

## It Isn't Working: Time for more Radical Policies

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### Abstract

The financial future of tens of millions of US households is getting grimmer and grimmer; default rates are rising fast for all types of borrowers, half of all mortgagors are predicted to be underwater, and many of them are falling for numerous financial and employment scams. A similar financial state can be observed for states and non-financial businesses and we argue that the Obama Administration has failed to grasp the source and the size of the problem. Like the Bush Administration, the current policymakers have focused most of their efforts on helping the financial sector in the hope that the “liquidity crisis” would go away. As a consequence, tens of trillions of dollars of financial assistance has been committed to deeply insolvent financial institutions that have used the funds mostly for their sole benefit. Financial institutions are now back to business as usual and have provided limited help to the non-financial sector. In fact, some of them are clearly committed to worsen households’ financial position and have oriented their activity toward this end in order to maximize their profitability. On the other side, households and other non-financial institutions, whose dire finance is at the heart of the crisis, have received very limited help. Loan modifications programs and fiscal measures to raise their income and restore their creditworthiness have been too small to deal with the massive size of their financial problems. We argue that it is time for the Obama Administration to implement a radical shift in its framework of analysis and policy implementation. We need massive loan modifications to make loans truly affordable for the length of the loan, we need large scale employment programs that restore households’ capacity to pay, we need to deal with the over-supply of homes and to help households to stay in their houses, and we need swift and cheap bankruptcy procedures that provide a fresh start to the households who cannot afford to keep their houses. At the same time, we need to establish a Pecora-like investigation of the financial sector that ruthlessly investigated all financial institutions, even those that are not under the jurisdiction of the federal government. Financial frauds have been left unpunished for too long and are continuing to this day. Finally, we need a profound restructuring of the financial system away from the trade-and-fee model and toward a system that focuses on carefully evaluating creditworthiness and on limiting the growth of ponzi processes over an enduring period of economic growth.

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With employment numbers dropping rapidly, the finances of state governments, households and businesses continuously worsening, and highly leveraged financial institutions overwhelmed by a mountain of “legacy” assets, 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 Administration appears to be trying to recreate the bubbly financial conditions that led to disaster. This is not likely to succeed, and is displacing policies that might actually prevent recurrence of another great depression. Even if the \$23.7 billion the federal government has so far allocated in the form of spending, lending, and guarantees does preserve the status quo, we believe it will just set the stage for another—bigger—financial crisis a few years down the road. This is why we recommend an abrupt change of course, to pursue a more radical policy agenda.

So far, instead of trying to revive the productive economy, most of the recovery effort has consisted of cardio-pulmonary-resuscitation for Wall Street. Fearing what it might find if it actually examined the books of financial institutions in detail, the administration put a chosen handful of them through a wimpy “stress test” after announcing that none would fail. Rather than closing massively insolvent institutions, Washington continues to allow them to operate “business as usual” and to cook the books to show profits so that they can pay out big bonuses to the geniuses who created the toxic waste that brought on the crisis.

In short, under the guidance of Larry Summers and Timmy Geithner, policy serves to preserve the interests of big financial companies, rather than implementing government programs that *directly* sustain employment and restore states’ finances. To make matters worse, the Obama Administration is already preoccupied with “paying for” additional spending through tax hikes or 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. We suspect the balanced budget craziness will get worse during the next election season—much as President Roosevelt’s 1936 campaign tied him to the fiscal tightening that threw the economy back into a great depression in 1937.

The US economy is today crushed by massive indebtedness in two sectors of the economy: the financial sector and the household sector. Maintenance of the status quo is not a solution. Administration proposals to relieve debt burdens by encouraging lenders to renegotiate mortgages have failed miserably. Personal income is falling at a terrifying rate. Already 6.5 million have lost their jobs—with June, alone, adding a half million job losses. The administration’s promise that the stimulus package will create 3.5 million jobs over the next two years is unsatisfying in the face of the challenges faced.

We need federal government spending programs to provide jobs and incomes that will restore the creditworthiness of borrowers and the profitability of for-profit firms. We need a swift and detailed investigation of financial institution balance sheets and

resolution of those found to be insolvent. We need to downsize “too big to fail” financial institutions, while putting in place new regulations and supervisory practices to attenuate the tendency to produce a fragile financial system as the economy recovers. We need to investigate fraud and to jail the crooks. We need a package of policies to relieve households of intolerable debt burdens. In addition, given that the current crisis was fueled in part by a housing boom, we need to find a way to deal with the oversupply of houses that is devastating for communities left with vacancies that drive down real estate values while increasing social costs. And we’ve got to reign-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 all of them. Income was leveraged by households and firms to take on more and more debt. As scholars at the Levy Institute have been warning for a dozen years, the private sector went on a practically unbroken deficit spending spree since 1996. The result was massive debt to income ratios, as we discuss in the next section. Financial institutions leveraged equity, with many using highly complex proprietary models to assess risk in order to calculate maximum permissible expansion of their balance sheets given Basle II capital requirements. They also leveraged safe, liquid assets (such as reserves and treasuries)—increasing the proportion of their balance sheets comprised of riskier assets. Banks moved assets off balance sheet onto “special” purpose vehicles so they could ignore capital requirements. The financial system as a whole increased leverage, creating a mountain of debt relative to the productive capacity of the economy, and relative to the prospective income flows of the nation as a whole. In other words, financial sector “layering” increased as the nominal value of financial assets and liabilities grew very much faster than GDP. Indeed, financial institution debt grew much faster than other private sector debt.

We could even say that the “FIRE” (finance, insurance and real estate) sector “leveraged” the rest of the economy as its employment and profits grew at a faster pace (it received 40% of the nation’s profits before the bust). Indeed, recent revisions made to our national accounts show that Americans now spend more on financial services and insurance (8.2% of personal consumption, \$832 billion annually) than they do on food and beverages to be consumed at home (7.9%). Back in 1995 that was reversed, with spending on food and beverages at 9% of consumption and financial services at 7.2%. We don’t want to get into a sterile argument about “productive” versus “unproductive” labor but it certainly appears in retrospect that the FIRE sector has played an outsized role in recent years, like a tail that wagged the economy’s dog. The “market” is now trying to downsize the FIRE sector, but Larry and Timmy only let market forces work their “magic” in the bubble, not when it bursts. Hence, all the efforts are aimed at keeping leverage high as the Fed and Treasury try to get banks to lend again as if another debt bubble is the cure for what ails the economy.

As Hyman Minsky argued, banking is an unusual profit-seeking business in that it is based on very high leverage ratios. Further, banks serve an important public purpose and

thus are rewarded with access to the lender of last resort and to government guarantees. Those government guarantees provide cheap and virtually unlimited credit to banks in the form of insured deposits. Because these bank creditors (depositors) will not lose should the bank fail, they do not need to closely supervise bank activities—even if they had the expertise and access to information that would be required to do so. Ignoring other types of creditors for a moment, there is no “market discipline” that such creditors will impose on bank management for the simple reason that depositors get paid off no matter what bankers do. The bank, in turn, can increase its profits on equity by raising the return on assets given a capital ratio, and by reducing the ratio of capital to assets (i.e., raising leverage). Each of these actions will increase the riskiness of banks—but can dramatically raise profitability for owners without increasing their capital at risk. Instead, it is the government insurer that absorbs any losses once the bank’s equity is destroyed by losses on bad assets.

Minsky (2008) provided a simple example. Consider a bank with \$25 billion in assets, \$1.25 billion in capital, and \$187.5 million in profits after taxes and allowance for loan losses. Its asset to capital ratio (or leverage ratio) is 20 and its return on assets is 0.75% so its profit on equity is 15% ( $20 \times 0.75$ ). Assume its rival also has \$25 million in assets and earns the same \$187.5 million in profits, but its equity is \$2.085 billion—for a leverage ratio of only 12. While it earns the same return on assets, its owners only earn 9% on equity. The rival can increase its profitability either by earning more on assets (all else equal, that means taking on riskier assets) or by increasing its leverage ratio (buying more assets against its relatively larger capital base). Note that the disparity in profitability due to differences in leverage ratios is dramatic: if the second bank increases its leverage to 20, it will expand its assets to \$41.7 billion and its profits to \$312.75 million as it increases its profit rate to the 15% enjoyed by the first bank. With the same amount of capital, the bank increases its loans and deposits by \$16.7 billion. The bank owners’ total exposure to losses remains \$2.085 billion, but the government insurer’s exposure increases by the full \$16.7 billion.

Further, as Minsky noted, simple arithmetic shows that banks with higher leverage and higher profit rates must grow faster to maintain their profitability (this is all the more true when shareholders impose a specific target to meet in terms of return on equity). Assuming a dividend payout ratio of one-third, banks earning a 15% profit rate will accumulate capital at a growth rate of 10% per year. To maintain leverage ratios at 20, bank assets and deposit liabilities will have to increase each year by twenty times the increase of capital. Assets will have to grow even faster if the return on assets grows, given a leverage ratio, or if banks decide to increase leverage ratios. Both of these events are likely in a boom. This is why an otherwise unconstrained financial system will tend toward explosive growth. Indeed, a recent paper by FRB-NY economists show that leverage in the financial system is highly procyclical, caused by expansion of assets relative to equity in a boom (and deleveraging in a bust). (Adrian and Shin 2009) The notion that legislated capital requirements (such as those promulgated by Basle II) can tightly constrain growth and risk is flawed.

