Reflections on Economic Policy in Time of Crisis

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President Obama inherited an economic crisis more serious than any President since Franklin Roosevelt. It has been an enormous honor to work with the President as he has provided an unprecedented response to unprecedented problems. This morning I want to reflect on the economic policies that the Obama Administration has pursued.

Before turning to those policies, let me just say a word about where the economy stands right now. The President’s program appears at this moment to be having many of its intended effects. While we still have a long way to go, the sense of free-fall that surrounded any reading of economic statistics a few months ago is no longer present. Now when we brief the President each morning on economic indicators, they exceed expectations about as often as they do not. I can assure you this was not the case in the first couple of months of the Administration.

However, no one should minimize the loss of 345,000 jobs last month – a figure comparable to the highest-loss months in the last two recessions. But, it also bears emphasis that the loss of 345,000 jobs is only half as many as the economy was losing each month just a few months ago. Consumer and business sentiment is increasing. And in what is perhaps an important predictor over a slightly longer term, the fraction of Americans, who feel the country is on the right track, has more than doubled. This strength has been matched by the strong performance of most financial markets in recent months, as the stock prices of financial institutions have risen and credit spreads have come down sharply.

To be sure, we cannot be complacent. There have already been several false dawns during this crisis and the history of major financial crises, whether during the Depression or Japan in the 1990s, suggests that there were periods of optimism and market strength even in the midst of the worst downturns. What can be said with confidence, however, is that we are closer to the end of the crisis than we were six months ago.

Many things have contributed to the improvement of the economy. Macroeconomic expansion has been pursued more rapidly in response to economic downturn than ever before in both the fiscal and monetary dimensions. Financial policy has taken many forms ranging from the very substantial expansion of the balance sheet of the central bank to the direct infusion of capital into financial institutions. Financial policy has also been bolstered by significant efforts to support and accelerate adjustment in the housing market. These areas of policy have been extensively discussed and debated.

In my remarks this morning, I would like to concentrate on policies towards individual institutions. The events of the last two years have been remarkable. The broader U.S. government has been forced to take extraordinary actions, including significant equity positions in such companies as Citigroup, AIG, and General Motors.

Inevitably, these steps have generated substantial debate. Some believe that government has been insufficiently intrusive in the economy, holding that banks should have been nationalized or that government should be taking a much heavier handed role with respect to the institutions in which it has intervened. Others suggest that these interventions represent an overreach, a kind of back door socialism that may threaten the very underpinnings of our market-based economic system.

Let me be absolutely clear at the outset about two aspects of President Obama's approach about which he has been particularly consistent and firm since the crisis began while he was campaigning for president:

- The first is an unequivocal recognition that we only act when necessary to avert unacceptable – and in some cases dire – outcomes. Barack Obama ran for president to restore America's role in the world, reform our health care system, achieve energy independence, and prepare our children for a 21st century economy.. He did not run for president to manage banks, insurance companies, or car manufacturers. The actions we take are those of necessity, not choice.
- The second point on which the President has been unambiguous is that any intervention go with, rather than against, the grain of the market system. Our objective is not to supplant or replace markets. Rather, the objective is to save them from their own excesses and improve our market-based system going forward.

Why Intervention Was Necessary

In the long sweep of history, Franklin Roosevelt's policies, denounced by many at the time as a radical attack on capitalism, are today understood to have helped preserve the market system. So, too, the approaches taken today are directed at protecting and strengthening, rather than replacing, the market system.

While the causes of today's crisis will be debated for many years to come, I believe that history will confirm this moment to be one of those rare occasions that Keynes wrote of where self-equilibrating markets break down. In these rare moments, vicious cycles replace self-correcting markets. Instead of falling prices leading to more demand and less supply, falling prices lead to more supply, driving prices down and creating a downward spiral. Nowhere has this been more evident than in our housing market, where lower prices led to increased foreclosures leading to less demand – because no one wants to buy a house whose price is about to fall.

When faced with such vicious cycles, the government has no alternative but to respond strongly to restore economic health. The responses that are most protective of the basic structure of the market system are those of macroeconomic policy: the general provision of credit and liquidity and the expansion of government demand support economic activity, but these actions do not involve intrusions in particular decisions that are usually reserved to the market. And that is why macroeconomic policy was, and appropriately is, the first line of response to crisis.

