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DEBTS, DEFICITS, ECONOMIC RECOVERY, AND THE U.S. GOVERNMENT

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Contents

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Preface

This brief by Research Scholar Greg Hannsgen and me evaluates the current path of fiscal deficits in the United States in the context of government debt and further spending, economic recovery, and unemployment. We are adamant that there is no justification for the belief that cutting spending or raising taxes by any amount will reduce the federal deficit, let alone permit solid growth. The worst fears about recent stimulative policies and rapid money-supply growth are proving to be incorrect once again. We must find the will to reinvigorate government and to maintain Keynesian macro stimulus in the face of ideological opposition and widespread mistrust of government.

Very high deficits are necessary for at least a few more years because of a dire economic situation. Moreover, we need to prevent another crisis by tightening regulation of the financial industry. Fiscal policy, while highly potent, has limited power, so we must strive for more profound reforms—for example, preventing loans that are likely to lead to bankruptcy, banning mortgage-related financial innovations that jeopardize borrowers, strengthening the bond-rating system, preventing dubious assets from being moved off the balance sheets of financial companies, returning to the use of the discount window (and reducing reliance on the federal funds market), and fostering community development financial institutions that address the needs of economically distressed communities.

We note that the financial boom-bust cycle observed by Hyman P. Minsky is still very much in evidence. America's current fiscal stance is part and parcel of the recession and financial crisis, and not the product of political whims. Moreover, the deficit cannot be treated as a policy problem when it is a nearly inevitable result of low economic growth, which reduces tax revenues. Furthermore, deficit spending helps the private sector, and the effects of higher deficits have moderated, and ultimately ended, most postwar U.S. recessions.

A good fiscal policy takes advantage of the benefits of automatic stabilizers (income taxes and unemployment benefits) that lead to increased spending during recessions without special legislation or government stimulus packages. In fact, Minsky was an early proponent of what we regard as a nearly ideal automatic stabilizer—an employer-of-last-resort program. However, we remain pessimistic about employment recovery in light of the narrow focus of the fiscal policy stance, combined with the near absence of many stabilizers that helped in the past.

According to a tally of total liabilities of our consolidated "federal sector," we find that federal government and Federal Reserve liabilities as a percent of quarterly GDP are much less now than they were at the beginning of 1947, so we are not in uncharted territory. On the other hand, government-sponsored entities (GSEs) and their mortgage pools have added more than 40 percent to federal sector liabilities. The mortgage-backed securities on the Fed's books are there to reduce interest rates on mortgages. And as long as the U.S. government provides its nearly explicit backing, GSE mortgage-backed securities should be easy to sell. In fact, there is no reason to sell these assets unless there is a need to influence interest rates on mortgages as well as other long-term interest rates.

It is time to mend some of the holes in the U.S. social safety net. Poverty and unemployment rates are trending upward, and these adverse effects of the recession are strongly affecting many of the poorest groups, including minorities. Initiatives that address key economic problems at the household level—such as an employer-of-last-resort program—can never bankrupt a sovereign nation like the United States.

As always, I welcome your comments.

Dimitri B. Papadimitriou, *President*
August 2010

Introduction

The U.S. federal deficit for the 2010 fiscal year is expected to equal about 10 percent of GDP. This seems like a large sum, and it is certainly far larger than most deficits incurred since about 1950. However, deficits need to be better understood and perhaps better measured, along with their potential benefits.

One must keep in mind that there has been panic about budget deficits before. Recall that independent presidential candidate Ross Perot may have swung the outcome of the 1992 election in favor of Bill Clinton with his attacks on deficit spending. At the time, the federal deficit was about 5.7 percent of GDP, and interest in new political movements was growing much as it is now.

Today, as then, deficit critics invoke the term "bankrupt"—but that adjective does not describe the United States or its government. Indeed, the term suggests a situation that rarely applies to advanced countries or their governments (Galbraith 2006).[1] Sovereign default (the failure of a national government to pay back borrowed money) is certainly common, but not in U.S. history. Countries with sovereign currencies, borrowing in their own currency, can never go bankrupt. They can be, at the extreme, shut out of international capital markets. But this remains very unlikely for the United States, with its currency still maintaining its role as the main international reserve currency. Indeed, most key interest rates continue to trend downward, indicating that fears of a sharp drop in the dollar (let alone a collapse) are secondary to far more immediate concerns about growth, unemployment, and poverty.

