught us that although markets are usually self-correcting, they occasionally enter destructive feedback loops in which a shock to, say, the financial system scares business and consumers so badly that they hoard money, which worsens the damage to the system, which further persuades other economic players to hoard, and so on and so forth.

In that situation, the role of the government is to break the cycle. Because businesses and consumers have stopped spending, the government breaks the cycle by spending. As clean as that theory is, it turned out to be a hard sell.

The first problem was conceptual. What Keynes told us to do simply feels wrong to people. “The central irony of financial crises is that they’re caused by too much borrowing, too much confidence and too much spending, and they’re solved by more confidence, more borrowing and more spending,” Summers says.

The second problem was practical. “What I didn’t appreciate was the extent to which we only got one shot on stimulus,” Romer says. “In my mind, we got $800 billion, and surely, if the recession turned out to be worse than we were predicting, we could go back and ask for more. What I failed to anticipate was that in the scenario that we found we needed more, people would be saying that what was happening showed that stimulus, in general, didn’t work.”

And even if Congress was willing to green-light more money, spending it turned out to be harder than the Keynesians had hoped. “Anybody who is honest and knowledgeable will say it is harder to move money quickly and well in reality than it is in the textbook model,” Summers says. “I don’t think the idea that lots more money could have been moved is credible unless there had been a whole set of prior planning.”

Prior planning, it turns out, is important. Keynesianism may be a theory of crises, but it requires planning during non-crisis periods. And looking back, we weren’t prepared to go Keynesian. At all.

For one thing, if you’re going to spend during downturns, you have to save during expansions. That wasn’t a big part of the George W. Bush administration’s policy, of course.

Another clear takeaway is that formulas are more reliable than Congress. It would be much better if federal support for programs such as Medicaid and unemployment insurance was explicitly tied to the unemployment rate. Hoping Congress will act responsibly over any extended period of time isn’t, as they say, a plan.

It would also be good to keep projects in “shovel-ready” condition when times are good so that federal money could be used effectively and quickly when times turn bad. Undeniably, the country’s infrastructure needs are great. If the federal government made a more explicit commitment to invest in infrastructure during downturns, states could be given the certainty and the incentives to keep a long list of projects ready to go.

But rather than improving on Keynes, the Republican Party has turned against him and the Democratic Party has stopped trying to defend him, much less continue to implement his recommendations.

“The polarization of fiscal policy is one of the worst legacies to come out of the recession,” Romer says with a sigh. “Before the crisis, there was an agreement that what you do when you run out of monetary tools is fiscal stimulus. Suddenly, it’s like we’re back in the 1930s.”
Free money! Or something even better.

This is going to be the most boring sentence I have ever included in a column, but it might also be the most important: The real yield on Treasury debt has, in recent months, turned negative. Sound impossibly dull? Sure. But here's what it means: free money!

Let's start by defining some terms: The “yield” on Treasury debt is how much the government pays to borrow money. The “real yield” is how much it pays to borrow money after accounting for inflation. When the “real yield” turns negative, it means the government isn’t paying to borrow money anymore. Rather, the situation has flipped, and the government is getting paid to keep money safe.

It also means that America is facing perhaps the single greatest investment opportunity in decades. But more on that in a moment. First, I have to convince you that free money — or, in this case, better-than-free money, as real yields are negative, not just zero — is possible.

If you’re an individual investor, you can put your money in the bank and be assured of its safety. Bank deposits, after all, are insured up to $250,000. But if you’re an institutional investor — if you’re playing with millions, or billions — it’s not quite that easy. You have to put that money somewhere. And right now, there aren’t a lot of safe spaces. Europe is a mess. China is slowing down. Brazil and India remain uncertain. Corporate profits can’t outpace a sluggish economy forever.

These investments don’t just carry the potential for weak returns. They carry the potential for big losses. So does stuffing money under the proverbial mattress, where you’d lose money every year simply because of inflation.

That’s where Treasury debt comes in. You won’t make much money investing in U.S. Treasurys. But barring a catastrophic outcome to some future negotiation over the debt ceiling, you won’t lose much, either. And right now, that’s good enough for the market.

Usually, the U.S. government has to pay quite a bit to borrow money. In January 2003, for instance, the interest rate on a seven-year Treasury was about 3.6 percent, which gave investors a yield of more than two percent after accounting for inflation. Right now, the interest rate is 1.52 percent, or minus-0.34 percent after accounting for inflation.

Here’s what this means: If we can think of any investments we can make over the next seven years that have a return of zero percent — yes, you read that right — or more, it would be foolish not to borrow this money and make them.

The case is even stronger with investments we know we will need to make over the next decade. The economy will get better, and as it gets better, the cost of borrowing will rise. The longer we wait, in other words, the more expensive those investments will become.

The only reason we wouldn’t take advantage of these rates is that we have no worthwhile investments to make. But that’s clearly not true.

