MONETARY POLICY AND THE STATE OF THE ECONOMY, PART II

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U.S. HOUSE OF REPRESENTATIVES

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MONETARY POLICY AND THE STATE OF THE ECONOMY, PART II

Thursday, February 26, 2009

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Members present: Representatives Frank, Waters, Watt, Moore of Kansas, McCarthy of New York, Baca, Miller of North Carolina, Scott, Green, Cleaver, Ellison, Perlmutter, Minnick, Adler, Kilroy, Driehaus, Kosmas; Bachus, Castle, Marchant, Posey, and Paulsen.

The CHAIRMAN. The hearing will come to order. I am going to make a brief statement and get right to our witnesses. The Humphrey-Hawkins Act calls for semiannual hearings in which the Chairman of the Federal Reserve testifies on the state of the economy and the progress we are making in reaching the goals of low inflation and high employment. It seemed to me that while that obviously is very important, there ought to be some comment on it as well. That is probably substantive and something procedural. I have admired the work of Mr. Bernanke. I found a great deal to admire in the work of Mr. Greenspan. But I think we have suffered from excessive deference to the Federal Reserve. And the notion that these were oracular pronouncements not to be questioned is not healthy in a democracy.

So we began having comments on the state of the economy right after the Federal Reserve testimony and on the testimony and what the Federal Reserve is doing. I think this is an important thing for us to continue, and that is this hearing today. With that, we are going to proceed right to our witnesses. The ranking member has graciously agreed with me that we don't need to do substantive statements now. There was a small enough membership. So I will announce that the 5-minute rule does not have to be strictly adhered to so that we can have some more rational conversation. And we will have perhaps 8 or 9 minutes or so each. We will just tell members that we don't want to abuse it. But the 5-minute rule has always been one of the obstacles to intelligent dialogue, and we can relax it some.

We will begin, in no particular order, just the way I am facing, with Dr. Alan Blinder, who is the Gordon S. Rentschler Memorial Professor of Economics at Princeton and Co-Director of the Center for Economic Policy Studies, as well as a former Vice Chair of the Board of Governors.

Dr. Blinder.

STATEMENT OF DR. ALAN S. BLINDER, GORDON S. RENTSCHLER MEMORIAL PROFESSOR OF ECONOMICS AND CO-DIRECTOR OF THE CENTER FOR ECONOMIC POLICY STUDIES, PRINCETON UNIVERSITY

Mr. BLINDER. Thank you, Mr. Chairman, Ranking Member Bachus, and other members of the committee. I have read Mr. Bernanke's last two testimonies before this committee. I have not had the benefit of all the Q&A that went on. But based on that, I would like to say that I agree with the Chairman, that is the Federal Reserve Chairman, on almost every particular that he mentioned in those testimonies. Indeed, I feel the country is fortunate to have somebody as creative and thoughtful as Ben Bernanke sitting in that very difficult chair right now. Now to specifics. Regarding conventional monetary policy, I think the Fed got off to kind of a slow start when the crisis first broke in 2007. But it has more than made up for lost time.

I was especially pleased and I applaud its decision to, first of all, reduce the Fed funds rate to zero in December, and then to state that it would continue to hold it there "for some time," a vague period to be sure, but I would guess that probably means a year, maybe more. The Fed has not said that. Nevertheless, the economic outlook, as Chairman Bernanke said yesterday, is quite bleak.

I would like to underscore two of the points that he made. Firstly, he suggested very strongly, I thought, that his own view of the economy was weaker than the FOMC consensus, and mine is too. The bottom end of that range is a 1¼ percent decline during the four quarters of 2009. I think we will lose 1¼ percent in the first quarter alone. And I certainly don't expect the next three to be on a break even level. So I think we will probably do worse than that.

Second, he emphasized that even that forecast was predicated, I think his words were, on the actions taken by the Fed, the Administration, and the Congress to try to get out of this mess. And I certainly agree with that. I would like to emphasize that I think it is important for congressional and public thinking to conceptualize this as fighting a two-front war. And as with most two-front wars, you have to win both fronts, otherwise you lose the war. One front is restoring aggregate demand. And that is what the stimulus and low interest rates and so on are about. The other front is reviving what is a pretty wounded, if not dead—dead in pieces, wounded elsewhere—financial system. And that is where TARP and the various bank bailouts and many of the extraordinary things that the Fed has done come into the picture.

So let me turn to the unconventional monetary policy which, these days, is much more important. I would like to especially praise the Fed for moving away to the maximum possible extent—which is not 100 percent—from going institution by institution with ad hoc rescue measures that while they solve an existing problem, don't take us even a baby step toward a solution, and also sometimes sow more confusion than clarity because there are no clear rules of who gets what when. And moving instead to a market by market approach, which the Fed has been doing since it intervened so heavily in the commercial paper market, where the objective is to restore a once moribund market to life. And it has already succeeded with CP.

This approach has many advantages, including that it really gets to the root of the problem. It takes us some steps toward a cure and, importantly, is roughly speaking, though not literally, rules based. There are rules to the game. There are procedures that are set up for doing these things. I think this is a far better approach, and it is the one that the Fed is pursuing very aggressively these days. What it amounts to in the short term is the Fed providing the commodity that is now in shortest supply in the U.S. economy, which is the willingness to bear credit risk. Nobody really wants to do that these days except the Federal Reserve, and I guess you could say, the Treasury.

Under normal circumstances, of course, we want the private sector, not the government, to be bearing and evaluating risk. And we will get back to that one day. But for now, with risk premia so wildly high, and some markets not working at all, the government is right to step in and provide the risk bearing services that nobody else seems willing to provide. That is the central idea, for example, behind the TALF, which is starting, I guess, any day now—I am not exactly sure when it is starting.

I would like to contrast that, by the way, with another aspect of quantitative easing that has been much discussed, which is buying long-term Treasury debt. One could imagine a time and a place where that is an appropriate thing to do once you have beaten the short-term interest rate down to zero. But I don't see that this is the time or the place. I don't see what would really be accomplished by doing that. The problem is not that we have a yield curve that is too upward sloping and that is doing damage. In fact, that is helping the banks recapitalize themselves, so we really don't want to flatten it. And there is no problem with riskless borrowing by the U.S. Treasury, which is still cheap. We need to work on the risk premia that private borrowers have to pay above treasuries when they borrow. And that is when the TALF—

The CHAIRMAN. The relaxation of the 5-minute rule will apply to all witnesses again. With the luxury of a fairly small membership, we can have some intelligent discussion unstructured by these time limits.

Mr. BLINDER. So did that mean I am cut off?

The CHAIRMAN. No, you have some more time.

Mr. BLINDER. The last thing I would like to touch on, which has been much discussed in recent weeks, is nationalizing banks. I don't think the talk of doing that has been particularly helpful. You can see that in the markets. That said, I recognize the possibility that at the end of the road after plans A, B, C, and maybe D fail, if they do fail, we may be there. So we should be realistic about that. But I don't think we are there now. And as I say in my written testimony, my problems with rushing to nationalization can be summarized in four words, and those four words are, "We are not Sweden." And by saying that, I mean a couple of things.

The most important is that Sweden had just a handful of banks to manage. We have over 8,300 banks. This is not a trivial management task. And importantly, it is not at all clear where you draw the line. We can nationalize 2 banks, 4 banks, 8 banks, 1,800 banks. There is a problem here because if you nationalize Bank A and Bank B has to go to market competing with Bank A, which has the power of the Federal Government behind it, you have put Bank B at a competitive disadvantage. You may drive Bank B into such a state of ill health that it has to be nationalized, too. And down the chain you go. As I say, we may have to get there at some point. But we are not there yet, and I hope we don't get there.

A second problem is that once you start going down this list, you encounter what some people have called the "slowest antelope in the herd" problem as speculators set their eyes on who is likely to be the next nationalized bank, and then attack it with short selling and selling the CDS and so on.

Thirdly, and here I would bow to the judgment of this committee, of course, but speaking as a citizen, the Swedes did their nationalization and denationalization with remarkably little political influence. It was a very technocratic operation. As a citizen, I am a little dubious that it would work that way in the United States of America. And let me leave it at that, Mr. Chairman.

[The prepared statement of Dr. Blinder can be found on page 40 of the appendix.]

The CHAIRMAN. Thank you. I will just interject myself now to say I would hope people would keep in mind one very important fact. If you want something to be decided essentially nonpolitically do not ask 535 politicians to decide it. I think that is an endemic—not a bad thing either in our system, but something to be taken into account. Next, we have another frequent witness before the committee in a variety of capacities, Professor John Taylor is a Mary and Robert Professor of Economics and the Bowen H. and Janice Arthur McCoy Senior Fellow at the Hoover Institution, and a former, was a Deputy Secretary, John?

Mr. TAYLOR. Under Secretary.

The CHAIRMAN. Under Secretary of the Treasury for International Monetary Affairs, and so we are glad to have Dr. Taylor return.

STATEMENT OF DR. JOHN B. TAYLOR, MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS AND BOWEN H. AND JANICE ARTHUR McCOY SENIOR FELLOW, HOOVER INSTITUTION, STANFORD UNIVERSITY

Mr. TAYLOR. Thank you, Mr. Chairman, and thank you, Ranking Member Bachus, for inviting me. I am going to focus my opening remarks, and in fact, much of my written testimony, on the extraordinary measures, part of the request to testify. I appreciate being invited here to do so. I think the first place to begin to think about these extraordinary measures is to look at the extraordinary increase in reserves at the Federal Reserve. And in my written testimony, I provided a chart. This chart, I think, is very useful, somewhat sobering, if you like, and it is worth a lot more than a thousand words. Reserves, of course, are the deposits that commercial banks hold at the Federal Reserve. It is a form of money. Economists call it central bank money or base money. It is really the foundation of the whole money supply in the United States economy. If you look at that chart, you can see that in September of last year, it started really exploding, I think is the word, and within a few months increased by 100 times from roughly $8 billion to over $800 billion. Again, these are the deposits that banks have on reserve at the Fed and can be converted into loans at an instant. This increase in reserves, I have both what has happened until now, it is a solid line in the picture, and also what might happen in the next few months based on current policy.

But why has this increase in reserves taken place? Why has this huge expansion in the creation of money, if you like, taken place? Well, it is because the Fed has used these reserves, used the creation of this money to finance the purchases of securities in the private sector, whether it is mortgage-backed securities now, or whether it is the securities that resulted from the Bear Stearns intervention, or whether it is the AIG securities, or whether it is loans to AIG, or whether it is the new purchases that will take place under the TALF, or under the recent proposal from the Treasury to create an initiative for consumer and banking loans. In other words, just like any other organization, the Federal Reserve has to finance its purchases or its lending, and it finances them by creating money.

It can finance them in other ways, but that is the main way it is doing it right now. If you look at that chart, you can see these reserves didn't increase for the first 13 months of the crisis. It was basically flat. And that was the way the Fed was controlling the interest rate. It started to explode when the Fed had to create money to provide these purchases. Now, where is this going in the future? I have estimated, based on the proposal from the Treasury and the existing proposals from the TALF, that we will have to increase a substantial amount more. And that is what that dotted line is trying to show you. It is really a continued explosion of this creation of money.

So that is my assessment of where we are and where we are likely to go with respect to probably the best overall measure of the extraordinary measures that have taken place. I have a few questions and concerns and a couple of recommendations which I will mention in the time allotted to me now. One concern, and this, of course, is potentially inflationary. If the Federal Reserve doesn't bring those reserves back out of the system, at some point in time, it will cause inflation. That is a huge increase in the money supply, and it will translate into inflation at some point.

People ask me about this all the time, it is on their minds, it is a concern. The Federal Reserve needs to address that concern. Right now, of course, we don't have an inflation problem. We seem to have the opposite. Inflation seems quite low. So it doesn't appear to be a problem now, and that is why the chairman has indicated he can withdraw these at the right time. I think the question for this committee and others to ask is, how will they be able to withdraw such a large amount of funds? That will mean selling these mortgage-backed securities, selling the consumer loans, etc., and it may be difficult politically.

The second concern I have is, I think it raises questions about the independence of the Federal Reserve. The recent proposal from the Treasury, the consumer business loan initiative, seems to me very similar to the kind of things that the Treasury did with the Fed before the so-called accord of 1950 when the Fed was given independence to conduct monetary policy. It is a request for the Federal Reserve to do things which it might not otherwise want to do or which might not be appropriate to do; that is to create this loan facility. The third concern I have is that not all of these measures are clearly productive. The statistical studies I have done, for example, show that the term auction facility has not alleviated the risk premia at all. And I think one of the reasons for that is that it is not to do with liquidity, it has to do with pure risk issues. Also, like my colleague Alan Blinder, a lot of the interventions have really not been rules based at all, but have really been ad hoc, and have caused more confusion, if you like, more uncertainty in the marketplace. I am not sure that we have improved the rules based aspect of this, but I certainly hope that he is right.

And then finally, I think this raises issues about the future of the Federal Reserve. These actions, while viewed extraordinarily now, could, in principle, become part of the normal way of doing business at the Federal Reserve, and that would raise grave questions to me about the success that we have had for 20 years, if you like, with monetary policy focusing on the overall economy, stating interest rates according to inflation and output. But if it becomes an organization of selective credit provision, whether it is bad times or weak times or just not so good times, it will raise serious questions about the effectiveness of the institution.

I have three recommendations: One, I think there could be more transparency about these operations. In this regard, I think the recent creation of a Web site by the Fed just this week, I think it began on Monday, is very good news. This is the first time people can get in and see exactly and understand this complication of their releases. And I congratulate this committee for encouraging that in the hearing on February 10th. I think more could be done. I have been urging that they publish the daily data. So, for example, we would know right now what the provision of reserves is for every day of last week and don't have to wait until the week is over on Wednesday. This is very important, and I have been urging it for years.

I think the Fed should also set ranges for these reserves that I have showed you in my picture. Right now all they say in the minutes of the last meeting was that the balance sheet will be kept high. That seems to me too vague. What does that mean? Does it mean it is going to be at the top of my dotted line, or is it going to mean the top of the blue line? What does it mean that the reserves are going to be kept high? More specificity is needed.

And finally I would recommend that each of these measures be subject to very serious evaluation studies, almost in real-time, if you like. Perhaps by third parties, but certainly by the Federal Reserve, to show how and why and when they are working and when they are not, so that we can assess going forward whether this is a good set of measures to take. Thank you, Mr. Chairman.

[The prepared statement of Dr. Taylor can be found on page 56 of the appendix.]

Mr. WATT. [presiding] Thank you very much for your testimony.

Our next and final witness is Dr. James K. Galbraith, the Lloyd M. Bentsen, Jr. Chair in Government and Business Relations at

Lyndon B. Johnson School of Public Affairs at the University of Texas at Austin. And you are recognized for your testimony.

STATEMENT OF DR. JAMES K. GALBRAITH, LLOYD M. BENTSEN, JR. CHAIR IN GOVERNMENT/BUSINESS RELATIONS, LYNDON B. JOHNSON SCHOOL OF PUBLIC AFFAIRS, THE UNIVERSITY OF TEXAS AT AUSTIN

Mr. GALBRAITH. Thank you very much, Mr. Chairman, Ranking Member Bachus, and members of the committee. It is again a very great privilege for me to appear today at these hearings, which as a member of the staff of this committee, I worked on from their inception in 1975. I wanted to make about six points that are really quite broad in their scope, but related to a central question or a central argument, which is that the crisis that we are passing through at the present time is qualitatively different from the economic downturns with which we have recent experience, and therefore requires us to adjust our thinking in certain important respects.

The first one of these has to do with our treatment of the short-term outlook, that is to say of the baseline forecast, which is very similar as between the Congressional Budget Office's baseline and that offered by the Federal Open Market Committee, both of which show a mild to severe downturn this year followed by a turnaround and a period of growth beginning in 2010. I think this is substantially too optimistic.

I think it is predicated on the mechanical inclusion in the model of a concept of a natural rate of unemployment toward which the economy will return by some unspecified process of labor market adjustment, and it is inconsistent with the likely path of liquidation of household debts which is very much underway at the present time. And the result of this is that I am very much in agreement with Alan Blinder that this year is likely to be substantially worse than the forecast.

And even if there is a bottom at the end of this year and a slow rate of growth afterwards, that means that the ongoing rate of unemployment will be very high. I think Chairman Bernanke was at least minimally realistic about this, that we are talking about 9 percent with no short-term or medium-term recovery toward high employment in prospect. Automatic stabilizers and the recovery plan just passed will help, but they will not rectify that basic situation for a long period into the future.

The second point is that in this situation, with a very, very strong liquidity trap in place, monetary policy has been very helpful in preventing a collapse of activity. And I, again, share Alan Blinder's high regard for the actions of the Federal Reserve in the crisis, and in particular of its effective measures in the commercial paper market.

The fact remains that the ability of monetary policy to deal with the crisis going forward is relatively limited. We have had a policy of zero interest rates, we are going to have that policy for some time to come. It has not succeeded in restarting borrowing because the risk premia on private borrowers are too high, the profit expectations are too low, and the collateral is too weak.

And in addition to that, the policy of zero interest rate has an adverse effect on the fiscal side because it depletes the incomes of those who have cash reserves, and that affects their spending power. This is particularly a problem for the elderly. Policy communication and selective support of asset classes are not useless, but they are weak reeds in this situation.

The third point relates to the plan with respect to the banks. I think it is plainly an effort to buy time in the hope that a financial market or broader economic recovery will refloat some of the biggest banks from the troubles which they are presently in. And it is conceivable that it might do that, but it is also possible that the plans as presented might fail, which in that case, would compound the taxpayer losses which are already in view as the guarantees that may be offered on the troubled assets are finally called. I am pessimistic about this, mainly because I think that a proper due diligence on the underlying assets, particularly residential mortgage-backed securities—an inspection of the loan tapes, which, by and large, has not been done so far as I understand—would show them to be rather badly infested by misrepresentation and even outright fraud and therefore unmarketable in the private marketplace at essentially any price. And if that is the case, the sooner we come to grips with it the better, because it is only through coming to grips with it and writing off assets which cannot recover that we will put the banking system as a whole back on a footing where those banks which are in better shape will be able to lead the way toward a restoration of private credit markets.

And here I do have a difference with Professor Blinder in that I think our experience would pass through receiverships in the workout of the savings and loan crisis, which was very extensive in the early 1990's, and more recently with such institutions as IndyMac, which is in such a receivership now, is reasonably good and reasonably free of political interference. This is indeed a job for the regulatory professionals. The only real question being whether they are sufficiently staffed up and prepared to handle that job with the scale of the institutions that we are talking about at the present moment.

In any event, the banking plan is unlikely to restart credit effectively, because I believe it is based upon a misconception of what credit is. As a rhetorical, metaphorical matter we hear a lot about restarting credit flows. But credit is not a flow, it doesn't come from one place to another, the problem is not a blockage. Credit is a contract between two equal parties, the lender and the borrower. The borrowers have to have reasons to borrow—profits in prospect—and they need to be creditworthy, which is partly a problem of the underlying asset that they bring as collateral. The first condition requires strong growth of demand, and the second depends upon fixing the foreclosure crisis and the chronic oversupply of housing, at least as far as residential credit is concerned.

The fourth point concerns the problem of demand: a compound of debt deflation in the household sector, and also I would argue of a terrific squeeze on the elderly, which is hitting them from all sides, affecting their home values, their equity holdings, and their interest income. The household income problem could be met by a substantially larger amount of tax relief working through the payroll tax—for example, a holiday on the payroll tax. The squeeze on the elderly could be met by raising Social Security benefits. And so from this point of view, I would suggest that as we go forward, we should stop thinking about the Social Security system as being a burden, but rather as potentially one of the more effective ways to restore effective demand in a crisis environment.

Obviously, it is going to take time before we can decide for sure where we are, whether the optimistic forecasts that we are seeing are, in fact, accurate or, as I believe, too optimistic. But in 6 months or 9 months, we would be able to make a judgment on these matters, and we should, I think, at that point, be prepared to consider a substantially larger spectrum of aggressive interventions than we have seen so far.

On the matter of housing, I want to say very briefly, as many members of this committee have said, it is important to stress the centrality of dealing with the foreclosure crisis to the ultimate resolution of these problems. In Texas, in the 1980's, it took us 7 years to get through a housing crisis. This is one on a substantially larger scale. The problem has to do with the fact that homes don't disappear, they tend to stay as a drug on the market for quite a long period of time. Keeping people in their homes is about the only way one can effectively reduce the oversupply.

That can be done either through resetting mortgages or by some mechanism that would convert to rentals and leave the former owners in a position to buy them back at an appropriate opportunity. But either way, that is a very big, arduous job, requiring a lot of judgments about individual cases. The sooner it is started, the sooner it can get finished. If it isn't started, this problem is simply going to hang on, as I think the fundamental obstacle to a recovery of the credit mechanism for quite a long time into the future.

