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JOINT ECONOMIC COMMITTEE OF CONGRESS
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Madam Chairman, thank you for this opportunity to speak before the Joint Economic Committee. Since its creation by the Employment Act of 1946, the JEC has been the premier congressional forum to discuss economic policy, and as a former staff member of the committee I am honored to participate in this hearing.

I wish to make three points this morning. First, economic history tells us that periods of sharply eroding public confidence in financial institutions have significant negative economic consequences, but they do pass. Also, seeking retribution from persons or institutions perceived to be guilty of contributing to the crisis because of errors of business judgment (as opposed to illegal activity) often does not help, and may actually significantly deter recovery. I am not suggesting that Congress should do absolutely nothing further; for example, a review and probable modification of some existing regulatory and other practices relating to the financial services industry is no doubt in order, but I am urging that caution and moderation be used.

Second, I would observe that this crisis is not simply an example of market failure, of irrational exuberance trumping common sense, thereby requiring government action. I, somewhat reluctantly, supported the \$700 billion bailout package and advised some of your colleagues to vote for it. I also believe in perilous times that government has a role to play in restoring confidence. However, I am also convinced that the crisis itself largely reflects a series of public policy miscues. In the absence of these governmental mistakes, this financial crisis would never have happened.

Third, I am very concerned about attempts by an overly zealous Congress to attempt to craft an economic program that likely will have adverse effects. In particular, expansionary fiscal policy in the form of higher government spending is precisely the wrong thing to do at this time, aggravating an explosion in inflationary expectations that I already fear will erupt, having detrimental effects on labor and financial markets.

HISTORICAL OBSERVATIONS

Let me briefly comment on each of these factors. Anytime a firm or an entire sector of the economy has low rates of capitalization relative to its liabilities, the possibility of declining asset values leading to a dangerous erosion of net worth increases. When claims against the assets of firms can be made at any time, as is typically the case in the financial services industry, the problem is aggravated. In October 1929, there were roughly 11 dollars in bank deposits for every one dollar of currency in circulation, while in March 1933 there were only about four dollars of deposits per dollar of currency. As cash was removed from banks and converted to currency by nervous depositors, bank cash reserves fell, and with that confidence was eroded in the ability of the banks to meet remaining liabilities. Hence over 40 percent of the banks in the United States closed their

doors between 1929 and 1933. I completely agree with Milton Friedman and Anna Schwartz that this was a significant factor in the Great Depression.

As long as we have fractional reserve banking, confidence in financial institutions is vital. Deposit insurance has helped enormously in relieving problems relating to a lack of confidence, and bank failures went from an average of about 600 a year even in the prosperous 1920s to a handful annually shortly after the creation of the FDIC in the Banking Act of 1933. Scholars as diverse as Arthur Schlesinger and Milton Friedman have heralded this as great legislation. Implicitly, people have shown their confidence in the full faith and credit of the United State Government which they have believed is behind the deposit insurance guarantee. Yet that confidence is something we should not take for granted, and the excessive commitment of the government to protect virtually everyone from every possible loss could lead to erosion in confidence in government, and with that the ability of the government to serve as the protector of last resort for the financial system. The government's resources are not limitless, and the evidence from public opinion surveys that young people do not believe that the governmental commitment will be met to provide them with Social Security pensions is an early warning sign that excessive governmental commitments relative to available resources could conceivably lead to a confidence crisis where there is no viable governmental line of defense, and thus to true Financial Armageddon. You must maintain the credibility of that defense by not making commitments that the public knows cannot be met. By the way, Franklin D. Roosevelt was very much aware of this problem in 1933, and the large potential contingent liabilities to the government made him very cool to the whole idea of deposit insurance, and led him to successfully oppose high insurance limits favored by a bipartisan group of Congressmen.

It is worth noting that in some previous panics *private* solutions to stemming eroding confidence were largely successful. For example, in the Panic of 1907, a group of private bankers led by J.P. Morgan amassed a fund that was used to prop up banks facing pressures from depositor withdrawals. On the other hand, in 1932, the Reconstruction Finance Corporation was created by a Republican President near the end of his term working with a Democratic controlled House and roughly evenly divided Senate, and it helped shore up bank capital by buying preferred stock in commercial banks. Sound familiar? It is also worth noting that the RFC outlived its usefulness, and in its later years after World War II became mired in scandal until it was finally abolished by Congress in 1953 during the Eisenhower Administration.

