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Strategies

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Picking Up The Pieces: What You Should Know About the Economic Crash

Michael Bordo, Professor of Economics at Rutgers University, is an expert on financial crises and has served as director of Rutgers' Center for Monetary and Financial History

Q. You've written that changes in the regulatory system caused this crisis. How so?

A. It was two things: changing regulations and lack of enforcement of regulations. There was a relaxing of a lot of controls on the credit markets and the financial markets in the 1970s, 80s, and 90s, which was a good thing, but we had an overreaction. We had a lot of financial innovation which led to excesses. Financial managers moved into areas that were extremely risky, which was the overreaction. The second issue was lax regulation. The sub prime mortgage crisis reflects the fact that the government wasn't really monitoring what the investment banks and mortgage brokers were doing, nor what was happening in the credit and derivative markets. All these things were going on without proper oversight. So there was a problem of actually enforcing the regulations that were in place. I think that's probably the more severe problem, which let the credit markets and financial markets operate more freely than they had.

Q. How do you feel about the monetary stimulus of the Federal Reserve Bank?

A. I think the Federal Reserve stimulus is a very good thing. It's going to slow the decline of the economy. It's going to attenuate the recession. It's going to prevent the recession from getting much worse than it was in the early 80s. The massive increases in the Federal Reserve's balance sheet and the increase in money supply is going to have the effects we need, and that's going to prevent things from getting extremely bad. Although there is a risk of inflation down the road. On top of that, we've got to deal with the banking crisis, we've got to resolve the underlying structural problems with the banks. These two things have to be done, but monetary policy is the number one agent for stemming the recession.

Q. Do you see this recession coming to an end fairly quickly?

A. Probably not. It looks like the banks are going to be disclosing more losses. They'll probably need more capital injected into them. As long as housing prices are falling, and they're still falling, there's going to be this downward pressure in the banks, and so I think it's probably going to drag on for at least another quarter or so, and the economy will be in recession until at least the middle of 2009.

(Continued on next page)

Contents

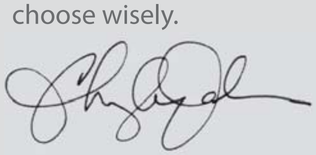
A MESSAGE FROM THE PRESIDENT & CEO

Greetings, and welcome to the Winter Issue of *Strategies*, the journal of ideas from the Chicago Urban League's Policy & Research Department.

Research is the foundation on which all our work stands; policy is how we put that research to action. *Strategies* lies at their intersection, where theory and practice come together. Four times a year our policy staff asks scholars, educators, political experts and other top-flight thinkers to weigh in on new and interesting ideas and programs affecting Chicago's African American community.

This issue is devoted to understanding the implications of the economic crash. The continuing crisis of the U.S. economy creates consequences for all Americans, but few will feel the sting of the economic downturn as severely as African Americans. With official unemployment topping 12.6% (versus 7.6% for the overall economy) African Americans and African American entrepreneurs must develop smart strategies fast. To that end we have assembled a selection of wise men and women to analyze the crisis and offer pathways out of it, including Rutgers University economics professor Michael Bordo, Stanford University Business School lecturer Jane Wei-Skillern and University of Chicago Chapin Hall Research Fellow Malcolm Bush.

Chicago is at a crossroads. The path we choose now will guide us for years to come. All we must do is choose wisely.



Cheryle R. Jackson
President & CEO
Chicago Urban League

Q. How does the current economic crisis compare historically to other recessions?

A. It's probably going to be as bad as the one we had from 1979-82 in terms of the decline in economic activity and increase in unemployment. In terms of the financial crisis, banks failing and problems with the financial market, it is hard to find a comparison in the post WWII period. The savings and loan crisis in the 1980s has similarities to what has been going on, but only a few major banks got into the serious trouble that many banks are in today. In some respects, there is some resonance with what we saw in the 1930s. It is not nearly as bad as that, and even mentioning the 1930s scares people, and I do not want to do that.

Q. Banks have received money through the rescue plan, but many of them still aren't lending. Why is that?

A. The problem is the banks' capital base. They have all these bad assets on their books, so what happens is that as housing prices keep falling, the number of bad assets keeps increasing. Banks are just worried about keeping afloat, so the money they got they're using to strengthen their capital. They're worried that they're going to lend to companies that will go bust later, and they're just going to have more bad loans. But also they haven't been lending because they have been using it to strengthen themselves, so they're caught in the current dilemma, which is not something they can do that much about.

