

TIME FOR A NEW “NEW DEAL”

By Marshall Auerback

As the current financial crisis has unfolded, Franklin D. Roosevelt has been frequently mentioned, both for his talent at rallying and reassuring the nation in crisis as well as for the economic policies he used to lead the country out of the Great Depression. In spite of recent attempts by diehard libertarian economists, particularly those of the Austrian school, to denigrate his economic achievements, we confess to having a soft spot for the New Deal--that remarkable moment that gives the lie to all of today's fashionable sneers about the impossibility of effective financial regulation and fiscal policy activism. In fact, we feel that the incoming administration of Barack Obama would do well to embrace FDR's economic legacy completely and introduce a new “New Deal” as the cornerstone of his economic policy as soon as possible. Is President-elect Obama another Franklin Roosevelt, ready to embark on a radical remaking of the country's political and social fabric?

We hope so. There is no shortage of places in which to invest: extended unemployment insurance, state fiscal relief, increased food stamp programs, and large scale infrastructure. No question, there will be more debt, lots and lots of it. That will have some tough consequences down the road, but the alternative is far worse: years of double digit unemployment, increased financial fragility, massive bankruptcy and epidemic foreclosures.

By the time Obama takes his oath in January 2009, he will face an economy which is still in a middle of a severe and prolonged recession where households will continue to face unaffordable mortgage and other debt, declining value of homes (that financed their consumption all these years), risk of debt default or foreclosure, tight access to credit with stringent borrowing conditions, erosion of their retirement savings amid a crashing stock market, lay-offs which may well take the unemployment rate to 7-8% and critical foreign policy challenges.

Therefore, immediate challenges for Obama will include cushioning the consumers (who account for over two thirds of GDP) from the economic slowdown by means of a large fiscal stimulus package and acting on a government guaranteed mortgage modification program.. In fact, he has also called for a fiscal stimulus in the form of grants for state and local governments, infrastructure spending to create jobs, scrap tax on unemployment insurance, tax cuts for lower income-groups and small businesses, tax credits for firms that create jobs and government aid for the ailing auto industry. Some of the tax cuts would be financed by taxing the windfall profits of oil companies. A financial transactions tax might be another component. Part of his program would allow households to draw up to \$10,000 from retirement funds during 2008-09 without any tax penalty. Obama also called for a ninety-day moratorium on foreclosures, modification of bankruptcy laws, a \$10 billion foreclosure-prevention fund and 10% mortgage tax credit for the middle-class. But more importantly he has emphasized preventing taxpayer funded bailout of banks and giving golden parachutes to CEOs of failing institutions. He has also strongly endorsed greater financial re-regulation (Glass-Steagall II?), control and reporting with the creation of a financial market oversight commission to oversee liquidity, capital and disclosure requirements and plans to streamlining regulatory agencies to prevent overlap and assign greater role to the Securities and Exchange Commission (SEC) to prevent market manipulation and to the Federal Reserve to carry out regulation.

As far as monetary policy goes, there appears little doubt today that Federal Reserve Chairman Ben Bernanke has internalized the lessons of the Great Depression and taken a huge number of measures (in the words of his famous November 2002 speech, “Deflation: Making Sure ‘It’ Doesn’t Happen Here”,) “*to prevent significant deflation in the United States and, moreover, that the U.S. central bank, in cooperation with other parts of the government as needed, has sufficient policy instruments to ensure that any deflation that might occur would be both mild and brief*”. Consequently, focus must surely revert to fiscal policy. It is time to take a page out of the history books and in the spirit of FDR’s great experimentation, do fiscal policy in a major way and expand budget deficits beyond what all but the most die-hard Keynesian economists have hitherto envisaged.

One advantage we have over the folks of 1930: we know this song. The gross policy errors made during the 1930’s — such as raising taxes and trade barriers — are far less likely today. And the landslide victory of Barack Obama and the corresponding gains of the Democrats in Congress ensure less visceral opposition to a major role for government going forward. Fiscal policy has been virtually absent from the US government’s policy arsenal for almost a generation, in part inhibited by a perception that the state’s sole role should be to protect property rights and ensure the supply of public goods, but not impart directional thrust. More specifically, the state should create and sustain (a) efficient, rent-free markets, (b) efficient, corruption-free public sectors able to supervise the delivery of a narrow set of inherently public services, and (c) decentralized arrangements of participatory democracy.