On the other hand, there have been plenty of real bankruptcies: 1.4 million Americans declared bankruptcy last year (BDP 2010). These bankruptcies were mostly due not to personal failings or bad character but to the problems that we as a society have failed to address. And these bankruptcies were mostly the result of problems that are within society's power to ameliorate: victimization by fraudulent or imprudent financial practices; an economy with more than four job seekers for every opening (BLS 2010b, 2010c); and a medical system in which many Americans resort to the use of credit cards to pay hospital bills. Hence, an adequate remedy for excessive debt should address the ways individuals incur debt by reforming the legislative process, campaign finances, lending practices, consumer regulations, and education. Also, work on the health care system may have to continue even now that a landmark reform bill has been passed. We will give some suggestions about the new regulations and laws needed near the end of this paper.

Yet the national debt and its size are very important political and economic issues. Indeed, as the case of Ross Perot reminds us, they were the subject of a vigorous debate even when deficits were much smaller. Another example is the 1970s, when the highest deficit was 4.2 percent of GDP (Congressional Budget Office [CBO] 2010a). Perhaps the reason for such deep-seated fears and controversy lies in the images that growing debts conjure up. One thinks of a cancer rapidly expanding and consuming a healthy body. Indeed, James K. Galbraith warned of the dangers of "radical surgery" on the federal budget (Galbraith 2006, p. 1). But the deficit issue cannot be thought of separately from the national crises that have led to the current fiscal situation. A deficit equal to about 10 percent of GDP certainly reflects deep problems in the case of the United States—including the most severe financial crisis and recession since World War II. Using postwar data from industrialized and emerging economies, Carmen Reinhart and Kenneth Rogoff (2009, p. 170) estimate that real public debt increased on average by 86 percent in the three years following a major banking crisis.

This raises an interesting question: how much of the current deficit is merely the inevitable result of a severe recession and financial crisis, however damaging it might be to fiscal health; and how much reflects freer spending by Congress and the president?

In a report and accompanying dataset released in January, the CBO (2010a) estimates that the recent recession and shaky recovery contributed 2 percentage points to the total 2009 federal deficit of 9.3 percent of potential GDP. As an estimate of the budgetary impact of the weak economy, this number is on the low side because neither the stimulus plan nor other recession-related but discretionary spending is included. On the other hand, according to the CBO, stimulus bill spending for 2009 amounted to only seven-tenths of a percent of GDP (CBO 2010a, p. 96). By the CBO's definition, discretionary spending (often thought of by conservatives as the big problem) increased by only 1.2 percent of GDP from 2007 to 2009. By contrast, "mandatory expenditures" (those required by Social Security rules, welfare eligibility rules, et cetera) increased by 4.5 percent of GDP. Means-tested benefit programs—a category that includes the program formerly known as food stamps, as well as unemployment benefits and supplemental security income (SSI)—grew by 72 percent in nominal terms between 2007 and 2009. Of course, this trend can be blamed mostly on the recession and financial crisis, and the government's response to these events.

Meanwhile, tax revenues fell from 18.5 percent to 14.8 percent of national output in that period. Once Congress sets tax policy, it is the strength of the economy that determines tax revenues. The stimulus bill accounts for 0.6 percentage points of this 3.7 percentage-point decline. The point of stating these facts is not to claim that the budget deficit is unrelated to recent political decisions, but to make it clear that America's current fiscal stance is part and parcel of the recession and financial crisis, and not the product of political whims.

To use a historical analogy, Presidents Hoover and Roosevelt faced strong headwinds early in the Great Depression when the deficit reached then-unprecedented levels (Hannsgen and Papadimitriou 2010). Some observers fuss over the size of Roosevelt's relief and public works programs. They should keep in mind that these programs directly employed about 2.2 to 3.7 million workers in each of the first 10 years of his administration, while unemployment reached nearly 11 million in 1932 and stayed above 4.9 million from 1931 through 1940, according to adjusted official figures (see Darby 1976, p. 7, Table 2). Moreover, state- and local-level government employment had plummeted, complicating Roosevelt's task.

Roosevelt faced strong opposition to his deficit-spending policies and despite a widespread sense of fiscal imprudence, the New Deal jobs programs never reached the size necessary to deal with Depression-era unemployment. It would have been unconscionable to do much less, yet Keynesianism was hard to sell even to a nation desperate for recovery. Hence, workers hired for federal employment programs were often laid off when there was no sign of job openings in the private sector.

