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Even though stock indices may have rebounded from their late November lows, the market remains volatile, and the economic outlook has taken a decided turn for the worse. A credit crunch has emerged on Wall Street with the sudden aversion among banks to lend because of the uncertain value of collateral when almost everything is tainted by years of sub-prime mania. The Federal Reserve took unprecedented actions last week out of fear that the credit squeeze will lead to a serious slowdown, possibly a recession over next few months. Leading economic forecasters polled by the Wall Street Journal recently put the chances of a recession at 38 percent. In the financial press, “toxic” has become the adjective of choice in describing many of the once-revered “creative” financial instruments linked in one fashion or another to sub-prime mortgages, the high-interest loans financial institutions gave to those who could not qualify for more conventional mortgages.

Wall Street’s implosion justifiably has produced much hand-wringing among budget makers in City Hall and Albany regarding tax revenues. It seems clear by now that the dot-com bubble was no fluke. The Wall Street resurgence and boom since 2003 was largely inflated by real estate and sub-prime lending and spending. Can Wall Street do well only by doing things imprudently -- and on a gigantic scale at that?

Wall Street’s booms are certainly good for the city and state’s tax revenues (the busts certainly aren’t), but are the booms good for the broader economy? Might there be a silver lining in Wall Street’s comeuppance?

The Boom and New York

In many respects, the Wall Street boom of this decade was not that good for the New York economy or for the nation.

Wall Street is often referred to, aptly, as the main engine of the New York City economy. When it revs up, it becomes turbo-charged, generating high incomes and tax revenues. Yet it also belches out the urban equivalent of diesel exhaust, affecting the quality of life for everyone else. Soaring Wall Street incomes helped fuel the demand for luxury housing, pushing up housing prices throughout the five boroughs and pushing out many middle-class people in the process.

Wall Street’s aggressive lending and marketing practices were as responsible as anything for the sub-prime debacle. The reverberations of collapse have been felt in New York City

neighborhoods far from the financial district. Thousands of Residents moderate-income New Yorkers , many of them once worthy of more conventional credit, have suffered from the implosion of the sub-prime bubble.

Steering the Economy – But Where?

Wall Street has taken center stage on the national economic scene. The trajectories for the last two economic cycles have been determined largely by Wall Street's bubble machine. First it was the dot.com and telecommunications bubble, then the real estate and sub-prime bubble. While the Federal Reserve and government "regulators" deserve a big helping of responsibility for not minding the money store, Wall Street's financial innovations helped pave the way for a debt-induced spending spree since 2001 with mortgage debt increasing four times as fast as wage and salary income . Easy money and mountains of unsustainable debt won out over a real policy debate about how to revitalize the productive economy in a more sustainable manner.

A dynamic financial sector is vital to a competitive, world-class economy. The ability to raise capital and move it across sectors in response to ever-shifting market conditions is essential to robust economic growth. New York City-based Wall Street investment banks have taken over many of the functions historically performed by commercial banks. Mergers, like the one between J.P. Morgan and Chase, have created gigantic financial institutions that amass large pools of capital and provide a wide range of loans, equity investments and other means for corporate finance to grease the wheels of commerce in the nuts and bolts economy producing goods and services.

The financial clout of New York-based Wall Street investment banks over the national economy today rivals the situation in the late 19th and early 20th centuries, before the advent of the Federal Reserve Bank and national regulatory bodies like the Securities and Exchange Commission.

In a well-functioning economic system, the financial sector helps facilitate business activity in the nuts and bolts economy. Wall Street's role is to help make the economic pie larger. What has happened, however, is that New York investment banks have become the tail wagging the dog. Wall Street's focus has been on financial innovation in the service of more and more short-term fees, regardless of their economic value or consequence. This has bred an undue tendency toward speculation, with the prices of stocks and other securities pushed higher and higher, drawing in unsuspecting investors.

In analyzing the financial market ills leading up to the 1929 stock market crash, economics great John Maynard Keynes wrote: “Speculators may do no harm as bubbles on a steady stream of enterprise. But the position is serious when enterprise becomes the bubble on a whirlpool of speculation.”

More recently, John Bogle, founder and former chief executive of Vanguard mutual funds, laments the rising share of the economic pie going to the finance sector. Bogle notes that 25 years ago the finance sector accounted for 6 percent of the profits of the Standard & Poor’s 500 large corporations. Prior to the recent market meltdown, the finance sector took about one-third of corporate profits. Bogle estimates that hedge funds, mutual funds, investment banks and the like “siphoned about $500 billion from shareholder returns” in 2006.

Readjusting the Economy and Wall Street’s Role in It

It is not at all clear how long it will take for Wall Street to right itself. Barely a year ago, Mayor Michael Bloomberg, Senator Charles Schumer and some other prominent New Yorkers worried that Wall Street was somehow losing competitive ground to London, Shanghai and other global financial centers. They blamed government securities regulations enacted in the wake of the Enron collapse. Now, it is more likely that there will be calls to effectively regulate Wall Street so that the bubble-making machine is de-activated in favor of a return to making money the old-fashioned way. The problem was not that Wall Street was regulated too much but that it was not regulated in the right way. Financial “innovation” run amok turned out to be the real threat, not London or Shanghai. Those market centers also are plagued by bubble tendencies and are in similar need of effective oversight.

As Wall Street regroups from its current woes, city economic policy-makers might want to consider a different set of priorities. In City Hall, the focus could be on really diversifying the city’s economy and using mega-development projects to make the city more livable and more likely to produce good, middle-income paying jobs. For the past few years, City Hall’s main real estate development goal has been ever more space for huge financial trading floors – a fixation that is no more sustainable than the latest financial bubble. The big challenge is to make sure that the jobs created in developments induced by city actions pay decent wages and offer career opportunities that lead to the middle class. New York will not have a middle class if it doesn’t have middle-class jobs.

In Albany, the state is still groping for an economic strategy responsive to the needs of New Yorkers. While some observers are eager to write it off, manufacturing still employs over a half-million workers in New York and remains the economic backbone of many upstate communities. Several manufacturing industries, including but not limited to ones deemed “high tech,” are highly productive upstate. It is myopic to think that high value-added manufacturing – microelectronics, optics, ceramics, biotechnology, instrumentation -- will entirely desert the U.S. or New York, with its world-class technical universities, advanced technology research base and highly skilled manufacturing workforce. The state should identify the strong performers among manufacturing firms, work to make them even more competitive and ensure that they can retain and develop more highly skilled manufacturing workers.

The state desperately needs to overhaul its economic programs across the board, from Empire Zones to Industrial Development Agencies, to transform them from giveaways and cronyism to strategic interventions addressing the failure of markets to invest sufficiently in further advancing New York’s human capital assets through skill training and research and development.

Both City Hall and Albany should also seriously pursue the many opportunities now unfolding to develop green jobs promoting energy conservation and the production of green building materials and other environmentally friendly manufactured products.

Economic sustainability is as desirable a goal as environmental sustainability. Our current economy is anything but that. In the long run, the state and city tax base will be more sustainable with an economy geared to providing ample opportunities for more good-paying jobs as opposed to our current highly polarized, Wall Street-dominated economic structure. With a strengthened and expanded middle class, New York will have stronger and more vibrant communities.Â