The propensity to do fiscal policy on a broad scale has also been affected by a historical revisionism now at the heart of FDR’s original New Deal, the essence of which is that his fiscal policy activism achieved little of lasting economic benefit and that it was only the advent of World War II which finally took America out of the malaise of the Great Depression. This is factually incorrect and self-serving to the degree that it has been used over the past 30 years to justify a minimal role for government and to support the neo-liberal drive to deregulate everything en masse and virtually eliminate any kind of valuable role for fiscal policy in the interests of market fundamentalism. There is in fact much evidence to support the contrary, as the following paper will illustrate.

As far as monetary policy goes, the measures taken in aggregate thus far by the Federal Reserve, and the other major central banks of the global economy, are likely to avert a systemic financial crisis. Not only is the Fed doing all it can to ensure that deflation “doesn’t happen here”, but the Fed is also acting as a global lender of last resort by offering virtually unlimited dollars to the ECB, the Swiss central bank, the BoE, the South Korean central bank, as well as the Mexican and Brazilian central banks.

Needless to say, this may not good for the U.S. dollar’s value over the long-term, although this longer term prognosis is certainly being masked today by a significant one-off deleveraging phenomenon whereby people scramble to obtain dollars in order to repay dollar denominated debt. In such circumstances, the Fed really had no choice. All of these central banks need the money for their domestic financial institutions. So rather than leave these banks at the mercy of the global credit markets, Ben Bernanke and company have stepped in and given the money to the local central banks who then help these companies by loaning them the dollars to roll over their debt or by helping them get out of dollars and into their own currency.

At this point, however, repairing the financial system will not stop a severe worldwide recession. All the "Comrade Paulson" jokes should at least be good for a decent respite from Market

Fundamentalism--the notion that unregulated markets automatically give you full employment and economic stability. Right now every individual financial institution is deleveraging--that is, reducing its use of borrowed money--at a terrifying pace. Financial houses are trying to recapitalize themselves by gouging depositors, borrowers, investors and credit card holders. As a group, they cannot succeed. They are collectively digging themselves into a black hole in which the gain of one is the loss of another, unless somebody from outside puts in new money.

The most recent economic data has been horrible. Sales of cars and light trucks have sunk to their lowest level in 30 years last month. The ISM index plunged in October to the deep recessionary level of 38.9 where 50 is seen as the level separating expansion from recession. Just two months ago, the index was at 50, where it has hovered since September 2007. However, since July the situation for manufacturing in the United States has deteriorated rapidly. Retail sales were abysmal, indicating a significant contraction in real PCE may be underway. Consumer spending last month was weakest since June 2004, further underscoring the precarious state of the economy. Single family housing starts fell to an unimaginably low 577,000 annual rate. Most disturbing perhaps was a record decline in the Michigan consumer confidence index to again an unimaginably low 54 despite a sharp drop in the gasoline price which tends to buoy this reading.

The fear is that the financial crisis may have set off a consumer contraction similar to that of the first half of 1980. Then a 20% peak fed funds rate and a call for curbs on consumer use of credit cards led to a drastic fall in real GDP at a 10% annual rate in the second quarter - the most severe in the post war period. In this instance the policy rate has been low but the credit crisis is so severe that there is quantity credit rationing to consumers and firms that exceeds that of early 1980. In addition, consumer net wealth has probably now fallen more in percentage terms than at any time in us history, even 1929. Typically equity and home prices do not crash together and that was the case in 1929 when home prices gave ground slowly.

It is also worth noting that in this instance the U.S. household sector ex fiscal stimulus checks has been close to zero and the household sector has remained dependent on credit flows to finance a current deficit. In all the other instances of a crash cited above the household saving rate was respectable. Econometric exercises relating changes in wealth to the household saving rate call for an ex ante rise in the saving rate and a corresponding fall in consumer spending that exceeds anything in any prior recorded business cycle. Of course, the consumer has behaved ahistorically for many years now, and that may not suddenly change. The U.S. imports half of its consumer goods so much of any contraction in consumer demand will not affect domestic production as much as it did in prior cycles. But the possibility of a second quarter 1980 contraction is very real.

