

Gerald Epstein

## Obama's Economic Policy: Achievements, Problems and Prospects

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# Obama's Economic Policy: Achievements, Problems and Prospects

## 1. Introduction

- 1 In late November, 2008, just after President Barak Obama won the American election, a group of progressive economists met in New York city at the New School for Social Research, to discuss the ongoing economic crisis and to try to reach a consensus on financial and macroeconomic policies that the group should advise the Obama Administration to implement. Organized under the sponsorship of the New School's Schwartz Center for Economic Policy (SCEPA) and the University of Massachusetts, Amherst Political Economy Research Institute (PERI) the group issued a document in December which was endorsed by many members of the group, and later was circulated and endorsed by fifty US progressive economists (see <http://www.peri.umass.edu/statement/>)<sup>1</sup>.
- 2 The Progressive Economist's statement called for a specific set of macroeconomic and financial reforms which we believed could both help protect the global economy from the massive slowdown created by the economic crisis, and that could also lay the foundation for a more stable, more egalitarian and greener model of economic growth.
- 3 Since that time, the Obama administration has proposed and implemented a large number of macroeconomic and financial initiatives. How should we assess the nature of these initiatives? Are they well conceived to address the serious macroeconomic and financial problems facing the US and the global community? How do they compare with the proposals put forward in the *Progressive Economists Statement*? What are some of the financial and macroeconomic policies that need to be implemented now for the US to design and implement macroeconomic and financial policies that will address the serious short term problems we face, while promoting a sustainable and egalitarian path to future development? These are the issues I discuss in this short paper.
- 4 The next section summarizes the key points made by the US Progressive Economists' group in their policy statement. Section III then compares those proposals with the policies implemented or initiated so far by the Obama administration in the areas of financial recovery and reform and short run and longer run macroeconomic policy. Section IV concludes with an over-all assessment of Obama's macroeconomic and financial initiatives thus far. I argue that the Obama administration's stimulus package and long-term budget proposals are important breaks with the neo-liberal past and push the United States toward a much more egalitarian, productive and sustainable future, including one that attempts to make the transition to a less carbon-based economy. The Obama team's attempt to lead a coordinated global fiscal response to the economic crisis is also positive and consistent with the proposals outlined by the group of progressive economists. But, the Administration's over-all handling of the banking and financial crisis has been very poor. In terms of its basic approach, it represents a continuation of the failed and inequitable policies of the Bush administration. Perhaps most worrisome is the political fall out of these problematic financial policies: the popular anger and opposition they are engendering threaten to undermine Obama's other, very important economic initiatives.

## 2. A Progressive Program for Economic Recovery and Financial Reconstruction

- 5 The *Progressive Economists' Statement* began by emphasizing the dire nature of the current economic crisis and the grave dangers to social health that would result from a failure to solve it, both in the short term and the longer term.

6 “Not since the Great Depression has the world faced an economic crisis as it does today, with enormous attendant loss in human progress and a serious threat of global instability. An interlocking set of down-ward pressures starting from the financial markets and extending into the real economy is unraveling economic stabilizers and institutions. This unraveling is especially cataclysmic because it follows a decades-long period of stagnating real wages, increasing inequality, disappearing decent jobs, deteriorating security for households and families in the US and recurring financial crises around the globe.”

7 Calling for “swift and coordinated action” by the incoming Obama administration, the group emphasized the need for global coordination of economic policies to deal with the deepening crisis. The economists emphasized that the crisis was the culmination of a long period of commitment on the part of economists and policy makers to a “neo-liberal” approach to economic governance, an approach that lay at the heart of the current economic disaster, and one that must be abandoned and replaced.

8 “It must reject the extreme ‘free market’ and ‘neoliberal’ policies followed by governments in the US and many other countries in recent decades, policies that contributed to the economic crisis we now face. Markets, including financial markets, must be properly embedded in and managed by governments and other social institutions for them to work efficiently and serve the needs of society. Economic policies should aim to promote green growth, while reversing the stagnating wages, extreme inequality, growing insecurity, and lax regulatory conditions that have led to debt-driven spending booms. Only then will the US achieve sustainable and widely-shared growth.”

9 While the economists did not provide a fully articulated alternative to neo-liberal analysis and policy prescriptions, the statement did provide a partial set of principles that, they argued, should guide policy in the current conjuncture.

