EZRA KLEIN
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 Democrats moved to the right to pick up GOP votes, Republicans moved to the right to oppose Democratic proposals.

As for the 1990 budget deal, Bush initially resisted tax increases but eventually realized they were necessary to get the job done. "It is 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 large 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 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.

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The Washington Post

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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-

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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 7,000 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 billion 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 government, 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 2006, 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, have 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.

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The dangers of misinterpreting Keynes

EZRA KLEIN
Economic and Domestic Policy

If 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 mistitled 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. 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," Summers says.

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 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."

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Free money! Or something even better.

EZRA KLEIN
Economic and Domestic Policy

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 impenetrably 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.

ISTOCKPHOTO

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 if 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 cut 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.

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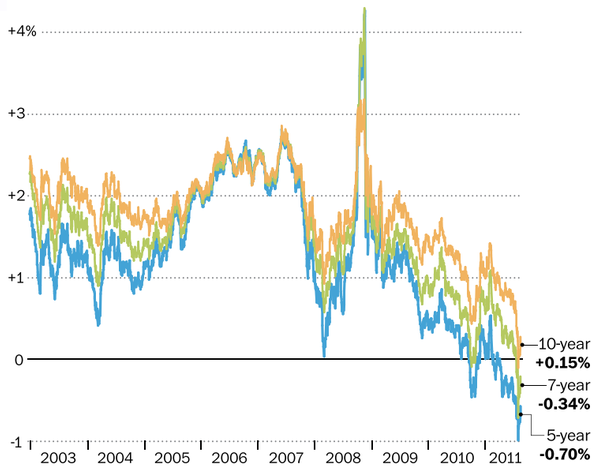
Daily real yield on Treasurys

In percent, from Jan. 2, 2003, through Aug. 26



Note: These real market yields are calculated from composites of secondary market quotations obtained by the Federal Reserve Bank of New York. The real yield values are read from the real yield curve at fixed maturities. This method provides a real yield for a 10-year maturity, for example, even if no outstanding security has exactly 10 years remaining to maturity.

Source: Treasury Department THE WASHINGTON POST

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ANALYSIS

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.

SHOUT FOR THE WASHINGTON POST

Christina 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 comprehensible, honest reports," enthused columnist Paul Krugman in the New York Times.

There was only one problem: It was wrong.

ECONOMY CONTINUED ON G6

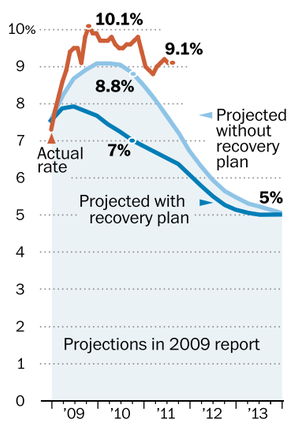
> The Recovery Act worked. The problem is we didn't keep our foot on the accelerator."
> — **Jared Bernstein**, former chief economist and economic policy adviser to Vice President Biden

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 actual monthly rate



Sources: "The Job Impact of the American Recovery and Reinviestment Plan," 2009, president's Council of Economic Advisers; Bureau of Labor Statistics, Labor Department

THE WASHINGTON POST

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." 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 the past three 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 measuring 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 almost 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 economy will quickly clamber out of the ditch because their workers are smarter and tougher, and their policymakers are wiser and more experienced. But it almost never does.

In March 2009, Reinhart and Rogoff took to Newsweek to critique the "chirpy forecasts coming from policymakers around the globe." The historical record, they said, showed that "the recessions that follow in the wake of big financial crises tend to last far longer than normal downturns, and to cause considerably more damage. If the United States follows the norm of recent crises, as it has until now, output may take four years to return to its pre-crisis level. Unemployment will continue to rise for three more years, reaching 11 to 12 percent in 2011."

It seems unlikely that unemployment will return to 11 percent this year, but if the global economy tips back into recession, anything is possible. Either way, Rogoff and Reinhart were a lot closer to the mark than most forecasters.

But the administration insisted on optimism. There was talk of "green shoots" and the "recovery summer." Events in Greece and in oil markets were chalked up to bad luck rather than the predictable aftershocks of a financial crisis. The promised recovery was always just around the corner, but it never quite 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 slog

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 boot 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.

In 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.

Perhaps 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 it.

There is no doubt that the post-crisis trajectory looks more like the slog 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 critique 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 administration 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 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 Romer 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 needed 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 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

> The Recovery Act worked. The problem is 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 positive. The Recovery Act worked. The problem is we didn't keep our foot on the accelerator."

That's not the sort of success the president had promised, though. He said the stimulus would "jolt our economy back to life." In Denver, the site of the 2008 Democratic National Convention, he said that although "this was not the end of our economic problems," it was "the beginning of the end."

