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February 23, 2009

To: Mark Wetjen, Office of the U.S. Senate Majority Leader

From: Elliott Parker, Professor of Economics

RE: Financial Crisis Proposals

I appreciated the chance to meet with you and several of my colleagues in the Department of Economics to discuss possible options for dealing with the current U.S. financial crisis. Though I think of myself as a Democrat, I believe that good ideas are not the monopoly of either party, and possible solutions can come from any source even if party affiliation affects how elected officials ultimately vote. Thus, it was good that you welcomed the views of those on both the left and the right.

In a recession, people cut back their consumption and investment spending, and a vicious cycle emerges as others are forced to cut back their own spending. For those who voluntarily choose to cut back spending, there is little we can do other than wait for economic prospects to improve. But there are many who are forced to cut back their spending because they cannot get access to credit, at least not at a reasonable price. This includes not only firms in need of functioning capital markets, but also households facing foreclosure and states with unexpectedly sharp drops in tax revenue.

It is important also to distinguish between insolvency and a cash-flow problem, between long-run and short-run benefits. Propping up firms that will ultimately fail anyway is bad public policy in the long-run, though in the short-run it may help ameliorate the recession. Helping potentially solvent firms survive without doing too much damage to their future prospects is good policy in both the short-run and long-run, if one can find the wisdom to tell them apart.

Homeowners are similarly affected. Most homeowners are still working and paying their mortgages, even if their mortgage is upside-down. Some bought houses they never could afford, on either speculation or bad advice; for most of these people foreclosure has already occurred, and for the rest it may be the best social outcome to punish them and their lenders. Many people, however, made decisions which seemed prudent at the time, but with declining housing prices and a weakening job market, some of these people find it harder and harder to stay in their houses and believe things will improve. Allowing these people to go into foreclosure will only make things worse by pushing down home prices even more, further reducing the value of mortgage-backed securities and related derivatives, worsening confidence and deepening the recession.

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While the federal government can do much, state and local governments can actually be much larger in their impact. Over the past two years, total government expenditures has averaged about \$4.8 trillion, about a third of our GDP, and the federal government accounted for more than half of this spending. If we exclude transfer payments like Social Security and Medicare, however, total government purchases averaged only \$2.8 trillion per year. This was only a fifth of GDP, but most importantly, the federal government accounted for only 37% of these purchases, most of it in national defense. What government produces through its own employees was even lower, only \$1.6 trillion, less than an eighth of our GDP, and the federal share was only 31% of it. Thus, when state and local governments are forced to cut back their purchases and production, this can more than offset any efforts by the federal government to increase spending.

In addition to the many components of the stimulus bill signed by President Obama last Tuesday, the housing bill he proposed on Wednesday, and the changes in the Treasury's bank bailout announced subsequently, I have another suggestion which I think may help.

I would like to suggest that the federal government use its access to the capital market and its low risk premium to guarantee loans to states and households. These loans could be made through the private banking sector, and be required to meet certain eligibility conditions. But most important, the federal government could convert any default into a tax obligation (for individuals) or a deduction from future matching grants (for states). These could be made available to firms as well, though limited liability might make it harder for the federal government to collect in case of default.

States could then borrow against future federal transfers at a low rate of interest in order to cover temporary revenue shortfalls. Individuals who are otherwise unable to get access to mortgage refinancing could then borrow against future taxes to stay in their homes. Banks would be able to have a safe way to make loans, rather than simply accumulating reserves against other bad debts. Borrowers would not borrow unless they believed they would be able to repay. Other taxpayers would not have to pay for any defaults, and the federal government would already have an institution in place that was able to collect revenue.