1. Capitalism, left to its own devices, is unstable and needs proper regulation and automatic stabilizers to avoid major destructive economic episodes.
2. Markets, including financial markets, must be properly embedded in and managed by governments and other social institutions for them to work efficiently and serve the needs of society.
3. Government is needed to provide leadership in economic areas that have major spillover effects and where markets are therefore likely to fail, such as health care, climate change, and public investment in basic infrastructure.
4. Families need financial support to help them provide their crucial care giving services. It is grossly unfair and ultimately self defeating for government to continue to function as a mechanism for socializing costs and risks for the financial sector, while ignoring the needs of workers, families and productive industries which provide good jobs with good wages and benefits.
5. Workers need a legal infrastructure such as the Employee Free Choice Act that allows them to fight for and win their basic rights. The achievement of these rights will promote better political governance and a healthier economy overall, and will better enable workers to achieve healthy living standards that will trickle up through the economy.

10 The economists emphasized: “This means restructuring the financial system to serve the needs of ordinary people and families – workers, taxpayers and homeowners. As for the future financial landscape, we call for resisting efforts to ‘hit the restart button’ and restore the economic trajectory we were on before the crisis hit. Instead, regulation of the financial system should aim to create a sustainable economy and to finance productive investment and innovation.”

11 Based on these guiding principles, the program focused on domestic and international macroeconomic and financial issues with an interlocking set of initiatives that included four major components: 1) a massive fiscal expansion program to promote economic recovery;

2) economic policies to restore the societal balance of power and health to labor, communities and families while making the transition to a greener economy; 3) policies to reconstruct, regulate and manage financial institutions so they will serve the needs of people and contribute to financial stability; and 4) principles for international cooperation and coordination to help the world economy recover and make a transition to fairer and more balanced global growth.

12 More specifically, the program called for policies to:

- Revive the economy by instituting a massive public investment and financial support program focusing on jobs, housing, state and local services, green investments, and infrastructure investments, supported by expansionary monetary policy.
- Reform the financial sector bailouts to be fairer, less costly and more effective, by broadening and strengthening the oversight of financial institutions and using government leverage to realize significant changes in how these financial institutions operate.
- Reverse extreme inequality and increase the prosperity and power of families and communities.
- Re-regulate and restructure the financial sector.
- Reform international economic governance to make the transition to a more balanced, prosperous and just global economy appropriate to changing global realities.
- Reverse extreme inequality and restore family and community health. Policies to reverse this extreme inequality must restore the power of workers to bargain for a decent living. These were among the most important policies.

## 2.1. Longer-term Policies for Financial Re-Construction

13 As the statement pointed out, prior to the crisis the “US and global economies have faced an ever worsening cycle of financial deregulation, financial explosion, financial crash and bailout, followed by a renewal of the cycle at a higher and more dangerous level. This cycle was described well by Hyman Minsky. Each cycle is punctuated not only by costly financial mistakes, but by widespread financial fraud and malpractice.”

14 This dynamic led to financial sectors in most developed countries that have become “bloated”. As a result, “the financial sector will have to contract”, in an “orderly fashion” without contributing to an economic collapse. Furthermore, financial markets must be re-regulated in order to prevent a build-up of the same problems that lead to the current crisis. Building on the proposals of Epstein and Crotty (2009), D’Arista and Griffith-Jones (2008) and others, the statement outlined key problems in the financial sector that lead to the crisis and a set of regulatory proposals to address them. These regulations would need to: 1) eliminate the perverse financial incentives that contributed financiers to take excessive risks; 2) increase the transparency of financial transactions; 3) reduce the pro-cyclicality of the financial system; and 4) restructure financial institutions to allocate credit to more socially productive purposes. In section III below, I summarize a set of financial regulatory proposals that could help achieve these goals. Here, I note that to promote financial institutions that contribute more toward social goals, the statement called for the government to implement “more public control and oversight over financial institutions”. This would be designed to enhance transparency and ensure that these institutions are contributing to the creation of jobs, home ownership, education and other goods that people want and need. “More specifically, the Obama administration should exert this authority through ‘its regulatory oversight, and/or by demanding seats on the boards of companies to which it has made major loans or investments’. Furthermore, these government actions must be transparent and accountable, and broad citizen representation must be included on financial oversight boards.” Finally, there need be no presumption that nationalized or partially nationalized financial institutions be returned quickly to private ownership; it is more important for the government to exert

appropriate control over these institutions, including the establishment of “codes of conduct” for financial institutions with respect to executive pay, and lobbying the government.

