The Financial Crisis- Views and Remedies

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Banking and Fiscal Issues

- Government is about public purpose
- The monetary system exists to support public purpose

Banking Issues

- Fed demands collateral when it lends to member banks. Why?
- Interbank markets. Why?
- Bank debt. Why?
- Bank lending model v.s. non bank lending model
- Mark to market v.s. mark to model

Fiscal Issues

- Aggregate Demand
- Distribution
- Fiscal policy is the stuff of 'quantity theory'
- The currency is a public monopoly
- Tax liabilites create the notional demand, including savings desires.
- Govt. spending is the supply that meets the demand.

2006- Demand Slows

- By 2006 the federal deficit had again become too small to support the credit structure.
- Financial obligations ratios reached limits
- The 'automatic stabilizers' work to end expansions by reducing federal deficits, and to reverse slowdowns by increasing federal deficits.

2006 (CONT.)

- At the same time, delinquencies on sub prime mortgages suddenly escalated.
- It was discovered that many lenders had been defrauded by lending on the basis of fraudulent income statements and fraudulent appraisals.
- Exports were replacing demand lost by housing.
- Real terms of trade deteriorated

2006 (CONT)

- Finacial issues surfaced as risk was repriced.
- Substantial bank capital was lost.
- Higher than projected actual losses reduced the present value of mortgage based assets.
- The banks were, generally, able to write down these losses and remain solvent with adequate capital.
- Lending standards were adjusted.

2006 (CONT.)

- Outside of the banking system (including bank owned SIV's) related securities fell in price.
- Unregulated entities supported by investors (who took more risk to earn higher returns) failed when losses exceeded capital.
- The non-bank funding model lost credibility
- Assets in that sector were repriced downward to yields high enough to be absorbed by those with stable funding sources – primarily, the banking system.

BEYOND 2006

- The banking system moves very slowly to accommodate this 'great repricing of risk.'
- At the same time the fiscal squeeze was continuing to sap aggregate demand.
- The recent fiscal package added about 1% to gdp
- Demand further weakened in Q3 as blind fear cut further into consumer spending.
- Lenders become reluctant to fund 'business as usual' for 'main street' as consumes retrenched and sales retail sales fell.

RECAP

- There are two issues: the financial sector stress and the lack of demand.
- They were triggered by two different forces: loan quality deteriorating due to fraud and the budget deficit getting too small.
- It is the combination of the two that is now suppressing aggregate demand.

The TARP

- The TARP may eventually alleviate some of the lending issues.
- It only addresses aggregate demand indirectly and with a lag.
- Bank sales of assets (at relatively low prices) doesn't mean banks will suddenly lend to borrowers who want to spend.
- Nor does it mean they will fund euro banks caught short $US that have no 'federal' authority backing deposit insurance and solvency.
- The eurozone appears to be in a downward spiral like the US.
- The slowing US economy has reduced the world's aggregate demand from levels already too low to sustain demand.
- World budget deficits are too low, with (declining) exports to the US sustaining demand.

TARP (CONT.)

- In other words, I don't see how the TARP will restore US or world aggregate demand in a meaningful way.
- Yes, the US budget deficit has been increasing, but not nearly enough. It's only maybe 3% of GDP currently, while the US demand shortfall is probably in excess of 6% of GDP.

Payroll Tax Holiday- the Silver Bullet

- Cutting the payroll taxes (social security and medicare deductions, etc.) is large enough (about 5% of GDP) to immediately restore aggregate demand.
- It's a regressive tax that returns income to those who currently need it to immediately support demand, as they spend, and also to make payments on their mortgages and other financial obligations.
- This supports the financial sector from the bottom up.
- It is the 'silver bullet' that immediately restores output and employment.

But…Deficit Myths Persist

- But we all know what stands in the way –
- Deficit myths perhaps left over from the days of the gold standard- that are now inapplicable with our non-convertible currency.
- The Clinton surplus has been spun as the driver of the prosperity of the late 90's, rather than the cause of the subsequent collapse that we have yet to overcome.
- The line between economic failure and prosperity is 100% imaginary.
- This is a nominal crisis, not a real crisis.

And Don't Forget about Energy

- And if we do restore output and employment without an effective energy policy we increase energy consumption and quickly support the forces behind much higher energy prices,
- This reduces our real terms of trade and works against our standard of living.

A Review of What Got Us Here: Fiscal policy

- Deficits of the early 90's drove the economic growth that followed.
- Funding impossible business plans further drove the economy via increased private sector debt.
- The countercyclical tax structure caused the strong growth of the late 90's to drive the federal budget into surplus.
- The surplus years of the late 90's removed income and the financial equity that supports the credit structure.

Fiscal Policy, cont.

- The collapse after y2k started to increase the deficit.
- Proactive fiscal policy in 2003 sufficiently increased the deficit to support moderate growth for several years.
- Growth was further sustained by the aggregate demand from 'borrowing to spend' on housing as lenders funded fraudulent sub prime mortgages.
- The growing economy again caused the budget deficit to decrease and by mid 2006 aggregate demand was slowing.

Fiscal Policy (cont.)

- By mid 2006 the lender fraud was being discovered as delinquencies increased beyond model projections.
- Demand from housing slowed abruptly as lenders no longer funded fraudulent borrowers.
- The federal deficit had gotten too small to support the credit structure and sustain demand.
- The recent fiscal package of about 1% of GDP supported q2 growth.
- While deficit spending is growing, it's still insufficient to sustain output and employment.

The role of Exports

- The US had an ever increasing trade deficit
- This was in response to a net ‘rest of world’ desire to accumulate $US financial assets.
- Foreign CB’s and monetary authorities accumulated $US financial assets to support their export led growth ideology.
- This all was beneficial to US real terms of trade at the expense of exporting nations.

