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IT ISN'T WORKING: TIME FOR MORE RADICAL POLICIES

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Introduction

The Obama administration has had a lot to deal with in its first few months in office. Unfortunately, like the Bush administration before it, the Obama team appears to be trying to re-create the bubbly financial conditions that led to disaster. This tack is not likely to succeed, and it is displacing policies that might actually prevent a recurrence of the Great Depression. Even if the $23.7 trillion the federal government has so far allocated in the form of spending, lending, and guarantees does preserve the status quo, we believe it will merely set the stage for another—bigger—financial crisis a few years down the road. This is why we recommend an abrupt change of course and the pursuit of a more radical policy agenda.

Policy serves to preserve the interests of big financial companies rather than to implement government programs that would *directly* sustain employment and restore state finances. To make matters worse, the Obama administration is already preoccupied with "paying for" additional spending through tax hikes, or through spending cuts elsewhere. It does not appear to be willing to let the fiscal position of the federal budget grow as needed to meet current challenges.

The U.S. economy is crushed by massive indebtedness in the financial and household sectors, so maintaining the status quo is not a solution. We need federal government spending programs to provide jobs and incomes that will restore the creditworthiness of borrowers and the profitability of firms. We need a swift and detailed investigation of financial institutions' balance sheets, and resolution of those firms found to be insolvent. We need to downsize financial institutions

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that are "too big to fail" while putting in place new regulations and supervisory practices to lessen the possibility of system fragility as the economy recovers. We need a package of policies to relieve households of intolerable debt burdens. Given that the current crisis was fueled in part by a housing boom, we also need to find a way to deal with the oversupply of homes and high vacancy rates that are driving down real estate values and increasing the social costs for communities. And we've got to rein in the money managers that seem to be dictating policy.

How Did We Get Here?

In a word: leverage. There are different kinds of leverage, and we used them all. Income was leveraged by households and by firms in order to take on more debt. For the past dozen years, scholars at the Levy Institute have been warning about the consequences of a practically unbroken deficit spending spree, as evidenced by exceptionally high debt-to-income ratios (see the following section). Many financial institutions leveraged equity using highly complex proprietary models to assess risk and expand balance sheets to the maximum extent under the capital requirements of Basel II. They also leveraged safe, liquid assets (e.g., reserves and Treasuries) and increased the level of risky assets as a proportion of their balance sheets. Banks moved assets off balance sheet and into "special purpose vehicles" in order to avoid capital requirements. Overall, there was an increase in financial sector "layering," as the nominal value of financial assets and liabilities grew much faster than GDP. Indeed, the debt of financial institutions grew much faster than other private sector debt.

We could say that the FIRE (finance, insurance, and real estate) sector "leveraged" the rest of the economy, as its employment and profits not only expanded but also accelerated (the sector received 40 percent of the nation's profits before the bust). All efforts are aimed at keeping leverage high, while the Federal Reserve (Fed) and Treasury try to get banks to lend again—as if another debt bubble were the cure for an ailing economy.

As Hyman P. Minsky argued, banking is an unusual profit-seeking business because it is based on very high leverage ratios. Further, banks serve an important public purpose, so they have access to the lender of last resort (the Fed) and government guarantees. Those guarantees provide cheap and virtually unlimited credit in the form of insured (bank) deposits. Because creditors (depositors) will not lose if the banks fail, they feel little need to supervise bank activities. The banks, in turn, can increase profits on equity by raising the return on assets under a given capital ratio and by reducing the ratio of capital to assets (increasing leverage). These actions increase the risk but can also dramatically raise profitability without upping the amount of capital at risk, since the government insurer will absorb any equity losses on bad assets.

Simple arithmetic shows that banks with higher leverage and profit rates must grow faster to maintain a certain level of profitability, especially when shareholders impose a specific return-on-equity target. Moreover, assets will have to grow at an even faster rate if the return on assets increases under a given leverage ratio, or if the bank increases its leverage ratio. Both of these events are likely in a boom, and this explains why an otherwise unconstrained financial system will tend toward explosive growth. Indeed, a recent paper by economists at the Federal Reserve Bank of New York shows that leverage in the financial system is highly procyclical, since assets relative to equity expand during a boom and decline during a bust (Adrian and Shin 2009). The notion that legislated capital requirements such as those promulgated by Basel II can tightly constrain growth and risk is flawed.