## 2.2. Global Reform and Global Macroeconomic Coordination

15 The statement recognizes that in this increasingly globalized world, financial regulations must be coordinated on a global scale and urged the Obama administration to take a leadership role in encouraging on a global scale the types of financial reforms discussed above. In addition, it was recognized that in the short to medium term, a globally coordinated fiscal expansion would be required to place a floor on the economic down-turn and to promote a global economic recovery. It called on President Obama to take a lead in promoting this large, globally coordinated fiscal expansion.

16 But in the longer term, more significant changes would be required to deal with a number of key structural macroeconomic problems. The statement addressed some of these broader issues of global macroeconomic coordination and global economic reform. It stated that: “The roots of the current crisis are complex... include the global imbalances that have dominated world economic growth over the last several decades. The state of affairs in which the US serves as the buyer of last resort and the world serves as dollar accumulators of first resort cannot any longer be the basis for the long-run trajectory of the global economy.” While in the short-term, the statement recognized that in the short term, the “US economy must continue to run significant current account deficits and act as a buyer of last resort”... “in the long term, it is neither feasible nor desirable for the rest of the world nor the US to continue in these roles”. Not only must “the surplus countries of China, Japan and Germany” play a bigger role as providers of global aggregate demand, but even more importantly, the global institutions must alter they types of macroeconomic policy they promote to developing countries. More specifically, the statement calls for “the IMF, the World Bank and other institutions... (to) shift away from the high conditionality, export-led, free capital mobility approach embodied in the neoliberal philosophy”, and promote “an approach that gives developing countries more policy autonomy and more resources to bolster domestic demand and capacity. To further these goals, the Obama administration and partners must initiate a dialogue to implement a major reform of global institutions and practices.”

17 Building on the work of Griffith-Jones et al. (2008), Ocampo (2008) and South Centre (2008) these principles include an inclusive governance process that gives much more voice to governments and citizens in developing countries in international policy making forums; more policy space for developing countries to allow them more freedom determine their own policy paths; and the expansion financing for development from the richer countries to the poorer ones. This could include, for example, mechanisms of issuing more (Special Drawing Rights) SDRs directly to developing countries for development purposes.

## 3. The Obama Record So Far

18 Since becoming President, Obama and his administration have implemented or proposed a large number of initiatives in a large number of areas. Here I focus only on those related to macroeconomic and financial policy and, within those, only the most important ones related to the proposals of the progressive economists’ statement. More specifically, the focus here will be on five areas: 1) Short-term macroeconomic stimulus program, including monetary and fiscal policy, housing policy and international efforts at leadership and coordination; 2) Management of the financial salvaging and reconstruction efforts; 3) Medium and longer term fiscal policy initiatives, including those directed at ending extreme poverty and initiatives for making a transition to a green economy; 4) Financial reform and re-regulation; 5) International initiatives for macroeconomic and financial governance.

19 The overall assessment at this early stage of the Obama administration is that it has undertaken or proposed many initiatives that are consistent with those proposed in the Progressive

Economists' statement. The two areas, however, where the Obama policy has utterly failed, is in the management of the financial crisis, including salvaging and restructuring the banks; it has also been very slow and tentative in proposing longer term financial reforms. On the other hand, with respect to most of the other areas, the administration has proposed many sensible programs and policies. The contrast between the finance proposals and those in other areas is so striking, it calls out for explanation.

20 Of course, the Obama administration faces an intense political struggle to implement many of these policies. Many political forces, both within the US and outside, oppose the Obama administration's approach. In the end, the administration will have to choose which initiatives on which it will decide to spend political capital. Here, in subtle form, the administration's true priorities will be revealed.

### 3.1. Short-term Macroeconomic Stimulus Program

21 The key short-term stimulus programs initiated by the Obama administration (and the Federal Reserve) consist of the following components: 1) Monetary policy initiatives; 2) The fiscal policy stimulus package "The American Recovery and Reinvestment Act"; 3) Policies to counter the home foreclosure crisis; and 4) Initiatives to promote global coordination of expansionary macroeconomic policy.