The economy is taking a big hit for an incredibly simple reason. Homeowners have lost an enormous amount of equity and therefore they are cutting back their consumption. When they cut back their consumption, companies lose business and profits. Some go out of business. This will lead to sharp declines in investment, which we have already been seeing. Given these circumstances, the US consumer can no longer serve as the traditional motor of the global economy, that "somebody else" must be the US government. The only cure will be finding alternative sources of demand. In the short-term, government is the entity required to take the place of retrenching consumers. That means a major fiscal stimulus.

In 1933, there was great disagreement about how to deal with an economic recession or depression, and Roosevelt's administration, and he himself, had conflicting impulses. Herbert

Hoover had made the worst possible selection of policy options: higher taxes and tariffs and a shrunken money supply. The unemployment rate was 33 per cent, about five times what it is now, and there was no direct relief for the unemployed. They could beg, steal or starve, though Hoover claimed that they prospered selling apples.

On Inauguration Day, 1933 (then March 4), there were machine-gun nests at the corners of the great government buildings in Washington, for the only time since the Civil War. All banks in 32 states had been closed *sine die*. Six other states had closed almost all their banks. In the other 10 states and D.C., withdrawals were limited to 5 per cent of deposits, and in Texas to \$10 a day. The New York Stock Exchange and Chicago commodity exchanges had also been closed indefinitely. The financial system had effectively collapsed, and was threatening to take the life savings of millions of people and what was left of the world's financial system with it.

In a fever of activity, Roosevelt guaranteed bank deposits, made the federal government a temporary non-voting preferred shareholder in thousands of suddenly under-capitalized banks – more than half the banks in the country – refinanced millions of residential and farm mortgages, tolerated cartels and collective bargaining to raise prices and wages, increased the money supply, effectively departed the gold standard, repealed Prohibition of alcoholic beverages (wrenching one of America's largest industries out of the hands of the underworld), and legislated reduced working hours and improved working conditions for the whole work force. In the next two years, in what became known as the Second New Deal, he set up the Securities and Exchange Commission, created the Social Security system, and broadened the powers of the Federal Reserve to equal those of other national central banks.

The Hoover agricultural policy had been to dump surpluses abroad, lend foreign governments the money to buy them, and then pursue them aggressively when the debtor countries defaulted. Roosevelt had farmers vote, by category of what they produced, on agreed production cutbacks, assuring sustainable agricultural prices, and compensated farmers for the production they had curtailed. The more extreme supply-side revisionists now claim that Roosevelt should not have stabilized food prices and financed, through public works projects, flood and drought control and rural electrification, because it would have been better to starve these people off the land and to the cities, where, a generation or more later, they would have had higher standards of living. This is the logic of the so-called Austrian School of Economics, taken to its logical and perverse extreme.

Apart from the fact that the resulting human misery would have been morally and politically unacceptable in the U.S., the already militant farm unions would have disrupted the nation's food supply. This policy would have put Roosevelt in the same general category of agrarian reform as Stalin and Mao.

The key to evaluating Roosevelt's performance in combating the Depression is the statistical treatment of many millions of unemployed engaged in his massive workfare programs. The government hired about 60 per cent of the unemployed in public works 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.

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.

Even pro-Roosevelt historians such as William Leuchtenburg and Doris Kearns Goodwin have meekly accepted that the millions of people in the New Deal workfare programs were unemployed, while comparable millions of Germans and Japanese, and eventually French and British, who were dragooned into the armed forces and defense production industries in the mid- and late 1930s, were considered to be employed.

This made the Roosevelt administration's economic performance appear uncompetitive, but it is fairer to argue that the people employed in government public works and conservation programs were just as authentically (and much more usefully) employed as draftees in what became garrison states, while Roosevelt was rebuilding America at a historic bargain cost.

