The Challenge of Creating Jobs in the Aftermath of the "Great Recession"

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It is a pleasure to address you concerning the State of the Economy and what needs to be done.

Though the situation today is far better than a year ago, it is no exaggeration to say that the situation remains bleak. We are at a critical stage in our recovery. The banks have been rescued and are set to pay out large amounts in bonuses. Yet there remain severe problems in our financial markets, with mortgages foreclosures continuing apace and massive problems in commercial real estate on the horizon. The suffering of those who have seen their life dreams vanish as their home equity—their major source of savings—disappear before their eyes, or the young people who, having knocked on door after door, see no job prospects in the immediate future, is palpable. We have an economic problem on our hands, but we also have a major social problem, with millions having lost their homes or about to do so. The divide between Wall Street, on the one hand, and the rest of the country, and even between the parts of the financial system that have received special favors from Washington and those that have not, has perhaps never been greater in recent memory. The fact that the stock market is up or that credit markets are less frozen should not distract us from the problems ahead.

These problems are especially grave in the labor market. We should not be fooled by the fact that the unemployment rate this month dropped by 0.2% to 10%. More than one out of six workers who would like a full time job still couldn't get one. But the unemployment rate is not lower because more jobs have been created but because more workers have become discouraged while looking for a job. According to the establishment data, the loss of jobs had slowed to 11,000 in October;

however, the loss in private sector jobs was large (18,000), and the loss of "regular jobs" (excluding temporary help services) in the private sector was 70,000. The fact that hours increased slightly, albeit from record low levels, is positive, but one should not read too much into one month's data.

Adjusted for changes in the structure of the economy, unemployment is the worst since the Great Depression. Other indicators suggest how bad things are: For instance, the duration of unemployment (the percentage of those in long-term unemployment) has reached another high. Weekly wages are essentially stagnating. When we look at particular groups and particular locations, the data is even bleaker. The numbers cited are averages for the whole country. Unemployment among males ages 16 to 19 stands at 30.3%, among those with less than a high school diploma at 14.5%, and among African-Americans ages 16 to 19 at 49.4%. And these numbers do not include those who have become so discouraged that they have stopped looking for a job or who have accepted a part time job because there is no full time job available.

We have been told that employment lags output. There are lags. Many firms won't start hiring until the shortened workweek, just over 33 hours, is extended. But these grim statistics are not just a matter of lags. Growth in private demand (i.e. without government action) is likely to be insufficient to restore employment to normal levels any time soon. The mathematics are simple: unless growth is greater than the sum of productivity increases and labor force growth, the number of unemployed, now standing at some 15.4 million, compared to 7.5 million at the start of the recession, will grow. Normally, the labor force grows around 1% per year and productivity around 2.2%, so that unless growth exceeds 3.2%, unemployment will grow. To bring the unemployment rate down rapidly requires growth in excess of that number for a considerable period of time—or by a considerable amount over a short period of time. Recent data suggests the problem *may* be even worse. Productivity has been growing faster than "normal" (recently at 8%), and that means that the break-even growth rate is far higher. There is little reason to believe that it will be sustained at such levels, but there is also little reason to believe that it will fall to below longer-run trends. (And, of course, if it should, it would not portend well for the economy's long-run prospects.)

It is imperative that something should be done about this. The stimulus package passed in February has been working. It was, however, not large enough and was not designed to maximize job creation. It was not up to the task required by the rapidly deteriorating economy. Unless action is taken, we risk facing a vicious cycle—unemployment contributing to a weak economy, more mortgage foreclosures, more bad debts, lower demand, and possibly more—but certainly not less—unemployment.

As we approach the looming jobs problem, we should not repeat the mistakes we have continually made in responding to this crisis—too little, too late. There is, in economics, something akin to the Powell doctrine in the military: one needs to attack the problem with overwhelming force. Australia did this, with its carefully designed but large stimulus package. It was the first OECD country to emerge from recession. If things should turn out better than the pessimistic prognosis given below, one can always scale back.

The basic economics of the situation is simple: what sustained the U.S. economy prior to the crisis was an unsustainable housing bubble, which fed a consumption boom. Household savings rates fell to an unsustainable level of zero. We might, through a variety of gimmicks, try to push the savings rate back down to near zero. That would be a mistake for the long-run strength of the economy. Households could get away with zero savings because they had an asset, a house, whose value seemed to increase without bounds. Their home equity has been greatly reduced, if not destroyed.