Our infrastructure is crumbling, and we know we’ll have to rebuild it in the coming years. Why do it later, when it will cost us more and we very likely won’t have massive unemployment in the construction sector, as opposed to now, when the market will pay us to invest in our infrastructure and we have an unemployment crisis to address?

More than 16 percent of Americans are unemployed or underemployed. This would be a good time for an employer tax cut to goose hiring, or a larger payroll tax cut to help families make ends meet.

State and local budgets are wrecked, and one casualty has been higher education. California, for instance, is hacking away at the University of California system, which is far and away the finest public higher-education system in the world. If we permanently damage our public colleges and universities, we’ll have lost a major source of economic strength. But it needn’t be that way. Kindly investors the world over are willing to pay the federal government to save our education system.

Everyone knows we have worthwhile investments to make. The real reason we won’t take advantage of this remarkable opportunity is ideology. Republicans argue that deficits are the only thing that matters for our recovery — unless anyone attempts to close them through tax increases, and then tax rates are the only thing that matters for our recovery. And Democrats have stopped even attempting to challenge them.

As an economic theory, that’s just dead wrong. Deficits matter, but in the long and medium term. What matters now is getting the unemployment rate down.

Need proof? Well, what’s worrisome about deficits? That high federal deficits will crowd out private borrowing. And how do we know that’s happening? High interest rates. And where are interest rates now? They’re negative.

They won’t be negative forever, of course. The path forward is obvious: We should borrow now and put in place a firm plan to reduce deficits later, once the economy is back on track and investors have other places to put their money. But refusing better-than-free money now in order to talk about reducing our deficit later? Well, that may be the craziest sentence I’ve ever had to include in a column.

Ezra Klein
Economic and Domestic Policy

Monitor your investments at a benchmark for small companies, or more, it would be foolish not to borrow this money and make them.
Could this time be different?

Ezra Klein: The biggest stimulus in U.S. history was too small to get the economy moving. But it’s no accident that crises so often turn out the same.

Chritina Romer had been asked to scare her new boss. It was six weeks after the 2008 election, and the incoming administration had gathered in Chicago. David Axelrod, Barack Obama’s top political adviser, couldn’t have been more clear in his instructions to Romer: The president-elect needed to know how bad the economy was going to get. No pulling punches, no softening the news.

So Romer, the preternaturally cheerful economist whose expertise on the Great Depression made her a natural choice to head the incoming president’s Council of Economic Advisers, worked up some numbers to show how quickly the economy was deteriorating and what would happen if the federal government wasn’t able to mount an effective response.

It was not a pleasant presentation to sit through. The situation was grim. Afterward, Austan Goolsbee, Obama’s friend from Chicago and Romer’s successor, remarked that “that must be the worst briefing any president-elect has ever had.”

But Romer wasn’t trying to be alarmist. Her numbers were based, at least in part, on everybody else’s numbers. There were models from forecasting firms such as Macroeconomic Advisers and Moody’s Analytics. There were preliminary data pouring in from the Bureau of Labor Statistics, the Bureau of Economic Analysis and the Federal Reserve.

Romer’s predictions were more pessimistic than the consensus, but not by much.

By that point, the shape of the crisis was clear: The housing bubble had burst, and it was taking the banks that held the loans, and the households that did the borrowing, down with it. Romer estimated that the damage would be about $2 trillion over the next two years and recommended a $1.2 trillion stimulus plan. The political team balked at that price tag, but with the support of Larry Summers, the former Treasury secretary who would soon lead the National Economic Council, she persuaded the administration to support an $800 billion plan.

The next challenge was to persuade Congress. There had never been a stimulus that big, and there hadn’t been many financial crises this severe. So how to estimate precisely what a dollar of infrastructure spending or small-business relief would do when let loose into the economy under these unusual conditions? Romer was asked to calculate how many jobs a stimulus might create. Jared Bernstein, a labor economist who would be working out of Vice President Biden’s office, was assigned to join the effort.

Romer and Bernstein gathered data from the Federal Reserve, from Mark Zandi at Moody’s, from anywhere they could think of. The incoming administration loved their report and wanted to release it publicly. Romer took it home over Christmas to double-check, rewrite and pick over. At 6 a.m. Jan. 10, just days before Obama would be sworn in as president, his transition team lifted the embargo on “The Job Impact of the American Recovery and Reinvestment Act.” It was a smash hit.

“It will be a joy to argue policy with an administration that provides comprehensive, honest reports,” enthused columnist Paul Krugman in the New York Times.

There was only one problem: It was wrong. 

ECONOMY CONTINUED ON G6
The Recovery Act worked. The problem is we didn’t keep our foot on the accelerator.”

— Jared Bernstein, former chief economist and economic policy advisor to Vice President Biden

The issue is the graph on Page 1. It shows two blue lines sloping gently upward and then drifting back down. The darker line — “With recovery plan” — forecasts unemployment peaking at 8 percent in 2009 and falling back below 7 percent in late 2010.