My broadest point is that we have been treating this crisis as an artifact of our economic projections—as something that is likely to be over within a couple of years, returning us to a situation of normality, in which we will be back dealing with more familiar problems. And I don't think that is an accurate perception. I think we will not return to normal. This is an historical event, like the Great Depression in that respect, which can only be dealt with by creating in effect a new world, a new economy, a future which will not resemble the 30 years of the recent past.

So the future is something that we now have to build. It obviously is going to involve reconstructing our public infrastructure on a long-term basis. That is something that we should be planning to do now. And dealing with our energy and climate change problems, which are obviously essential to the sustainability of any economy that we may construct going forward. Thank you very much, Mr. Chairman.

[The prepared statement of Dr. Galbraith can be found on page 45 of the appendix.]

The CHAIRMAN. Thank you, gentlemen. Let me turn to a couple of the points that Professor Galbraith made. I was particularly pleased to see you include the language about Social Security, the notion that a long-term budget approach should be to focus on Social Security. There are two problems for me. One is not directly relevant here, except in the broader sense. And that is it puts way too much attention on Social Security and way too little attention on the military budget. We are in the process now, I believe, of being asked to commit, at least this is a policy from the previous Administration, several billion dollars in tax revenue to protect the Czech Republic from Iran.

I am not a regular reader of all the fatwahs, but I am not aware that the Iranians have threatened the Czech Republic to the point where we need to put billions of dollars in to defend them. I was pleased to see the President refer to the need to cut unneeded Cold War weapons there. On the other hand, though, on the Social Security issue, and you mentioned, Professor Galbraith, obviously Medicare and Social Security, and I do think, and I know you agree, there is a separation.

Because it is not that Medicare does not deserve attention, but it deserves that attention in the framework of a broader health care policy. So let us start with that one. There is a point I want to emphasize. You talk about, for example, the advantage of dropping the Medicare age. What would the impact be, for instance on the automobile industry if we were to do that. We are going to be confronted with a need to provide some aid to keep the automobile industry, the American automobile companies, functional. What would the impact be of the drop in the Medicare age, for example, and other related health care issues?

Mr. GALBRAITH. Well, I think in a great many industries, including the auto industry, that are in crisis it would have two effects. It would relieve the industry of health care burdens for older workers, but it would also give a fair number of workers who have the resources to retire but are unwilling to do so because they don't want to lose health care coverage a chance to take that opportunity. And so it would enable the industries to downsize and restructure in a much more orderly way.

The CHAIRMAN. I confess I have been thinking about the first of those, which was taking the burden off. Because if we could somehow get the burden of retiree and even current worker health care off the backs of GM, it would go a long way toward selling it. But the incentive to retire or the removal of disincentive against retirement is also very important. On Social Security, I will ask you, because I don't think this gets enough attention, to elaborate on the argument that Social Security is in a crisis and if we do not do some drastic changes, including some reduction of benefits, that we will default on our promise to people who plan to retire in 30 years. What is your response?

Mr. GALBRAITH. The U.S. Government need not default on any of its obligations. The issue for us going forward is how do we provide an adequate retirement for an elderly population which is growing. And we have of course had a balanced approach to that with a certain element of private asset building. The real crisis is there. Social Security exists as a way of buffering the elderly against that problem and should be seen as a tool toward that purpose. There is no reason, in other words, to treat Social Security as somehow a kind of financial albatross to the Federal Government. It is, after all, the one part of the Federal Government which has its own revenue stream assigned to it. That is not true of the

Pentagon budget, not even true of the net interest, yet nobody believes that the Federal Government is going to fail to provide for national security or fail to pay the interest bill.

The CHAIRMAN. Let me ask all, and I will start with Dr. Blinder, one of the things we are told we have to worry about is that U.S. Treasuries will lose their appeal as an investment vehicle and that we will be severely disadvantaged. I will say that I see no evidence of that happening now. When I think about whether or not people can buy U.S. Treasuries in the future I am reminded of a figure. I often quote the 20th Century philosopher, Henny Youngman, whose response to the question, "How is your wife?", was "Compared to what?" And I think when we are told people are not going to invest in U.S. Treasuries, the question is, compared to what? Are we in danger if we don't make some drastic changes in public policy, let me start with you Dr. Blinder, of seeing a drastic decrease in people's willingness to buy U.S. Treasury paper?

Mr. BLINDER. I think in the near term, we are in no danger for exactly the Henny Youngman principle. Look what has happened recently. As we all know, this mess, this worldwide mess, started here, right here in the good old U.S.A., and the whole world is trying to buy U.S. Treasury bonds, so we are really the safe haven. That said, as you all know, we are now looking at budget deficits of 10, 12, and 14 percent of GDP. I think that is the right thing to do in the current circumstances. We are in terrible need of stimulus, both from the monetary and from the fiscal side, given the state of the economy. But there is a limit to how many years you can keep that up.

And so I think raising the deficit was really the right thing to do, even though a lot of commentators were scratching their heads about the security contradiction, of the Administration talking about long-run budget control at the same time that it was ballooning the budget deficit in the short-term. You are talking about long-run budget control over a period of a decade. But it is not a contradiction, it is the right thing to do. I do have some fear—I wouldn't put a very high probability on it—but some fear that, if the view became dominant in the marketplace that the U.S. Government was going to run a 10 percent of GPD deficit more or less indefinitely, then I think we have to worry about interest rates and the financial market's attitude toward the Treasury debt.

Mr. TAYLOR. I am certainly concerned about making U.S. Treasuries attractive for the long-term. I think that we have to be vigilant about it, quite frankly, Mr. Chairman. And to the extent that we are going to run deficits like we are this year as far as the eye can see, and some people worry about that, it is going to be hard quite frankly to get people to buy these Treasuries for the long-term. I think it should be a direct concern. And by the way, I think there is an inconsistency about currently increasing the deficit by a large amount and simultaneously saying it is not going to be for long.

I think it is one case, here is what I am doing, and the other case is, here is what I am saying I am going to do. And it raises questions about consistency which we should be concerned about. On Social Security, I would say it just seems to me this is something that could be addressed. It is more of a political than an economic issue. I think we would show a great deal of leadership and confidence in government if we could come to grips with that sooner rather than later. There are more difficult problems, the ones you are asking about. But why not take that on at this point. It is a long-term issue, but it is a very important one to show the government can address it.

The CHAIRMAN. I would just add that I understand the potential inconsistency. I very much agree with Dr. Blinder; we often do things to respond to an emergency that we don't necessarily want to do in the future. But it does seem to me that was one argument for, as we did the economic recovery, or we do similar things if we had to do more, I would have done more, to try to do one-shot things, that contrary to some arguments to the extent that you are doing things that have an immediate impact but don't build in a repetitive pattern that you alleviate some of that inconsistency. Professor Galbraith.

Mr. GALBRAITH. Just on the question of sustainability. I don't think there could, in principle, come a time when people would not buy Treasury securities. The issue is at what price, and specifically whether we are looking at an inflation problem down the road, which again is what Professor Taylor mentioned as a concern. And I think that is a concern, an appropriate concern for another day. I don't think it is likely in the present environment or for the foreseeable future, simply because there is so much excess capacity, because there is debt deflation at home, and because the rush into the dollar is actually driving down our costs.

The CHAIRMAN. The gentleman from Alabama.

Mr. BACHUS. Thank you, Mr. Chairman. I want to say for the record that my wife is wonderful, so that is how I would answer the question as a married man.

The CHAIRMAN. Well, I will listen carefully. You never know. Some day for me, so I will store that up.

Mr. BACHUS. I could never get away with that answer. Thank you, Mr. Chairman. I spoke to the women in the housing and finance group here in Washington about 6 weeks ago, and this is something I said, and I may want your comment on this. I said that the critical failure in the government's response to the financial crisis is that we are waiting for events to overtake us and then reacting in an environment of crisis. The essence of the problem is the core breakdown in decisionmaking. We postpone decisions until we are overwhelmed by the problems of the day.

And I describe this as kind of a reactionary fire brigade mentality. Dr. Blinder, you, I think, called it an ad hoc piecemeal approach. And some of the problems I see with that is sometimes we cross the proverbial Rubicon. I mean, we are rushing to fix a problem and we go beyond points where normally we would sit back and say what are the long-term consequences of this. I would just like your comments.

Mr. BLINDER. I think there is some truth to that, both to the worry and to the criticism. That said, as these really stunning—and, I would say it is not too strong a word to say, unbelievable—events have unfolded since the pot blew in August 2007, it would have required superhuman foresight to see what was coming. I mean, even just to take something concrete, I think it would have been extraordinary, even in early September, to foresee what was going to happen with AIG on around September 16th or 17th or whenever.

Mr. BACHUS. Of 2008.

Mr. BLINDER. 2008, yes. It would have been next to impossible. What happened on those days took my breath away. Now, if you raise the point, well, wasn't it very ad hoc? Yes it was. Might it have been done better? Probably.

Mr. BACHUS. Let me say this: I agree with you. In August-September, I don't think anyone had any idea of the magnitude of this. I think by October-November we did, but generally there is still not a comprehensive approach, although the Term Asset-Backed Securities Loan Facility of $1 trillion may actually be an example of something that is more comprehensive. Now, let me say this. You asked about it. They are still going through the regs and rules for TALF and it is not out there yet.

Mr. BLINDER. So I agree with what I think you just implicitly said. I think the TALF is a rules-based, transparent, systemic, and systematic approach to restoring the viability of some of these credit markets. And that is what is warranted. I mean, I think that if I look at the pantheon of things that have been done, my favorite things start with the commercial paper facility and then lead into the TALF. I think those are real steps towards a cure. I think I said in the testimony that I was praising the Fed since October.

You could look back to that September-October and even before, and I think find things to criticize. I see a turning point, although Chairman Bernanke didn't make a big deal of it at the time, as coming when they did the commercial paper facility. That was sort of the first step. And now it continues. And while there is no guarantee that it is going to work, but the early returns, I would say, are good. The commercial paper market now is very much back on its feet. When they started, there was only one buyer, the Federal Reserve. That is not true anymore. The Fannie and Freddie MBS market, because of the Fed's purchases, are looking much, much better than it did before. And that has had spill-overs to mortgage rates and so forth.

Mr. BACHUS. Let me ask Dr. Taylor and Dr. Galbraith, too.

Mr. TAYLOR. Let me comment on this, because I think what you say has a great deal of truth, Mr. Bachus. In fact, I have been studying this crisis for a while and decided just about the time that Alan Blinder said things turned to just write up, if you like, my assessment of: first, what caused it; second, what caused it to last so long because it did flare up in August of 2007; and third, why did it worsen so much last fall in the panic of last fall? In each case, I look at the kind of things you are saying, that the government basically didn't get it right. They got off track from some policies that were working really well in much of the 1980's and 1990's.

First, the monetary excesses which led to this boom and bust in housing, in terms of lengthening or prolonging it, if you like, misdiagnosing it and then reacting in ways which didn't do any good. By the way, I would include the stimulus package of last year, the stimulus of 2008, which sent checks to people and didn't do much good, or I would include the term auction facility in that.

And then finally, last fall, the very ad hoc reaction which confused people. The testimonies were taken very negatively and caused a lot of fear. And so in all those cases, it seems to me you are right. So the government actions and interventions led to where we are, and I hope things are getting better. I still don't think a lot of, I think there could be more rules, if you like, with respect to how the Fed is operating.

I don't like very vague statements about the total amount of reserves they are creating. I think that is going to lead to even more concerns. And it is good if they are being more specific about their initiatives. I worry about the Treasury's request for a whole new initiative for consumer and business lending. I don't know where that came from. I am sure I know the board has agreed to it. But still that raises questions about the nature of responses and the same kind of things you raise in your point.

Mr. BACHUS. Mr. Galbraith.

Mr. GALBRAITH. A modest difference with my colleagues. I think it was possible and that there were people who had a reasonable understanding of how dangerous the situation was becoming as the subprime lending expanded, and as the housing bubble expanded. And there were people in the spring of 2008 who were close enough to the markets and had the right sort of models who had a pretty good sense of how bad the crisis could get.

And if I could submit for the record a memorandum that was based upon a seminar in June, which I think got the scale and character of the subsequent events approximately right. The problem here is that when you have a small group of people who do appreciate it, they are generally unable to project that to the larger policy-making community. And that is not by accident. It is simply that people who are very specialized and who see these things generally don't have the same reach and influence that people who are less close to the events may have.

Cassandra was always right, but no one believed her. There were reasons for that. And so in this situation we are still, I think, underestimating the gravity of the crisis and still in a situation where time will have to pass before the policy-making community is willing to move at the scale that is going to be required actually to deal with events.

Mr. WATT. [presiding] I fear that the number of people on the committee who show up will continue to grow. And while we gave pretty much latitude for the opening statements, that we probably ought to return to an element of discipline in the marketplace here. So if you all don't mind, we will try to return to the 5-minute parameters. And it may be necessary under those circumstances for you all to submit responses in writing to some of the questions that get asked because otherwise we are not going to be able to get to everybody. I will try to apply that discipline to myself since I am the next person to be recognized. Dr. Taylor, let me clarify the reserve chart that you have given us to this extent. The Fed—is this the same thing that yesterday Chairman Bernanke was describing as assets, or does the Fed itself have some kind of reserve. Is this a dollar-for-dollar assessment, or is this something, a reserve similar to what we would think of as reserves in a bank, for example?

Mr. TAYLOR. These are the liabilities that correspond to the assets. He was talking about the assets, the commercial paper or the mortgage-backed securities that they were purchasing.

Mr. WATT. But it is a dollar for dollar? If he has valued the liabilities and he has valued the assets correctly, it is a dollar for dollar. So in that sense, it is not 10 percent of the liabilities, it is an actual offset figure, is that right?

Mr. TAYLOR. It is really as they are created. In other words, if you were to go out and buy a mortgage-backed security, you would have to pay for it with something. Well, so does the Fed. The Fed has to pay for it. What they can do is pay for it, either by actually printing the money, or in this electronic age, crediting their accounts to a commercial bank so the bank has a deposit. So that is how they pay for it. They have to pay for it, you know.

Mr. WATT. So in that sense, it is a dollar for dollar.

Mr. TAYLOR. As it is created, yes.

Mr. WATT. I just wanted to be clear on that. Dr. Galbraith, your merger of this question of Social Security with the situation that we are in actually raises something that another academic with whom I was having a conversation last weekend suggested. And I will put it out here, although he has promised to send me something in writing that kind of fleshes it out. I may be misstating it. But his idea was that since we have now nationalized, federalized, taken over Fannie and Freddie, at some point their assets will be fairly substantial we hope, and that short-term we—longer term, I will deal with it longer term, when those assets become more and more valuable over time it would be a wonderful source of revenue for Social Security.

And I guess the corollary of that is shorter term, we ought to be thinking about merging these entities to use some of the Social Security surplus to get us through this transition until housing stabilizes and those assets come back. Is that even remotely akin to what you are suggesting here, and can you give me your reaction to that notion.

Mr. GALBRAITH. There are many ways to mobilize resources and put them to work. You mentioned the Social Security surplus at present, which is to say payroll tax revenues greatly in excess of benefits currently being paid. There is really no reason for that. I think that is a target of opportunity. If you wanted to provide tax relief to working families and cut the payroll tax, you will not harm the finances of the U.S. Government by doing so, but you will very effectively put cash in the pockets of working families who can use it to pay their mortgages and their car debt. And that is the useful way to think about this.

On the other side, Social Security benefits are a great engine, very widely received in the elderly population. Putting more resources, putting more money into those accounts is a very effective way to hold that population a little bit harmless from all of the other losses that they are presently suffering.

Mr. WATT. Do either of the other witnesses have a quick response to that notion? Dr. Blinder.

Mr. BLINDER. We are doing that in a sense. When you look at the unified budget, which is what you generally focus on in terms of measuring the deficit, the Social Security surplus part is in there and the non-Social Security part would have an even larger deficit. So it is all put into one pot. And you could say that we are now using it for something, because we are in a big overall deficit position. On the asset sales that you mentioned, if, and we all have our fingers crossed, we can sell some of these things at a profit some years down the road, that will again go into the Federal kitty, just as it is going out of the Federal kitty now. But, importantly, that is a one-shot event. If you think about closing a long-run actuarial gap in Social Security, that is just a one-shot event and not a permanent flow.

Mr. WATT. I am going to impose the discipline on myself first so nobody else thinks I am being unfair to them. Mr. Castle is recognized for 5 minutes.

Mr. CASTLE. Thank you, Mr. Chairman. Dr. Taylor, you had three recommendations, and I took brief rights, I may not have gotten this quite right. But the last one was something to the effect of serious evaluation studies by the Federal Reserve, that is. Is that evaluation studies of how their programs are actually working in terms of the advances they have made to the various institutions on the outside, is that what that means basically?

Mr. TAYLOR. Yes, that is basically what I have in mind. And it is very important to public policy always to evaluate the effectiveness. I think in this case it is particularly important because it actually, as Mr. Bachus was saying, there is a tendency to keep reacting and proposing new things. So my observation early on, for example, was that the term "auction facility" the Fed created, at least with the express purpose of reducing the spreads in the money markets, bringing LIBOR down, didn't really do that. And there are now multiple, 10 or 15 more, programs that need to be evaluated in the same way. And it is important, too, because if these reserves, money is going to be brought down from my chart, it could be some of these things could be ended if they are not being effective. So the TALF is still very large, there are still large loans to foreign central banks. So those might be some of the ways this money could be brought in. But in order to know that, you have to see which are effective and basically just make some cost benefit analysis. I think that is very important.

Mr. CASTLE. I tend to agree with you on that. And Dr. Blinder, you think the Federal Reserve has done a good job, maybe since October, but has done a good job on all of this?

Mr. BLINDER. [no verbal response]

Mr. CASTLE. Dr. Taylor, had those three recommendations. One, I think we probably all agree on. But more transparency in the Web site is a good start he said in that area. And then setting the range of reserves and then the serious evaluation studies. Do you consider those, even if the Fed is doing a good job, do you think those to be good improvements or would you critique any of them or not recommend any of them?

Mr. BLINDER. I would be 100 percent behind 2 of them, the transparency and the evaluation. We should always be evaluating what we do, especially when we are stepping into unchartered waters. I might add that, when you step into unchartered waters, the evaluation is not a trivial task because you have no model for it. You have done this 6 times before. The one that I would not endorse by any means is trying to establish some sort of target for the Fed's balance sheet. I think the conceptualization of the target that Chairman Bernanke has now, which is not at all numerical, is exactly the right one: in this crisis, do whatever it takes. If it is another $500 billion, it is another $500 billion. If it is not, it is not.

We will get market signals as the markets return to normalcy and we learn that banks no longer want to hold these enormous amounts of excess reserves. That is what they are. That whole gap that you see in Dr. Taylor's charts are excess reserves. Deposits haven't skyrocketed like that. These are mostly excess reserves. That is the symptom of a banking system cowering in catatonic fear. The one thing you know is safe are reserves at the Fed. So they want those reserves now. As Dr. Taylor says, when the system normalizes, they will not want reserves like that. And if you leave them out there, you are going to have a lot of inflation. But the Fed will see that happening right away. I just don't see that it makes any sense, nor do I see how the Fed could actually execute it, if the Fed was to follow a suggestion to post a target for its balance sheet.

Mr. CASTLE. Thank you. Dr. Galbraith, the mortgage bailout program, bank bailout program, to some degree was sold to us as troubled asset relief purchases, and of course, it didn't unfold that way as it turned out. Do you believe that we need to have some program that is going to go after those toxic assets and relieve the banks that we saw? I continue to read that banks just can't return to normalcy without that somehow being undertaken. Where should we be going with that issue?

Mr. GALBRAITH. This is an area where evaluation would also be very useful, because we are, I think, working with a mental model of these assets as marketable assets which are being priced at below something that may be their long-term reasonable value, and I am not at all sure that that is correct. I suspect that a private investor who is charged with doing real due diligence on these assets, who looked at the underlying loan tapes, would find that there was just not, in the nature of a subprime security, not any way that you could in good faith tell your client that you had information on the basis of which to value them.

And if that problem is really pervasive, as we have some indication it is, as some sampling of the files suggests it may be, then the sooner these assets are fully assessed and dealt with, written down, and the institutions who held them evaluated it on that basis, the more quickly we will get through the crisis, however big it is.

If we make the other bet that these assets will recover or can recover and are proven wrong, then we are going basically the Japanese route of forbearance and holding the institutions afloat, but without any real prospect that they will return to a normal behavior as you have just heard the other witnesses describe.

Mr. CASTLE. Thank you.

Thank you, Mr. Chairman.

Mr. WATT. The gentlelady from California.