The Great Depression was needlessly prolonged by dreadful public policies, some not directly related to financial services, especially the high wage policies of both Presidents Hoover and Roosevelt. But the bashing of bankers and other business leaders by governmental officials also contributed to extremely low levels of business confidence and investment during the 1930s. President Hoover supported an increase in top income tax rates from 25 to 63 percent near the bottom of the downturn, ostensibly to raise funds but in part to punish the alleged perpetrators of the 1929 downturn and its aftermath. Congress added to the problem by mercilessly attacking a prime symbol of American capitalism, the second J.P. Morgan, in hostile Congressional hearings in 1931. In the

Roosevelt administration, the President's constant attack of businessmen as "economic royalists" and the absolutely unconscionable hounding of Paul Mellon, long time Secretary of the Treasury, donor of the National Gallery of Art located just blocks away, and a prominent leader of the American business community, added to the fear of businesses to invest. Net business investment did not return to 1929 levels until after World War II. The writings of Robert Higgs and Amity Shlaes document these points in far more elaborate detail.

GOVERNMENT OR MARKET FAILURE?

There are already persons characterizing the current crisis as an example of market failure, of greedy bankers absorbed with increasing their wealth leading relatively innocent borrowers astray through inappropriate lending practices, aggravated by ill advised financial deregulation. In short, we are told that it was an act of market failure accompanied by a failure of government to perform its appropriate role in correcting market imperfections. I think this interpretation is mostly incorrect, and contributes to a form of governmental hubris that could lead to exceedingly ill advised retaliatory measures and stranglehold regulations that could stifle America in general and our financial services industry in particular, an industry already losing world preeminence because of previous ill advised policy moves, starting as early as the separation of commercial and investment banking in the Banking Act of 1933 (that, ironically, is a casualty of the current crisis) and continuing through Sarbanes-Oxley and beyond.

To be sure, private business people have made lots of mistakes. Banks made too many loans to too many people who were not credit worthy, and also lowered their lending standards and made implicitly dubious and excessively optimistic assumptions about the future of housing prices. The securitization of mortgages, while making some sense in terms of promoting market efficiency, also often largely shielded banks and loan officers from the adverse consequences of making bad and inappropriate lending decisions. The separation of the lending decisions from the adverse consequences of those decisions may on balance have been a mistake.

But even more important were government failures. The Federal Reserve System promoted excessively loose monetary policies including very low and even negative real interest rates, even on long term government securities. The market rate of interest fell below that interest rate consistent with the degree of human preferences for use of funds today rather than in the future, and that led to overinvestment in housing and other capital-intensive variables, very much in keeping with the business cycle theories of Ludwig von Mises and Friedrich A. Hayek. This is demonstrated in the accompanying graph. Inflation-adjusted t-bill rates fell from their customary long term average of roughly 2 percent or so into negative territory in the 2002-2005 period, inappropriately contributing to an increased demand for housing which could be met in the short run only by sharply rising housing prices. When the Fed reversed course, especially in 2006, tighter monetary policies and rising interest rates caused housing prices to start falling and left some persons with not enough money to make payments on mortgages on

properties for which they had little or no equity, leading, of course, to massive foreclosures beginning about two years ago.

Congress did not help, failing to deal with Fannie Mae and Freddie Mac despite repeated warnings, and shielding those organizations from rigorous regulation despite their being extremely thinly capitalized and engaging in dubious practices. Politics and campaign contributions trumped good economics. Incidentally, I identified some problems with these organizations in a JEC study done 26 years ago. The Community Reinvestment Act, while well intentioned, has provided an environment where bankers have been encouraged to adopt substandard lending criteria for certain classes of borrowers, no doubt contributing to a culture where traditional lending standards have been considered old-fashioned and no longer applicable. The old admonition that bankers who borrow short should not lend long too much, an adage that historically led banks from shunning very large scale real estate investments, went out the window. Regulators stopped requiring financial institutions to meet solid lending standards. The move to mark-to-market accounting standards, while arguably justified as promoting honest financial transparency, no doubt contributed to the nervousness of investors and the corresponding flight from investing in many businesses.

Reliving the past has limited utility, but it does point out human frailties are not confined to either the private or the public sector of the economy. Seeking to replace private judgments on the allocation of capital resources with public judgments is not in itself a recipe for success, and given the politicization of many public economic decisions in modern times I would bet that on balance a dramatic tilt in decision-making with respect to the allocation of financial capital would have far reaching adverse effects. I rather have thousands of bankers making those allocation decisions rather than one or two Ben Bernankes and/or Treasury secretaries, independent of their competence, integrity, or political affiliation. And past efforts by Congress to mandate certain untenable arrangements, such as the separation of commercial and investment banking, or in more modern times the peculiar status of Fannie Mae and Freddie Mac, does not inspire confidence that rigorous regulation will work – the cure could well be worse than the disease.