If these workfare Americans are considered to be unemployed, the Roosevelt administration reduced unemployment from 33 per cent in 1933 to 13 per cent in 1936, to less than 10 per cent at the end of 1940, to less than 1 per cent a year later when the U.S. was plunged into the Second World War. If the federal workfare employees are accepted as employed, the corresponding numbers are 33 per cent, 7 per cent, 3 per cent and 0.5 per cent. Virtually all the genuinely unemployed received basic social benefit payments from 1935 on.

There were five successive New Deals. After the emergency measures of the first 100 days and the Second New Deal (1935-36), which included industrial relations and utilities industry changes, and some entirely political tax increases to stave off Huey Long and other economic extremists, came a period of relative inertia and reduction of welfare spending to test traditional capitalist theory, which provoked what Republicans tried to promote as a Roosevelt Recession. In reality what occurred was that Roosevelt deficit spending during his first term led to an improving economy but a growing government debt. Many economists argued that if the debt /GNP ratio reached 25% the economy would be bankrupted.

Consequently to win re-election, the alternative of cutting spending was part of Roosevelt's reelection campaign of 1936 --and the President did cut spending for fiscal 1937 drastically. In the first 9 months of 1937 the economy tanked and reached levels close to those in the bottom of the Great Depression. But by fiscal 1938 this fiscal conservatism was out the window and with WPA, PWA, etc the economy recovered and then as war threatened, and preparations for war caused even greater spending the economy closed in on full employment.

The Third New Deal in 1938 produced a massive return to workfare programs, which resumed economic progress. The Fourth New Deal was the greatest defense build-up in history, starting in 1939, including the first peacetime draft in the midst of the 1940 election campaign.

So it is fundamentally incorrect to argue that FDR's New Deal did nothing and that only the Second World War actually got the American economy out of the Great Depression. Such historical revisionism has been made popular during the past 25 years by a cadre of ideologically motivated economists and historians keen to debunk the effectiveness of Keynesian economics in favor of the neo-liberal market fundamentalist Washington Consensus.

So what form should a new 'New Deal' take today? As in FDR's era, this time the stimulus should also take the form of actual government spending rather than rebate checks that consumers probably wouldn't spend. Virtually everybody agrees that America's national infrastructure is a

mess and a large degree of public works expenditure should be focused on infrastructure renewal. Beyond that the main operating principle should be that fiscal stimulus is channeled towards basic consumption by those facing hardship (e.g. unemployment benefits, food stamps, etc.). In any reasonable future, everybody will eat, so offering money to those struggling to put food on their table or a roof over their heads will create less uncertainty about future tradeoffs than subsidizing discretionary consumption by those better off. It may be a cliché, but a true cliché nonetheless, that our public infrastructure is crumbling. Pulling forward restoration projects that will be necessary unless there are radical changes in the structure of American life also introduces relatively little noise.

As anybody who has taken intermediate macro knows, in a Keynesian framework (arguably the relevant one when there are underutilized resources in the economy, i.e., when the aggregate supply curve is pretty flat), a dollar's worth of expenditures on *goods and services* yields a larger multiplier than that on transfers or tax cuts. This suggests that supporting already planned investment in infrastructure -- by states and municipalities that are currently liquidity constrained, and squeezed by declining tax revenues -- would be a more effective way of supporting aggregate demand than tax cuts (state and local balance on a NIPA basis has decreased by about 1 ppt of GDP since 2006Q1, suggesting that there will be further compression in state and local spending as the balanced budget requirements, credit constraints, and declining tax receipts collide). That suggests aid to states as a means of *fast* spending (the argument against discretionary). The following measures rank highly according to the criteria for good stimulus:

- *Strengthened unemployment insurance.* As discussed, temporary increases in unemployment insurance benefits are a particularly effective form of economic stimulus. The benefits go to workers who have lost their jobs and suffered a temporary decline in their income relative to their normal expenditures. As a result, the added income is likely to be spent quickly. Analysis by economists Alan Auerbach and Daniel Feenberg concluded that per dollar of cost, the automatic stabilizer effects of the increase in unemployment insurance payments that occurs in a downturn are at least eight times as large as the effects of the reduction in tax collections that occurs.