Ms. WATERS. Thank you very much, Mr. Chairman.

I think that the hearings that we have been holding, the bank CEOs that we have been bringing in and others, and, of course, Mr.

Bernanke's testimony here yesterday is helping us to get a better handle on what we can do public policywise to help during this crisis.

I have a question that I would like to ask of any of our witnesses here today, because some of the actions that we have taken are not quite understandable. We have a number of small and community and regional banks that were invested in Fannie and Freddie. They bought their preferred stock because it was so safe. And when we took over, those small regional minority banks lost all of their preferred stock investment. Now some of them, I suppose, will stand in line and beg for some TARP money. But it seems to me that somehow that preferred stock that they had in our government enterprise should have been protected and not taken from them. Are you aware of this? Do you have any thoughts on that? I can start with Mr. Blinder.

Mr. BLINDER. Yes, I am aware of it, though I hope you won't quiz me on the exact details for any bank. I think it would be appropriate for the bank regulatory agencies to make special allowances—and I think they are. It is a version of regulatory forbearance because after all, as you said, Congresswoman, the Federal Government did this to them. They were holding this stuff, this preferred stock. It was thought to be a safe asset. It was treated as a safe asset by the regulatory authorities. They liked banks having this on their balance sheets. And then it was a Federal intervention that devalued the asset.

I think it is appropriate bank regulatory policy, and I am pretty sure the regulatory agencies agree with this, to treat that differently than when poor banking decisions lead you to balance sheet troubles. So I would treat it mostly—not so much in the way you suggested, but it is not so very different—with regulatory forbearance. That is, this is a piece of your capital structure that we, the national government, impaired. You didn't do anything. So we are going to give you a lot of time to get back to your proper capital position.

Ms. WATERS. Dr. Taylor?

Mr. TAYLOR. I basically would say I agree and just add that I think it is an example of what we were talking about earlier, how so often what has happened here is there have been some government interventions that have had these unintended consequences. And, of course, it is not just these banks that have held that; a lot of other private citizens and people have as well. So it is an example to be careful before you do these kinds of things. But otherwise, I would agree.

Ms. WATERS. Well, this was brought to our attention, and I think our Chairman, Mr. Frank, dealt with it, but we did not deal with it in terms of getting our regulators to take a look at this. Chairman Frank, I just brought up the fact that for all of those regional banks, small banks, minority banks that had preferred stock in Fannie—and when our government-sponsored enterprises were taken over, we allowed that preferred stock to be taken over from those banks. And now those banks, I suppose, have to get in line behind the big banks and try to beg for some TARP money. And it just seems to me there ought to be some kind of policy that would at least give some thought to how you give some protection to those regional banks rather than have them come back in line over in the TARP line and say, lend me some money or give me some money so that I can stay in business.

Dr. Galbraith, what do you think about that? And do you think—well, let me just say this: I had a private citizen come yesterday, and the private citizen said his whole family, he, his mother and all, they also have preferred stock in Fannie, and that just a few days before the government took over the stock, Paulson and others were saying that it was not in trouble—I don't know where these statements were made. I am going to look for them—that there was no contact with them. There was no indication that these government-sponsored enterprises were in trouble, that they were going to be taken over. And they still to this day have not been contacted, even though they have lost everything.

Dr. Galbraith, what do you think about the regional banks that lost all of their money, which put them in danger? And also private citizens who were not warned, have not been contacted, had no idea? This was a government—as you say—intervention.

Mr. GALBRAITH. Well, I am inclined to rely on Alan Blinder's authority on this matter as well, and to say that I think the position that he articulated is a very reasonable one. There are probably precedents from the era of the savings and loan crisis which are worth looking into for dealing with problems of this type. But I would have to look at the record just to give you a better, more complete answer than that.

Ms. WATERS. Thank you.

The CHAIRMAN. Mr. Posey, the gentleman from Florida.

Mr. POSEY. Thank you very much, Mr. Chairman.

A question for Mr. Blinder. You talked about the nationalization of banks in Sweden. What year was that?

Mr. BLINDER. I think about 1991. It was in the early 1990's.

Mr. POSEY. Did they formally nationalize them or just control them like we are?

Mr. BLINDER. My understanding is they formally nationalized some banks. And then to get around the problem that I was mentioning about Bank A and Bank B, they subsidized the other banks so they wouldn't be forced to fail.

Mr. POSEY. Did it seem to solve their problems?

Mr. BLINDER. Yes, it did. I think they came out of that banking crisis, which was extremely deep and severe, quite quickly and reprivatized the banks that they had nationalized. That is why Sweden is held up as sort of the poster child for successful nationalization and then denationalization.

Mr. POSEY. Yes. Some of us think that is just a buzzword.

Do you know what their corporate income tax rate was when they nationalized?

Mr. BLINDER. I am sorry; I do not.

Mr. POSEY. I think it was about 45 percent.

Do you know what it is now?

Mr. BLINDER. I do not.

Mr. POSEY. The nationalization didn't improve GDP. It didn't solve any problems. You know, it created an illusion, kind of like we are. I think their corporate income tax rate is probably 10 or 12 points lower than ours now. I am not sure. I think it was to focus on increasing their GDP, on creating jobs, real jobs that solved their problem. And nationalization got credit for it, nationalization of the banks.

Dr. Taylor, what happens if the foreign investors who are absorbed in their own domestic economic challenges decide it is not in their best interest to purchase our Treasury notes?

Mr. TAYLOR. I am sorry, not in their best interest to what?

Mr. POSEY. Purchase our Treasury notes.

Mr. TAYLOR. That is the kind of thing you should worry about, if not today, then in the future. That is why I say it is so important to think about the things like Social Security, to think about the fact that we have a large deficit coming in now. We should try to get that down. We probably shouldn't have had such a big one this year, it has been my view. So those are exactly the reasons I would be concerned. And you have a lot of people who have been buying our debt for a long time. Some people have been worrying about it for a long time, and I think we should worry about it. We think it is important to do everything we can to make sure that people have confidence in the United States and in our fiscal responsibilities and our intention to support our debt no matter what.

Mr. POSEY. The same thing with our secondary market securities?

Mr. TAYLOR. Which securities?

Mr. POSEY. Mortgage notes, our other paper.

Mr. TAYLOR. Well, that is anything that we are, of course, involved in now, absolutely. But from the point of view of individuals, yes. I mean, the idea is to do everything you can to be creditworthy, to maintain your creditworthiness and get back to basic principles.

Mr. POSEY. Do you see any way a cramdown could do anything but devastate that secondary market?

Mr. TAYLOR. No. I think anything—these cramdowns or any of these special interventions to the extent that you always have to think about what that is going to do to future borrowing, and to get out of this you have to make lenders want to borrow. If they are worried about cramdowns, or they are worried about interventions by judges that are ad hoc, it is going to make them less willing to lend and not more willing to lend.

Mr. POSEY. I wouldn't think anybody would buy anything that the government can simply devalue tomorrow at an arbitrary, capricious rate.

Dr. Galbraith, in your written testimony, you indicated that the arguments that Social Security and Medicare are a problem are mistaken dangers. Did I read that correctly?

Mr. GALBRAITH. Yes. That is right.

Mr. POSEY. I just want to make sure. I thought they gave me a paper that had some errors in it possibly.

You said the programs cannot go bankrupt any more than the Government of the United States can go bankrupt, which it cannot.

Mr. GALBRAITH. Right.

Mr. POSEY. Would you describe bankruptcy for me?

Mr. GALBRAITH. Bankruptcy is a term that applies to a private corporation which comes to the protection of a court when it is unable to pay its debts. And since the U.S. Government cannot get into that position, essentially it cannot go bankrupt in that sense.

Mr. POSEY. So you believe the U.S. Government can have no limit whatsoever on its liabilities and minimal assets, and that wouldn't be a problem?

Mr. GALBRAITH. Well, there are two senses in which one can talk about the word "limit."

Mr. POSEY. Let us talk about infinite. Infinite debt means no assets.

Mr. GALBRAITH. The question is whether there is an operational limit. The answer to that is no. Whether there are limits of prudence, the answer to that is yes. Obviously the government can spend too much or tax too little, and can conduct its affairs in ways that are economically unwise. The consequence for that—and this gets back again to the colloquy that you were having with Professor Taylor—is not that people would refuse to buy our—

Mr. POSEY. Because of time, could you give us a written answer to that?

Mr. GALBRAITH. Sure. But in one word, the problem is inflation.

The CHAIRMAN. The gentleman will get a written answer. I agree with what my colleague from North Carolina said: We don't have the luxury of time. We have more interests.

The gentleman from Kansas.

Mr. MOORE OF KANSAS. Dr. Blinder, in these difficult times when our constituents are anxious and frustrated with the state of our economy, I believe transparency is very, very important to communicate what actions we are taking to protect the U.S. taxpayers. An issue that came up at our Subcommittee on Oversight and Investigations hearing on Tuesday of this week was a potential oversight blindspot that may exist at the Fed. In particular, I have a concern that there may be a lack of sufficient oversight of TARP funds that pass through the Fed.

I understand the Fed's TALF program will use TARP funds to lend up to $1 trillion to thaw the consumer lending markets. The Acting Comptroller General, who testified as a witness before our hearing on Tuesday, expressed concern about GAO's ability to oversee TARP funds passing through the Fed.

I believe independence for the Federal Reserve is very important, but when the Fed invokes emergency powers through section 13(3) of the Federal Reserve Act and greatly expands its balance sheet, should Congress consider adding emergency oversight authorities to better track the use of funds?

Before you respond, let me give you one example. The congressional oversight panel at this hearing led by one of the witnesses, Professor Elizabeth Warren, testified at our hearing Tuesday that the Treasury Department overpaid an estimated $78 billion in its first round of investments into troubled banks. Professor Warren testified that, "There may be good policy reasons for overpaying, but without clearly delineated reasons, we can't know that. Without strong oversight protections of the Treasury's use of TARP funds, we would not have learned that."

So my question is, does this argue for having emergency oversight authorities at the Fed when they use emergency powers and taxpayers' money?

Mr. BLINDER. It is a hard question. Let me say a couple of things that I know and then speculate.

The TARP legislation that was passed by the Congress has multiple layers of oversight. The original infamous 2½ pager, which you will remember, didn't.

Mr. MOORE OF KANSAS. Yes, sir.

Mr. BLINDER. But what was eventually passed had tremendous amounts of oversight, some of which you just cited. My answer to the question, should it have heavy, heavy oversight, is yes. And I think it has that.

The problem that you were alluding to, Congressman, is that the early expenditures of the TARP—I don't want to say all of the first $350 billion, but a lot of it—seems to have been poorly documented, and poorly designed, by the way—poorly documented, poorly accounted for, etc. Some of this, I think, you can forgive because they were in a hurry. But I think a lot of it you can't forgive, that it just wasn't done the way it should have been.

Regarding the Federal Reserve, this committee and the corresponding committee in the Senate have oversight over the Federal Reserve. Chairman Bernanke and others come down to testify frequently. It is not obvious to me you need any further authority. Do you have oversight authority over the Fed? It is reporting to you now, I think—you will correct me if I am wrong—bimonthly on the section 13(3) actions, the extraordinary actions. And, of course, should the Congress reach the judgment that is not frequently enough, it can request that the Fed report more frequently than that. It is not obvious to me that any further powers are necessary to get done what you quite correctly want to get done.

Mr. MOORE OF KANSAS. Thank you.

I would ask the same question if any of the other witnesses have additional comments.

Mr. TAYLOR. I think that the mere fact that you are asking this question about whether you need more powers over the Fed is an example of my concerns that the Fed moving in this direction raises tensions about their independence. I really think the independence of the Federal Reserve has been very important and why we have basically had good policy for 20 years. And there is a concern about these actions, losing some of that. So I would say, whatever you do, you know, exercise the longer term and the shorter term, maybe find other ways to consider accountability, if you like.

Mr. MOORE OF KANSAS. Well, as I said, I agree with that, but I am concerned if, in fact, the Treasury Department overpaid an estimated $78 billion in its first round of investments in troubled banks, we need to address that situation and make sure that doesn't happen.

Dr. Galbraith.

Mr. GALBRAITH. I spent several years, Congressman, sitting behind where you are sitting now. So I very much take the view that while the Federal Reserve is properly independent of the President and the Executive Branch, it is in no sense independent of the Congress. It is a creature of the Congress, an artifact of the Federal Reserve Act, and you do have the authority and the responsibility to exercise appropriate authority over the central bank.

Mr. MOORE OF KANSAS. Thank you to our witnesses.

And thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Minnesota is next, I believe. Yes, the gentleman from Minnesota.

Mr. PAULSEN. Thank you, Mr. Chairman.

Given that our economic system is generally designed to be self-correcting, what recommendations do you have to minimize the other sectors right now that are being protected somewhat, the financial sector, the auto sector where we have had some discussion, these organizations that are essentially too big to fail? Do not some of these sectors need to have some correction applied to them and through market forces? And are the interventionist policies of the government that are being discussed now, are they the answer to sorting out or downsizing or rightsizing these sectors? Can you provide some perspective on that?

Mr. BLINDER. I don't think they are the answer, Congressman. But I would appeal to analogies that have been made by Chairman Bernanke and others that when the house is burning, you put out the fire, and you don't worry about the fire code. But you do worry about the fire code later.

And I take your point about the fire code. I think we need very large changes and multiple changes in the regulatory system. There is a very long list of things to do which I won't try to go over now. But just to take one point that you raised, about too big to fail, I think one of the things—once we have this problem, "solved"—well, it will never be literally solved, but once we are back to something like normalcy, we are going to be facing a financial system that has some giants in it that we never contemplated, the results of these forced shotgun marriages. And that really raises the too big to fail doctrine to an entirely different level.

I think we are going to have to think about whether—later, not now—we are going to have to think about whether one approach to too big to fail is to make it very difficult for organizations to actually get that big. That is a very large departure from what we have done in the past. But I think it should be on the congressional agenda—but again, for the future, not for today.

Mr. PAULSEN. I would be happy to hear some of the other comments you would have. In that sense, are we better off having one insurance company or 100 different ones to spread out the risks so that we don't have quite the too big to fail concepts, one AIG, for instance, which we could effectively nationalize some of these institutions?

Mr. BLINDER. Yes, that is a good example. I think it was a tremendous mistake, made largely by the private sector really and not by the State, to have so much of the CDS risk concentrated in one company. I mean, we should have never gotten to a position like that.

Mr. PAULSEN. Mr. Taylor.

Mr. TAYLOR. With respect to the self-correcting mechanisms, I sometimes think that government should have more faith in these self-correcting mechanisms. And in some sense, it screws them up, if you will, by intervening too much and too often.

Quite frankly, one way to deal with the too-big-to-fail problem is to establish a credibility about sometimes saying no. It seems to me more often it is going to help if you can establish the credibility of an institution—while this may not be too-big-to-fail, and we will have other ways to deal with the impacts if your institution fails—and therefore not just create the expectation that government will always be there.

As I mentioned before, and I study this crisis, it seems to me so often it is the government actions that have prolonged and worsened things, not the market. And the presumption, of course, these days is the government will be able to fix it. But I think dealing with too-big-to-fail through better market mechanisms, better resolution mechanisms is important, but ultimately it is going to come down to the credibility of the policymakers occasionally in the right circumstances with a lot of notice saying no.

Mr. GALBRAITH. I would say most living systems are self-adjusting. Animals get sick. They normally recover, and sometimes medicine helps them recover a little more quickly. But there are circumstances when they won't or when it will require really exceptional interventions to prevent the animal from perishing, to make recovery possible. That is when you need the intervention to be conducted with the greatest skill. You are never entirely sure that it is going to succeed. And the trick is distinguishing between this normal condition when recovery is to be expected at some point, and the exceptional condition when you are at risk that recovery may not happen.

That is the problem that I see facing the system at the moment. It is being subjected to such severe stress, failure both of vital internal institutions, the banks, and external shocks, that we have to think really quite freshly about what the appropriate degree of policy intervention is.

Mr. PAULSEN. I yield back.

Mr. WATT. [presiding] Thank you.

We have been called for a series of two votes, but we want to get one additional question in first. Mrs. McCarthy is recognized.

Mrs. MCCARTHY OF NEW YORK. Thank you. Thank you for the hearing.

Dr. Galbraith, I was going through your testimony, and one of the sections was about keeping people in their homes. That is the area that I am really concerned about. This morning's unemployment numbers came out. They were not good. Also we have another 500,000 people without a job. And you came up with two ideas, and you also were looking at a Warren Mosler, who I don't know, coming up with an idea. Could you go over some of the ideas that you had? Certainly Dr. Blinder and Dr. Taylor, if you have ideas, too.

Mr. GALBRAITH. My thinking on this is informed to a large extent by what was done by the Home Owners' Loan Corporation in the 1930's. What the government did at that time was basically to take over it and discount the troubled mortgages, renegotiate them, and manage the housing so that people could stay in their homes. And they managed that for about a million homeowners during a 15- or 20-year period.

Mr. Mosler's idea, which I think is an interesting one because it would minimize the amount of institutional disruption, is that you allow people to go through the foreclosure process, but then have the government pick up the house at the lowest of the appraisal price or the mortgage balance and allow the previous owner, if they want to, to live in the house on a fair-market rental basis with an option to repurchase when conditions improve. At that point, you are essentially rebooting the market mechanism for housing, but also trying to the maximum extent to keep homes occupied so that you stop the cycle of blight, which is going to keep driving down home values and also damaging the quality of life in neighborhoods for an indefinite period into the future otherwise.

Mrs. MCCARTHY OF NEW YORK. Do either of you have a—

Mr. TAYLOR. Just very briefly. I think that one of the problems here is the disconnect between the servicers and the investors. And in a normal circumstance, a bank would be able to work it out with the customers. They know them in the neighborhood, or know the nature of the loan. So dealing with that is an issue. And one suggestion is to give some incentive to the servicers. I think that is actually being considered now by the Administration.

But I think another thing would be to work on transparency. A lot of the original loan documents are not made available to the investors. And it is complicated because of the securities being packaged. But if the servicers would provide more information about that original loan documentation, then you would be able to distinguish between if you like the creditworthy borrowers originally and the ones that, you know, was a no doc loan, if you like. And I think more maybe even require transparency, but certainly more transparency is needed there.

Mr. BLINDER. Very briefly, Congresswoman, first of all, the Administration's program has a number of things in it that would go to exactly what you are talking about—keeping people out of foreclosures—including the approach to the servicers to free them of the legal liability, or at least to minimize it, that they now have.

Secondly, this committee and the corresponding committee in the Senate originated the HOPE for Homeowners program. As you will remember, to get that bill passed, the parameters were set so that the budget cost was practically nothing. That program could be liberalized and made to work. The problem basically was that it was put in a budgetary straitjacket that would cost nothing. You don't get too much when it costs nothing. But the parameters could easily be changed—I am talking about what it costs for the FHA guarantee, the eligibility requirements and so on—by an amendment to that Act.

Thirdly, and finally to the specific point you made, foreclosure mitigation won't be the whole thing, because the sad truth is some people got into ownership who never should have. They always should have been renters, and some of these mortgages are just not salvageable. So some ideas of converting owned homes to rental units, I think, are going to be a logical part of the ultimate solution.

Mrs. MCCARTHY OF NEW YORK. My concern is, especially at the fair-market price—I come from New York. Fair-market price to rent an apartment is almost a mortgage payment, where, you know, you go south or you go to the Midwest, apartments are much—certainly you get a lot more for your money, I will put it that way. That is my concern. Because with all these people who are going to be going out on unemployment, they have been paying their mortgage. Most of them probably have a 30-year mortgage.

And yet they are going to probably find several months down the road that they don't have the money to pay for their mortgage, and that is what I am concerned about.

These are good people, good risks, hard-working people. Hopefully, we can work something out to protect those people. What are we going to have, several hundred thousand people homeless? I mean, one way or the other, we are going to have to pay for them.

Thank you. I yield back.

Mr. WATT. The gentlelady's time has expired.

We are in the process of having two votes, so the committee will stand in recess until immediately after the votes. If anybody wants to ask questions, please come back immediately, and we will try to get back.

The CHAIRMAN. These may be the only votes today, I think. So people will be able to come back undisturbed, if the members of the panel can stay. Thank you.

[Recess]

Mr. SCOTT. [presiding] The hearing will resume. We have members coming in from voting. But in all fairness to our guests, we want to get started. We are very considerate of your time. We certainly appreciate you all coming.

It is my time next for comments, and I will start mine and then proceed with other members as they come in.