We had a bubble which has broken. The Fed was wrong in saying that one couldn't ascertain whether there was (likely) a bubble before it broke. It was very wrong not to have taken preventive actions. We have all paid a very high price for its flawed ideology. But it would be even worse for us now not to recognize that and to encourage households to consume as if house prices and asset values will once again be restored to bubble levels. That is why consumption, representing some 70% of GDP, will almost inevitably be weaker than before the crisis. Measures designed to "smooth" the adjustment will at the same time prolong the adjustment.

This is a synchronous global meltdown, and it is impossible for every country to export its way out of the crisis. We can try to export our way out through competitive devaluation, a form of beggar-thy-neighbor policy. But such policies will hurt our trading partners, and in the end, if their economies are weak, it will be difficult to sustain exports. But even if exports do well, they are unlikely to compensate for weaknesses in consumption.

With consumption weak, it will be difficult for investment to be strong, though eventually, because of the rapid pace of innovation in some sectors, obsolescence will necessitate new investments. But the overhang of residential and commercial real estate will mean that these will not resume to pre-crisis levels any time soon (though growth rates may look impressive, given the current low base).

I should say a brief word about my assessment of the economy's prospects over the next year or two. This crisis has been complex—a mixture of a financial and an economic crisis. The economic crisis, in turn, has at least three components: (a) an inventory adjustment; (b) a real estate "adjustment"; and (c) a longer-term restructuring from manufacturing to a service sector economy. The current rebound is largely a response to an excessive depletion of inventories, combined with the impact of the stimulus programs. It will be a long time before real estate recovers; indeed, some believe that the problems in commercial real estate are just beginning to surface. And many of the jobs lost in manufacturing are not likely to return; indeed, another 41,000 jobs were lost in manufacturing in November. In short, the economic crisis is far from over.

While the financial sector has been brought back from the brink, there are likely to be many bumps on the road ahead. Mortgage foreclosures are likely to continue, with one out of four homes underwater. There is a broad consensus among economists that what has been done so far has been inadequate; what is needed is a write-down of principle, not just lowering payments. At best, the current program will help a little; at worst, it will push the problems out into the future. (I will return to these issues later in my testimony.)

The effects of the stimulus will provide some strength to the economy through 2010, but there are two other looming problems (besides the uncertainties already noted in the financial sector): the substantial shortfall of revenues at the state level and the withdrawal of the stimulus spending in 2011. States have balanced budget frameworks, and thus if their revenues decline, they have to either increase taxes or cut back spending—a strong negative stimulus to the economy. Property taxes are an important source of revenue, and the decline in property values will hit them hard. The full impacts are just beginning to be felt. The effect of the shortfalls has been softened by the stimulus package; the end of the stimulus will heighten the problems. Those dependent on public services are likely to be especially hard hit, but so too will the macro-economy.

There is a third looming problem—the "exit" of monetary policy from its current stance—which I discuss below.

In short, there is no alternative to strong government expenditure and job creation programs. Today, the worry in some quarters is the resulting impact on the deficit. We need to be careful not to succumb to deficit fetishism. The government's debt is only one side of its balance sheet. No one would assess the state of a firm by looking only at what it owes. One needs to look at the assets too. If assets increase in tandem with liabilities, then the balance sheet can remain in good shape. If money is spent on infrastructure, education, and technology, the long-run productivity of the economy is increased at the same time that jobs are created today, in the short run. Numerous studies have shown that such investments can yield high returns, far higher than the government's cost of capital.

Deficits unaccompanied with increases in assets do matter, and that is one of the reasons why I have been so concerned about spending that creates deficits (including deficits in the future) but does not create a productive asset. Spending on the war is an example.[1] My earlier book with Linda Bilmes highlighted the huge costs of the Iraq and Afghanistan wars, including the future costs of providing disability payments and caring for the large number of injured and permanently disabled returning troops. At the time, we estimated, for instance, those costs to be in the order of half a trillion dollars. Evidence since the publication of our book suggests that those numbers were excessively conservative. They also suggest that the costs in Afghanistan are markedly higher than in Iraq. Using the Administration's estimates of about $1 million per troop (which does not include future costs of disability and health care, which, over time, will add substantially to the national debt), the money spent on the 30,000 additional troops surge could have created more than 1 million jobs in America that pay $30,000—and the jobs created in America would have higher multipliers (second and third round effects).

