

Is the Economy Recovering?

An Interview with Dr. Fadhel Kaboub

Street Speech interviews economist Fadhel Kaboub about the recession and the financial reform bill. Questions by Mary Loritz



Dr. Kaboub answers questions about the economy for Street Speech. Interview by Mary Loritz.

Q: The financial crisis occurred almost two years ago, and we are still in a major recession. We have heard a lot of talk about derivatives, subprime mortgages, etc. Still, I think there is a lot of confusion as to its cause. Could you please refresh our memories -- Why did the crisis happen again?

A: The subprime mortgage crisis is almost the result of a "perfect storm" so-to-speak. You have financially burdened families who aspired to own homes and achieve their American dream; a deregulated financial industry that preyed on people's hopes and dreams, and a government with a blind belief in free market ideology.

The tremendous growth in real estate values that began in the mid-1980s was thought to be an unstoppable phenomenon. In addition, the repeal of the Glass-Steagall Act of 1933, which was replaced by the Banking Modernization Act of 1999, opened the door for a tremendous growth in financial innovation to speculate in the real estate market. The availability of cheap financing and refinancing convinced everyone that the democratization of homeownership is finally going to be a reality. Banks lowered their lending requirements to the point where they are giving mortgages to individuals with no income, no jobs, and no assets – the so-called NINJA loans. These adjustable rate mortgages were thought to be safe assuming that 1) real estate values continue to grow, and 2) cheap refinancing remains available (low interest rates). With these two assumptions, the early 2000s saw a fictitious democratization of homeownership, and a fictitious increase in demand for homes, which was followed by a real increase in housing construction. The whole thing fell apart when interest rates began to rise in 2006 and real estate prices began to decline

in 2007. Millions of people lost their homes, their jobs, and their savings.

The real estate crisis turned into a financial crisis because of the way the mortgage industry was structured, and because of the massive speculative investment that was built on the residential mortgage market. Banks were allowed to bundle mortgages into collateralized debt obligations (CDOs) and offer them on Wall Street as a lucrative investment opportunities. CDOs were rated by top credit rating agencies such as S&P, Moody's, and Fitch; and they were insured through credit default swaps (CDSs) by some of the top insurance companies such as AIG. All of these players collected commission and fees in every step of this process. Initial profits were leveraged many times over to keep the bubble growing until it became clear that the whole thing was a fiction. Then the blame was put on reckless consumers who bought homes that they couldn't afford! Can you imagine a situation in which an 80 year-old lady living on fixed income twisting a banker's hand to refinance her fixed interest mortgage into an adjustable rate subprime mortgage, and fooling sophisticated Wall Street investors, S&P, and AIG into believing that she could afford it? Maybe, but can millions of subprime borrowers do that? Probably not.

In the end, the message from Wall Street banks to the government was loud in clear. You either bail us out and make sure we recover all of our losses, or else the American economy and its people will suffer through a Great Depression. And that's exactly what happened. The people continue to suffer while Wall Street hoards hundreds of billions of dollars in tax payers bailout money.

Q: Is the economy beginning to recover? If not, when and how do you think that will finally happen?

A: Despite the huge increase in government spending that we've seen in the last two years, the economy is still far from getting out of this recession. Government spending is still very low relative to the magnitude of the recession. The spending is also not being directed very effectively. Bailing out big banks may have saved a few high-salary-high-bonus investment banking jobs, but it certainly did not save any jobs in Ohio or Michigan. Let's also not forget that we're spending billions of dollars every day on the

Wars in Iraq and Afghanistan.

The recovery requires a very-well targeted government spending approach that focuses on job creation. We can't afford another attempt at jobless economic growth; that is economic growth without a significant decrease in the unemployment rate. We have a tremendous opportunity today to kill two birds with one stone. We face an economic crisis and a global environmental crisis. We could revamp our economic system by massively investing in green technology, mass transit, wind and solar energy, and sustainable urban renewal. The opportunities are endless, the resources and the skills are available, but we lack the guts to do it. President Obama is taking baby-steps in this direction, when we could be leading the way in 21st century economic and environmental sustainability.

Q: The new financial regulation bill that was so difficult to pass -- what effect do you expect this bill to have? Will it stabilize the economy or have an impact on regular working people?

A: In my opinion, the new financial regulation bill is too weak. A financial reform that doesn't get rid of shadow banking, off the books transaction, and lack of transparency is doomed to failure. The truth is that Wall Street thrives on financial innovations. New financial instruments are by definition new and unregulated. A great financial innovation is by definition a new instrument that evades existing rules and regulations. As a result, any financial regulation that is not dynamic enough to catch up with all the new financial innovations is also doomed to failure.

The problem with financial reforms is that they are usually pretty good at preventing



Stock Market Graph. Photo courtesy of Photo Stock Exchange.

