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Obama: The First Hundred Days (I)

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On March 3, 1933, in his first inaugural address, Franklin Delano Roosevelt said dramatically, “This nation asks for action and action now. . . We must act, and act quickly.” And act quickly he did, issuing a blizzard of executive orders, including a federally-required bank “holiday,” designed to arrest panic-driven withdrawals following thousands of bank failures; eleven months later the FDIC was created to insure deposits. On March 16, he sent Congress an unprecedented bill aimed at raising prices for farm products by establishing federal allotments; a year later it emerged as the Agricultural Adjustment Act. At his urging, laws were enacted to provide immediate relief and employment via such new agencies as the Works Progress Administration and the Civilian Conservation Corps. In April Congress passed the National Industrial Recovery Act, giving the government sweeping powers over business – a program the Supreme Court ruled unconstitutional in 1935. Gradually, he also introduced longer-term measures such as the TVA, rural electrification, the Wagner Act to encourage unionization, and what are now called infrastructure projects. On Sunday evening, March 12, only nine days after his inauguration, FDR gave his first “fireside chat” over the radio, reassuring people that their deposits would be safe and urging them to be calm and confident. On Monday, when the remaining banks reopened, people who had withdrawn their funds stood in line to redeposit them. The humorist Will Rogers famously summed up the reaction: “America hasn’t been so

happy in three years as they are today, no banks, no work, no nothing . . . They know they got a man in there who is wise to Congress, wise to our so-called big men. If he burned down the Capitol we would cheer and say, ‘Well, at least we got a fire started anyhow.’”

That initial period came to be called the administration’s “first hundred days.” It inspired hope, offered relief for those in abject poverty, and began to reduce unemployment. But hardship lingered on. Only defense mobilization and war itself finally brought an end to what came to be called the Great Depression. In retrospect, it is pretty clear that recovery was so long in coming mainly for two basic reasons, monetary and fiscal.

On the monetary side, both the Federal Reserve Bank and the Treasury did too little to stop wholesale bank failure resulting from the market crash or to counteract the contraction of credit that followed. President Hoover, hoping to stamp out “an orgy of speculation,” had restricted the money supply -- exactly the wrong prescription to forestall a depression. The Federal Reserve Bank was much too timid in injecting liquidity into the banking system and expanding lending by its own financial operations. The lesson of this failure was later drawn by Milton Friedman and his collaborator Anna Schwartz in what became a classic study of how the recession turned into a depression; this time the Fed under Bernanke and the Treasury under Geithner are using every means available to show that this lesson has been learned.

On the fiscal side, the Keynesian strategy calling for deficit financing in times of recession was slow to replace the conventional view that the best government policy was always to strive for a balanced budget. Eventually, military spending provided the sort of massive economic boost that Keynes called for at the bottom of the business cycle. The stimulus package adopted by the Obama administration is of course another turn to the Keynesian prescription.

The parallels between conditions then and now are unnerving, though there are differences and so far this fallback is much less severe. When FDR took office, forty-six percent of the nation's farms faced foreclosure. A bushel of corn in Iowa was selling for less than a package of chewing gum. In Mississippi, cotton sold for less than a nickel a pound. Crops rotted in the fields because it was uneconomical to harvest them. A housing bubble burst and helped precipitate a financial crisis. In the years leading up to the 1929 crash, mortgage debt tripled. Another housing bubble has triggered the latest crisis. Once the bubble burst, about a year ago, home prices plummeted and the value of the mortgage loans fell even more precipitously than in the 1920s because of modern-day subprime lending, leveraging, and repackaging. As a result, the banking system, now greatly consolidated by the emergence of giant national banks, has been threatened with insolvency. In one year, the total wealth of Americans has declined by 18%, which translates into \$11 trillion. The stock markets lost 30-40% of their value, compared with a drop of 89% by July of 1932. Rates of unemployment, home foreclosures, and bankruptcies are rising, and it remains uncertain when or even if the recession will bottom out and a recovery set in.

Now, however, the unemployment rate is "only" 8.5 %, as against 25% when FDR took office, though the current number would be higher if it included the underemployed -- those who have been forced to work fewer hours or in lower-paying jobs. Thanks to unemployment insurance and Social Security -- both legacies of the New Deal and its aftermath -- the effects of the economic crisis have been cushioned for some of the most vulnerable.

Otherwise, the current economic crisis is jarring because it comes after a long period of rising prosperity, albeit one in which real income for low wage earners has not kept pace with the

income of those in the higher brackets. A higher standard of living brings higher expectations. Thanks to a number of influences, home buying became a popular form of investment. The influences include rising affluence, low interest rates, federally-insured mortgages, the deductibility of mortgage interest and property taxes, the flogging of subprime, no-down-payment mortgages, and the decision in 1997 to exempt the first \$500,000 of capital gains on home sales. The result is that two-thirds of American households are now homeowners, compared to only 40% before the 1930s. Ironically it is the very collapse of home values and the mortgages they carry that has affected so many and triggered this recession. And now, in Sacramento and Fresno, we even have shanty towns to remind us of the Hoovervilles of yesteryear.