Three years later, with the economy still in tatters, that line has formed the core of the case against the Obama administration’s economic policies. That line lets Republicans talk about “the failed stimulus” theory. That line that has discredited the White House’s economic policy.

But the other line — “Without recovery plan” — is more instructive. It shows unemployment peaking at 9 percent in 2010 and falling below 7 percent by the end of this year. That’s the line the administration used to scare Congress into passing the single largest economic recovery package in American history. That line is the nightmare scenario.

And yet this is the cold, hard fact of these three past years: The reality has been worse than the administration’s nightmare scenario. Even with the stimulus, unemployment shot past 10 percent in 2009.

To understand how the administration got it so wrong, we need to look at the data it was looking at.

The Bureau of Economic Analysis, the agency charged with tracking the size and growth of the U.S. economy, initially projected that the economy shrank at an annual rate of 3.8 percent in the last quarter of 2008. Months later, the bureau almon doubled that estimate, saying the number was 6.2 percent. Then it was revised to 6.3 percent. But it wasn’t until this year that the actual number was revealed: 8.9 percent. That makes it one of the worst quarters in American history.

Bernstein and Romer knew in 2008 that the economy had sustained a tough blow; they didn’t know that it had been run over by a truck.

There were certainly economists who argued that the recession was going to be worse than the forecasts. Nobel laureates Krugman and Joe Stiglitz were among the most vocal, but they were by no means alone. In December 2008, Bernstein, who had been named Biden’s chief economist, told the Times, “We’ll be lucky if the unemployment rate is below double digits by the end of next year.”

The Cassandras who look, in retrospect, the most prophetic are Carmen Reinhart and Ken Rogoff. In 2008, the two economists were about to publish “This Time Is Different,” their fantastically well-timed study of nine centuries of financial crises. In their view, the administration wasn’t being just a bit optimistic. It was being wildly, tragically optimistic.

That was the dark joke of the book’s title. Everyone always thinks this time will be different. The bubble won’t burst because this time, tulips won’t lose their value, or housing is a unique asset, or sophisticated derivatives really do eliminate risk. Once it bursts, they think their aftershocks of a financial crisis. The promised recovery was always just around the corner, but it never came.

Eventually, the American people stopped listening. A September poll showed that 50 percent of Americans thought Obama’s policies had hurt the economy.

This time, it turned out, wasn’t different. But could it have been?

The boot and the sloop

The basic thesis of “This Time Is Different” is that financial crises are not like normal recessions. Typically, a recession results from high interest rates or fluctuations in the business cycle, and it corrects itself relatively quickly: Either the Federal Reserve lowers rates, or consumers get back to spending, or both.

But financial crises tend to include a substantial amount of private debt. When the market turns, this “overhang” of debt acts as a boil on the throat of the recovery. People don’t take advantage of low interest rates to buy a new house because their first order of business is paying down credit cards and keeping up on the mortgage.

A subsequent research with her husband, Vincent Reinhart, Carmen Reinhart looked at the recoveries following 15 post–World War II financial crises. The results were ugly: Forget the catch-up growth of 4 or 5 percent that so many anticipated. Average growth rates were a full percentage point lower in the decade after the crisis than in the one before.

As a result, in 10 of the 15 crises studied, unemployment simply never — and the Reinharts don’t mean “never in the years we studied,” they mean never ever — returned to its pre-crisis lows. In 90 percent of the cases in which housing-price data were available, prices were lower 10 years after the crash than they were the year before.

There is no doubt that the post-crisis trajectory looks more like the sloop Reinhart and Rogoff described than the relatively rapid rebound predicted by the administration and many forecasters. Yet even among economists who admire Reinhart and Rogoff’s work, there is skepticism.

One source comes in how Reinhart and Rogoff find the economic phenomena they’re trying to study. “There’s an identification problem,” Stiglitz says. “When you have underlying problems that are deep, they will cause a financial crisis, and the crisis itself is a symptom of underlying problems.”

Another is in their fatalism. “I don’t buy their enthusiasm in the sense that this was an inevitability,” says Dean Baker, director of the Center for Economic and Policy Research and one of the economists who spotted the housing crisis early.

“The Obama administrations didn’t buy the idea of inevitability, either. The team crafted a multi-pronged approach of stimulus spending, programs to address the housing market, and policy coordinated with an activist Federal Reserve. It firmly believed that it was better to do too much than too little. Its credo was well expressed by Romney at that December meeting, when she told the president, “We have to hit this with everything we’ve got.” But in reality, the administration could only hit it with everything it could persuade Congress to give. And that wasn’t enough.

Finding fault with the stimulus

Some partisans offer a simple explanation for the depth and severity of the recession: It’s the stimulus’s fault. If we had done nothing, they say, unemployment would never have reached 10 percent.

That notion doesn’t find much support even among Republican economists. Doug Holtz-Eakin is president of the right-leaning American Action Forum and served as Sen. John McCain’s top economic adviser during the 2008 presidential campaign. He’s no fan of the stimulus, but he has no patience with the idea that it made matters worse.

