



A Short-Lived Recovery?

Adam S. Posen cautions that as the economy recovers and the banking system stabilizes, the United States still needs to treat several underlying problems to prevent another downturn.

Recorded April 10, 2009. © Peterson Institute for International Economics.

Steve Weisman: This is Steve Weisman at the Peterson Institute for International Economics. Our guest is Adam Posen, deputy director of the Institute. We're going to talk about banks and whether or not, as some say, a recovery and a stabilization of the banking system is under way. Thanks for joining us, Adam.

Adam Posen: Thanks for the opportunity to bring some, at least, good news.

Steve Weisman: Is there good news? There's been some in the papers. The markets think there might be some. What do you make of it?

Adam Posen: I've been saying for a while, and I'm obviously not alone in this, that the US economy was going to recover, now is recovering. I think we're probably going to see growth cease shrinking. We're going to see positive growth by the fourth quarter, possibly even earlier this year. Unemployment will probably continue to rise for a good six months after that, but the bottom will soon be found.

Why do I think this? I think there are three things going on: first, the policy measures taken in terms of fiscal stimulus, which is now being spent by the states; monetary policy, where the Fed is really buying up a lot of different assets and getting money in the hands of people; the refinancing boom, where they're trying to promote housing. All have a big impact. I think the second thing is that it's very hard to keep a modern economy down if you're not Zimbabwe or North Korea; in other words, if you're an economy with rule of law, property rights, basic market structures, the nature of things is they tend to bounce back.

Even in the United States in the Great Depression, the economy was already bouncing back by 1932. In Japan, it bounced back several times and it got whacked over the head in the 1990s by bad policies. But generally, you get a recovery. We're heading into two years of recession and it's time for the United States to recover.

The final point is one that our colleague Mike Mussa has made, which is a certain number of houses have to be built eventually no matter what. If you build too many houses in suburban Las Vegas or Bakersfield, California, that's one thing; but if you have population growth in Arlington, Virginia, and hurricane damage in southern Florida you've got to build houses where those things are.

So, those three together—the policy, the fundamentals, the housing recovery—I think all contribute to the growth we’re going to see in the next several months.

Steve Weisman: Your mention of the first glimmerings of growth in the Great Depression in 1932 raises a question, though. Although there may have been such glimmerings, there was a banking crisis in 1933. Is there a possibility that even though we’re seeing these kinds of cyclical shifts in growth, the banking system itself is still precarious and in danger?

Adam Posen: It’s a legitimate concern. I think what the Obama administration has done so far has been very good about preventing outright panic and, to a lesser degree, kicking the problem off the road for a few years. They’ve sort of gone soft on the banks in some ways, provided a lot of guarantees, made it so the current management and shareholders feel secure, which on the one hand means you don’t see closures of banks the way you did, say, as you correctly refer to, Steve, in 19’33, when Franklin Delano Roosevelt came in and shut down a third of the country’s banks overnight.

But it means that there are some underlying problems there, and it is a question whether the economy just grows out of those problems as some people would advocate. Those are the people saying all the banks have good assets, it’s just they’re not performing well right now because things are so bad and they are being forced to sell in a fire sale.

Then there are people like me, and I’m not alone, who say, well, actually, as long as the banks are in that state, they’re going to probably engage in bad behavior. At a minimum, they’re not going to lend as much as they should, and probably will just roll over loans to bad borrowers, because they don’t want to write off the bad losses. So, if that’s the case, probably we will have a banking crisis a year or two down the road.

Steve Weisman: You and I are talking at a moment when two initiatives of the administration are being rolled out. First is this Public-Private Investment Partnership scheme in which the banks are going to be selling their so-called toxic assets to investors with the help of generous terms from the federal government—lending terms. And second, of course, is the stress tests, which are supposed to be done by the end of April. What is your sense of whether these are palliatives or real steps that can reform the system? Or are they buying time?

Adam Posen: My view is that they’re well intentioned but they’re basically time-buying or what you would call palliatives. They get us through the situation. To be fair to the Obama administration, to the guys in their team, I think a lot of this is because they would like to do the right thing, which means to be very tough with the banks and recapitalize them, but they can’t get more money out of Congress right now. That’s been made very clear, so they have to come up with these alternatives.

So looking at the Public-Private Investment Partnership, the PPIP, or whatever they’re calling it now, how are we going to tell whether it works or not? I would suggest there are two very big markers. One is how much total gets sold of these

assets. The IMF estimates that roughly a trillion dollars worth of bad assets are still out there on US balance sheets.

You could argue they've written off some of it but there still should be several hundred million dollars worth. And if they only end up selling a couple hundred billion or less, that's an indication they haven't really gone after the problem.

Steve Weisman: They could be selling the better ones and leaving the worst ones on the books.

Adam Posen: Absolutely. And that leads into the second point, which is you have it right. The banks right now, because the stress test doesn't really mean much, and because mark-to-market accounting requirements have been lifted, don't have an incentive to sell anything that they think is worth something. They can sit there and say, well, the economy's coming back, listening to Adam Posen, so therefore, I might as well sit on this because this real estate security or this loan to this business could be worth more three years from now.

Steve Weisman: Is there jawboning that Treasury can and should do? Should they say, "Look, we've got this program. We want you," talking to the banks, "to sell not just your more attractive but still troubled assets but real stuff that is sitting there that isn't worth that much, and we want you to take the loss on that"?