In these three meetings, then, we will look at the response of this administration during its first hundred days. We will first review the steps taken by the President and Congress in domestic economic policy. Next, we will look at the administration's national security and foreign policy, and finally we will consider whether the changes we are going through could also entail shifts in our political and social values. This is a tall order and I don't pretend to have the range of expertise or the clairvoyance that would be required to give anything like a definitive assessment, but that hasn't stopped me in the past and I make no apology for trying because we all need to try to get our minds around what is happening. That is why Jack gave me this assignment and why I agreed to take it on.

I want to tackle the domestic issues by stating as a framework a fairly simple thesis, but one that has a sting in the tail. It has three related parts. I suggest first that the underlying cause of this crisis has been, more than anything else, the several-decades-long assault on the legacy of

the New Deal that began with the resurgence of the Republican Party in the 1970s. The rollback was greatly accelerated under Reagan and brought to a climax by George W. Bush, even though both presidents frustrated conservative expectations, Reagan by raising taxes and Bush by increasing federal spending. This campaign to undo the regulatory shackles of the New Deal brought a revival of the gambling-casino economy of the 1920s, complete with Social Darwinism, buccaneer capitalism, and the Jake Gatsby-like lifestyles of the rich and famous. Second, I suggest, as others have, that what is now being done by the Obama administration to deal with this crisis amounts to a revival and extension of what FDR began. And third --and here's the sting -- I propose that in order to achieve this revival and extension, we will need to reinvent the American economy and rewrite our social contract in ways that build on but go beyond the legacy of the New Deal.

I am aware that officials of the administration have insisted, according to the *New York Times* columnist David Brooks, that they do not see themselves as liberal crusaders out to undo the Reagan Revolution but as pragmatists aiming to restore balance. My thesis is that a pragmatic effort to right the balance must necessarily revive the role for government and the concern for social equity that animated the New Dealers and that any realistic assessment of what needs to be done must recognize that restoring the status quo ante will not be enough. To put this another way, we can restore balance, in the sense of full employment, consumer confidence, and a general feeling the country is moving in the right direction, only by transforming our way of life and the rules of the game in certain key respects. Fortunately, President Obama understands this very well, whatever his staff people may be telling David Brooks.

To emphasize the third point of my thesis about the need for reinvention, I want to call attention in advance to one statistic, which is that 80% of our economic activity – and a corresponding percentage of jobs -- is now in the service sector, as distinct from manufacturing and agriculture. The service sector includes everything from banking, insurance, real estate, and finance, to education and research, health care, every form of entertainment and leisure activity, legal services and law enforcement, all the way to housecleaning and trash removal, not to mention the contributions of the underground economy, such as illegal gambling, drug pushing, and other activities proper society deems vice, except when they happen in Nevada. Financial services alone account for 7.7% of our Gross Domestic Product, and in the current decade that sector accounted for no less than 41% of domestic corporate profits, up from about 16% in 1985! These statistics alone help explain why the turmoil in that sector has had such an impact on our economy, but they have a larger significance even than that. When sociologists say that as a society we have moved into the post-industrial phase of history, they mean that we are now increasingly living off the earnings of the service sector – directly by the income it provides and indirectly by the taxes it pays. The New Deal could foster recovery by reviving farming, retail business, resource exploitation, and manufacturing; this administration will foster recovery only if its actions continue to improve productivity in these sectors and at the same time revitalize and reform the service sector so that together all three sectors can provide the added income needed to balance the debt we are accumulating for all the imports we buy and the deficit spending we are now doing to forestall a depression.

So let us look at each of the three parts of my thesis.

First, recessions are a normal part of the business cycle, but a basic reason this one is much deeper than usual is that the regulatory role of government established in the New Deal was allowed to atrophy. Government came to be derided, in Reagan's phrase, as the problem rather than the solution. Instead, there arose an attitude that Alan Greenspan, then chairman of the Fed, called "irrational exuberance." This attitude encouraged the same high-stakes gambling by corporations and individuals that helped give the decade of the Roaring 'Twenties its name. Executives came to regard their companies as personal ATM machines and the ratio of executive compensation to workers' wages exploded. The economist Paul Krugman has pointed out that in the mid-1970s, the CEOs of major companies were paid on average \$1.2 million each in today's dollars, or 40 times the pay of the average full-time worker. By the early 1990s, CEO pay averaged more than \$9 million a year in today's dollars, or 367 times the pay of the average full-time worker. The link between pay and performance was completely severed. Richard Fuld, the CEO of Lehman Brothers, was paid \$350 million between 2000 and 2007 before the firm he allegedly managed went out of business in 2008. The *New York Times* reported recently that the executives at seven major financial institutions that have collapsed, were sold at distressed prices, or are now deeply indebted to the taxpayers, have received a total of \$464 million in performance pay since 2005 – almost half in cash. Since 2007 these same seven firms have reported losses of \$107 billion, and their shareholders have lost about \$740 billion since the prices of the companies reached a peak in 2007. [An AFL-CIO investment director described these payments as "a giant fraudulent conveyance, where money was paid out to executives at firms that were fatally undercapitalized." And then there are the stratospheric bonuses at AIG, paid with funds supplied by our taxes, to the culprits in a single division who laid the company low – bonuses described by one business journalist as "legalized theft."

