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ECONOMIC VIEW

Restore Order and Win a Financial War

By ALAN S. BLINDER

MANY Americans are bewildered, aggrieved and even angry about the financial shenanigans that led to the current mess — and about the seemingly unending stream of government bailouts. They should be.

A bunch of wealthy, supposedly smart financial “experts” made irresponsible bets that went bad, pushing our economy to the brink and taking the rest of us down with them. Millions of people worldwide have already lost jobs. Millions more will. And taxpayers are being handed monstrous bills for mistakes that were not their doing.

It is maddening that hardly any of the miscreants have been punished, not to mention that many remain well paid. But foolishness is not a crime, and most of them broke no laws. Perhaps worse, a host of safeguards that were supposed to protect us — from corporate boards and ratings agencies to regulators and elected officials — all failed. To add insult to injury, hardly anyone has apologized for the disaster, or even explained how we got into it and how we plan to get out.

Let me try the latter.

In the bubble era, even sophisticated people deluded themselves into believing that home prices would soar indefinitely and that lending risks were minimal. On those weak foundations, a huge house of cards was built. Wall Streeters designed a hideously complex financial system to enrich themselves. Financial institutions took on far too much debt. People signed mortgages they could ill afford and did not understand. Regulators, the Bush administration and Congress looked the other way. The bubble grew until it burst.

Much of this shouldn't have happened. But we are where we are, and the urgent priority is to extricate ourselves from this mess as quickly as possible, with minimal damage. Here's how I conceptualize the master plan.

American policy makers are fighting a two-front war. On the eastern front, they are battling a shortage of demand, as traumatized households and businesses pull in their horns. Less spending by some people means fewer jobs for others who, in turn, curtail their own spending. Keynes diagnosed this vicious recessionary spiral in the 1930s, and we are now in the midst of the worst one since then.

Fortunately, we know how to fight a demand shortage — with more government spending, tax cuts and lower interest rates. That is why Congress enacted a huge fiscal stimulus in February and why the [Federal Reserve](#) has cut interest rates to virtually zero. But the cure takes time, and we are still sliding downhill. Depending on how long and deep the recession gets, we may need more firepower. But at least policy makers know what

to do — and are doing it.

The western front is vastly more complex. All economies run on credit, and ours developed an extreme dependency. Largely through their own failings, banks have been seriously damaged. Bankers are paralyzed by fear of further loan losses and shrinking capital that might subject them to regulatory penalties — or worse. One way or another, the banks must be restored to health and emboldened to lend.

How? The Fed has made huge loans to banks and flooded them with cash. But the banks also need capital, and private money is not stepping up to the plate. That was why [Henry M. Paulson Jr.](#), the former [Treasury](#) secretary, decided to devote the [Troubled Asset Relief Program](#) to injecting capital into banks last fall. I disagreed with both his decision and the way he executed it. But there was a rationale for what he did, and the current Treasury secretary, [Timothy F. Geithner](#), will eventually be back for more money for this purpose.

But banks are just part of the problem. Much modern lending is securitized by the so-called shadow banking system — a complex web of interlocking, sometimes mysterious capital markets. Invisible to most people, it is crucial to getting credit to mortgagees, credit card holders and businesses. And while the financial implosion wounded the banks, it decimated the shadow banking system.

The most obvious — but not the only — disasters stem from mortgage delinquencies, fears of more, and consequent uncertainty about the values of mortgage-related securities. Bringing these markets back to life is one rationale for both the administration's foreclosure mitigation programs and its public-private investment programs. It is also a principal rationale for many of the Fed's unprecedented lending and money-creation activities.

Thus the war plan has four essential components that hang together logically: stimulating aggregate demand, limiting foreclosures, rescuing (most of) the banks and rehabilitating the shadow banking system. Three of the four are in place. We await Mr. Geithner's bank rescue plan, which, I hope, will be some version of the good bank-bad bank idea I mentioned here last month.

Unfortunately, the administration seems to have a penchant for complexity in designing its programs, and I certainly would not defend all the details. But it's essential that citizens see through the trees to the forest. All this taxpayer money is being put at risk for a good, simple reason: Victory in a two-front war requires winning on both fronts. We won't defeat the recession unless we restore some financial order.

Countries do unpalatable things in wartime, and collateral damage is common. So it is here. The impending [federal budget](#) deficits are monstrous. The Fed is printing money like mad. People who deserve punishment are receiving help instead. The government's investment partnerships may enrich some investors.

There will be time to address these problems later. For now, the nation must focus single-mindedly on winning the war. There really is a plan.

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