It wasn't.

Critics and defenders on the left make the same point: The stimulus was too small. The administration underestimated 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 Romer thought the economy could get away with — rather than $1.2 trillion — what she thought it needed. Then the Senate watered the policy down to about $700 billion. Compare 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 congressional leaders had been quite clear with the White House: Don't send over anything that passes the trillion-dollar mark. To try and double the bill's size based on a suspicion that the recession was much worse than the early data indicated would have been a hard sell, to say the least.

Even if Congress had been more accommodating, 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 Goolsbee, 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 billionth 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 always 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 February of 2009 based on political and implementation 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 immediate relief to millions of Americans. That would help the administration build the political capital to pass more stimulus, if necessary. But when the economy failed to respond as predicted, the political theory fell apart, too.

"The biggest problem we had in terms of the loss of political capital is we came in and did a bunch of stuff, and things got worse," 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 administration 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 steadily 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 initiatives. The frenetic pace made the White House seem inattentive and unfocused amid a mounting crisis.

But the alternative is similarly difficult to imagine. No one believes that significantly reining in the agenda would have led to much more stimulus. Perhaps the president would have benefited politically from speaking more about jobs and less about health care, but then again, he had historic majorities in both houses of Congress and had come into office promising dramatic change.

A more accurate understanding of the recession could, however, have led to a somewhat different stimulus — and perhaps a more durable political strategy. The policy was constructed at breakneck speed, with the emphasis on getting money spent fast. That led to more tax cuts, as they could happen quickly, and less infrastructure, as projects — particularly anything 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 around that could be easily dropped into the legislation. That, according to Holtz-Eakin, solidified Republican opposition.

"If you're a staffer and you have been watching business in the House and Senate for a long time," he says, "what you saw them doing was pulling old ideas off the shelf — old ideas you had fought and that Democrats had abandoned. So Republicans 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 unemployment rate rather than setting them to expire after two years. With the knowledge that it had years of low growth to combat, there could have been a short-term infrastructure component — potholes, school repairs and the like — followed, in separate legislation that Congress would have had more time to consider, by a long-term infrastructure component for big investments such as high-speed rail and health-information technology.

But there's little reason to believe that would have turned unemployment numbers around. In fact, we have seen fairly regular extensions of unemployment benefits and tax cuts over the past year. A bill with a longer time frame perhaps would have saved the administration from political 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.

'Politics on housing are hideous'

The stimulus 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-driven crisis without doing anything about, well, debt.

In our crisis, 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 housing 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 7.5 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."

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 cognizant 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 a defense of its housing policy.

Its efforts to heal the troubled market at the core of the financial crisis are widely considered weak and ineffective. The Home Affordable Modification Program, which proposed to pay mortgage servicers to renegotiate with financially stressed homeowners, couldn't persuade the servicers to play ball and so has left

ECONOMY CONTINUED ON **G7**

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.

> “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

most of its $75 billion unspent. The Home Affordable Refinance Program was projected to help 5 million underwater homeowners. It has reached fewer than 1 million.

Even so, the administration rejects the more radical solutions that are occasionally floated. The problem, it says, is that the choices are mostly between timid and unworkable.

One problem was that mortgage finance giants Fannie Mae and Freddie Mac were ultimately controlled by the independent Federal Housing Finance Agency. Created by Congress in 2008, the agency was initially led by a Bush administration appointee, James B. Lockhart III, and when he stepped down, by another Bush administration appointee, Edward DeMarco. The Obama administration’s November 2010 effort to nominate its own director was foiled by Senate Republicans.

By that time, the administration had been in office for almost two years and seen 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 it, 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. “Cramdown,” in which judges simply reduce the principal owed by underwater homeowners, 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 this housing debt?” 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 Lehman Brothers in late 2009.

Which means that the ultimate question was how much housing debt the American taxpayer was willing to shoulder. Whether that debt came in the form of nationalizing the banks and taking the bad assets off their books — a policy the administration estimated could cost taxpayers a trillion dollars — or simply paying 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 seconds after their neighbors are asked to pay their mortgages. Recall that Rick Santelli’s famous CNBC rant wasn’t about big government or high taxes or creeping socialism. It was about a modest program the White House was proposing to help certain homeowners restructure their mortgages. It had Santelli screaming bloody murder.

“This 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 hand.” The traders around him began booing loudly. “President 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.