What if the bank that increased its leverage ratio discovers that a lot of its new loans are going bad? Assume that about one out of eight turns out to be toxic waste, so owner's equity has disappeared (and leverage has approached infinity!). One strategy is to patiently rebuild capital through retained earnings (assuming the other assets remain profitable). A more aggressive strategy would be to "bet the bank" by making riskier loans and hoping to recoup losses. Which option will be chosen depends on management incentive structures as well as regulatory and supervisory practices and the general expectational environment. If management's performance is closely scrutinized, and its pay is closely tied to short-term performance, it is likely that it will choose to hide losses and pursue a higher risk/return path. Strict capital requirements combined with lax oversight makes this even more probable as management will try to rebuild capital before regulatory agencies discover losses and close the institution. We know that this is how the thrift industry reacted to insolvency in the 1980s—indeed, the Reagan Administration's regulators encouraged them to do just that (Black 2005).

This is why former Treasury Secretary Paulson's argument (parroted by Geithner) that government had to inject capital and get bad assets off the books of banks in order to encourage them to lend again was so nonsensical. First, loan losses and lack of capital (unless it is discovered and sanctioned by authorities through prompt corrective actions and other means, something that most Administrations have failed to encourage) is not a barrier to lending, indeed, can encourage rapid growth of risky loans. The owners had little to lose once capital ratios declined toward some minimum (zero in the case of an institution subject only to market discipline, or some positive number set by government supervisors as the point at which they take-over the institution), so would seek the maximum, risky, return permitted by supervisors. Second, more lending is not a solution to a situation of excessive leverage and debt!

In any event, there is always an incentive to increase leverage ratios to improve return on equity. Given that banks can finance their positions in earning assets by issuing government-guaranteed liabilities, at a capital ratio of 5% for every \$100 they gamble, only \$5 is their own and \$95 is effectively the government's (in the form of insured deposits). In the worst case, they lose \$5 of their own money; but if their gamble wins, they keep all the profit. Imagine if you walked into a casino and the government gave you \$95 to gamble, for every \$5 of your own—and you get to keep all the winnings. What would you do? Play for high stakes! If subjected only to market forces, profit-seeking behavior under such conditions would be subject to many, and frequently spectacular, bank failures. The odds are even more in the favor of speculators if government adopts a "too big to fail" strategy—although exactly how government chooses to rescue institutions will determine the value of that "put" to the bank's owners. This is why guarantees without close supervision are bound to create problems.

Note that while the Basle 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, the Basle agreements contributed to the financial fragility that resulted in the global collapse of the financial system. Effective capital

requirements would have to be very much higher, and if they are risk-adjusted, the risk assessment must be done at arms-length by neutral parties. If we are not going to closely regulate and supervise financial institutions, capital requirements need to be very high—maybe 100%—to avoid encouragement of excessively risky behavior. We used to have “double indemnity”: owners of banks were personally liable for twice as much as the bank lost. That, plus prison terms for management, would perhaps give the proper incentives. Failing that, the only solution is to carefully constrain bank practices—including types of assets and liabilities allowed.

In addition, supervisors should always be wary of rapid growth because it has proven to be a reliable predictor of future insolvency. At any point in time, there is always a limited supply of credit-worthy borrowers so rapid growth is achieved by lowering credit or underwriting standards. If income grows at a 4% pace, ability to service debt cannot grow orders of magnitude greater than that. Yet, as we saw from the example above, with high and rising leverage, financial institutions must grow faster. This is part of the reason that an ever greater share of the nation’s GDP and profits were captured by the FIRE sector (Tymoigne 2009c).

But it is very much worse than these examples indicate. In the early 1980s Chairman Paul Volker’s high interest rate policy killed the thrifts and we transitioned to a “market-based” financial system. To be sure, there already had been a long run trend away from commercial banking (in which a bank makes and holds a loan, financing its position in the asset by issuing deposits) and toward non-bank financial institutions (what is now called the shadow banking sector). We need not repeat the details here (see Wray 2007 and Minsky 2008) as everyone is now familiar with the story of the transformation of home finance to the “originate to distribute” model, which is just one example of the transition. Banks and others would originate loans that serve as the collateral for securities sold in markets. Jimmy Stewart’s thrift was replaced by a high stakes casino with almost everyone in the home finance food chain tacking on fees for services, including mortgage brokers and banks and thrifts that originate loans, property appraisers, accountants, title insurers, ratings agencies, lawyers, mortgage insurers, securities insurers (including credit default sellers), and securities brokers and dealers. Whatever was left of the homeowner’s principal and interest payments was parceled out to the various tranced securities held by managed money. With everyone’s hand in the homeowner’s pockets to grab fees, not much was left of the principal and interest. A similar transformation occurred throughout the financial system. For this reason, leverage had to be very high to meet return-on-equity goals—so leverage increased to 30 and even to 300. As competition reduced returns, leveraged money sought ever riskier assets—hence, low docs, no docs, and NINJA loans. A flier sent by a mortgage company to mortgage brokers in 2003 tells it all: “Did You know NovaStar Offers to Completely Ignore Consumer Credit!” (Morgenson 2007b). We know the outcome, and it is not pretty.

Leverage is a beautiful thing on the way up, and disastrous on the way down. In our example above, to reduce leverage from 20 to 12 requires that the second bank has to unwind \$16.7 billion of loans (40% of its balance sheet). Most de-leveraging took place

off the books of banks for two reasons—aside from the obvious fact that banks had declined in importance, holding only a quarter of financial system assets. First, it has always been very hard for banks to de-lever loans and deposits. Traditionally, loans are hard to sell because of their idiosyncratic nature (presumably, loans on the books of banks today are those that were more difficult to securitize); and they usually cannot be called-in because debtors do not have cash-on-hand for repayment. Thus, positions can only be slowly unwound as loans are repaid or credit losses progressively materialize, while a mark-to-market accounting system leads to the immediate recognition of huge and erratic market losses. Second, as highly leveraged institutions subject to at least some oversight, banks could not afford to recognize losses thus could not sell even marketable assets into declining markets. Thus, as Figure 1 shows, bank credit has not declined substantially even during this deep financial crisis and economic recession, and it is today following an upward trend (the funding provided by banks comes from purchases of private securities rather than loans and the latter is not significantly going down and is also following an upward trend). However, the shadow banking system has greatly reduced its leverage, writing off bad debts and recognizing losses. Of course, that is just the other side of the coin of the global loss of financial wealth. Thus much of the public scolding of banks for “not providing credit” is misplaced—as shown in Figure 2, it is the shadow banking sector that is shrinking balance sheets and thereby cutting off credit; and it is doing so for all the activities it previously financed, not only mortgages.

Figure 1 Here

Figure 2 Here

One of the supposed advantages of the market-based model is that it made illiquid assets (such as home mortgages, credit card debt, and student loans) marketable and thus more liquid. Unfortunately, that was only in the boom—with the bursting of the bubble, they became hot potatoes that could be sold only into declining markets.<sup>1</sup> And because they were largely held by institutions that do (and in many cases must) “mark to market”, falling prices trigger more sales to avoid even greater losses, pushing prices ever lower in what Irving Fisher and Minsky called a debt deflation process. The higher the leverage ratio, the greater the impact of a decision to get out of a toxic asset class.

The panic was made much worse because financial institutions typically financed their positions in assets by issuing liabilities held by other financial institutions (rather than to insured depositors). Financial institutions offer collateral against the credit others extend to them. Creditors allow a maximum leverage in collateralized borrowing, demanding a “haircut”. As Adrian and Shin (2009) explain, if the haircut is 2%, the borrower can borrow \$98 for each \$100 of assets pledged as collateral. The haircut must come out of equity (the borrower can only finance \$98 of its position in assets by issuing debt, so \$2 must be covered by capital). That means a maximum leverage ratio of 50 when the haircut is \$2. With a haircut of \$4, the maximum leverage is 25; and so on. The haircut

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<sup>1</sup> Of course, one may argue that they 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 them still have entailed a buy-and-hold strategy because of very thin markets (Tymoigne 2009c).

varies by riskiness of asset and over time. For example, before the crisis, US treasuries had a haircut of a quarter of one percent (so the borrower could obtain a loan equal to 99.75% of the value of securities pledged); this increased to 2-4% for prime mortgage backed securities and up to 18-25% for mezzanine leveraged loans. If the average haircut across a particular bank's assets was 8, the maximum leverage ratio was 12. By August 2008 (during the severe liquidity crisis), the haircut was raised to 3% for US treasuries, 10-20% for prime MBS, and above 35% for mezzanine loans; it rose to as much as 40% for high-yield (junk) bonds and to 60% for asset backed securities. Since banks and shadow banks had leveraged their safe assets over the boom, they were stuffed full of assets that now were exposed to large haircuts, making it expensive to raise the credit necessary to continue to finance positions in assets, and ultimately they were forced to sell their position, depressing asset prices and further reinforcing their leverage problem (International Monetary Fund 2008).

Indeed, recall that financial institutions are highly leveraged, so that if the average haircut for their whole portfolio of assets is 25%, they can finance their position in only 75% of their assets through collateralized borrowing. The maximum leverage falls to 4. From our example above we know that if leverage falls from 12 to 4, the financial institution is forced to downsize its assets on a tremendous scale in order to de-lever, thus, must sell assets--especially the most illiquid ones. With the entire shadow banking sector trying to de-lever, each institution was refusing to extend credit to other institutions except at huge haircuts, and trying to sell assets to institutions that could not finance positions in the assets they already held. Asset prices had to collapse in a self-reinforcing spiral.

