American Enterprise Institute for Public Policy Research

On the Issues

November 2008

# Congress's Role and the Financial Crisis

## By Harvey Golub

*A veteran CEO and AEI trustee asks whether Congress understands its role in the financial crisis and provides several tip-offs that will indicate whether the institution is serious about addressing it. They include the shape of the stimulus package, the structure of mortgage relief, support for additional bailouts, and changes to tax and trade policies.*

It is the week after a historic election, and I cannot help but worry. I am one of those people who are pessimistic about the near- and medium-term prospects for our financial markets and our economy.

I am not pessimistic about our country or our capitalist system: they are not the problem. I am pessimistic about whether our next president and the savants in Congress can deal with the massive economic issues we face.

Members of Congress—regardless of party affiliation or the election's results—will continue to meddle in matters beyond their knowledge. In doing so, they will exacerbate our current economic downturn and delay the recovery of our financial markets.

In recent months, Congress has displayed a fundamental lack of understanding of how our economy and our financial markets actually work. They believe they can say a bank is likely to become insolvent and that it will not lead to a run on the bank, or that they can say a major insurance company is in trouble and not have insurance stocks tank. They believe they can extend a $700 billion Troubled Asset Relief Program (TARP) beyond its charter and not have every institution under the sun try to get cheap capital. Most significantly, although Congress is a large cause of the collapse of the home mortgage market—witness the folly of Fannie Mae and Freddie Mac—members believe the markets are too stupid to recognize Congress's culpability and will maintain confidence in Congress's ability to resolve the financial crisis.

To restore confidence in the markets, Congress needs to demonstrate that it understands the nature of the problem it is trying to solve. Moving from TARP and the legislation needed to attack the liquidity and credit problems, it is beginning to address the foreclosure problem by "helping people stay in their homes" and to increase economic activity by "stimulating the economy." This sort of language does not bode well for a swift recovery.

The most fundamental economic problem we face as a nation is overleveraging—by our financial institutions and by individual consumers and homeowners. In effect, we owe more than either we can repay or what is supported by the assets underlying our debt.

The recent rise in foreclosure rates is fundamentally related to falling home prices, rather than a change in people's ability to pay those mortgages. The bubble bursting was inevitable, and, consequently, those foreclosures were bound to occur at some point. Many people took out loans to buy homes without having the earnings necessary to support such loans. They believed

---

Harvey Golub, a former chairman and CEO of American Express, is an AEI trustee. A version of this article appeared in the *Wall Street Journal* on November 5, 2008.

that housing values would continue to rise at record rates. And now that the bubble has burst, under our bankruptcy system, they are able to walk away with relatively little inconvenience. A great many of these people bought homes on speculation, never actually living in them; many bought them without any verification of their capacity to repay the loans; some did so fraudulently; and others had no skin in the game—otherwise known as a down payment—or with negatively amortized mortgages.

Imagine if I told you I would sell you a $10,000 block of stock with no money down and a low interest rate for the next five years, and you could walk away at any time with my only recourse being to take back the stock. In this scenario, I would not worry much either because I would have securitized the loan and sold it to Fannie Mae or some other financial institution. This is exactly, in substance, what many people did.

Meanwhile, others saved up a 20 percent down payment, bought a house they could afford, and are paying their mortgage. They paid more because millions of other people were buying houses they could not afford, serving to drive up prices. Some of these people have had a serious downturn in their economic circumstances. Others delayed buying their home because they could not afford to. These are the people who deserve our sympathy.

Why did institutions make the loans? Clearly, they were poor at assessing risk or thought that the party would never end. But they were also encouraged by Congress and regulators to make these loans, while at the same time, Congress was encouraging Fannie and Freddie to buy the loans. Barney Frank (D-Mass.) said, back in 2003, these now immortal words: "I want to roll the dice a little bit more in this situation toward subsidized housing."

The solution to this problem is simply stated: home values have to reach a market-clearing level. At that level, new people who can afford those houses will buy. Over time, the available inventory will get absorbed and new construction will start, even in the most difficult states of Nevada, California, Florida, Georgia, and Michigan. With a growing economy, asset values will ultimately rise. The issue is: how do we get the economy growing again?

The government needs to do two things. First, it must provide enough liquidity so that the capital markets continue to function. This should not be a bailout. It is maintaining the markets so that the broader economy can continue to function. Much of what is needed in that arena is already being done through the TARP legislation.

Second, Congress needs to promote economic growth. The fastest and surest way to do so is to cut the marginal rates on corporate and individual income taxes and to maintain lower levels of taxation on capital. These measures will guarantee that investment spending will occur, creating jobs and generating wealth.

---

If Congress meddles where it should not, we could find ourselves back in the 1930s.

---

Congress and our next president have to explain to Americans that the cost of corporate taxes is ultimately borne by workers and consumers—not corporations. In addition, they need to explain that high corporate tax rates stifle job growth and reduce the attractiveness of the United States as a place to invest. In short, we need a corporate tax rate significantly lower than the current 35 percent, which is the second highest in the developed world.

We must also realize that consumers have to reduce their spending levels to get their debt under control. Growth in debt must be slower than growth in earnings until this control is achieved. During this period of adjustment, consumer spending will be a less important part of total economic growth than has been historically the case. Since we are a consumer-driven economy, and that consumer drive has been significantly fueled by debt—in mortgages, second mortgages, and personal credit lines—it will take time to bring down consumers' leverage to the point that spending growth can occur on a consistent basis. The sooner we see underlying economic growth, however, the sooner this adjustment will occur.

How can we tell if Congress begins to understand its role in causing the problem and what it must do to help solve it? Here are some signs:

- If Congress passes a stimulus package that simply gives people money—like this year's $168 billion stimulus package, which was mostly rebates—they do

not get it. Rebates will not stimulate the economy and will not solve the underlying problem.

- If Congress tries to "help" the people who cannot afford the house they are in, be assured that they are wasting money and delaying the recovery. (Banks can better decide whether to foreclose or make a deal than any governmental entity.)

- If Congress forces the Treasury to provide cheap equity to companies that are solvent, or to automobile companies because of the debt owed unions in a politically important state, or if it continues with politically motivated spending, all of us will suffer a long and deep recession.

- If Congress raises marginal tax rates, erects trade barriers, and makes it easier for unions to organize without secret ballot through "card check" legislation, then the recession will be even longer and deeper.

It is my belief that comparisons between the current crisis and the Great Depression are generally overblown. If Congress does indeed do these things, however, and meddles where it should not, we could find ourselves back in the 1930s.

2008-62 #23678