



**Title** *Bank Bail-outs and Obama's Green New Deal*

**Description** In this second podcast, Linda Yueh and Jonathan Michie discuss President Obama's Green New Deal, banking bail-outs, quantitative easing and whether we can spend our way out of the economic crisis.

**Presenter(s)** Linda Yueh and Jonathan Michie

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**Linda Yueh** I am Linda Yueh. I am a fellow in economics at St. Edmond Hall at the University of Oxford. My recent book 'Macro Economics' covers quite a lot of the global economy, but clearly needs a new chapter on the economic crisis.

**Jonathan Michie** I am Jonathan Michie, Professor of innovation and knowledge exchange at the University of Oxford, President of Kellogg College and Director of the University's department for continuing education. My most recent book on globalisation did indeed warn that economic globalisation wasn't quite such a free lunch as some people seem to think it might be.

**Linda Yueh** Well Jonathan, I think since we last spoke, we are now confronted with another bail-out package of the British banks. I think the measures announced this week have been put together by the Government in an attempt to get credit flowing again. But I think it probably raises a few questions at least about the extent to which the initial measures of recapitalising the banking system last October was really sufficient.

**Jonathan Michie** Absolutely. I think it shows that the government didn't go far enough the first time around. I suspect that was largely for political reasons, of being nervous at being seen to nationalise the banks and nationalise the banking system, which has obviously in the past been seen as a radical measure which would be a step way too far. Even though other countries: France, Sweden and others have taken the whole banking sector into public ownership in the past.

I suppose the trail for it actually was Northern Rock, which of course eventually was nationalised, and now actually the government is thinking of using more proactively to make loans. But it was, if we remember, months of dithering before they did that. And now we have seen the fast round of major intervention on the banking system in general. The 37 billion, some months ago, has actually ended up taking what has turned out to be majority ownership stakes, for us the taxpayer, in some of the largest banks.

Of course, we have actually paid more than the entire worth of the banks, given their current stock market valuation. So I think the big question is for how much longer can the government stave off nationalising banks. Or in the case where they have already got 70% of ownership, biting the bullet and admitting that they are nationalised and that they are in public ownership.

I suppose the key point, what you correctly say, about the need to get credit flowing, is why the government is complaining about the behaviour of banks that they own. And why don't they

actually use them to directly direct that credit themselves, and make the banks that they own actually give the credit to successful businesses who do need credit on a day to day basis.

**Linda Yueh** I think that is a question that has come up quite a lot, is why is it that... we know the banks are the source of the credit crunch. But in what way is the government really achieving a satisfactory result by running the banks, in their view, at arms' length, so preventing state directed lending. But at the same time realising the lack of credit in the economy is really squeezing the real economy.

So I think in a way the banks are put commercially in a difficult position. Because they are told simultaneously to build up their balance sheets because of their lack of original capital that has caused them to become so fragile. At the same though, interest rates are historically at a lot point at 1.5%, making lending for them very difficult in terms of the margins that they would achieve if they were to lend.

They are being asked to lend to firms which are, for the most part, experiencing a decline in their orders because of the economic slowdown. So quite a lot of businesses just don't look at viable as they did before. I think an added difficulty for the banking sector is that half of all lending in the UK actually comes from foreign banks. Foreign banks and financial institutions. So once those sources of funding have withdrawn, the British banks are asked to make up for the slack.

So not only are they being asked to lend at 2007 levels, provide available credit at those levels. They are also really being asked to expand into the space being left behind by foreign lenders. That is an incredible expansion of their lending at a time when, as you were saying, banks like the RBS are now worth something like £5 billion. A fraction of what they were worth before. So I think the pressures on the banking sector are considerable.

I don't think anybody wants the sector to be nationalised. I think there is a strong abhorrence to the idea of it. But I fear the trend isn't looking very promising. I suppose one other issue which would be quite critical to evaluate how successful the bailout is going to be. And the Prime Minister said this himself in the FT last weekend, is they still don't know the extent of the write-downs of the banking system.

So it is all fine and well putting capital into the banking system. But if you don't know how much liability still is attached to mortgage backed securities, and the derivatives traded on them, then how do you know how much liquidity recapitalisation is enough? So why don't the banks declare all their bad debts, and this way we know which banks are in the most trouble, and they can get the help they need or even nationalisation. Once that is cleared up, I think you restore a lot more confidence in the banking system.