A similar process is now underway in the commercial real estate sector. One way of calculating the value of commercial real estate is the income approach. Malay Bansal (2009) provides the following example of commercial real estate losses using commercial mortgage backed securities lenders, based on real world values that existed pre- and post-crisis. Suppose an office building is expected to generate \$600,000 per year and markets in 2006 are capitalizing that income flow at a 6% rate. The building is then worth \$10 million. Further assume that lenders will accept a loan to value (LTV) ratio of 80%, so a purchaser must put up \$2 million to borrow \$8 million for the purchase. The term of the loan is 5 years, so the position in the asset will have to be refinanced. After the financial crisis, markets raise the capitalization rate to 8% and lower the acceptable loan to value ratio to 60%. Assuming rental income is not affected, the building is now only worth \$7.5 million and the owner can borrow only \$4.5 million in the refinancing operation. The owner must pay-off \$8 million, so will need to come up with another \$3.5 million. If the owner cannot find the cash (or if the owner decides it is best to cut losses and sell the building) then the price of the building will fall to between \$4.5 million (the amount borrowers should be able to obtain) and \$7.5 million (the value determined by expected rental income). Thus, moving from a "6% cap, 80% LTV" world to an "8% cap, 60% LTV" world means that the same rental income results in an asset price depreciation of between 25% and 65%. Real world results could be a lot worse because rental incomes are depressed by the crisis and expectations of further real estate price depreciation would affect willingness to buy.

That is the downside to a market-based system—and one of the primary reasons we moved away from such a system with the New Deal reforms. Faced with the liquidity crisis, the Fed and Treasury came to the rescue by extending deposit insurance, guaranteeing (and lending against, and even buying) commercial papers, 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. With the government guarantee, there would be no “haircut” so effectively this would act as a circuit breaker to stop the normal market process of deleveraging through asset sales by allowing shadow banks to finance positions in assets using depositors as creditors. As we explained above, this type of creditor does not discipline financial institutions that have taken on too much risk. In addition, as discussed, the government extended loans against troubled assets and guaranteed a wide range of financial institution liabilities. By doing so indiscriminately and by focusing on legacy assets, it has rewarded destructive competition rather than constructive competition. Indeed, it rewards those who maintained and grew their market shares by any means without any consideration for others (especially the financial well-being of borrowers), and it punishes financiers who refused to resort to unprofessional underwriting practices even if it meant a drastic reduction of their market share (Schwartz 2007). The latter (usually small financial institutions) should be rewarded (to some extent, they are because their market share is growing in the crisis) and the former should be punished.

If the problem had been one of excessive leverage in the financial sector alone, this would have resolved the crisis. After all, lending by financial institutions to financial institutions must net-out when we aggregate the financial sector—so if we can get them to accept each other’s liabilities they will be able to refinance their positions in each other’s assets. But the problem was one of excessive leverage throughout the entire economy. There was too much lending against prospective income flows that will not—probably could not—be realized; and even worse, there was too much lending against expected asset appreciation that will not—could not—occur. The market wants more deleveraging—now because of solvency risks, not liquidity problems—but Washington wants to prevent it. However, debts remain far too big and incomes are collapsing. Even though some scavengers are now buying toxic waste at deep discounts, debtors will not be able to service the debts (those buying “stressed assets” probably know this, but hope to squeeze some more fee income before debtors are foreclosed and their collateral—houses—is sold). We will not obtain a sustainable recovery until debts are reduced and incomes begin growing.

### **The Debt Problem: Where is the Problem and How Big is It?**

As shown in Figure 3, the level of indebtedness of the US economic sector is at an all time high and is well above the debt-to-GDP ratio on the eve of the Great Depression. In the early 1930s, the nominal level of debt was three times higher than the value of nominal GDP, in 2008 debt was five times larger than GDP.

Figure 3 here

Even though politicians and commentators have been clamoring that the government debt is overwhelming and that the “large” fiscal deficits are unsustainable, it is the debt level of the private domestic sector that should be of great concern. In 2008, the ratio of private domestic debt relative to GDP was 3.6 compared to 0.73 for the government sector (0.53 for the federal government). GSEs took the rest of the leverage with a ratio of 0.58. The debt problem is, therefore, very serious, but the current concern for the federal deficit and its effect on the public debt is misplaced. Not only is the government debt low relative to the size of the economy, but also, as a matter of national accounting, deleveraging in the private sector cannot happen without an increase in the government’s deficit (the government’s deficit equals by identity the nongovernment’s surplus, so if the US private sector is to rebuild its balance sheet by spending less than its income, the government will have to spend more than its tax revenue; the only other possibility is that the rest of the world begins to dissave massively—letting the US run a current account surplus—but that is highly implausible). In addition, if the government deficit does not grow fast enough to meet the saving needs of the private domestic sector, national income will decline, and, given the size of the private sector’s debt problem, a full-blown debt-deflation process will emerge.

Within the private sector, two specific subsectors are a major source of concern: the private financial sector and households. As shown in Figures 4 and 5, their debt has grown over the past half century, and it has increased very rapidly since the mid 1980s for the financial sector and since the early 2000s for the household sector. In 2008, the debt-to-GDP ratio of households and private finance were respectively 1.3 and 1, and their sum accounted for 64% of the debt-to-GDP ratio of the private sector. Nonfinancial corporate debt has grown also but at a more moderate pace, although it was pushed upward recently by a wave of leveraged buyouts (International Monetary Fund 2008).

Figure 4 here

Figure 5 here

To be sure it is not easy to say how much debt is too much (and the quality of debt matters as much, if not more, than the quantity of debt). Debt ratios have been rising since 1960, although the rate of growth increased in recent years, and by the mid-1980s the overall debt-to-GDP ratio rose above the ratio reached on the eve of the Great Depression. How much debt can be safely serviced depends on a number of factors. An important one is the relation between debt service requirements and the normal source of cash flow of borrowers. If we think about the old post-war home finance model, it was based on fixed-rate, thirty year, self-amortizing loans. Interest rates were relatively low and households did not have much other debt. Incomes were doubling every generation, so locking into a 30 year fixed payment meant that the burden of servicing the debt out of income would fall by half over the course of the loan. Of course it was more complex than this: families typically kept a mortgage only 7 years, often trading up to a more expensive house; divorce rates rose over the period, increasing the burden of making mortgage payments (possibly on two houses); and second mortgages were taken out to finance college education. But even though careful calculation shows that purchase of a

house was usually not the wisest investment one could make from a purely financial perspective, house prices tended to rise fast enough to accommodate even these additional burdens. After the early 1970s, median real wages stagnated and unemployment ratcheted upward and job tenure became less secure. Interest rates were more unstable and generally higher. Adjustable rate mortgages became more common. Households took on other debts—more consumer loans, auto leases and loans, student loans, medical debts, cash-out equity loans, and so on. Thus, the acceleration of the growth of debt and the growing use of shorter-term debts with adjustable interest rates and high fees/penalties occurred precisely as ability to service debt out of income declined.

How could that have been justified? The answer is rising asset values, especially of housing. Rather than focusing on income, lenders were blinded by the rising value of collateral. History shows (Chairman Greenspan's favorite phrase) that lending against expected rising asset values is almost always a recipe for trouble—it is what Minsky called a Ponzi scheme. If asset values stop rising, if income falls, or if finance costs rise, the debt cannot be serviced. Yet there is a natural affinity for “market-based” finance to move toward asset-based measures of lending. The value of an asset includes prospective income flows plus appreciation, plus in the case of business assets, “goodwill”. The purchaser of the asset, and the lender assessing the collateral value of the asset, will build in a margin of safety. In recent times, that is largely a function of asset price volatility. The belief that we entered an era of “the great moderation” (as Bernanke called it) meant that volatility had fallen so that margins could be reduced. This is a common feature of speculative booms—the mass delusion that we have entered a new economy in which the only direction is up (recall the “Dow 36,000” projections of the late 1990s, or Irving Fisher's statement on the eve of the crash in 1929 that stock prices “have reached a permanently high plateau”<sup>2</sup>). Further, in an asset price bubble, appreciation and goodwill grow faster than projected income, so that a larger portion of an asset's valuation will depend on these ephemeral sources. Finally, unlike current documented income, future asset prices depend on expectations that are subject to “whirlwinds” of optimism.

Here is the reason why the shift to markets and away from banks matters. When a commercial bank makes a loan, the loan officer wonders “how will I get repaid”. Because the loan is illiquid and will be held to maturity, it is the ability to repay that matters—and it is most prudent to rely on income flows rather than potential seizure and forced sale of the asset at some time in the possibly distant future and in unknown market conditions. On the other hand, when an investment bank makes a loan, the loan officer wonders “how will I sell this asset”. The future matters only to the degree that it enters the value of the asset today because it will be sold immediately. Even the buyer of the asset need not worry about the distant future because the liquid asset can be unloaded quickly (Tymoigne 2010). Especially when confidence is high and euphoria reigns, it is easy to sell assets whose value is disproportionately determined by expected asset appreciation (and goodwill). The sky is the only limit to how much an asset's value might rise, hence

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<sup>2</sup> Galbraith (1997: 70). Bernard Baruch presaged Greenspan's cheerleading for the 1990s New Economy boom when he said in June 1929 that “the economic condition of the world seems on the verge of a great forward movement.” Ibid.

no euphoric expectation can be easily dismissed. And any debt ratio can be justified as sound because it will automatically fall as the asset appreciates. As late as spring 2007, Fed economists were still giving papers (at the Levy Institution's annual Minsky conference) denying that real estate was over valued and that there was a credit bubble—the vast majority of economists were similarly in a perpetual state of denial—because real estate values would continue to rise, validating the debt. As Greenspan said during the dot-com boom, how can one argue with the wisdom of tens of millions of market players?<sup>3</sup> Galbraith nicely captures the circularity of such group-think: “It is difficult not to marvel at the imagination which was implicit in this gargantuan insanity. If there must be madness something may be said for having it on a heroic scale.” (Galbraith 1997: 64)

Indeed, this was a fundamental reason for the separation of commercial banking from investment banking in the aftermath of the 1930s collapse. Commercial banks would make and hold loans, issuing insured deposits to finance positions. As loans would be held to maturity, there was no need to mark to fleeting market values. Banks would not be able to count asset price appreciation during a bubble as a source of profits and equity, nor would they have to recognize losses if asset prices temporarily fall. Since the value of most of their liabilities (deposits) would not fluctuate in value, this practice of ignoring asset price fluctuation kept their balance sheets stable. By contrast, investment banks and other types of financial institutions would be subject to these market fluctuations—recognizing capital gains and rewarding traders with bonuses in good times, and taking losses and downsizing portfolios in a bust. The market-based institutions would be highly pro-cyclical, while commercial banks could be much less so. (Of course, they would still be somewhat pro-cyclical because the demand for loans as well as credit-worthiness moves with the cycle. But they would not be forced to sell off their loans simply because asset prices were falling; so long as firms and households would eventually recover sufficiently to service debt, the loans could be retained and marked to original value.)