It is also one of the reasons why I have been so critical of the manner in which the bank bailouts were conducted. The Congressional Oversight Panel has described how at the time we got back 66 cents on the dollar in preferred shares and warrants. Not to put too fine a point on it, we as taxpayers were cheated. Had we gotten a fair deal, our national debt would in the future be that much lower. We should not be misled by the fact that some of those to whom we have given money have paid us back with interest. No oil company drilling wells would say, "Look, this oil well has more than paid back my investment." Yes, the good wells pay off; but they have to

[1] The critique of this spending on the wars in Iraq and Afghanistan go deeper: the concern is that they are unlikely to increase our security and that there are huge human costs that go well beyond the economic costs. See Linda Bilmes and J. E. Stiglitz, *The Three Trillion Dollar War,* New York: WW Norton, 2008.

pay enough to compensate for the dry holes. There is little prospect that we will ever recover the money put into AIG, with interest sufficient to justify the risks borne. We as a country have paid a very high price for not following the normal rules of capitalism, which require that a firm that cannot pay back its creditors should be put into receivership and that a bank that is undercapitalized should be put into conservatorship.

Investments in jobs can even help reduce the deficit in the long run. Unemployed workers lose their job skills. We are at risk of replicating a phenomenon observed in Europe in the 80s, called hysteresis: those with extended periods of unemployment never return to the labor force, or if they do, it is in a job with vastly lower wages and productivity. Unless we manage this crisis well, we could be setting ourselves up for an extended period of high unemployment. What economists call the "natural unemployment rate" may be significantly increased. And if that happens, GDP and tax revenues for years to come will be lower than they otherwise would be—with the result that the national debt will be higher.

Our financial markets have been unbelievably short-sighted, which has brought us to the brink of ruin. Their short-sightedness led them to pay out bonuses and dividends with money intended to recapitalize them. It would be a mistake now if we replicated this short-sightedness by focusing on the deficit.

There are clear criteria for the form of stimulus: (a) high multipliers—large GDP "bang for the buck"; (b) large job creation bang for the buck; (c) creating assets with high returns, especially those directed at national needs, like improving technology and improving public transportation systems; (d) flexibility—automatic stabilizers which increase spending commensurate with the economy's needs; and (e) meeting some of the economic and social exigencies created by the economic crisis.

Assessing alternative measures in these terms gives the following priorities:

(i) *Extending unemployment benefits*. Such benefits have high multipliers, and in the absence of these benefits, there can be enormous suffering. Mortgage defaults are also likely to increase, exacerbating the problems in the financial sector.

(ii) *Aid to states*. We should make up for the shortfall of their revenues arising from the economic recession.[2] State governments have reduced employment by 8,000 over the past year, and local governments have reduced their employment by another 96,000. Governments at the state and local levels are compounding the problem of the jobs deficit and weak economy; they are engaged in pro-cyclical policies, exacerbating the downturn. But unless they have help, they have no choice. To be sure, matters would be worse without the stimulus. They will get worse when the stimulus is removed.

(iii) *Tax credits*. Giving tax credits for weatherizing homes helps provide jobs for those who have lost jobs in the construction industry, while at the same time they help meet the challenge of global warming.

(iv) *Government job programs*. Labor intensive government job programs can create large numbers of jobs at relatively low cost

(v) *Research and technology programs*. We have been underinvesting in this area for a long time, but the problems have become more acute as private universities face declining endowments and public universities face declining support. Some universities are furloughing teachers; others are cutting back on hiring.

(vi) *Longer-term investment*s. It was natural to begin with "shovel ready" projects. But the downturn is likely to be a long-term downturn, and we should use this to our advantage. We should begin drawing up plans *now* for high return public infrastructure projects that are not shovel ready—but

[2] The assistance should be open ended, with as few strings as possible except that states and localities should maintain their tax effort; the federal government should fill the budget gap (what revenues would have been had growth been "normal") for the duration of the crisis. Given the difficulties states currently face in borrowing, the Federal government should also extend credit to them, passing on the advantage of the low interest rates at which it can borrow and taking as effective collateral payments that the Federal government makes to the States under a variety of programs.

could be ready in one or two years time. If it turns out that the economy recovers (unlikely), these can be undertaken eventually, as funds come available; if the economy is still weak a year or two from now, we will have a portfolio of high return projects from which we can choose.

