

Sustainable Developments

Priorities for Fixing the Financial Crisis

Policies can avert disaster only if they interrupt the cascading threats to the U.S. economy

BY JEFFREY D. SACHS



The origin of the U.S. financial crisis is that commercial and investment banks lent trillions of dollars for housing purchases and consumer loans to borrowers ill equipped to repay. The easy lending pushed up housing prices, which then ratcheted still higher when speculators bought houses on the expectation of yet further price increases. When the easy lending slowed and then stopped during 2006 and 2007, the housing prices peaked and began to fall. The housing boom began to unravel and now threatens an economy-wide bust.

The U.S. economy faces four cascading threats. First, the sharp decline in consumer spending on houses, automobiles and other durables, following the sharp decline in lending to households, will cause a recession as construction of new houses and production of consumer durables nose-dive. Second, many homeowners will default on their mortgage payments and consumer loans, especially as house values fall below the mortgage values. Third, the banking sector will cut back severely on its overall lending in line with the fall in its capital following the write-off of bad mortgage and consumer loans. Fourth, the retrenchment of lending now threatens even the shortest-term loans, which banks and other institutions lend to one another for working capital.

The gravest risks to the economy come *back to front*. The fourth threat is by far the worst. If the short-term commercial paper and money markets were to break down, the economy could go into a severe collapse because solvent and profitable businesses would be unable to attract working capital. Unemployment, now at 6 percent, could soar to more than 10 percent. That kind of liquidity collapse was why national incomes in some Asian economies fell by around 10 percent between 1997 and 1998 and was why the U.S. economy fell by around 30 percent in the Great Depression.

The third threat, the serious impairment of bank capital as banks write off their bad loans, could cause a severe recession but not a depression. Unemployment might rise, for example, up to 10 percent. The ongoing fall in bank capital is already forcing banks to cut back their outstanding loans. Major investment projects are being scaled back. Some major nonfinancial companies will likely go bankrupt as well.

The second threat, the financial distress of homeowners, will be painful for millions of households. Many will lose their homes; some will be pushed into bankruptcy. Others may see their credit terms eased in renegotiations with their banks. Consumers as a group will start to become net savers again after years of heavy

net borrowing. That trend will not be bad in the long term but will be painful in the short run.

The first threat, the cutback in sales of housing and other consumer durables, is the Humpty Dumpty of the economy that cannot be put back together. The inventory of unsold homes is now large; housing demand and new construction will be low for many years. Consumer spending on appliances and cars is also plummeting. These consequences are largely unavoidable and will force the U.S. into at least a modest recession, with unemployment likely to rise temporarily to perhaps 8 percent.

The goal of any new policy must be to avoid an outright collapse or deep recession. Two actions are thus critical. Most important, the government and the Federal Reserve must prevent the collapse of working capital by supplying short-term loans and taking other measures to sustain the commercial paper market, interbank lending and the smooth functioning of money market funds. The government should also aggressively promote a recapitalization of the banking system, with both public and private funds, so that bank lending is not squeezed for years to come. Unfortunately, the \$700-billion bailout approved by Congress does not focus adequately on those liquidity or recapitalization challenges.

The legislation is better than nothing (to help forestall panic), but the real work of stabilizing and recapitalizing the banking system will now await the next administration, and the Federal Reserve Board will need to stay aggressive to prevent a liquidity collapse. Additionally, the government should encourage easier repayment terms on existing mortgages and engage with other countries, especially in cash-rich Asia, to stimulate their economies to offset, at least partly, the U.S. downturn. ■

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