But I suppose the difficulty with how you implement this, is that banks, if they really were to come clean, we pretty much would end up nationalising them. Because the market to market accounting, by which they judge their balance sheets, means the loss of market value of their shares and of their holdings, make any bad debts they hold much more substantial than if say the market was on an upturn.

So maybe we don't want to know the truth. But I would come down on wanting to know the truth. And this idea of letting them linger with such bad debts is not a very good one. Because you could think about what happened in Japan. By contrast, Sweden created a bad bank, or an aggregator bank, which has been discussed in the US and in Britain. To take all of these bad assets off the bank's balance sheets of the banks and put them into a bad bank. And then that bad bank, in a sense, can recover the value of the underlying mortgage backed securities when the housing market, which it will, eventually goes up again.

So I suppose the practical difficulty of this is valuing these bad debts, and how much liability would end up on the taxpayer's back as a result of it. Valuation was probably one of the reasons why this original aim of the US TAUP plan was abandoned. However, that being said, allowing

the bad debts to linger doesn't seem like a good way to get the banking sector back on its feet. And I suppose until they do that we are really not going to see the end of the lack of confidence in the banking system. Which has caused quite a lot of downgrading of their shares.

**Jonathan Michie** Yes, absolutely. Given the lack of transparency up to now, the surest way, and possibly the only way, we will find out exactly what the banks have been doing, what assets they own, if indeed they really are assets at all, is by owning the banks through nationalisation. And it is interesting looking at this history of economic political thought, in regards to nationalisation and public ownership. Where obviously there has always been ideological and political ownership and it reminds people of the debates in Britain during the 1920's and 1930's about coal mining, which of course was a huge part of the British economy at the time.

Whether that should be nationalised and taken into public ownership, endless commissions of enquiry into it. Everyone knew that private owners weren't investing. They weren't running the industry properly. But it was only after the big shock of the 2nd World war, the election of a labour government, that the coal mines were nationalised. But then it just seemed to become common sense. Not just coal of course, gas, electricity, railways, the whole idea that these basic industries infrastructure should be nationalised in public ownership.

The interesting thing is when the Conservatives were re-elected in 1951, they actually didn't privatise any of those basic industries. It was really only steel which was a political football. But gas, electricity, railways, coal mining, was kept in public ownership as nationalised industries. But the Conservative administrations from '51, re-elected in '55, re-elected in '59, right through to 1964. Thirteen years of Conservative rule keeping all of those industries as nationalised industries.

The reason obviously was because the government of the public sector wasn't investing in them and providing productive infrastructure for private sector companies. You know, it could well be that over the next ten, twenty, thirty years that the financial sector, the banking sector, gets seen in the same sort of way that successful industries, whether in the energy sector or consumer goods sector whatever, needs a basic functioning infrastructure including a banking sector. And having that in the public sector just becomes seen as a natural way of organising it.

**Linda Yueh** I certainly think there is a historical precedent for it. I think one of the difficulties for the government to consider, is if they were to take on all of the banking system. How bad does that make the public finances. This has been an issue with Northern Rock. When they nationalised Northern Rock, the liabilities of Northern Rock really went on the public balance sheet.

We know from the precipitous fall of sterling, that global markets now view Britain as being a not very safe and secure economy. Taking on record numbers, amounts of debt through the banking system and the bailout packages will have effects. Not just in the short term on say the value of the currency, but also in terms of future taxes, higher interest rates and a period of stagnation that could follow as a result.

That is also historically [[*apropo* 0:10:41]] because that is indeed what also happened three decades ago, when you had high levels of public debt which ended up with high levels of stagnation. We know that some European countries like Spain have already had their sovereign credit rating downgraded slightly. If that were to happen that would be extremely worrisome for Britain. Especially looking ahead.

I suppose that brings us to another measure, policy measure that is being discussed. How can you finance the bail out and stimulate the economy without the government borrowing any more, thus the idea of quantitative easing. Whereby, I suppose the best example of this is what the United States did, as to think about whether or not this is something the UK ought to consider seriously. The indication is that Britain is considering it seriously, according to the testimony of the deputy director of the Bank of England Paul Tucker, on Wednesday January 21st.