Small and Medium Sized Enterprises

I want to spend a minute talking about small and medium sized enterprises (SMEs), which are the source of job creation. They are facing increasing difficulties in getting access to credit, even as the banks seem to be recovering. This is understandable. Banks and their supervisors are raising lending standards. Competition has been reduced. Many borrow on the basis of real estate collateral, and the value of that collateral has declined. Credit card companies have been raising their already high interest rates, and many very small businesses rely, at least partially, on credit cards.

More than a year ago we were told that we needed to bail out the banks to maintain lending. But in giving huge sums to the banks, we put no conditions on how they used the money. They used it in ways that were predictable, reflecting that the private incentives of bank executives differ from the social returns. Much of the money didn't go to recapitalize the banks, as we were promised, but to pay bonuses and dividends. And even with recapitalization and access to low interest funds, the banks are not increasing lending to SMEs, though there is a concern that in the successful emerging markets the money is fueling new bubbles.

The following seven point program may help alleviate the problems:

(a) Requiring all banks to allocate a certain fraction of their portfolio to SMEs (along the lines of CRA requirements); and restricting lending which directly or indirectly might contribute to the formation of bubbles.

(b) Directing more of TARP moneys into banks that are committed to lending to SMEs.

(c) Using TARP money to help establish new financial institutions committed to providing support for SMEs.
(d) Using TARP money to help lay off some of the cyclical risks associated with SME lending.
(e) Extending tax loss carry-back provisions for SMEs that engage in incremental investments or job creation.
(f) Restricting lending by banks for speculative purposes (especially banks making use of access to Federal Reserve money at low interest rates), which would encourage them to direct more of their lending towards the creation of new jobs.
(g) Carefully expanding SBA programs, recognizing not only the high risks that small businesses face in an extended economic downturn but also the difficulties that they currently face in getting access to credit.

Whatever benefits we give (access to credit, taxes, etc.) should be linked to job creation. A capital gains tax benefit for a small business engaged in real estate speculation is not exactly what the economy needs at this juncture. More generally, tax preferences have contributed to our country's current problems, and we must be more thoughtful about extending them.

Mortgages

I have long argued that doing nothing about mortgages while we were pouring money into the banks was akin to giving a mass transfusion to a patient suffering from internal hemorrhaging. It was a mistake not to have taken measures in the fall of 2008. It is now recognized that the measures taken in February 2009 were totally inadequate. Something must be done about writing down principle.[3]

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[3] Elsewhere, I have argued for a homeowners' Chapter 11 that would enable a smooth and orderly write-down of principle. There are other proposals that would have a similar effect, involving "equitization" of the debt and "right to rent," allowing individuals to stay in their homes as tenants, at market rates, with an option to repurchase. Such programs would protect the housing stock and communities and at the same time would provide service providers a powerful incentive to

Otherwise, foreclosures will continue at an unacceptable rate, and real estate prices will be unnecessarily depressed. This affects the rest of the economy through a variety of channels. First, as more mortgages are underwater, defaults and foreclosures rise, exacerbating the downward vicious circle we have already seen. The resulting losses of banks impact their ability and willingness to lend. But the declining prices also play into the problems in the labor market. As I noted, small businesses depend on asset-backed loans. Many small-business owners borrow on the basis of their homes. As home prices decline, access to credit declines. And that means jobs get destroyed.

But the weak housing market will contribute to high unemployment and lower productivity in another way: a distinguishing feature of America's labor market is its high mobility. But if individuals' mortgages are underwater or if home equity is significantly eroded, they will be unable to reinvest in a new home.

Supply side policies

The problem of unemployment in coming years may be worse than in a "normal" cycle for another reason (in addition to those already recounted). Many approaching retirement have lost a substantial part of their retirement savings and are considering postponing retirement. This will lead to a shortfall in vacancies, implying fewer jobs for new entrants into the labor force. Reducing the age of eligibility for Medicare and the penalties for early retirement under Social Security might help alleviate this problem.