First of all, I want to thank Dr. Galbraith for his help to me personally. When we were faced with the early response in this fall and October, and we were putting together the first effort to recover and help our financial institutions, we were very concerned that there was nothing in that package, as some of you may remember, for what we considered the crucible of the problem, which was this extraordinary slide in home prices, the real estate market, and certainly due to outstanding mortgages and people unable to pay for mortgages, and so we needed to address that. And there was a number of us who were very concerned about that. The leadership stopped the process. We couldn't get the votes there because we didn't have enough on foreclosure. We were assigned to go get a plan together to address that, and we put a call in to Dr. Galbraith down at the University of Texas, and we were responded with that. And for that, Dr. Galbraith, we are very, very grateful to you.

I want to start my questioning off because I think we need to start right there on the whole issue of housing, home foreclosures, which is at the root of this problem, much of what we put forward in that first effort. The key word is remember, Dr. Galbraith, that we both secured that initial package was on, making sure there was sustainability, that we could come up with a way to sustain individuals in their homes, and we had put forward the effort of patterning it after the HCL, the housing corporate loan corporation back during the Depression. We were able to incorporate some of those. We laid the foundation for it. And I am very pleased that on the other issue of the moratoriums where we don't get success, we did get success last week when we had the leadership of the banking community before us. We asked that they put a moratorium on home foreclosures until we get this in place, and they did. So we have the pieces in place.

Dr. Galbraith, let me start with you on this question. Are we doing enough right now in the home foreclosure area? If we are not, what do you recommend that we need to do?

Mr. GALBRAITH. Well, first of all, Mr. Chairman, thank you for your remarks just now. I think that the housing plan that the Administration has announced is a very positive step, and I think that the step that you just mentioned, having gotten the commitment of the major banks to a moratorium on foreclosures, is another very positive step.

At the same time, the force that drives down housing prices is very inexorable. It is a massive downdraft on the whole credit system. And, of course, it has spread far beyond the subprime adjustable-rate mortgages to prime credits, and put a great many people in the position where from an economic standpoint, they are better off walking on their debts. And many, many more will do that.

So I think we are at the moment where we should be pulling all these pieces together and taking a comprehensive approach. And the trouble with a comprehensive approach is that, while there may be some way to do this without essentially checking on individual cases and sorting the hopeless cases from the sustainable ones and the honest cases from the fraudulent ones—but if there is a way of doing that, I certainly haven't come up with it. And I think that we need to adjust our ideas to the scale of this operation. As I have said before, the HOLC took 20,000 people to handle 1 million mortgages in the 1930's. It is a very big job and it will require a lot of effort.

Mr. SCOTT. Do you believe, Dr. Galbraith, that given the fact that we have $75 billion in this new program that the President has put forward, do you believe that is sufficient going forward, especially given the fact that it is estimated that in the next 2 to 3 years, there will be 9 million families in homes that default to foreclosure?

Mr. GALBRAITH. Well, my understanding is that the thrust of the President's program is to protect people who are shy of the threshold of foreclosure at this moment, so that people whose homes are too deeply underwater are not eligible for, for example, the extension on the limits of mortgage renegotiation. And so my answer to that is there is still a very large hole in the housing problem which has not been dealt with, and it has probably not been dealt with because it is pretty much the most difficult problem. But it is still, in my view, essential if one is going to shorten the period during which this excess supply of housing is acting as a drug on the market and driving down the asset prices.

Mr. SCOTT. If I may, I know my time is short, on the final point of my question, before I turn it over to one of my colleagues, to each of you, to give—if you could each of you give a very succinct answer to this question. We are moving on the housing front stabilization. Do we have our hands around the stability of our banking system? It concerns me that we have some debate over an issue of what we call—various people call it various things. But let us just deal with it as it is being called, and that is nationalization of our bank. How does each of you feel about the extent of the government's role in the banking industry? And are we close to that?

And specifically, I would like for to you comment to the Citigroup situation. I asked Fed Chairman Bernanke that yesterday, and as is the case with so many of our Fed Chairmen, out of great respect, your answer sometimes comes back to you in a way that even confuses the question that you put to get a clarity of the answer as to whether or not we are approaching nationalization.

But I would like to submit you to the point on the front page of The Wall Street Journal from yesterday. The CEO of Citigroup made the comment that he was in touch with Federal regulators and Federal officials from the Fed, and the essence of the article was that he was asking, in effect, that they not make decisions regarding their senior management. That tells me right there that he who makes a decision about who stays and who doesn't stay in terms of running the bank is in charge of that bank.

So I want to get an answer from each of you. Are we at that point of some form of nationalization? Is that what we are approaching? And the other thing, is it necessary in order to deal with the scope and the magnitude of the problem, I think, vis-a-vis what they did in a couple of our European countries? I will start with you, Dr. Blinder.

Mr. BLINDER. Well, very briefly, as I said in my testimony, I don't think we are at that point yet. I am hopeful that we won't get to that point. But I think we need to understand that we might get to that point, because one thing we have learned about this financial crisis is it keeps getting worse than we think. So I wouldn't rule it out. But I certainly wouldn't be eager to go there now for reasons that I outlined in the testimony.

As to Citi and others, I wouldn't pull out Citi for special treatment other than it seems to be first in line in its talking to the government. I think—and there are many—I think the right approach is the so-called good bank/bad bank solution. Now, that is not a well-defined—there are many variants of good bank/bad bank. I point out that the first time this was actually used—I think it was in 1990 with Mellon. They did it themselves. It was a purely private operation without the government.

Now, I think the holes in some of these balance sheets that we have now, especially if we mark the true market valuations, is so large that to make a good bank/bad bank solution to any of these large banks work now, public moneys would be needed. When you hive off the bad stuff into the bad bank, you start with an institution that has negative net worth. You have to bring that at least up to zero, which is a small number. And I don't think the private capital, frankly, in this state of the economy is going to be there, so it will need public funds. But that is not nationalization.

Mr. TAYLOR. Just very briefly. I listened to part of Chairman Bernanke's testimony the last couple of days, and I thought it was actually very helpful in clarifying that nationalization was not as commonly defined—at least not the way he would go about this. And I think the markets responded positively to that. Again, it is talking more about these large, complex institutions, because the FDIC frequently has taken over banks before they are sold off. So I thought his testimony was—maybe your standards here are too high, Mr. Chairman, but I thought it was very clear about that.

And also with respect to the Wall Street Journal article about Citi, it seems to me that is reflecting something very common today. The government is involved. It causes all sorts of issues, political. The government is not good at managing private firms, in my view. The New York Fed is now managing AIG. Look what is happening there. So it is something that we should be staying away from as much as we possibly can. I am not surprised when I read the tension in The Wall Street Journal. I am sure it is true, and in many of the other institutions.

Finally, I think now the most important thing is to try to get some clarity about what our policy is, and people are really clamoring, if you like, for clarity. So whatever it is, let us get on with it. And I think that will be probably the most important thing to do to get the stability you are asking about.

Mr. SCOTT. Thank you, sir.

Dr. Galbraith.

Mr. GALBRAITH. I take a different view. When a bank is troubled, when it is threatened with insolvency, let alone when it is, in fact, insolvent, the Federal Government, the regulatory authorities have the responsibility to intervene to protect the depositors who are insured by the FDIC, and the FDIC is charged with doing that under the law. A pass-through receivership is the standard mechanism for the resolution of these problems. In American law and practice, it was done scores of times with savings and loans in the late 1980's or early 1980's. It is being done with banks as we speak. It was done under the Bush Administration with IndyMac. It involves protecting the depositors, putting in new management, and the reason you want to do that, is that new management is required. It can be recruited from the banking industry, but it is required in order to get a clean audit so that you can effectively separate the bad assets from the good ones, and so that the public knows the extent of the hole in capital and the extent of potential liabilities to the insurance fund.

And then you go about arranging for the bank to be reorganized for sale. It may be merged, it may be sold, it may be broken up and sold. It may require infusion of public money. But until you have gotten a clear assumption of responsibility and a clear accounting, you won't know exactly what to do. The FDIC has experience with this, is in general competent to do it, although obviously doing it with very large banks is a daunting challenge. And that should be their call and their responsibility free, I believe, of political interference from the Congress, for that matter, or from the Treasury Department. It really is a professional judgment. That is why I don't like the term "nationalization," which implies a political decision. This really seems to me to be a professional regulatory responsibility.

Mr. SCOTT. Very good. Thank you, all three of you. Very interesting.

Mr. Green of Texas.

Mr. GREEN. Thank you, Mr. Chairman.

Friends, I will move as quickly as possible because I have a number of areas that I would like to cover. And I would like to employ the voir dire system wherein I ask you to simply raise your hands so I get a quick indication of where you stand. So let me start and thank you for coming.

Let us start with Chairman Bernanke indicating yesterday that we were on the verge of what may have been considered a financial meltdown. Do you agree that we were on the verge of a financial meltdown last year? If so, would you just kindly extend a hand into the air? This will be helpful.

I have one disagreement. Mr. Taylor, could you as tersely as possible indicate why you do not think we were not on the verge of a financial meltdown?

Mr. TAYLOR. On the verge is so hard to describe. I didn't hear his testimony, didn't know the context. We are in a very serious financial crisis.

Mr. GREEN. Let me ask you this: Last year were we in the midst of a very serious financial crisis? Is your answer yes or no?

Mr. TAYLOR. Well, it worsened—

Mr. GREEN. I borrowed your language, by the way.

Mr. TAYLOR. Yes.

Mr. GREEN. Given that we were in this serious financial crisis, do you agree that the TARP funds were spent such that they had a positive impact on the financial crisis? If you could kindly extend a hand into the air, it would be helpful. The TARP funds, were they spent such that they had a positive impact on the financial crisis, the possible meltdown?

Mr. BLINDER. Are we allowed to say positive but poorly spent?

Mr. GREEN. Poorly spent, but positive impact. Okay. Mr. Taylor.

Mr. TAYLOR. I didn't see a positive impact.

Mr. GREEN. Positive impact, sir?

Mr. GALBRAITH. I am right on the fence on that one, as Alan is. You can point to specific positive effects, but in general it could have been done much better.

Mr. GREEN. Let me follow up with you. If you concur that we were on the verge of a financial meltdown, and I assume that you do not conclude that currently we are on the verge of a financial meltdown—

Mr. GALBRAITH. No. My view actually is that the meltdown had already occurred.

Mr. GREEN. That we had already gone through the financial meltdown?

Mr. GALBRAITH. The problem here was the extraordinary explosion of these toxic assets, and that problem still sits in the banking system. The core of the system has melted. It is a question of whether the containment structure is—

Mr. GREEN. All right. Let me move on with a few other things. The concept of the bad bank. Dr. Blinder, you indicated that you would employ this. We did not hear specifically from the other panelists as to where you stand. Mr. Taylor, where do you stand on it, please?

Mr. TAYLOR. I would not like to go in that direction.

Mr. GREEN. You would not. Okay.

Dr. Galbraith.

Mr. GALBRAITH. The good bank/bad bank?

Mr. GREEN. Yes, sir.

Mr. GALBRAITH. I think one—the reorganization of the banks should be the responsibility of the FDIC.

Mr. GREEN. Is your answer no? I have other questions, that is why.

Mr. GALBRAITH. They will isolate the bad assets.

Mr. GREEN. Is your answer yes or no? I am not sure. Sometimes when people finish, I do not know whether they said yes or no.

Mr. GALBRAITH. Well, I am not entirely sure I have understood the thrust of the question.

Mr. GREEN. The thrust of the question is this: As the concept exists now, good bad/bad bank, the bad bank to take in assets, acquire these assets, these toxic assets, is that something you would see as doable?

Mr. GALBRAITH. As a part of reorganizations of failed institutions, yes, that is what you do.

Mr. GREEN. Moving to another area. Let us talk quickly about judicial modification of mortgages. Is as proposed, which is a retrospective approach, not a prospective, but a retrospective approach utilizing judicial modification, is this a part of one of the tools that we might utilize? And we will start with you, Doctor.

Mr. BLINDER. My brief answer is yes, though it is not my favorite approach.

Mr. GREEN. As a last resort. Only after the person who happens to have the mortgage has made an effort to settle with the servicer who represents the investors.

Mr. BLINDER. Yes. My preference would be to take this out of the realm of bankruptcy courts. But if this is what—what you just said is actually on the congressional table right now—

Mr. GREEN. Yes.

Mr. BLINDER. —it is a lot better than nothing.

Mr. GREEN. Okay. And I must move quickly here.

Mr. TAYLOR. No.

Mr. GREEN. Dr. Taylor, no.

Mr. GALBRAITH. Yes.

Mr. GREEN. Yes. Let us move quickly to one additional thing, and maybe I will be able to get your rationale as to why not, Dr. Taylor.

But credit default swaps. They have almost gone off the radar in terms of being an issue du jour. Let me ask you if this is something that is still lurking out there that could possibly overwhelm us in the sense that my understanding is that these credit default swaps can total more than what the entire stock market happens to have within it currently. So, Doctor, is this something that we have to give serious attention to?

Mr. BLINDER. I think absolutely. It was just in the paper the other day that AIG is liable to be coming in for yet more money because of yet more losses on credit default swaps. It is not over.

Mr. GREEN. Dr. Taylor?

Mr. TAYLOR. Yes. One of the proposals to create some kind of central-clearing mechanism is really what we need.

Mr. GREEN. Dr. Galbraith.

Mr. GALBRAITH. Yes.

Mr. GREEN. I am sorry I had to move so quickly, friends. The final question will be sort of a general question. We talked about the Home Owners' Loan Corporation from the 1930's. That paradigm seems to have been somewhat efficacious at the time. Is there a means by which we can employ something similar at this time as a tool to help us through this crisis? Dr. Blinder.

Mr. BLINDER. Yes. I think you did. I think the HOPE for Homeowners was a variant of the HOLC. The HOLC made the government the banker and actually owned the mortgages. The HOPE for Homeowners made the government the guarantor; not the owner, but the guarantor.

Mr. GREEN. I understand. But I will follow up with this: It was a voluntary system.

Mr. BLINDER. So was the HOLC.

Mr. GREEN. We didn't get a lot of participation, but because of the lack of participation in the system, the question is, how do you tweak it so that it is utilized? Because while it is a great idea, if nobody embraces it, it is an idea unused.

Mr. BLINDER. I couldn't agree with you more. I learned in the break that this committee has actually passed the liberalization or a tweaking of it. I didn't even know that. I applaud that. I think what it also needs is some form of extensive outreach. The sad fact is that in all the government's programs—I mean, this is true even of food stamps and things—a lot of people who are eligible for these programs have no idea they are eligible. They don't even come in and ask for them. So this goes to your question of the take-up rate. I think you probably need to add to that some substantial outreach.

Mr. GREEN. I am going to yield back, but I would like, if I may, to get answers to the two remaining—

Mr. TAYLOR. I am not familiar with the modification of the bill to which you are referring, so I think I will just pass.

Mr. GALBRAITH. I am in full agreement with Alan Blinder on this.

Mr. GREEN. Thank you, Mr. Chairman.

Mr. SCOTT. Dr. Galbraith, did you comment on that? Did you have a chance to comment on it?

Mr. GALBRAITH. Yes. I said I fully agree.

Mr. SCOTT. Okay. The gentleman from Missouri, Mr. Cleaver.

Mr. CLEAVER. Thank you, Mr. Chairman.

I think, Dr. Blinder, you earlier mentioned how you thought that using the term "nationalization of banks" was negative, which I agree with. The problem we have is that, frankly, we are not in charge of how issues are framed, so people who are opposed to what we are doing begin to talk about nationalization of banks. It gets out. I don't think you can find any instances where the Chair or anybody in a responsible position in Congress would talk about nationalizing banks. I think that is dangerous. And also we are now inserting into the lexicon "bad bank/good bank." It is going to be a problem as well. And I am hopelessly on a crusade to try to stop it, but I lost a long time ago. I guess crusades are supposed to take place with the possibility of not winning.

I just think we are headed in the wrong direction on that, and it is going to be out. And then our constituents are going to be raising questions about, well, is this a good bank, or is this a bad bank? You know, you have a—you know, some kind of bad experience is a bad bank. It is not going to be a good thing. The Treasury, I think, may have made a mistake since they are the—I think on this issue—the framer.

But anyway, that was some meaningless rambling about our lexicon, and it won't get us anywhere. What I want to talk to you about, Dr. Galbraith—actually I want the three of you to be engaged in it—but someone raised the issue earlier about our debt to China, which actually is not as great as our debt to Japan. But we are moving toward $2 trillion Chinese holdings of U.S. assets. And the question is constantly raised when I am out in my district about what happens when China decides they don't want to acquire any more U.S. paper? And my answer is usually that the Chinese have no other options for investments, and that they will, in all probability, want to continue to invest. We might have a problem of interest rates rising if they do become weary, and then we will have to go with the interest rates in order to continue to get the investment. Is there another scenario that you would like to add to what I have just said?

Mr. GALBRAITH. I think the Chinese may not be very happy with their portfolio position, but they don't have much choice about it. They want to sell exports to us. They are going to earn dollars. They have to do something with them. They also accumulate a lot of those reserves actually not from trade, but converting dollars that were brought in to invest in the real estate and the stock market in China. That is also something that they did incidentally to other public purposes that they had.

So I don't think it is likely that the Chinese are going to suddenly adopt a policy of active dollar dumping or moving away from dollar assets. If they chose not to renew their securities, we would simply debit their securities account and credit their reserve account. They would then have the dollars. They would have to sell them off to somebody else, and probably the Europeans would end up with the dollars.

But with all that said, it just seems to me that it is not an immediate and maybe not even a distant problem that the Chinese or the Japanese would prefer to hold euro or some other major currency as a reserve asset rather than the dollar. The vulnerabilities of the banking system in that part of the world are at least as great as they are here, and the credits of the government—the security of the governments that are behind the euro—is much less than it is here.

Mr. CLEAVER. Is there any concern—and I have not been able to find the answer to this question. Is there any concern that the Chinese actually are holding substantial securities that were acquired from Fannie and Freddie which are actually subprime mortgages? I have not seen any information on whether or not that has, in fact, happened with the Chinese.

Mr. GALBRAITH. I have not either. I know they have—they hold a lot of agency debt, but I don't believe that they have been—in their official accounts—holding the privately securitized subprime debt. But that is a question I don't have an answer to, for sure.

Mr. CLEAVER. Thank you, Mr. Chairman.

Mr. SCOTT. Thank you.

The gentleman from Colorado, Mr. Perlmutter.

Mr. PERLMUTTER. Thank you, Mr. Chairman.

And, gentlemen, thank you for your time today and your sort of advice on these things.

I have a couple sort of macroeconomic questions. The first is, we have sort of divided this thing up into three parts. One was to try to stabilize the financial markets, which some positive effects out of TARP could have been done better. Second is, in my opinion, stimulate the economy, get it going again. Third is to restore confidence in the system. We have regulations to deal with. So we are going to have a hearing soon on some of the regulations that may have been eliminated in the past and some that are in place and seem to be compounding problems overall within the system.

So my question to the three of you, let us start with mark-to-market, which seems to get a lot of conversation here, and I am looking at it closely. Within the overall economy, do you all have an opinion on whether we should be maintaining on a daily basis some mark-to-market that banks need to collapse their capital or not? Does anybody have an opinion on that? And if you want to reframe the question, I am happy to have you do that, too.

Mr. BLINDER. I am generally very favorable to mark-to-market. And while there is a lot of debate, as you have mentioned, on whether it is part of the problem or part of the solution, I am much closer to "part of the solution." We need to know how big the balance sheet holes are. When I say "we," the markets need to know. And then you can start doing things.

That said, there are at least two things that I think we should think of as, I don't really mean exceptions, but qualifications. One is that banks have always had these hold-to-maturity accounts where most loans are, for example. They are not going to sell these loans. They will hold them to maturity. They reserve against them, which is the version of mark-to-market that you get there. I don't see any big need to change that. Now, the reserving might be inadequate. That is what supervisors are supposed to be watching, to make sure there is enough reserving.

The second thing, which is a much knottier problem, which we really haven't had to face until recently, is: what do you do when, so to speak, markets disappear? What if you have an asset that is ask 60/bid 20? Bids and asks are supposed to be right next to each other. But when it is 60/20, the whole notion of mark-to-market becomes a difficult one to deal with. And I don't have a fixed answer to that. Some people have said the answer is simple: you mark to 20. I am not so convinced that is the right answer, and I think it needs a lot of thought.

Mr. PERLMUTTER. Okay. Thank you.

Dr. Taylor.

Mr. TAYLOR. I don't have too much to add to that. I think mark-to-market provides the information you need. But in some cases where the securities are going to be held to maturity and it is in a bank, then there are other ways to do it. I think there is some sense of forbearance here is what people are looking for, and I am very positive about that.

Mr. PERLMUTTER. Dr. Galbraith.