The US at the end of last year, when interest rates fell to between zero and a quarter percent, were essentially at a place where the price of money, the interest rate, no longer had an effect. That meant they turned to quantitative easing, directly targeting the quantity of money. So the Federal Reserve at that point issued \$800 billion dollars into the economy, 600 billion of which was targeted to buy up mortgage backed securities.

Another 200 billion was aimed at helping homeowners and small businesses. This injection increased the amount of credit in the economy. It is a nominal injection, hoping to have real affects in terms of the credit available to small businesses. But what was extraordinary about it was that it elicited almost no debate and discussion on the American media, and it didn't go through congress. Because this was essentially creating money, there was no borrowing involved, so congress wasn't involved.

If you contrast that to TAUP, the \$700 billion plan, which is still being debated in congress, as President Obama asked for this second trench. It is an extraordinary comparison. So in many ways, heavily indebted governments probably look at quantitative easing as a valuable policy tool under those circumstances of zero interest rates and a risk of deflation. In particular with a risk of deflation because of how dramatic the economic slowdown has been.

Reflating the economy with liquidity, with credit, eases the deleveraging process. By which households and firms are shedding all of their debt. Because we know that some inflation reduces the real value of borrowing. But of course they're a lot of downsides to this policy, including the same reflation also damages the real value of savings in the economy. There is always this danger of too much change in inflation expectations which can come as a result of this kind of money injection.

So I think the US of course has already done it. Whether it works or not, perhaps will be the best indicator as to whether or not Britain will pursue this if interest rates come down from 1.5% to 0%.

**Jonathan Michie** Yes I agree. There is no question that the British government should and will print money in order to help boost the economy. I think it's... the question is only the degree to which you do it. Particularly being alert and being able to reverse the policy when the time is right. So it is a question of the extent you have pursued the policy, but also the competence with which you do it. It doesn't need to be, and indeed it shouldn't be, a counter post against other aspects of policy.

I think that the government should be pursuing all elements of policy. So that is cutting interest rates, which of course they have been unable to do because they handed the decision making over to the Bank of England. So unfortunately interest rates weren't cut quick enough when they should have been. Low interest rates and printing money – quantitative easing – to prevent deflation. But also being active on the fiscal side: expanding government spending, using deficit finance as appropriate. Which we talked about in the previous of these interviews.

It seems to me, the key question isn't whether the government should be active, which obviously they should, it is a question of how you do it. It seems to me, maybe we will come on to it in a few minutes, talk about Barack Obama. The active government investing in bridges, electronic highways and so on, is actually a better route than just cutting 2.5% off VAT, which didn't have much impact.

So with quantitative easing, printing a money supply, I think just as with interest rates, fiscal policy and indeed the nationalisation of the banks and the act of industrial policy. I think the important thing is to be active on all fronts and making sure that the overall policy is coherent.

**Linda Yueh** Yes, I think that is absolutely right. I suppose one more word of warning for the British government, is it thinks about using quantitative easing and credit creation, is that it didn't work in Japan. Japan of course had a deflationary stance on the back of their asset bubble bursting through

the 1990's. At the beginning of the noughties they engaged in quantitative easing. But it didn't work for a number of reasons.

One was that it still remained the case that the bad debts in the banking system clogged up the credit flowing through the economy. So the transmission mechanism was the problem. It wasn't the amount of injection into the monetary base. So for that reason, as well as inflation expectations, not really being changed by this expansion of money in the system, meant that after a few years this policy was eventually abandoned by Japan.

The government at that point, about three years ago, went back to trying to grow by real means. I suppose luckily for them they have sold a lot of exports to China amongst other places. And they saw themselves actually beginning to recover. But then of course we know it has happened in Asia since.

You did mention President Obama, and certainly that has got to be the news of the month. His inauguration on January 20th certainly marked a turning point in US politics. His economic policies do hold a great deal of promise. He has got a few things in the air. One of them is the use of the rest of the TAUP funds, \$300 billion, he asked President Bush to ask congress to release.

They want to use a larger proportion of those funds to help homeowners. But I suppose the more exciting part of this plan is, as you were saying, is the investment in green infrastructure and this is the \$825 billion economic recovery plan that is going through Congress for a vote next week. A large proportion of that is geared at creating or saving jobs, and revitalising infrastructure. Certainly we do prefer our governments to invest rather than to simply spend, if they are going to do it on the back of borrowing.