If management's performance is closely scrutinized and pay structures are tied to short-term performance, management will likely choose to hide losses and pursue a higher risk/return path. Strict capital requirements combined with lax oversight makes this response even more probable, as management tries to rebuild capital before the regulatory agencies discover the losses and close the institution. This is why former Treasury Secretary Henry Paulson's argument that government had to inject capital and get the bad assets off the books in order to encourage banks to lend again was nonsensical. Loan losses and lack of capital are not barriers to lending; rather, they can encourage rapid growth of risky loans. Too, more lending is not a solution to excessive leverage and debt! In any event, there is always an incentive to increase leverage ratios and improve the return on equity. And government-guaranteed liabilities without close supervision are bound to create problems.

While the Basel agreements were supposed to increase capital requirements, the ratios were never high enough to make a real difference, and the institutions were allowed to assess the riskiness of their own assets for the purposes of calculating risk-adjusted capital ratios. If anything, Basel I and II contributed to financial fragility and the collapse of the global financial system. In lieu of closely regulated and supervised financial institutions, effective capital requirements need to be very high and risk assessments must be performed at arm's length by neutral parties.

Supervisors should always be wary of rapid growth, which has proven to be a predictor of insolvency. Since there is always a limited supply of creditworthy borrowers, rapid growth is sustained by lowering either credit or underwriting standards. High and rising leverage means that financial institutions must grow faster, and that is partly the reason a greater share of GDP and profits was captured by the FIRE sector (Tymoigne 2009c).

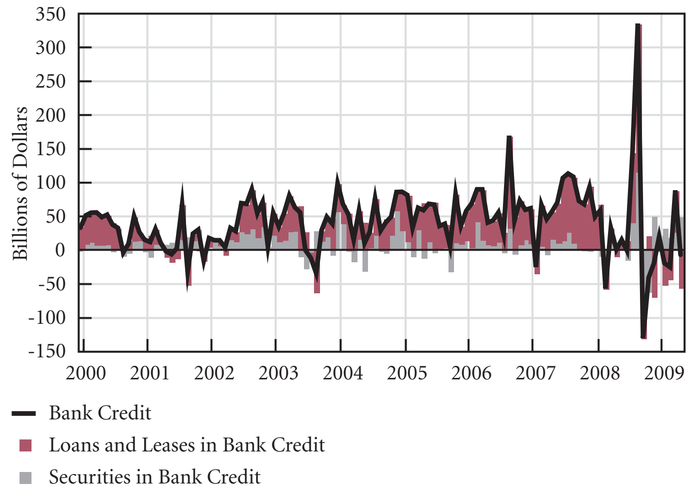
In the early 1980s, we transitioned to a "market-based" financial system. To be sure, there already was a long-term trend away from commercial banking and toward nonbank financial institutions—what is now known as the "shadow banking sector." One illustration of this transition is the "originate to distribute" model, where institutions originate loans that serve as collateral for securities sold in markets (Wray 2007, Minsky 2008). Everyone in the home finance food chain tacked on fees for services: mortgage brokers, banks and thrifts that originate loans, as well as property appraisers, accountants, title insurers, rating agencies, lawyers, mortgage and security insurers (including credit default sellers), and security brokers and dealers. Whatever was left of the homeowner's principal and interest payments was parceled out to various tranched securities held by money managers.

A similar transformation occurred throughout the financial system, so leverage had to be very high to meet return-on-equity goals. Since competition reduced returns, leveraged money sought progressively riskier assets. Leverage is a beautiful thing on the way up, and a disastrous thing on the way down.

Most deleveraging took place off of the bank's books, for two reasons. First, it is difficult to delever bank deposits and loans because loans are idiosyncratic and therefore hard to sell, while a mark-to-market accounting system immediately recognizes huge market losses. Second, as highly leveraged institutions subject to some oversight, banks cannot afford to recognize these losses or to sell their marketable assets into declining markets.

As shown in Figure 1, bank credit has not declined substantially since the recession began in late 2007. Rather, it shows an upward trend, as funding comes from the purchase of private securities rather than loans, which are also trending upward despite the transition to a market-based system.

Figure 1 **Bank Credit at All U.S. Commercial Banks, 2000–09 (in billions of dollars)**