The best way to think of recent deficits is as a logical and necessary response to a severe recession, as they were in the Depression. Even CEO David M. Walker of the Peter G. Petersen Foundation, an antideficit think tank, earlier this year joined President Lawrence Mishel of the Economic Policy Institute in acknowledging that the United States must address "jobs now and deficits later" (Mishel and Walker 2010). Their February 24 op-ed in *Politico* cites the "moral imperative" to provide jobs when one-fifth of Americans are unemployed or underemployed, as well as the long-term costs and the effects of mass unemployment, including reduced future earnings for affected workers. Mishel and Walker call for two years of elevated deficits.[2] Unfortunately, it seems unlikely that the unemployment rate will fall very far within that time span. The Fed governors and bank presidents forecast in June that unemployment will fall to between 8.3 and 8.7 percent in 2011 and between 7.1 to 7.5 percent in 2012 (Board of Governors of the Federal Reserve System 2010). More recent private sector forecasts indicate that average unemployment will remain above 9 percent in 2010 and 2011 (Willis and Scheuble 2010).

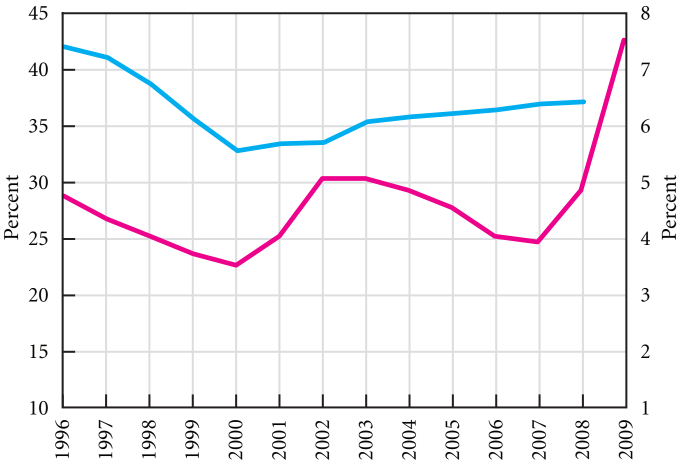
We are pessimistic about employment recovery, as well. Hence, more stimulus may be needed over a longer period than Mishel and Walker believed when they wrote their article in February. We hope that widespread agreement on the need for fiscal stimulus will continue when the one-fifth unemployed and underemployed figure cited by Mishel and Walker falls to one-tenth or one-twentieth, though there will always be disagreements on the exact amount of stimulus needed. Some perspective might help here: during the 1960s, 1970s, and 1980s, many western European economies enjoyed prolonged periods of unemployment below 3 percent![3]

Government Budget Deficits: Indispensible Tool for Economic Stability

How can fiscal policy be used effectively at a time when the budget deficit and the unemployment rate are both at frightening levels? A good fiscal policy takes advantage of the benefits of "automatic stabilizers" (e.g., income taxes and unemployment benefits) that automatically lead to increased deficits during recessions without special legislation, as well as "stimulus packages," though the latter term is a relatively new one. Hyman P. Minsky was an early proponent of what we regard as perhaps the best automatic stabilizer: an employer-of-last-resort (ELR) program, which would offer a job to anyone who met a minimal set of eligibility criteria (see Papadimitriou 1999 for more details on this idea). In general, "entitlements," derided by fiscal conservatives, make it difficult to control spending but often help insure that spending is highest when it is needed most.

Another reason for additional social spending during times of higher unemployment and underemployment is the near absence of many stabilizers that helped in the past. One example of a now-defunct automatic stabilizer is the Aid for Dependent Children (AFDC) program, which provided cash benefits to millions of low-income single parents. "Reforms" to this program that were implemented in the late 1990s did not immediately bring the sharp increase in female and child poverty that some expected, partly because of a strong job market at the time, as reflected in a steadily falling unemployment rate for women

Figure 1 The Link between the Poverty Rate and the Unemployment Rate for a Key Demographic Group Impacted by Welfare Reform, 1996–2009 (in percent)



Poverty Rate for Families with a Female Householder and at Least One Child under Age 18, and No Husband Present (left scale)

Unemployment Rate (standard definition) for Women over Age 19 (right scale)

Sources: U.S. Bureau of Labor Statistics; U.S. Department of the Census

(Figure 1). Hence, some felt affirmed in their judgment that AFDC did little good, even for its recipients. However, since 2000, poverty rates for most groups have gradually trended upward, including a notable increase in poverty for households without a husband that is approaching 40 percent. This trend has coincided with a rise in the unemployment rate for women over age 19, from 3.6 percent in 2000 to approximately 8 percent so far this year. Reforms to the welfare system appear to have worked only when help for the poor was needed least—in a strong job market.

