

DOES THE BAILOUT OF BANKS IMPLY HIGHER FUTURE TAXES: THE FISCAL IMPLICATION OF REPLACING ONE BUBBLE ASSET WITH ANOTHER

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(A no equation version)

My previous blog with the same title had equations in it. Here is a version that does not use equations.

The previous version assumed that the current crisis was caused by the collapse of bubble assets like mortgage-backed securities. It argued that the current bailout spending does not imply higher future taxes as long as the amount spent is less than the pre crisis value of the bubble assets.

To illustrate this point, imagine a remote village in which everyone values a rock that is overlooking the village. The ownership of the rock is clearly defined. People in the village hold pieces of papers that say: This paper is a claim on 1% of the rock. These pieces of papers are like stocks and they are traded in the village's stock exchange. Thus, a typical individual in the village who feels like consuming more than his income will typically sell his stocks for consumption to someone who feels like consuming less than his income. In addition the existence of the asset facilitates specialization. People can sell for example, guitar lessons for claims on the rock and use these claims later to buy food.

A prophet arrives. The prophet convince everyone that worshipping the rock and placing value on it is bad and that everyone should believe in a more abstract god. The villagers are convinced and immediately no one wants to buy claims on the rock: The rock becomes worthless.

An economic crisis follows the change in beliefs. The guitar teacher decides that he is no longer willing to give lessons for claims on the rock. He is willing to give lessons

directly for food but he has a hard time finding someone who has the kind of food that he likes to eat.

The village newly elected chief decides to act. He prints pieces of paper that says: "In god we trust" and distributes these papers free of charge. For some reason people value these papers and the previous equilibrium is restored. In particular, our guitar teacher is willing to give guitar lessons in exchange for the newly printed papers. And people who want to save are willing to sell their output for the newly printed papers.

The villagers are nevertheless upset. They claim that the chief is spending a lot of money and their grandchildren will have to pay for it. There is a debate.

Someone decides to read an old breed of economic literature called monetary economics. He points out that the grandchildren will not have to pay for the spending of the current chief as long as they will keep the faith and hold the papers. This requires that they will not go back to believing in the rock and will not create substitutes for the newly printed papers.

From a technical point of view, the monetarist argues that the pieces of papers distributed today represent both expenditure and revenues. The revenue part is called seigniorage.

But shouldn't we worry about the deficit that the previous chief has created? Yes. The old chief's deficit was done when the rock was still valued. The grandchildren should pay for that because there is no easy seigniorage money that can be made to cover this deficit. But this was well known before the economic crisis.