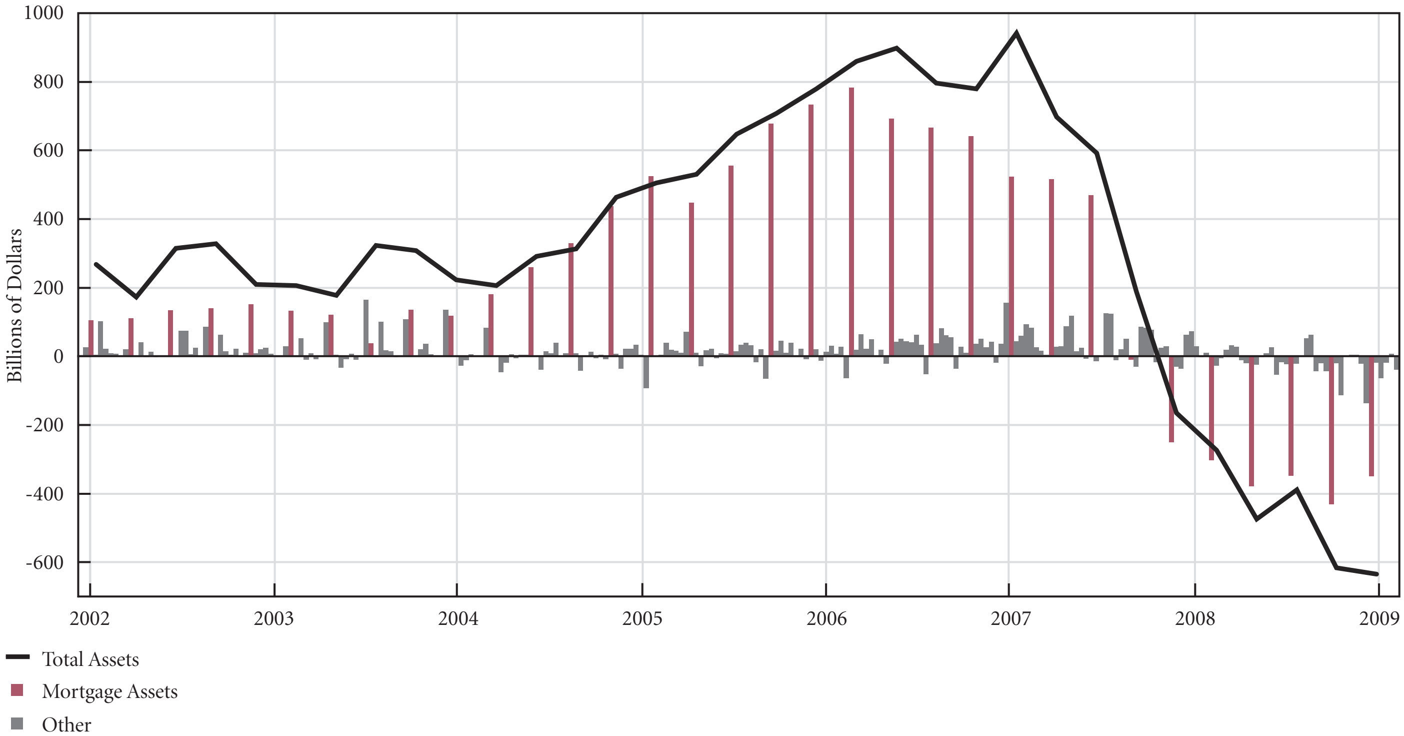
Source: Federal Reserve (Series H.8)

However, the shadow banking sector has greatly reduced its leverage by writing off bad debts and recognizing losses. Thus, much of the public scolding of banks for "not providing credit" is misplaced. As shown in Figure 2, it is the "shadow" sector that is shrinking balance sheets and cutting off credit—for *all* previously financed activities, not just mortgages.

One of the supposed advantages of the market-based model is that it made illiquid assets (e.g., home mortgages, credit card debt, and student loans) marketable and more liquid. Unfortunately, that was only during the boom. When the bubble burst, these assets became hot potatoes that could be sold only into declining markets.[1] And, since the assets were held mainly by institutions that "mark to market," falling prices triggered more sales to avoid greater losses, pushing prices even lower, in what Irving Fisher and Minsky described as a "debt-deflation process": the higher the leverage ratio, the greater the impact when exiting a toxic asset class. The panic during this process was made much worse because financial institutions typically financed their asset positions by issuing liabilities held by other financial institutions (rather than to insured depositors).

By August 2008 (during the severe liquidity crisis), the banks and shadow banks, which had leveraged their safe assets during the boom, were forced to sell their riskier assets such as mezzanine loans and asset-backed securities positions, depressing asset prices further and reinforcing their leverage problem (IMF 2008). When the entire shadow banking sector tried to

Figure 2 **Change in the Assets of Asset-backed Securities Issuers, 2002–09 (in billions of dollars)**



Source: Federal Reserve (Series Z.1)

delever, institutions refused to extend credit to one another except at huge discounts, and they tried to sell assets to other institutions that could not finance positions in the assets they already held. Asset prices subsequently collapsed in a self-reinforcing spiral. A similar process is under way in the commercial real estate sector.

