BIG BANK, BIG GOVERNMENT, AND MARKET-BASED ECONOMY

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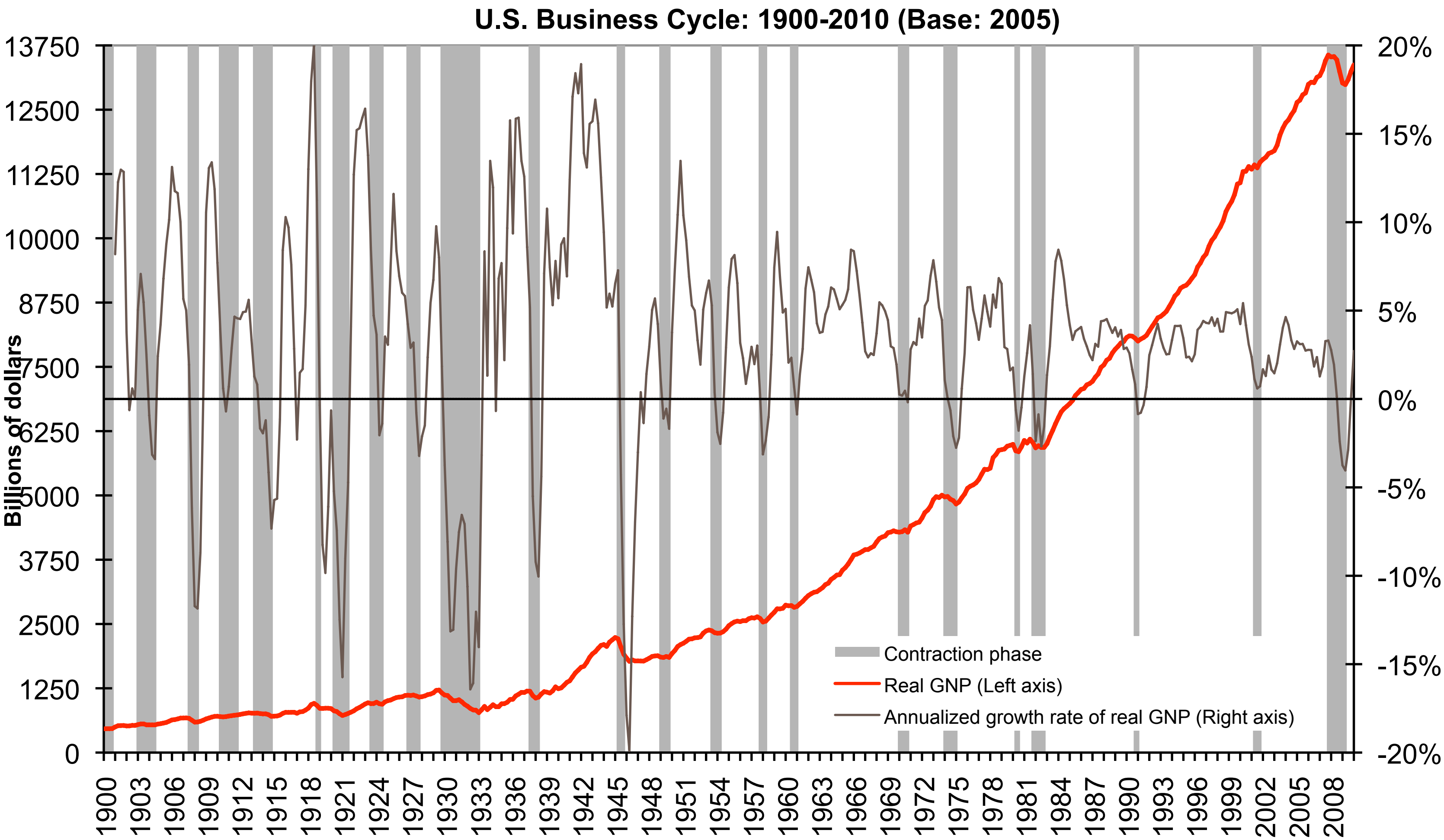
Market Economies before Big Government and Big Bank

- Market economies are highly volatiles
  - Economic recessions:
    - Severe
    - Very Frequent
    - Lengthy
  - Financial crises:
    - Highly destructive
    - Banking and twin crises are frequent

Economic Recessions Before and After Big Government and Big Bank



Sources: NBER, BEA, *The American Business Cycle* by R.J. Gordon (ed.).

Economic Recessions Before and After Big Government and Big Bank

	Number of contractions	Average Frequency	Average Length	Average Decline in real GNP
1900-1946	12	3.9 years	18.1 months	-6.8%
1947-2009	11	6.1 years	10.4 months	-1.7%