A fiscal stimulus package accordingly should include a temporary measure to provide additional weeks of federally funded UI benefits for workers who exhaust their regular UI benefits before they can find work. Additional weeks of UI benefits have been provided in every recession in recent decades, and the case for them will be especially strong if a new recession sets in. The percentage of unemployed workers who have remained without a job for more than 26 weeks (the normal duration for regular unemployment benefits) and continue to search for work -- a group sometimes referred to as the "long-term unemployed" -- has remained stubbornly high and is considerably higher now than it was at the start of the last recession (17.5 percent in December 2007, compared with 11.1 percent in March 2001). In addition, UI benefit levels are quite low in many states, so a temporary increase in the weekly benefit amounts also would warrant consideration.

In addition, Congress should take long-overdue action to address weaknesses in the UI program itself. UI coverage has eroded in recent decades, and only 37 percent of unemployed workers now receive unemployment benefits. The design of the UI program dates in substantial part from the 1930s; many low-income and part-time workers who are laid off do not qualify for UI benefits because of outmoded rules that do not reflect today's workplace. (This is a particular problem for low-income women who lose their

jobs.) In the mid-1990s, the congressionally chartered, bipartisan Advisory Commission on Unemployment Insurance recommended measures to remedy this problem, but Congress never acted on them.

In October 2007, the House finally passed UI reform provisions that reflect several key commission recommendations and would provide states with incentives to modernize their UI systems so more female, low-income, and part-time workers who lose their jobs through no fault of their own can qualify for benefits. (The measure is fully paid for through a renewal of the federal unemployment insurance surtax, a step that President Bush called for in his last budget.) If the Senate were to act expeditiously on these provisions or similar legislation in January, these reforms would be in place to strengthen UI's automatic stabilizer role in the next recession, whenever that occurs. But if rapid Senate action on that legislation is not forthcoming, this problem could be addressed on a temporary basis as part of a stimulus package.

- *State fiscal relief.* As noted, temporary federal fiscal relief reduces the need for states to enact tax increases and spending cuts in a recession. A temporary increase in the federal Medicaid matching rate (to help states avert cutting Medicaid coverage) is one effective component of such relief, along with the provision of general fiscal relief to states. In addition, in light of the growing pressures on local governments from declining property tax revenues, fiscal relief should be designed to encourage states to temporarily increase assistance to local governments, rather than to cut back such aid, as states often do in economic downturns to help balance their budgets. In short, as in 2003, temporary fiscal relief to states could include a combination of general aid and Medicaid-specific relief. University of Texas economist Jamie Galbraith has suggested re-enacting Richard Nixon's idea of federal revenue sharing. States and localities should get the funds to plug their revenue gaps and maintain real public spending, per capita, for the next three to five years.
- *Uniform tax refunds.* Tax cuts can provide effective economic stimulus, if, but only if, taxpayers spend quickly the resulting increase in their disposable incomes. This argues against proposals for across-the-board reductions in income tax rates or other tax breaks that would provide the largest benefits to higher-income taxpayers, who are likely to save rather than spend a substantial portion of any tax cut they receive. (At a recent Brookings Institution forum on stimulus, Martin Feldstein concurred that a temporary tax rate cut would not be effective as stimulus.) This also argues against tax cuts in capital gains or dividends, which would go even more disproportionately to those high up on the income scale.

In contrast, a tax rebate of a uniform amount for all tax filers would put money into people's hands quickly and direct a large proportion of the total to people likely to spend it. The rebate could go to all taxpayers who filed a federal income tax return the previous year, or to everyone who worked and paid FICA taxes (whether or not they filed an income tax return). The amount, presumably several hundred dollars, would be the same for all taxpayers and would not be tied to how much tax they paid.

- *Temporary increase in food stamp payments.* Many low-income consumers are not tax filers and do not receive unemployment insurance. Hence, they would not qualify for a

tax rebate or for extended UI benefits. Yet they experience particular hardship when the job market is weak and when states cut back on services. A temporary increase in food stamp benefit levels would provide helpful support to poor households and would almost certainly be spent very quickly. Dollar-for-dollar, this is one of the most effective forms of stimulus available.

