Spend More, Tax Less

Source: Crisis Economics Roubini and Mihn, cap. 7.

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Introduction

Hoover in the 1930 wounds of the economic system will be healed by the **action of its cells**. Increase of public expenditure but **not deficit spending**.

Keynes and the necessity during a crisis of increasing **demand** to retrieve house consumption and reactivate the **'animal spirits'** of capitalism that determine investments.

Introduction

Public expenditure started with short run demand expansion and enlarged to comprehend **tax cuts** and **industrial policy**.

Nowadays politicians face the same **hoover dilemma**: increasing expenditure but debt, intervention or moral hazard?

New Deal

With the **New Deal**:

- 24,000 miles of sewer lines;
- 480 airports;
- 78,000 bridges;
- 780 hospitals;
- 572,000 miles of highways;
- 15,000 schools, court-houses and public building

From **1933 to 1937 unemployment drop from 25% to 15%**. A restrictive policy in 1937 lead to a recession again. WW2 allowed the definitive exit from the crisis.

Public expenditure

In the **’70s monetarism** was against public expenditure: less government and less discretionary expenditure.

The **’90s crisis in Japan** reopened for huge expansionary fiscal policies without great success (wrong investments, too little or pulled back too soon)

Public expenditure

Fiscal Policies:

- Public current expenditure;
- Public investment;
- Tax cut;
- Transfer payment.

In 2008 $ 152 billion, the **American Recovery and Reinvestment Act** of 2009 $787 billion. The **European Economy Recovery Plan** $200 billion of euros. **China** $586 billion

Public expenditure problems

Fiscal policies implies **debt creation** that may not be reduced through inflation.

Huge **debt may lead to high interest rate** which, in turn, may hamper investment and consumption.

So **expenditure can be followed by austerity**, this reduce consumption expectations (Ricardo equivalence).

Public expenditure problems

Cutting tax cannot increase consumption: in 2008 and 2009 only the 25 or 30% of fiscal cuts are translated in consumption.

Specific tax cuts can **steal demand from the future** increasing prices.

It is difficult to **implement huge expansionary policies** in a democracy

Let the Bailout Begin: guarantee on deposits

In the ′30s was created the Federal Deposit Insurance Corporation (**FDIC**) and the (FSLIC) for saving and loans. Funds created by fees of commercial and thrift.

In **the ‘80s** with the failure of saving and loans **FDIC and FSLIC were not enough** and $153 billion from the tax paper were necessary to cover them.

In 2008 arms race to guarantee deposits: in US from 100,000 to 250,000. In German and Italy all the deposit were under guarantee.

Also **credit unions** were saved by the government spending $80 billion.

Cover Bank Short Term Bonds

After Lehman Brother collapse nobody wants to buy short term bonds issued by banks: both EU and US has to cover these bonds with tax payer money (in US 1.5 trillion dollars)

US government saved Fannie Mae and Freddie Mac $400 million for the takeover. Moreover, it covered 5 trillion of guarantees and 1.5 on bonds issued.

The Housing and Economic Recovery Act (in 2008) $320 billion to help homeowners pay their mortgages.

The **Troubled Asset Relief Program** (TARP): $80 billion to automotive industry; 340 billion to financial institution as capital injection as preferred shares.

A Capital Idea?

Fed can cover **liquidity problems** providing loans or buying assets, while if banks have severe asset problem the only solution is a **capital injection**.

In case nobody wants to inject money a bank can fail or bank can be relaunched trough **'debt equity swaps'**.

Government intervention may take the form of **nationalization**.

TARP capital injection could let to losses if the financial institution is not able to recover.

Toxic Waste

The problem of asset that continue to lost value remain even if you make capital injections.

A solution is **splitting the bank into a good and a bad bank**. The good bank can resume its operation.

The original TARP plan was based on the idea of buying the toxic asset but at what price?

Assuring part of the toxic assets may be a solution sharing losses between the bank and the government, in exchange government gain shares of the bank.

Moreover, the government may provide **loans to buy toxic assets**.

The Aftermath

In the ’30s thousands of bank failed, three quarter of household with mortgages failed, unemployment soared. **FDR intervention started only after the economy was stagnating**.

This time **the financial sector was saved**:

- At the beginning standard fiscal and monetary policy;
- After CB become lender of last resort even of non financial institutions;
- IMF and FED granted international liquidity;
- Government injected capital;
- CB made quantitative easing and swapped safe assets for riskier ones.

The Aftermath

The financial system was saved and the crisis did not **spiraled out of control**.

However, the **public debt** increased and this was a problem in particular for EU.

Moreover, the **financial system** was not under control, the large amount of liquidity may be transferred in other bubbles.

The vitality of the system was compromised eliminating moral hazard?