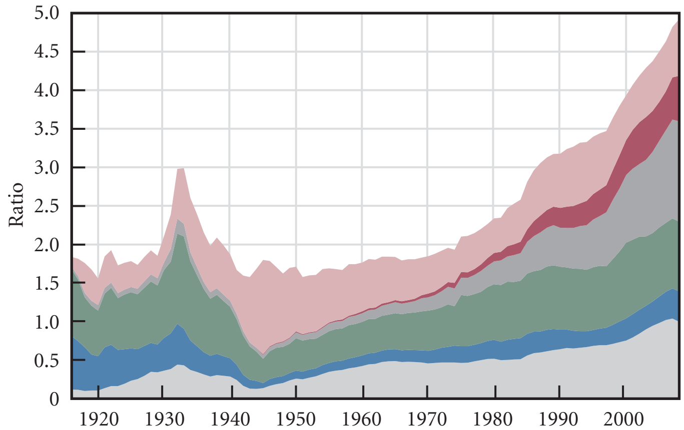
This exemplifies the downside of a market-based system and was one of the primary reasons for the "New Deal" reforms enacted by Washington, when the Fed and Treasury confronted the liquidity crisis by extending deposit insurance; guaranteeing, lending against, and even buying commercial paper, asset-backed commercial paper, and mortgage-backed securities; opening the discount window to some shadow banks; and handing bank charters to investment banks so that they would have access to insured deposits. The government guarantee acted effectively as a circuit breaker to stop the normal market process of deleveraging through asset sales.

If the problem had been one of excessive leverage exclusive to the financial sector, the crisis could have been resolved by getting the financial institutions to accept one another's liabilities and refinance their positions in one another's assets. But the problem was one of excessive leverage throughout the global economy, where there was too much lending against prospective income flows and expected asset appreciation. Although the market now wants more deleveraging because of solvency risks (rather than liquidity problems), Washington wants to prevent it, despite excessive debts and collapsing incomes. There will not be a sustainable recovery until these debts are reduced and incomes are growing.

The Debt Problem: Where Is the Problem and How Big Is It?

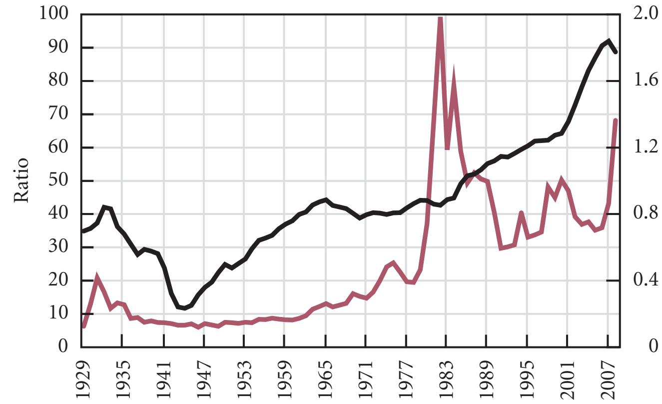
As shown in Figure 3, the level of U.S. indebtedness is at an all-time high, and well above the debt-to-GDP ratio on the eve of the Great Depression. Even though politicians and commentators have been clamoring over the staggering government debt and unsustainable fiscal deficits, it is the debt level of the private domestic sector that should be of greater concern. The ratio of private domestic debt relative to GDP in 2008 was 3.6,

Figure 3 Total Financial Liabilities Relative to GDP by Sector, 1916–2008*



Sources: Carter et al. 2006; U.S. Census Bureau 1975; NIPA; Federal Reserve Flow of Funds Accounts (from 1945)

Figure 4 Household and Financial Sector Debt Relative to Their Respective Income, 1929–2008



Sources: Bureau of Economic Analysis; Carter et al. 2006; NIPA; Federal Reserve Flow of Funds Accounts (from 1945)

compared to 0.73 for the government sector (0.53 for the federal government) and 0.58 for government-sponsored enterprises. While the debt problem is very serious, the concern about the federal deficit and its effect on the public debt is misplaced. The government's debt is low relative to the size of the economy, and as a matter of national accounting, deleveraging in the private sector cannot happen without an increase in the federal deficit.[2] Given the size of the private sector's overall debt, national income will decline and a full-blown debt-deflation process will emerge if the deficit does not grow fast enough to meet the saving needs of the private domestic sector.

Two specific subsectors in the private sector are a major concern: private finance and households. As shown in Figures 3 and 4, their debt has increased dramatically since the early 1980s (private finance) and early 2000s (households). How much debt can be serviced safely depends on a number of factors, one of which is the relation between debt service requirements and the normal source of cash flow for borrowers. After the early 1970s, when median real wages stagnated and unemployment ratcheted upward, the growth of debt and the greater reliance on short-term debt with adjustable interest rates—and high fees and penalties—occurred precisely as the ability to service debt out of income declined.