Global imbalances

This is a global economic downturn. Well before the crisis, there was a worry that there would be a "disorderly unwinding" of the global imbalances. This disorderly unwinding was not the cause of the current crisis, but it could be of the next. It is

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renegotiate. Unfortunately, some of the accounting rule changes and some of the bailout programs undermined incentives to renegotiate, exacerbating the problems of mortgage restructuring.

important that something be done about these imbalances, which include America living beyond its means. Unfortunately, while household savings rates have increased, government deficits have increased in tandem, so the national savings rate remains low. The decreasing trade deficit (reflecting the narrowing gap between national savings and investment) is largely due to lower investment.

China has been put under a great deal of pressure to increase its exchange rate and its consumption. We should, however, be aware that it will have only a limited effect on our trade balance or exports. We are more likely to simply switch the source of our imports, to buy textiles and apparel from some other developing country rather than China.[4] From the global perspective, we should not be encouraging others to imitate our profligate consumption patterns. There are huge needs for investment, for instance in response to the threat of global warming or to improve the livelihoods of the 40% of the world living on less than $2 a day. The challenge is to recycle the savings to where they are needed.

In any case, as China increases its consumption (and it has been increasing at a rapid pace in recent years, though not as rapidly as GDP), some of it will be directed at improving education and health. We cannot expect much of it to show up as imports from the U.S. In short, we have to focus our attention in putting our own house in order, if we want a resumption of robust growth here. We cannot rely on some international fix, some magic that might result from correcting global imbalances.

Exit from Current Monetary Policies

By now, it should be clear that I think it is premature to begin to think of an exit from current strong actions on the part of government to stimulate the economy. The monetary authorities are now talking about an end of the extraordinary

[4] Moreover, in some cases, prices will adjust; in that case, the major impact of the revaluation will be a profit squeeze for some Chinese exporters.

measures that they have undertaken, and especially the quantitative easing. I want to highlight the dangers ahead, both for our economy and our national debt.

First, though, I want to comment briefly on the performance of the Fed. While everyone is thankful that we have been brought back from the brink, we should recognize the role of the Fed in creating the crisis in the first place. It was front and center. There is a broad consensus that its actions, guided by a flawed economic philosophy, led to the crisis. It believed that one could not tell a bubble before it broke, that it did not have the instruments with which to deflate the bubble, that the cost of cleaning up the mess after the bubble broke would be less than any costs incurred in early action. On each of these points it was wrong, very wrong, and we have paid a high price. Of course, one cannot be sure that there is a bubble before it breaks—but one can make strong probabilistic statements, and the role of any policymaker is to make judgments under uncertainty and to manage the risks.[5] The dereliction of its regulatory responsibilities provided full scope for the excesses of the years before the crisis.

I emphasize this because one of the issues before this Congress is reform of our regulatory structure. Giving more power to an institution which has failed so miserably, with results that have imposed such costs on all of us, cannot be the right solution—unless there are deep and fundamental reforms in the institution, of a kind that are beyond those currently being discussed. To do so would send a message to our own citizens and the world that we have no system of political accountability. To be sure, those on the board of the Fed today may (or may not) have learned a lesson, though economic philosophies often do not change that quickly. But even if they have, we have a country that is supposed to be governed by laws; the success of our system should not depend on the fact that those in charge have had their fingers burnt. If we take that approach, then in five years, or fifteen

[5] One can't be sure about the rate of inflation before it occurs, either, yet the fact that there is uncertainty does not impede it from acting.

years, we will have someone else in charge, someone who has not learned these lessons at such cost, and our country risks suffering again.[6]

Traditionally, the Fed intervenes only by affecting the short-term interest rate, and it only takes T-bills as collateral. Other rates are left to the market. In the extraordinary steps taken by the Fed in response to this crisis, it has entered into other markets, taking other assets as collateral. It seems to have *temporarily* lowered long-term mortgage rates, and this has facilitated the refinancing of mortgages. But any private party buying such mortgages knows that, when the program ends, mortgage rates will rise, and those holding the mortgage will take a substantial capital loss. It is no surprise then that the government program has, in effect, crowded out the private market—the Fed is on target to hold a trillion dollars of mortgages, on which it will suffer a large capital loss. The fact that the Fed won't recognize this loss does not mean it is not there. The reason that the private sector won't buy these assets is that they know the returns are lower than they will be able to get on new mortgages issued after the Fed exits. There is an opportunity cost. The loss in the value of the assets measures the (present discounted value) of that opportunity cost. It measures, in other words, how much higher the national debt will be as a result of the government program.