Macroeconomic policies can and have made a substantial difference. Policies that have led to higher incomes have led to greater ability to repay loans and a stronger financial system, leading in turn to more economic activity and higher incomes. Direct provision of credit by the Federal Reserve has led to lower capital costs, increased investment, and more economic growth.

But in a modern economy suffering a crisis, direct general macroeconomic policies, while necessary to assure economic recovery, may not be sufficient. When institutions are substantially interconnected, their failure can lead to the cascading failure of other institutions as the experience of bank panics teaches. But the idea that interconnections can lead to cascading failures is not only confined to finance in a world of integrated supply chains during exceptional circumstances such as the current recession.

Indeed the idea of vicious cycles is closely related to the idea of self-fulfilling prophecies. Think about a bank or a company or indeed, a country that is expected to fail financially. If it is expected to fail, no one will want to be the last one to try to withdraw their money, and the result will be that everyone seeks to remove their money at once. Even a basically healthy institution cannot withstand that pressure. And so it appropriate in extreme cases for the government to intervene when the disorderly failure of sufficiently large and interconnected institutions is a possibility.

What is crucial and where our focus has been as we have intervened when necessary is on the intervention being temporary, based on market principles, and minimally intrusive. Let me say a little bit about each of these principles, and then turn to the broader question of how we are going to prevent these types of crises in the future.

1. Temporary

To ensure that government interventions in individual companies are consistent with the President's principle of preserving the private market system, we must design them to be as temporary as possible. That is why it is constructive that, in the wake of the stress tests, major financial institutions were able to raise private capital to replace the government's capital infusions and repay the US Treasury approximately $68 billion in just six months. It is also why the President was clear and explicit that his objective is to exit the government's investments in auto companies as quickly and deliberately as is practicable.

The person who inherits a structurally-deficient house faces a choice: he can make only the necessary structural improvements so the house can pass inspection or he can take on new renovation projects with the ultimate goal of moving in? Our answer with respect to government stakes in major enterprises is clear. It is the former. We do not want to be owners; we want to be stewards to structural soundness and nothing more. And that is why we will work to transfer government holdings into private hands as soon as practicable.

2. Based on Market Principles

Second, our interventions are based on market principles. Private market transactions in situations of economic distress take many different forms. They may involve a range of different types of restructuring. They may involve private investors providing debtor in possession finance or taking equity positions. This is also the case, in situations of distress, where it is necessary for the government to become involved.

Our approach has sought to parallel what would have been the private sector process. Where possible we have provided secured loans where possible, such as in the various Fed facilities to support the banking system. Where this is not possible, we have sought to provide unsecured debt or preferred stock investments without taking on control rights.

Where institutions are fundamentally insolvent and government has had to provide the finance necessary in the context of bankruptcy, we have sought to do so in the same way a private sector lender would have done. I emphasize this point because a number of transactions, including the Chrysler transaction, have generated some controversy. So let me be clear: in a bankruptcy reorganization, each class of creditors is entitled to more than they would receive in a liquidation. I am aware of no serious argument that in any transaction in which the government has participated, this criteria has not been met.

On the other hand, it is standard practice for those providing debtors in possession finance capital – the lenders of last resort – to make purely commercial decisions that end up treating some creditors more generously than they would be in the context of a liquidation. For example, in the steel restructurings that took place some years ago, the private providers of capital chose to provide greater recoveries to the union health care trust than to many of the companies' other creditors. Those investors made a business judgment that to run steel companies effectively in the future, they needed to maintain a smooth ongoing relationship with the union. For the same reason, certain unsecured creditors of various forms are often treated much more generously than secured creditors in bankruptcies. From this perspective, there is nothing at all remarkable about the way in which finance was provided during the Chrysler or General Motors transactions.