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Wall Street vs. Main Street. Photo courtesy of Photo Stock Exchange.

the previous crisis from happening again, but they usually fail miserably in detecting, let alone preventing, the next crisis. Wall Street recruits armies of highly-paid rocket scientists working 24/7 to find ways to make money. Can the Federal Reserve Bank or the Securities and Exchange Commission compete with Wall Street at this level? They should, but the reality is that they

Of course, today we're in the midst of this Great Recession with banks refusing to extend credit to credit-worthy businesses, let alone heavily-indebted households. We could either work out a solution, perhaps a new financial innovation, which will allow banks somehow to extend credit to consumers so that they can jump-start the great American Consumerism machine. This will clearly push that debt-to-income ratio to even higher levels and will probably make the next financial crisis even more catastrophic. Or, we could empower the working class to finally experience a steady growth in real wages to match the growth in productivity, so that consumers can lower their debt-to-income ratio and continue to spend in a sustainable way. Wall Street and big corporations, of course, favor the former solution, because they get to kill two birds with one stone: low wages and high productivity translate into bigger profits; while at the same time consumer debt keeps workers disciplined.

Now, if the average American has no problem with this situation, then fine; but if we believe in justice and equity, then we should be supportive of stronger labor unions, higher living wages, and stronger consumer protection laws. Only then, we can speak of financial stability, economic security, and true recovery.

Q: Do you think another financial crisis is likely to occur in the future?

A: I hate to be the bad news reporter, but I'm afraid that it is very likely indeed. We live in a capitalism system that is driven by financial markets that thrive on speculation. Speculation builds financial bubbles that are always destined to burst. All these bubbles are driven by new financial instruments. These instruments usually carry higher returns than the market average, but as they become popular those returns begin to decline, so then the volume is pumped

up to make up for the declining returns. The bubble keeps growing until the market realizes that there is no possible way that the value of this instrument is actually backed by an equivalent tangible economic asset. That's when everyone rushes toward the exit sign in a classic chaotic stock market crash. The scenario is always the same, but the instruments are always different. It's sad that we never learn our lessons.

You have to forgive me here, but I can't help but quote President Obama's statement at the signing ceremony of the financial reform law. He said that "because of this law, the American people will never be asked again to foot the bill for Wall Street's mistakes." I don't want to comment on the political context of this statement, but I hope that the President of the United States is not this naïve, and I certainly hope that taxpayers aren't going to sit back and relax believing that they will never have to worry about another financial crisis ever again, or that they will not be forced to foot the bill for Wall Street and big corporations. A strong democracy is a very labor intensive system, it requires active and engaged citizens working together at the grassroots level to keep politicians in check; and so does a strong and health economy.

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don't.

Does that mean that we should give up on financial reform? Of course, not. What we hope to create is a dynamic regulation system that can adapt quickly to new financial regulations before any major abuses occur.

Q: In your expert opinion, what will help the economy to recover and prevent another crisis? What should be done?

A: The short answer is: Good paying jobs! The American consumers are knee-deep in debt. The engine of the American economy over the last several decades has been consumer spending. Unfortunately, since the late 1970s there has been a severe stagnation in average real wages despite the steady increase in workers' productivity. Nevertheless, consumers continued to boost economic growth thanks to various waves of financial innovations that allowed the American consumers to keep spending while accumulating more debt. We're talking about a debt-to-income ratio of about 135% these days. That's phenomenal.

Food For Thought

Note from a Vendor/Board Member, Robert D. McClendon

At age 51, I have experienced much within life! Many trials, tribulations, and triumphs! True triumphs have but recently appeared, 'cause only within recent years have I realized what True triumphs are! I have learned that affiliation brings about assimilation, that my chosen peers mirror who I am thus-what I choose to stand for! An invaluable truth-My quality of Life is determined by the choices I make, for ultimately who I am and how I affect others is the result of said decision-making! Today I know never to blame others, nor circumstances, for my behavior or my plight! No matter my consequences-be they good or be they bad, I must honestly assess the part I play! Becoming a part of one's environment is text-book; for good or for bad. During our formative years this occurs (Elementary, & early Junior High), our moral fabric begins to develop and direction unfolds in our lives... For those of us who are led astray this isn't an excuse, it's simply a thing to be understood! As individuals we are always to be held responsible for ourselves, for as is our right to be

respected-It is our responsibility to be Respectable! Those of us who have been unfortunate early in life can and do rise above our constraints once aware or enlightened we are not confined to them! When this transition becomes possible we see what society is meant to represent and seek our True place therein! Right living not only becomes possible, it becomes referable, even comforting! Many do not escape what they deem to be their lot in life, never nearing even a fraction of their true potential... It's a blessing, extremely fortunate when clarity is unearthed, when a persons realizes they are more than they have allowed themselves to be! We must Know that Hope exists for All- Who Embrace It! It's Our responsibility to provide a Hand-Up to those who have Chosen to Stand-Up! I have chosen to Stand-Up, those of us Standing are a Beacon which others embrace as they themselves begin to Stand! Again, We, The Columbus Coalition for the Homeless; "Thank You" for being Stand-Up, as We as a Community help others to Stand!