Adam Posen: Well, I think jawboning is of limited effect this year because there are two things that the Treasury could have done that basically compelled that. One is, again, going back to the stress test: These stress tests are essentially simulations where they use a standard computerized framework and say this is what is on the bank's balance sheet, and make certain assumptions about how these assets move together, and what the underlying conditions are, and then project what these could be worth under stress.

And if the stress test had been serious, they could have been done literally in less than a week because the government officials are already there, the data's already there, it's just a question of recalibrating it. And so, the fact that they're trying to get the asset sales on their way before the stress test takes place is consistent with the fact that they don't seem to think they want the stress test to be too tough.

The second piece compelling the banks to sell the stuff they think could be good but needs to be sold is that they just announced that the banks can now set up their own entities to buy toxic assets or buy distressed assets. What does this mean? Well, it means you have Gotham Bank and you have Bank of the United States, and Bank of the United States sets up an off-balance sheet entity and buys a bunch of Gotham Bank toxicity, and Gotham Bank sets up an off-balance sheet entity and buys a bunch of Bank of the United States toxicity. And both of them in theory have moved stuff off the balance sheet with the ...

Steve Weisman: With the help again of...

Adam Posen: Subsidies and guarantees from the federal government. But it's just really swapping between coconspirators in the sense that the net position of the systems are no better, except for whatever transfers the federal government has provided to these banks.

Steve Weisman: Shouldn't Congress or somebody prevent this sort of speculative behavior?

Adam Posen: Absolutely. And there's an entity affiliated with Congress, the so-called Congressional Oversight Panel, chaired by Professor Elizabeth Warren of Harvard Law School, that came out with very forthright statements the other day criticizing the Treasury for not being tough enough and being too vague.

Steve Weisman: Is that going to have any effect?

Adam Posen: I would hope so, but so far it does not seem to.

Steve Weisman: If you look at it historically, Adam, this is a moment, in the famous phrase of Rahm Emanuel: "You never want to waste an opportunity..."

Adam Posen: "Never let a good crisis go to waste."

Steve Weisman: "Never let a good crisis go to waste." Okay, it almost sounds like this crisis, because in your view, it is becoming a wasted opportunity in terms of bringing about real reform of a system that delivered the crisis in the first place.

Adam Posen: That's always the tradeoff in political economy. You're sort of damned either way. If you don't do the longer-term reforms when there's crisis, and this is particularly true in the financial sector, because that's when the financial sector is potentially least influential, then you may never get the constituency you need for the reforms.

On the other hand, if you do the reforms in the midst of the crisis, you end up having to close some banks, you end up temporarily cutting back on lending because you're raising standards and it could make the economic effects of the crisis worse and seem more expensive in the short term because you have to put up more money.

And so this is why Rahm Emanuel can talk tough about that. But the historical record in the United States, as you've pointed out in your reading of Alan Brinkley, but also across countries, is that crises don't tend to promote much in the way of reform. It's very rare that you get reform with crisis, but in two out of three crises, you don't get reform. Those are the kinds of basic political constraints this administration is finding itself up against.

Steve Weisman: Let me return to the opening subject which is the recovery that's going on. Are you also saying that if we don't reform now, this recovery's going to be weak and it could go back into a downturn in a year or two? Why would that happen?

Adam Posen: It is what I think would happen. Everybody's picking up a letter in the alphabet. There are those talking about the L-shaped recovery, meaning there is no recovery. There are those who talk about a V-shaped recovery, meaning we bounce back about as high as we went down. Despite the bad association of it, I'm in favor of the letter W, which is that we get a bounce now but very quickly thereafter we go back down again.

I think the banking system is a big piece of that. If, when the fiscal stimulus and the monetary stimulus wear off, the banking system still has these underlying problems, it may put a limit on how much growth we have going forward. There's also this ongoing potential that people wake up if the economy doesn't grow fast enough, long enough and say, hey, the banks really aren't safe after all. They do still have a lot of bad things in their books. More broadly though, I think we're going to see a W even without the banking system.

Steve Weisman: For what reasons?

Adam Posen: Essentially, what's going on is, the US trend rate of growth, even before this crisis, has slowed down. I think we've talked about this in past Peterson Perspectives, but the Institute was ahead of the curve about two years ago and has identified the fact that the trend growth rate in productivity, the trend growth rate in labor force, were slowing. Whereas the US economy has been growing an average of about 3.5 percent year over year, real terms, through the early part of this decade, it's now probably only capable of growing 2.5 percent.

And what that means is that if we get a real bounce, yes, there'll be some slack to be taken up in the economy, certainly some unemployed people, but we could very quickly start running into real inflation. And the Federal Reserve is likely in standard normal fashion to have to reverse its course and worry about inflation because otherwise interest rates go through the roof and you get the recovery cut off anyway.

In that scenario, it's sort of like the late 1970s early 1980s. You're coming out of stagflation, you're coming out of a miserable period, the Fed is reluctant to raise rates and Congress wants to keep spending going. But the Fed is forced to act like Paul Volcker in the early 1980s, saying in the end, I can't let this get out of hand and that causes a recession because the Fed raises short-term interest rates. So that's how you get the W. And then the banking system would just add on to that.

Steve Weisman: We'll certainly be here to watch it as it unfolds and see what shape the recovery is going to be. Thanks very much, Adam Posen, for joining us on Peterson Perspectives.

Adam Posen: Sorry to bear the bad news but glad to be here.

