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OP-ED CONTRIBUTOR

An Economy You Can Bank On

By CASEY B. MULLIGAN

Chicago

THE Treasury Department is now thinking about using some of the \$700 billion it has been given to rescue Wall Street to buy ownership stakes in American banks. The idea is that banking is so central to the American economy that the government is justified in virtually nationalizing much of the industry in order to save us from a potential depression.

There are two faulty assumptions here. First, saving America's banks won't save the economy. And second, the economy doesn't really need saving. It's stronger than we think.

Bear with me. I know that most everyone has been saying for a couple of weeks that something has to be done; a banking crisis could quickly become a wider crisis, pulling the rest of us down. For this reason, the Wall Street bailout is supposed to be better than no plan at all.

Too bad this line of thinking is seriously flawed. The non-financial sectors of our economy will not suffer much from even a prolonged banking crisis, because the general economic importance of banks has been highly exaggerated.

Although banks perform an essential economic function — bringing together investors and savers — they are not the only institutions that can do this. Pension funds, university endowments, venture capitalists and corporations all bring money to new investment projects without banks playing any essential role. The average corporation gets about a quarter of its investment funds from the profits it has after paying dividends — and could double or even triple that amount by cutting its dividend, if necessary.

What's more, it's not as if banking services are about to vanish. When a bank or a group of banks go under, the economywide demand for their services creates a strong profit motive for new banks to enter the marketplace and for existing banks to expand their operations. (Bank of America and J. P. Morgan Chase are already doing this.)

It's important to keep in mind, too, that the financial sector has had a long history of fluctuating without any correlated fluctuations in the rest of the economy. The stock market crashed in 1987 — in 1929 proportions — but there was no decade-long Depression that followed. Economic research has repeatedly demonstrated that financial-sector gyrations like these are hardly connected to non-financial sector performance. Studies have shown that economic growth cannot be forecast by the expected rates of return on government bonds,

stocks or savings deposits.

It turns out that John McCain, who was widely mocked for saying that “the fundamentals of our economy are strong,” was actually right. We’re in a financial crisis, not an economic crisis. We’re not entering a second Great Depression.

How do we know? Well, the economy outside the financial sector is healthier than it seems.

One important indicator is the profitability of non-financial capital, what economists call the marginal product of capital. It’s a measure of how much profit that each dollar of capital invested in the economy is producing during, say, a year. Some investments earn more than others, of course, but the marginal product of capital is a composite of all of them — a macroeconomic version of the price-to-earnings ratio followed in the financial markets.

When the profit per dollar of capital invested in the economy is higher than average, future rates of economic growth also tend to be above average. The same cannot be said about rates of return on the S.& P. 500, or any another measurement that commands attention on Wall Street.

Since World War II, the marginal product of capital, after taxes, has averaged 7 percent to 8 percent per year. (In other words, each dollar of capital invested in the economy earns, on average, 7 cents to 8 cents annually.) And what happened during 2007 and the first half of 2008, when the financial markets were already spooked by oil price spikes and housing price crashes? The marginal product was more than 10 percent per year, far above the historical average. The third-quarter earnings reports from some companies already suggest that America’s non-financial companies are still making plenty of money.

The marginal product has accurately reflected hard economic times in the past. From 1930 to 1933, for instance, the marginal product of capital averaged 0.5 percentage points per year less than the postwar average. The profit per dollar of capital was also below average in the year before the 1982 recession and the year before the 2001 recession. Sure, the financial industry has taken a hit, and so have cities like New York that depend on that industry. But the financial system is more resilient today than it has been in the past, because it’s a much easier industry for companies to enter than it was in the 1930s.

When banks failed during the Great Depression, there were not so many foreign investors that were cash-rich (or these days, oil-rich) and appreciative of how some of the bank assets, personnel and brand names in the United States could be used to earn profits in the future. And don’t worry about foreign ownership: Americans would benefit if foreigners brought money into our economy to enable banks to continue to lend.

And if it takes a while for banks and lenders to get up and running again, what’s the big deal? Saving and investment are themselves not essential to the economy in the short term. Businesses could postpone their investments for a few quarters with a fairly small effect on Americans’ living standards. How harmful would it be to wait nine more months for a new car

or an addition to your house?

We can largely make up for this delay by extra investment when the banking sector reorganizes itself. Americans waited years during World War II to begin private-sector investment projects (when wartime production displaced private investment), and quickly brought the capital stock (housing and big-ticket consumer items) back to normal levels when the war ended.

So, if you are not employed by the financial industry (94 percent of you are not), don't worry. The current unemployment rate of 6.1 percent is not alarming, and we should reconsider whether it is worth it to spend \$700 billion to bring it down to 5.9 percent.

Casey B. Mulligan is a professor of economics at the University of Chicago.

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