#### 3.1.1. *Monetary Policy*

22 The Federal Reserve System (Fed) in the US has a significant degree of political independence, but as the financial crisis has evolved, it has been forced to coordinate its policy quite closely with the US Treasury. The Progressive Economist's statement proposed that the Federal Reserve's main task now is to support fiscal policy and that is what it has done. The Fed has adopted a virtual "zero interest rate policy", a massive increase in unorthodox credit operations to provide or guarantee credit for many segments of the US and global financial system, including commercial paper, automobile loans, housing credit, money market funds, and in the international sphere, it has entered into SWAP agreements with many central banks. In terms of directly supporting fiscal policy, the Fed has begun to directly buy longer term Treasury Securities, to try to lower the cost of government borrowing, a direct measure to support fiscal policy expansion. Of course, not everything the Fed has done is consistent with the spirit of the Progressive Economists' Statement. In terms of "international cooperation" and helping to serve as an international lender of last resort, the Fed has not only entered into SWAP agreements with foreign central banks; but the Fed has also sent, in a completely non-transparent way, billions of dollars to major European banks through its bailout of the American International Group (AIG) insurance company. The Fed's role more generally in the bank bail-out operations and regulatory debate has been highly problematic, as I discuss more below.

#### 3.1.2. *The American Recovery and Reinvestment Act*

23 Within a month of taking office, President Obama and the Democratic majority in Congress passed a major fiscal stimulus plan, "The American Recovery and Reinvestment Act", which involved spending \$787 billion over ten and a half years, including \$501 billion in increased spending and \$285 billion in tax cuts (Committee for A Responsible Federal Budget: CARB, 2009). This plan reflected a number of significant compromises and changes from the original bill proposed by the Obama Administration. The Obama administration had proposed a stimulus plan of over \$800 billion dollars over two years, with a larger portion spent on infrastructure and "green initiatives" but the plan that ultimately passed had much less in infrastructure and green spending, and significantly more in tax cuts. A key concern of the bill was to spend the money quickly to fight the recessionary forces. The program as passed into law spends 23% in the first year and will spend over 91% by the end of the third year. (CARB,

2009). Many progressives were disappointed with both the size of the package, as well as the excessive amounts spent on tax cuts, which are widely seen as less effective in stimulating jobs. In addition, there is no significant government “employer of last resort” program, as the progressive economists had proposed. Still, with all its flaws, the plan was a significantly positive departure from the lack of significant effort by the Bush administration to address the deepening crisis.

24 Yet, many economists argue that the government will have to implement a further significant stimulus package during this year. The progressive economists had proposed a \$600 billion dollar program in each of the next two years, and this is consistent with levels proposed by many other economists, as well. Among the massive problems insufficiently addressed by the Obama stimulus package but emphasized by the Progressive Economists is the serious fiscal situation of the state governments. Most states are required by law to balance their budgets, and due to the crisis, the vast majority (47 out of 50) are expected to face a budget shortfall of more than \$350 billion dollars during 2010 and 2011. Unless the Federal Government is able to send significantly more money to the states, they will have to raise taxes or fire teachers, firefighters, police and other public employees, significantly worsening the recession, and dramatically reducing the quality of public services. (McNichol and Lav, 2009)

### 3.1.3. Addressing the Home Foreclosure Crisis

25 The home mortgage crisis is at the heart of the economic crisis and now is becoming a massive social crisis in the United States. More than 2 million Americans have lost their homes since the crisis began and by some estimates, over 8 million foreclosures will take place by 2012 if effective counter-measures are not taken (Credit-Suisse, 2008) and banks are holding billions of dollars of bad assets because of the collapse of the housing market. Clearly, a major effort is needed to keep people in their homes and dramatically reduce the home foreclosure rate, as the Progressive Economist’s statement made clear.

26 The Obama administration passed legislation in early March that attempts to keep Americans from losing their homes. It has three parts. The first part makes it easier for the nationalized housing banks Fannie Mae and Freddie Mac to buy housing loans, which should lower the costs of mortgages and make them more available to more people. This will allow people to refinance their mortgages even if the value of their loans exceed the value of their homes by five percent. The trouble is that the value of many people’s houses is below the level of their mortgages by even a greater percent. A second part of the plan gives a subsidy to mortgage servicers to agree to reduce monthly mortgage payments for distressed home owners. A third part of the plan allows bankruptcy judges to modify the mortgage loans so that the principle amount can be written down without the threat of lawsuits from bondholders who own CDO’s based on these mortgages. The problem with this is that it is a case by case approach, not a comprehensive one affecting millions of homeowners at once.