ECONOMIC STIMULUS AND APPROPRIATE FUTURE POLICY

I am particularly worried that the already announced fiscal and monetary policies, rather than restoring investor confidence, may lead to a sharp rise in inflationary expectations, which, in term, will trigger increases in interest rates and employee compensation that will have significant adverse economic effects, a reprise of the stagflation of the 1970s. The growth in the money supply in recent months has been noteworthy, and the increase in governmental expenditures and the potential inflation arising from both factors bodes very poorly for actual investor performance and thus confidence in the community of persons who finance most of our economic growth. The accompanying table provides regression results that indicate that stock market averages tend to fall when government expenditures rise as a percent of GDP, and when inflation picks up –even adjusting for the business cycle. When government spending crowds out private activity, investors are

disheartened, stock values fall, pension fund assets deteriorate, consumption declines, and so forth. The excessive increase in government spending in recent years along with some increased perception that inflation may not be completely under control are, in my judgment, the single most important factors in declining real equity wealth in the U.S. in this decade. The prospects of rising taxes and inflation in the coming years no doubt is contributing to a pall on equity values at the present.

Of special immediate concern is the call for a second economic stimulus package. If we learned one lesson from the era of large budget deficits, it is that fiscal stimulus does not promote economic recovery. Even in the heyday of Keynesian domination of the economics profession, scholars freely admitted that funding governmental infrastructure projects was a dubious way to stimulate the economy, simply because of the practical difficulties of timing – it takes typically years, not months, for new appropriations on infrastructure to actually lead to, for example, new road or school construction. Very often any stimulus provided by such construction comes long after recovery has already occurred, creating inflationary conditions that could have been avoided. That is in addition to other problems arising from financing such stimulus, such as the crowding out effects of higher spending that manifests itself through higher interest rates, inflation rates, and/or taxation. There are no free lunches, and the funding of stimulus packages inevitably would have adverse effects. Raising taxes to fund economic stimulus would be particularly foolhardy, as the disincentive effects of taxation could cause further damage to the real economy.

The creation of an infrastructure construction bureau within the government was, of course, what the Works Progress Administration, or WPA, was all about during the Great Depression. This became the largest New Deal agency before World War II, and at its peak in November 1938 the WPA employed 3.3 million persons. Relating to the timing issue previously mentioned, it is interesting that it took over 3 and one-half years to get to that level of activity, and that was in the era before we had environmental impact and affirmative action requirements that inevitably delay construction. It is noteworthy that the unemployment rate when the WPA hit its peak size was 17.7 percent, only slightly less than the 18.7 percent rate prevailing in April 1935 when the agency was created. Relative to leading European countries like Britain or Germany, our recovery in this period was anemic. It is fairly clear that the WPA was not a big success in creating jobs, and it was formed at a time when the federal budget deficit as a percent of GDP was smaller than today but when unemployment in those days was greater than today, meaning that the crowding out problems implicit in funding stimulus packages are probably even greater today than it that era.