There are important reasons why the poor are among those most affected by a weak economy. Labor economists have long noted that the workers in the poorest groups—including minorities, those with less education, and welfare recipients—tend to be the last in line for new jobs and the first to lose them. They often lack seniority and hold positions with little job security. Hence, automatic stabilizers are needed to alleviate a burden—mass unemployment—that falls especially heavily on many groups that lack resources to begin with. Hence, a great deal of thought must be given to targeting help to the poor and the unemployed. Given the lessons we have learned recently about how vulnerable these groups are, it may be time to mend some of the holes in the social safety net dating from the 1980s and 1990s with simple, nonstigmatizing, cost-effective programs that make the best use of people's talents, skills, and ambitions.

This approach—improving and creating programs that directly address key economic problems at the household level—would certainly not bankrupt a nation like the United States. Though the pre-Reagan U.S. welfare state was deeply flawed, it can be viewed as a benchmark providing a sense of the scale of the expenditures required for a large and ambitious program to aid the poor. AFDC cost the federal and state governments about $12.0 billion in 1980 (DHHS 2010), or $30.1 billion in today's dollars. Over the life of the Troubled Asset Relief Program (TARP), the government will be providing a net $36 billion in assistance to the insurance firm AIG, a figure that is only slightly higher (CBO 2010b, p. 3). And AIG is just one corporation. The total federal deficit for 2009 was approximately $1.4 trillion—46 times the inflation-adjusted costs of the much-maligned AFDC program before the cuts of the 1980s and 1990s. Although Minsky criticized the federal government for not doing enough to help people with low or moderate incomes, he was also highly critical of programs that merely paid for needed consumption goods because he believed that they caused inflation (Minsky 2008 [1986], p. 26). However, along with his proposal for an ELR program, he supported a universal children's allowance that would be available to all families, regardless of income (p. 301).[4]

Such programs are costly. But it is important to consider even seemingly grandiose options when extremely large bailout programs are justified, for the most part, on the grounds of kitchen-table economics.

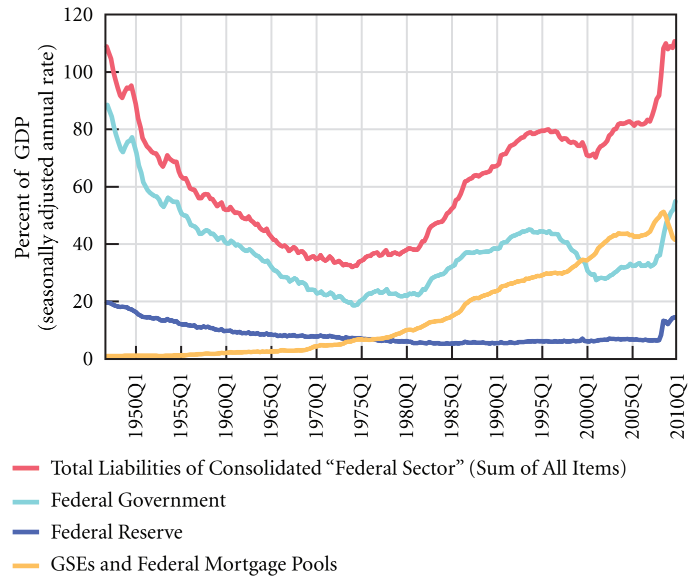
Any deficit spending, whether oriented toward business or households, helps the private sector, which must thrive in a capitalist system to provide a tax base and the bulk of commodities. In his book *Stabilizing an Unstable Economy*, Minsky cited three main mechanisms through which fiscal policy stabilized the economy (pp. 13–37). During a recession, higher deficits increase (1) government demand for goods and services; (2) the *surpluses* of the private and/or foreign sectors; and (3) the stock of very-low-risk financial assets in private portfolios. Minsky documented that these three effects were among the main forces behind most postwar economic recoveries. The second effect is a corollary of the national accounting identity, which is emphasized in our *Strategic Analysis* reports (e.g., Zezza 2010 is the most recent issue), and all three effects remain potent.

Also, we hasten to add that Minsky generally approved of the kind of lender-of-last-resort actions taken by the Fed since

2008, though he might have objected to the specific steps that the Fed took to stabilize the financial sector during the recent crisis. Minsky's view was largely a matter of pragmatism in the face of profound threats to the functioning of an economy.

We have a badly ailing economy. When it comes to policy, we should follow the tradition of political economists going back to the French physiocrats and Adam Smith, and think in terms of a cure for the whole body, which functions well when goods, services, and assets are produced and circulate properly. The deficit cannot possibly be treated as the main problem when it is the product of a poorly functioning economy. The institutions of the economic system must adapt, and the deficit is an important part of the healing process. Also, some attention has to be given to wounds, illnesses, and other immediate threats to well-being, which necessitate direct aid to households that increases in hard times.