27 Critics argue that these plans are not comprehensive enough and will not help enough homeowners, especially the poorest and most vulnerable. Robert Kuttner estimates that the Obama housing plan will only help about one –third of those who need it. (Kuttner, 2009, March 3).

28 Kuttner and the Progressive Economists’ statements had proposed more radical solutions, including a moratorium on home foreclosures and a revival of the 1930’s era Home Owners Loan Corporation where the Federal Government uses the government’s long-term borrowing rate to refinance mortgages directly, taking an equity position in the homes so that when housing prices recover, the tax payers also receive a capital gain when the houses are sold. (PERI/SCEPA, Progressive Economists’ Statement, 2008; Kuttner, 2009).

29 As with the stimulus package, the Obama administration has made a good start, but has not gone far enough. Here too, it will have to come back to revisit this problem soon and probably take more radical action.

### 3.1.4. Promoting global coordination of expansionary macroeconomic policy

30 The Obama administration has been quite aggressive in promoting coordinated expansionary fiscal policy, most notably at the G-20 meeting in London, in early April. It has also pushed the IMF to enhance its lending facilities to promote economic recovery while reducing the degree of neo-liberal conditionality involved in these loans. These are both elements of the Progressive Economists' statement. These initiatives, however, have not been terribly successful, at least not as of this writing. Most members of the G-20, including the French and German governments, are strongly resisting a major, coordinated fiscal stimulus package. And the United States has not pushed the IMF strongly enough to reduce its conditionality, so that the effectiveness of IMF lending is likely to be dramatically undermined. This is especially worrisome since the center-piece of the G-20 plan from the London Summit is to triple the resources going to the IMF.

### 3.2. Management of the financial salvaging and reconstruction efforts

31 The Progressive Economists' statement emphasized the need for the Obama administration to use its public investment in US financial institutions to alter the operations of these banks to support the economic recovery in the short run and to aid the longer-term reconstruction of the US economy. They also urged a code of conduct on these banks that would limit the pay of high level officials, eliminate their ability to lobby the US government, and that would dramatically increase the transparency and accountability of these institutions. The statement was agnostic about the issue of nationalization, but supported the idea if it was necessary to achieve the goals listed above. It has now become clear that as major US banks are or are nearly insolvent, that nationalization of a number of them is likely to be the best solution.

32 Yet the policies implemented by Treasury Secretary Timothy Geithner, Federal Reserve Chair Ben Bernanke – all with the support of Barack Obama – have failed to live up to these guidelines. The firestorm over AIG bonuses and other big pay packages for banking executives illustrates that the Obama administration has not implemented a serious code of conduct for the banks; and the recent Public-Private Investment Program (PPIP) designed to use a massive government subsidy to encourage private equity firms and hedge funds to buy de-valued (so-called “legacy”) bank assets makes clear that the government is desperate to avoid the nationalization option, or any option that will involve significant government control over private banks (for critiques of *the PPIP see, for example*, Sachs, 2009; Buitter, 2009; Galbraith, 2009). The essence of this program is to use government guarantees, provided through the already allocated Troubled Assets Relief Program (TARP) money, and guarantees from the Federal Reserve and Federal Deposit Insurance Corporation (FDIC) to guarantee 94% of any investment taken on by private wealth holders. The structure allows the Obama administration to avoid going to Congress to get an additional allocation of public money. This is widely seen not only as non-transparent and lacking in accountability, but also as a massive subsidy for the banks, private equity firms and hedge funds.

### 3.3. Longer Term Macroeconomic and Green Policy Initiatives

33 While the financial management policies thus far have been highly misguided, the longer term macroeconomic and “green” policy initiatives have been much more in line with the Progressive Economists' program. Obama's plans are contained in his administration's preliminary budget document “A New Era of Responsibility: Renewing America's Promise”. This outline of longer term (10 year) policy initiatives have been widely praised by progressives as representing a break from the neo-liberal era of business dominance and inequality ushered in by Ronald Reagan in the 1980's and a move toward a policy of more widely shared growth with government playing a more central management and investment role (see for example, Robert Reich, “Obamanomics Isn't About Big Government; It is About Human Capital” Wall Street Journal, March 29, 2009). There is of course a long way to go

before these policies are passed into law, much less implemented as policy. But I will mention here a few of the key aspects that are consistent with some of the priorities outlined by the Progressive Economists' Program:

### 3.3.1. *Making the Transition to a Greener Economy*

34 Obama called for major investment in a green energy economy (See, Obama, 2008; PERI, 2008). The centerpiece of the program is a "Cap and Trade" program which would sell permits to place manufacturing firms and energy utilities operating in the US which would allow them to emit "greenhouse gases", and allow them to trade these permits. It is estimated that by 2012, the US government would earn \$78.7 billion in revenue, some of which would be sent back to households to partially compensate for the increased cost of energy that would result from the permit sales, and partially used to invest in "clean energy", through direct public investment and subsidies. (See for example, Bloomberg, "Obama Plan Has \$79 Billion from Cap – and – Trade in 2012", February 26, 2009.) This program, along with a more general plan for making the transition to a greener economy, has been introduced into the Congress under the heading, "American Clean Energy and Security (ACES) Act". Any proposal along these lines will face a difficult political fight, but many progressives are encouraged that the Obama administration has made the fight against global climate change a major priority.

### 3.3.2. *Reforming Health Care*

35 The Obama administration has also proposed initiatives to move toward a more universal form of health care coverage, while trying to reduce health care costs (Obama, 2009; Center on Budget and Policy Priorities, April 1, 2009). While most progressives prefer a truly universal system of health insurance in the US, some will see the Obama plan as a perhaps adequate movement in the right direction. (See "Physicians for A National Health Program" <http://www.pnhp.org/>, for information on National Health Care Proposals in the US; and the bill introduced by Vermont Independent Senator Bernie Sanders, Independent of Vermont for Universal National Health Insurance [http://www.pnhp.org/news/2009/march/singlepayer\\_health.php](http://www.pnhp.org/news/2009/march/singlepayer_health.php))

### 3.3.3. *Ending Poverty and Extreme Inequality*

36 Making health care more affordable, and confronting the housing crisis will help many who have fallen into poverty. But to reduce extreme inequality, there must be significant income tax reform. The Obama administration has taken tentative steps in that direction by proposing that a number of tax loopholes used by corporation and the very rich are closed. But they have not proposed a massive change in the tax system that would greatly improve the relative after-tax, after-transfer position of the poor. So again, Obama is taking steps back toward the progressive direction, but they are quite tentative and small at this stage. (See Citizens for Tax Justice, <http://www.ctj.org/>, for discussions of more progressive tax reform.)

### 3.3.4. *Increasing Labor's Bargaining Power: Employee Free Choice Act*

37 A key to reducing extreme poverty and inequality in the US is to increase the power and organizational abilities of labor, which has been decimated during the neo-liberal era. "The Employee Free Choice Act" a bill under consideration in Congress, is designed to do that. (See the materials posted at PERI: <http://www.peri.umass.edu/efca/>) The goals of the Employee Free Choice Act are to: strengthen penalties against companies that coerce or intimidate workers trying to form unions and bargain; establish mediation and binding arbitration when the employer and workers cannot agree on a first contract; and enable employees to choose between two options for gaining union recognition: majority sign-up or the National Labor Relations Board election process.

38 The Obama administration is supporting the passage of the bill, but it faces an uphill battle in Congress. It seems unlikely to pass soon. In the end, it will be difficult to say whether the Obama administration has made passage of the act a major priority, despite the very important

support of organized labor in the 2008 election. (See [www.peri.umass.edu](http://www.peri.umass.edu) for information on the Employee Free Choice Act)

39 In sum, many progressives are highly supportive of the longer term directions taken by the Obama administration in these key areas, though they remain concerned that the Obama administration will not move far enough or fast enough, partly because of strong opposition within his own party, and partly because of opposition by Republicans and business groups.

### 3.4. Financial reform and re-regulation

40 The Obama administration has indicated that it plans to make financial regulatory reform a top priority. (<http://www.ustreas.gov/press/releases/tg72.htm>) There have been plenty of blueprints for reform developed (see for example Crotty and Epstein, 2009; Progressive Economists Statement, 2008; D'Arista, Griffith-Jones, 2008; DEMOS/Kuttner, 2009) The Obama administration has not yet unveiled its complete plan for financial regulatory reform but it has indicated the four areas that it plans to address: Systemic Risk; Protecting Consumers and Investors; Eliminating Gaps in The Regulatory Structure; Fostering International Coordination. While these seem to be the key areas, the Obama administrations specific proposals are not encouraging. Crotty and Epstein (2009) and the Progressive economists called for a nine point program of financial regulation. The six most important components are these:

41 **1. Transform financial firm incentive structures that induce excessive risk-taking.**

Asymmetric and perverse incentives for top financial decision makers are ubiquitous in the present system. They receive enormous bonuses when their firms make profits from excessive risk-taking in the boom that they do not have to give back in the downturn. We need a system of "clawbacks" through which bonuses paid in the upturn would have to be returned after, say, five years if their firms' profits fell substantially in that period. Clawbacks could be required in compensation contracts or implemented via the tax system through a series of escrow funds.