**Jonathan Michie** Yes, absolutely. The question is whether the British government is going to miss the boat here, and lose out in green technologies to America over the next few years. Just like we have over the last few years compared to Germany and other countries, which have invested in the green technologies. Where Britain have been putting all our eggs in the city of London financial sector of the economy basket, thinking that is where the future of growth is going to be.

So unfortunately Britain actually is lagging in the green technology area. It is obvious to everyone that that is where important growth has to be over the next few years and decades. So I think from our point of view, Obama's policy while obviously provoked by the economic recession and the need to save jobs and create jobs, could actually benefit the economy in the same way as a previous era. Having new roads, bridges and so on help create the infrastructure.

Obama himself has linked it to the idea of having a modernised infrastructure as well. So not just the green technology, but also the superhighways, the broadband, the investment in Universities. I'm glad he mentioned in his inaugural speeches as well as schools. It's that sort of imagining and far reaching long term vision that it would be good to have more of in Britain. And not, actually I think the key thing which is needed is to give confidence that we can have another era of sustainable, prosperous expansion.

Not just the next six months and wait until the economy recovers. But over the next ten or twenty years. Because I think that's the most worrying thing still. The desperate attempt by Gordon Browne and the current government, seems to be just to try to get back to the situation it was a year ago and then everything will be alright. Even though actually that is where it ended us up in the current mess.

Actually the point about it banning speculation, short selling was a good example, where it creates havoc on the stock market, so that was banned. There was no short-selling or speculation allowed. Then after three months it was allowed again. For no purpose it seems, other than this idea of just trying to get back to how things were.

I think what was refreshing about Obama's speech was this long-term look into the future. The idea of investing for the future and rejuvenating the economy. I think it would be good along with

low interest rates, quantitative easing, the government made the fiscal stimulus much more focused on long-term investment, and productive infrastructure, and green sustainable technologies.

**Linda Yueh** Yes, I completely agree with that. I think in many ways the economic crisis has shaped the Obama position a great deal. It is quite interesting because when he began to pull away from John McCain during the election, it was because of the economic crisis. How he came across as having more ideas and seemed more on top of the issues than his opponent. Of course, since he became President this is one of the first things on his agenda.

I think what struck me was, when he was making his campaign promises, this is before the economic crisis really struck last September. There were a lot of doubts to how he would pay for it. It sounds great to renew America's infrastructure, invest in green technology, build a digital superhighway, revitalise the bridges, upgrade buildings, schools and hospitals and create green jobs, and make an American leader in this area.

It all sounded great. Lots of people were asking, "How will you pay for it?" Because certainly under the previous administration, the US national debt has increased exponentially. However, since the economic crisis has worsened so much, this idea that government should use everything in their toolkit, that means deficit spending as well as monetary policy and outright purchases of shares and backing commercial paper and what have you.

It all of a sudden, that part of the debate, doesn't seem to be that important anymore. It doesn't seem to matter so much how will you pay for it? Because we now think we need deficit spending, to prevent this recession from becoming a prolonged depression. So in some ways it became an opportunity for Obama to put together the kind of investment approaches and spending that he wanted to do. He will still face opposition, but how to finance it doesn't seem to be as important as how big a stimulus, how well it is positioned and whether or not these will be public investments that will give us returns far into the future, while creating jobs in the present.

So I think in that way, everything we thought he was going to have to compromise on before the crisis struck, just before the crisis struck. Just in terms of being able to finance what he wanted to do doesn't seem to be as important a debate now. As certainly much more how much of this package is tax cuts and is that enough. How much it is geared at investment, and are these in the right areas. Are there shovel ready projects, the ones that we want to go ahead. Are the states putting together the kinds of things they should invest in straight away? So sometimes Obama says he has been a very lucky politician. I think he has actually been, in some ways, a beneficiary of the economic crisis.

**Jonathan Michie** Yes, and also Obama has made clear that while certainly the approach won't be just tax cuts for the rich, which is very much was under George Bush. In his inaugural speech he did have that phrase about 'You don't create a prosperous economy just by supporting the prosperous.' He has also said that he will try to clamp down on the tax havens, international tax havens. The way that the rich get out of paying taxes.