“The argument that the stimulus had zero impact and we shouldn’t have done it is intellectually dishonest or wrong,” he says. “If you throw a trillion dollars at the economy, it has an impact. I would have preferred to do it differently, but they need to do something.”

A fairer assessment of the stimulus is that it did much more than its detractors admit, but much less than its advocates promised.

“The thing that people who want to argue that the stimulus failed to have to deal with,” Bernstein says, “is that if you look at the trajectory of job losses, you will find that right on the heels of the Recovery Act, the rate of job losses began to diminish

Estimates and realities of unemployment

A 2009 report by the president’s Council of Economic Advisers projected the jobless rate with and without the recovery plan. The actual rate turned out much higher.

Unemployment rate

In percent, quarterly with recovery plan and without recovery plan, and annual median receipts

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<th>Unemployment Rate</th>
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Projected recovery plan

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| Actual rate       | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% |

Projected with recovery plan

| Projected rate    | 5.5%  | 5.5%  | 5.5%  | 5.5%  | 5.5%  | 5.5%  | 5.5%  | 5.5%  | 5.5%  | 5.5%  | 5.5%  | 5.5%  |
| Actual rate       | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% | 10.8% |

The Recovery Act worked. The problem is that we didn’t keep our foot on the accelerator.”

— Jared Bernstein, former chief economist and economic policy adviser to Vice President Biden

and then the jobs numbers turned posi-
tive. The Recovery Act worked. The prob-
lem is that we didn’t keep our foot on the
accelerator.”

Critics and defenders on the left make the same point: The stimulus was too small. The administration underestimat-
ed the size of the recession, so it follows that any policy to combat it would be too small. On top of that, it had to get that policy through Congress. So it went with $800 billion — what Romney thought the economy could get away with — rather than $1.2 trillion — what he thought it needed. Then the Senate watered the policy down to about $787 billion. Com-
pare that with the $2.5 trillion hole we now know we needed to fill.

But it is hard to credit the argument that the stimulus could have been much larger at the outset. This was already the biggest stimulus in U.S. history, and con-
gressional leaders had been quite clear with the White House: Don’t send over anything that passes the trillion-dollar mark. To try and get a trillion-
dollar stimulus based on a suspicion that the recession was much worse than the early data indicated would have been a sin, to say the least.

Even if Congress had been more accom-
mmodating, there was a challenge to vastly increasing the size of the initial stimulus: The more you spend, the less effective each new dollar would become.

“We were trying to spend 10 times what had ever been spent in a year,” says Greens-
bee, who chaired the Council of Economic Advisers until this year. “The tension was
that the biggest bang for the buck comes from direct spending like infrastructure, but once you use up the big-ticket items, you eventually come to a point where the tax cuts are better bang for the buck than the $300 billion infrastructure dollar.”

And tax cuts, frankly, aren’t a very good bang for the buck.

But although the administration’s team hoped the initial stimulus would work, it figured that if it didn’t, it could go back to Congress for more.

“If you’re at the barber and they don’t cut your hair short enough, you can al-
ways ask them to go a little further,” Bernstein says. “That’s sort of how I thought about stimulus policy. I don’t think we could have done more in Febru-
ary of 2009 based on political and imple-
mentation constraints. But I probably didn’t recognize how hard it would be to go back to the barbershop.”

The theory was that success would beget success. Passing the stimulus would stabilize the economy; prove the White House’s political mettle and deliver im-
mediate relief to millions of Americans.

That would help the administration build the political capital to pass more stimu-
lus, if necessary. But when the economics failed to respond as predicted, the politi-
cal theory fell apart, too.

“The biggest problem we had in terms of the loss of political capital is we came in and said, well, the housing market, and policy coordinated
in the business cycle, and it corrects
in its own time,” says Ron Klain, who served as chief of staff to Biden. “And some of that was just bad luck. If we didn’t have the 22nd Amendment and Barack Obama became president in late March rather than in late January, things would have been much worse when we came in than they were. And then the Recovery Act would have come not in February, but in May. We would already have hit bottom, and it would seem like things were getting better.

This has led to a what-if that torments the White House’s political team: What if it hadn’t taken on so much? The admin-
istration rushed from the second bucket of bailout funds to the stimulus to the auto-
industry rescue to health care to climate
change legislation to financial regulation.

In a world where the economy was stead-
ily recovering, Obama might have amassed a record comparable to Franklin
Roosevelt’s. But as the situation slowly deteriorated, the American people turned
against the administration’s crush of ini-
tiatives. The frenetic pace made the White House seem inattentive and unconfi-
menced amid a mounting crisis.

But the alternative is similarly difficult to imagine. No one believes that signifi-
cantly reining in the agenda would have helped much more stimulus. Perhaps the
president would have benefited political-
ally from speaking more about jobs and less about health care, but then again, he had historic majorities in both houses of Con-
gress and had come into office promising
dynamic change.