42 **2. Extend regulatory over-sight to the "shadow banking system."**

The unregulated 'shadow banking system' of hedge and private equity funds and bank-created Special Investment Vehicles played a major role in the creation of the crisis. These institutions must be brought under a strict regulatory framework that should be applied to all important financial institutions.

43 **3. Restrict or eliminate off-balance sheet vehicles.**

Banks hid trillions of dollars in risky assets off their balance sheets in the buildup to the crisis that hid their vulnerability from regulators and investors. All assets should be held on bank balance sheets and adequate capital must be set aside to support them.

44 **4. Implement a financial pre-cautionary principle.**

Destructive financial innovations such as collateralized debt obligations (CDOs) and credit default swaps were major contributors to the development of the crisis. A regulatory precautionary principle should be implemented for new financial products and services similar to the one used by the US Food and Drug Administration to determine whether new drugs should be allowed on the market. Regulators would determine whether proposed innovations were likely to increase systemic fragility. In many cases, the regulatory authority would tell financial institutions that their innovations could be implanted as long as held adequate capital to support them. However, there would be important innovations that the regulatory authority would prohibit on the grounds that even with more capital they would have serious negative spillover effects on the system.

45 **5. Move most important financial security transactions onto exchanges.**

Eighty percent of all derivative products and one hundred percent of the complex CDOs, credit default swaps and other exotic financial instruments implicated in the current crisis are not traded on markets, but rather in private over-the-counter transactions. If regulators insisted that all derivative securities must be exchange traded, those OTC securities that could be simplified

and commoditized would shift to exchanges where they would be transparent, involve less counter-party risk, and could provide a less expensive source of credit. The most complex products, including many CDOs and credit default swaps, cannot be sufficiently simplified and would likely disappear from the market.

#### 46 **6. Restrict the growth of debt through counter-cyclical capital requirements.**

The first five reforms should help reduce the excessive growth of debt in the boom, but will not eliminate the inherently pro-cyclical nature of financial asset creation. As asset prices rise, bank capital rises as well, creating new capacity for credit creation. More bank lending leads to a rising demand for securities and thus higher security prices, which allows the process to continue. To assure control of the rate of expansion of financial assets, regulators should impose *counter-cyclical* capital-asset ratios or reserve provisioning.

47 There is very little indication that the Obama administration is willing to implement serious regulations of the type suggested here. So here again, there seems to be a much weaker commitment to confronting Wall Street and grappling with serious financial reform than there is in other areas.

### 3.5. Longer Term International Financial Reform and Coordination

48 The Progressive Economists' Program calls for a significant reform of the international economic structure. These include increasing the role of developing countries in global economic governance; expanding the policy space available to developing countries by altering the neo-liberal policy apparatus that emanates from the IMF and other international organizations; finding mechanisms to increase resources flowing to the poorest countries through a scaling up of foreign aid and issuing Special Drawing Rights (SDRs); and reducing the reliance on the United States as the "global buyer of last resort" by urging the surplus countries to re-orient their economies away from exports and toward domestic demand.

49 The Obama administration has not yet confronted many of these issues so it is too early to tell what progress will be made on them. Among these, the only one Obama has addressed so far is the desire to see surplus countries, and especially China, to increase domestic demand, reduce reliance on exports, and become more of an engine of global economic growth. At the same time, the Obama administration has not proposed any new initiatives to institute such a new global model of growth.

## 4. Conclusions

50 Obviously, it is much too soon to judge President Obama's macroeconomic and financial policies against the benchmark of the Progressive Economists' program. He has only been in office for several months. In some ways, his administration has taken major steps away from the neo-liberal approach of the Bush and Reagan administrations and toward some highly significant policies, especially with respect to addressing climate change. But in the area of financial crisis management and financial reform, the Obama administration seems oddly stuck in the prior regime. Of course, circumstances will force Obama, Bernanke, Geithner and Lawrence Summers to accept more financial regulation than did Alan Greenspan or Bill Clinton. But, so far at least, their focus has been more on trying to preserve the prerogatives of finance in the face of strong political and economic forces demanding that they control these forces.