The fact that the Federal Reserve might not *recognize* the losses doesn't mean that the losses have not occurred.[7] Our banks got into trouble partly because of their funny accounting—they tried to deceive the regulators, their investors, and the tax authorities, and they wound up in part deceiving themselves. We should be clear why markets froze beginning in August 2007: each bank knew that it didn't know

[6] The problems of governance of the Federal Reserve system are well known. The regional banks, for instance, can, and often do, have on their boards representatives of the systemically dangerous institutions. Capture is built into the governance structure. Moreover, even if old leadership and institutions were admirable, it is useful, after a crisis such as this, to have new leadership that can assess with dispassion what went wrong.

[7] It is important to have accounting frameworks that recognize such losses, and proposals to force the Fed to do so should be encouraged. Otherwise, behavior will be distorted in attempts to hide them. Examples are given below.

its own balance sheet, so it couldn't trust that of any other. One of the criticisms of the manner in which we have handled the bailout is the lack of transparency.

There are proposals that the Fed keep these mortgages on their balance sheets *in order to avoid recognizing the losses*, and, when the time comes to rein in lending, to do so by inducing banks to hold more money at the Fed by offering higher interest rates. That too comes at a high cost—money paid on deposits at the Fed is money that may help the banks' balance sheets but that is not available to help the government's balance sheet. There are other regulatory instruments that may be far less costly to the taxpayer and far more certain in their impacts on lending.

Regulatory Reform

Finally, I want to say a few words about reform of the regulations affecting our financial system. We should have begun both regulatory reform and bailouts with a conception of what kind of a financial system we wanted—and what was wrong with the financial system of the past. Our financial system failed to perform its critical social functions of allocating capital and managing risk with low transaction costs. Instead, it created risk and misallocated capital, all with high transaction costs. That some 40% of corporate profits were garnered by the financial system should have been a sign that something was awry. A financial system is a means to an end, not an end in itself. Our financial system has engaged in predatory lending. It has resisted the creation of an efficient electronic payment mechanism that modern technology could have provided. Instead of the pennies that it should cost to transfer money from one account to another, charges of 1%, 2%, or more of the sales are imposed. It is like a tax—a tax that dampens business, especially hurting small and medium sized businesses and competitive industries operating at low margins. But the revenues from this tax do not go to public purposes but to pay outsized bonuses to those in the banks.

We are emerging from this crisis with a banking system that is more concentrated and less competitive and able to extract more rents from the rest of the economy, evidenced by usurious interest rates on credit cards. While the money will help recapitalize the banks, the higher interest rates will slow the recovery, and a less competitive banking system will neither serve our citizens nor our economy well.

There is a simple test of the adequacy of "reform" (regulatory and structural reforms) of our financial system: if these reforms had been in place, say in 2003, would the crisis have occurred, and if it had occurred, would it have been less costly? My assessment of the reforms currently on the table is that they fail to meet this test. Unless we pass an adequate regulatory reform, we can look forward to another crisis some years down the road. This is not good news either for our citizens or for our economy.

Take the issue of incentives. The one subject on which economists agree is that incentives matter. Bankers' incentive structures encouraged short-sighted behavior and excessive risk taking. They acted in a manner totally consistent with their incentives. Why should we be surprised at what resulted? Excessive risk taking might not matter, were it not for the large externalities: the failures of our banks have imposed large costs on all of us, on homeowners, on workers, and on taxpayers. That is the reason that we need regulation, and especially for systemically significant institutions.

I remain unconvinced that we have done enough to deal with the institutions that are too big to fail or institutions that are even too big to be financially resolved. The Governor of the Bank of England has recognized how critical it is to fix the problem that they pose. Fixing this problem is not the only issue—there is no such simple solution. It is necessary, but not sufficient. The reason that something has to be done should be obvious: too big to fail institutions have perverse incentives. If they gamble and win, they walk off with the winnings; if they fail, we pick up the losses. The way we have addressed this crisis has made these problems worse. Concentration in the financial sector has increased, and so has moral hazard. I testified to this committee on this issue earlier, and I will not repeat what I—and all the other witnesses at that hearing—said then.[8]

Steps taken so far are moves in the right direction, but they don't go far enough. Creating a $150 billion fund to finance the next bailout is desirable if we fail in preventive action, but $150 billion is clearly insufficient: we have spent $180 billion on the AIG bailout alone. But the fund itself is an admission of defeat: if we had a well-functioning regulatory structure, it would close down banks before the losses had mounted to the size that they could not or would not be borne by bondholders and shareholders.