Unfortunately, we moved strongly in the opposite direction as we freed commercial banks to become brokers and dealers in marketed assets. We allowed them to leverage government money (insured deposits) with little supervision. We allowed them to use their own complex and proprietary models to value assets and to assess risk. When crisis came, we handed bank charters to the last remaining investment banks so that they, too, could use government money to speculate in asset markets. This represents an ironic completion of the circle because the main justification for deregulating commercial banks was that they had to be allowed to compete with the much more efficient shadow banking sector, and when the shadow banks collapsed in a spectacular manner we gave them

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<sup>3</sup> He might have been channeling the ghost of a Princeton professor Lawrence who remarked in summer of 1929: “the consensus of judgment of the millions whose valuations function on that admirable market, the Stock Exchange, is that stocks are not at present over-valued. Where is that group of men with the all-embracing wisdom which will entitle them to veto the judgment of this intelligent multitude?” (Galbraith 1997: 70) The inability of economists to foresee crisis is well known, but what is less recognized is their inability to face up to crises even once they are underway. As Galbraith notes, in November of 1929, the Harvard Economic Society (comprised of the university's more conservative economics faculty) announced that “a severe depression like that of 1920-21 is outside the range of possibility. We are not facing protracted liquidation.” (Galbraith 1997: 71) He goes on to note that the Society reiterated this view over the course of the depression until the Society was itself liquidated.

access to insured deposits so that they could compete with the banks. We also promoted consolidation to create “too big to fail” and “too big to supervise” institutions so that management and owners have nothing to fear—only government money is at risk and government has neither the will nor competency to oversee the gambling.

And, yet, these policies have failed to “jump-start” even Wall Street, let alone the economy. The debt loads remain too high while income and employment continue to fall and delinquencies and foreclosures continue to rise. Even at current depressed prices, assets are overvalued. Many financial institutions (probably including most of the big ones) are hopelessly insolvent, holding mountains of toxic waste that will never be worth anything.

What has the Obama Administration done to deal with those issues? Let us look in some detail about the policy response.

### **The Response of the Obama Administration**

Under the guidance of Geithner and Summers, the Obama Administration has implemented several policies that have at their core two premises. First, echoing arguments made by Irving Fisher in the early 1930s, the administration has stated that the current crisis is a simply monetary crisis and, as such, requires monetary measures to strengthen the financial system before the rest of the economy can recover. As James Galbraith has argued, the problem is said to be no more serious than some clogged plumbing—a bit of Drano in the form of government handouts and guarantees should be sufficient to get credit flowing again. Second, most major banks are not insolvent but rather have a temporary liquidity problem induced by malfunctioning financial markets. Time will allow market mechanisms to restore the true, higher, value of “legacy” assets. Once the banks are healthy, the economy will recover.

These two arguments have been used to focus almost all of the administration’s efforts on the preservation of the financial interests of major banks. The government (through the Troubled Asset Relief Program (TARP), the Federal Reserve, FDIC and the US Treasury) has committed *at least* \$23.7 trillion dollars to support the economy, out of which \$2.3 trillion have been spent through June 30<sup>th</sup> (SIGTARP 2009: 139ff.). Most of this money has been allocated to the financial sector, and only minimal efforts have been applied to solve the debt problems of households and non-financial businesses.

To help the financial sector, the Obama Administration first continued the Bush-Paulson TARP under a cloud of secrecy that allows Treasury to pick winners for government funding (Morgenson and Van Natta 2009). After weeks of outcry about the slow progress to improve oversight, the TARP Special Inspector General (SIGTARP) and the Congressional Oversight Panel (COP) were finally made operational in December 2008. SIGTARP and COP have been very worried about fraud, especially with the extension of TARP programs toward so-called “legacy/troubled” assets. To this day, they both have been complaining about the lack of transparency of TARP and have noted that the Treasury “has repeatedly failed to adopt recommendations” that SIGTARP made in terms

of uses of funds, valuation and performance of TARP assets, TALF borrowers, and other matters. (SIGTARP 2009: 7) SIGTARP has already reported two investigations and is in the process of improving the transparency of TARP on its own without the support of the Treasury.<sup>4</sup>

The Capital Purchase Program (CPP) of TARP was followed by eleven more sub-programs in which some of the \$700 billion were used as seed money; seven of those plans have been directed toward restoring the profitability and solvency of financial institutions, and, with CPP, they account for 77% of the \$441 billion already used (SIGTARP 2009: 37ff.). All this came on top of massive effort by the Fed, FDIC and others to stabilize financial institutions. Within TARP, three core plans are the Capital Assistance Program (CAP), the Public-Private Investment Program (PPIP) and Term Asset-Backed Securities Loan Facility (TALF), which aim at showing to the public that banks are solvent and only need temporary assistance because of malfunctioning financial markets.

For example, the PPIP was promoted to create a market for “legacy” assets. The program was highly generous for potential buyers, with the Treasury and FDIC taking most of the risk and very few of the gains (so much for a market approach); however, the program has so far failed because of the unwillingness of banks to sell at a huge discount (sometimes as low as 10¢ on the dollar) that would reveal the deep insolvency of banks. Above all, banks do not want those legacy assets to be valued properly. PIMCO flirted with the idea of creating a fund that would allow investors to take positions in toxic waste, but apparently decided this could create a public relations nightmare. If PIMCO were seen to be making profits at taxpayer expense, there could be a backlash. Worse, if the public bought into the fund which then collapsed because the troubled assets never recovered, PIMCO would be blamed for bilking investors. More recently, however, BlackRock has rushed into the void, announcing it will create a cash for trash fund to be capitalized by the federal government. BlackRock will earn fee income, while investors in the fund as well as taxpayers would earn returns if the bets pay off. This would let the general public share in recovery. Of course, if the assets continue to depreciate, Uncle Sam and the investors assume the losses. Previously, BlackRock, with the support of the Treasury and three big US banks, proposed to do the same thing under the M-LEC, a.k.a. “superfund,” scheme. The main difference was that banks were supposed to take most of the risk. The superfund never took off because its sponsors never found enough willing banks to participate in its funding. Financial insiders knew that M-LEC was too small (only \$75 billion when trillions were needed) and only a temporary means to park trash to avoid massive unloading of toxic assets by SPEs. Having failed to find any other financial professional willing to hold the hot potatoes, financial institutions holding toxic assets are turning to Uncle Sam for more cash to burn.

All those programs have failed to deal with the core issue at stake: many financial institutions are probably insolvent and need to be closed; assets must be analyzed carefully to figure out their profitability potential and the true financial state of financial institutions; an investigation must be open to determine responsibility among top

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<sup>4</sup> SIGTARP recently released a report on the use of funds by financial institutions that used TARP funds.

managers. Even though financial markets have stabilized, they are still under heavy assistance by the government and we have not dealt with the solvency problems. Banks have been posting profit but, gains largely come from exceptional cash inflows (e.g., the sale of Smith Barney by Citi), they still need large government help to make those profits (Goldman Sach repaid \$10 billion of CPP money to avoid the executive pay limit, but still got \$12.9 billion from the help provided to AIG (Scheer 2009)), and suspicions of accounting manipulation (if not fraud) are surrounding the valuation of assets. The COP, in its April and May Reports, clearly illustrates the problem with the approach used by the Obama Administration:

The recently announced Public-Private Investment Fund focuses directly on the problem of impaired assets; that initiative reflects the working premise that it is possible through government-subsidized, highly leveraged asset purchase vehicles to obtain valuations for non-performing or otherwise troubled assets, sell those assets at those values to willing buyers, and perhaps avoid the need for the reorganization or even the break-up of systemically significant financial institutions. Treasury has not explained its assumption that the proper values for these assets are their book values – in the case, for example, of land or whole mortgages – and more than their “mark-to-market” value in the case of ABSs, CDOs, and like securities; if values fall below those floors, the banks involved may be insolvent in any event. Treasury has also failed to explain its assumptions about the economic events that would cause investors to default or how long it believes assets will have to be held to produce a reasonable return for private investors. (Congressional Oversight Panel 2009a: 75)

TALF cannot address the creditworthiness issue. It can provide more funds to the lenders for lending, but asset-backed securities have never been the source of significant funding for small businesses. This report raises the question of whether TALF will have a meaningful impact on small business credit. (Congressional Oversight Panel 2009b: 4)

In short, the entire array of programs will work only if we have a temporary illiquidity problem, not a problem of excessive leverage, excessive debt, and a legacy of assets that were vastly overvalued based on economic scenarios that had no chance of coming to fruition. Given the inappropriate premises under which the Administration has dealt with the leverage of financial institutions, we may expect that problems will continue to languish if the Administration does not change its course of actions. This will constrain heavily the capacity of the US economy to recover and may lead to a Japanese-style lost decade.

