

# Why Are Good Macro Policies Political Losers?

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Last month I talked about how the big valid complaints about U.S. macropolicy over the past fourteen months were not that it has run up the national debt and not that it has rewarded the princes of Wall Street, but rather that it had, if anything, been on too small a scale--that we ought to have done more. And I noted the puzzle that these policies today appear, somehow, to be political losers in Washington right now: nobody is proposing to do more along the same lines. This is strange: usually when something works the natural impulse is to do it again. And I said that thought two different things were going on-- with respect to the Obama fiscal boost that is the ARRA, simply (a) an outbreak of extraordinary intellectual and political dishonesty that (b) the press refuses to call what it is. But I left hanging the question of why American politicians today are allergic to the banking policies the Federal Reserve and the Treasury have followed over the past fourteen months.

Now let me pick up this question I had left hanging.

Perhaps the best angle from which to view a financial crisis is to look at it as a collapse in the risk tolerance of investors in the private financial markets. Why this collapse in risk tolerance comes to pass is a second-order question: perhaps the culprit is the recognition of lousy internal controls in financial firms that over-reward subordinates for taking risk, perhaps it was government guarantees with the same effect that are now called into question; perhaps it is that a long run of good fortune left the financial market dominated by cockeyed unrealistic overoptimists who have finally figured out who they are, or perhaps it is simply an unreasoning unmotivated panic. In any case, the risk tolerance of the market crashes and with this crash comes a crash in the price of risky assets as well. This crash erodes or eliminates the capital of financial intermediaries. Everybody knows that there are immense unrealized losses in financial assets. Nobody is sure that they know where those unrealized losses are. To buy or even to hold risky assets in such a situation is a recipe for financial disaster. And to buy or hold the equity of organizations previously thought of as safe that may have bought or may be holding risky assets is a recipe for financial disaster as well.

This crash in the prices of risky financial assets would not be of great concern to the rest of us were it not for the fact that in its aftermath the price system is sending a peculiar message to the rest of the economy. The price system is then saying: shut down risky production activities. The price system is then saying: don't undertake any new activities that might be risky. There aren't enough safe and secure and sound enterprises on the shelf for all the workers laid off from risky enterprises to find new jobs. And if the nominal wage declines to signal that there is an excess supply of labor that only makes things worse: the general deflation eliminates the capital of yet more financial intermediaries, and makes risky even a larger share of the assets in the economy that had previously been seen as safe.

In such a situation since 1825 the standard response of central banks has—except during the Great Depression—been the same: raise up the prices of risky financial assets, support them, keep financial markets from sending to the real economy the signal that risky enterprises should be wound up and risky investments should not be undertaken. The first-order problem is

that this rewards those who are long risky assets in their portfolios, and many of those who are long risky assets are those who accepted risk with open eyes and who bear some responsibility for causing the crisis. You cannot do an effective rescue any other way. A policy that leaves owners of risky financial assets impoverished is a policy that sends the real economy a signal to shut down risky enterprises and eschew risky investments.

This problem, however, can be finessed: as Federal Reserve Vice Chair Don Kohn says, teaching a few thousand feckless financiers not to overspeculate is much less important than securing the jobs of millions of Americans and tens of millions around the globe.

But there is a second-order problem that cannot be finessed. Financial rescue operations that benefit even the unworthy can be accepted if they are seen as benefiting all—even if the unworthy gain more than their share of the benefits. However, financial rescue operations that benefit the unworthy cannot be accepted if they cause losses to other important groups as they define themselves—like taxpayers.

When Vice Presidential candidate Jack Kemp attacked Vice President Al Gore in 1996 for the U.S.'s lending money to the feckless Mexican government during its 1994-1995 financial crisis, Al Gore responded that the U.S. government has made \$1.5 billion on the deal. When Senator Alfonse D'Amato criticized the Rubin Treasury and the Camdessus IMF for committing public money to the rescue of New York banks that had loaned to feckless East Asians in 1997-8, Robert Rubin and Michel Camdessus responded that (i) they had not rescued the truly bad speculative actor, Russia; (ii) they had not bailed-out the New York banks but rather had bailed them in, requiring that they pony up additional money to support the economy of Korea; and (iii) that everyone had benefited massively above and beyond the public budgetary impact because a global recession had been avoided.

Now, however, the U.S. government cannot say that a global recession has been avoided, cannot say that they bailed-in the banks, cannot say that—

with the exception of Lehman and Bear Stearns equity holders—they forced the bad speculative actors into bankruptcy, and cannot say that the government made money on the deal. It is still the case that the banking-sector policies undertaken were good ones, or at least were vastly better than the government’s washing its hands of the financial sector a la Republican Treasury Secretary Andrew Mellon in 1930-1931. But there is nothing concrete to point to to make that real. Instead, what there is to point to is that because of the U.S. government’s banking-sector rescue policies, bank bonuses are up and the U.S. Treasury is down.

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