One commentator (David Rothkopf) has said that “the values of business – profit above all, wealth as the prime measure of success, short term over long term – became society’s values.” Irrational exuberance intoxicated not only the CEOs of financial institutions but also the managers of pension funds and ordinary individual investors. In today’s stock market, margin requirements are much higher than in the ’twenties, but exposure to equities for pension plans, 401K plans, and the like has become far more extensive than it was then. Finance companies sought to leverage their assets to higher and higher levels, heedless of the risks they were running. In 1999, a Republican-dominated Congress passed the Gram-Leach-Bliley Law allowing commercial and investment banks to consolidate. In 2000, Congress, at the urging of Fed Chairman Greenspan and Treasury Secretary Lawrence Summers, agreed to de-regulate over-the-counter derivatives, financial instruments that essentially represented bets on the future value of some underlying assets. Formerly conservative banks jumped at the opportunity to bundle mortgage loans into derivatives, thus mortgaging their own futures to what became toxic assets when the housing bubble burst.

And the same attitude spilled over into housing. To foster greater home ownership, which was said to be what the American dream boiled down to, lenders were encouraged to underwrite mortgages for householders who had no or little capital to lay down as a deposit and levels of income that could not support the payments. Refinancing, based on rising real estate prices, sustained the mortgage payments until the bubble burst. Unscrupulous lenders took advantage of poorly informed would-be borrowers, sometimes using fictitious income data and valuations they knew to be inflated. In poor areas like inner-city Detroit, they wrote subprime mortgages which were then resold to Wall Street banks.

The historian Niall Ferguson explains what happened next: “The banks, in turn, bundled these loans into high-yielding residential mortgage securities (RMBS) and sold them on to investors around the world. . . Repackaged as collateralized debt obligations (CDOs), these subprime securities could be transformed from risky loans to flaky borrowers into triple-A rated investment grade securities.” The rating agencies certified them on the ground that the top tier of these securities was unlikely to go into default; the riskier mezzanine and equity tiers were more risky but yielded correspondingly higher interest.

The key to this financial alchemy was that there could be thousands of miles between the mortgage borrowers in Detroit and the people who ended up receiving their interest payments. The risk was spread across the globe from American state pension funds to public health networks in Australia and even to town councils beyond the Arctic Circle. In Norway, for example, the municipalities of Rana, Hemnes, Hattjelldal and Narvik invested some \$120 million of their taxpayers’ money in CDOs secured on American subprime mortgages. At the time, the sellers of these ‘structured products’ boasted that securitization was having the effect of allocating risk ‘to those best able to bear it.’ Only later did it turn out that risk was being allocated to those least able to understand it. Those who knew best the flakiness of subprime loans – the people who dealt directly with the borrowers and knew their economic circumstances – bore the least risk. They could make a 100 percent loan-to-value ‘NINJA’ loan (to someone with No Income Job or Assets) and sell it on the same day to one of the big banks in the CDO business. In no time at all, the risk was floating up a fjord.

All of this happened because intellectual fashions changed. In this post-New Deal world, the classical liberalism that serenaded the magic of the invisible hand of the market had a rebirth, both in the universities and in the business world, under the influence of economists like Milton Friedman and Friedrich Hayek and ideologues like Ayn Rand who inspired Greenspan. Friedman blamed the depression on monetary policy, not fiscal policy. He was right about monetary policy but wrong in supposing that a fiscal remedy would not also be needed. Apart from monetary policy, he disparaged belief in the positive role of government and revived faith in the tenets of classical economics, which held that the freer the market, the more productive the economy. According to Friedman, minimal government regulation was a necessary evil to prevent fraud and enforce contracts, but more would only stifle initiative and prevent the market system from working at its most efficient. He and Rand argued that the use of the tax system to redistribute income would reward the indolent and punish the hard-working, creating welfare dependency and thereby interfering with the social analogue of Darwinian natural selection. It followed too that imposing political objectives such as environmental protection by federal mandate would be acceptable to remedy third-party or neighborhood effects, but would otherwise be unwise economically and wrong morally because it would interfere with the voluntary exchanges that made the market the engine of ever-increasing prosperity. Let the nightwatchman state simply enforce contracts and require that publicly traded firms report regularly to actual and prospective shareholders, and the self-regulating market would take care of the rest. More active intervention and nationalization would produce stagnation instead of the “creative destruction” that Joseph Schumpeter thought was the secret spring of capitalism. Karl Marx said that the guiding slogan of capitalists was “Accumulate, accumulate! That is the Law and the Prophets.” For the Friedmanites it has been “Privatize, privatize – that is the Gospel of Wealth!”

This critique of New Deal orthodoxy became very popular, and its echoes can be heard in complaints about Obama's policies. In 1937, my teacher Max Lerner contended that the New Deal would lead to the rise of a new social philosophy he called "democratic collectivism." This was of course a coy way of saying that we were headed for democratic socialism. Lerner knew perfectly well, just as Edward Bellamy did before him, when in his novel *Looking Backward* he prophesied the rise of "nationalism," that the word socialism was too foreign-sounding and frightening for the American ear. Lerner, in a book entitled, *It is Later than You Think*, asked rhetorically, not who killed Cock Robin, but "who killed Adam Smith." As things turned out, Adam Smith—or at least the caricature that has been made of this subtle moral philosopher -- refused to rest in peace. Seventy years later, his resurrected ghost haunts the editorial offices of the *Wall Street Journal* and the otherwise empty mind of a certain know-it-all who dominates talk radio from a mansion in Florida.