Financial Crises before and after Big Government and Big Bank

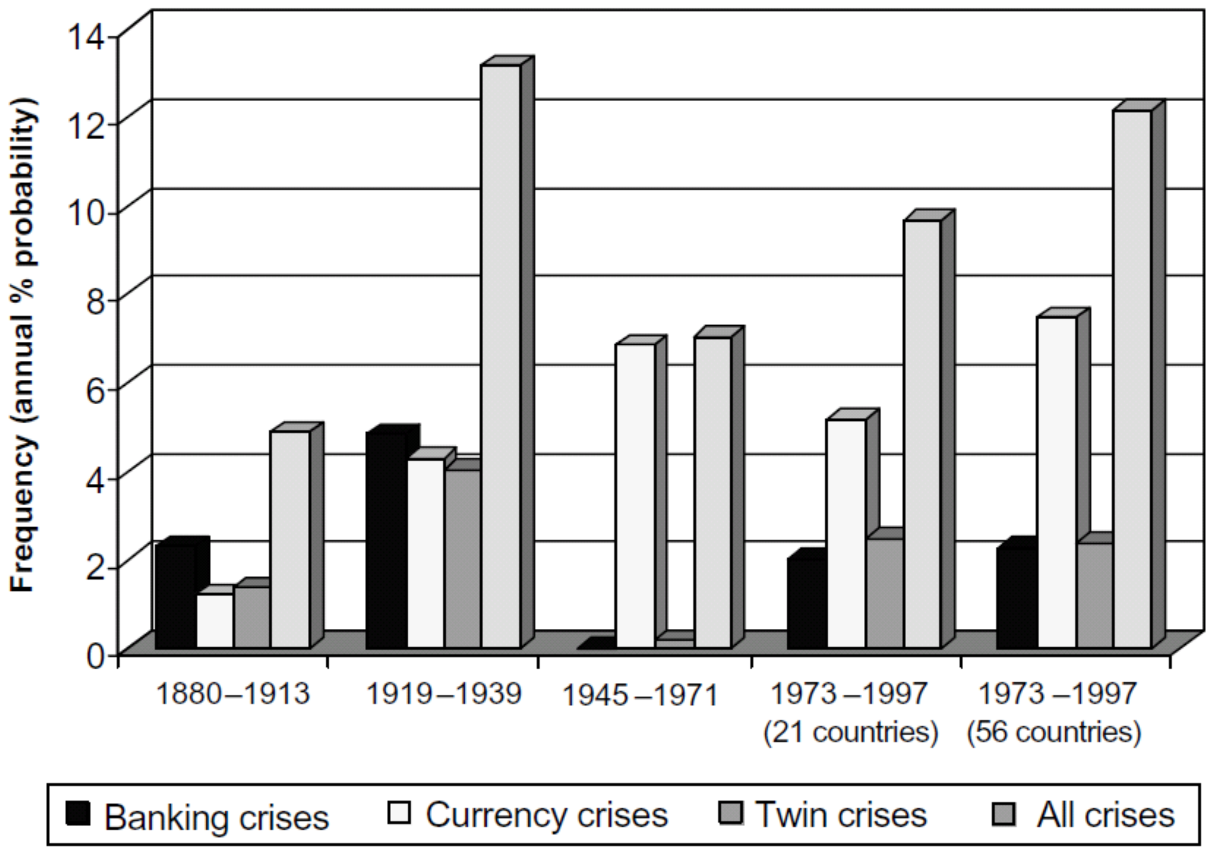


Figure 1. Crisis frequency, 1880–1997

Source: Bordo et al. (2001)

Table 1. Duration and depth of crises

All countries	1880–1913	1919–1939	1945–1971	1973–1997 21 nations	1973–1997 56 nations
			Average duration of crises in years		
Currency crises	2.6	1.9	1.8	1.9	2.1
Banking crises	2.3	2.4	[a]	3.1	2.6
Twin crises	2.2	2.7	1.0	3.7	3.8
All crises	2.4	2.4	1.8	2.6	2.5
			Average crisis depth (cumulative GDP loss in %)		
Currency crises	8.3	14.2	5.2	3.8	5.9
Banking crises	8.4	10.5	[a]	7.0	6.2
Twin crises	14.5	15.8	1.7	15.7	18.6
All crises	9.8	13.4	5.2	7.8	8.3

Notes: [a] indicates no crises

Source: Bordo et al. (2001)

Big Bank and Big Government: Stabilizing Market Economies

- Big Bank: Central banks acting as lender of last resort, payment-system unifier and banking regulator
  - First created to help government finances and/or to establish a uniform monetary and payment system, then used as a means to manage gold -parity.
  - Role as regulator/supervisor and lender of last resort emerges mainly during the 20th century
  - Federal Reserve Act: "An Act To provide for the establishment of Federal reserve banks, to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes."

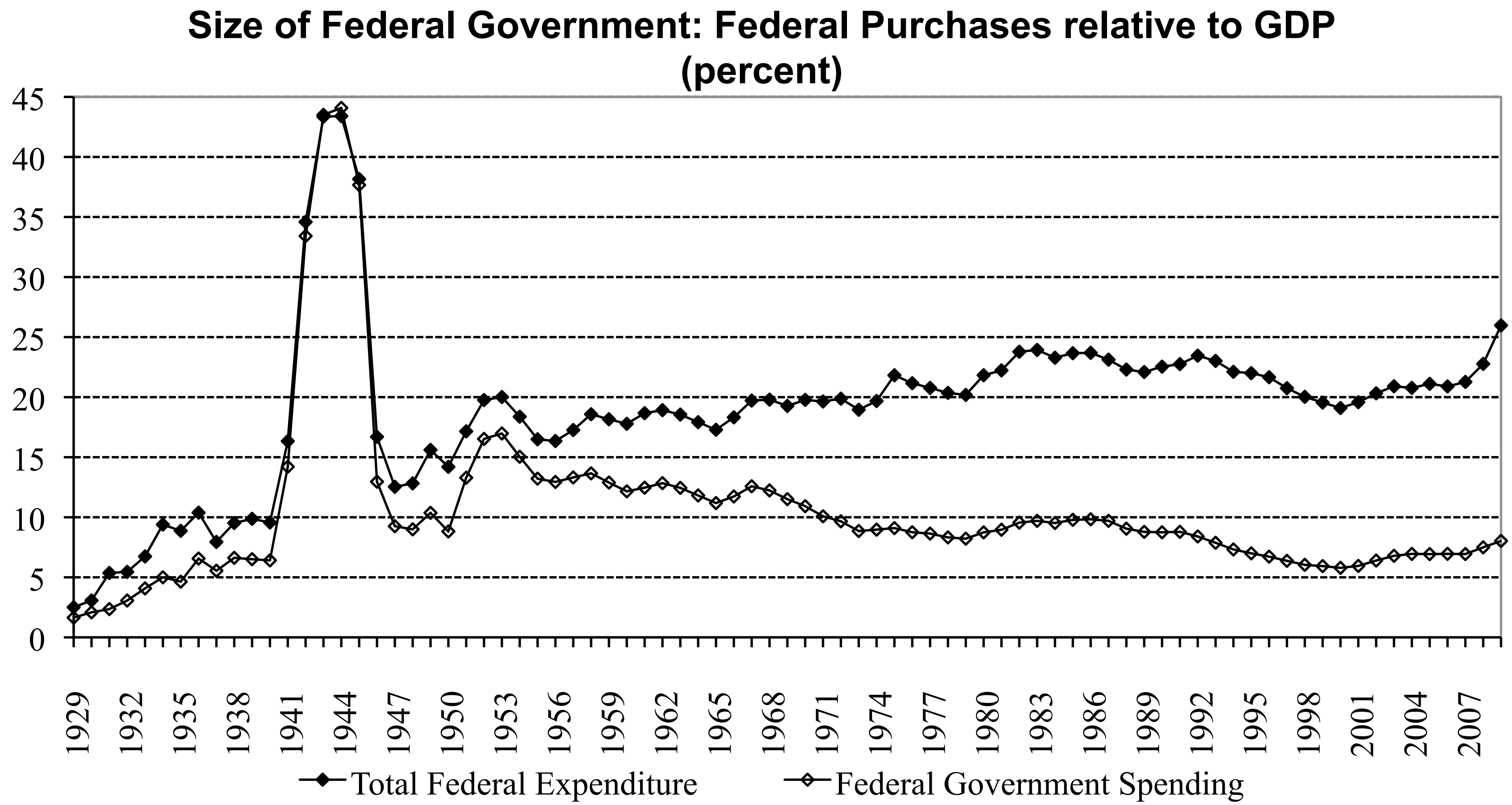
Big Bank and Big Government: Stabilizing Market Economies