In addition to eight TARP programs and other policies oriented toward the financial system, several programs have dealt with non-financial sector debt. However, the total committed support for the non-financial sector is only about \$887.4 billion (including, in addition to expenses directly committed to help non-financial entities, the \$700 billion of potential guarantees by FDIC, the \$75 billion allocated to servicers to help to modify mortgages, and \$8.4 billion used to help credit unions to modify mortgages). Of the \$887.4 billion committed, just \$130.4 billion has been spent through a TARP fund provided to car producers, a \$19 billion tax credit provided by the Housing and Economy Recovery Act in 2008, and other means (SIGTARP 2009: 137). All this represents about

3.7% of the \$23.7 trillion committed to support the overall economy (5.7% of the \$2.3 trillion spent); the rest is allocated to financial institutions.

Among the programs helping households, the Making Home Affordable Program (MHA), which expended the Hope for Homeowners program put in place during the Bush Administration, was allocated \$50 billion through TARP (for a total funding allocation of \$75 billion). MHA aims at providing financial assistance to *servicers* to modify private-label mortgages and to refinance conforming mortgages. This program was expended by the Helping Families Save Their Homes Act last May. The need for those programs is as great as ever with delinquency rising sharply for all types of loans and all types of borrowers. This rise is not only due to rising unemployment, but also, more significantly, to years of poor underwriting procedures, even among prime borrowers. This is very well illustrated by Figure 6 that shows that prime borrowers with adjustable-rate mortgages (ARM) have about the same serious delinquency rate as some subprime borrowers.

Figure 6 here

Preliminary results for government programs show that they do not go far enough to deal with the debt problem of households, with only 235,247 mortgages modified as of July 2009 (Department of the Treasury 2009). HOPE NOW, a private initiative supported by the Treasury, HUD and Freddie Mac (which provided a grant of \$2.5 million), has been more successful in 2008 by helping 2.3 million homeowners to avoid foreclosures. However, none of these programs has been able to keep pace with the size of the problem as foreclosures have been growing rapidly as shown in Figure 7.

Figure 7 here

This is creating a growing frustration among households that have been unable, despite months of trying, to reach their *servicers*. This problem is not even close to go away. On the contrary, the number of interest-rate resettings is expected to continue to rise until the at least the end of 2011 so defaults will continue to rise sharply if nothing substantial is done (International Monetary Fund 2007: 8). At the same time, a Deutsche Bank report predicts that the number of mortgagors underwater will rise to 48% by 2011, which represents about 25 million US households. Currently, around 27% of all mortgagors are underwater and most of the increase will occur among households that have conforming mortgages (most exotic mortgages are already underwater) (Weaver and Shen 2009).

There are additional concerns with the current ways of helping households because they discourage *servicers* (and holders for structured securities) from renegotiating, making modifications even more unlikely and marginal when it happens. First, the redefault rate is expected to be as high as 30% to 45% six months after a loan modification (Adelinon et al. 2009). A recent report by the OCC and the OTS shows that, among 64% of the first lien mortgages, serious delinquency (90+ days past due) reached 36.1% after nine months for loans modified during the first quarter of 2008 and 41.8% for loans modified during the second quarter. Loans modified during the third and fourth quarters were on track to

perform even worse (Office of the Comptroller of the Currency and Office of Thrift Supervision 2009: 29). Thus, marginal and temporary loan modifications will not do; we need a significant and permanent reduction of debt payments; this is even truer if one consider that second lien mortgages are even more likely to redefault.

Second, loan modifications may entail large fees and penalties that households cannot afford to pay; and, depending on circumstances and state laws, mortgage modifications might lead to a change from a non-recourse loan to a recourse loan, which makes households who redefault much worse than they were before the modification. Third, loan modifications usually have occurred far too late—after the borrower has long been delinquent. In fact, past policy initiatives like Project Lifeline gave a strong incentive to become a 90-day delinquent because a loan modification would not be considered until a borrower reached that stage. This state of affairs contributes to higher redefault rates because data shows that “the more serious the delinquency, the less likely the borrower will remain current after modification” (Office of the Comptroller of the Currency and Office of Thrift Supervision 2009: 31).

Fourth, financial scams have been on the rise. Subprime lenders are converting themselves into loan modifiers and are luring households to pay large upfront fees for modifications with no result (like “fresh starts” consisting of simply rolling delinquent payments into future amounts owed) and/or for modifications that actually worsen their financial situation (Goodman 2009a). An example of the latter is an actual modification by IndyMac. It proposed a “5-year hybrid, 30-year term, 8-year graduated payment, 176% combined loan-to-value, mega-balloon, super bendover ARM” (Mr. Mortgage 2008). This loan combined two mortgages for a total lien of 840K on a house worth 470K, and started with a 3% interest rate for 5 years that gradually rose to 6.25% by year 9. The balloon payment was about 250K at the end of year 30. This type of modification crushes a debtor under a heavy financial burden and has a high probability that the borrower will need to sell the house at the end of the mortgage.

Fifth, securitization is preventing modifications because the financial interest in outstanding mortgages has been spread among many different parties through securitization and resecuritization. This is especially true for non-conforming mortgages that were packaged into private-label MBSs, which prevents servicers from providing significant loan modifications. These limits to efficient modification are compounded by the fact that servicers have a fiduciary duty toward the holders of structured securities: “Changing the terms of the mortgages, they contend, can hurt investors by reducing interest payments. Lawsuits could follow.” (Morgenson 2009) As a consequence, the redefault rate is much higher on securitized mortgages:

Loans held on the books of servicing banks and thrifts had the lowest re-default rates at 35.06 percent after three month, and 50.86 percent after six months, compared to loans serviced on behalf of third parties. The lower re-default rate for loans held by servicers may suggest that there is greater flexibility to modify loans in more sustainable ways when loans are held on a servicers’ own books than when loans have been sold to third parties. (Office of the Comptroller of the Currency and Office of Thrift Supervision 2008: 21)

In addition, nobody seems to know where the mortgage deed is nor who holds it, often leaving judges with little means to bring financial troubles to a close (Morgenson 2007a). The practice of foreclosing without the deed, even though illegal, apparently had become very common during the boom (Porter 2007) but with the mounting number of cases, judges fortunately are becoming stricter.

Sixth, as noted above, servicers have contributed to this problem by providing dubious or marginal modifications, charging dubious fees, prematurely foreclosing, destroying checks made by homeowners to service their mortgages, and others illegal actions (which mostly went unpunished) (Porter 2007; Morgenson 2007c). Porter (2007) found unsubstantiated fees and missing documentation about half of the loan examined, and a recent report by the Associated Press shows that the previous problems are quite extended among servicers helped by MHA (Associated Press 2009). In fact, servicers have an incentive not to renegotiate and but rather to hold out for a foreclosure. Indeed, perhaps the real problem is that those same financial institutions that created this mess are preventing resolution because it is far more profitable for them to ride out the collapse as there is a lot of money to be made squeezing debtors under fees and penalties (Goodman 2009b; UBS 2007). Servicers have a financial incentive to impose additional fees on consumers:

Mortgage servicers earn revenue in three major ways. First, they receive a fixed fee for each loan. Typical arrangements pay servicers between .25% and 1.375% of the note principal for each loan. Second, servicers earn “float” income from accrued interest between when consumers pay and when those funds are remitted to investors. Third, servicers often are permitted to retain all, or part, of any default fees, such as late charges, that consumers pay. In this way, a borrower’s default can boost a servicer’s profits. A significant fraction of servicers’ total revenue comes from retained fee income. Because of this structure, servicers’ incentives upon default may not align with investors’ incentives. Servicers have incentives to make it difficult for consumers to cure defaults. [...] Mortgage servicers can exploit consumers’ difficulty in recognizing errors or overcharges by failing to provide comprehensible or complete information. In fact, poor service to consumers can actually maximize servicers’ profits. (Porter 2007: 5-6)

As discussed above, when we destroyed the thrifts in the 1980s, we transitioned to a new “market-based” home finance model that involves independent mortgage brokers, property appraisers, risk raters, title companies, mortgage insurers, credit default swap sellers, mortgage servicers, securitizers, accounting firms, commercial banks, investment banks, and pension funds and other managed money that ultimately hold the securities. In this “originate to distribute” model, almost all concerned live on fee income rather than on the interest and principal payments of homeowners (which service the securities). Of course, this is part of the reason that no one ever bothered to check whether the homeowner would actually be able to make the mortgage payments.

It is also the reason that almost no one in the home finance food chain cares about resolving the home mortgage crisis—it is far more profitable to most concerned parties if the homeowner cannot and does not make any payment. When the homeowner stops

making payments, the mortgage company that services the loan makes the payments that are then distributed to the securities holders. In return, the mortgage company collects its normal servicing fee, plus late fees of 6% of the monthly payment. As the NYT reports, these late fees alone can amount to 12% of the total revenue received by loan servicers. (Of course, it is no different in the video rental business or in the credit card business—late fees are a major source of profits.) It can be in the interest of the mortgage companies that service mortgages to maximize the number of delinquencies as well as the amount of time each household is delinquent.

When a house is finally foreclosed, the mortgage servicer has first claim to the revenue from sale of the house. According to a UBS study, foreclosure can take up to two years (depending on the state and on complications) and total costs—including paying off the servicer—can absorb 90% of the revenue from the home sale. This is why the total losses on home mortgages (borne mostly by the securities holders) are so huge even if home values fall by “only” 30%. These mortgage companies actively interfere to ensure that homeowners are not able to renegotiate terms of mortgages instead of going into foreclosure. According to the New York Times, they prefer a “purgatory—neither taking control of houses and selling them, nor modifying loans to give homeowners a break” (Goodman 2009b). When the foreclosure proceeds, the mortgage companies not only accumulate late fees, but also pay for many other services—often to their own subsidiaries that are paid for title searches, insurance policies, appraisals, and legal findings. That is all recouped with the property sale. This explains why none of the government policies to date have been able to keep people in their homes by negotiating better mortgages. Indeed, even though the government is offering mortgage companies up to \$4000 to modify a loan, they make more money if they drive the owner out of the home. Ideally, they will accumulate claims on the house up to the total market value.