Having plans for an orderly resolution—living wills—is also a step in the right direction; but in the context of a crisis, it is unlikely that anything will go as planned. Giving additional resolution powers too is a move in the right direction; but the issue is not so much having the powers but a willingness to use them, as large and powerful financial institutions in a crisis will use the same kind of scare tactics that they used in the current crisis. Existing powers were not fully used either before or after the current crisis. Authorities will worry about the turmoil that will result if bondholders and shareholders are let go.

We cannot let institutions grow to the size where they are too big to fail. We must prevent them from becoming so intertwined that they represent systemic risk, and we must restrict risk taking activities of any institution that is sufficiently large that it might be bailed out. It is a matter of fairness and a matter of efficiency. These too big to fail institutions have an advantage not based on superior banking skills but on the implicit subsidy provided by the U.S. taxpayer. This distorts the financial sector, not only tilting the playing field towards the large banks but also encouraging

[8] Joseph E. Stiglitz, "Too Big to Fail or Too Big to Save? Examining the Systemic Threats of Large Financial Institutions," testimony before the Joint Economic Committee, April 21, 2009.

excessive investment in the financial sector.[9] A dynamic can be set in motion with increasing concentration, decreasing competition, and increasing risk borne by the taxpayer.

Large institutions must, in addition, be restricted in their risk taking, e.g. in their leverage and in their trading. They should not be allowed to engage in proprietary trading—including speculation underwritten by the U.S. government. What is required is not changing the name of proprietary trading but instead changing the rules that allow them to make investments on their own account, with part of the downside risks implicitly being borne by the taxpayers.

But of even more concern is the role of the big banks in credit default swaps and other derivatives. We must remember how much these have cost us. The AIG bailout alone has amounted to $180 billion. Whatever benefits may have accrued to our economy, I know of no evidence that suggests that those benefits exceed the costs. We have had exchange traded risk management tools—such as futures markets—well before CDS's. While the new products may have lowered transactions costs, they have also enabled shifting risk to taxpayers, and this may be their primary advantage to those who make use of them and the banks that sell them. But this is also the reason that we must restrict them. If they are risk management products that can survive on their own merit, then other institutions will find it desirable to issue them, though even then they will have to be regulated.. CDS's are either insurance instruments, in which case they should be regulated as insurance; or they are gambling instruments, in which case they should be treated

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[9] The financial sector has imposed large costs (both financial costs through bailouts, as well as the more general economic externalities associated with the economic disruptions which they have caused) on the rest of the economy, and repeatedly so, distorting our economy's structure. There is a general principle in economics called the "polluter pays" principle: those who impose costs on others should be forced to bear those costs. If they do not, the economy is distorted. It is a matter of fairness and efficiency. More generally, taxes should be imposed on activities generating negative externalities. This suggests the imposition of taxes on the financial sector. One tax gaining increasing support around the world is a financial services transactions tax. Taxes on short term capital gains might even serve to stabilize markets. Tax policy could also be used to encourage better compensation structures.

as such. But when they are underwritten by the too big to fail institutions—as almost all of them are—they are effectively underwritten by the US taxpayer. And yet, we treat them more favorably than either insurance or gambling, for no justifiable reason other than that they are written by these powerful institutions. Indeed, by giving them seniority in bankruptcy, we treat them more favorably than any other securities. In this way, they impose negative externalities on others. The economic consequences—besides the huge risks to which the taxpayer is exposed, so evident in this last crisis—are serious: they are underpriced, and anything that is underpriced is oversold. It is understandable why big businesses who benefit from the current arrangement in their hedging strategies might complain about any change that could eliminate this underpricing: anyone would complain about a loss of a subsidy, but as in so many cases, they are misguided, since they probably receive little of the benefit of the subsidy—most accrues to the issuers. But even if their costs were to increase, that is as it should be. Even when these derivatives are being used as legitimate instruments of private insurance, there is no reason that the government should be subsidizing that insurance and no reason that it should be subsidizing one form of insurance over others.