A more accurate understanding of the recession could, however, have led to a somewhat different stimulus — and per-
haps a more durable political strategy.

The policy was constructed at breakneck speed, with the thinking that getting money spent fast. That led to more tax cuts, as they could happen quickly, and less infra-
structure, as projects — particularly any-
things more complex than road repair —
can take years to begin, by which point a typical recession has ended of its own volition.

Another cost of moving quickly was that it put a premium on policies already floating and doubled the bill’s size. And then the stimulus was much more
than too little. Its credo was well ex-
acted. “The argument that the stimulus had
failed has to deal with the nightmare scenario. Even with the stimulus,” it was “the begin-
ning of the end.”

The Bureau of Economic Analysis, the
agency that studied, unemployment simply never —
the crisis itself is a symptom of underlying
economic problems,” it was “the begin-
ning.”

One source comes in how Reinhart and
Reinhart argue that the stimulus failed have to deal with the nightmare scenario.

In their view, the administration
bet was pretty much all-in, and it failed.

In December 2008, Bernstein, who
wrote “This Time Is Different,” told the Times, “We’ll be lucky if the
Democrats had abandoned. So Republi-
cans in Congress just hated it.”

A stimulus conducted with the Rogoff
Reinhart lessons in mind might have been broken into pieces and spread over a longer time frame. The administration
could have pushed to tie key components such as unemployment benefits, state and local aid, and tax cuts to the unemploy-
ment rate rather than setting them to expire after two years. With the knowl-
edge that it had years of low growth to combat, there could have been a short-
term infrastructure component — pot-
holes, school repairs and the like — fol-
lowed, in separate legislation that Con-
gress would have had more time to con-
sider, by a long-term infrastructure com-
partment for big investments such as high-speed rail and health-information technology.

But there’s little reason to believe that
tourism would have turned unemployment num-
bers around. In fact, we have seen fairly regular extensions of unemployment ben-
efits and tax cuts over the past year. A bill with a longer time frame perhaps would have saved the administration from politi-
cal headaches down the road, but it could have even made it harder to ask Congress for more, as the initial policy would not have finished spending out yet.

To this day, Holtz-Eakin thinks the proposal made sense. There was one
problem. “No one liked that plan,” he says. “In fact, they hated it. The politics on
housing are hideous.”

The Obama administration, perhaps
cynizant of the politics, was not nearly so
bold. It focused on stimulus rather than housing debt. The idea was that if people could keep their jobs and pay their bills, they could pay their mortgages. But today, few on the Obama team will mount much of an defense of its housing policy.

Its efforts to help the troubled market
in the wake of the financial crisis are
widely considered weak and ineffective. The Home Affordable Modification Pro-
gram, which proposed to pay mortgage servicers to renegotiate with financially stressed homeowners, couldn’t persuade the servicers to play ball and so has left

— Shrinkning economy

This was a bet that we could get out of this recession through the one
path everyone can agree on: growth. The bet was pretty much all-in, and it failed.

Reinhart and Rogoff are not particularly surprised. It’s hard to get through a debt
without doing anything about, well, debt.

In the saying “the debt” in question is housing debt. Home prices have fallen almost 33 percent since the beginning of
the crisis. All together, the nation’s hous-
ing stock is worth $8 trillion less than it
was in 2006. And we’re not done. Morgan
Stanley estimates there are more than
2.2 million homes sitting vacant, and
75 million more facing foreclosure. It is
housing debt that has weakened the
banks, and mortgage debt that is keeping
consumers from spending.

In late 2008, when the economy was
cratering, Holtz-Eakin convinced McCain
that the way out of a housing crisis was to
tackle housing debt directly. “What we
proposed at the time was to buy up the troubled mortgages, pay them off and let
people refinance at the lower rates,” he
recalls. “That would have filled up the
negative equity and healed bank balance
sheets.”

By this time, Holtz-Eakin thinks the
idea of inevitability, either. The team
On October 9, 2011

SUNDAY, OCTOBER 9, 2011

The Washington Post

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Shrinking economy

Annual rate at which the economy shrank in the final quarter of 2008: 3.8%

Initial projection by the Bureau of Economic Analysis:

6.2%

Revision released months later:

6.3%

A further revision:

8.9%

Actual rate at which the economy contracted. Figure released this year.

ECONOMY CONTINUED ON G7
most of its $787 billion unspent. The Home Affordable Refinance Program was pro-
ject ed to help 5 million underwater home-
owners. It has reached fewer than 1 mil-
lion.

Even so, the administration rejects the more radical solutions that are occasion-
ally floated. The argument, it says, is that the choices are mostly between timid and unwor-
kable.

One problem was that mortgage fi-
nance giants Fannie Mae and Freddie Mac were ultimately controlled by the inde-
pendent Federal Housing Finance Agen-
cy. Created by Congress in 2008, the agency was initially led by a Bush adminis-
tration appointee, James W. Lockhart III, and when he stepped down, by an-
other Bush administration appointee, Edward DeMarco. The Obama administra-
tion’s November 2010 effort to nominate its own director was foiled by SenateRepublicans.