Mr. GALBRAITH. The argument against marking to market the subprime mortgage-backed securities has been that the market is somewhat artificially depressed relative to the real value of those securities. I am very suspicious of that argument. I think it is very unlikely that, even if you did take them off the books of the banks at a guaranteed value that was higher, that the Resolution Trust Corporation that would eventually sell them would be able to get rid of them for anything higher than the market price. And the reason is that I suspect that the markets understand that there is, in the case of these securities, practically no way to know what the underlying risk really is, because the documentation they would normally rely on isn't present. And that seems to be a real problem with modifying mark-to-market in this particular circumstance.

Mr. PERLMUTTER. All right.

The second question, which is similar to a mark-to-market, is the cramdown. I mean, that is marking to market. If we, and again on a macroeconomic basis, and I don't know exactly how many people will take advantage, if we do a cramdown in a Chapter 13 and we have 10 million potential foreclosures out there—I don't know what the number is, maybe you all know—what is going to happen? Do you have any opinion of what will happen to the system if everybody takes advantage of a cramdown?

I will start with you Dr. Galbraith, and work backwards.

Mr. GALBRAITH. Well, if you replace a completely unmarketable security with a mortgage which has a lower return but which in fact is documented, has some capacity to be sustained, you might actually move to a better market environment after the cramdown than before. And that is what I think you would be hoping to accomplish by putting these mortgages on a sustainable 30 year, 40 year, 4 percent basis, if you can do it.

Mr. PERLMUTTER. Dr. Taylor.

Mr. TAYLOR. Any, if you like, force cramdown, like the one I think you are talking about, raises questions about future lending and what is going to happen in the future, especially if it is retroactive. So I am very cautious about any kind of legislation like that.

Mr. PERLMUTTER. Dr. Blinder.

Mr. BLINDER. I actually think, going forward—and this is not the current congressional proposal—I would like to see homes treated like vacation homes and other assets. It is not the case that you can't get loans against assets that can be crammed down in bankruptcy. Basically, all business assets can be crammed down in bankruptcy. It probably results in a couple more basis points, I don't know, on the cost of credit. But that is going forward.

The retroactivity, I think all of us are very uneasy about retroactivity. I am. It should be a general constitutional principle: You don't pass retroactive laws. This looks to me like an emergency. I think there may be better ways to do it. But as I said in an answer to another question, if that is the proposal that is actually on the congressional table, then I would support it, though it is not the sort of thing that, generically, I like to support.

Mr. PERLMUTTER. Thank you.

Thank you, Mr. Chairman. I yield back.

Mr. SCOTT. [presiding] Thank you. In all fairness to the proposal that is on the table, it is narrowly drawn. It doesn't apply to all of the mortgages falling in foreclosure, and it would not extend beyond the enacting of the bill. The intent of what we are trying to do in grappling with this issue is to try to put a floor. At some point, you have to try to put a bottom and a floor on. And these are in the most desperate situations.

And then, certainly, there is a fairness issue that, for the wealthy, who can have this benefit for their second home or third or vacation home, here you have the primary residence. And then the other issue is, certainly, going back to what we mentioned earlier with Dr. Galbraith, we have to find a way of sustainability to keep people in their homes.

And this cramdown and this bankruptcy is a grappling issue, and hopefully, we can get it right.

I think we will come back next week, as you know, Mr. Perlmutter, and try to wrestle with it again.

Thank you very much.

And now we will turn to the gentlelady from Ohio, Ms. Kilroy.

Ms. KILROY. Thank you very much, Mr. Chairman, and thank you to our guests.

I have been very interested in your testimony and the various ideas that challenge us to find the right pathways to go and to do our work here in the Financial Services Committee well and appropriately, not—allowing the regulators to do the work that they are professionally trained to do. I thought those were very interesting comments.

Many of the questions that I had come prepared to ask have already been covered by the committee. But I wanted to go to some of the thoughts and ideas that are a little bit, moving away a little bit from issues like retroactivity, which we could debate, and cramdowns. In talking about some of the ways that we can do to restore long-term financial stability to our country and to our economy, measures that we could take a look at the big picture, infrastructure, social security, health care, I would like to ask the panel to maybe revisit that a little bit before we adjourn today.

Mr. TAYLOR. Well, I think the earlier questions about this is whether we should be addressing something like social security now or wait until later, and my view is, yes, now. We should be getting on with these things, because they demonstrate that we are concerned as a country with our fiscal imbalances. That is a huge imbalance down the road. So I would be of the view that let's get started with those now. That is actually economically one of the easier ones. It is politically very difficult. But I think it would demonstrate a great degree of confidence, if you like, that the government has taken on something like that.

Mr. BLINDER. I agree with that very much.

And I would put just a slightly different nuance. Given the incredibly difficult issues that the Congress has been grappling with now, the huge sums of money, and it is not over, Social Security has actually become the low hanging fruit. This is an easy issue actually. You do not have to do horrific things to get Social Security back into actuarial balance.

Secondly, because Social Security is running a big surplus now, and it is inherently a very long-run problem, the natural things to do will be clipping benefits, if you want to use that term, and raising revenue down the road. It is not at all urgent to do it now.

So the Congress can enact now fixes that will take place years from now. That is what the Greenspan commission did in 1983. That is not nearly as painful as appropriating $1 trillion to rescue banks today. And I think it would send a terrific signal about this seemingly contradictory position that we are going for huge deficits today but fiscal responsibility tomorrow. That would be a tangible manifestation, written into law, of a modicum of fiscal responsibility tomorrow.

Mr. GALBRAITH. I am in very deep disagreement with my colleagues on this point. I can see no economic reason why going forward we should be concerned about the balance between a stream of revenues called payroll taxes and a stream of obligations called Social Security benefits. If you are concerned with that question of balance, you could solve that problem. It actually is not a problem, but you could solve that cosmetic issue by assigning some other tax source to Social Security. The estate tax, as the late Social Security Commissioner Robert Ball suggested, could be put into the trust fund. You don't need to solve this problem, this alleged problem, by legislating today reductions in a core benefit on which 40 percent or more of the American elderly rely for practically all of their income, and particularly not at a time when the other sources of income and wealth that support the elderly population have taken an enormous hit, with housing values, stock equity values, and the interest income on cash holdings all going down simultaneously.

Social Security is more important than ever as the bulwark of the middle class standing, the nonpoverty status of the elderly population. So I would hope very much that we would resist the temptation to make this what is essentially a symbolic and political gesture at this time or at any time.

At the same time, on the broader question that you raised of whether one should be treating this as a long-term or a short-term problem, my view is this crisis is the opening act of a long-term transformation of the economy. And we are going to need, as we think about building the economy back up from the calamity through which it is passing, we need to think about this from a long-term perspective.

And one of the defects of what we have been doing so far has been the assumption that the economy will recover within 2 or 3 years and, therefore, we can limit the scope of action to the shovel-ready projects and the short-term expenditures. I don't think that is going to work. We will only discover over time whether I am right or not. But if I am right, then the right approach is to think about the public investments that are truly transformational and begin to do them now—to build institutions like a national infrastructure bank, the Dodd bill, that can finance that transformation going forward, and to build into these projects the kind of development of new industries that deal with our energy problems, with our climate change issues, with the creation in some sense of the living space that we want to have for the next generation. It seems to me that if we do that, we will be remembered for having made an opportunity out of a crisis.

Ms. KILROY. Thank you.

I yield back.

Mr. SCOTT. The gentlelady's time has expired.

Thank you very much.

On behalf of our Financial Services Committee, on behalf of the Congress, and of the American people, we really thank each of you. We are at a critical, crucial point in the history of our country. And the hopes and aspirations of millions of Americans, and our children and grandchildren have come to rest on what we do here today.

And your intellect, your ideas, have been very helpful to us as we move forward to grappling with these very monumental and critical issues. You know, it is the tough times that determine the character. We have had tough times in our Nation before, and that is why we have a tough character that has made us a great Nation.

We thank you, Dr. Galbraith, Dr. Taylor, and Dr. Blinder.

This meeting is adjourned.

[Whereupon, at 1:12 p.m., the hearing was adjourned.]

A P P E N D I X

February 26, 2009

Federal Reserve Policy in the Current Economic Situation

Testimony of
Alan S. Blinder
Gordon S. Rentschler Memorial Professor of Economics and Public Affairs
Princeton University
to the
House Committee on Financial Services

February 26, 2009

Mr. Chairman, Ranking Member Bachus, members of the Committee, I'd like to start by saying that I have read Chairman Bernanke's prepared testimonies of February 10th and February 25th but have not had full benefit of the Q&A that followed each. Subject to that proviso, I agree with the Chairman on almost every particular. And I feel the country is fortunate to have someone as courageous, creative, and thoughtful as Ben Bernanke sitting in that chair in this perilous time. Since October, he has been doing an impossible job very well. Now to some particulars.

Interest rates

Regarding conventional monetary policy, the Fed got off to a rather slow start when the crisis first broke in the summer of 2007, but has more than made up for lost time. Specifically, I applaud the FOMC's decision to lower the federal funds rate to virtually zero in December and pledge to hold it there "for some time."[1] Indeed, it terms of its aggressiveness in cutting rates, the Fed has set an example for the world.

Nevertheless, the economic outlook is bleak, as Chairman Bernanke said yesterday. He made two points that I'd like to underscore. First, he strongly suggested that his own

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[1] Ben S. Bernanke, Statement before the Committee on Financial Services, U.S. House of Representatives, February 25, 2009, p. 3. All Bernanke quotations in this testimony are from this source.

outlook for 2009 is worse than the FOMC's central tendency.[2] So is mine. The bottom end of the Committee's range is a 1¼ percent decline over the four quarters of 2009. I expect we'll lose that much ground in the first quarter alone, and I'll be thrilled if the next three quarters net to zero.

Second, he observed that, "If actions taken by the Administration, the Congress, and the Federal Reserve are successful in restoring some measure of financial stability—and only if that is the case, in my view--there is a reasonable prospect that the current recession will end in 2009…" (p. 7). Again, I agree—with emphasis on the "only if" part.

We are now fighting a two-front war and, like most two-front wars, you only win if you prevail on both fronts. Specifically, we must both restore aggregate demand and revive the financial system. The two interact, in both vicious and virtuous cycles. The vicious cycle is what we have experienced to date: first, the financial collapse dragged the real economy down, and now the recession is weakening the financial sector further. But that same interaction can operate as a virtuous cycle: A stronger economy will reduce loan losses, and a stronger financial system will help the economy recover.

Quantitative easing

Let me now turn to *unconventional* monetary policy, which is far more important these days. Here, the Fed has been terrifically creative. I want, in particular, to praise its moving away—to the maximum extent possible, which is not 100%—from the institution-by-institution approach to the market-by-market approach. The former is a series of *ad hoc* rescue operations for (or decisions not to rescue) troubled institutions. These rescue operations, while sometimes necessary, take us nowhere toward a cure and leave markets wondering about the rules of the game. The market-by-market approach,

[2] In his words (p. 7): "I believe that, overall, the downside risks probably outweigh those on the upside."

by contrast, seeks to revive moribund markets, and operates within a set of relatively well-defined rules. Using this approach, the Fed is now supplying the commodity that is in shortest supply these days: the willingness to bear credit risk.

Under normal circumstances, of course, the private sector, not the government, should bear such risks. One day, we will get back to that. But for now, risk premiums in most financial markets are wildly high, and some markets have almost ceased to function. As long as such abnormal conditions persist, the government is right to step in to provide the risk-bearing services that no one else seems willing to provide. The central idea behind the TALF, for example, is for the Fed to nurse one moribund market after another back to health—as it has already done with commercial paper—and then withdraw.

I think that's the right thing to do, and I'd like to contrast it with the idea of buying longer-term Treasury notes and bonds. To be sure, buying long bonds would be on anybody's list of possible quantitative easings, once the federal funds rate is driven to zero. And Chairman Bernanke has mentioned doing precisely that, though not in yesterday's testimony. I must say, however, that I don't understand what purpose would be served by buying long-term Treasuries now. Today's problem is *not* that the yield curve is too steeply sloped; in fact, a steep yield curve probably helps recapitalize banks. The problem, as I have just mentioned, is that various risk premiums are way too high. And I don't see how buying *riskless* Treasury bonds will help that.

Before closing, I'd like to touch briefly on two other issues.

<u>Transparency</u>

First, I applaud Chairman Bernanke's forthright new position on Federal Reserve transparency. He said, "The presumption of the committee will be that the public has a right to know, and that the nondisclosure of information must be affirmatively justified by clearly articulated criteria for confidentiality… (p. 6)" As you may know, this has been my position on Federal Reserve transparency for many years. I think it is the right one, and I am delighted to see the FOMC embrace it—permanently, I hope.

Nationalization

Finally, there has been much talk in recent weeks about nationalizing banks--talk that has not been very helpful, in my view. While I recognize the possibility that some U.S. banks might eventually have to be nationalized, restructured, and then either re-privatized or euthanized, we are not there yet. This seems also to be Chairman Bernanke's position.

My problems with rushing to nationalization can be summarized in four words: *We are not Sweden*. By that, I mean four things:

First, Sweden had a handful of banks, while we have over 8,500. Where to draw the line on nationalization is a real problem since, e.g., nationalizing Bank A but not Bank B will disadvantage Bank B when the two banks compete for funds in the marketplace. For this reason, nationalizing some banks will weaken others. And I don't think anyone contemplates nationalizing all 8,500 banks. Nor should they.

Second, and related, if we began a bank-by-bank nationalization process that wipes out existing shareholders, speculators would start attacking those banks deemed most likely to be nationalized, thus destroying their share values and ballooning their CDSs. Such market reactions could create a vicious cycle of self-fulfilling prophecies.

Third, the nationalization and denationalization process in Sweden was amazingly free of political interference. You ladies and gentlemen can judge better than I, but as a citizen, I'm dubious that that would happen here.

And finally, even though I'm an economist, I wouldn't entirely dismiss the notion that nationalization is "un-American," by which I mean that it runs against deeply ingrained political and economic traditions. If so, the act of nationalization might actually undermine rather than enhance confidence.

Statement by James K. Galbraith, Lloyd M. Bentsen, jr., Chair in Government/Business Relations, Lyndon B. Johnson School of Public Affairs, The University of Texas at Austin and Senior Scholar, Levy Economics Institute, before the Committee on Financial Services, U.S. House of Representatives, Hearings on the Conduct of Monetary Policy, February 26, 2009.

Mr. Chairman and Members of the Committee, it is again a privilege to appear today at these hearings, which as a member of the staff I worked on from their inception in 1975.

In 1930, John Maynard Keynes wrote, "The world has been slow to realize that we are living this year in the shadow of one of the greatest economic catastrophes of modern history." That catastrophe was the Great Crash of 1929, the collapse of money values, the destruction of the banking system. The questions before us today are: is the crisis we are living through similar? And if so, are we taking adequate steps to deal with it? I believe the answers are substantially yes, and substantially no.

This statement covers six areas very briefly:

– Why the baseline forecast is too optimistic, and why the recovery bill was too small.

– Why low interest rates will have limited effectiveness going forward.

– Why the banking plan will not work.

– Why Social Security and Medicare are not part of the problem, but of the solution.

– How to keep people in their homes, and

– Why our long-term infrastructure and energy needs should be addressed now.

1. The Baseline Forecast is Too Optimistic and the Recovery Bill was Too Small.

In early February the CBO baseline projected a "GDP gap" averaging about six percent over the next three years (Table One). They also expect a recovery beginning late this year and a return to normal by 2015. That was the baseline: the forecast even if the ARRA had not passed.

The baseline rests on a mechanical assumption: that there is a "natural rate of unemployment" of exactly 4.80 percent. The assumption is that labor-market adjustments will return us to this rate over time. By labor-market adjustment, economists usually mean a fall in real wages, sufficient to make workers more attractive to employers.

This assumption is unfounded. No fall of wages will restore employment. Employment does not depend materially on wage rates, but on the prospect for sales and profits. And these require credit. Flow-of-funds data for December show that the fall-off in new borrowing is the greatest in 40 years. The Levy Institute's accounting-based macro model, based mainly on the rate at which households are liquidating their debts, now suggests that the GDP gap will be as much as 12 percent of GDP, with *no* recovery in sight. This is shown in Figure One. This gap is compatible with unemployment rates near ten percent, indefinitely.

The ARRA should add between 2 and 3 percent to total demand, per year for two years. With normal multipliers (about 1.5 for spending) the total boost to GDP might be between 3 and 5 percent. This would be enough to turn a baseline recession averaging 6 percent into something quite mild. But if the true collapse is twice as bad, the stimulus was too small. And the multipliers are probably overstated, because in a deep crisis liquidity preference grows stronger. A 12 percent GDP gap might require a stimulus of, say, 10 percent including automatic stabilizers to cope with it. The bill as enacted was far short of that.

Chairman Bernanke, in his speech at London in January, said "the global economy will recover." He did not say how he knows. And the truth is, this is merely a statement of faith. In present conditions the most dangerous position is that of the unfounded optimist. Those who use this position to defend a program of inaction, or of little action, or to defend a program of action that is geared to a forecast of automatic recovery, might possibly turn out to be right. There might be a deliverance. But to rely on that possibility in the design of policy is surely unwise, for at least two reasons.

First, we know that bad news has been outrunning the forecasts for months. Professional economists, working with the normal models, failed to predict the crisis. In many important cases, including high officials, they actively denied it could happen. Chairman Bernanke was typical: through July of 2007, he argued that the Federal Reserve Board's predominant concern was inflation; thus the Federal Reserve was unable to give Congress a foretaste of a crisis that was to erupt within days. And as the crisis has unfolded, events have repeatedly come in worse than expected or caught us by surprise. This should tell us something.

Second, we know that the origins of the crisis lie in a breakdown of the banking and financial system, following a breakdown in the regulation of mortgage originations, in underwriting, and in credit default swaps. This is something we have not seen in our lifetimes. We know that the actions already taken in response – the TARP, the nationalization of the commercial paper market and the swap agreements with the ECB and other central banks – are unprecedented. We know that these measures have, at best, only averted a deeper catastrophe. And we know that the baseline forecast, which is a mechanical procedure based on statistical relationships between non-financial variables, for the most part, takes none of this into account.

We therefore have no basis for confidence in the baseline forecasts, and we should prepare ourselves, as Churchill said to Parliament at the time of Dunkirk, "for hard and heavy tidings."

2. Monetary Policy Alone Cannot Restore Growth and Employment

Chairman Bernanke deserves respect for his forceful interventions since the crisis broke. A failure, last October, to nationalize the commercial paper market would have been disastrous. Increasing deposit insurance limits warded off a run on the banks. The extension of currency swap agreements to Europe and elsewhere helped stabilize global markets temporarily, though there is a grave question, as to whether those swaps can be unwound.

I also supported this Committee's version of the TARP, despite its limitations. At that time, a collapse of the payments system in the last months of a dying presidency was to be avoided at all costs. And the most unworkable idea in TARP, the outright repurchase of bad assets at inflated prices, was abandoned in favor of a step – the purchase of preferred equity in banks – that was possibly unnecessary but not the worst that might have happened.

Despite the fact that these steps were able to ward off complete disaster, monetary policy today has little power to restore growth. In the Depression they called it "pushing on a string." With interest rates already at zero, there is little more the Federal Reserve can do. Chairman Bernanke's London speech grasps at a number of straws, including "policy communication" and the reduction of long-term interest rates. But the former is a weak reed and the latter is of very doubtful effect in a liquidity trap. If rate cuts do not lead to new borrowing – as they have not – then their effect is actually counterproductive, since they reduce the interest income flowing to the elderly and others who hold the national debt, or (what is the same thing, economically) cash and cash-equivalents in the banks.

The phrase "quantitative easing" – or in Chairman Bernanke's formulation, "credit easing" – is often heard these days. What does it mean? Not much, in my view. Can it be relied on to produce a return to economic growth? No. Credit easing, at its heart is about liquidity – a problem monetary policy can deal with. But the problems of the economy go far beyond liquidity. Chairman Bernanke's discussion of "heterogeneous effects" -- the supposed differences between lending to banks, to the commercial paper market or elsewhere, strikes me as a keen example of wishful thinking. It is unlikely that the Federal Reserve can, merely by making judicious distinctions, materially reduce the perception of risk in these markets and therefore the credit spreads that are strangling them today.

The deeper problem obviously lies in the lack of demand for output, in the collapse of confidence, in the grim prospects for profit, and in the absence of collateral to support new loans. These problems will require much more work -- work to persuade the public and the business community that effective, long-range, sustained, visible action is underway. The Federal Reserve is not the agency that can persuade the world of this.

Thus, in this situation the main responsibility for pulling the ox from the ditch is not Chairman Bernanke's. Let me turn next to the question of whether Secretary Geithner's plan to restart the "flow of credit" can take up the slack.