It is always unclear by definition almost how much that would bring it. His aids are reported as thinking that that could be as much as \$50 billion. Which even in these current days of these large figures, would be quite substantial. But again, what is interesting there is, there does seem to be an emerging international consensus behind those moves, which of course is all important.

The problem of trying to clamp down on tax dodging, as if you are doing it yourself as a country, they just go and move somewhere else. But France and Germany, they are key players in the European Union, have been talking about the need for more moral capitalism. There have been international moves to introduce new measures to stop tax evasion avoidance on a global scale. In these large, amounting to these large figures.

The depressing thing unfortunately is that the one government really opposing it is the British government. Which still seems hung up on this idea about having free international capital

markets, which will somehow be inhibited if people have to disclose how much they earn, where it is and so on. So I think that may be one benefit actually to us in the UK, if Barack Obama really does push ahead with trying to get international agreements to stop the tax evasion. If it means that the UK government is brought into that move.

**Linda Yueh** Yes, it will be interesting to see how much he calls upon this special relationship. One thing actually I heard this morning in an interview with Chris Patton, who of course is the Chancellor of our University. He said, "If Obama really is as multi-lateralist as he says he is, then that may mean he will come to his multi-lateral partners and ask for things in return." So it will be interesting to see the extent to which the Obama leadership really does extend, and bring other countries along the way.

I suspect he will, at least initially, in these kinds of dire economic times. He struck me in his inaugural address as somebody who was cognisant of the realities of the challenges that America and the world faces. But also optimistic that by changing a lot of the past behaviour that led us there, we will enter a new era of more sensible I thought consumption and policies.

Going back to basic core values which was very appealing I think. At a time when all we hear about is how greed and disregard for others perhaps has contributed to where we are. So I am highly hopeful that Obama will bring this type of tenor to all of his policies. In particular the economic one as we reconstitute the kind of economic system that we have in the developed world.

**Jonathan Michie** Yes, those global economic issues are of course absolutely fundamental aren't they? And incredibly important because of the danger that always is with recessions, depressions, unemployment of racism under reactionary backlash. A blaming of foreigners for taking away our jobs and so on. It is often posed, as it was in the President's election campaign, of the danger of protectionism. But the problem is, if the alternative to protectionism is just seeing to be trying to return to previous pre-market system which produced the problems in the first place.

I don't think it is as strong an alternative as it could be. I think what potentially is very important about Obama's election, and as you say creating a new ethos underpinning the whole idea of international economic relations, will be if that becomes accepted to be under the basis of fair trade equality bit between nations. Not just Britain and America trying to promote their companies to make profit throughout the world.

So I think that is very important obviously for continuing to develop productive economic relations and trade globally. But also developing a globalisation that actually does operate in the interests of the people of the world and the countries. Rather than thinking that a global free market will, in some mysterious way, deliver. Which was always of course spurious. Because there are huge global players, in terms of multi-nationals involved.

Yes, so I think the whole question about global economic relations is very important. It would be good if the UK government would come in it a bit more positively. Because again, going back to where we started in the financial crisis here, it has been ironic with the UK government having majority stakes in major UK banks. To hear Gordon Brown then complaining that the majority of their lending has been to foreigners rather than to domestic individuals and companies.

Aligned with what you said previously, part of the problem is that a lot of the loans that UK companies were dependant on, were from banks overseas who are now obviously retrenching. That is actually a very interesting way of illustrating this whole question about globalisation and the discussions and debates over the last twenty years. Where there has been an idea pushed that it is some sort of inevitable tendency, and it is somehow backwards to think that the national ownership of a company mattered.

The question is asked rhetorically almost so regrettably, what does it matter if a company is owned by the Japanese, the Americans or the British or the French. I think this crisis has illustrated

very concretely that it does matter. Because precisely the UK domestic companies who were reliant on overseas banks for their credit, have seen that those overseas banks have understandably retrenched their loans domestically.

So I think hopefully out of this, it will be seen that we have to develop international economic relations, just as we do domestically. Through intelligent and proactive policies, rather than just a reliance on some sort of supposed market mechanism that will deliver.

**Linda Yueh** I think that when our Prime Minister, Gordon Brown, hosts the G20 summit in a couple of months, I am sure we will return to this theme. But I think we've covered banking rescues, printing money and a green new deal, and it seems like quite a lot. So perhaps we will leave it there for this time.

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