- Big Bank helps to stabilize the economy by:
  - Providing a stable payment system:
    - Clearing of debts (clearing of checks, inter-bank clearing (Fedwire); provision of ultimate means of payment)
    - Maintenance of nominal parity between government and private monetary instruments (cash and demand deposits convert at parity all the time)
    - Providing commercial and investment banking services to the Treasury: BIG GOVERNMENT no longer face solvency and liquidity constraints
  - Maintaining a stable financial market
    - Limiting the volatility of interest rates on a daily basis
    - Providing funding sources at low discount rate in times of panic: Central banks acting as lender of last resort.
  - Financial regulation and supervision.
    - Adequate capitalization (bank capital, margin requirements) and liquidity buffers.
    - Proper management and underwriting procedures

Big Bank and Big Government: Stabilizing Market Economies

- Big Government:
  - Until the Great Depression, the US Federal Government was very small: 2% of GDP (Post Office, Army, Police, Law). Mostly the same around the world.
  - The Great Depression led to a large increase of Federal/National government involvement in the Economy: averages 20% to 50% of GDP depending of developed countries

Big Bank and Big Government: Stabilizing Market Economies



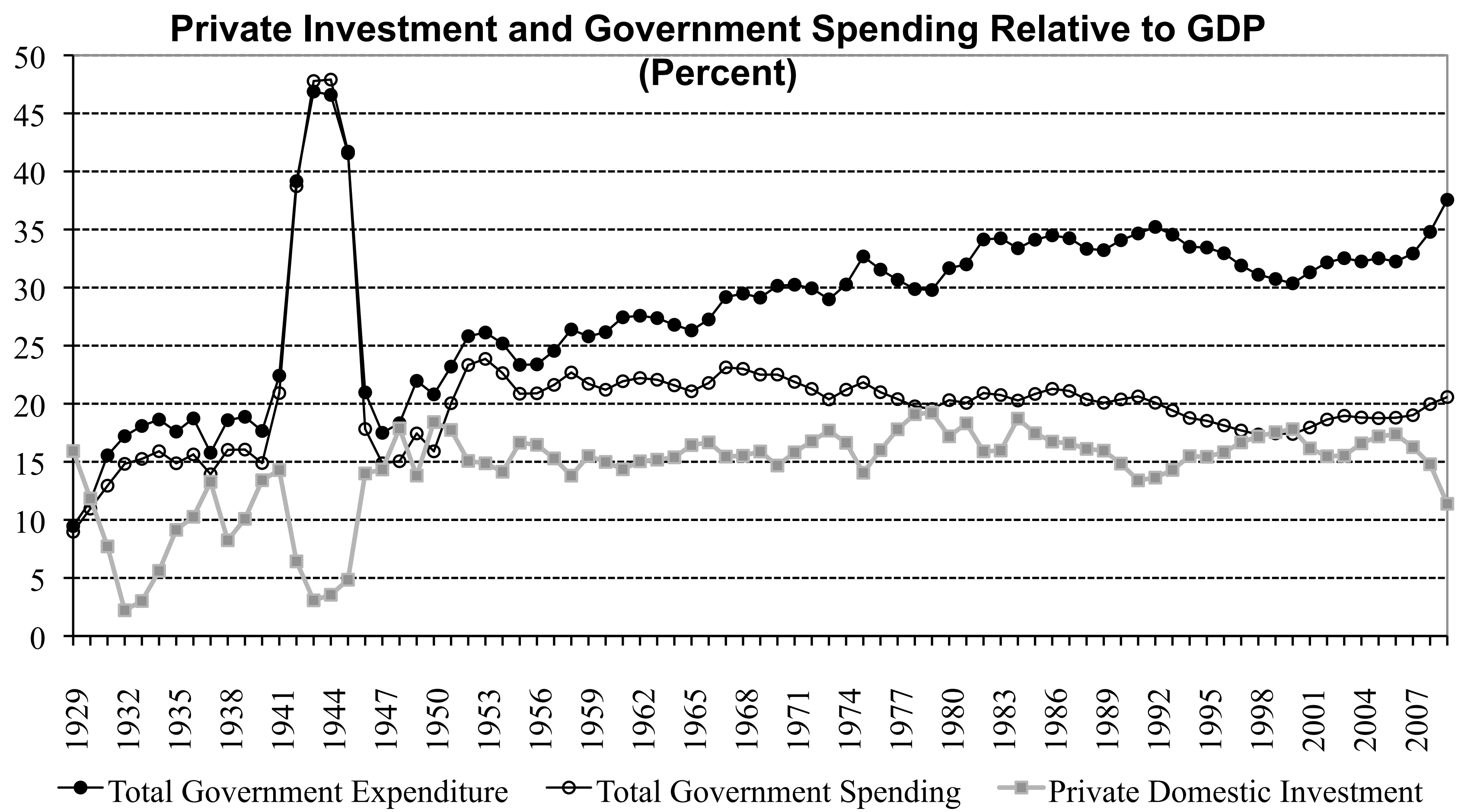
Source: BEA. Government spending is equal to government consumption expenditures plus gross government investment. Total Federal expenditures equals current expenditures(government consumption expenditures, interest payment and transfers) plus gross investment expenditures plus other miscellaneous items