By that time, the administration had been in office for almost two years and
sees the Democrats’ 60-vote majority in
the Senate come and go. If it had moved more quickly to appoint a director when it
had firmer control of the Senate, it could perhaps have used Fannie and Freddie to
kick off a giant wave of refinancing for underwater homeowners. That alone
would have done something to ease the pressure on stressed households.

But when talking about what might have worked on a massive, economy-wide
scale — that is to say, what might have made this time different — you’re talking
about something more drastic. You’re talking about getting rid of the debt. To do
that, somebody has to pay, or somebody
has to take the loss on it.

The most politically appealing plans are the ones that force the banks to eat the
debt, or at least appear to do so. “Cram-
down,” in which judges simply reduce the
principal owed by underwater home-
owners, works this way. But any plan that
leads to massive debt forgiveness would blow a massive hole in the banks. The
worry would move from “What do we do
about all these housing loans?” to “What do we do about all these failing banks?”
And we know what we do about failing banks amid a recession: We bail them out to
keep the credit markets from freezing up.

There was no appetite for a second Leh-
man Brothers in late 2008.

Which means that the ultimate ques-
tion was how much housing debt the
American taxpayer was willing to shoul-
der. Whether that debt came in the form of nationalizing the banks and taking the
bad assets off their books — a policy of an administration estimated could cost tax-
payers a trillion dollars — or simply pay-
ing off the debt directly was more of a
political question than an economic one.

And it wasn’t a political question anyone
really knew how to answer.

On first blush, there are few groups
more sympathetic than underwater homeowners or foreclosed families. They
remain so until about two years after their neighbors are asked to pay their
mortgages. Recall that Rick Santelli’s fa-
mous CNBC rant wasn’t about big govern-
ment or high taxes or creeping socialism.

It was about a modest program the White House was proposing to help certain
homeowners restructure their mortgage:

It had Santelli screaming bloody mur-
der.

“That is America!” he shouted from the
trading floor at the Chicago Board of
Trade. “How many of you people want to
pay for your neighbor’s mortgage that has
an extra bathroom and can’t pay their bills? Raise their hands.” The traders
around him began boosing loudly: “Presi-
dent Obama, are you listening?”

If you believe Santelli’s rant kicked off
the tea party, then that’s what the tea
party was originally about: forgiving housing debt.

Ultimately, concerns about the politics
and policy questions behind widespread
debt forgiveness were sufficient to scare
the administration off of the policy. It’s a
decision some ex-members of the White
House regret.

“I’ve had thought harder about Rogoff
and Reinhart, we might have made some
different trade-offs regarding debt reduc-
tion,” Bernstein says. “Moral hazard is a
big problem when you’re making policy
regarding write-offs and principal cram-
downs. It was always in the room when you
were trying to help one underwater homeowner write off some debt while the
person next door was playing by the rules
and paying their mortgage every month.

But with hindsight, I might have argued
more rigorously against the risk of it.”

The Fed’s inflation option

There was, however, one institution
that some think could have reduced the
debt overhang crushing the economy and
that didn’t face such political obstacles:

the Federal Reserve.

The central bank manages the nation’s
money supply and credit and sits at the
center of its financial system. Usually, it spends its time guarding against the
threat of inflation. But in December 2008, Rogoff argued that the moment called for
the reverse strategy.

“It is time for the world’s major central
banks to acknowledge that a sudden burst of moderate inflation would be extremely
helpful in unwinding today’s epic debt morass,” he wrote.

Inflation — the rate at which prices for
goods go up and buying power goes down
— makes any amount of money worth less
time. It can help a depressed econo-
my in three ways: It erodes the real value
of debt. It gives people an incentive to
spend and invest now, as their money will
not go as far later. And it tends to drive
down the value of the dollar against other
foreign currencies, making U.S. exporters more competitive.

At the Federal Reserve, inflation is a
four-letter word. It has spent the past few
decades convincing the market that it can
and will “anchor” inflation at about 2 per-
cent. Lifting that anchor could cause
problems down the road, without making
much good in the present. After all, Fed-
eral Reserve Board Chairman Ben S. Ber-
nanke doesn’t have a red inflation button
beneath a glass case on his desk. Creating
inflation is difficult when demand for
goods is low, and it’s not even clear that
the Fed can do it.

Rogoff scoffs at this. “Creating inflation is not rocket science,” he wrote. “All cen-
tral banks need to do is to keep printing money to buy up government debt. The
main risk is that inflation could over-
shoot, landing at 20 or 30 percent instead
of 5 or 10 percent. Indeed, fear of over-
inflation paralyzing the Bank of Japan for a
decade. But this problem is easily nego-
ciated. With good communication policy, inflation expectations can be contented,
and inflation can be brought down as
quickly as necessary.”