This response was justified because of rising asset values, especially housing, as lenders were blinded by the surging value of collateral rather than income. History shows that lending against expected rising asset values is almost always a recipe for trouble—what Minsky called a Ponzi scheme. The belief that we had entered the era of "the Great Moderation" meant that volatility had fallen, so margins could be reduced. This is a common feature of speculative booms—mass delusion that we have entered a new economy in which the only direction is up.

Here is the reason why the shift to markets and away from banks matters: When a commercial bank makes a loan, the ability to repay matters because the loan is illiquid and will be held to maturity. When an investment bank makes a loan, the future matters only to the degree that it enters the asset's value today, since the asset will be sold immediately. As late as spring 2007, Fed economists were presenting papers (e.g., at the Levy Institute's annual Minsky conference) that denied real estate was overvalued or that there was a credit bubble because real estate values would continue to rise and validate the debt (the vast majority of economists were in a similar state of denial).

Indeed, this was a fundamental reason for the separation of commercial and investment banking in the aftermath of the 1930s collapse. Unfortunately, as we freed commercial banks to become brokers and dealers in marketed assets, we moved strongly in the opposite direction, allowing them to leverage government money (insured deposits) with little supervision. We also allowed them to use their own complex and proprietary models to value assets and assess risk. When the financial crisis arrived, we handed bank charters to the remaining investment banks so that they could also use government money to speculate in asset markets. This response represents an ironic completion of the circle, since the main justification for deregulating commercial banks was to allow them to compete with the shadow banking sector. But when these shadow banks collapsed, we gave them access to insured deposits so that they could compete with the banks. We also promoted the consolidation of institutions that were "too big to fail" (or rather, "too big to supervise"), so that management and owners had nothing to fear: only government money was at risk, and government had neither the will nor the competency to oversee the gambling undertaken by these institutions.

Such government policies have failed to "jump-start" Wall Street, let alone the economy. Debt loads remain excessive, while income and employment continue to fall, and delinquencies and foreclosures continue to rise. Even at current, depressed prices, assets are overvalued and many financial institutions are insolvent, holding mountains of toxic waste that will never be worth anything.

The Response of the Obama Administration

The Obama administration has implemented several policies with two premises at their core. First, the administration has stated that the crisis is simply monetary and thus requires monetary measures to strengthen the financial system before the rest of the economy can recover (echoing arguments made by Fisher in the early 1930s). Second, most major banks are not insolvent but rather have a temporary liquidity problem induced by malfunctioning financial markets. Market mechanisms will restore the true, higher value of "legacy" assets over time, and the economy will recover when the banks are healthy.

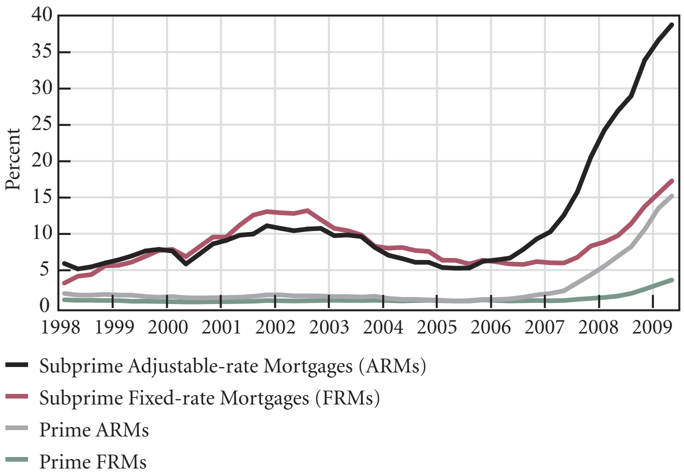
These two premises have been used to focus most of the administration's efforts on preserving the financial interests of major banks. The government has committed *at least* $23.7 trillion dollars to support the economy—through the Troubled Asset Relief Program (TARP), Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and U.S. Treasury—and $2.3 trillion has been spent through June 30, 2009 (SIGTARP 2009). Most of this money has been allocated to the financial sector, and only minimal effort has been made to solve the debt problems of households and nonfinancial businesses.

At the outset, and under a cloud of secrecy, the Obama administration allowed Bush-Paulson's TARP to continue helping the financial sector, and the Treasury to continue picking the winners for government funding (Morgenson and Van Natta 2009). Following an outcry about the slow progress in improving oversight, the TARP Special Inspector General (SIGTARP) and the Congressional Oversight Panel (COP) were installed in December 2008. These bodies have been very worried about fraud, particularly with the extension of TARP programs to legacy assets, and have complained about TARP's lack of transparency.