Q. So how can this be remedied?

A. A lot of people are talking about trying to have the government somehow remove the bad assets from the books of the banks, either by creating what are called 'bad banks,' which would buy up all these assets, or putting a fence around them which is called guaranteeing them with some kind of insurance. There are a number of ways of doing this. This has been done before: in the case of Japan in the late 90's banking crisis, and in Sweden in the early 90's, when they took the bad assets, put them into bad banks, and then they injected capital in the banks that were basically good. They also nationalized a lot of the banks, which is something that the U.S. is not willing to do. That means the government comes in and buys up the banks, and the shareholders lose their money.

Q. Could something like that happen here?

A. That may happen, but to go across the country and nationalize all of the banks is something that the U.S. is going to be pretty reluctant to do, because of the large number of banks, and because that's something that's just not done in the U.S. It's done in Europe. There are all kinds of pitfalls, because once the government runs the bank, it doesn't allocate credit the way the private bank does, and it starts the political process with the money and that can lead to really serious problems with allocation of resources.

Q. You mentioned the crises in Japan and Sweden. What can we learn from their experience?

A. I think the Swedish case is a good lesson, which is that you have to act fast when you have a big banking crisis like they had, which was comparable in scope with ours. They had a really serious recession, and the only way you could get out of a really serious recession is getting the banks straight and strengthened. So they acted quickly and they were successful. It took them two or three years to get the banks recapitalized, and they became profitable and were sold off and successful. In Japan, they ended up doing the same thing, but they waited some seven or eight years, and so they went through a really long drawn out period of stagnation. It wasn't like the Great Depression where prices fell by ten percent a year and output fell by 12 percent a year. It was a slowed stagnation. So if we don't act quickly, this recession's going to last a long time, and it doesn't matter what the fiscal stimulus is; if the banking system is close to underwater, the banks aren't going to lend and the credit system isn't going to work very well. So those are the lessons we get from those two countries: Sweden did things quickly, decisively. It's a smaller country, they have different traditions, so we can't do what they did, but they were successful. On the other hand, Japan took 8 or 9 years and they were ultimately relatively successful, but they're still not doing great.

Q. What do you feel should be done to prevent another such economic collapse?

A. Well, this is kind of a fairly unique event. Things usually don't happen exactly as they did before, but, the government needs to in some way strengthen the banks. It has to solve this problem of bad assets, and it has to get the banks recapitalized. So there's going to need to be a fair amount of rationalization with regulations on the financial sector. For example, the Securities and Exchange Commission botched up this crisis. They just didn't solve any of the problems that came about. The most immediate thing is to deal with the crisis and that's going to require very swift actions in terms of removing the bad assets that the banks are holding and recapitalizing them.

Q. What should the government do to get public confidence in the economy again?

A. It needs to send signals that monetary policy is succeeding. It needs to have signs that suggest that it's working. The big fiscal stimulus package that's coming up will sort of galvanize people's expectations. They'll think the government's doing something. I'm kind of skeptical as to whether it will really work, but that may actually have something to do with confidence. Roosevelt gave people a lot of confidence, even though he didn't really accomplish what he said he was going to do. Fiscal policy was actually not expansionary in the 1930s, and what got us out of the depression was actions on the monetary front, Treasury actions like buying gold. A lot of the New Deal actually had negative effects, but there was this effect on confidence, which may be similar to Obama with the fiscal stimulus. If you see things going on, like building highways and roads with a big sign that says "this is coming from the federal government," it tells people that everything is ok, which will affect confidence. It's not going to get us out of the recession, but a collapse of confidence can be addressed that way, and it can be addressed by very positive actions by the government.

Q. What should people know about this recession?

A. It's important for people to get things in perspective. The media and politicians give the rhetoric that this is the worst thing that ever happened, that this is a situation that is comparable to the 1930s. It is not that bad. Unemployment is bad, and it will go up to 9% which we haven't seen since the early 80s, but it's not going up to 25%. Output is not going to collapse by 12% a year. It might fall total by 6%. So things aren't that bad in relative perspective. Also, people have to remember that the government does understand much better than it did in the 1930's how to get the economy back to its original position. The American economy has a lot of resilience. The capitalist system has some resilience to recover by itself. When prices fall low enough, people start to find opportunities to buy and to invest, and that's going to happen, so it's not just government actions, but people themselves will get us out of this by investing and buying. We're going to get out of this thing.

Interview by Jessica Fulton, CUL Policy & Research Associate.