3. The Bank Plan Will Not Work

The scale of the ARRA was predicated on the baseline and also on the idea that lending by the banking sector can be made to return to normal. That is, it assumed, implicitly, that Secretary Geithner's plan for the banks will succeed. So we must ask, will it?

The bank plan appears to turn on a metaphor. Credit is "blocked" or "frozen." It must be made to "flow again." Take a plunger to the toxic assets, a blowtorch to the pipes, it's said, and credit will flow. This will make the recession essentially normal, validating the baseline forecast. Add the stimulus to a normalization of credit, and the crisis will end. That's the thinking, so far as I can tell, of the Treasury department in this new administration.

But common sense begins by noting that the metaphor is wrong. Credit is *not* a flow. It is not something that can be forced downstream by clearing a pipe. Credit is a contract. It requires a borrower as well as a lender, a customer as well as a bank.

The borrower must meet two conditions. One is creditworthiness, meaning a secure income and, usually in the case of a private individual, a house with equity in it. Asset prices therefore matter. With a chronic oversupply of houses, prices fall. Collateral disappears, and even if borrowers were willing many of them would not qualify for loans.

The other condition is a willingness to borrow, motivated by the "animal spirits" of business enthusiasm or just the desire for more worldly goods. In a slump such optimism is scarce. Even if people have collateral, they want cash. And it is precisely because they want cash that they will not deplete their reserves by plunking down, say, a down-payment on a new car.

The "credit-flow" metaphor implies that people came flocking to the auto showrooms last November and were turned away because there were no loans to be had. This is not true. What happened was that people stopped coming in. And they stopped coming in because, suddenly, they felt poor, uncertain and afraid.

In this situation, stuffing the banks with money will not change their behavior. Banks are not money-lenders. Banks are money-creators. They do that by making loans. And the bank chiefs have made it very clear, in testimony here and elsewhere: they will not return to ordinary commercial, industrial and residential lending until they can see a reasonable way to make money at it. If given the chance, they may go off on another bender in commodities or some other quick way to repair losses. More likely, they will hunker down, invest in Treasuries and prime corporate bonds, and rebuild capital for the long-term, as they did from 1989 to 1994. Only this time, with the yield curve as flat as it is and the insolvencies as deep as they are, it could take a decade or longer.

Seen in this light, the latest version of the plan to remove bad assets from the banks' balance sheets is a costly exercise in futility. It will protect incumbent management, for a time. It will keep the equity values above zero, for the benefit of those who did not sell their shares when they were high and those who now speculate on a public rescue. It will do this at the expense of driving public debt, as a share of GDP, to very high levels. But there is no reason to believe that the "flow of lending" will be restored, nor that banks which long ago abandoned prudent and ordinary lending practices will now somehow return to them, chastened by events. Why should they change behavior, if their losses are in effect guaranteed by the Treasury Department?

The Treasury plan, if put in place as described, would have a perverse effect on the distribution of wealth. To guarantee bad assets at rates above their market value is simply a transfer to those who hold those assets. It would enable them to convert those assets, sooner or later, to cash. The plan would thus preserve the wealth of bank insiders and financial investors, while failing to prevent the collapse of the wealth of almost everyone else. I cannot believe that the American public will tolerate this, for very long.

There is an argument, made by those who would suspend mark-to-market accounting, that the true value of the mortgage-backed securities has been depressed by fire-sale conditions, and that a guarantee would help to restore confidence and would be validated, in changing economic conditions, by improved performance of the loans. This is something that does, in fact, sometimes happen: good loans go bad in bad times, but become good again when conditions improve. But it is not an appropriate argument for the current case.

Why not? Because the sub-prime securities that are at the bottom of this problem were, and are, in very large measure, corrupt, abusive and even fraudulent from the very beginning. They should never have been issued, and they should never have been securitized, and the ratings agencies engaged in fraud, on the face of it, by giving them AAA ratings in certain configurations, without actually inspecting the loans. No private buyer, with responsibility to do due diligence on these loans, will ever purchase them simply because due diligence is going to reveal the truth. So far as we know, the loans, almost uniformly, lack documentation or show *prima facie* evidence of fraud or misrepresentation. The ratings agency Fitch so determined, when it reviewed just a small sample of loan files in 2007: there was fraud or misrepresentation in practically every file. The default rates on these loans will be very high no matter what happens. It is only a matter of time. Therefore, there is no reason to think that the Treasury's guarantees, at any price above the market price, are likely ever to be made into a profitable investment by changing economic conditions.

Finally, one has to worry about the long-term consequences of issuing new public debt just to wash away the sins of the banks. Those in the larger world who have, in the past, trusted the transparency, efficiency and accountability of the U.S. financial system – and have therefore been willing to treat the US as a haven of financial safety and stability – are bound to take note. It can't be good for the long-term reputation of the government, and therefore for the long-term stability of the dollar. Moreover, while there is no reason to treat these asset exchanges as new public spending, it is certain that adding ten or twenty percent of GDP to the public debt (fruitlessly) will complicate the political problems associated with the effective fiscal expansion measures that getting out of the crisis may require. In short, the Treasury plan will not achieve its stated goals, and meanwhile risks both triggering inflation and obstructing growth.

If we are in a true collapse of finance, our models will not serve and our big banks will not serve either. You will have to replace them both. Since several very big banks are deeply troubled, there is in my view no viable alternative to placing them in receivership, insuring their deposits, replacing their management, doing a clean audit, isolating the bad assets. Since these banks were clearly too large, in my view they should be broken up, and either sold in parts or relaunched as multiple mid-sized institutions with fresh capitalization and leadership.

And meanwhile, how do we keep the economy running? There should be a public bank to provide the loans to businesses – small, medium and large – sufficient to keep them running through the crisis. This was the function, in the Depression, of the Reconstruction Finance Corporation. While the need for this today is very clear in the automotive sector, as time goes on a much larger part of American industry and commerce will face similar problems and similar needs. The resulting forced liquidation of the productive sector is a distinct possibility, and is not in our national interest.

4. Social Security and Medicare Are Not the Problem

A repeated theme from certain quarters holds that the financial meltdown is only a side-show, that the real "super sub-prime crisis" is in the federal budget, and that the most urgent need today is "entitlement reform," which is code for cutting Social Security and Medicare, in the guise of saving those programs. Some of this was heard earlier this week at the White House meeting on "fiscal responsibility."

These arguments are both mistaken and dangerous.

By long-standing political convention Social Security and Medicare are attached to designated funding streams – portions of the payroll tax. It was the original intent that Social Security benefits would be largely matched by these taxes, but this was never true for Medicare, and as the aging population grows and lives longer it has become contentious for Social Security as well. Thus we have frightening estimates of "unfunded liabilities" running to the scores of trillions of dollars over long or infinite time horizons, with dire warnings that these will drive the entire government of the United States into bankruptcy, whatever that means.

These arguments are testimony to the power of accounting to cloud men's minds, and not much else. Let me make some obvious points.

First, a transfer program reassigns claims to output. It neither creates nor destroys production. What comes from somewhere, goes somewhere else. Thus Social Security *liabilities* to the government are matched by *assets* in the hands of the aged and those who will become aged --

that is to say, in the hands of citizens of the country. From the standpoint of the country, the two sides of the balance sheet necessarily balance. Talk about "unfunded liabilities" without discussing the corresponding assets is intrinsically misleading: the liabilities in question are owed to citizens of the United States, and represent to them a very modest degree of income security and as well as access to medical care in old age.

There is no operational reason why the country cannot transfer income to its elderly, as a group, as much or as little as it wishes. The supposed inter-temporal aspect of this transfer is meaningless, for two reasons. First, the goods and services actually provided to the elderly at any point in time are always produced only shortly before they are used. Second, the workers on whom the liabilities supposedly fall today, are the same people who accrue the assets that they will enjoy later. It is true that Social Security's real burden will rise as the population ages: from about 4.5 percent to about 6.5 percent of GDP over the century ahead. There is no reason to be afraid of this, it is simply the mechanical consequence of the fact that there will be more old people to care for. Those people would exist, and would be cared for to some degree, without Social Security. But the process would be much more erratic, much less fair, and subject to the neglect and petty cruelties of private financial relations.

The only issue posed by a deficiency of payroll taxes, now or later, is whether the funds devoted to Social Security and Medicare might be described as coming, in part, from other sources: from the wealthy, or from bondholders. So what if they are? There is no reason in principle why income or estate taxes (as the late Commissioner Robert Ball suggested), or a financial transfer tax, could not be assigned to cover Social Security and Medicare costs. The Social Security compromise of 1983, which raised payroll taxes on my generation, plainly envisaged that the obligations to cover my generation's retirement would come, in due course, from somewhere else. That is what "paying back the Trust Fund" is all about.

Part of the worry about "entitlements" relates to borrowing, and thus to future deficits. Are these "unfunded liabilities" so large as to threaten the creditworthiness of the government? Clearly this is not the case. Despite immense efforts by the gloom-and-doom chorus on this question, the government of the United States is today funding itself, long term, for less than it did in the 1950s. Solvency was not a question then and is not a question now. This also suggests that the long-term deficit projections for the government as a whole, though much discussed at the fiscal responsibility summit, are not a worry for the financial markets, either.

The preoccupation with Social-Security-and-Medicare is actively dangerous to the prospects for economic recovery. Why? Because it raises concern and anxieties among today's working population, who have been told repeatedly that these programs will not be present for them when they will need them. The rational individual response, in that case, is to save more and spend less. I don't think this effect is very large, right now, but it is a risk. There are cases in the world (notably in China) of distressed populations over-saving obsessively, to try to provide for security that could be provided much more cheaply by social insurance.

More immediately, our elderly population is under a tremendous squeeze, from the stock market collapse, from falling house prices and from falling interest rates. It has already lost, through these channels, a major part of its wealth. The economist Mark Zandi told the House Democratic Caucus in December that this alone could subtract around $200 billion per year from total spending, and the situation is worse now than it was then.

Talk about the supposed need to cut back on Social Security and Medicare thus gets in the way of the discussion we should be having. This is over how to use these programs to get us out of the hole we are in. Each them could be powerful and useful. To wit:

– a permanent increase in Social Security benefits would help offset the losses that the elderly population, as a group, is suffering on its equity investments and its cash holdings. A thirty percent increase in Social Security benefits would not repair individual losses, but it would keep the elderly out of poverty as a group, and relieve severe difficulties in many individual cases.

– a payroll tax holiday would powerfully ease the financial situation of America's working families, giving them roughly an 8.3 percent pay increase and their employers a comparable reduction in the cost of keeping them on the job. Many mortgages would be paid, and many cars purchased, that otherwise would default or go unsold.

– a reduction in the age of eligibility for Medicare would be a powerful response to the industrial crisis, permitting many older workers who would like to retire but who cannot afford to lose health insurance to do so. This would relieve health burdens from private industry, while not infringing on the employer-insurance systems still in effect for the prime-age workforce. Note that transferring workers from private health care to Medicare in this age bracket has no real economic cost: the same health care is provided to the same people. In fact, the reduction in private insurance claims and bookkeeping constitutes a real saving.

These measures are among the most promising available at this moment. Congress should be prepared to use them if and when it becomes clear that the present policies are insufficient. And the historical linkage between Social Security and Medicare benefits and the payroll tax should then be broken. Social Security and Medicare obligations should be treated, henceforward, as simply the bonded obligations of the government – like net interest, backed by the full faith and credit – thus making explicit what is obvious to any careful observer, which is that these programs cannot go "bankrupt" anymore than the government of the United States can go bankrupt, which it cannot.

And of course the United States Government has not gone bankrupt, in more than two centuries of continuous operations and through much bigger deficits and greater trials than we are experiencing just now.

5. Keep People in their Homes.

The housing crisis is at the root of our difficulties, for since the Tax Reform Act of 1986 our economy has been strongly biased toward collateralizing lending with homes. This model, which built up a structure of debt over a very long period of time, has now collapsed. It has collapsed, moreover, in ways that not only have destroyed the market for sub-prime securities, but that also have compromised secondary markets for prime mortgages.

There is no way for public policy to stabilize housing prices as such in the near term. House prices are private contracts for idiosyncratic goods, and cannot be controlled. Therefore, policy must focus on the proximate problem, which is chronic excess supply. The only way to do that, short of buying up surplus homes and knocking them down, is to find a means to stop the wave of evictions, vacancies, trash-outs and forced sales that is overwhelming the system.

In economic terms the problem is simple: how to align, in a way that is fair and sustainable, the payments people are required to make on their houses with their actual capacity to pay? But there is a corollary which is not so simple: how to do so in ways that do not encourage irresponsible behavior on the part of homeowners who are not in trouble?

The administration's plan of action in the housing sphere is a bright spot on the policy horizon. It meets, so far as I can tell, the tests of fairness and sustainability reasonably well. But it does so only for a limited class of borrowers, who are not too deeply underwater already on their homes. It will provide a measure of relief, but it will not, so far as I can tell, either stop the wave of foreclosures or prevent a continued decline in prices.

There are, I think, two basic alternatives that might work. One would be to declare a comprehensive moratorium on new foreclosures, and then to turn over the entire portfolio of troubled mortgages to an entity like the depression-era Home Owners Loan Corporation for triage and renegotiation on a case-by-case basis. The advantage of this approach is that, if done on a large enough scale, it would work. An HOLC could distinguish honest from fraudulent borrowers, fit legitimate homeowners into appropriate work-out categories, and manage or dispose of the properties of the rest. Meanwhile people would enjoy a presumptive right to stay in their homes. The difficulty is that this would take a long time and a lot of money and manpower, and the system would still be prone to manipulation, at least to some degree.

An alternative, suggested by Warren Mosler, is to allow the ordinary foreclosure process to work. But, after foreclosure, owner-occupied properties would be bought at the lower of the appraisal price or mortgage balance by a new federal entity, and the previous owner allowed to stay in the house for a fair market rent, with the option of repurchasing the home at a fair appraisal value later on. This would have the advantage of protecting against moral hazard, while at the same time preserving occupancy, to the maximum extent possible.

6. The Long Term Starts Now: Infrastructure, Energy and the Dollar.

Finally, though these remarks depart from the realm of monetary policy in a strict sense, it is important to make them briefly.

First, no recovery program will work unless crude oil imports in the upswing are effectively curtailed. Failure to do this simply leaves the power to set oil prices in the hands of speculative markets and the swing producers – Saudi Arabia and possibly Russia. This is the channel that poses the most serious inflation risks going forward.

Second, a growing economy down the road will need new focal points for public and private investment. Infrastructure and energy are clearly the great challenges ahead: infrastructure because this vital contributor to efficiency and competitiveness has been severely neglected for decades, and energy because of the danger of climate change. The correct approach to infrastructure remains a National Infrastructure Fund – a permanent facility that can provide funds to state and local governments and to regional authorities independently of market conditions, while serving as a source of standards and providing a measure of oversight.

Third, energy conservation and the production of sustainable energy are areas with potential for great gains; since the United States is the world's greatest per capita greenhouse gas emitter we have the capacity to make the largest improvements. But there is also the potential here for economic gains: if we do this job right, we can develop new industries which will set standards for efficient and sustainable energy production and use, and reduce our trade deficits, over time, both by curbing imports and by exporting these new products to the world. These new industries will help sustain the international position of the dollar in the long run.

For the time being, the world crisis has revealed the relative strength of the dollar and the structural weakness of the euro and of other major currencies. This situation, which has surprised many, removes the concern that the dollar will lose its reserve status – at least for the moment. But it awakens an equally serious danger, which is that instability between world currencies could produce a cumulative spiral of global economic collapse. This is an important danger, for which we are ill-prepared. There needs to be a new attention to the financial architecture, both to achieve a coordinated fiscal expansion and to admit the serious possibility of an even larger crisis, preparing for the moment when major reforms may be required.

The time to start work on all of these issues is now. Let's face it. We are not in a temporary economic lull, an ordinary recession, from which we will emerge to return to business-as-usual. We are at the beginning of a long, profound, painful process of change. Of irreversible change. For better or for worse. We need to start thinking and acting accordingly.

Thank you very much for your time and attention.

Table One. CBO's Baseline Forecasts, February 11, 2009, from a letter from Douglas Elmendorf, Director, to Senator Judd Gregg

Table 1.

Estimated Macroeconomic Impacts of a Stimulus Package (Average of House-Passed and Senate-Passed Versions of H.R. 1), Fourth Quarters of Calendar Years 2009 Through 2019

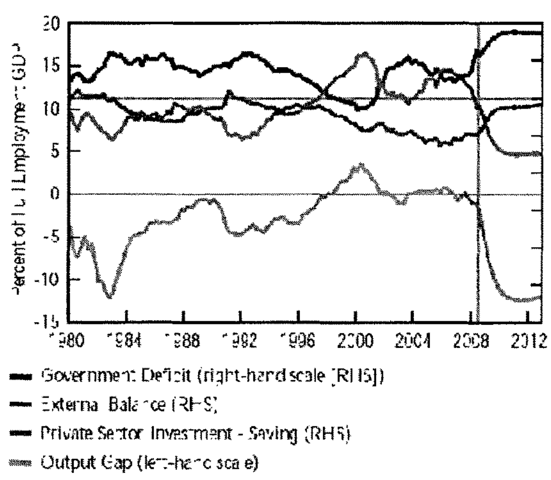
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019
Real GDP (Percentage change from baseline)											
Low estimate of effect of plan	1.4	[illegible]	0.4	[illegible]	[illegible]	-0.1	[illegible]	-0.2	-0.2	-0.2	-0.2
High estimate of effect of plan	3.8	3.3	[illegible]	0.7	[illegible]	[illegible]	[illegible]	0.0	0.0	0.0	0.0
GDP Gap[a] (Percent)											
Baseline	-7.4	-6.3	-4.1	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	0.0
Low estimate of effect of plan	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	0.0
High estimate of effect of plan	[illegible]	[illegible]	[illegible]	-1.7	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	0.0
Unemployment Rate (Percent)											
Baseline	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Low estimate of effect of plan	[illegible]	8.1	7.2	6.3	[illegible]	[illegible]	[illegible]	4.8	[illegible]	[illegible]	4.8
High estimate of effect of plan	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
Employment (Millions of Jobs)											
Baseline	141.8	143.3	146.2	[illegible]	[illegible]	[illegible]	[illegible]	155.7	[illegible]	157.0	[illegible]
Low estimate of effect of plan	142.4	[illegible]	146.8	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]	[illegible]
High estimate of effect of plan	143.9	146.0	148.1	[illegible]	152.5	[illegible]	[illegible]	[illegible]	156.4	[illegible]	[illegible]

Source: Congressional Budget Office.

a. Real GDP is gross domestic product excluding the effects of inflation. The GDP gap is the percentage difference between gross domestic product and CBO's estimate of potential GDP. Potential GDP is the estimated level of output that corresponds to a high level of resource (labor and capital) use. A negative gap indicates a high unemployment rate and low utilization rates for plant and equipment.

Figure One. The Output Gap: Levy Institute Strategic Analysis, December 2008.

Figure 1 U.S. Main Sector Balances and Output Gap



Sources: Federal Reserve and authors' calculations

Monetary Policy and the Recent Extraordinary Measures Taken by the Federal Reserve

Testimony before the
Committee on Financial Services
U.S. House of Representatives

John B. Taylor
Professor of Economics
Senior Fellow, Hoover Institution
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February 26, 2009

Thank you Chairman Frank, Ranking Member Bachus, and other members of the House Committee on Financial Services for inviting me to testify on monetary policy and the "extraordinary measures" taken by the Federal Reserve over the past 18 months.

The best way to begin examining these extraordinary measures is to look at the extraordinary increase in reserve balances at the Fed shown in Figure 1. Reserve

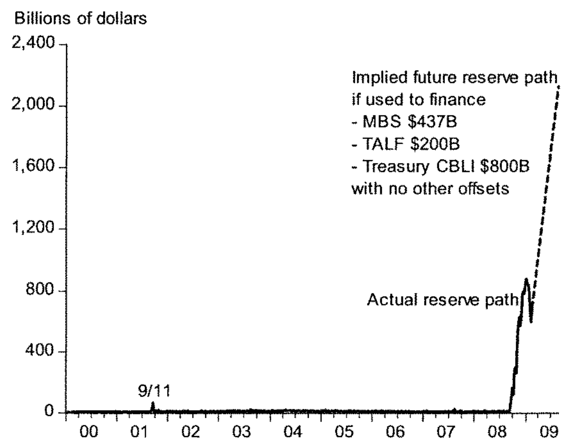

Figure 1. Reserve Balances The solid line shows the actual movements and the dashed line shows the implied future movements.

balances, or deposits at the Fed, are the key component—along with currency—of base money or central bank money which the Federal Reserve is responsible for controlling and which ultimately brings about changes in the broader money supply measures. The sharp increase in reserve balances began in mid September 2008. For the week ending September 10, banks and other depository institutions held $8 billion in reserve balances at the Fed. By the week ending December 31, 2008, they held $848 billion. The Fed had increased the supply of reserve balances by 100-fold in a very short period of time. Note also how large this increase is compared with the then-extraordinary increase around the time of 9/11 and the physical damage to the financial markets.