The Capital Purchase Program (CPP) of TARP was followed by 11 subprograms, of which seven have been directed toward restoring the profitability and solvency of financial institutions, and which, along with CPP, account for 77 percent of the $441 billion already used as seed money (SIGTARP 2009, 37ff.). Three core plans within TARP are the Capital Assistance Program (CAP), the Public-Private Investment Program (PPIP), and the Term Asset-Backed Securities Loan Facility (TALF). These plans aim to show the public that banks are solvent and need only short-term assistance because of (temporarily) malfunctioning financial markets. The PPIP program has failed, largely because of banks' unwillingness to sell at huge discounts and thus reveal their deep insolvency. Above all, banks do not want legacy assets to be valued properly. Moreover, the continuing failure to find other financial professionals willing to hold toxic assets has meant that financial institutions are turning to Uncle Sam for more cash to burn.

None of these programs has dealt with the core issues at stake: many financial institutions are probably insolvent and need to be closed; assets must be analyzed carefully to figure out potential profits and the true state of financial institutions; and an investigation must determine the responsibilities of top managers. Although financial markets have stabilized, they remain heavily supported by the government, and we have not dealt with the solvency problem. Banks have been posting profits but their gains come largely from exceptional cash inflows (such as the sale of Smith Barney by Citibank), and they still need government help to make those profits. Goldman Sachs, for example, repaid $10 billion of CPP money to avoid the

Figure 5 **Serious Delinquency among Mortgagors, 1998–2009 (in percent)**



Source: Mortgage Bankers Association

Figure 6 **Number of Foreclosures, 1979–2009 (in thousands)**

Source: Mortgage Bankers Association

executive pay limit but received $12.9 billion as part of the AIG bailout (Scheer 2009)—despite suspicions of accounting manipulation (if not fraud) surrounding the valuation of assets.

In addition to eight TARP programs and other policies oriented toward bolstering the financial system, several programs have addressed debt in the nonfinancial sector. However, the total committed support for this sector—$887.4 billion—represents just 3.7 percent of the $23.7 trillion pledged to support the overall economy, and only 5.7 percent of the $2.3 trillion already spent. The rest is allocated to financial institutions.

The Making Home Affordable (MHA) program expanded the HOPE for Homeowners program and aims to provide financial assistance *to servicers* to modify private-label mortgages and refinance conforming mortgages. In May 2009, this program was expanded upon by the Helping Families Save Their Homes Act. There is a great need for initiatives of this kind. Delinquency rates are climbing sharply, the result of rising unemployment and, more significantly, poor underwriting procedures. Figure 5 clearly illustrates that prime borrowers with adjustable-rate mortgages have delinquency rates equivalent to those of subprime borrowers.

Preliminary results for government programs show that they do not go far enough in dealing with the household debt problem, as none of these programs has been able to keep pace with the rapidly growing number of foreclosures (Figure 6). There are additional concerns about how households are being helped, since current approaches discourage servicers and holders of structured securities from renegotiating loans. First, the rate for redefaults within six months of a loan modification is expected to reach 30 to 45 percent (Adelino, Gerardi, and Willen 2009), so we need a significant and permanent reduction of debt payments. Second, loan modifications may entail large fees and penalties that households cannot afford. Third, these loan modifications usually occur after the borrower has been delinquent for a long time. Fourth, financial scams are on the rise and there is a high probability that the borrower would have to sell the house at the end of the mortgage (e.g., when there is a balloon payment). Fifth, securitization prevents loan modifications because the financial interest in outstanding mortgages is spread among many different parties so the redefault rate is much higher on securitized mortgages. Sixth, as noted above, servicers have contributed to this problem by providing marginal modifications, charging dubious fees, prematurely foreclosing on properties, and engaging in illegal actions that have gone unpunished (Porter 2007, Morgenson 2007).

Servicers have an incentive to hold out for a foreclosure rather than renegotiate: based on the money to be made by squeezing debtors with fees and penalties, it is more profitable to ride out the collapse (Goodman 2009, UBS 2007). In this originate-to-distribute model, almost everyone who services the securities lives on fee income rather than on the interest and principal payments related to mortgages. Of course, this is part of the reason why no one bothered to check whether homeowners could afford to make their mortgage payments. It is also the reason that almost no one in the home finance food chain cares about resolving the mortgage crisis—it is far more profitable if the homeowner cannot or does not make any payment. This explains why current government policies are unable to keep people in their homes. In spite of government offers to pay mortgage companies up to $4,000 to modify a loan, the companies make more money by driving owners out.