Figure 2 **Liabilities of Consolidated "Federal Sector"* 1947Q1–2010Q1 (in percent of GDP)**



* Federal government, Federal Reserve, GSEs, and federal mortgage pools

Notes: Data points for 1947 through 1951 are interpolated from annual observations using a linear technique. Quarterly observations are used for all other years. The term "Federal Sector" has no legal meaning.

Sources: Federal Reserve Flow of Funds Accounts; Federal Reserve Bank of St. Louis, FRED database

Trends in the Federal Debt and the Stock of Money: How Unpleasant?

Nonetheless, there are some questions in the media about whether these recent deficit projections really "add up." Common sense seems to tell us this is the crucial question. Is there any objective way one can decide if the current path of fiscal deficits will lead us off the tracks? There are many uncertainties about what deficits mean for economic performance, but perhaps the only sure thing is the government budget constraint. Roughly speaking, the government's spending in excess of tax revenues and other government receipts must equal increases in the government's liabilities:

$$G_t - T_t \equiv L_t - L_{t-1}(1 + i_t)$$

In this identity, the *t* subscripts indicate the calendar quarter. *G* represents government spending, *T* stands for taxes and other government revenues, *L* is liabilities, and *i* is the interest rate. The first three variables are expressed in dollars or any other currency. (We include net transfers under the rubric "spending." Sales and purchases of assets can also finance spending, but we leave those out of the identity for the sake of simplicity, assuming that no such transactions occur.) In the case of the U.S. government, these liabilities are mostly those of the Federal Reserve (especially paper currency and the banks' reserve "deposits" at the Fed) and Treasury securities, including savings bonds and Treasury bills. The budget constraint, by itself, has few direct implications for the effectiveness of any particular policy, but it places limits on what is possible. For example, high deficits are impossible without a rapidly growing supply of federal liabilities, a category that includes government bonds, currency, and reserves held by banks at the Fed. Putting such liabilities on private sector balance sheets, where they help fill holes created by the housing bust and financial crisis, is one of the three ways mentioned above that the government can fight recessions.

Figure 2 shows how the government has been using its ability to generate assets for other sectors of the economy. An entity we call the "federal sector" includes (1) the Fed, (2) the federal government, and (3) a combined entity that includes both the government-sponsored enterprises (GSEs such as Fannie Mae and Freddie Mac) and the mortgage pools that technically hold many of their assets. Three of the lines on the figure separately show the liabilities of each of the three sectors. Liabilities are excluded if they are held as assets by any of the sector's three components. The top line is the sum of the other lines and represents a measure of the liabilities of the entire federal sector to entities outside the sector.

Our previous consolidated federal balance sheets (e.g., Papadimitriou and Hannsgen 2009) did not include the GSEs and their mortgage pools. Some of the most important GSEs were effectively taken over by the federal government in 2008 and have received large infusions of public funds. "Federal sector" is only a term we find convenient to describe the above combination; it has no legal or political meaning.[5] Nonetheless, it is clear that it makes sense to think of this entity as a single unit, since the parts are collectively responsible for the government's finances. For example, there is no doubt that the Fed coordinates its activities carefully with those of the Treasury Department to ensure that funds are available to pay for government operations while, at the same time, interest-rate targets are met (Wray 1998; Bell 2000). Similarly, the debt of the GSEs was never credibly removed from the federal sector balance sheet, even after most were formally privatized. The government knew that a major financial crisis might occur if these organizations defaulted on any of their debt, and that Washington would take much of the blame—despite the fact that most GSEs were profit-making entities. Hence, investors and GSE insiders remained confident that the government would take charge of the GSEs in the event of imminent failure.

Incidentally, we have left out the large portion of the government's debt that technically is owned by the Social Security Trust Funds; essentially, the bonds in these funds represent only promises to tax or borrow money from the public to pay benefits when they are due. The trust fund purchases bonds with payroll tax revenues. These bond sales do not in themselves increase or decrease the legal liabilities of the government to the public, though the collection of payroll taxes reduces the amount of money the government must "print" or borrow each year from investors. Some similar "unmarketable" assets held by various other federal retirement funds are also not considered true government liabilities for the purpose of constructing Figure 2.

One bit of good news is that we are not in uncharted territory, even considering our somewhat unorthodox inclusion of the GSEs in the aggregate federal sector. In the first quarter of 1947, the total liabilities of the federal sector were about 109.3 percent of GDP. In the first quarter of 2010, the figure rose by 2.3 percentage points over the previous quarter, to 111.1 percent of GDP. In particular, federal government liabilities were 88.8 percent of GDP in 1947 and are now only 55.0 percent of GDP. Meanwhile, Fed liabilities currently stand at about 14.4 percent of GDP but equaled almost 19.5 percent of GDP in 1947. Hence, without the GSEs, total federal sector liabilities in 2010 would be far lower than they were in 1947. However, the GSEs and their mortgage pools add 41.7 percent to federal sector liabilities, while they did not reach even 1 percent of GDP in 1947.