51 Part of the explanation for this apparent divergence in policies between finance and almost all other economic issues, is that President Obama is probably worried that if he undermines the confidence of finance, the whole economy could come crashing down. As a result, the President decided early on to listen to "experienced" advisors, which effectively means advisors who have a lot of experience with and probably a bias toward finance. Equally if not more important, though, is that Obama finds himself stuck with a democratic coalition that, at least since Bill Clinton and almost certainly before, had a very strong Wall Street constituency

(eg. Epstein, 1981; Ferguson and Rogers, 1986; Pollin, 2005). The political power of the finance lobby in the United States is significant. For example, a recent study described the twelve key steps of financial de-regulation in the US that significantly contributed to the crisis. According to the study, *Sold-Out: How Wall Street and Washington Betrayed America*, during the last 10 years, these financial firms spent over 5 billion dollars in campaign contributions and to hire “lobbyists” to promote these and other policies of financial de-regulation (Essential Information, 2009). This is just the “tip of the iceberg” of the political power of finance as it also has strong representation in key economic institutions of economic decision making in the US, notably in the US Treasury and the Federal Reserve (Epstein, 1981; Ferguson and Rogers, 1986).

52 Unless a much stronger coalition of labor, industry, and community members organizes the political power to pull Obama away from the Wall Street constituency, it is likely that we will continue to see much of the same financial policy for the rest of his administration. Groups of economists such as those that met in New York in November, 2008, must mobilize to keep the pressure on the Obama administration. Fortunately, there are a number of important organizations of economists and “progressive” “Think Tanks” in the US that are pushing the Obama administration to adopt more progressive and effective policies, including those with respect to the financial sector.<sup>2</sup> This infrastructure of progressive research institutes and think tanks has been built up over the last fifteen years or so (though some of the older institutions such as the EPI and IPS have been around much longer than that), and now can make a significant difference in the policy debates. For example, these organizations are very active in writing policy papers and promoting their ideas in the press and at meetings and conferences and can have a significant impact. When the time comes, some of these groups will undoubtedly revisit and update the PERI/SCEPA *Progressive Economists Statement* or similar broad programs, and try to promote them widely.

53 Still, economists are a relatively small force compared to the raw political power that comes from mobilizing voters and lobbyists. Here, the “progressive forces” represented by progressive labor unions and others are still relatively weak in the US to be sure, the mobilization of forces carried out by the Obama campaign, and those further stirred up by the economic crisis could produce a significant strengthening of these groups. However, as is well known from history, severe economic crises can also strengthen the forces of the right, and only time will tell how these pressures will play out. What we can say is this: unless the Obama administration is able to move forward quickly and change their approach to finance by developing a financial strategy that is seen as fair, equitable and can also work to get finance flowing to the real economy, then more radical forces are likely to gain increased power. And, one should remember that in the US, we are coming out of a long period in which it is the radical forces of the right, rather than of the left, that have tended to prevail.

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## Notes

1 The meeting was organized by Gerald Epstein, Co-Director of PERI and Teresa Ghilarducci, Director of the New School's Schwartz Center for Economic Policy Analysis (SCEPA). The full document was drafted by Radhika Balakrishnan, James Crotty, Edwin Dickens, Gerald Epstein, Thomas Ferguson, Teresa Ghilarducci, Jo-Marie Greisgraber, Stephany Griffith-Jones, Robert Guttman, Arjun

Jayadev, Anush Kapadia, David Kotz, Michael Meerepol, Fred Moseley, Jose Antonio Ocampo, Robert Pollin, Malcolm Sawyer, and Martin Wolfson and other participants of the November meeting. Almost 100 economists endorsed this document or a related, shorter statement of principles.

2 These include the Center for Economic Policy Research (CEPR), DEMOS, the Economic Policy Institute (EPI), The Political Economy Research Institute (PERI), The Levy Institute, The Institute for Policy Studies (IPS), The Schwartz Center for Economic Policy Analysis (SCEPA), The Union for Radical Political Economy (URPE), the Citizens for Tax Justice (CTJ), the Center for American Progress (CAP) and Center on Budget and Policy Priorities (CBPP) among many others.

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### ***Droits d'auteur***

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