It remains to be seen whether progressive liberalism will again trump classical liberalism, but that is certainly what Barack Obama has in *his* mind. During his remarkable election campaign, he promised change, and the change he is now trying to deliver amounts to a renewal and extension of the New Deal. As Rick Hertzberg observed in the *New Yorker*, Obama's agenda is aimed at overthrowing the worship of the untrammelled free market that has guided our national policy since the election of Ronald Reagan. "For some thirty years," Hertzberg has observed, "the American political conversation has been dominated by a strain of ideological conservatism that wields market fundamentalism as a sword and cultural populism as a shield." Indeed, I would add parenthetically that market fundamentalism and cultural populism came together in a particularly deadly way during the Bush administration when Congress deliberately neglected to extend the ban on sales of assault weapons. The result is that according to Mexican

authorities, 90% of the deadly weapons being used by drug cartels in Mexico against the police and government have been purchased in the United States. It took the murder of three policemen in Pittsburgh for Governor Rendell to urge that Congress reconsider, and President Obama has pledged to act to halt the flow of such weapons of Mexico. One important step would be to reinstate the ban.

Obama is trying to redirect the American conversation, and to back up words by deeds. He has gotten a largely partisan majority in Congress to adopt an almost \$800 billion economic stimulus package that will include tax cuts, spending on infrastructure, aid to the states, and other short-term and long-term measures, along with an annual appropriation calling for the expenditure of another \$400 billion. The Federal Reserve is supplementing these fiscal efforts with monetary policy, keeping interest rates close to zero, as its chair, Ben Bernanke, applies one of the lessons of the Great Depression he learned in a career studying it. The Fed and the Treasury are cooperating to lend enormous sums to AIG and the major banks, to sell their bad assets, and to keep General Motors and Chrysler on life support. The Fed may even buy \$300 billion in Treasury bonds and up to \$1.25 trillion in mortgage securities, in order to lower the cost of credit. To deal with a foreclosure crisis that reached an all-time high of 2.2 million at the end of last year, the government has set up a mortgage relief plan costing \$75 billion. This is the most ambitious such effort since the 1930s and is designed to save as many as four million home-owners from losing or walking away from their homes. The plan includes a provision that enables bankruptcy courts to cut the principal on a mortgage as well as reduce the interest rate in hardship cases. These measures may not be enough, but they are certainly a serious try.

The President is also taking steps to strengthen the regulatory agencies, lest they repeat the inexcusable misfeasance of the SEC when it failed to investigate adequately a report it received in 2005 on the Madoff Ponzi scheme entitled “The World’s Largest Hedge Fund is a Fraud.” Nothing symbolizes the mindlessness of the crusade for deregulation better than this abject failure by a major regulatory agency. He is also reversing the fixation on outsourcing government responsibilities that proved so wasteful, corrupting, and inefficient in Iraq and in the aftermath of Hurricane Katrina. In 2005, contractor employees outnumbered federal workers four to one. As Obama has said, “Far too often, [government] spending is plagued by massive cost overruns, outright fraud, and the absence of oversight and accountability. In some cases, contracts are awarded without competition. In others, contractors actually oversee other contractors.” To remedy these abuses, he has called upon government agencies to adopt new rules specifying when contracting is appropriate and when it isn’t and to investigate performance under existing contracts.

At the same time, Obama has put forward a ten-year budget that, as Krugman has remarked, “represents a huge break, not just with the policies of the past eight years but with policy trends over the past thirty years.” The budget aims to promote an energy transition away from reliance on fossil fuels, to make health care more available and less expensive, and to promote education in such a way as to enable the country to remain competitive. Critics are complaining that much of this budget is not aimed at stabilizing the economy but at enacting the liberal agenda of the Obama administration. They are completely missing the point, perhaps deliberately. That agenda is designed to get the country to deal with problems that have emerged precisely because of a dogmatic infatuation with the supposed magic of the market.

In tax policy, the New Deal changed the rules that had prevailed in the 1920s, when the top income tax rate was 24% and the inheritance tax on even the largest estates was only 23%. Under FDR, the top income tax rose first to 63%, then to 79%. That is of course why FDR was called a traitor to his class. By the mid-1950s, when we had to pay for the Cold War, it rose to 91%. The estate tax rose as high as 77%. In subsequent years, a booming economy led to lower rates of taxation at all levels. In recent decades, however, the further lowering of tax rates at the high end (including rates on capital gains and dividends) and pressure on domestic wages due to globalization resulted in greatly increased income inequality. According to Frank Levy, a student of income distribution, median family income, in constant 2005 dollars, rose from about \$22,000 to \$50,000 during the period from the end of World War II through 1980. Since then, it has been relatively flat; and between 2007 and 2008 it actually fell. Meanwhile, the median income of the top 1% of households – much of it coming from the financial sector – increased between 1986 and 2005 by about \$250,000.

Obama is acting in the same leveling spirit as FDR did in calling for the repeal of the Bush tax cuts and a modest increase in the top income tax rate, from 35% to 39.6%, which will affect only 3% of wage earners, and a rise in the capital gains and dividend tax from 15% to 20%. The tax breaks for the wealthy were enacted by the Republicans under the inspiration of the failed supply-side economics aptly named the Laffer Curve. Instead, this administration is calling for tax relief for those who need it most -- those in what Americans quaintly call the middle class. Because we cannot bring ourselves to think in quasi-Marxist terms, in America most of us are presumably in the middle class, except that some are more middle than others.