Big Bank and Big Government: Stabilizing Market Economies

- Big government helps to stabilize the economy by:
  - Sustaining net cash flows to households and companies: transfers, taxes, and spending
  - Providing liquid default-free financial assets.
  - Helping indirectly to sustain asset prices and so net worth.
- How big should Big Government be? To be able to stabilize the economy, the government, especially the federal government must be big enough. To see how big the Kalecki equation of profit is a good point of departure.

$$\Pi = I + (G - T) + NX$$

Big Bank and Big Government: Stabilizing Market Economies

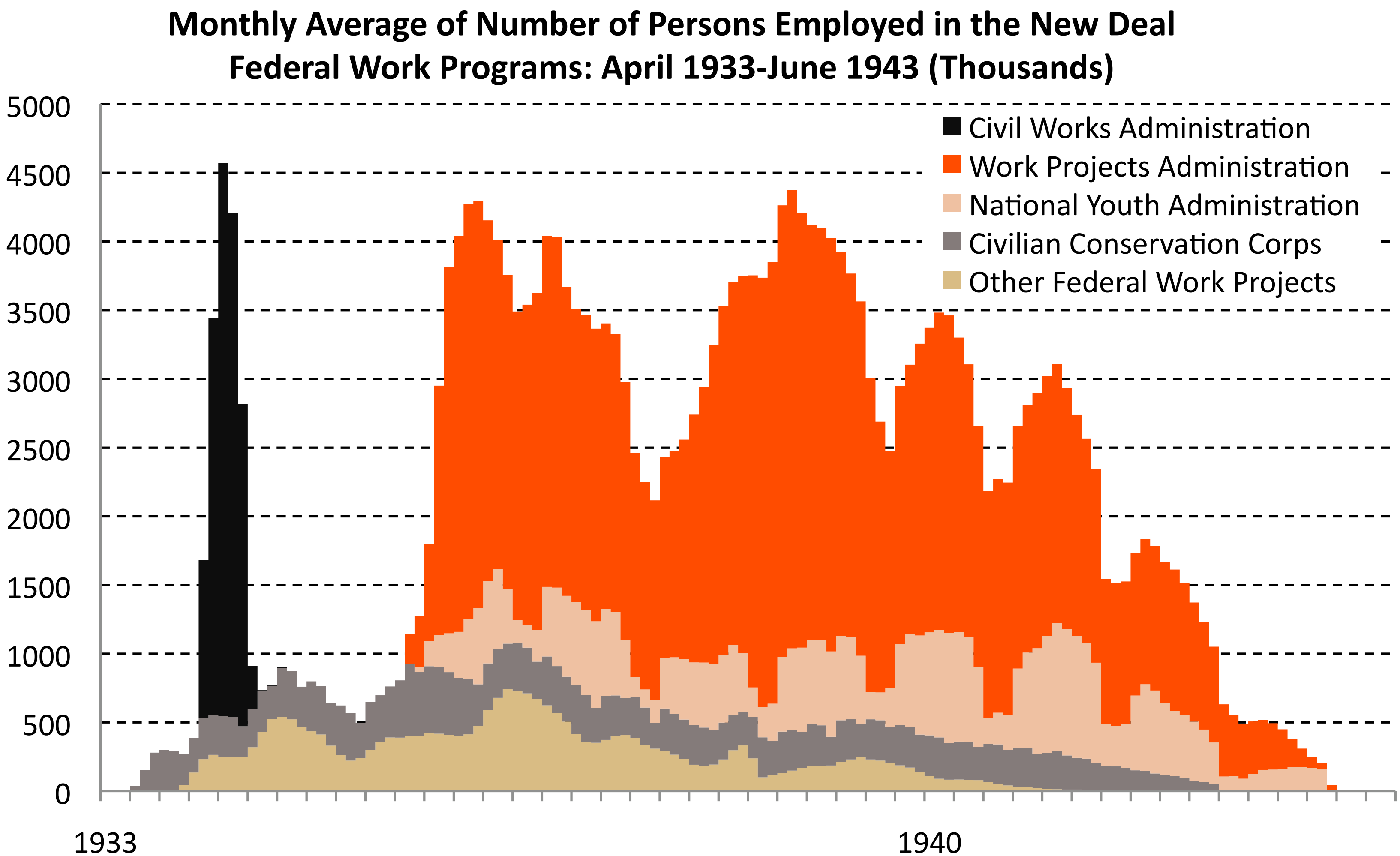


Source: BEA.

