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Obama's rescue plan: build but don't borrow

Anatole Kaletsky

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If the President looks across to Europe, he'll see how to revitalise his key areas of housing and construction

Tomorrow evening Barack Obama will deliver the most important speech of his presidency. With the US economy apparently on the brink of another recession and standard monetary and fiscal policies exhausted, has America, and indeed the Western world, run out of options?

Conventional wisdom maintains that the US, along with Britain and most of Europe, is now stuck in a "new normal" of high unemployment and economic stagnation, similar to the "lost decades" suffered by Japan since 1989. This dismal economic outlook is an inevitable consequence of the 2008 financial crisis and decades of debt-fuelled overindulgence. It virtually guarantees that the Obama presidency will go down in history as an ignominious failure. Mr Obama tomorrow has perhaps his last chance to prove such prophecies wrong.

To do this he would have to end the present adversarial stand-off between his Administration and the US business communities and to do something even more difficult for any American leader — learn from the experience of other countries and acknowledge that some economic policies have been more successfully managed in Britain and other parts of Europe than the US.

If Mr Obama looked across at the experience in Europe and other advanced economies such as Australia, he would realise that economic stimulus need not always mean spending vast amounts of public money. This is particularly true today in America because the key to an improvement in the US employment outlook lies in just one part of the economy: housing and construction.

Construction is a sector that normally powers the early stages of recovery in the economic cycle and this is the only part of the US economy whose weakness is truly exceptional today. Two years ago such weakness was inevitable because housing was still recovering from the bubble conditions. But today US house prices are cheaper in relation to personal incomes than at any time in postwar history and the glut of new properties has been eliminated by the biggest collapse on record in new building.

Meanwhile, the decay of America's physical infrastructure has become so obvious that there would be ample opportunities for profitable investment in roads, bridges, airports and so on if only Mr Obama engaged with US business and finance to mobilise the enormous amounts of excess private savings that are at present flooding unproductively into government bonds.

Conditions in the US housing market could be transformed if the President were to learn from four strands of policy in the rest of the world. First and most important, he could begin to reform America's antiquated, inefficient and dysfunctional system of government-run mortgage finance.

The US is the only country in the world where government policies encourage homeowners to take out mortgages with interest rates that are fixed, very expensively, for 15 or even 30 years. When interest rates fall, the only way that homeowners can benefit is by paying off their old mortgages and taking out new ones — an expensive procedure at the best of times and impossible for people whose homes have fallen in value, leaving them with negative equity. As a result of this distortion, low interest rates have much less stimulative impact than in economies with variable mortgage rates, such as Britain.

A cost-free policy that would offer the US economy an immediate stimulus would be to move as many households as possible from traditional fixed-interest mortgages costing up to 7 per cent to British-style adjustable rate loans, which would cost only 2 or 3 per cent. The President could do this without new legislation simply by issuing executive instructions to Fannie Mae and Freddie Mac, the government-sponsored enterprises that guarantee almost all new mortgages in the US, to refinance existing fixed-rate loans even for borrowers with negative equity.

Second, Fannie and Freddie could be ordered to stop dumping foreclosed homes on to the housing market, thereby undermining prices, and instead be required to retain ownership of these houses and possibly rent them out, with zero- interest financing provided by the Federal Reserve.

Third, the President could announce an emergency initiative to revise US bankruptcy law, which currently allows borrowers to walk away from their loans without filing for bankruptcy, but simultaneously "protects" mortgage lenders by prohibiting American bankruptcy courts from revising the terms of home loans. This is the opposite of what is needed: the laws in almost every other country threaten borrowers with bankruptcy if they stop paying their mortgages but allow bankruptcy judges to ease mortgage terms.

These three measures between them — or indeed any one of them — would drastically reduce foreclosures, bolster the housing market and boost consumer spending power, transforming the US economy.

Turning to infrastructure, Mr Obama could create the world's largest privatisation programme. Highways, bridges, airports, sanitation, water and postal services, which have long been privatised in Europe, are mostly still government-owned in America. For example, 89 per cent of US households are served by public water utilities, compared with 10 per cent in France and Britain. Public-private partnerships to rebuild schools and state hospitals are almost unknown. The quid pro quo, of course, would have to be robust monopoly regulation based on the successful systems established for privatised utilities in Britain, France, Australia and other advanced economies.

If all this is so obvious, why does it not happen? Part of the answer is the short-sightedness of business lobbies such as the banking associations, which have opposed all reform of mortgage laws to the enormous detriment of their own shareholders. An even bigger problem is simply the lack of awareness among US policymakers of the economic reforms in other countries.

US economic policy is still paralysed by paternalistic and ideological attitudes characteristic of an old-fashioned socialism discredited in Britain and the rest of Europe in the past century. If President Obama wants to revive the US economy and his own re-election chances, maybe he should abandon the American-style socialism of the 20th century and try the European-style capitalism of the 21st century instead.