A similar story applies to other sectors in the economy, where financial market participants who helped to create the crisis are subsequently hired as contractors to deal with the fallout. Thus, there is more money to be made from a long and deep crisis. Hence, most of the effort toward solving household debt problems has focused on refinancing and loan modifications rather than on sustaining or improving income and creditworthiness—and the effort has failed miserably.

By the end of summer 2009, the United States had lost about seven million jobs, versus a gain of 2.5 million new jobs during a normal expansion of the labor force—a total of 9.5 million fewer jobs than at the start of the downturn. President Obama's promise to create three million new jobs (and estimates that the stimulus package will save between 2.5 and 3.5 million jobs) indicates that current efforts are grossly insufficient.

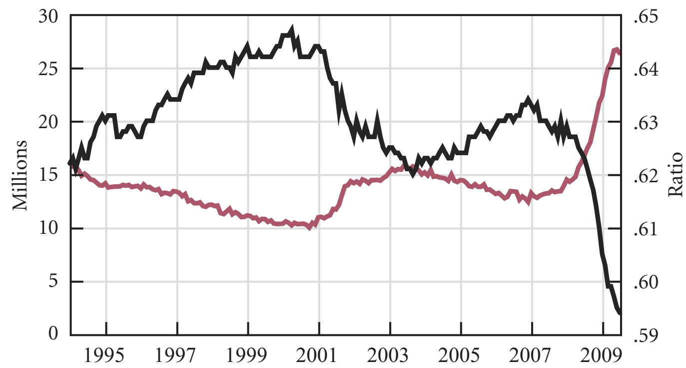
Much of the talk in Washington is about the "unsustainable" budget deficits, so it is unlikely that another stimulus package will be forthcoming. We believe that this response is due in large part to the public's fury toward the government's rescue of Wall Street. In this sense, the financial bailout has crowded out more sensible spending policies.

Alternative Policy

Using arguments very similar to those made by John Maynard Keynes in the 1930s, the approach taken by the administration has been critiqued very thoroughly by many economists who deny that our problems can be solved by rescuing Wall Street (e.g., James K. Galbraith and William Kurt Black). In addition, Wray 2009 provides a detailed set of policies both for the short run (to deal with the crisis) and for the long run (to build a sustainable economic and financial system).

We focus in the broadest terms on two issues: how can we stimulate recovery, and how can we put finance into its proper role? In our view, most administration proposals are fundamentally misguided, since they are based on the twin presumptions that Big Banks face only a liquidity problem and that, if this problem is resolved, the economy will recover. We believe these presumptions are entirely mistaken. The Big Bank problem is insolvency, and these banks should not be saved because they form a barrier to a sustainable recovery. Given a chance, they will resurrect the bubble conditions that led to the current crisis.

Figure 7 **Number of Unemployed, Dissatisfied Underemployed, Marginally Attached, and Discouraged Workers, 1994–2009 (in millions)**



Employment-Population Ratio (right-hand scale)
Unemployed, Dissatisfied Underemployed, Marginally Attached, and Discouraged Workers

Source: Bureau of Labor Statistics

The best approach resembles a banking "holiday," where the largest (19) banking and shadow banking institutions are closed for a brief period so that supervisors can assess the problems—including uncovering the claims that the Big Banks have against one another. It is highly likely that such claims represent trillions of dollars of bad assets. By consolidating the balance sheets of these types of banking institutions and netting out such claims against one another prior to shutting them down, the collateral damage for the other banks and shadow banks, as well as the level of government assistance, will be relatively small. This approach will help to downsize the financial sector and reduce monopoly power.

Greater supervision and regulation of the financial sector is particularly important if we're to stop the practices that brought on the crisis. And a more effective way to place the economic process on solid ground is to deal with the underlying cause of the problem: borrowers cannot service their debts. This situation implies sustaining incomes and employment, and, if necessary, drastically modifying the debt-service burden.

There are two key ways to alter this approach to economic growth and stimulate recovery. First, a household's main source of income is employment, which is linked to the state of the economy. Policy can "decouple" this link through countercyclical government employment programs such as those created in the 1930s under the New Deal, when more than 20 million Americans (one out of six!) were receiving assistance from the "Welfare State."[3]

About 26 million people currently lack a steady full-time job, and this number is climbing rapidly (Figure 7). Government employment programs would automatically resolve this kind of unemployment in the absence of private sector hiring. And, in an economic upswing, the private sector would subsequently hire workers out of the government programs. This would strengthen the automatic stabilizer effect of these programs, since spending would be countercyclical.

