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rebuilding the economy

Government's role in economy getting too big?

The US may have headed off a deeper recession by investing hundreds of billions into major companies. But it drives up deficits and creates uncertainty among investors.

By Mark Trumbull | Staff writer/ May 3, 2009 edition

The US government is undertaking a historic expansion of its role in American industry with interventions that are economically risky, even as it aims to cushion America from a deep recession.

Chrysler's bankruptcy filing last week underscores the depth of the federal government's involvement in some of the biggest names in American business, from General Motors to Citigroup.

Neither President Obama nor President Bush before him espoused any desire to run car companies or banks. But the federal role is rising all the same, based on the concern that the failure of vital companies could cause lasting damage to the economy.

Collectively, the actions mark a level of government involvement in managing the economy not seen in decades, some economists say. The dangers are significant. The government could delay rather than speed up the revival of these industries. Bailout costs could burden the US economy for years to come.

At the very least, federal intervention creates an element of doubt among key actors in the marketplace as businesses and investors struggle to predict what the government will do next.

"This creates huge uncertainty," says Dan Ferris, an editor at Stansberry & Associates Investment Research in Baltimore. "The whole nature of TARP [Troubled Assets Relief Program] from the beginning has been this moving target."

Negative consequences

By way of example, he suggests that efforts to save industries in the short run might have negative consequences in the longer term.

To pave the way toward more government aid for GM and Chrysler, an Obama administration automotive task force has been brokering deals with creditors, workers, and retirees – trying to win concessions from all of them.

But the bondholders, for one, argue they've been offered a bad deal. Seeking what they see as a fairer deal, Chrysler's bondholders have pushed the process into bankruptcy court.

Mr. Obama's bid to save jobs at the carmakers risks inadvertently sending a signal to creditors nationwide: Invest at your own risk, Mr. Ferris says. If that's the message that emerges from the bankruptcy proceedings at Chrysler, companies in other industries would have a harder time raising funds.

At some point, Ferris adds, the way to get the economy moving again is for the government to "just back off."

Walking the line

The debate is complicated. While many economists are concerned about government intrusion in the marketplace, many also say that without some large interventions, the current recession would be much deeper.

Obama has been trying to walk a careful line, avoiding interventions when possible. Yet the government may remain involved automaking and banking for years to come.

"You know, I don't want to run auto companies. I don't want to run banks," Obama said in a recent press conference. "I've got more than enough to do. So the sooner we can get out of that business, the better off we're going to be."

Once voters and taxpayers effectively have a large ownership stake in corporate America, it can be hard for politicians to avoid putting their hand on the steering wheel.

At car companies, Obama and Congress are calling for Detroit to become the global leader in energy-efficient vehicles – a goal that could run counter to a speedy return to profitability.

At banks, federal aid comes with close scrutiny. Lawmakers want to make sure that money from the TARP fund is used for loans, not managerial bonuses.

Some economists worry this effort could have unintended consequences.

"If the government's involvement continues over the longer term – as appears likely – executive compensation limits may siphon off talented executives to nonfinancial firms and leave a key sector with relatively less qualified and experienced managers," Jagadeesh Gokhale writes in a recent analysis for the libertarian Cato Institute.

Too much spending?

Others have a different concern: that the cost of bailouts, coupled with other federal spending, will push federal deficits or taxes to the point that they hinder economic growth.

The current fiscal course of the government may mean that the economy grows at about 2 percent a year, rather than the 3 percent annual pace that's been common for the past four decades, estimates Michael Cosgrove, a University of Dallas economist and forecaster.

Mr. Cosgrove, in his EconoClast newsletter, cites a 2008 study by European Central Bank economists, which found that "countries with a higher share of government expenditure … tend to grow more slowly."

If government spending rises by 1 percentage point of GDP, the economic growth rate falls on average by 0.13 percent, the study found.

On Friday, Congress's Government Accountability Office posted its own fiscal warning.

"Updated simulations continue to show escalating and persistent debt that illustrates the long-term fiscal outlook is unsustainable," the agency said.

In one scenario, government debt would reach a level equal to one year's GDP before 2025. That level is considered a danger zone, and some economists worry that the result will be higher borrowing costs for the nation as lenders mark down America's credit rating.

Aware of the risks on this front, Obama has recently voiced determination to pursue long-term fiscal controls, but with little certainty yet on how he will achieve the objective.

The government has long been intertwined with the private sector in various ways, from regulation of banks to providing postal and passenger-rail services. This isn't the first time that major chunks of the banking sector have been rescued in a financial crisis. And it isn't just President Franklin Roosevelt who used the might of the government to engineer economic results during hard times. Republican President Nixon tried wage and price controls to battle Vietnam-era inflation.

A high water mark for government involvement was World War II, when much of American industry was mobilized for military production.

When will the bailouts end?

Yet the current government role in the private sector is unusually large.

How large could depend upon the performance of the economy. The longer the US is mired in a slump, the harder it may be for the government to unload its stake in carmakers or banks to private investors.

In the case of GM, the largest US carmaker, Obama's task force is pursuing a deal in which the federal government would have majority ownership of a downsized company.

Regarding the financial industry, the Treasury Department's "stress tests" – set to be released this week – could result in the US pouring more money in banks. If a bank is deemed to be short on capital reserves, government investment might be the only viable way to raise new capital.

So far, Obama has maintained strong public approval ratings. But Republican critics see government intervention in the economy as a potential chink in Obama's armor.

In an appearance on CNN Sunday, former Rep. Susan Molinari (R) said Republicans can appeal to voters who believe "that government shouldn't own a significant chunk of the private sector."