A similar story can be told for other sectors, where the same financial market participants that helped to create the crisis are now hired as contractors to deal with the fall-out. The longer and deeper the crisis, the more money there is to be made.

Hence, to date, most of the efforts oriented toward solving household debt problems have focused on refinancing and modification rather than sustaining/improving income and creditworthiness—and they have failed miserably. In addition to efforts to help the financial sector, plus the small amount of funding offered to help homeowners, the Obama Administration and Congress provided for \$787 billion for stimulus, under American Recovery and Reinvestment Plan (ARRP). Of this approximately \$150 billion was allocated to state and local governments and unemployment benefits, \$250 billion to households (tax cuts and some social spending), and \$200 billion to infrastructure. An alternative minimum income tax “fix” was also included, but congress has been providing this adjustment every year to avoid having more middle class families hit by what was supposed to be a tax on the wealthy.

However, to date, only 6% of the fiscal package has been implemented, with \$50 billion spent through the end of May. Of this nearly half went to state and local governments, mostly to help with Medicaid. The rest went to households, largely for additional Social

Security benefits and unemployment compensation. A total of \$80 billion per quarter should be added until the end of 2010—about 2.25% of GDP. However, first quarter personal income fell at an 8% pace! Hours worked fell by 7% in the second quarter. This would seem to indicate that early numbers on GDP (which had it falling at “only” a 1% pace) will likely be revised downward. We have lost about 7 million jobs (by late summer 2009), while given normal growth of the labor force we should have created about 2.5 million new ones. Hence we are already short 9.5 million jobs in comparison with the start of the downturn; Obama’s promise to create 3 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. Finally, much of the talk in Washington is about the “unsustainable” budget deficits, making it improbable that another stimulus package will be forthcoming. In large part, we believe, this is because the public is furious about the funding of the Wall Street rescue package. In this sense, the financial bail-out has “crowded out” more sensible spending policies.

### **Alternative Policy**

Using arguments very similar to those made by 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 saved by rescuing Wall Street (e.g., Galbraith and Black). In addition, Wray (2009) has provided a detailed set of policies both for the short-run to deal with the crisis, and also for the longer-run to try to build a sustainable economic and financial system. We will not repeat those arguments here. Rather we focus on only two issues: first, how can we stimulate recovery, and second, how can we put finance into its proper role. Here we will only state in the broadest terms what is required. In a subsequent piece we will provide a more detailed agenda.

In our view, most of the current administration proposals are fundamentally misguided because they are based on the twin presumption that big banks face only a liquidity problem, and second that if the big bank liquidity problem can somehow be resolved, the economy is recovered. We believe both views are entirely mistaken. The big bank problem is one of insolvency; further big banks cannot be and should not be saved. They do not hold the key to recovery; if anything, they are a barrier to sustainable recovery. Given a chance, they will try to resurrect the bubble conditions that led to this crisis.

We believe that most major banks are insolvent and cannot (and should not) be saved. We suggest that the best approach is something like a banking holiday for the largest 19 banks and shadow banks in which institutions are closed for a relatively brief period. Supervisors move in to assess problems. It is essential that all big banks be examined during the “holiday” to uncover claims on one another. It is highly likely that supervisors will find that several trillions of dollars of bad assets will turn out to be claims big financial institutions have on one another (that is exactly what was found when AIG was examined—which is why the government bail-out of AIG led to side payments to the big banks and shadow banks). There probably are not “seven degrees of separation”—by taking over and resolving the biggest 19 banks and netting claims, the collateral damage in the form of losses for other banks and shadow banks will be relatively small.

Government lending, guarantees, and purchases of bad assets will be much smaller if we first consolidate the balance sheets of the biggest players, net the assets, and shut down the institutions. This will help to downsize the financial sector and reduce monopoly power. Moving forward, policy should favor small, independent, financial institutions.

In addition, it will be necessary to increase supervision and regulation of the financial sector. It is particularly important to put a stop to the practices that brought on the crisis. As the experience of the early 1930s as well as that of the 1980s tells us, if left alone to deal with the current problems, market mechanisms will push management and owners of insolvent institutions to ramp up losses. The result can be massive deflation, massive bankruptcies, massive destructions of physical assets, and enormous unemployment.<sup>5</sup> This will continue until the debt structure is simplified. In the process, social unrest will grow to the point that the entire socio-economic system will be threatened.

A more effective way to restart the economic process on the solid ground is to deal with the underlying cause of the problem: borrowers cannot meet the required payments. This implies sustaining their income and employment and, if necessary, drastically modifying their debt service burden. The whole boom of the 2000s (and more broadly the growth process that emerged at the in the early 1980s) was based on household borrowing and the continuation of negative saving trends (that is, household deficit spending). A good place to start recovery efforts, therefore, would be to change this method of economic growth. There are two key ways to do that.

First, a household's main source of income is its employment, which itself is heavily tied to the state of the economy. Policy can "decouple" this link to some degree through creation of counter-cyclical government employment programs. There are plenty of non-profitable, even though crucial, economic activities that require labor (from massive infrastructure programs to social services). CCC, WPA, and other programs of the New Deal employed millions of people, creating jobs very rapidly in extremely useful projects. In its first six years, the WPA spent \$11 billion, three-quarters of that on construction and conservation projects and the remainder on community service programs. During that time, WPA employed about 8 million workers. The Civilian Conservation Corps (CCC) put approximately 2.75 million unemployed young men to work to reclaim government land and forests through irrigation, soil enrichment, pest control, tree planting, fire prevention and other conservation projects. Workers earned a dollar a day, and had to send part of their wages home to their families. Through the National Youth Administration (NYA) the government made it possible for 1.5 million high school students and 600,000 college students to continue their education by providing them with part-time jobs to meet their expenses.

By the end of 1934, more than 20 million Americans (one out of six!) were receiving jobs or public assistance of one form or another from the "Welfare State". During the Great Depression, "the government hired about 60 per cent of the unemployed in public works

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<sup>5</sup> From 1929 to 1931, those deflationary market mechanisms were reinforced by recessive fiscal and monetary policies on the principle that government should get out of the way. In addition, fiscal and monetary policies were tied by the need to maintain the exchange rate between the dollar and gold.

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 2008: 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 future Senator Douglas (Auerback 2008; National Resources Planning Board 1942: 342-343, notes 4, 5, 8).

In addition to the job losses discussed above, the US has had a chronic shortage of jobs so that many potential workers (especially males with low educational attainment) have left the labor force. There are also many millions of workers were forced to work part-time even before the crisis because they could not find a full time job. Currently, the number of people lacking a steady full-time job is about 26 million and this number is rising rapidly as shown in Figure 8. Government employment programs would resolve automatically these kinds of unemployment—providing jobs for those left behind in good economic times, and also for those who lose jobs in a downturn. In an upswing, the private sector would hire workers out of the government program. This will also further strengthen the automatic stabilizer effect of government intervention since spending on the program would be counter-cyclical.

Figure 8 here

The employment programs would be permanent programs rather than just available during a crisis (10 to 15 million people are left behind even during the best of times). In addition, they could pay a living wage tied to productivity gains, which would help to restore the purchasing power of households that has been eroded by 35 years of stagnant real wages. This would put the growth process back on sound financial grounds—with consumption growing as real wages grow (in line with productivity to avoid fueling inflation). This readily availability of employment is today all the more urgent that desperate unemployed are falling for employment scams that promise help, or even home work, for a large upfront fee (Richmond 2009).

However, guaranteeing access to employment will not be enough to deal with the current crisis. Indeed, following decades of growing debt, households have accumulated debt well beyond their means, and even if employment programs are put in place, they will pay on average a lower wage than what many jobless households used to earn. Given that many households could not service their debt with their previous income, providing them employment (at a wage that could be below their previous wage) will only provide some relief from their debt problem. We, therefore, need a massive modification of loans and possibility bankruptcy (which must be made simpler and less costly). Some economists, remembering that this was done in the past, have suggested a debt jubilee; credit card

companies have already begun to go down this road (Streitfeld 2009) and more could be done here. The government could provide incentives to encourage more financial companies to go down this path.

If borrowers can meet their payments, lenders will receive their funds and will return to profitability; in turn, some of the securitization processes will be revived. Of course, many banks are no longer used to making most of their money from interest payments, but it may be time to return toward a less trade-and-fee driven financial sector. That would mean further reform in the financial system along these lines—something that is not the way taken by the 2009 Department of Treasury Report on financial reform, which is mostly a copy of the 2008 Paulson’s Report. We will not go into details in this piece—Tymoigne (2009b) provides a detailed critique of the recent proposals for financial reform—but what is needed is to move back in the direction of term lending by regulated financial institutions that hold loans, restoring the incentive to engage in proper underwriting.<sup>6</sup>

One specific problem with the current crisis is that it involves highly desirable long-term physical assets: homes. Traditionally, dealing with debt problems may involve a liquidation of assets of borrowers, possibly for their scrap value, as well as a destruction of assets. Given the high desirability of homes, rather than bulldozing them, an alternative method of dealing with excess supply should be sought. Several economists (e.g., Mosler and Baker) have already provided one solution to this problem. The government would simplify the foreclosure process and stand ready to buy the homes of distressed mortgagors at the lesser of current market value or the value of the mortgage. It would allow the homeowner to lease the home at a fair market rental price, with an option to buy it back after two years at the then prevailing market rate. This would not only help to deal with the excess supply of homes (and so put a floor under home prices), but also would help to restructure the finances of households while allowing them to remain in their homes. A small step in this direction was recently proposed but we need to go further and faster.