Everyone else is in the underclass. There is by definition no lower class or, God forbid, a working class.

There may be no working class but there are workers, organized and unorganized, and one of the goals the administration has adopted, in the hope of getting Congressional action this year, resembles what the New Deal did through the Wagner Act of 1935. In most recessions, unions actually lose strength since layoffs tend to be concentrated in manufacturing, the traditional stronghold of the labor movement. American labor unions now hope to benefit from new legislation that could enable them to recruit even in the private service sector. A sweeping change in labor law, known as The Employee Free Choice Act, would restore the ability of unions to organize a workplace once a majority of employees sign authorization cards—avoiding the secret-ballot elections instituted by the 1947 Taft-Hartley Law. These elections have put union organizers at a disadvantage because they are preceded by pre-election campaigns in which companies control the information workers receive and sometimes harass or fire a worker promoting unionization as a warning to others. Even more importantly, the legislation provides for swift binding arbitration when employers challenge the outcome of a vote, and imposes stiffer penalties for employers who tamper with organizing efforts by using union-busting consulting firms, the modern-day equivalents of old-time strikebreakers like the Pinkertons.

When the Wagner Act legalized collective bargaining, most workplaces seeking union representation were manufacturing sites, with high concentrations of receptive workers. Now

that the service sector accounts for four-fifths of economic activity, and many companies can move production offshore, the challenges of union organizing are more daunting. Private sector union membership peaked in 1953 at 35.7 % of the U.S. workforce and has now fallen to a mere 7.6 %, compared to the public sector, where 36.8 % are union members. Obama campaigned aggressively on behalf of a return to card check, and labor advocates are hopeful that his support, combined with shifts in the public mood, will produce a political boon to unionism.

Congressional representatives in both parties from anti-union “right-to-work” states will resist the measure, and even if it passes, organizing efforts will not be easy at a time when so many working people are anxious to get or hold a job on any terms. If it succeeds, however, wages could rise not just in the affected companies but throughout the economy, just as happened after the passage of the Wagner Act. And if union strength increases, there will be more political support for policies that will temper the inequality in incomes that has developed over the past several decades. One reason low-tax, low-regulation policies were implemented is that lawmakers became less and less dependent on union campaign contributions and more beholden to the rich. A study in the late 1990s of congressional elections showed that 80% of campaign contributors earned more than \$100,000 a year and only 5% earned less than \$50,000.

The New Deal has often been described as an exercise in the distinctively American philosophy of pragmatism, designed not to replace capitalism but to save it from its excesses. That pragmatism is evident in the effort to shore up the banks begun under the Bush administration and continued under Obama. This is something both classical and progressive liberals should be able to agree on because it is simply a necessary practical step to save the system of credit on which the entire economy depends. The bailout is being continued by the

Obama administration, this time with somewhat stricter rules on executive compensation, bonuses, and the like, and it will surely entail new rules to require that the banks consolidate and behave more conservatively, after the manner of the Canadian banks, which have not been brought down. One sign that this is not an ideological issue is that even conservatives like Alan Greenspan and Lindsey Graham have gone so far as to say that temporary nationalization may be necessary for some ailing big banks, and the example of Sweden is being touted as one that we might follow. Socialist Sweden! Oh, the humanity!

Not that the administration's methods are beyond reasoned controversy. There is reason to suspect that Goldman Sachs alumni gave that company favored treatment they did not give to Lehman Brothers. Critics of the multi-billion dollar bailout of AIG and the major banks contend that any aid to these institutions should be used to enable them write down their bad assets, failing which they should be temporarily nationalized. Critics of the mortgage bailout contend it would be both fairer and more effective if it helped those with a marginal ability to pay and not only those below the established threshold. Although the Republican leadership sees tax cuts for all and for corporations (arguably a contributing factor to the difficulties we are now experiencing), some propose that a cut in the payroll tax would be a better stimulus than the variety of programs the administration is pursuing. These are debates about means rather than ends, important as they are.

Otherwise, however, the measures the Obama administration has taken are more radical in their goals. The economic theory of classical liberalism has been called "trickle-down economics." I suggest that the economic theory of progressive liberalism might be called "bubble-up economics." The theory behind it is that by providing jobs for the unemployed and

underemployed, if necessary in public works, by providing tax relief to those most likely to spend what they receive, health insurance via Medicaid, and help to those in the greatest danger of losing their homes – whether they deserve help or not -- the entire economy will be stabilized and everyone will benefit.

The immediate result will be ballooning federal deficits – very much in keeping with Keynesian thinking that FDR did not at first appreciate. And at the same time, Obama faces global challenges such as FDR could do little about because of lingering isolationism and the economic crisis. Today, most Americans are more than dimly aware that we can no longer pull up the drawbridge of Fortress America and are very much more affected by what happens in the rest of the world, so this administration is trying to promote stability abroad as well as at home, as we will see in more detail next time.