Paulson does not exaggerate when he implies that just soldiering on and letting markets work will trigger a depression and collapse of the currency. But he remains captive to an ideology which ultimately undermines his plan's belated focus on a systemic solution designed to reopen money and financial markets to normal transactions. Currently there is simply too much junk out there for anyone in money markets to be sure of getting repaid if they loan to anyone else, even overnight. The refusal to establish pricing transparency is inducing a massive hoarding of dollars, which cuts against the plan's efforts to increase private sector lending. Everyone knows that other institutions are full of bad assets that are hugely depressed; but each sees for sure only their own desperate condition. So nobody trusts anybody.

Treasury Secretary Hank Paulson agreed to invest \$125 billion in the nine largest banks, including \$10 billion for Goldman Sachs, his old firm. But, if you look more closely at Paulson's transaction, the taxpayers were taken for a ride -- a very expensive ride. They paid \$125 billion for bank stock that do not even come close to matching the terms paid by Warren Buffett in his recent Goldman Sachs investment. Leo W. Gerard, president of the United Steelworkers, raised this issue recently in a stinging letter sent to Paulson this week. The union did what any private investor would do. Its finance experts vetted the terms of the bailout investment and calculated the real value of what Treasury bought with the public's money. In the case of Goldman Sachs, the analysis could conveniently rely on a comparable sale twenty days earlier. Billionaire Warren Buffett invested \$5 billion in Goldman Sachs and bought the same types of securities -- preferred stock and warrants to purchase common stock in the future. Only Buffett's preferred shares pay a 10 percent dividend, while the public gets only 5 percent. Dollar for dollar, Buffett "received at least seven and perhaps up to 14 times more warrants than Treasury did and his warrants have more favorable terms," Gerard pointed out. The investments also compare poorly with the 12 percent preferred stock received by the UK taxpayer as a quid pro quo for taxpayer recapitalization, or the 10 percent received by the Dutch government in their recent investment in ING.

This is hardly a way to restore trust and restart markets. Alas, not only is the so-called TARP pushing the most expensive and likely to soak average Americans the most, but it is likely to be politically discredited if it is perceived to be serving the interests solely of Wall Street bankers, so it must be modified to some extent.

One hopes that the new Obama administration, less prone to Paulson's market fundamentalism, will adopt a page out of the FDR playbook, by not only injecting capital directly into financial institutions with a reasonable prospect of survival in the long run, but also inspect and certify the solvency of financial houses as a quid pro quo for receiving the funds. Of course, this entails further pricing transparency, something which is anathema to Wall Street, but essential if private sector hoarding of dollars is to stop. That must also be extended to the money market funds, the utility of which is doubtful if FDIC insurance is extended to cover all bank deposits.

It also makes sense to insist that firms receiving aid issue senior debt to the government with rights over all other bonds, etc., they have outstanding. That's to make sure some money comes

back right from the start and that managements cannot keep all the earnings for themselves by reducing accounting profits and paying themselves more.

To recapture some of the broader market gains flowing from the injection of public money, and to pay for the increased fiscal expenditures anticipated in the coming few years, one could place a modest new tax on interest, dividends, and capital gains. "Carried interest," the ludicrous special tax break for private equity and hedge funds that not only Republicans but Senator Schumer and other Democratic Congressional leaders continue to defend, should also be eliminated as part of any political deal on a bailout. It is beyond crazy to ask American workers to subsidize firms that will soon be back trying to break up their firms and throw their rescuers out of work.

And finally, obviously, it is necessary to tackle the root cause of the current malaise, rather than its symptoms. There is no need to look to express this problem in the context of a generalized discussion about deflation. The problem is quite simply a massive loss of housing wealth, compounded by the recent loss of stock wealth. The best way to tackle housing, probably, is by reviving something like the Home Owners Loan Corporation that worked so well in the New Deal. That bought mortgages from people who were in danger of losing their houses and converted them into obligations that they could afford to repay. This sort of bailout has the wonderful property of directing public money to the public, rather than Wall Street. But it would still bail out Wall Street, since reviving housing and stopping mortgage defaults feeds directly through to mortgage bonds values and derivatives based on them. And, yes, there is an element of moral hazard here, so the focus as much as possible should be on homes where there is a reasonable justification for a mortgage workout. This means where the home price can be reasonable, the mortgagee can afford it, and the mortgage holder willing to take a modest haircut.