The recent increase came about as a direct result of the Fed's decision to purchase securities and make loans to certain sectors and financial institutions. More specifically, the Fed financed these securities purchases and loans by creating reserve balances—creating money. The Federal Reserve has since called this action credit easing.[1] It is more like *selective* credit easing, or perhaps an industrial policy, because expansions of the Fed's balance sheet always lead to credit easing in some form. Moreover, the Fed has been financing these actions by creating money; that is why I had earlier used the term mondustrial policy as a way to help explain this complex combination of monetary policy and industrial policy to those not familiar with monetary issues or with the details of the Fed's balance sheet.[2]

As a matter of accounting the Fed can obtain additional funds to finance its purchases of private securities and lending in the three ways. First, it can create money; that is, it can pay for the purchases by crediting banks with deposits at the Fed. Second, the U.S. Treasury can borrow the funds and deposit them at the Fed. Third, the Fed can borrow the funds itself by issuing debt. Of course, the Fed can also adjust the composition of its own portfolio, by selling government securities to make room for more private securities and loans.

Indeed, for the first thirteen months of the financial crisis, up until the week of Sept 10, 2008, the Fed adjusted the composition of its portfolio by selling off government securities and using the funds to increase loans to depository institutions through its Term Auction Facility, to provide loans to investment banks through its Primary Dealer Credit Facility, or to purchase private assets such as those in the Bear Stearns intervention. By simply adjusting its asset portfolio it kept reserves from increasing. However, starting in September there were apparently not enough government securities left in its portfolio to sell without interfering with its operations or disrupting other programs.

Hence, the Fed resorted to the first method of finance listed above and started to create money for its purchases and loans starting in the week of September 17. The Fed also used the second method to a smaller degree as the Treasury borrowed and the Fed created a special account where the Treasury deposited funds; that account is now diminishing, so reserve creation has had the main financing role.

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[1] Ben Bernanke, "The Crisis and the Policy Response," January 13, 2009, The Stamp Lecture, London School of Economics, London England.

[2] John B. Taylor, "The Need to Return to a Monetary Framework," Prepared for the National Association of Business Economics Panel, "Long-Run Economic Challenges: A Federal Reserve Perspective," San Francisco, January 3, 2009 and forthcoming in *Business Economics*, Vol. 43, No 2. A list of the major private securities and loan programs is found Table 1 which is drawn from that paper.

As Figure 1 shows the actual level of reserve balances came down in the first six weeks of this year, but has increased again, according to the latest available data, as the Fed has started to buy mortgage backed securities (MBS) which increased by $85 billion in the most recent reporting week. Where will reserve balances go in the next few months?

The Fed's program to purchase mortgage backed securities is now at $63 billion and is expected to grow to $500 billion. So that is an additional $437 billion to come. There is also the Term Asset-Backed Loan Facility (TALF) to buy securities backed by credit card debt, student loans, and auto loans which will grow to $200 billion. The U.S. Treasury has recently requested another Fed program, the Consumer and Business Loan Initiative (CBLI), for $1 trillion, though that is apparently net of the TALF program adding another $800 billion. Thus the total increase could be as much as $1,437 billion. In Fig 1 I have drawn in the implied increase in reserve balances (dashed line) if these additional purchases are financed by creating reserve balances and there is no other change. This is not a forecast but rather an implication of the practice of continuing to finance purchases of this size by money creation.

Relation to the Near Zero Interest Rate and the Quantity of Money

It is sometimes said that the policy of increasing reserves by large amounts as shown in Figure 1 started when the Federal Reserve interest rate target hit zero, and there was no more easing possible in the sense of lowering the interest rate further. However, this is incorrect. In fact, the explosion of reserves took place when the federal funds rate target was at 2 percent. The decline in the interest rate from 2 percent to near 0 percent took place over the next several months. The decline followed the expansion of reserves and was likely caused by the expansion. The FOMC decisions to lower the target for the federal funds rate followed the declines in the federal funds rate, effectively ratifying them. So the increase in reserves did not start because the interest rate was at zero, but because of the need to finance securities purchases and loans.

In any case, now that the interest rate is effectively at zero, decisions about monetary policy ought to shift to quantities like the quantity of money. For example, a traditional monetary policy framework of the kind discussed widely before interest rate guidelines became popular would focus on the level or the growth rate of the quantity of a monetary aggregate. The decisions would be about what is the appropriate growth rate of money for dealing with the recession and helping the recovery from recession. If an increase in money growth is called for then monetary policy would bring this about by open market operations. An increase in base money would then increase the growth rate of a monetary aggregate by some amount.

But this is not the type of policy that is in place at this time. Rather, as described above, it is a policy where the driver is intervention into particular markets with the amount of base money growth determined by the amount of this intervention. The increase in M1 or M2 is determined by that reserve growth and by how much banks decide to hold as excess reserves. So far the banks have held a large amount of the increase in reserves, though there has been a marked increase in the growth rate of currency, demand deposits, and M1

Questions and Concerns

I have a number of questions and concerns about the current policy.

First, the enormous increase in reserves is potentially inflationary. Many people ask me if it is inflationary, so I know it is on people's minds. With the economy in a weak state and commodity and many other prices falling, inflation is not now a problem, but at some time the Federal Reserve will have to remove these reserves or we will have a large increase in inflation. Recall that increases in money growth affect inflation with a long lag. The question is whether the Fed will be able to reduce the reserves in time and whether people will expect the Fed to do so. If reserves get to the level shown by the dashed line in Figure 1 it will have to sell a huge amount of securities backed by consumer credit, mortgages, student loans, and auto loans. This will be difficult to do politically.

Second, if we are to have a selective credit policy with the inherent credit risks involved in such a policy, I believe it is more appropriate for the Treasury or some other agency to take it on with the approval of the Congress with the purposes stated and debated transparently. What justification is there for an independent government agency to engage in such a selective credit policy? For the Federal Reserve to be taking on these responsibilities raises questions about its independence. Indeed, the recent request by the Treasury for the Fed to assist in creating a Consumer and Business Loan Initiative is certainly reminiscent of the request by Treasury for the Fed to help out in its own borrowing operations before the Accord of 1950. The request has the appearances of breaking the Accord, even though the Federal Reserve Board is in agreement.[3]

Third, it is not clear how effective these interventions are, and they may be counterproductive. Though the Federal Reserve has argued that these actions are necessary because of the financial crisis and many in the financial markets agree, I have found that, for example, the Term Auction Facility had no noticeable impact on interest rate spreads. I have a concern that such actions prolonged the crisis by not addressing the fundamental problem of counterparty risk in the banks.[4] At the least the Fed should increase its policy evaluation work in this area.

Fourth, the extraordinary measures have the potential to change the role of the central bank in the future in ways that could be harmful. The success of monetary policy during the great moderation period of long expansions and mild recessions was not due to a lot of discretion but to following predictable policies and guidelines that worked. While the Fed uses the authority in Section 13(3) of the Federal Reserve Act, one can question its applicability now and one can certainly imagine it being cited in many other contexts in the future. For example, the recovery might be viewed as too slow, with calls to provide more assistance to financial firms to help the auto loan market or the consumer loan market. Can one continue to apply Section 13(3)

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[3] Milton Friedman and Anna Schwartz argue that the pre-Accord situation was not one where Treasury and the Federal Reserve were in much disagreement. See *A Monetary History of the United States*, Princeton University Press, 1963. P. 625

[4] John B. Taylor. *Getting Off Track; How Government Actions and Interventions Caused, Prolonged, and Worsened the Financial Crisis.* Hoover Press, Stanford University, Stanford, California, 2009

when firms and people assisted can get credit but at a rate that seems too high? Will such interventions only take place in recessions, or will Fed officials use them in the future to try to make economic expansions stronger or to assist certain sectors and industries for other reasons?

Recommendations

In my testimony before your committee one year ago I urged more transparency about the Federal Reserve's balance sheet, mentioning for example the need for daily data[5] and I have reiterated those recommendations since then especially since the explosion of reserve balances. I am very encouraged that, following your hearing of February 10, 2009, the Fed has created a web page to explain its new programs and its balance sheet. This is excellent news. The Fed has also has clarified some of the line items such as "other Federal Reserve assets" which had contained hundreds of billions of dollars of loans to other central banks. I still recommend that daily rather than only weekly data be provided for more accurate and timely analysis.

As soon as conditions warrant, the policy framework should again focus on systematic procedures for setting the overnight interest rate—a policy which works well, as has been demonstrated during the great moderation period of the past quarter century. In the meantime, other instruments of monetary policy such as reserve growth, or base money growth, or the growth of a monetary aggregate should be the focus of decision making and accountability to Congress.

Currently the only broad quantitative statement by the Federal Open Market Committee is that it will keep the size of its balance sheet "at a high level for some time" (Minutes of January 27-28 meeting). That seems too vague. Does it mean the scenario like the dashed line in Figure 1? Or does it mean that reserves will stay where they are now?

Instead, the FOMC could give ranges for the growth of reserve balances, base money, and broader monetary aggregates. The Federal Reserve staff could study the impact of various growth rates for the quantity of reserve balances or the money supply, and the FOMC could discuss and vote on these quantities, until such time as the interest rate goes above zero. Right now we do not know if the outcome in Figure 1 is the intent of the Fed or what the contingency plan is for reversing this increase

[5] John B. Taylor "Monetary Policy and the State of the Economy," Testimony before the Committee on Financial Services, U.S. House of Representatives February 26, 2008

<u>Table 1 Major Factors Supplying Reserves</u>

Securities (Treasury and Agency) held outright
Repos
Loans from the TAF
Other Loans

- o Primary Credit Facility (discount window)
- *o Primary Dealer Credit Facility*
- *o Asset Back Commercial Paper Money Market Mutual Fund Liquidity Facility*
- *o Loans to AIG*
- *o Term Asset-Backed Securities Loan Facility (credit card, student, auto)*

Private Portfolio holdings

- *o Commercial Paper Funding Facility*
- *o Maiden Lane I (Bear Stearns)*
- *o Maiden Lane II (AIG)*
- *o Maiden Lane III (AIG)*
- *o Money Market Investor Funding Facility*
- *o Mortgage Backed Securities Purchase Program*

Loans to foreign central banks

Additional Information Provided for the Record by James Galbraith

Congressman Posey asked for my written response on the sustainability of U.S. government bond debt, and the consequences of too much spending or too little taxation.

My answer is that there is, and can in principle be, no risk of default on U.S. government bonds, because the Treasury has complete control over those payments. The relevant issue is whether the world will choose to hold the bonds at their current price. If it doesn't, the dollar will decline and there is a risk of inflation as the result of a rising price of imports. This is the opposite of the problem we currently face, but there are conditions under which it could arise.

For a longer answer, possibly at my peril, I attach testimony given yesterday to the Federal Accounting Standards Advisory Board.

Comments on the FASAB Exposure Drafts relating to "Comprehensive Long-term Projections for the U.S. Government (ED 1)" and to "Accounting for Social Insurance. (ED 2)"

Testimony Submitted by:

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Date: February 25, 2009

In this testimony we supplement our earlier letter, which responded to specific questions on the first exposure draft. Here we set out general principles of federal budget accounting, and then we offer specific comments on the proposed reporting procedures in both of the exposure drafts.

General Principles of Federal Budget Accounting

Even though some principles of accounting are universal, federal budget accounting has never followed and should not follow the exact procedures adopted by households or business firms. There are several reasons why this is true.

First, the government's interest is the public interest. The government is there to provide for the general welfare, and there is no correlation between this interest and a position of surplus or deficit, nor of indebtedness, in the government's books.

Second, the government is sovereign. This fact gives to government authority that households and firms do not have. In particular, government has the power to tax and to issue money. The power to tax means that government does not need to sell products, and the power to issue currency means that it can make purchases by emitting IOUs. No private firm can require that markets buy its products or its debt. Indeed taxation creates a demand for public spending, in order to make available the currency required to pay the taxes. No private firm can generate demand for its output in this way.

Neither of these statements is controversial; both are matters of fact. Nor should they be construed to imply that government should raise taxes or spend without limit. However, they do imply that federal budgeting is different from private budgeting, and should be considered in its proper, public context.

While it is common to regard government tax revenue as income, this income is not comparable to that of firms or households. Government can choose to exact greater tax revenues by imposing new taxes or raising tax rates. No firm can do this; even firms with market power know that consumers will find substitutes if prices are raised too much. Moreover firms, households, and even state and local governments require income or borrowings in order to spend. The federal government's spending is not constrained by revenues or borrowing. This is, again, a fact, completely non-controversial, but very poorly understood.

The federal government spends by cutting checks – or, what is functionally the same thing, by directly crediting private bank accounts. This is a matter of typing numbers into a machine. That is all federal spending is. Unlike private firms, the federal government maintains no stock of cash-on-hand and no credit balance at the bank. It doesn't need to do so. There are surely limits of wisdom and prudence on federal spending, as well as numerous checks, balances, and self-imposed constraints, but there is no operational limit. The federal government can, and does, spend what it wants.

Tax receipts debit bank accounts. So does borrowing from the public. These are operationally distinct from spending. There is no operational procedure through which federal government "uses" tax receipts or borrowings for its spending. If, perchance, one chooses to pay taxes in cash, the Treasury simply issues a receipt and shreds the cash. It has no need for the income in order to spend. This is why it is a mistake to look at federal tax receipts as an equivalent concept to income of households or firms.

As we discuss below, federal government spending has exceeded tax revenues, with only brief exceptions, since the founding. There is no evidence, nor any economic theory, behind the proposition that federal government spending ever needs to match federal government tax receipts—over any period, short or long. The deficit per unit time is the difference between taxing and spending over that time. To repeat, the taxing on the one hand and the spending on the other are operationally independent. Any reasonable observer should conclude that federal government spending is not, and need not be, dependent on, constrained by (or even related to) tax revenues in the way that the spending of households or firms is related to their incomes.

The difference between microeconomic and macroeconomic accounting is also pertinent. An individual household or firm has a balance sheet that consists of its assets and liabilities. The spending of that household or firm is constrained, in a fairly concrete sense, by its income and by its balance sheet— by its ability to sell assets or to borrow against them. It is meaningful to say that its ability to deficit-spend is constrained: a household must get the approval of a bank before spending can exceed income, and therefore its borrowing is subject to banking norms. But if we take households or firms as a whole, the situation is different. The private sector's ability to deficit-spend, to spend more than its income, depends on the willingness of *another sector* to spend *less* than its income. For one sector to run a deficit, another must run a surplus. This surplus is called saving – claims against the deficit sector. In principle, there is no reason why one sector cannot run perpetual deficits, so long as at least one other sector wants to run surpluses.

In the real world, we observe that the US federal government tends to run persistent deficits. This is matched by a persistent tendency of the non-government sector to save. The nongovernment sector accumulates net claims on the government; the nongovernment sector's "net saving" is equal (by identity) to the US government's deficits. At the same time, the non-government sector's net accumulation of financial assets (or "net financial wealth") equals exactly the government's total net issue of debt -- from the inception of the nation. Debt issued between private parties cancels out; but that between the government and the private sector remains, with the private sector's net financial wealth consisting of the government's net debt.

This identity does not change once we allow for a foreign sector, which is just a part of the nongovernment sector. Since the US has in recent decades run persistent current account deficits, the foreign sector has been accumulating net financial claims in dollars; thus the role of dollar-denominated securities as reserve assets. Whether this is "good" or "bad" does not change the accounting identities. It is identically true that US government deficits equal nongovernment surpluses, and US government debt equals nongovernment net financial wealth. Yet these macroeconomic relations are not obvious when one looks to individual firms or households, or if one examines the US government as if it had an independent balance sheet.

Do the FASAB Exposure Drafts Recognize the General Principles of Federal Budget Accounting?

The reporting proposed by the two exposure drafts does not appear to recognize the fundamental differences between public and private budgets. There are numerous problems in the drafts. Some of the most basic principles of accounting are neglected. Key terms are left ill-defined or undefined. Projections are misused. Unjustified policy prescriptions are slipped into the drafts in the guise of accounting standards. And revenues are matched to spending for parts of the federal budget, notably Social Security and Medicare, in ways that have no economic justification.

A Basic Principle: Liabilities and Assets.

The FASAB drafts are intended to be "statements of financial condition" for "the government" and for "the nation." These two concepts – government and nation -- are not interchangeable. To use them interchangeably, as the exposure drafts do, is a source of confusion.

In our understanding, a statement of "financial condition" is, in general, a balance sheet. These are constructed with two columns: one for liabilities, and the other for assets. This very basic principle is no different for the public sector, and for the nation as a whole, than it is for private sector accounting.

The "nation's financial condition" – a term used repeatedly in the exposure drafts -- is a combination of the financial condition of the government and that of its citizens. Yet the proposed "federal financial reporting" contains no mention of the assets that correspond to the liabilities that would be reported when accounting for "the nation." For example, it would treat the obligations of the Social Security system as a liability. That same Social Security benefit liability is, of course, an asset to the public. The Social Security wealth of the current population is just as real as the liabilities that support it. Yet nowhere is this Social Security wealth reported or even remarked on. Put another way, a transfer program, from one group of citizens to another, via the government or otherwise, merely transfers resources. It does not increase or diminish them. This is an economic reality, and a financial statement for "the nation" should reflect it.

The picture is further confused by treating the forecast difference between Social Security benefits and FICA tax revenues, projected over time and discounted to the present, as a "net liability" of the government – and, by implication, of "the nation" as well. In this way, intergenerational accounting purports to show an "unfunded burden" on the government, for the benefit of the future retired population. This overlooks the fact that the underlying citizens, who support the government, are the same people: today's workers will become, eventually, tomorrow's retirees. It is therefore hard to see why workers should object if the burden of payroll taxes does not, in present value terms, equal the value of social security benefits.

We shall return later to other issues. Here our point is a matter of accounting: the asset of payroll tax revenues to the government is just a liability to the working population, just as the liability of future benefits is an asset to the public. In both cases, the books balance, between the public and the private sector – taken together, "the nation." And if the public's books taken alone don't balance, it merely means that the private sector's books, taken alone, don't balance either: the deficit of the one is the surplus of the other. There is nothing alarming about this. Just as the public debt can be eternal, and need never be paid off, a net debt position for Social Security and Medicare can likewise be eternal as well, since the government's net deficit is balanced by the nongovernment sector's net surplus. Spelling out the balance sheet in full for "the nation" would be good financial-reporting practice. And in this case, it would usefully reduce the scare-content of claims that focus on liabilities without acknowledging the corresponding assets.

Ill-defined Terms: What is a "Budgetary Resource"?

The proposed reporting speaks of "budgetary resources." The apparent concern is that the federal government operate within the "budgetary resources" available to it. Specifically the drafts are concerned that budgetary resources be sufficient to "sustain public services and meet obligations as they come due." But there is no clear definition of what "budgetary resources" means.

If what is meant is "tax revenue," the definition is totally inappropriate. As we have stated and demonstrated above, the government does not need tax revenue sufficient to match spending in order to "sustain public services and meet obligations as they come due." This is obvious: the government almost never has sufficient tax revenue for that purpose. (It has run significant surpluses for only seven very brief periods in the history of the nation, each of them producing a depression or a recession.) This is why we have a national debt to begin with. Yet the US federal government has never, in 233 years of operation, lacked for "budgetary resources" sufficient to "sustain public services and meet obligations as they come due." This is also obvious, insofar as the federal government has never defaulted on its obligations, including making all interest payments on its debt.

If, on the other hand, the term "budgetary resources" means "tax revenues and public borrowings" sufficient to "sustain public services and meet obligations as they come due," this too is inappropriate. The standard in that case would appear to be intended to inform the public about the borrowing capacity of the government of the United States. Yet the procedures contain no information about and no guidance as to how to assess this question.

Can we imagine that the US domestic sector will reach a point such that it will refuse to accumulate dollar claims on our government, in the form of currency and interest-bearing government bonds? If so, that would only mean that government spending would be immediately inflationary, to the extent the government tried to force deficit spending as did Germany in 1923. Would we reach the point where American businesses would refuse to sell their wares for US currency?[1] If households had more currency than desired would they refuse to substitute it for Treasuries? Would private banks refuse to exchange excess reserves for Treasuries? We think not. Nor would it be catastrophic if households or banks did refuse to substitute cash or reserves for Treasuries—the Fed and Treasury could simply avoid selling them.