In line with my confession of inadequate expertise, I admit that trying to follow what ails the banks and mortgage industry gives me a headache, what with all the complexities of derivatives, collateralized debt obligations, credit default swaps, mark-to-market accounting, bundled subprime mortgages, mortgage “cramdowns,” etc. But like so many others in my generation, what economics I was required to learn came from the widely assigned textbook written by Paul Samuelson. So I was relieved when I came upon an especially enlightening interview with Samuelson conducted by another economist named Nathan Gardels. This Osher audience will be particularly pleased to learn that Samuelson is now 93 years of age and as sharp as ever. Here is what he said:

Nathan Gardels: You have outlived Milton Friedman, who died in 2006. And now your Keynesian ideas have also outlived his radical free-market ideology. Is economics back to where you started?

Paul Samuelson: You are right. I am old enough to have seen the cycle come full circle. ... I first became actively engaged in economic policy on Jan. 2, 1932, at the rock bottom of the Great Depression, when I was an adviser to the Federal Reserve Bank in Washington. In subsequent years, I was principal economic adviser to President-elect John F. Kennedy in 1960 and recruited the team for his Council of Economic Advisers.

I became a centrist early on. Of course, the central planning system of the socialist states we still contested with ideologically in those days was idiotic, but that didn't mean government doesn't play a critical role.

And today we see how utterly mistaken was the Milton Friedman notion that a market system can regulate itself. We see how silly the Ronald Reagan slogan was that government is the problem, not the solution. This prevailing ideology of the last few decades has now been reversed.

Everyone understands now, on the contrary, that there can be no solution without government. The Keynesian idea is once again accepted that fiscal policy and deficit spending has a major role to play in guiding a market economy. I wish Friedman were still alive so he could witness how his extremism led to the defeat of his own ideas.

Gardels: How does the current economic crisis compare to the Great Depression?

Samuelson: The current situation is very similar, and certainly the worst experience America or the world has faced since the end of World War II. In some cases -- the housing market -- it is even worse.

Clearly there is going to be an extraordinarily long recovery period even with very large deficit spending by the government. Obama has a good team -- including my nephew Larry Summers. But as an old veteran of battles over economic policy in Washington, I am sure Obama will run into a lot of overt and covert resistance. His honeymoon will be short.

Current projections that we might see some recovery by the second half of 2009 are highly implausible. I suspect we won't see a recovery before 2012, and possibly even 2014. That more closely resembles the time frame it took Roosevelt from his inauguration in March 1933 to the eve of World War II.

I'm afraid that young people listening to Obama's reassuring remarks lack historical perspective on this score. Obama has a fighting chance, but it is going to be very, very difficult.

There have been ups and downs and economic bubbles since the cavemen. What makes this meltdown different is that we have built such an elaborate house of cards on the fiendish financial schemes of "brilliant" MIT and Wharton School graduates that it will take a great deal of time to unwind the mess and rebuild confidence in the financial system. They created instruments so complex that no CEO understood them. They so lacked transparency that the meltdown came as a surprise.

Gardels: The Obama approach includes tax cuts as well as infrastructure spending. Some argue that tax cuts are less bang for the buck in terms of creating new jobs quickly than infrastructure,

which has more bang for each buck. Back in the Kennedy days, you proposed tax cuts as a way to stimulate the economy. What is your view now?

Samuelson: In the Kennedy days, we worked hard to get a tax reduction, which we finally got. It did help then. But the legacy that Bush leaves us with is terrible because people today confuse his giveaways to the rich with tax reductions that can have a meaningful effect on economic growth. Obama's plan should give tax breaks to the lower middle class; that will work. But giving tax cuts to the Fortune 500 companies and their shamelessly overpaid executives is not going to make them suddenly dynamic.

The system of corporate governance that has allowed CEOs to earn 400 times the median wage of their employees -- two decades ago it used to be 40 times -- has undermined any case for tax cuts to the upper brackets. Corporate pay based on quarterly earnings instead of long-term growth, combined with golden parachutes even if executives fail, undermines productivity. Tax cuts for this group, then, are literally counterproductive. Bush's policies failed miserably on this score.

On infrastructure, you have to distinguish between the short run and the long run. If there are "shovel-ready projects" -- for example a mass transit project in some major American city which already has zoning and environmental approvals and only awaits federal funding -- we should just pitch ahead. But terms like "jumpstarting" the economy or "priming the pump" are wrong. That is like tossing dollar bills out of an airplane across the country, letting them fall where they may and hoping they do some good. Shots in the arms don't produce much.

Any effort must be sustained, not one off. Bridges to nowhere won't lead to recovery; they have to be bridges that connect economic activity between two places so net growth is produced over the long run.

Gardels: Obama is proposing a stimulus of between \$800 billion to \$1 trillion. Is that enough to do the job?

Samuelson: It is in the right ballpark. In the end, it may take more.

Gardels: With all that deficit spending, shouldn't we worry about inflation?

Samuelson: If, optimistically, we are back at 4 percent unemployment by 2012, the price level will be higher than it is today, probably rising at 2 percent a year, culminating in 8 percent. I think that is worth it because deflation is the greater worry. Given the circumstances, we should err on the side of over-stimulus. Nobody in their right mind would try to roll back that level of inflation if it avoids deflation and leaves us with an intact, self-sustaining economy again.

Gardels: The U.S. has been able to fund its overspending habits by borrowing from the Chinese and others who have reserves from their trade surplus. That has kept borrowing costs down. With the global financial crisis, capital is still "fleeing to safety" in the U.S., propping up the value of the dollar. Will that last?