Obviously, these figures are stunning. However, while we analyze the financial facts, we should keep in mind the other staggering realities of our time, including unemployment that has persisted at well over 9 percent. This rate will not come down easily or quickly, and it does not begin to tally the human costs of enforced idleness, including discouraged job seekers who have stopped looking for work. With such a dire situation, it is reasonable that macroeconomic policy should be more stimulative than at the height of the last recession or the one before that, when unemployment stayed below 8 percent. Few politicians overlook the fact that growth and employment must be maintained even at great cost, and fiscal prospects will only deteriorate further if they are not. (Even positive, but moderate, growth will not be enough to revive tax revenues.) There is no justification for the belief that cutting spending or raising tax rates by any amount whatsoever will reduce the federal deficit, let alone permit solid growth. Indeed, government revenues depend on the performance of the economy, not just government policy. And any foreseeable policy that does not encourage growth also cannot reduce the deficit. That is where economic models and good policy come in—not with a simple edict or rule about the size of the deficit.

Before we turn to future prospects, it is worth taking a quick look at a breakdown of the Fed's assets, because its balance sheet has changed rapidly since the financial crisis began in earnest in late 2008. There has been much hand-wringing over the Fed's possible difficulties in selling off the assets it has acquired in its efforts to cleanse the financial sector's balance sheets. It is sometimes thought that perhaps the Fed would not be able to sell enough of the assets on its balance sheet if it needed to reduce the stock of bank reserves and U.S. currency. However, it seems unlikely to us that the Fed would have problems reducing its holdings of garden-variety assets such as government bonds. It does so routinely, of course, with the understanding that interest rates usually rise when private investors are called upon to hold more of the government's debt securities. Hence, the eventual decision to unwind the roughly $300 billion in Treasury securities purchased since last March will only be a matter of deciding upon the best interest-rate policy for the economy, and, of course, avoiding a panic in the bond market by selling the bonds gradually. In fact, there is no reason to bother selling Fed assets unless there is a need to influence interest rates.

Likewise, the mortgage-backed securities on the Fed's books are there primarily to reduce interest rates on mortgages. Fannie and Freddie are financially weak, with a government agency backing the bonds that they use to borrow money and the mortgage-backed bonds that they underwrite and sell. (Fannie Mae's 2009 financial report to the Securities and Exchange Commission [2010, pp. 26–27] seems to state this explicitly, but its reports before the 2008 takeover do not.) Few have ever doubted that the government would step in if there were a danger of default by any GSE. Ginnie Mae has always been owned by the government, though it shares the "GSE" designation. As long as the government provides its guarantee, the assets involved should be easy to sell—a situation that has reduced spreads between the yields of mortgage-backed securities and Treasury bonds to nearly zero in recent weeks. The government stopped buying GSE bonds at the end of March and plans to allow its holdings to fall gradually as these securities reach maturity. GSE-related debt now comprises more than half of the Fed's assets; these holdings do not add to the total amount of liabilities shown in the chart, since intrafederal debts are not included in liabilities of the GSEs and/or the mortgage pools.

When it comes to the Fed's other assets, such as those obtained in the rescue of AIG, the Fed's ability to shrink its balance sheet will depend upon the markets' views on the strength of those assets. The bottom line is that if the Fed loses money on these investments, the losses add to the deficit of the consolidated federal sector. This presents no less or more of a financial problem than new expenditure by the federal government or a loss on similar holdings of the U.S. Treasury, though the accounting involved might not recognize these as identical financial events.

Given the views of mainstream economists, intense financial and journalistic interest in the exit from "quantitative expansion" should come as no surprise. Since the mid-1990s, most U.S. neoclassical economists have been convinced that proper monetary policy could hold inflation in check. Economists tended to believe that the Fed's experience under Chairmen Volcker and Greenspan had proven that this was possible. Many agreed with Milton Friedman's statement that "inflation is always and everywhere a monetary phenomenon." This accounts for the inflation-hawks' recent focus on the process of shrinking the Fed's balance sheet and other monetary policy matters. Could they be missing the greatest threat to inflation containment?