But the policymakers who would have needed to create that inflation aren’t so
sure. “It’s difficult, if not impossible, to
create persistent inflation without de-
mand exceeding potential supply over an
extended period,” says Donald L. Kohn,

President Obama, back to camera, attends an economic meeting at the White House in October 2009. The administration crafted a multi-portfolio approach of
stimulus spending, housing market programs and policy coordinated with the Federal Reserve. Even with the bailout, unemployment shozt past 10 percent that year.

(continue)
There were political limits to what we could do, but we thought we were operating to expand the scope of those limits.

I used to say to people, ‘Which mistake is harder to correct: doing too much, or doing too little?’ — Timothy F. Geithner, Treasury secretary

who served as vice chairman of the Feder-
al Reserve Board until 2010. “Yes, chang-
ing expectations might push inflation higher, but why would expectations change materially and persistently under current circumstances?”

Bernanke seems to agree. So, it seems, does the administration, at least judging by the economists it considered nominat-
ing to the Fed.

Summers, who had the inside track to chair the central bank if the Obama ad-
ministration decided against renominat-
ing Bernanke, echoes Kohn’s skepticism. “In the model I understand,” he says, “inflation is mostly driven by demand, and when you increase demand, you in-
crease inflation. And if you don’t increase demand, you don’t increase inflation. But if you’ve solved demand, you’ve solved your problem.”

Nobel laureate Peter Diamond, whom the Obama administration nominated to fill a vacant seat on the Fed’s board, puts it this way: “If the Fed says we are deter-
mined to keep going till we have, say, 4 percent inflation, would that really turn around expectations in a way that would stimulate the economy and create higher inflation? I doubt it.”

And, of course, the Fed might be insu-
lated from politics, but it’s not immune to it. In recent years, Rep. Ron Paul (R-Tex.) has gained national prominence in part on an “End the Fed” platform. Texas Gov. Rick Perry, a Republican presidential con-
tender, has threatened to do something “ugly” to Bernanke. Congress passed leg-
islation to audit the Fed. Even noted monetary economist Sarah Palin weighed in, saying, “It’s time for Ben Bernanke to cease and desist.”

To the Fed, the nightmare scenario is that it tries to create inflation now and fails. It would have given up its hard-won credibility as an inflation fighter and invited political backlash, all without helping the economy.

Labor market’s long period of pain

Growth-focused and debt-focused strategies are attempts to end the reces-
sion. They’re policy on the offensive. But perhaps the real lesson from Rogoff and Reinhardt is that these recessions rarely end quickly, and so officials must manage a long period of pain — defensive policy, so to speak. America doesn’t do defense very well.

“We’re trying right now to keep our lifestyles going,” says Michael Spence, a

Shrinking stimulus

<table>
<thead>
<tr>
<th>Amount of stimulus the Senate passed</th>
<th>Amount of stimulus that was actually needed</th>
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<tbody>
<tr>
<td>$1.2 trillion</td>
<td>$700 billion</td>
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<tr>
<td>$800 billion</td>
<td>$2.5 trillion</td>
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Nobel Prize-winning economist at New York University. “It’s not really working, but the way we’re doing it is putting all the burden on the unemployed while trying to leave the employed untouched. Event-
ually, this is going to require a redistribu-
tion of that burden.”

In other countries, he says, the burden is more widely shared. The employed work less and get paid less — so there are more jobs to go around. That leads to a little pain for a lot of people, rather than a lot of pain for fewer people. It also keeps more workers on the job, which means their skills don’t deteriorate and the econ-
omy isn’t left with people who became unem-
ployed and then found themselves unemployable.

That’s what we’ve seen here: Employ-
ers have become so leery of hiring the unemployed that the Obama adminis-
tration has proposed to make it illegal to discriminate against them. Such a policy is easier said than done, but it speaks to the downside of letting workers fall out of the labor force for long periods of time.

Germany’s response to the recession included a work-sharing program that

paid the private sector to save jobs that was not the administration’s only option. There was also the possibility of simply paying workers to work.

For one thing, the government could have refused to fire anyone. Says Baker, of the Center for Economic and Policy Re-
search: “We’ve lost 500,000 state and local jobs, and before that, we were creat-
ing 160,000 a year. If we hadn’t had those losses and had done more to keep creation at that pace, we would have almost an-
other million jobs.”

It also could have started hiring. Romney, for instance, proposed to add 100,000 teacher’s aides. Imagine similar proposals: Every park ranger could have had an assistant park ranger. Every fire-
fighter station could have added three trainees. Every city could have expanded its police force by 5 percent. Everyone between ages 18 and 26 could have signed up for two years of paid national service.

In a relatively quick recovery, these strategies are less radical than some. Bet-
ter to support the economy more general-
ly and let workers migrate from unpro-
ductive sectors to productive ones. Em-
ploying workers directly is, at best, a

Economist Ken Rogoff has said that a sudden burst of moderate inflation would be helpful.