Killing the Goose

- Tsy. Sec. Paulson labeled China and others ‘currency manipulators’ and ‘outlaws.’
- US foreign policy caused the monetary authorities of most oil producing nations to allocate reserve away from $US financial assets.
- Fed policy had the appearance of not caring about inflation which caused portfolio managers to allocate portfolios away from $US financial assets.
- The $US fell in value to levels where foreign holders decided US goods and services were cheap enough to buy.
- The result has been a US export boom and rapidly declining US real terms of trade.

KILLING THE GOOSE (CONTINUED)

- Rising US exports and falling non petoleum imports reduced rest of world agg. demand.
- Rest of world also suffers from deficit myths and won't act to sustain demand.
- They also believe the monetary myth that lower rates make a difference.
- Instead of using fiscal policy that does work, they rely on monetary policy that doesn't work.

The Role of Crude Oil Prices

- Only the Saudis have excess capacity and are therefore necessarily ‘swing producer’ and price setter.
- They strongly deny this and try not to make it obvious.
- Higher crude and prices make $US ‘easier to get’ for foreigners as the US imports over 10 million bpd of crude and products.
- The increasing crude prices and the drop in foreign demand due the Paulson/Bush/Bernanke ‘success’ were negative for the $US and positive for US exports and declining US real terms of trade.

The Role of Crude Prices (cont.)

- Biofuels link food prices to fuel prices.
- The monetary system will burn up whatever fuel can be produced until the marginal person starving to death has sufficient political power to stop it.

The Role of Crude Oil Prices (cont.)

- Declining real terms of trade were manifested by
    1. Exports supporting output and employment
    2. US workers losing income to higher food and fuel prices and cutting back on other consumption.
- This also meant less income to service debt.
- The recent fall in crude prices helps, but prices remain far higher than just a few years ago.
- Falling crude prices now make the $US 'harder to get.'
- This has supported the $US and the slowed the growth of exports.

Review of the Monetary System: Unemployment and Taxes

- Govt. is desirous of moving real resources from the private to the public domain.
- Tax liabilities cause people to offer their goods and services for sale to get the funds to pay the tax and net save.
- People seeking paid work are defined as unemployed.

Unemployment and Taxes (cont.)

- Govt. spending satisfies the need to pay taxes and net save as it reduces the unemployment created by tax liabilities.
- If Govt. spending is insufficient to satisfy the need to pay taxes and net save the evidence is unemployment and excess capacity in general.
- Today's unemployment and excess capacity is evidence the federal deficit is too small.

Unemployment and Taxes (cont.)

- Net savings of financial assets can only come from Govt. deficit spending:
- Govt. deficit = non Govt. surplus (net accumulation of financial assets)
- Net financial assets constitute the financial equity that supports the credit structure.

Budget Deficits Myths: We are Leaving this Debt to our Children

- Twenty years from now, when we build 40 million cars, will our children have to send them back in time to pay off their debt?
- Are we sending goods and services back in time to 1945 to pay for WWII?
- No, whoever is alive gets all the current output.
- The only intergenerational transfer is when we leave real goods, technology, and knowledge to our children.
- The transfer can only be forward, not backwards.

Budget Deficit Myths: Govt. Deficits Reduce Savings

- No, Govt. deficits add to non Govt. savings, as a matter of accounting:
- Govt. deficit = non Govt. surplus
- Beware the term ‘National Savings’ which is inapplicable with convertible currency.

Budget Deficit Myths: Federal Solvency Risk

- Operationally, Govt. spending is not revenue constrained.
- Govt. spends by crediting accounts at its own central bank, or otherwise distributing it's currency of issue.
- Operationally, funds for paying taxes and buying Govt. securities come from Govt. spending

Budget Deficit Myths: Deficits are Inflationary

- Yes, in that they are the most powerful policy tool to add aggregate demand as desired.
- How govt. spends does matter.
- Deficit spending to build the Panama Canal reduced costs and was net deflationary.
- And deficit spending to blow up the Canal would be inflationary.

The Innocent Fraud of the Trade Deficit

- Exports are real costs
- Imports are real benefits
- Domestic demand management can ALWAYS readily sustain domestic full employment
- The importer is not dependent on foreign (financial) capital.
- Domestic credit funds foreign savings

The Innocent Fraud of Savings and Investment

- It is incorrectly believed that savings is needed to fund investment.
- This results in legislative initiatives to create tax advantaged savings plans.
- This drains aggregate demand that can only be offset by private or public deficit spending to sustain full employment.
- Those who favor Govt. savings incentives oppose deficit spending.

Conclusion

- We will continue to suffer the real losses of unemployment until the deficit myths and innocent frauds that sustain it are understood and overcome.
- The current unemployed labor buffer stock with all its associated real costs will continue to be sustained in the name of price stability.

Current Proposal (Short Version)

- Normalize bank liquidity by allowing Fed member banks to borrow unsecured from the Fed in unlimited quantities.
- Have the Fed set term lending rates out to 3 months in addition to the Fed funds rate.
- Extend FDIC insurance to Fed deposits at member banks to keep any insolvency losses at the FDIC.
- Remove the cap on FDIC insurance to eliminate the need for money market funds.

Current Proposal (cont.)

- Declare a ‘payroll tax holiday’ and reduce social security and medicare payroll deduction rates to 0%.
- This would immediately end the current crisis by supporting demand for goods and services and supporting the finacial sector from the bottom up.
- Remaining issues include the increased demand for energy consumption as the economy recovers, and associated price pressures and environmental issues.

Other Proposals

- Energy- 30 mph national speed limit
- Health care poposal
- Tax policy

Other Issues

- The end of the euro
- See: www.moslereconomics.com for ‘mandatory readings.’