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Preventing Another Crisis

The Need for More Profound Reforms

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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 the dire economic situation. Moreover, we need to prevent another crisis by tightening regulations 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.

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 US 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 a nearly ideal automatic stabilizer: an employer-of-last-resort program. However, we remain pessimistic about employment recovery in light of inadequate fiscal stimulus combined with the near absence of many stabilizers that helped in the past.

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 the massive bailouts and stimulus bills that have strained government finances will be hard to avoid in the future.

According to a tally of all "federal sector" liabilities, 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 US 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 US social safety net. Poverty and unemployment rates are trending upward, and these adverse effects of the recession are strongly impacting 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—will not bankrupt a sovereign nation like the United States.

For a more detailed discussion of this topic, go to www.levyinstitute.org/pubs/ppb_114.pdf.

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