In economist Carmen Reinhart’s view, the Obama administration was wildly, tragically optimistic.
subsidized salaries when employers trimmed the hours of individual workers to keep more people on the job. If workers attended job training, the government gave a more generous subsidy.

The program worked. Even though Germany's economy was devastated by the recession — declining by almost 7 percent — the jobless rate fell slightly, from 7.9 percent at the start of the recession to 7 percent in May 2010.

There are reasons to question whether work-sharing programs would have been as effective here as they were in Germany. For one thing, they work best in sectors where jobs are bound to return after a recession — such as Germany's export sector — rather than sectors that need to be downsized after being inflated by a credit boom.

Germany also has a different labor market. Employers, unions and the government work together with an unusual level of cooperation. The culture is much more hostile toward layoffs than the United States' is, which has caused Germany problems in the past but has been a boon throughout this recession.

There were political limits to what we could do, but we thought we were operating to expand the scope of those limits. I used to say to people, 'Which mistake is harder to correct: doing too much, or doing too little?'” — Timothy F. Geithner, Treasury secretary

we would otherwise have had in a crisis like this. That isn't fully appreciated.”

In that way, Reinhart says, this time really was different — at least from the Great Depression, when output shrank by 30 percent and a quarter of the workforce was unemployed. “If the choice was this or the ’30s,” she says, “I’d take this hands down.”

Give policymakers some credit: They really have learned from the Depression. So did the Japanese. In the 1990s, they pumped monetary and fiscal stimulus into their economy, too, and they didn’t suffer a depression. But they never found themselves in a recovery. They stagnated for a decade, and then for another.

What we’re looking at more like Japan in the 90s than the United States in the 30s, Reinhart doesn’t think that’s an accident; she thinks it’s a product of the initial successes. “The same policies that serve you well in limiting the output collapse do not serve you well in speeding the recovery up,” she says.

By saving the banking system, you end up with banks that are quietly holding on to toxic assets in the hope that one day they’ll be worth something. By limiting the output gap, you keep the economy from getting so bad that truly radical solutions, such as wiping out hundreds of billions of dollars of housing debt, become thinkable. You limp along.

The question, of course, is why do governments limp out of recessions when the weight of history tells them to run?

“Now knowing how much worse the storm was, people look back and say, you guys undershot,” sighs Treasury Secretary Timothy F. Geithner: “But we didn’t think we were underestimating at the time. We thought that the dominant strategy had to be massive, overwhelming force. There were political limits to what we could do, but we thought we were operating to expand the scope of those limits. I used to say to people, ‘Which mistake is harder to correct: doing too much, or doing too little?’”

Yet the Obama administration did too little. Its team of interventionist Keynesians immersed in the lessons of the Depression and Japan did too little. Everyone does too little, even when they think they’re erring on the side of doing too much. That’s one reason “this time” is almost never different.

The tendency thus far has been to look at these crises in terms of the identifiable economic factors that make them different from typical recessions. But perhaps the better approach is to look at the political factors that make them turn out the same, that stop governments from doing enough even when they have sworn to err on the side of doing too much.

These crises have a sort of immune system: There is never possible for the political system to do enough to stop them at the outset, as it is never quite clear how bad they are. Even if it were, the system is ill-equipped to take action at that scale. The actors comfort themselves with the thought that if they need to do more, they can do it later. And, for now, the fact that this is the largest rescue package anyone has ever seen has to be worth something.

Perversely, the very size of the package is part of its problem. With something extraordinary that is nevertheless not enough, the economy deteriorates, and the government sees its solutions discredited and its political standing weakened by the worsening economic storm. That keeps it from doing more.

Meanwhile, the opposition’s capacity to do more is arguably even more limited, as it has turned against whatever policies were tried in the first place. Add in the almost inevitable run-up in government debt, which imposes constraints in the eyes of the voters and, in some cases, in the eyes of the markets, and an economy that started by not doing enough is never able to get in front of the crisis.

These sorts of economic crises are, in other words, inherently politically destabilizing, and that makes a sufficient response, at least in a democracy, nearly impossible.

There’s some evidence for this internationally. Larry Bartels, a political scientist at Vanderbilt University, examined 31 elections that took place after the 2008 financial crisis and found that “voters consistently punished incumbent governments for bad economic conditions, with little apparent regard for the ideology of the government or global economic conditions at the time of the election.” Just look to Europe, where the path to ending the debt crisis and saving the euro zone — the group of nations that use the currency is clearly the most economists but impossible for any European politician.

That isn’t to say that this time couldn’t have been different or that next time won’t be. But it is no accident that these crises so often turn out the same, in so many countries, with so many types of governments, who have tried so many kinds of responses.

In general, the policies that are vastly better than whatever you are doing are not politically achievable, and the policies that are politically achievable are not vastly better. There were many paths that could have been taken in January 2009, and any one would have made this time a bit different. But not different enough. Not as different as we wish.