Samuelson: I do not share the conviction of some that the American dollar will remain strong because we are the last refuge of safety. That won't endure. This crisis will quickly teach Asian nations, in particular China, that they need to shift from an export orientation to building

domestic consumption if they want sustainable growth. When the immediate panic is over, they will need all that capital at home, not parked in U.S. treasuries.

What Samuelson says here is sobering. He is confident the policies being adopted will work, but that they will do so only over several years, and will be followed by inflation as all the pent up demand of these years is released. And he warns in effect that we had better prepare seriously to reduce the deficit because foreigners like the Chinese will not be willing to buy our Treasury bonds much longer. But he thinks that this is nevertheless the right course to get out of this crisis.

Assuming he is right and the measures being adopted bring stabilization, other changes in prospect amount not to a restoration of the New Deal but to its extension, much as the New Deal was an advance over Progressivism. The New Deal was called the use of Hamiltonian means for Jeffersonian ends. The New Deal reinterpreted Jefferson's pledge to make the pursuit of happiness a fundamental right by adopting the safety net we call Social Security. For the first time in our history, the American government adopted a plan whereby a fund would be created from worker and employer contributions to provide old-age survivors a guaranteed income floor. Now that baby boomers will be retiring and the work force shrinking, this plan needs amendment to keep the trust fund solvent, but changing it to take account of the increasing average life span and to encourage supplemental saving need not pose an insuperable problem.

The bigger challenge will come in maintaining Medicare and Medicaid and extending that Jeffersonian pledge to include the right to universal healthcare and a safe and healthy environment. The President is calling for the government to spend \$634 billion over the next decade to move toward universal health care. The goal is to create a system that will allow those

who have coverage now to keep it, to extend coverage to the 15% of the population that is uninsured, and to provide ways of paying for the added expenditures by raising taxes on the wealthy, slowing the growth in the cost of care by negotiating drug prices, computerizing record keeping, capping payments to providers, and possibly taxing employee health benefits. The details will be contentious and the vested interests are already girding for battle. To devise a plan that will satisfy even the minimal objectives of all stakeholders, especially at a time when we are running huge deficits, will be hard politically, but at long last there seems to be a public consensus in favor of trying seriously.

The concern to make government a better steward of the environment will now finally extend to making the U.S. a participant in the global effort to ward off dangerous climate change. That aspect of the president's program dovetails with another long-overdue objective of reducing dependence on fossil fuels, especially on oil that must be imported from the insecurity-plagued Middle East. The stimulus package includes subsidies for a modernized electricity grid, for alternate energy projects, and for a project to determine whether it is practical to sequester underground or under water carbon dioxide produced in the burning of coal. The President is asking Congress to curtail greenhouse gas emissions by a cap-and-trade system. Under the proposed plan, the federal government would set an overall limit on emissions each year and then auction tradable permits to companies enabling them to emit greenhouse gases up to that level. The firms would either have to cut emissions or compete to buy a steadily shrinking number of permits. The plan calls for reducing emissions by 14% by 2020 and 83% by 2050. That would amount to an indirect tax on consumers but precisely because it is indirect, it doesn't raise political hackles the way a carbon tax would. Even so, the Republican leader in the House

has rightly said that cap-and-trade “will increase taxes on all Americans who drive a car, who have a job, who turn on a light switch, pure and simple.” He is absolutely right and that is why it is needed. The same is true for those who hold, as one letter to the editor put it in the Wall Street Journal, that “cap and trade is like letting someone on Weight Watchers buy points from someone else so they can eat more.” The letter writer is still trapped by his individualistic blinkers. What he fails to see is that even under his analogy, total consumption – or emissions -- would be capped. One way or another, we will have to bear the economic burden of warding off a potential catastrophe. But because the tax system is to be revised, the burden will not fall on those least able to bear it. Obama has promised that the roughly \$80 billion a year expected to be raised by the sale of cap-and-trade emission permits will be redistributed to lower income workers and hardest-hit industries. There is no political stomach in this country for the imposition of taxes on gasoline, as the Europeans have done, but at least cap-and-trade will provide an incentive for car companies to develop hybrid and hydrogen-powered vehicles and for consumers to buy them.

Let me sum up, then, by listing some of the key means I believe Obama now intends to use.

The regulatory role of government over those sectors and companies that are critical to the economy will need to be greatly strengthened. At the same time, federal and state governments will need to improve the efficiency of civil service and revalue careers in public service lest these vocations continue to be degraded and caricatured as nothing but incompetent and bungling bureaucracy.

Controls will be put in place to restrain the propensity of the top tier of corporate executives, especially in the financial sector, to take reckless risks aimed at fattening their own bonus pools rather than the good of their companies and the economy. To do this it will be necessary to increase oversight, accountability, and the role of moral censure, and we will also need to change tax policy to constrain their perverse incentives.

The economy will have to be redirected more broadly than ever toward high-technology industry that will increase the productivity of our factories and farms and invent new products and processes that we can export or license. This may well require tax incentives and subsidies as well as the encouragement of more partnerships between government and research university laboratories and the private sector.

Businesses, institutions, and consumers will need to change their use of energy radically, to protect the global climate system and reduce dependency on insecure and diminishing supplies of oil – as I am pleased to report our own campus is doing in remarkable ways.