We, therefore, need a significant modification of principal and interest owed so that debt servicing becomes possible through the normal source of funding of homeowners—that is, income—for *the length of the loan* (meaning no balloon payment, no teaser payment, etc.). The amount owed should also be modified to account for the large negative equity held by some homeowners. We also need to make bankruptcy simpler and less costly. In addition, modifications should not assume that a home sale will be a normal means to service the mortgage in any way in the future.

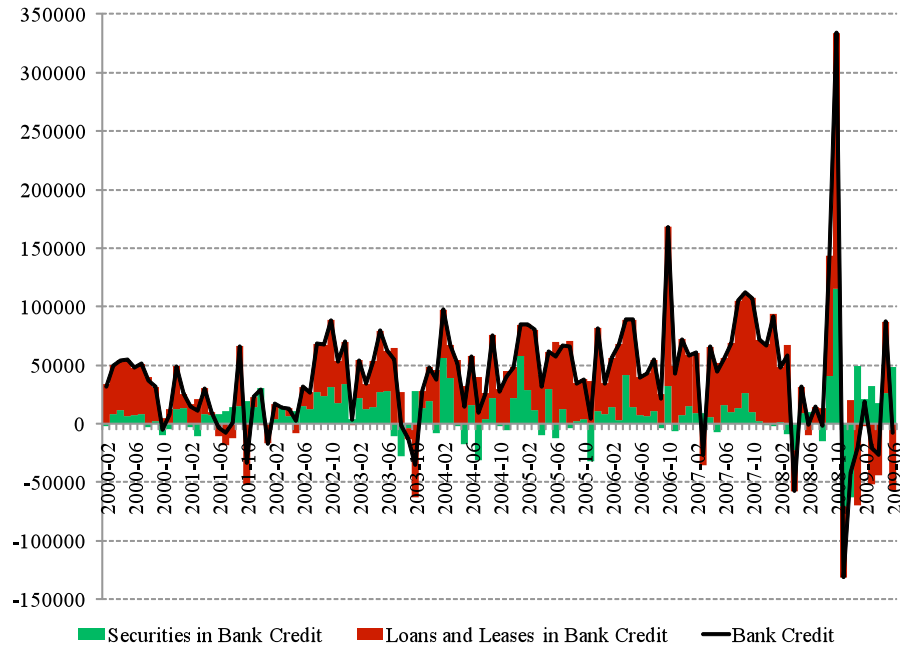
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<sup>6</sup> Recent proposals to make the Federal Reserve the main regulator of financial stability are also misplaced. This is especially so that the task would be mainly given to economists (who mostly believe in the neutrality of money and have a poor understanding of finance and accounting issues), and given the poor track record of the Fed in terms of handling financial stability issues. Substantial modifications to the Fed structure and its framework of analysis would have to be implemented before it may become an effective financial stability regulator (Tymoigne 2009a).

If a modification is done by lowering monthly payments by 20% or more, data shows that the redefault rate is significantly lower, with a 60+ day delinquency of 37.6% after 12 months instead of the 58.8% delinquency rate that is common when a modification does not entail any change in debt payment (OCC and OTS 2009: 32). However, as even the lower delinquency rate shows, the current payment modifications do not go far enough and may include future balloon payments or other cost hikes in the future. In addition, all (prime and non-prime) mortgages that have unsustainable terms (in the sense that income alone is expected to be too low to meet debt payments) must be modified even if borrowers are not currently delinquent.

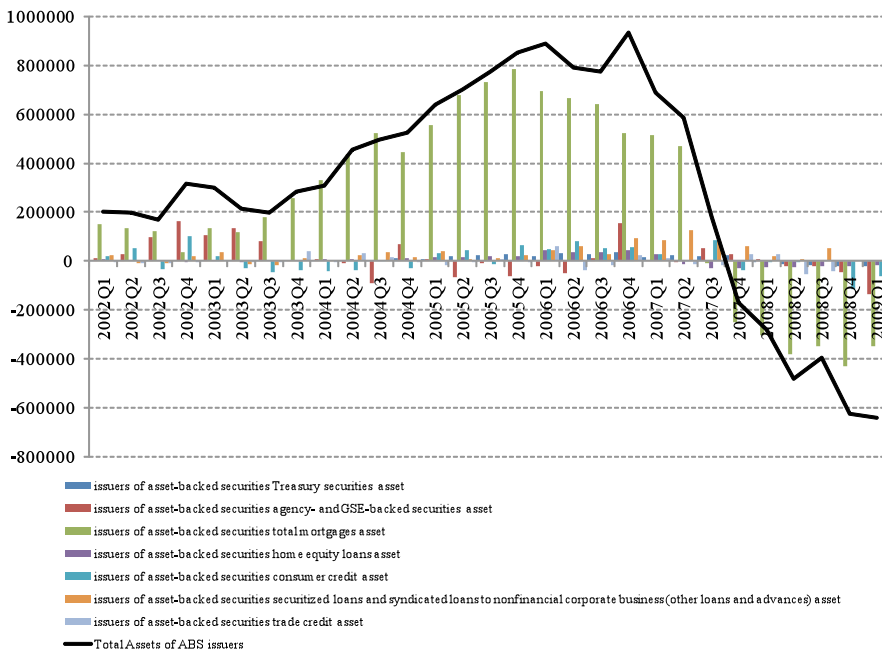
All this will certainly require a major increase in government spending, but this is the only way deleveraging will be able to occur in a smooth manner. In addition, new money may not necessarily have to be committed; rather, part of the \$20+ trillion committed to help the financial sector could be reallocated to finance the programs above. In any case, the budget deficit is really a red herring, as sovereign government can always afford to buy anything that is for sale—whether that is unemployed labor, real estate, or bad financial assets. And it is not clear that the spending outlined above will actually increase the budget deficit, which is already exceeding \$1 trillion per year *before the stimulus package has kicked-in*. This is because a budget deficit is mostly endogenously determined. There are two ways to obtain large budget deficits: the “ugly” way and the “virtuous” way. We have mostly used the ugly way—much as Japan did during its “lost decade”—by destruction of tax revenue caused by a collapsing private sector. The other way is through much more aggressive fiscal stimulus—which would then turn around the private sector and begin to produce more tax revenue so that the large deficits would be short-lived. If we continue down the “ugly” path, such that robust recovery does not begin for many years, we will have large budget deficits for many years to come. While that does not worry us (in the sense that this cannot generate insolvency of our sovereign government) the outcome in terms of job losses and real suffering of the population does. Far better to spend now on a much bigger scale in order to create jobs and get the private sector growing again. If we do that, the budget deficit will begin to shrink, GDP will grow, and measures of government debt and deficit to GDP will fall. This will allow all the deficit “chicken-littles” to find something else to worry about.

Figure 1. Bank Credit at all US Commercial Banks (Millions of Dollars)



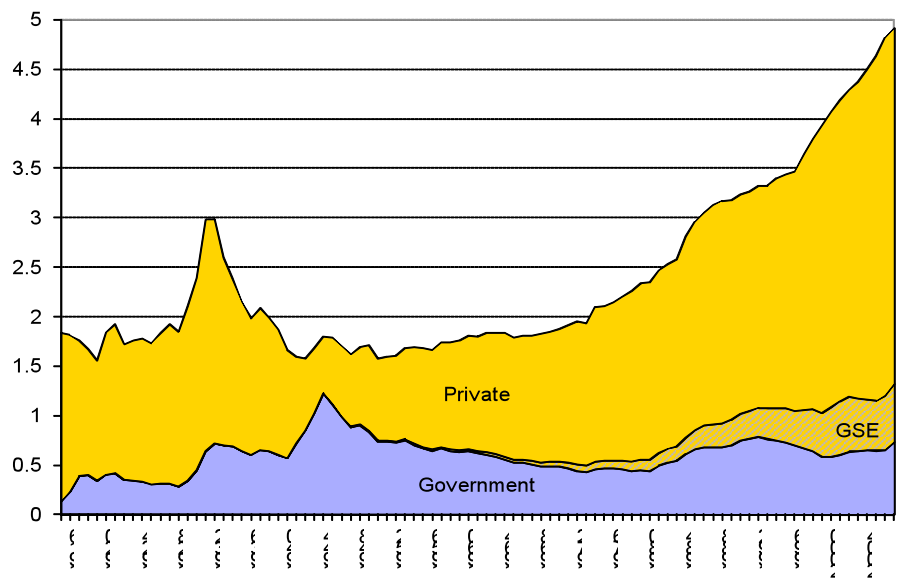
Source: Federal Reserve (Series H.8)

Figure 2. Change in the Assets of Asset Backed Securities Issuers (Millions of Dollars)



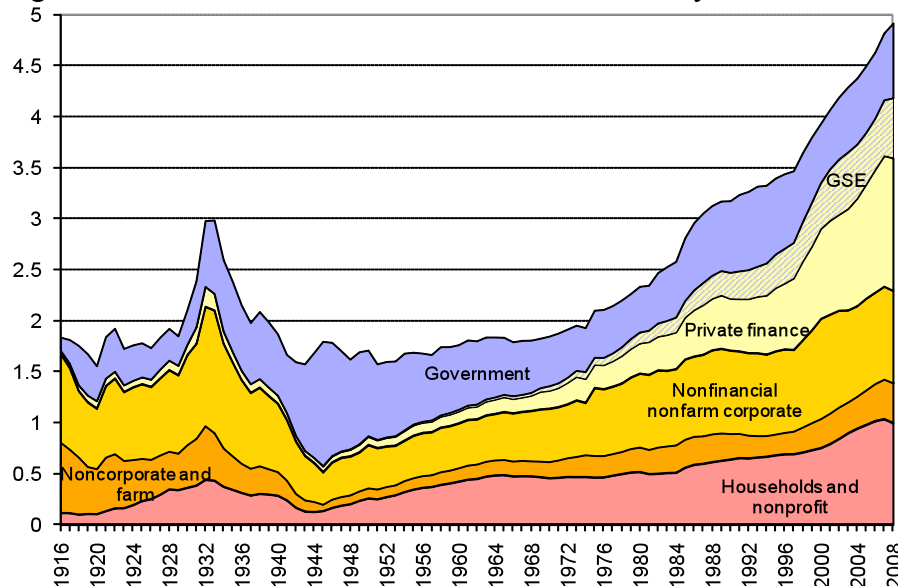
Source: Federal Reserve (Series Z.1)

Figure 3. Total Financial Liabilities Relative to GDP



Sources: *Historical Statistics of the United States: Millennium Edition* (Tables Cj870-889 and Ca9-19), NIPA, Flow of Funds (from 1945).  
 Note: Prior to 1945, net public and net private debts are used (as defined by Census Bureau). From 1945, Census data is replicated by using data about total financial liabilities provided by the Flow of Funds accounts. Data for net public debt is approximated by taking total financial liabilities for each level of government and by removing any monetary, life insurance, and pension liabilities (the government sector excludes monetary authorities). Private debt is computed by starting from "total finance total financial liabilities" and "domestic nonfinancial sectors total financial liabilities" and by removing some items to get as close as possible to the definition used by the Census Bureau (which excludes monetary instruments and other liabilities of financial institutions).