Emergence of Big Government: The Great Depression

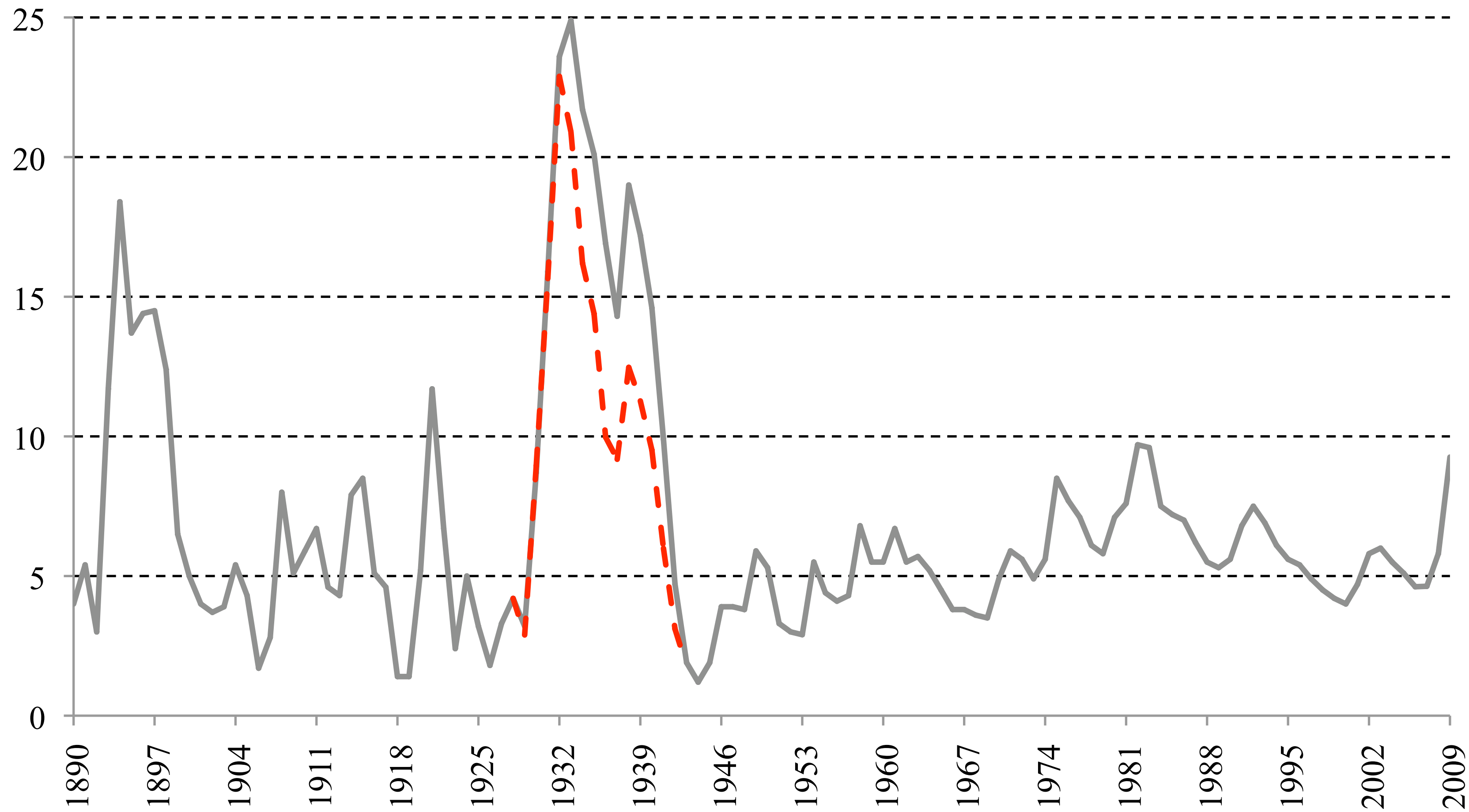
- In the US, Big Government emerges during the Great Depression:
  - Federal Reserve: Abandons Real Bill Doctrine, and widens collateral acceptance to anything it deems acceptable, from anybody if necessary.
  - Financial regulatory system is massively increased.
  - Federal government becomes highly involved in the economy. In some ways more than today: employer of last resort.

Employer of Last Resort



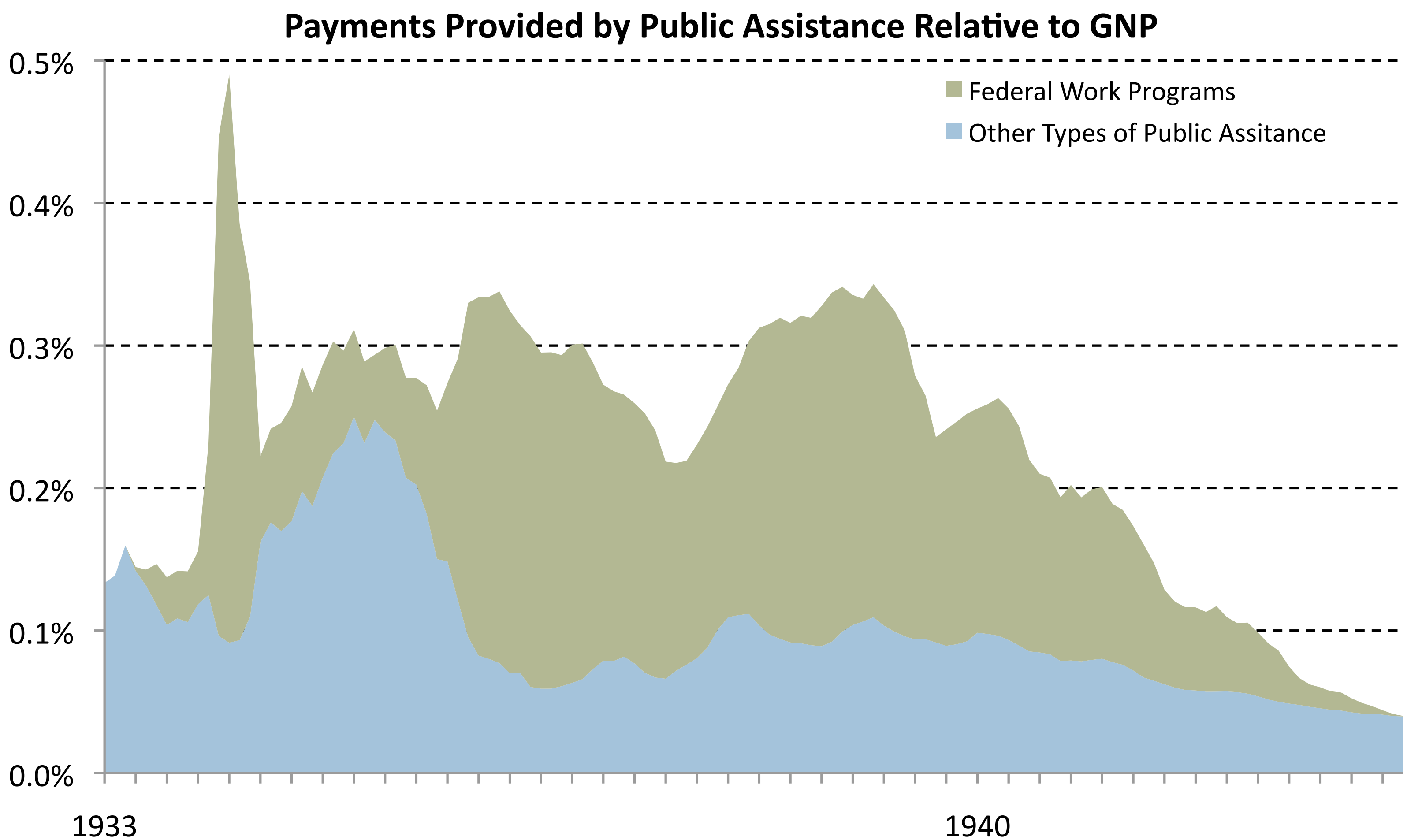
Sources: Social Security Bulletin, Federal Works Agency, Federal Security Agency (War Manpower Commission), Office of the Director of the Civilian Conservation Corps, Office of the Director of the Emergency Conservation Work, Works Progress Administration.