After relying on voluntary private sector led loan modifications, FDIC is now moving in a new direction, recently proposing a plan where government would offer \$500 billion in guarantees as an incentive for mortgage lenders to restructure troubled mortgages for approx. 2-3 million homeowners **based on their ability to repay**. These mortgages would be refinanced to reduce monthly payments for 5 yrs before raising interest rates. The program's approx. \$40-50 bn cost will be covered under TARP and govt. would bear 50% of losses from any possible default. To paraphrase Paul McCulley, such mitigate the home owner's proclivity to exercise the "put" on his home, avoiding the phenomenon of vacant houses, social blight, and banks selling repossessed homes into a declining market.

Above all else, the main focus must be on fiscal policy. The question of taxpayer costs for bailouts of financial institutions is typically part of discussions by the mass media. The question "what is it going to cost the U.S. taxpayer?" reflects an unthinking bias against active government policies to prevent recession and depression. Asking how much an active government policy to prevent a financial market calamity is going to cost the taxpayer can only be based on an economic theory that assumes that the macroeconomic activity in the economy will be unchanged whether or not the government takes any positive action to remove distress in financial markets.

But consider the historic precedents. In the words of Professor Paul Davidson:

Let us look at a historical example where if this type of "what will cost to the tax payer and/or the economy?" question were asked, one of the most desirable government policies would never have been undertaken. At the Bretton Woods

conference it was recognized that the European nations would need significant aid to help rebuild their economies after the war. Keynes estimated that the need would be between \$12 and \$15 billion. U.S. representative Harry Dexter White indicated that Congress could not ask the taxpayers to provide more than \$3 billion. Accordingly, the Keynes Plan was defeated at Bretton Woods, and the Dexter White proposals were adopted

Suppose that in 1946 it was recommended that U.S. give a gift of \$13 billion dollars over four years to various European countries to help them rebuild their war-ravaged economies (in 1940s current dollars, this sum would be well over \$150 billion in 2007 dollars). Obviously if Dexter White was correct, the Congress would never have approved the Marshall Plan. Since the Marshall Plan did not reveal in advance that it would provide foreign governments \$13 billion over a period of four years, Congress approved the Marshall Plan. The Marshall Plan gave foreign nations approximately two percent of the United States' GDP each year for four years. Was the Marshall Plan costly to U.S. taxpayers and the U.S. economy?

The statistics indicate that, during the Marshall Plan years, for the first time in history the U.S. did not experience a serious economic slowdown immediately after a war. And this despite the fact that federal government expenditures on goods and services declined by approximately 57 percent between 1945 and 1946. Furthermore, four years after World War II, federal government expenditure was still approximately half of what it had been in 1945.

When the U.S. emerged from World War II, the federal debt was more than 100 percent of the GDP. Accordingly, there was great political pressure to reign in federal government spending to make sure that the federal debt did not grow substantially. Clearly, then, it was not "Keynesian" deficit spending that kept the U.S. out of recession in the immediate post-World War II years.

What was the cost of the Marshall Plan to the U.S. economy and the U.S. taxpayer? In 1946, the GDP per capita was 25 percent higher than it had been in the last peace years before the War. GDP per capita continued to grow during the Marshall Plan years. Despite giving away two percent of U.S. GDP, American residents (and taxpayers) experienced a higher standard of living each year. – (Paul Davidson, "How to Solve the US Housing Problem and Avoid a Recession: A Revived HOLC and RTC" - Schwartz Center For Economic Policy Analysis: Policy Note, January 2008)

It is this kind of thinking which must be foremost in the new Administration's mind. It has become politically fashionable to rant against government spending and demand fiscal responsibility. But right now, increased government spending is just what the doctor ordered, and concerns about the budget deficit should be put on hold. As our new President with a large Democratic majority in both houses of Congress, Barack Obama will clearly find less of the traditional knee-jerk opposition to spending. But he will face a chorus of conventional IMF types telling him that he has to be responsible, that the big deficits the government will run next year if it does the right thing are unacceptable. Like FDR, he must ignore that chorus. The responsible thing, right now, is to give the economy the help it needs. Now is not the time to worry about the deficit. It's time for a new "New Deal".

