THE WHYS OF U.S. ECONOMIC RECOVERY POLICY

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Practitioners and students of economic life worldwide can no longer overlook the importance of the institutional foundations which enable their activities. The legal and credit institutions on which they rely to assure that property and contract rights are enforced and that claims on resources can be exchanged have always been fundamental, if unnoticed. But now the reliability of parts of the credit structure has been squandered. Along with the malefactors, far more innocents have had their lives damaged. To use the demeaning and heartless phrase of military conflict, they are the collateral damage. In the U.S., virtually no one is immune.

Two general types of damage have been done. Though they interact, each has its special significance. There have been important income effects and wealth effects. The income effects are much noted in rising unemployment rates, extension of the average duration of unemployment, changes in hours of work, loss of work related (particularly health insurance) benefits, and the appearance of unemployment among those in occupations in which this has rarely been a problem. The immediate follow-on effect of declining purchases exacerbates the ills. But most people have jobs and though their level of concern has risen, their incomes are reasonably stable.

The wealth effect, the declining net value of assets on balance sheets, is far more ubiquitous. Few have escaped it. The value of their homes, of their retirement funds, of their direct and indirect holdings of bonds and stocks have all diminished. Revisions of spending plans, education plans, retirement plans, life expectations are all occurring. The emotional hardship is matched by the downward force on economic activity. Over recent decades, Americans were told to secure their future through the personal management of their wealth. They were not told enough about risk and they relied too heavily on effective government regulation and private institutional integrity. Even the vaunted former Chair of the Federal Reserve admits to this.

Two types of short term policy responses are now underway with long term basic reform promised.

The first, and basically simpler, are designed to offset the income effects of the recession. Through tax reductions, direct payments, job-creating programs, grants, and income supplementation they are all intended to add to spending and therefore incomes. The relative efficacy of each of these is disputed. Some are claimed to be counterproductive and others are opposed because they are said to initiate new programs that are likely to become continuing features of an enlarged governmental role. Others extol them for just that reason. Still others find particular merit in educational, health care and physical infrastructure programs that are designed to improve the achievement of long term goals while aiding short term performance.

The short term program to counter the wealth effect is harder to conceive and implement. The simplest approach is to have government replenish wealth by buying assets – houses or bonds, for example -- for more than their present worth. No matter what the façade placed on this, it engenders reluctance even when coupled with the hope that someday their values will rise to equal or exceed the government's cost. The initial expenditures seem to fly in the face of logic, they will replenish the wealth of the profligate as well as the collateral damagees, they will only help those whose wealth was in assets the government is buying, and they induce moral hazard. They turn investment into a "heads you win, tails we lose" bargain.

A more complex approach is to stem the decline in asset values. This is of particular pertinence to the declining value of houses because it can also stem the dreadful process of foreclosure and eviction. If mortgages can be realigned with present house values and housing payment abilities, families would not be forced out and the market would not have the overhang of empty, foreclosed houses waiting for a buyer. In this case, and in others, the process is costly to the government, costly to the initial lender, and complicated by the ingenuity of the credit marketers who sliced and sold debt till it is hard to discern to whom debts are owed. Apparently, many of the debt holders are abroad, many are indirect holders through pension and mutual funds, and many are the financial institutions which were expected to assure satisfactory performance of credit markets. In other words, many are the victims of their own machinations.

Preserving these institutions is proving costly and immensely complex. Current discussion focuses partially on the semantic riddle of whether we are in the process of "nationalizing" them. Regardless of the meaning given the term, some things are clear. For the foreseeable future, major financial institutions will be increasingly subject to governmental scrutiny and their behavior censored. Their owners will get little or nothing for their prior stake in them. And until we return to a situation that features them as willing lenders to willing borrowers, collateral damage will persist and grow. Fortunately, the U.S. has operating examples of satisfactorily performing financial institutions and protective practices on which to build.