CRISIS BY THE NUMBERS

February 6: US Bureau of Labor Statistics reports 598,000 jobs lost in January alone; national unemployment rate: 7.6%

January 28 2009: International Monetary Fund (IMF) forecasts world economic growth of 0.5% for 2009, lowest level of growth since World War II

December 19: President Bush announces rescue plan for General Motors and Chrysler of $13.4 billion in loans

October 3: Emergency Economic Stabilization Act of 2008, also known as the Troubled Assets Relief Program (TARP) authorizes up to $700 billion in spending to support faltering banking system

September 15: Lehman Brothers $639 billion bankruptcy.

Community Economic Development in a Post Crash World

By Malcolm Bush

It is hard to summarize a crisis that affects all kinds of economic activity. What seemed to start as a problem with sub prime mortgages in the U.S. has now turned into a global credit crisis and slump. Without effective federal interventions to stimulate demand by investing in, for example, decaying infrastructure, lending and investing will stay frozen and businesses will continue to lay-off workers. And the laid-off workers will spend less leading to lower production and more layoffs in a devastating downward spiral.

Some argue that the current crisis caught everyone by surprise and that no one is to blame. But people at the highest levels of the financial services industry and government displayed enormous arrogance and/or a disregard for warning signs for many years. In 1999, Fed. Chairman Alan Greenspan suggested that the U.S. was beyond such problems and was "enjoying a virtuous cycle," of spending and growth. He even raised the possibility that the economy had "moved beyond history." When a fellow Federal Reserve Board Governor privately warned the Chairman of the ominous signs in the housing market in 2002, the Chairman responded, "You know I don't like regulations." A few months ago, Greenspan trying to explain the current crisis said he simply didn't realize how greedy Wall Street had become.

But community leaders in Chicago and elsewhere knew what was happening in their neighborhoods. In 1998, a year before Mr. Greenspan made his unfortunate remarks about the end of history, Chicago's Woodstock Institute published a report on the beginnings of the sub prime mortgage crisis and its likely impact on neighborhoods titled *"Two Steps Back: The Dual Mortgage Market, Predatory Lending and the Undoing of Community Development."*

There is plenty of blame to go around. Individuals made the decisions behind each link that led to the crash. Mortgage brokers and loan officers arranged loans that individual home-owners couldn't afford even before the onset of the crisis. Outright fraud was involved as in the frequent overstatement of a borrower's income and concealing from the borrower the true interest rate and fees associated with the loan. Investors bought and sold investments that were based on increasingly insecure and over-valued assets. Financial institution risk managers were overwhelmed internally by the arguments of investment officers eager for higher profits. Federal bank regulators didn't implement existing regulations and were reluctant to issue new regulations that covered the new financial institutions and instruments that fell outside the existing regulatory structure. And for eight years the White House promoted a sweeping anti-regulatory ideology in this and other spheres of public policy. The national policy response must include remedies for all these failures in the sound regulation of markets.

But what are the local consequences of the crises and what local responses are possible? The effects of the crises are felt in communities and neighborhoods across the country. Skyrocketing home foreclosure rates are the most visible signs. In the Chicago six

county area in figures compiled by Woodstock Institute, 2007 saw a then record 38, 215 foreclosure filings for the whole year. In the first half of 2008 the six month figure reached 26, 248. The first half of 2008 saw increases in foreclosure rates of up to 180% in some communities. To add to the misery, the unemployment rate in Illinois already exceeds 7% a figure that does not count so-called "discouraged workers" who no longer show up in the official statistics.

What now then for local communities? Since the crisis is multiple, there is no silver-bullet. But several principles for community development emerge from the rubble. Local communities saw the crisis approaching before Washington. The community development world must ask the tough question of why Washington ignored their voices and how they can better communicate their unique insights in the future. Second, while many elements of the crisis are beyond local amelioration, some local development issues demand local involvement if only because local residents care about them more than anyone else.