Unemployment Rate (percent)



Sources: BLS, U.S. Census Bureau, Weir (1992). Red dotted line removes people employed in government-work programs from the unemployed (official BLS data considers them unemployed).

Was ELR expensive?



Sources: Social Security Bulletin, *The American Business Cycle* by R.J. Gordon (ed.).
Note: Public assistance includes monetary transfers (elders, farmers, blind, etc.) and wage payments from employment assitance (state employment programs, WPA, etc.)

Did it improve economic welfare? Was it "productive"?

- Some of the accomplishments of Big Government during the 1930s:
  - Infrastructures:
    - Transportation: Highways, road, street lighting, bridges, airports, tunnels, etc.
    - Public buildings: Schools, hospitals, libraries, barns, firehouses, offices, etc.
    - Recreational facilities: Parks, swimming pools, tennis courts, athletic fields, etc.
    - Public utilities and sanitation: telephone lines, electric power lines, water lines, water treatment plants, sewer lines, etc.
    - Conservation and flood control: reforestation, river banks, irrigation systems, etc.
  - Education and childcare: school lunch, teachers, etc.
  - Consumption goods: furniture, clothes, etc.

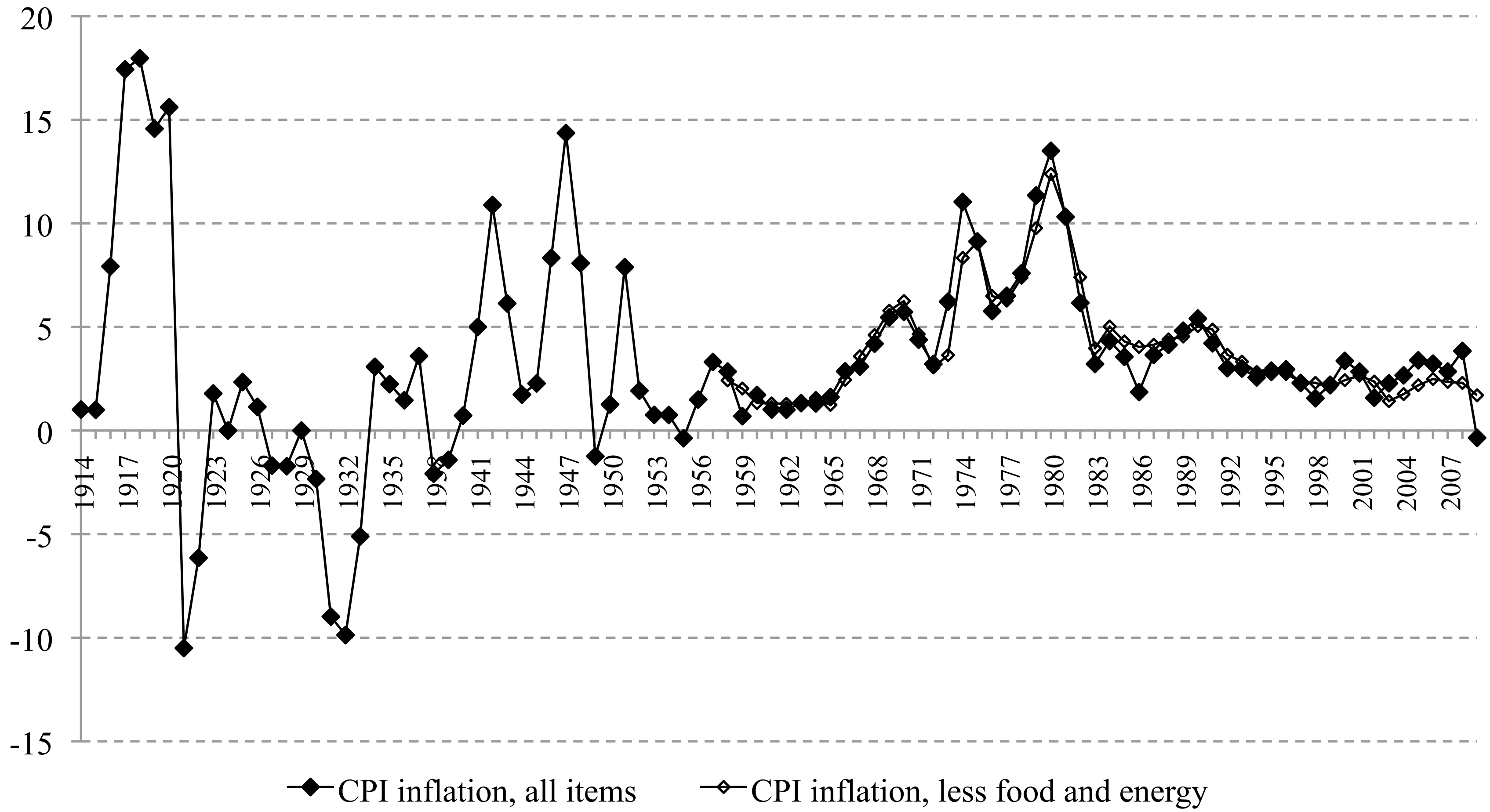
Some issues with big government and big bank