This idea of following market principles has shaped what we have done in other respects. Reasonable financiers in the context of bankruptcies do not provide finance so enterprises can repeat the mistakes that caused them to go bankrupt in the first instance. That is why President Obama rejected the first restructuring plans that were put forth by both General Motors and Chrysler and insisted on much more radical restructurings that provided for profitability even in severe recession conditions in the car industry. That is why, despite sizable government resources, more painful changes including plant and dealership closings were necessary. And that is why it will be our objective to act in a fashion that is consistent with protecting taxpayers by acting just as a responsible market participant would.

3. Minimally Intrusive on an Ongoing Basis

The third aspect of our approach is that we seek to be minimally intrusive on an ongoing basis. While it is our objective to act as a private sector financier would, in the context of intervention in financial institutions, we cannot lose sight of the fact that the government is very different from a private sector actor. The government would be abdicating its responsibility to taxpayers if it did not ensure that financial assistance was deployed in a way that promoted growth and stability. Before providing tax-payer resources, it is sometimes necessary – on an ex ante basis – for the government to require that the company make significant changes or commitments to justify the intervention.

Government officials involved with any company are subject to political pressures of many different kinds. They have a much broader array of objectives than do private sector actors. For this reason, while it would not be uncommon for a private equity firm that invested in a distressed company to take an active role in its ongoing management over a long horizon, we have taken a very different approach.

Our approach focuses on ensuring, as a pre-condition of intervening, that appropriate management and governance are in place. It focuses on ensuring upfront that a credible and robust restructuring plan is adopted. It is not to seek to manage companies or their operations and certainly not on an ongoing basis.

We understand this approach is controversial. For example, here are those who believe that the government should use its stake in automobile companies to advance environmental objectives or to pioneer new labor management practices. This is not the President's approach. The President believes that automobile companies, in areas like CAFE standards or safety, should be regulated in the same way, by the same agencies whether or not government has an economic stake in those companies. It would be both politically improper and economically unwise to view interventions in private companies as opportunities to achieve broader policy objectives. On that the President has been clear.

Our approach has been to insist on a restructuring of the board of directors in the case of troubled companies, and where appropriate to insist on changes in management. But we have resisted, I believe wisely, the temptation to intervene in day-to-day business decisions. For example, in the restructuring of the auto companies, the government insisted on strategic plans that would enable the companies to thrive even if car sales do not rebound to former levels – but it did not decide or dictate the specifics of those plans in terms of plant or dealership closings. In the case of the TALF program, the governments set which broad categories of asset-backed lending were eligible, but did not involve itself in particular decisions about which assets should be funded.

These principles – maintaining investments as temporary, following market principles, and being as non-intrusive as possible – do not assure success. They cannot remove the need for judgment. But they provide a framework in which necessary, painful actions can be taken consistently. It is too early to know whether our policies have succeeded. It is not even clear how we will know ultimately whether they have succeeded because of the difficulty of knowing what would have happened had we not intervened.

But, if you take one fact from today, take this: Only if government is no longer a major presence in any of the companies well before a decade from now will it have fully succeeded in achieving a critical objective as we work to support the market system.

Reform of the Financial Regulatory System

Frankly, it is no accident that there are countless TV dramas about curative medicine and none, to my knowledge, about preventive medicine. Brain surgery makes for better drama than blood tests. Though in terms of the ultimate health of the population, the latter may be more important. So I would be remiss if I did not conclude by talking about what is in many ways a more important and more fundamental objective than the necessary agenda of intervention that I have just talked about. This is the agenda of crisis prevention through stronger regulation.

In the last generation, prior to the current crisis, we saw the Latin American debt crisis, the 1987 stock market crash, the commercial real estate collapse and S&L debacle, the Mexican financial crisis, the Asian financial crisis, the LTCM liquidity crisis, the bursting of the NASDAQ bubble, and Enron. That is one major crisis every three years.

In each case, the financial system did not perform its intended function as a bearer and distributor of risk, but instead proved to be a creator of risk. Problems emanating from the financial sector in each case profoundly disrupted the lives of hundreds of thousands or even tens of millions of people. Surely our fellow citizens are right to demand of those of us involved with the financial system greater stability and safety. That is why President Obama has made financial regulatory reform a central legislative priority of this early phase of his Administration. While many of the details are complex, the necessary fixes come from the application of common sense in an area where complexity can blind sophisticated observers to the obvious. There will be much to debate but here are some things with which I think we should all be able to agree.