Recently, a paper presented at a conference in India argued that high deficits could eventually undermine the low-inflation economic regime often attributed to former Fed Chairman Volcker and his successors (Cecchetti, Mohanty, and Zampolli 2010). The essence of the argument was that current high deficits, in combination with tight money, might not prove sustainable (see Sargent and Wallace 1981). In particular, prolonged high deficits might eventually force an explosion of the money supply and inflation, regardless of the central bank's initial intentions to keep inflation under control. These authors and others believe that U.S. policymakers might be setting the stage for losing control over inflation, owing to their overconfidence in the effectiveness of interest-rate policy alone. They share the belief—common among mainstream economists—that controlling the money supply is the key to fighting and preventing inflation, but doubt that the Fed will be able to choose a slow rate of money-supply growth when huge deficits must be financed and old debts paid off or refinanced.

Arguments of any kind to the effect that the quantity of money was the ultimate determinant of inflation met with skepticism from most macroeconomists during their battle against inflation in the 1970s and 1980s, despite the fact that monetarist Friedman was beginning to gain adherents (including President Reagan). Few believed that the growth rate of the money supply could be controlled tightly, even for only a few months, or that if it were, low inflation would be guaranteed. Of course, inflation was brought in check and has stayed generally low for more than 25 years. But this cannot be attributed to a successful effort to target the growth rate of the money supply: the Fed overshot its M1 and M2 targets consistently over a three-year period[6]—the most determined effort by the U.S. central bank to adhere to a monetary intermediate target. Even after the "monetarist experiment" ended and the money supply continued to explode by some measures, inflation stayed in check. No matter how successful it was, then, the experiment cannot be cited as proof of what might happen as the result of achieving a steady money-supply growth rate. Obviously, then, other developments were responsible for the elimination of serious inflation. The harsh recession of 1980–82—for which tight monetary policy deserves much of the blame—was largely responsible for the elimination of inflation. In this case, the phrase "tight monetary policy" simply means a remarkably high federal funds rate, which was certainly achieved in the Volcker era to a far greater extent than a steadily and slowly growing money supply.

The worst fears about recent stimulative policy and rapid money-supply growth are proving to be incorrect once again. Indeed, the monetary base, a measure of the money supply often preferred by monetarists, has grown by about 58 percent since August 2008. This increase was already well under way by the end of 2008, and there have been few inflationary reverberations, with CPI inflation remaining under 3 percent since then. In recent months, inflation has fallen well below the Fed's informal target range. Broader measures of the money supply, which include bank accounts of various kinds, have also been increasing, without triggering significant inflation. At the same time, cash from the Fed has allowed many banks to repair their balance sheets, so that large financial institutions once facing bankruptcy are now flush with reserves. If anything, this situation again raises the question: couldn't the government solve numerous other, even more serious, problems the same way—by essentially printing money and spending it as needed? Perhaps it could have, though it took a profound threat to some of the largest and most powerful U.S. companies to elicit such a rapid and huge escalation of expenditures.

A Proactive Approach to Controlling Expenditures: Reduce Financial Risk-taking

The first part of this brief argued that very high deficits are necessary for at least a few more years because of a dire economic situation that was mostly inherited from previous administrations, especially that of George W. Bush. We also need to work to prevent the emergence of another crisis by tightening regulation of the financial industry, which was weakened greatly under previous administrations. The recently passed financial reform bill may help and detailed research in the tradition of Hyman Minsky continues at the Levy Institute and elsewhere.

One can think of many useful reforms. At the level of consumer protection, regulation can help prevent lenders from making loans that are likely to lead to bankruptcy. For example, so-called "payment option" mortgages, in which the borrower has the option of putting off scheduled payments, have not proven beneficial to consumers. Mortgage-related financial innovations should be scrutinized before rollout, and banned if they jeopardize borrowers. The bond-rating system should be strengthened to reduce conflicts of interest. Maneuvers of various kinds to move dubious assets off the balance sheets of banks and other financial companies have caused trouble, and should be prevented. Adequate capital is always an issue. A return to the use of the discount window—to reduce reliance on the federal funds market—would also help. As in the past, the Fed would have the right to scrutinize the balance sheets of banks seeking funds at the window, enabling it to check the quality of assets. In addition, the Fed could easily use the discount window to provide liquidity to markets that were about to freeze up during crises. Regulators should foster the existence of a large number of small- or medium-size banks to reduce dependence on banks and financial conglomerates that are "too big to fail." An abundance of relatively small competitors would make the financial system more robust, and such firms would not need fewer firewalls between various divisions with overlapping or conflicting interests. An important example of such firms is community development financial institutions, many of which have effectively addressed pressing needs in economically distressed communities (Minsky et al. 1993).