A system of affordable universal health care will be proposed and we will be asked to avoid overburdening it, by accepting more personal responsibility to adopt healthier lifestyles.

This consumption-driven society will not readily turn into a series of suburban Carthusian monasteries, living simply off labor and land, but we will be encouraged to rethink the craving for McMansions and gas-guzzling vehicles regardless of their impact on the environment.

The educational system will be overhauled so that it rears new generations of Americans qualified for the jobs that will be created. They will also need to be smart enough to understand

how interest charges can become an unsustainable burden and they will need to be able to distinguish between thoughtful debates and the peddling of snake oil panaceas.

Finally, we will in effect be asked to rewrite our social contract to provide greater basic security for those who cannot fend for themselves, including the elderly poor, the mentally and physically infirm, and those altogether down and out and homeless, by asking those who can manage better to bear a greater burden. But this will have to be done carefully, so as not to remove the incentive for entrepreneurial risk-taking and plain hard work and without discouraging families from saving for their own needs. This may be the most difficult adjustment of all because it runs against the American belief in nurturing self-reliance and discouraging indolence and indiscipline. To end welfare as we know it, the best solution is not to tell the needy or the maladjusted to sink or swim but to use vocational education, economic incentives, and family planning to alleviate the conditions that breed hopelessness and antisocial behavior. Fortunately, Americans have shown themselves to be extraordinarily generous as individuals in helping others in distress in times of emergency; now we, as a society, must show that generosity even in ordinary circumstances to recreate the real sense of community that every good society must exhibit.

Succeeding in these efforts will take a sustained campaign and will impose costs. Solar and wind power currently contribute only about 1.1 percent of our total energy consumption. Costs for both are comparing down, but they are still not competitive with electricity derived from fossil fuels or nuclear power. In the immediate future, we will surely have to rely more on our abundant supplies of natural gas and we may well have to revive efforts to build nuclear

power plants, stalled because of costs, fears of its insecurity, and debate about the storage of wastes.

Finally, and no less importantly, the administration recognizes that long-term security, health, and welfare depends on improving American education from the bottom up, i.e., from k to 12, from community colleges to the research university and its spin-offs in everything from aeronautics and space science to biotechnology, electronics, computers, communications, and nanotechnology. In an increasingly competitive globalized economy, our one comparative advantage, apart from the blessings of our incredibly fertile agriculture, is in the general area of innovation. There are many types of innovation, but the one with the greatest multiplier effect is technological invention. We have maintained our prosperity since World War II, even as other countries recovered, by our leadership in a variety of areas of innovation, including the technological forms. We need only think of the effects of American pioneering in laser printing, the computer, the internet, the cell phone, and a host of medical products and processes. Other countries are following the lead of Japan – notably China -- in challenging our leadership in this effort. We cannot hope to remain as far ahead of others as we were in the past, but it is critical that we at least keep pace by maintaining support for basic and applied research and educating the scientists and engineers that will be needed in our high-tech industries. Along with the financial sector, the entertainment industry, the agricultural sector and some areas of manufacturing, high tech industry is our strongest suit in the global economy. President Obama has pledged to restore science to its proper place in the counsels of government and he has made excellent appointments to the major advisory and mission-oriented agencies that are important in developing and administering science policy. And he is making a serious effort to support the

far-flung effort to reform early education and keep young people in schools and at the same time encouraging more students to finish college by expanding the tax credit for college tuition to \$2,500 a year and increasing student Pell grants to \$5,000 a year.

On balance, then, the Obama agenda is at least as ambitious as the New Deal and in many ways a revival of the spirit of collective uplift that was at the heart of that great national effort of rebuilding. But it is not simply a return to the New Deal program, nor is it a reckless policy of “tax and spend,” as its opponents claim -- despite the lamentable willingness of the administration to tolerate the continuation of “earmarks,” at least for one more budget cycle. It involves real efforts to rein in government spending and waste to pay for the programs advocated. It is a commitment to use the powers of the federal government to promote growth, insure fairness, and promote the general welfare. That in essence was what the New Deal was about, along with ending the Depression. New Deal2.0 or New Deal beta will be even harder to achieve than the first version, in the face of the many problems, uncertainties, and opposition that will need to be overcome. Politicians will not suddenly stop pandering to business interests that provide their campaign financing, and those from farming states will still demand wasteful subsidies for agribusiness. Ambitious businessmen will still dream of becoming Masters of the Universe. And as conditions improve, the very people who will have been rescued by government aid will, like “Joe the Plumber,” will imagine they can do even better without it. Populist resentments could hamper a revival of the banking system and promote short-sighted protectionist measures that will only invite retaliation and thereby stall recovery. Still, if these new programs do succeed, there is good reason to think they will be just as reinvigorating for the nation and the world as those that flowed from the first “hundred days.” If that happens,

America will become a much more efficient, and a fairer and exemplary country, once again a beacon of hope to the rest of the world. Because FDR led us out of the Great Depression and through a terrible war, he is rightly considered one of our greatest presidents. Let us hope that Barack Obama, who has also made an auspicious beginning in his first hundred days, achieves a comparable success in the current economic crisis without having to confront so awesome a challenge to our national security. We will turn to that second question next time.