1. Systemic Risk

Any financial institution that is big enough, interconnected enough, or risky enough that its distress necessitates government intervention is an institution that necessitates oversight by an agency responsible for managing the overall risk to the financial system. In a world where financial innovation is, for good reason, pervasive and where market conditions constantly change, public regulatory authorities need to have the ability to perform what might be compared to the “free safety” function in football: taking a holistic view of the playing field, identifying gaps, pointing to unsustainable trends, and raising questions about new kinds of interactions. Over-the-counter derivatives, for example, have largely existed outside the regulatory framework despite their explosive growth in recent years. Such markets should be regulated (in new ways) and monitored:

- To prevent them from posing new systemic risks,
- To promote the efficiency and transparency of those markets,
- To prevent market manipulation, fraud, and other market abuses, and
- To ensure that they are not marketed inappropriately to unsophisticated parties

2. Resolution Authority

Whatever measures we put in place to manage systemic risk, we must also be prepared to manage the failures of individual institutions. We have long had tools of resolution with respect to banks. But as we discovered last fall, painfully and expensively, a huge gap exists in our system in the lack of resolution authority for bank holding companies and non-bank financial institutions.

I would suggest to you that we will not have a financial system that is failsafe until we have a financial system that is safe for failure.

3. Capital Adequacy

Perhaps most fundamentally, I would venture this generalization: There has virtually never been a financial crisis in which leverage was not centrally involved. Archimedes famously observed that if you gave him a long enough lever, he could move an unbelievably large object, even the Earth itself. We have seen it powerfully demonstrated in financial markets that if you give people enough leverage, they can lose an unbelievably large amount of their own money and that of their clients. As Secretary Geithner has said when asked what's most important for financial stability, "The three most important things are capital, capital, and capital."

Looking forward, we intend to address capital adequacy in the financial system as a central element of the Administration's reforms.

4. Regulatory Arbitrage

There are some common sense points about the structure of regulation as well. Can it surprise anyone that if institutions choose their regulators and their regulators compete for institutions either domestically or globally, that standards fall, and that there is a race to the bottom. Instead of sponsoring races to the bottom, we need to drive competition to the top by insisting on strong standards.

5. Consumer Protections

A corollary of the idea that regulators should not compete for institutions is the idea that the regulation of consumer issues must put the interests of consumers above the interests of regulated financial institutions. The credit card legislation the President signed into law provided an overdue correction with respect to some serious abuses. Just as serious were the abuses in subprime lending that preceded the current crisis. Fixing our regulatory framework provides another opportunity to ensure that financial consumers are adequately protected.

Monitoring systemic risk, implementing a resolution authority, ensuring capital adequacy, eliminating regulatory arbitrage, enhancing consumer financial protections – If we can reform our financial system, we will minimize the recurrence of the situation we all find ourselves in today.

Conclusion

Since the first day of this Administration, I've often been asked what the Administration's most important economic objective is. I've usually answered by noting that when my daughters studied U.S. History, they learned a great deal about the Great Depression but that they were taught nothing about the 1975 recession, the 1982 recession, or even the 1987 stock market crash, exciting as those events were to many of us in economic policy. We will have succeeded in our policies if students who study U.S. history in 2040 are not taught about the economic and financial crisis of 2009 but learn instead, about the positive changes we've made.

Making the right choices is of immense historic importance, not only for people's immediate economic well-being, but for the longer-term implications regarding the legitimacy of the market system.

America has faced this challenge more than once before. A Republican Roosevelt, Theodore, and a Democratic Roosevelt, Franklin, both presided over periods in which capitalism's excesses and inadequacies imperiled its very survival.

I would suggest to you that going forward we have an enormous challenge of saving the market system from its current excesses and inadequacies.

If we can meet this challenge, there are more opportunities to create more prosperity and better lives for more people than in any other time in history. And when we look back on this period, we will look at it as a period that was difficult and painful, but also a period when we made profoundly important investments as a country, when we learned profoundly important lessons about responsibility, and when we built a foundation for an even greater prosperity in the future.