Low long-term interest rates tell us that the markets are not troubled by this possibility and the US government is not now facing financial concerns due to any one of these conditions (nor even due to the current global crisis!). Nor is it possible for such concerns, should they arise in the markets, to become actual problems, even with the growth of "entitlements" over the next three-quarters of a century. The drafts presume that financing of Treasury spending could at some time become problematic but do not explain, operationally, how problems could arise. It is not sufficient to show that on some set of assumptions projected tax revenue might fall short of projected spending. Rather, there must be some explanation as to why that should be a matter of concern, why and how borrowing might become difficult or constrained— particularly given that we now have accumulated over two centuries of experience of tax shortfalls with, predictably, no suggestion of government insolvency.[2]

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[1] Since the funds to pay taxes come only from public spending, this would also imply a refusal to pay taxes.

[2] Looking overseas, it might be interesting, for example, to know whether there is a point at which, despite continuing surpluses in China's trade with the United States, the People's Bank might become unwilling to add to its stock of US Treasury bonds (and whether, if that were to happen, it would matter). There is no mention, let alone analysis, of the policies of the People's Bank of China in these documents. Indeed, we note that all indications of the intention of the People's Bank are to the contrary: China continues to pursue policy that will allow it to accumulate dollar reserves and bonds.

On the assumption that what is termed "budgetary resources" by the FASAB includes public debt issue, the proposed procedure betrays a false supposition that there is some economic limit to the nominal value of the bonds that can be issued by the U.S. Treasury. The reality is: no such limit exists. Nor does the government have to issue securities, operationally, in order to spend. As an operating matter, the government spends first and issues securities later, by transferring funds from interest-bearing reserve accounts at the Federal Reserve to interest-bearing Treasury securities. (The latter are also merely accounts at the Federal Reserve.) Treasuries are net issued (in the open market by the Fed and in the new issue market by the Treasury) when financial institutions in the aggregate hold more reserves than desired. The function of sales of Treasuries is to substitute bonds for reserves; Treasury spending cannot be constrained by nongovernment unwillingness to lend. The exposure drafts appear to wish to resolve problems that do not, perhaps cannot, exist. At the same time, they ignore some real problems, to which we now turn.

Misuse of Economic Projections and Assumptions

The exposure drafts provide no guidance on the choice of economic assumptions to be used in making projections. This is a serious shortcoming, particularly insofar as it has become a habit for the Social Security actuaries to violate generally accepted accounting practices when making economic projections relevant to the financial flows of the Social Security System. Specifically, past performance is characteristically ignored, and future projections are systematically pessimistic with respect to past performance. This has led in recent years to repeated, systematic revisions of the financial projections for Social Security, always in the direction of rolling back the projected dates when benefits exceed payroll taxes and the so-called Trust Fund is exhausted. This pattern has been so systematic, so that it is reasonable to conclude that the actuaries have been systematically and persistently pessimistic. FASAB guidance on this point should specifically address two issues: the proper relationship of economic projections to generally accepted accounting principles, and the appropriate ways in which to factor into projections the effect of policy changes on economic performance. We turn next to this question.

As a matter of plain English definition, one cannot assess "the impact on the country of the government's operations and investments" without assessing the *economic effects* of such operations and investments. If, for instance, a "stimulus bill" produces a higher rate of growth and lower rate of unemployment than would otherwise be the case, then that is surely an "impact on the country of the government's operations and investments." What else could it be?

The procedures in the exposure drafts explicitly propose to ignore those impacts. That is, *irrespective of the government action*, the economic projections used to assess that action will not be changed. The assumption will be made, however arbitrarily, that there is *no effect* of that action on the rate of economic growth, on the rate of employment and unemployment, on the mix between consumption and investment, or on any other pertinent real economic variable. The inference will therefore be drawn that the program necessarily involves costs -- entirely nominal, associated with the debt -- without real economic benefits, associated with higher growth or lower unemployment. This procedure is *prima facie* absurd. It can serve only to confuse public debate, and to obstruct rather than advance public purpose.

It might be acceptable, and even necessary, for an individual household or firm to ignore possible effects of its actions on the rest of the economy. But when dealing with an entire sector, and especially with the public sector, this cannot be the case. The actions of the government sector taken as a whole cannot be assessed in isolation from their consequences for the nongovernment sector, and the performance of the economy. For example, the government sector might want to run a surplus, but it cannot achieve this unless the domestic nongovernment sector and/or the foreign sector will run a deficit. So long as the non-government sector (including the foreign sector) wishes to save, it is futile and counterproductive, as well as unnecessary and pointless, for the government sector to wish to save as well.

Government spending can be excessive. But the consequence of excess government spending is not a refusal (on the part of foreign creditors or anyone else) to hold the bonds associated with deficit spending. It is, rather, a possible devaluation of the dollar and a possible decline of the real terms of trade of the country. But this possibility – an appropriate concern up to a point and under certain conditions – is also ruled out by the FASAB's proposed assumption of unchanged economic conditions. Unlike the non-issues discussed above, this is a real concern, and one that deserves actual attention. So again, the proposed reporting fails to promote understanding of the nation's financial condition.

Note also that in recent months, even as the US budget deficit has grown and as the possibility of a large fiscal package implies much larger future deficits, interest rates have fallen and the dollar has appreciated. Clearly the low short-term interest rates are due to a Federal Reserve decision to lower them, and nothing else. The rise in the dollar, despite sharply lower interest rates, is due to the fact that the rest of the world has run to the world's safest asset, US Treasuries -- driving down long term U.S. interest rates. These trends should be described as votes of confidence in the US dollar and strength of the Treasury. Of course, the foreign holding of U.S. debt results from the willingness of foreigners to sell to us their excess output, and to accumulate dollar assets; it, too, is an attribute of their confidence in the dollar as a reserve asset. The two EDs do not consider these matters, nor provide any guidance regarding how the US dollar's role as international reserve asset should be considered.

In a world of financial interdependence, it is of course essential that accounting standards applied to the federal government show an understanding of the basic position of the United States dollar and dollar-denominated assets in the world economy.

Back Door Policymaking: What is the "Fiscal Gap"? What is "Fiscal Sustainability"?

In the exposure drafts, the Board introduces the concept of a "fiscal gap," and states as a policy norm that it would be desirable to "maintain public debt at or below a target percentage of gross domestic product." There is an apparent belief that this is an accepted, perhaps even non-controversial, position. And, we agree, to set a target for the debt-GDP ratio, which implies that public debt can grow alongside GDP, at least rationally recognizes that public budget deficits, rather than balance, are normal.[3]

Yet, no such policy objective exists in any statute of the United States Government. Nor can such an objective be justified by reference to any known economic theory or operational constraint. There are times, including the present, when the level of debt in relation to GDP should rise to advance public purpose. There are times when it should fall. There are times when it will fall or rise irrespective of policy. To repeat, there is no justification in law or theory for attempting to legislate in an accounting standard a debt-to-GDP ratio as a target for economic policy.

Further, the exposure drafts fail to distinguish among total public debt, public debt held by the public, guaranteed agency debt, and implicit liabilities in the form of guarantees. The guidance in ED 1 refers to these concepts as "alternatives" but fails to take a position as to which alternative is meaningful and which is not. As such, the measure of the so-called "fiscal gap" is essentially meaningless.

The concept of "receipts" in the calculation of the fiscal gap should also be clarified. It should, of course, include bonds issued as well as tax receipts – though we repeat, even these taken together do not present an operational constraint on spending.

Putting issues of bonds and also reserves and currency into the total for receipts of course would make clear that the *concept* of fiscal gap is meaningless, as well as its measure, since tax receipts plus "receipts from borrowing" (broadly defined as new issues of currency, reserves, and bonds) are by accounting identity equal to total spending. But while the accounting information will always show that federal government spending equals tax receipts plus new issues of currency, reserves, and Treasuries, the exact ratio between federal government spending and any one of the items on the other side of that equation is largely determined by spending and portfolio decisions of the nongovernment sectors.[4] Those ratios are "sustainable" so long as the nongovernment sector seeks to sustain them. For example, if the nongovernment sector prefers to accumulate cash and reserves, there will be no need to issue Treasuries ("borrowing" falls); if the nongovernment sector preferences change toward Treasuries and away from cash and reserves, then more Treasuries will be issued ("borrowing" will rise). If the nongovernment sector decides to reduce its saving, it will spend more, the

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[3] Thus if the public debt is fifty percent of a sixteen trillion dollar GDP, and the nominal growth rate is five percent, it would be normal under the proposed guideline for deficits to equal four hundred billion dollars per year. Recognizing this would certainly represent progress, compared to a desire to balance the budget. It is obvious, though, that this implicit recommendation conflicts with the main thrust of the exposure drafts.

[4] In fact, it's the Federal Reserve's job to accommodate these decisions, as part of interest rate targeting, through what it calls "offsetting operating factors."

economy will grow faster, tax receipts will rise and the budget deficit will shrink. These outcomes are equally plausible and equally sustainable.

The EDs define "fiscal sustainability" as a condition of policy under certain arbitrary economic assumptions such that "public debt does not rise continuously as a share of GDP." The difficulty here is that the assumption of a stable inflation rate under hypothetical conditions of excessive fiscal expansion is untenable. If fiscal expansion is excessive, inflation and therefore nominal GDP would rise, and the public debt will eventually cease to rise as a share of GDP. This effect is known to economists as the "inflation tax." The inflation tax is an automatic stabilizer, which prevents excessive growth of real demand, which is necessarily limited by actual output. Inflation is unpleasant, but an unlimited debt-to-GDP ratio is not a consequence of it. The inflation tax therefore vitiates the problem of "fiscal sustainability" as defined in ED 1.

Dividing up the Budget in Arbitrary Ways

The FASAB proposes a minimum level of disaggregation for the basic financial statement. For example, projected receipts and spending for major programs such as Medicare and Social Security would be shown separately from those of the rest of government. This proposal also reflects a substantial misunderstanding of the purposes of federal budgeting.

The purpose of a program budget is to discipline the program. It is to hold managers accountable, and to discourage fraud. This is why specific amounts of funds are appropriated to specific programs. Without budgetary constraints (as well as oversight and other means of exercising control), it is likely that "mission creep" would lead to continual expansion of any particular program. Thus, it is certainly appropriate to hold programs accountable to ensure that they do what they are supposed to do.

However, there is little public or governmental interest in reporting long range projections of the "fiscal balance" of particular portions of the budget. And while officials in any program should be held accountable after the fact, there is little public purpose, and no economic interest, served by reporting the resulting, after-the-fact fiscal balance of particular portions of the federal budget. For example, if Congress appropriates $100 billion for a transportation project, those in charge should provide an *ex post* accounting for all spending. They should explain reasons for cost overruns, and their careers should depend on acceptable performance. However, whether the total tax revenue received from any particular source (for example, from gasoline taxes) equals spending on transportation over some arbitrary period adds nothing to this.

We do understand the desire to provide an *ex ante* projection of total federal government spending and revenues for coming quarters or even years. This facilitates analysis of the expected impact of fiscal operations on aggregate demand, and thus on economic growth, inflation, and employment. There may also be some interest in disaggregating spending and taxing, to match in an *ex ante* manner transportation-related spending and transportation-related tax receipts. This is not because fuel taxes actually "pay for" transportation spending, but because such a process can perhaps help to discipline the budgeting process, by "allocating" in an ex ante sense expected revenues among program spending. However, the success of the transportation projects should not be measured by the *ex post* balance between total spending and total tax receipts related to transportation over the course of a fiscal year or any other arbitrarily chosen period. It might be very poor public policy to cancel a vital transportation project merely because projected fuel tax revenues fall short of expected program spending.

By extension, the long-term success of Social Security should not depend on, nor be assessed by, matching spending on that program with some portion of federal tax revenue. The economic effects of budget deficits are the same whether they result from Social Security spending that exceeds payroll tax revenue or from transportation spending that exceeds transportation taxes. If, over time, we should find that projected payroll tax receipts fall significantly short of desired Social Security spending, then it would no longer make sense to adopt a budgeting procedure that dedicates—in a purely planning sense—payroll tax receipts to the Social Security program. In other words, whether we are setting fuel taxes or payroll taxes, the tax rate should be administered in such a manner that it achieves the public interest, not with a view to matching spending in any particular federal program. Likewise, when deciding how much to spend on transportation or Social Security, the program budget should be set to achieve the public purpose, rather than constraining spending to projected receipts from a specific tax.

So far as transfer programs are concerned, given that both assets and liabilities should be reported, and given that we are concerned ultimately with the financial condition of "the nation," a few exercises will demonstrate that assets and liabilities necessarily balance. The government's deficit is the private sector's surplus, and vice versa; contingent liabilities of the government are contingent assets to the public.[5] Therefore it would seem unnecessary to present many alternatives, since all would show the same thing. The "basic financial statement" is, as proposed in the EDs, a document that defies understanding. Efforts to make it clear are therefore somewhat beside the point. (Public purpose might be better served by efforts to make it confusing.) We naturally oppose the inclusion of "scare charts" such as those included in the draft.

Arbitrary, Capricious and Misleading Time Horizons

The FASAB's proposed time horizons are also problematic. They are so long, that they will involve making assumptions that are, in the nature of things, impossible.

An example is the assumption of current Medicare forecasts that health care costs will continue to rise indefinitely more rapidly than nominal GDP, so that the share of health

[5] In an open economy, foreigners can accumulate a portion of the government's debt. This opens the possibility that the US current account deficit could reverse to a surplus, with foreigners using their dollar claims to increase consumption of US output. That would stimulate US production and growth. How it would affect projections of US government tax receipts and spending (and whether that matters) is not considered by the drafts. It could affect terms of trade and real living standards—again matters that are not considered. It would not affect the government's ability to make all promised payments as they come due.

care in GDP rises without limit. While the focus of the exposure drafts is on implications for the federal budget, the effect on the private sector would be worse. In the limit, there would be few or no resources left to produce food, shelter, industrial goods or education, and the health care burden on households and firms would become intolerable. This cannot happen, therefore it will not happen. Stein's Law applies: when a trend cannot continue, it will stop.

No understanding of the issues is gained by a procedure that necessarily incorporates unrealistic assumptions of this type. Since the time horizons are arbitrary, the present value of future "liabilities" can be blown up to any size, simply by changing time horizons and discount rates. Most readers of the proposed budgetary documents are unlikely to be aware that the exercise is purely arithmetic in this sense.

For Social Security and other permanent programs, what matters for long-range projections are demographics, technology and economic growth.[6] Financing is virtually irrelevant. If by 2083 everyone is over age 67, no financing scheme will allow us to meet our commitment to let people retire at a decent living standard at age 67. This, however, is most unlikely. Indeed, all plausible projections of demographic trends show only gradual and moderately rising real burdens on those of normal working age in terms of numbers of dependents (aged plus young) per worker. The OASDI part of Social Security currently moves less than 4.5 % of GDP to beneficiaries and that rises to about 6.5% over the next 75 years. On one hand, this is a significant increase, but on the other, similar shifts have occurred in the past without generating economic crisis or intolerable burdens. And it still leaves over 93% of GDP outside OASDI.

Moreover, in economic terms a rise in this burden is substantially less worrisome, when considered in the context of a falling stock market, which reduces dividend income and capital gains available to wealthier elderly. The current crisis drives home the necessity of having the Social Security leg of the retirement stool—a leg that promises to deliver benefits no matter how poorly the economy performs. While the promise is in financial terms, because of the manner in which benefits are calculated, benefits will tend to rise in real terms as the economy's capacity to produce rises. As the population ages, there will necessarily be a rise in the real burden of supporting them.[7] The other legs of the retirement stool (private pensions and individual savings) cannot guarantee that the real needs of elders will be met. First, this is because financial markets are subject to wild swings—so that many will retire at inopportune times (when assets are falling in value). Second, there is no mechanism operating in financial markets to ensure that asset values rise sufficiently faster than prices of consumer goods to shift a larger share of the nation's output to the retired. Indeed, it is precisely the ability of Social Security to increase the share of output going to beneficiaries (that is, to raise the real burden) that will be required as the nation ages. Finally, if all of our projections turn out to be incorrect,

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[6] In an open economy imports of goods and services are also relevant for the support of retirees. Even if the ratio of retirees to US workers is rising, the real burden of providing for Social Security beneficiaries need not rise, if foreigners want to sell their output to the US in exchange for reserves.

[7] The caveat discussed in the previous note again applies. We will not continue to mention this point in the discussion that follows.

Social Security benefits can be changed (increased or reduced as necessary) as a matter of public policy—rather than as a result of the performance of financial markets.

The growing "real burden" of providing for an aging population is captured by the projection that while we have three workers today "supporting" each beneficiary, that will fall to only two workers sometime around mid-century. Two questions follow from this. First, can we expect productivity to rise enough over the next half-century to ensure that two workers will, indeed, produce as much as three today? All reasonable projections—including those of the Trustees—do assume this. Indeed, over the past half-century, productivities of workers in manufacturing have doubled or tripled, depending on the industry—far more than what is necessary to guarantee that we will have enough output to raise the living standards of retirees, workers, and other dependents.
Suppose (however unlikely the event) that productivity does not rise by the necessary amount. Is there any *purely* financial change we can make to the program -- including privatization -- that will avoid a "crisis"? The answer is clearly no. Getting more money into the hands of future retirees would just mean that they'd bid more of tomorrow's production away from workers and other dependents, leaving those groups worse off. To be sure, there would be policy actions that could attenuate the crisis by raising the ratio of workers to retirees (immigration in 2050 of workers, for example)—but financial expedients are not among them. If worse comes to the worst, so that we have fewer workers per beneficiary and no increase in productivity, then in 2050 taxes will have to be raised or benefits cut -- or some combination of the two to share the pain of lower living standards. But it is best left to voters in 2050 to make such a decision.

In short, it serves no useful purpose to project financial shortfalls for Social Security and Medicare into a far distant future, and no purpose whatever to revise those programs today on the basis of such projections. We summarize the reasons:

First, Social Security spending need not be politically constrained by tax receipts from any particular source.

Second, so far as fiscal impacts on the economy go, what matters is the overall fiscal stance of the government, not the stance attributed to one part of the budget.

Third, the most important factors determining future real burdens are demographic and technological, not financial. Uncertainties about demographic and technological trends increase exponentially as the length of the projection period increases. Almost any projections of birth rates, family size, death rates, or labor productivity for 2085 would be equally plausible, and very slight changes to trend rates for any of these variables would make huge differences for projections of real burdens. For this reason, basing policy today on such projections is almost certainly swinging in the dark.

Fourth, if we do face problems in the distant future due to aging of the population, they are not financial problems. The Federal government will always be able to make all benefit payments as they come due; the only question is whether the payments correspond to an appropriate share of total product at that time.

Conclusion: The Folly of Intergenerational Accounting

Many of the FASAB's proposed procedures appear to rely on the notion of intergenerational accounting. This exercise attempts to assess financial burdens through time, especially with a view to claiming that financial decisions taken in one generation can impose burdens on another. But this argument is specious. It refuses to count as real assets the infrastructure and other national assets that the current generation will leave for future generations. And it does not understand that federal government debt never needs to be retired, any more than private sector net saving needs to be eliminated.

In real terms, there obviously are no intergenerational transfers, except for the knowledge, the physical assets and the larger environment, which the present leaves to the future. The real goods produced in 2050 will be distributed to those alive in 2050, regardless of the public debt in existence at that time. And then, just as now, the deficits of the state will fund the nominal savings of the nongovernment sectors. In short, intergenerational accounting is a deeply flawed, experimental, and unsound concept. It should not be included in any government document.

In general, and in conclusion, the FASAB's exposure drafts have not made a persuasive argument about basic matters of accounting. The Board should work on getting these matters straight, and stay very far away from the additional challenges of determining public policy. We mean no disrespect to members of the Board, for many others have been seduced by the equating of household balance sheets with those of the federal government. No household can forever spend beyond its income plus ability to borrow. But that fact is simply irrelevant to a discussion of federal government spending. Federal spending can, and almost always does, exceed tax receipts. And that is almost always a good thing, because it provides the wherewithal to allow the nongovernment sector to save in the form of highly desired, safe, dollar-denominated financial assets. Further, there is an important counterbalancing asset to the government's liability: the accumulated financial, physical, and human capital of our nation that is available to be called upon should we ever need to mobilize these to serve the public purpose.

The notion that there is some "unfunded liability" amounting to tens of trillions of dollars is hogwash. There cannot be any "underfunding". The US government always has the operational ability to make all payments as they come due, and, we note, could do so even if through some strange accounting mistake or trick one concluded that government liabilities exceed private assets.

We apologize for the blunt tone of these remarks, but these are important matters. We fear the FASAB has been led astray by intergenerational warriors, who must not be allowed to take control of our Federal budgetary process. The danger is, of course, very real, for the application of "intergenerational accounting" to Social Security and Medicare can only mean the gutting of these vital programs, which are the mainstays of life security for America's elderly -- and for the working population that hopes to be elderly some day.

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