- Big Government and Big Bank have some drawbacks:
  - Potential Moral Hazard:
    - Financial risk
    - Lack of motivation of the workforce:
  - If fine-tuning is the main thing it is used for: Inflationary tendencies
    - Fine tuning: no consideration for supply side and financial instability, subject to political influence and lags.
  - If Use of government mostly for unproductive tasks
    - Military: Main federal spending since the end of World War II.
    - Prison: During WPA, building prisons was the lower priority despites a large increase in robberies and crimes (only 181 prisons built out of 35000 public buildings built, smallest increase of any building) (today it is a major expense especially for state governments)
    - Tends to be inflationary.

Some issues with big government and big bank

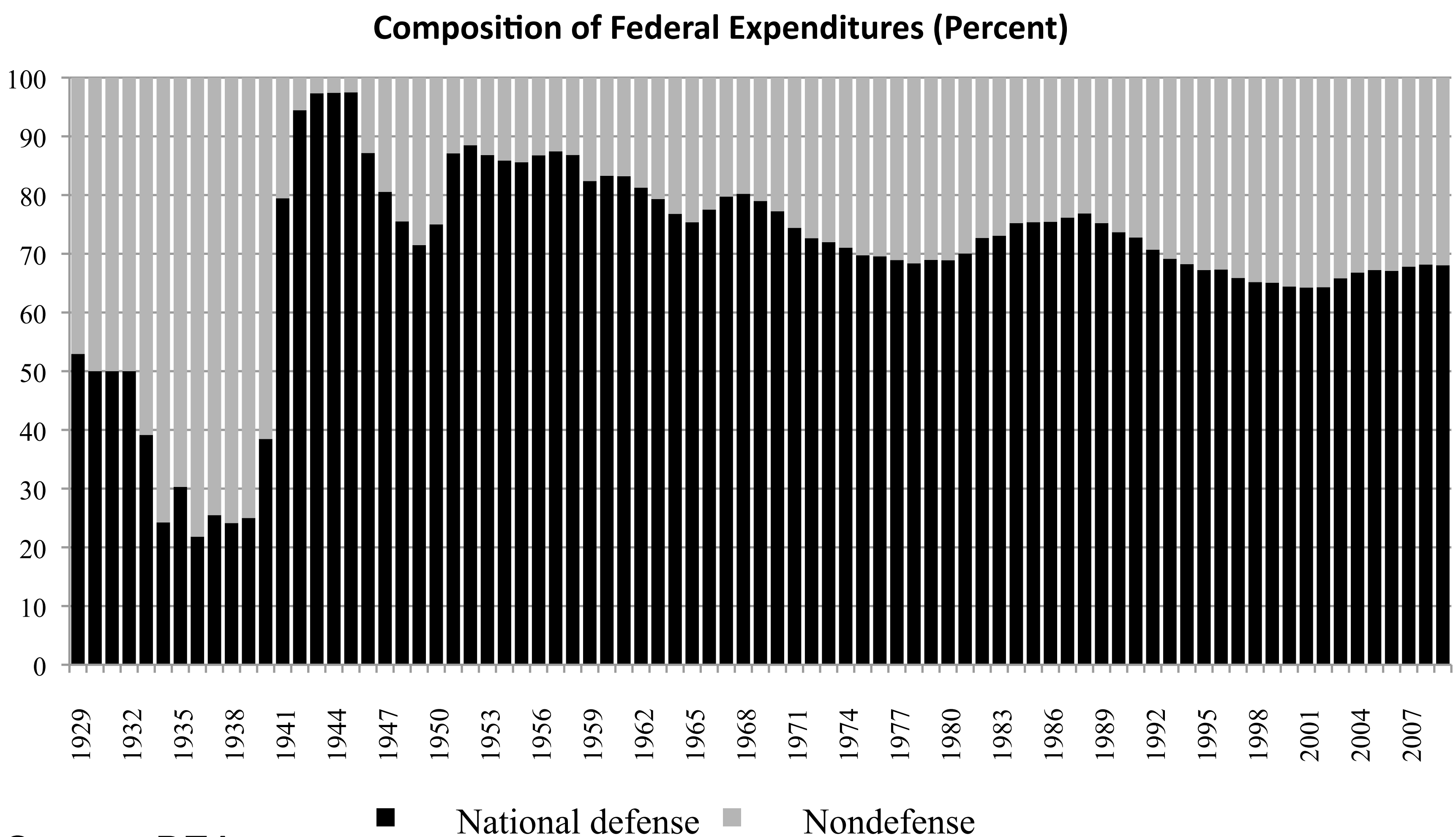
- "All that was assimilated from Keynes by the policy establishment and its clients was the analysis of an economy in deep depression and a policy tool of deficit financing. […] Keynesian economics, even in the mind of the economics profession, but particularly in the view of politicians and the public, became a series of simple-minded guidelines to monetary and fiscal policy. […] The institutional structure has not been adapted to reflect the knowledge that the collapse of aggregate demand and profits, such as occasionally occurred and often threatened to occur in pre-1933 small government capitalism, is never a clear and present danger in Big Government capitalism such as has ruled since World War II." (Minsky 1986: 291, 295)

Some issues with big government and big bank



Source: BEA.