It is not always understood why the federal government has spent so much money on bailouts over the years, yet the financial system remains unstable. TARP and other rescue measures have favored the interests of large financial companies, but the hand of government has been badly weakened in crises; officials often have no choice but to agree to bailouts when the alternative is the collapse of major corporations and, indeed, of large segments of the financial sector. The consequences of the 2007–09 crisis would have been far worse in the event of a laissez-faire policy toward failing institutions, and top officials at the Treasury and Fed were well aware of a potential calamity. The government insurance programs for banks have come under fire for encouraging financially reckless activities, but it is important to notice that a firm like AIG enjoyed no formal government protection but took great risks anyway. Of course, corporate officials took great personal risks, but they were mindful that the government would probably not be able to let one financial firm after another fail, whether or not it had a formal agreement to protect them. If Citibank, Bank of America, and other very large depository institutions had not offered insured accounts, it is hard to imagine that they would have been less likely than AIG to receive large amounts of government help.

Political scientist James O'Connor (2002 [1973]) pointed out long ago that the impetus for fiscal crises, paradoxically, often comes from the private sector. He argued that budget deficits were increasing in the industrialized world because leaders were compelled to keep the economy and the capitalist system humming, or else lose their jobs. To do so, they had to provide expensive help to large corporations, even when they would have preferred to spend the money on other priorities. The latest run-up in the deficit seems to fit O'Connor's theory better than most previous episodes of fiscal stimulus in U.S. history, partly because such a huge sum of money was spent on an explicit effort to rescue the financial system.

The financial fragility of the modern economy is likely to remain a major threat to government finances. Minsky once chided former Fed Chairman Arthur Burns for his view that more zealous regulation would prevent financial crises. He argued that financial instability was a "fundamental characteristic of an economy with financial institutions such as those of the United States" (Minsky 2008 [1986], p. 51). Economic history is replete with examples of financial crises large and small. On the other hand, Minsky certainly saw many potential benefits in regulatory reforms, and proposed numerous ideas for reform during his career.

Financial regulation has tended to be weak and the government has often been forced to respond to crises ex post. Minsky saw budget deficits, along with lender-of-last-resort actions by central banks, as necessary and effective responses to incipient crises. Yet "the effects of Big Government mean that an investment boom generates demand for finance that leads to another bout of inflation and crisis" (p. 95). He believed that the result was "a system that sustains instability even as it prevents the deep depressions of the past" (p. 95). The financial boom-bust cycle observed by Minsky is still very much in evidence, though it has turned out that inflation is not an inevitable accompaniment to financial euphoria and large deficits—consider the U.S. economy of the 1990s and 2000s.

In other words, the huge bailouts and stimulus bills that have strained government finances will be hard to avoid in the future. Of course, good policy across the board will help. A narrow focus on fiscal policy will not work, since policymakers do not have the ability to literally "choose" the best size for the budget deficit. Also, fiscal policy, while highly potent, has only limited power. We can and must strive to initiate more profound reforms even if, as Greg Mankiw (2010) asserts, "government regulators will always be outnumbered and underpaid compared with those whose interest it is to circumvent the regulations." There may be few workable alternatives to this uphill battle.

As of now, there is still strong interest among the electorate in reining in corporate behavior. At the same time, there is similar populist sentiment among large numbers of Americans against the federal government. What seems most relevant now is finding the political will to "reinvigorate government" (Madrick 2009), as well as to maintain Keynesian macro stimulus in the face of ideological opposition and widespread mistrust of government.

Notes

1. Two interesting and recent critiques of standard objections to budget deficits are Kregel 2010 and Nersisyan and Wray 2010.
2. The op-ed piece appeared in February. D. Walker (2010), a fiscal conservative, is still calling for short-term stimulus initiatives. Gallup polling reports that as of June, 18.3 percent of the workforce is either unemployed or underemployed, somewhat above the broadest government unemployment measure, which was 16.7 percent in June (BLS 2010a; Gallup, Inc. 2010).
3. For example, the LABORSTA database, maintained by the International Labour Organization (ILO), reports that the unemployment rate for Sweden remained below 3 percent every year from 1969 to 1981 (ILO 2010). It remained below 4 percent every year until 1992. During this period, Sweden ran rather large budget deficits.
4. The details of his proposal were interesting, though. It would remake the welfare system along the lines of the current Social Security retirement program, which provides help to rich and poor alike. Also, it would be available regardless of choices about living arrangements, marriage and divorce, and participation in the workforce. Inflating Minsky's calculations to February 2010 dollars, a program of $2,000 annual child allowances for a population of 55 million children under 16 years of age would cost $110 billion per year (Minsky 2008 [1986], 301).
5. The consolidated approach to the public sector's finances is advocated by L. Randall Wray (1998), Stephanie Bell (2000), and other chartalists, among others.
6. See Figures 9-1 and 9-2 of Bryant 1983, 92–93.

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