The most immediate step on home foreclosure is to encourage homeowners to consult with their lenders and reputable credit counselors before they miss

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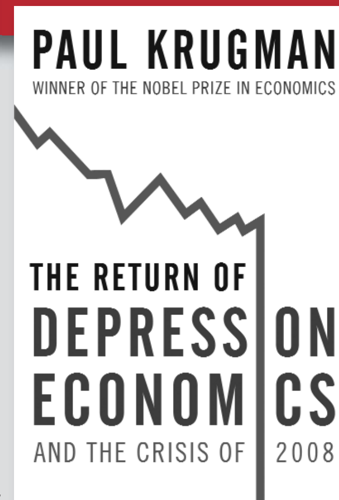
BOOK REVIEW



The Return of Depression Economics and the Crisis of 2008 *(W.W.Norton & Company)*

About ten years ago, Economist Paul Krugman published an analysis of the economic crises in several nations, and suggested that people take note of the possibility of crises to come. Last December, the Princeton University economist and Nobel Prize Winner updated this analysis in The Return of Depression Economics and the Crisis of 2008. Krugman artfully showed how the failure of a genteel parental babysitting co-op explains why countries like Mexico, Argentina, and Japan had continuing economic problems during the 1990s. He then uses that background to explain the current economic crisis. Krugman explains that this crisis marks the return of depression economics, which he describes as "the kinds of problems that characterized much of the world economy in the 1930s, but have not been seen since."

In his new book, Krugman notes that although he's "tempted to say that this crisis is like nothing we've ever seen before…it might be more accurate to say that it's like everything we've seen before, all at once." This description of the current crisis may seem threatening, but Krugman breaks it down, relating what happened this time to the past, and showing that the features are familiar. He compares the current real estate bust to the late 1980s occurrence in Japan.

After explaining the current financial mess, Krugman presents solutions. He suggests that in order to end the economic slump, policy makers need to spark credit flow and spending. He explains that the former is difficult because of the lack of trust in financial institutions, as well as because of depleted capital at these institutions. Krugman suggests that the United States follow a recapitalization scheme, which has precedents in the Roosevelt Administration in 1933, in Sweden in the early 1990s, and in Japan in 1998. This is the basis behind the first $700 billion federal bailout plan. He warns that this amount may not be enough. It may not all reach the "shadow" banking system, and the banks may not be willing to lend out the money they receive. As for increasing spending, Krugman suggests that the government try a different approach from the fiscal stimulus plan of early 2008. Instead, he suggests that Washington increase aid to local and state governments, and put more money on infrastructure, a prescription not unlike the Obama plan.

Krugman gives readers an increased understanding of the current financial crisis through entertaining models and examples from history. By explaining past crises, he gives readers insight as to where this crisis may lead, and how we can get out of it.

Reviewed by Jessica Fulton, CUL Policy & Research Associate.

mortgage payments. Community leaders (and regulators) should also press financial institutions to arrange standard refinancing deals for groups of similarly situated borrowers. It simply takes too much time to rewrite mortgages one by one. More broadly, local communities know their own strengths and how those strengths can be magnified for the community's benefit. They care more about their local school, safety on the streets, and the health of the local retail strip than anyone else, and while other actors such as municipalities bear heavy responsibility for these concerns, local involvement is crucial. Sometimes these agendas are best tackled through detailed community change plans; sometimes by seizing particular opportunities. Community leaders should also shine the spotlight on their most vulnerable members including the many young people who have not made a successful transition from school to work and who need assistance getting on the job ladder. As an immediate step, pressure should be put on the Obama Administration to implement its public investment and job stimulus program to reach lower-income communities directly. Enough of trickle-down!

The current crises raise a broader question. What kinds of problems should community groups tackle on their own? For what issues do they need significant external resources? And lastly, when external circumstances overwhelm local efforts, when and how should local leaders and organizations join with others to demand more effective responses from Washington?

Malcolm Bush is research fellow at Chapin Hall, University of Chicago. He was president of the Woodstock Institute, 1993-2008.

Entrepreneurship in the Social Sector

By Jane Wei-Skillern

Nonprofits and other social ventures once claimed combined revenues of $700 billion in the U.S. But in today's dire economy, resources will decline. Wei-Skillern, co-author of Entrepreneurship in the Social Sector, recommends social entrepreneurship as a tool to maximize limited resources.

Social entrepreneurship has become increasingly prominent as an approach to societies' problems across a variety of fields -- from public health, education, to environment, to name but a few. As traditional approaches to addressing the challenges facing society have failed, many have pursued social entrepreneurship as a way to better leverage resources, enhance effectiveness through innovative partnerships, raise levels of performance and accountability, and ultimately achieve more sustainable social impact. Social entrepreneurship involves solving old problems in new ways, using existing resources more efficiently, effectively, and sustainably. I would expect that in leaner economic times there will absolutely be a strengthening of interest and activity in the field of social entrepreneurship.