Some issues with big government and big bank



Source: BEA.

1980s to 2000s: A return of volatility

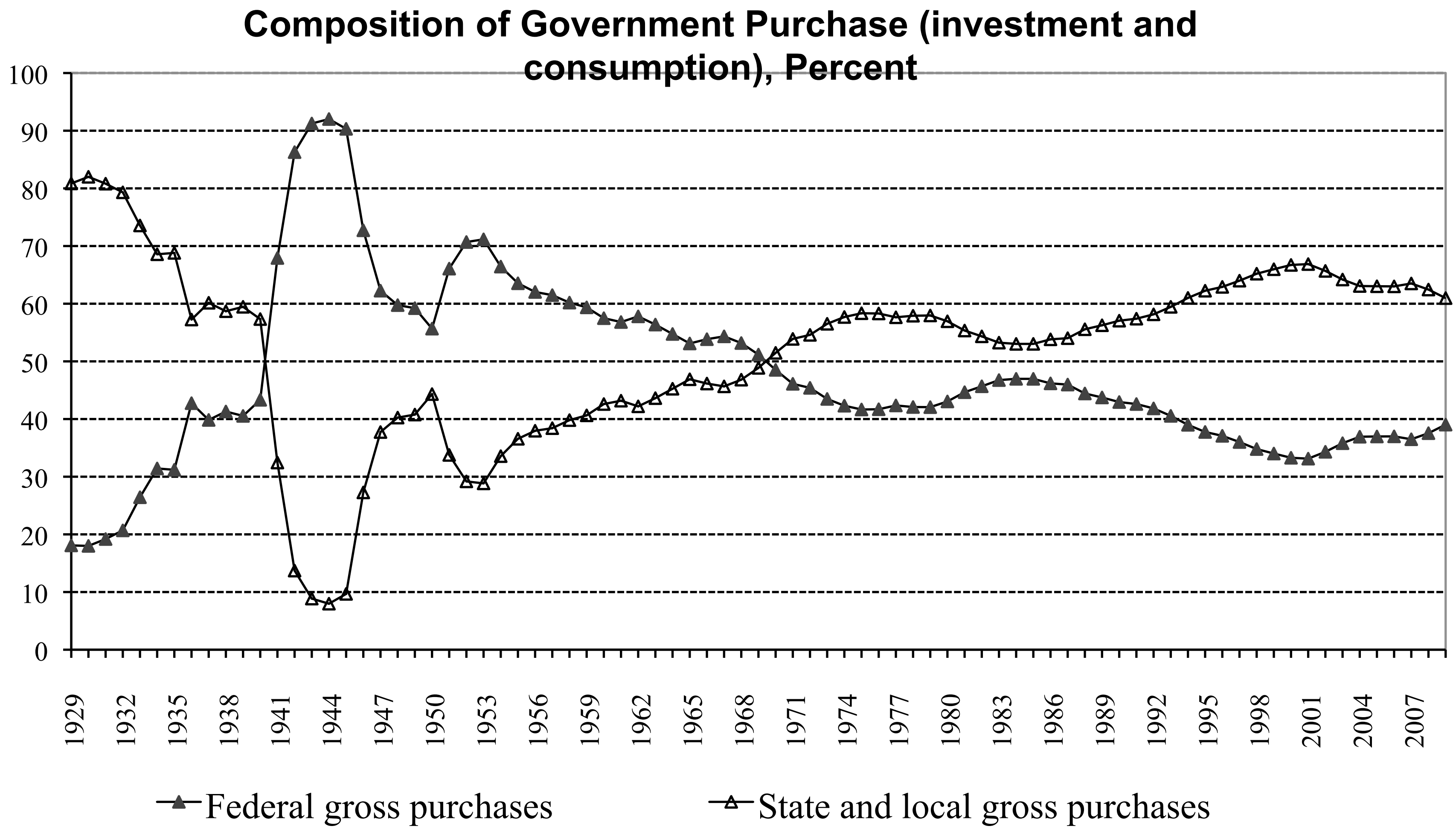
- Economic Crises: The Great Recession
  - Longest contraction since the Great Depression but still much shorter.
  - Deepest contraction since the Great Depression but still much milder.
  - Return of debt-deflation forces and they are much stronger than during the Great Depression.
- Financial Crises:
  - Twin crises are highly destructive like during the interwar period.
  - Independent currency and banking crises are not as destructive as prior times but their frequency has increased

1980s to 2000s: A return of volatility

- Disinvolvement of the federal government:
  - Burden of government spending (G) has been mostly shifted to state and local government
  - Transfer become the major expense of the federal government: only kicks in when things are already bad.
  - Decrease in regulation: financial, environmental, medical, labor
  - Decrease in supervision: lower staff, less qualified
  - Decrease in enforcement: lax, let frauds and misconduct continue

=> Capacity of the government to stabilize the economy has declined

1980s to 2000s: A return of volatility



Source: BEA.

What should big government and big bank do today?

- Quality of spending matters as much, if more, as the quantity of government spending:
  - American infrastructures were given a D average by the American Society of Civil Engineer: repair and expand.
  - Green technologies: Federal work programs of the 1930s helped to bring the US economy in the 20th century. New programs would help to bring the US economy into the 21st century.
  - Education: Promote fields in needs, research
  - Childcare, eldercare
  - Healthcare: Medicare for all, research
- Permanent, federally funded, locally implemented, employer of last resort program.
- Regulation, supervision and enforcement.

Conclusion

- Keynes noted that the "outstanding faults of the economic society in which we live are its failure to provide for full employment and its arbitrary and inequitable distribution of wealth and incomes" (Keynes 1936: 372). A big government and a big bank should work toward eliminating those faults.
- Market mechanisms, BG, and BB are complementary elements of a successful economy