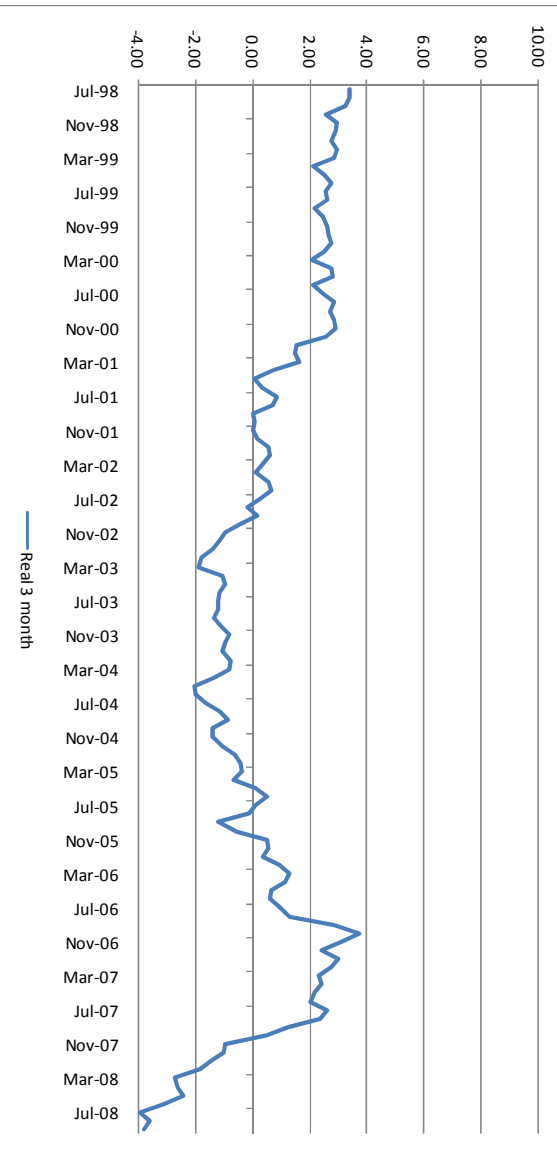
CONCLUSIONS

In conclusion, I urge you not to panic. The Federal government has taken the most aggressively interventionist position ever taken to deal with a crisis of investor confidence. For example, your legislative actions have made the government stockholders in vast portions of our financial system. You seem to be poised to provide massive aid, totally inappropriately in my judgment, to the automobile industry,

substituting your judgments for that of consumers and producers operating through markets. You have authorized a vast potential unfunded liability through the radical expansion of deposit insurance, which I think I can assure you Franklin D. Roosevelt would have opposed if somehow he could have come back to life for a day. By the way, I personally do believe some expansion in deposit insurance probably *was* justified, but it needs to be funded, and that is not without its problems, and raises the moral hazard issue and the possibility that unsound banking practices will be subsidized rather than discouraged. You have already muted the important signals that markets give off that lead to what on the whole are growth-inducing reallocations of resources. The impact of all of this may be to prevent an imminent collapse of the financial system, but only at the possible price of future stagflation, declining income and wealth, and a rise in national malaise reminiscent of the 1970s if not 1930s. You have done enough for now, probably more than enough. Relax and recover from your labors and allow the healing properties of markets to be asserted again.

Thank you for your attention.

Real Interest Rates - 90 day Treasury Bills



Dependent Variable: REAL_SP_500				
Method: Least Squares				
Date: 10/29/08 Time: 09:41				
Sample(adjusted): 1 154				
Included observations: 154 after adjusting endpoints				
Convergence achieved after 22 iterations				
Backcast: -4 0				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	10024.81	1102.462	9.09311	0.00000
PERCENTHCPI	-111.833	28.00107	-3.99389	0.00010
GOVGDP	-313.706	47.33265	-6.62768	0.00000
UNEMPLOYMENT	-158.301	45.96725	-3.44379	0.00075
MA(1)	1.308486	0.081075	16.13914	0.00000
MA(2)	1.349681	0.116504	11.58482	0.00000
MA(3)	1.227476	0.128638	9.542101	0.00000
MA(4)	0.895551	0.119073	7.521015	0.00000
MA(5)	0.328755	0.082276	3.995748	0.00010
R-squared	0.972932	Mean dependent var		2320.105
Adjusted R-squared	0.971438	S.D. dependent var		1405.252
S.E. of regression	237.4903	Akaike info criterion		13.8348
Sum squared resid	8178240	Schwarz criterion		14.01228
Log likelihood	-1056.28	F-statistic		651.4793
Durbin-Watson stat	1.755846	Prob(F-statistic)		0
Inverted MA Roots	.23 -.87i -0.67	.23+.87i	-.54 -.56i	-.54+.56i

Dependent Variable: REAL_DJ				
Method: Least Squares				
Date: 10/29/08 Time: 09:43				
Sample(adjusted): 1 154				
Included observations: 154 after adjusting endpoints				
Convergence achieved after 20 iterations				
Backcast: -4 0				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	25539.21	3197.33	7.987666	0.00000
PERCENTHCPI	-303.043	82.35887	-3.67954	0.00033
GOVGDP	-774.307	135.0164	-5.73491	0.00000
UNEMPLOYMENT	-387.542	141.999	-2.72919	0.00714
MA(1)	1.437822	0.082577	17.41188	0.00000
MA(2)	1.494018	0.125912	11.86559	0.00000
MA(3)	1.340847	0.141379	9.484038	0.00000
MA(4)	0.943099	0.128838	7.320027	0.00000
MA(5)	0.29777	0.082139	3.625191	0.00040
R-squared	0.972619	Mean dependent var	6491.195	
Adjusted R-squared	0.971108	S.D. dependent var	4014.194	
S.E. of regression	682.3187	Akaike info criterion	15.94553	
Sum squared resid	67506024	Schwarz criterion	16.12302	
Log likelihood	-1218.81	F-statistic	643.8226	
Durbin-Watson stat	1.772639	Prob(F-statistic)	0	
Inverted MA Roots	.18 -.88i -0.6	.18+.88i	-.60 -.51i	-.60+.51i