Some researchers and practitioners have argued that the opportunities and challenges in the social sector require not only the creative combination and adaptation of social and commercial approaches, but also the development of new conceptual frameworks and strategies tailored specifically to social value creation.

Thus, more general conceptualizations of social entrepreneurship refer to innovative, social value creating activity that can occur within or across the nonprofit, government or business sectors. A prime example of this conceptualization of social entrepreneurship is a network approach.

A network approach requires leaders to focus not only on management challenges and opportunities at an organizational level, but also more broadly on how to mobilize resources both within and outside organizational and sectoral boundaries to create social value. A prime example of this network approach is from a Harvard Business School case study that I co-authored, *Guide Dogs for the Blind Association*. Social entrepreneur Geraldine Peacock, GDBA's chief executive, used an innovative network approach to achieve tremendous mission impact by mobilizing resources and building capacity beyond GDBA's immediate control.

The organization worked with other nonprofits, government agencies, and private sector groups as equals, to build a network of long-term, trust-based relationships to deliver on the mission. A key lesson from this case is that successful networks depend upon a willingness among all participants to invest significant resources (not just financial), relinquish control, and share recognition with their partners to advance the mission, not their organizations.

Just as with commercial entrepreneurship, failures are of course inevitable. Social entrepreneurs face the same types of challenges as any entrepreneur. They must have a clear vision and mission, undying commitment to their cause, the ability to mobilize sufficient resources toward that cause, lead in such a way as to achieve sustained impact that attracts ongoing support from donors, and adapt to a continuously changing environment, among other things. Failure to execute on any of these can contribute to the failure of a social enterprise.

We define social entrepreneurship as an innovative, social value-creating activity that can occur within or across the nonprofit, business, or government sector.

Because minority businesses are already skilled at being particularly resourceful and innovative to run a profitable business, those that choose to add a social purpose beyond their commercial goals are well positioned to do so. A corporate social entrepreneurship agenda may be an especially good way to differentiate and strengthen a minority-owned business.

Focus on "Soft" Infrastructure

A decade from now, when historians of the future look back on Chicago in 2009 and ask if we wisely use the gifts placed on our doorstep, let's all hope the answer they come up with is a resounding "yes."

By then, I hope, we will have solved our $9 billion state budget deficit, rebuilt our transportation and public education systems, revitalized the small businesses in our neighborhoods, developed a high-tech, high-skills workforce, and catapulted Chicago into the top tier of prosperous international metropolises.

But for now, as we await our cut of the billion federal economic stimulus package from Washington DC, and as we await an up or down vote on our 2016 Olympic bid from Lausanne, Switzerland, policy makers should know that politics -- and spending -- as usual simply won't cut it when it comes to lifting our economy out of the deepening global recession. Leveraging the investments triggered by an Olympics ($5 billion is a conservative estimate of spending) and a massive federal stimulus (possibly as much as $20 billion for Illinois) present once-in-a-lifetime opportunities. But unless we're strategic, disciplined and equitable in the decisions we make today, historians of tomorrow may also wind up asking a second question: how did we let it slip through our fingers?

A few priorities are in order. First, the stimulus package spending must feed the engine of jobs. As President Obama has said, the most bang for the buck comes through infrastructure -- roads, bridges, highways, important buildings. But in Chicago and other parts of Illinois, infrastructure spending has traditionally been controlled by politics and has worked to the exclusion of African Americans and other ethnic minorities. That must change. Federal stimulus money and Olympics spending should be focused directly on increasing minority work training and participation. Chicago Urban League's Policy and Research department has worked out detailed plans around these propositions.

Secondly, payroll tax credits and other incentives to hire workers will not only give entrepreneurs a much-needed break, they will directly accelerate the recovery by freeing up cash so businesses can reinvest in themselves. For African American businesses, a large percentage of which are involved in service delivery, the extra savings can help them meet capital requirements for larger loans and higher bonding ceilings. A good place to focus federal assistance is on the professional services sector which offers high wages and is a proven source of entrepreneurs. There are 13,000 such firms in the Chicago region owned by African Americans. Structured assistance to these entrepreneurs could prove transformative not only to those businesses but to the regional economy as a whole.

Experts have a term for this focus on human capital -- it's called "soft infrastructure." It's the way forward to a future we'll all be proud of.

David E. Thigpen is Vice President for Policy and Research at the Chicago Urban League.

WINTER 2009/Vol. 1 No. 4

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4510 South Michigan Avenue
Chicago, IL 60653-3898