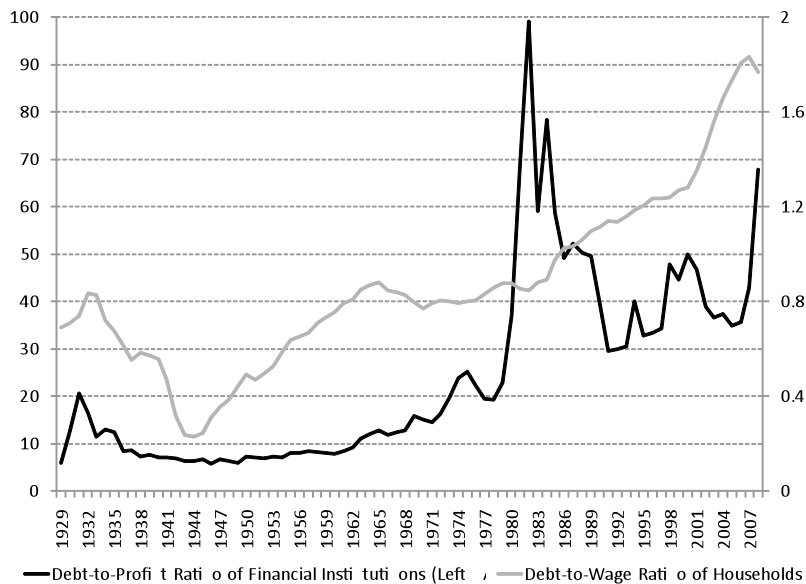
Figure 4: Total Financial Liabilities relative to GDP by Sector



Sources: *Historical Statistics of the United States: Millennium Edition* (Tables Ca9-19, Ce42-68, Cj265-272, Cj362-374, Cj389-397, Cj437-447, Cj748-750, Cj751-765, Cj787-796, and Cj870-889), *Historical Statistics of the United States: Colonial Times to 1970* (Series X 689-697), NIPA, Flow of Funds (from 1945).

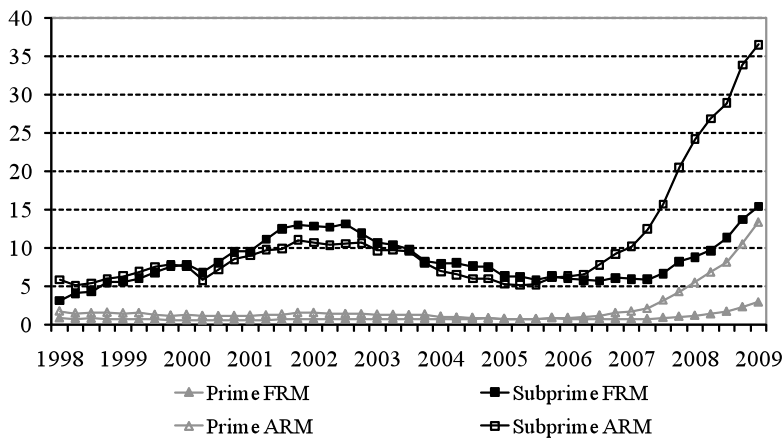
Note: The government sector excludes all financial activities of the government (retirement funds, GNMA, etc.). GSE sector includes government-sponsored enterprises and agency- and GSE-backed mortgage pools (includes, among others, GNMA and FHA pools). "Private finance" excludes the GSE sector and monetary authorities (which are both part of the financial sector in the Flow of Funds accounts). Before 1945, data for financial institutions is computed from data of the Census Bureau by taking all the liabilities (excluding equity) of commercial banks, credit unions, savings institutions, life insurance stock companies, and property and life insurance companies, and by removing private banks notes, all monetary deposits, and life insurance reserves. Data for the households and noncorporate sectors is deduced from Census Bureau data about net increase in liabilities and by computing backward from the 1945 level provided by the Flow of Funds accounts. From 1945, the total financial liabilities of the financial sector excludes, net interbank liabilities of commercial banks, liabilities of monetary authorities, private and public pension fund reserves, money market mutual funds shares, mutual funds shares and the items previously cited. The liabilities of monetary authorities are not included anywhere.

Figure 5. Households and Financial Sector Debt Relative to their Respective Income.



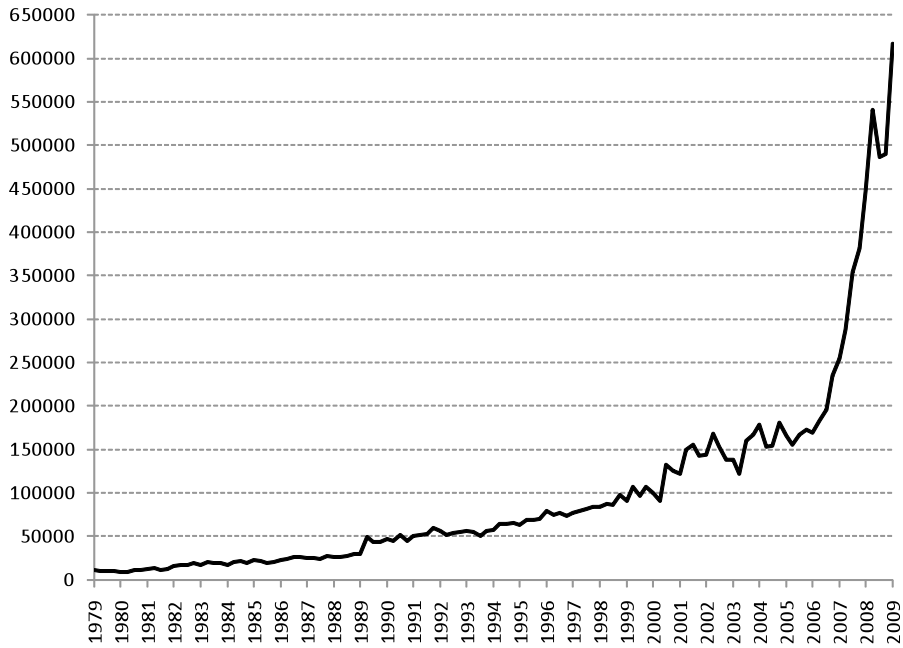
Sources: BEA, *Historical Statistics of the United States: Millennium Edition*, Flow of Funds.

Figure 6. Serious Delinquency among Mortgagors.



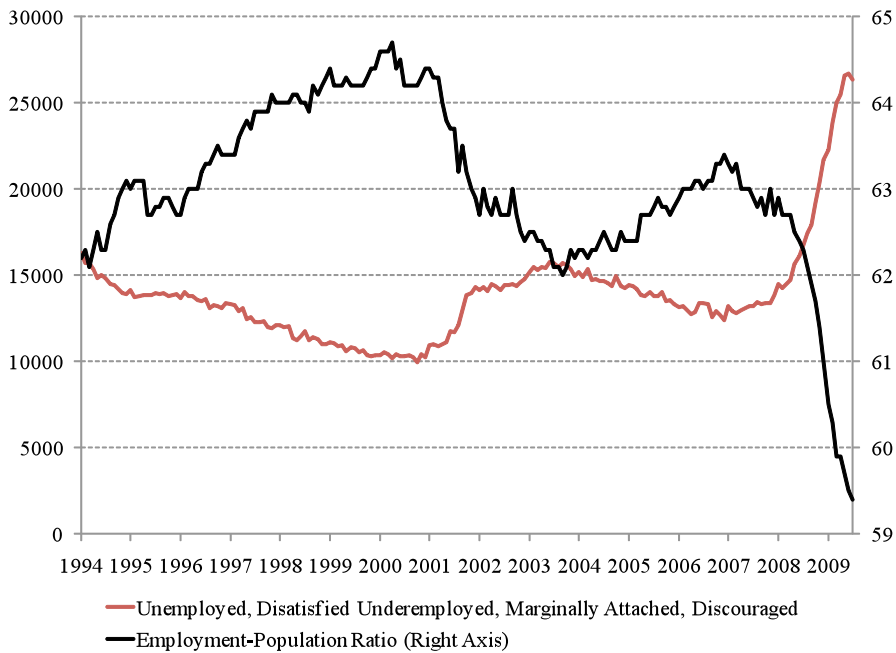
Source: Mortgage Banker Association.

Figure 7. Number of Foreclosure Started



Source: Mortgage Bankers Association.

Figure 8. Unemployment, Employed Part Time for Economic Reasons, and Marginally Attached Individuals (in Thousands).



Source: BLS.

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