“If we had thought harder about Rogoff and Reinhart, we might have made some different trade-offs regarding debt reduction,” Bernstein says. “Moral hazard is a big problem when you’re making policy regarding write-offs and principal cramdowns. 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 over time. It can help a depressed economy 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 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 percent. Lifting that anchor could cause problems down the road, without doing much good in the present. After all, Federal Reserve Board Chairman Ben S. Bernanke 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 central banks need to do is to keep printing money to buy up government debt. The main risk is that inflation could overshoot, landing at 20 or 30 percent instead of 5 or 6 percent. Indeed, fear of overshooting paralyzed the Bank of Japan for a decade. But this problem is easily negotiated. With good communication policy, inflation expectations can be contained, 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 demand exceeding potential supply over an extended period,” says Donald L. Kohn,

PETE SOUZA/THE WHITE HOUSE

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

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who served as vice chairman of the Federal Reserve Board until 2010. "Yes, changing 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 nominating to the Fed.

Summers, who had the inside track to chair the central bank if the Obama administration decided against renominating Bernanke, echoes Kohn's skepticism. "In the model I understand," he says, "inflation is mostly driven by demand, and when you increase demand, you increase 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 determined 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 insulated 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 contender, has threatened to do something "ugly" to Bernanke. Congress passed legislation 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 recession. They're policy on the offensive. But perhaps the real lesson from Rogoff and Reinhart 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 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. Eventually, this is going to require a redistribution 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 economy isn't left with people who became unemployed and then found themselves unemployable.

That's what we've seen here: Employers have become so leery of hiring the unemployed that the Obama administration 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 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.

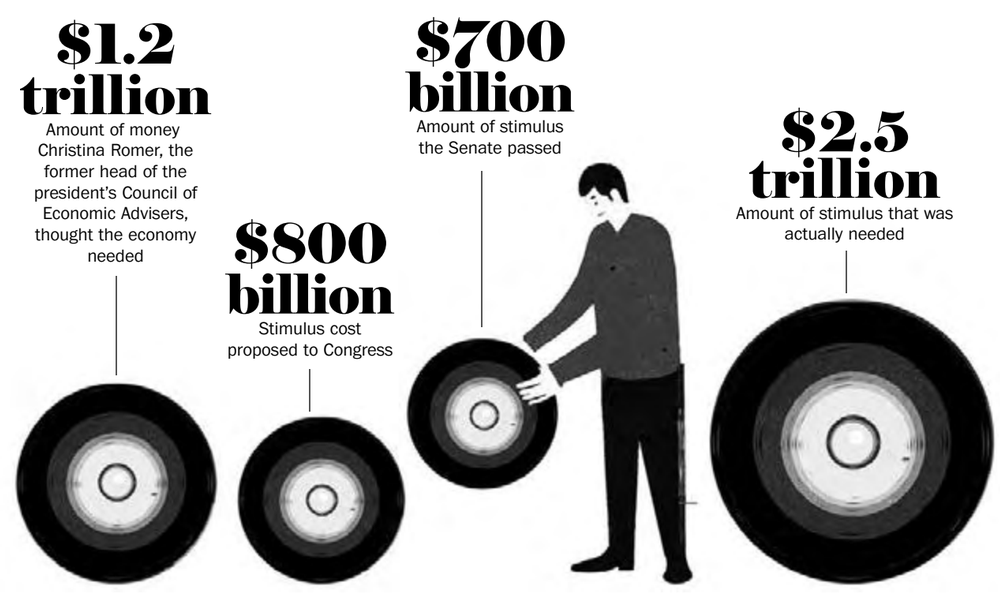
But paying the private sector to save jobs was not the administration's only option. There was also the possibility of simply paying workers to work.

For one thing, the government could have refused to fire anyone. Says Baker, of the Center for Economic and Policy Research: "We've lost 500,000 state and local jobs, and before that, we were creating 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 another million jobs."

It also could have started hiring. Romer, for instance, proposed to add 100,000 teacher's aides. Imagine similar proposals: Every park ranger could have had an assistant park ranger. Every firefighter 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 programs wouldn't have made sense. Better to support the economy more generally and let workers migrate from unproductive sectors to productive ones. Employing workers directly is, at best, a

Shrinking stimulus

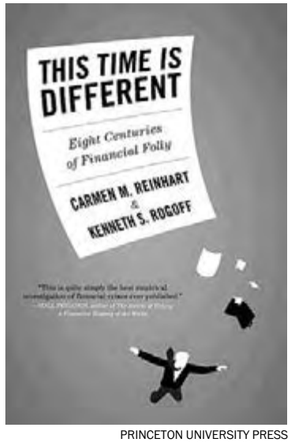


ANDREW HARRER/BLOOMBERG NEWS

In economist Carmen Reinhart's view, the Obama administration was wildly, tragically optimistic.

JEROME FAVRE/BLOOMBERG NEWS

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



PRINCETON UNIVERSITY PRESS VIA BLOOMBERG NEWS

Reinhart and Rogoff's book covers nine centuries of crises.

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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 in looks 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 time it takes to get out," 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 undershooting 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. It 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 clear to 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.

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