These federal jobs programs should be permanent, since 10 to 15 million people are unemployed or underemployed during the best of times. In addition, these programs could be structured to pay a living wage tied to productivity gains, which would help to restore the purchasing power of households after 35 years of stagnant real wages. The growth process would be sound financially, as consumption would grow in tandem with real wages (and with productivity to avoid inflation).

Employment guarantees, however, are not enough to deal with the current crisis, since households have accumulated debt well beyond their means and government employment programs would pay, on average, lower wages than many households previously earned. As a result, there is only partial relief of the debt problem, and a need for loan modifications combined with simpler and less costly bankruptcy proceedings. Based on past solutions, some economists have suggested a "debt jubilee"—the cancellation of household sector debt—and credit card companies have begun to use this approach (Streitfeld 2009). We believe that the government should provide incentives to encourage more financial companies to follow suit.

If borrowers meet their payments, lenders will return to profitability and some of the securitization processes will be revived. It may be time to reform the financial system by reducing the trade-and-fee-driven financial sector, but such reform was not taken by the 2009 Department of Treasury Report, which is mostly a copy of the 2008 Paulson Report. What is needed is a return toward term lending by regulated financial institutions that hold loans and a restoration of incentives to engage in proper underwriting.[4] (Tymoigne 2009b provides a detailed critique of recent proposals for financial reform.)

One specific problem with the current crisis is that it involves highly desirable long-term physical assets: homes. Several economists, including Warren Mosler (2009) and Dean Baker (2009), have already provided a solution to the problem of excess supply. The government would simplify the foreclosure process and stand ready to buy the homes of distressed mortgagors at current market value or the value of the mortgage, whichever is less. This would allow the homeowner to lease the property at a fair rental price, with an option to buy it back after two years at the prevailing market price. This approach would not only deal with the excess supply of homes (and put a floor under home prices) but also help households to restructure their finances while remaining in their homes (a small step in this direction was made recently; see Merle 2009).

We need to modify, significantly, the principal and interest owed, so that debt servicing becomes possible through the normal funding of homeowners (i.e., income) *for the length of the loan* (meaning, for example, no balloon or teaser payments). The amount owed should also be modified to account for large negative equities held by some homeowners.

A major increase in government spending is the only way to smooth the deleveraging process. As opposed to new money, part of the $20 trillion–plus committed to help the financial sector could be reallocated to finance the programs outlined above. We have destroyed tax revenue caused by a collapsing private sector (much as Japan did during its lost decade). It is better to spend on a much bigger scale now in order to create jobs and rekindle private sector growth. If we do that, the budget deficit will shrink and GDP will grow, while government debt- and deficit-to-GDP rates will fall.

Notes

1. Of course, one may argue that these assets always were hot potatoes. Loans are illiquid even with securitization. Asset-backed securities (which are securities issued by special-purpose entities that are backed by illiquid claims) have been somewhat more liquid, but many of these still entail a buy-and-hold strategy because of very thin markets (Tymoigne 2009c).
2. By identity, the government deficit equals the nongovernment surplus. If the U.S. private sector rebuilds its balance sheet by spending less than its income, the government has to spend more than its tax revenue. The only other

possibility is that the rest of the world spends massively—letting the United States run a current account surplus—but that situation is highly implausible.

3. During the Great Depression, "the government hired about 60 percent of the unemployed in public works and conservation projects that planted a billion trees, saved the whooping crane, modernized rural America, and built such diverse projects as the Cathedral of Learning in Pittsburgh, the Montana state capitol, much of the Chicago lakefront, New York's Lincoln Tunnel and Triborough Bridge complex, the Tennessee Valley Authority, and the aircraft carriers Enterprise and Yorktown" (Auerback 2009, 4). It also built or renovated 2,500 hospitals, 45,000 schools, 13,000 parks and playgrounds, 7,800 bridges, 700,000 miles of roads, and a thousand airfields. And it employed 50,000 teachers, rebuilt the country's entire rural school system, and hired 3,000 writers, musicians, sculptors, and painters, including Willem de Kooning and Jackson Pollock. The late Hyman Minsky worked in the WPA as a young economist, estimating Cobb-Douglas production functions for the future Senator Paul Douglas (Auerback 2009; NRPB 1942, 342–43, notes 4, 5, 8).
4. Recent proposals to make the Federal Reserve the primary regulator of financial stability are misplaced, since the task would be given mainly to economists (most of whom believe in the neutrality of money and have a weak understanding of finance and accounting issues), and since the Fed has a poor track record in terms of handling financial stability issues. Substantial modifications to the Fed structure and its analytical framework would have to be implemented before it could become an effective financial stability regulator (Tymoigne 2009a).

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