The administration is right that transactions should be encouraged to go to standardized products traded over exchanges or clearing housing. It is again understandable why the issuers would prefer to keep their non-transparent OTC products. The lower the transparency, the less perfect competition, the higher prices and profits; and OTC derivatives have become an important profit center for some institutions. But as a matter of public policy we should be trying to make markets work better. Our financial markets failed us, and we should not forget that. They can and will fail us again unless we correct the underlying problems. We need to make markets as transparent and competitive as we can if markets are to perform as they should. Capital markets are supposed to provide discipline, but they cannot provide discipline if they do not have the requisite information. If the banks' balance sheets can change as rapidly as, for instance, AIG's seemed to in October 2008, how can any investor know how to assess a firm's prospects?

Without knowledge of the counterparty risks, how can there be market discipline? In short, with opaqueness, we are converting financial markets into a crap shot. I have seen no evidence that the risks covered could not be reasonably adequately covered by standardized products. In most cases, costs would actually be lowered, but even in the few instances in which that would not be the case, I can see no benefit commensurate with the costs, including those borne by taxpayers and the rest of the economy.

"Encouraging" movement to standardized products does not go far enough. The devil is in the details, and we should have little confidence that our regulators will get it right, unless we spell out what that means. Those who love opacity—and profit from it—will put pressure to keep that opacity.[10]

But demanding that they be traded on exchanges is not enough either. We must be sure that the exchanges are adequately capitalized, lest the taxpayer be forced to pick up the losses when the exchange collapses. There is a simple remedy: making all those trading on the exchanges (or trading in CDS's in non-exchange traded transactions with any institution) being jointly and severally liable for all losses in the market. Let those who allegedly benefit from the market absorb the downside risk—rather than imposing the costs on taxpayers, or by giving these instruments seniority in bankruptcy, forcing legitimate businesses to bear the costs. I suspect that were we to make the participants in the market bear these losses, there would be greater transparency and less trade, and prices would begin to better reflect the real risks.

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[10] Those who love opacity also love it in legislation. It appears that a small alteration to legislation intended to force trading into standardized products traded on clearing houses and exchanges has been gutted by the insertion of language that broadens acceptable trading platforms to include "any electronic trade execution or voice brokerage facility"—which might seem to include any telephone call. If such a provision were to pass, it would make a laughing stock of regulatory reform and subject the whole effort to derision.

While I commend the House for moving to create a Financial Products Safety Commission, the exemptions have effectively gutted its effectiveness. There is in this area a kind of Gresham's law. Bad products can drive out good ones. We should have learned that lesson from this crisis. Homeowners didn't have to succumb to predatory lending.[11] They didn't have to buy the explosive and toxic mortgages. But many Americans are not able to assess risk—not a surprise, given that our financial wizards failed so miserably. And they can be encouraged to use products that are unsuitable for their circumstances. They can, and are, being preyed upon. Allowing such predatory activities might generate more profits for the banks. But this is not the way to recapitalize our banking system.

Reforming the regulatory processes and institutions

Three comments on regulatory processes: We have seen the risks of regulatory capture. We know the pressures under which regulators are placed. Those pressures are present in booms—no one wants to be a party pooper—and they are even stronger in a crisis: no one wants to be blamed for exacerbating its depth. There is always hope that a little bit of forbearance will go a long way. That is why we have to hardwire much of the regulatory framework; discretion can and has been abused.

Secondly, we have to make sure that the regulators are drawn disproportionately from those who will be harmed by bad behavior of those in the financial sector, not helped. That is one of the reasons for the Financial Product Safety Commission—a regulatory body focusing on potential adverse impacts of the products being sold.

Thirdly, we should recognize that our regulators, including the Federal Reserve, performed far more poorly than central banks in other countries. We like to be

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[11] Some of the predatory lending is linked with fraudulent behavior on the part of certain lenders. In 2004, the FBI warned publicly of an epidemic of mortgage fraud, but the part of the FBI responsible remained vastly understaffed. Strong enforcement of anti-fraud laws is essential for the maintenance of the integrity of our financial system.

proud of our institutions, believing that we are setting an example for others to follow. In this case, our institutions were far from the head of the class. Canada, Australia, India, Brazil, and Spain all had central banks that thought far more deeply about the common issues confronting their economies and what actions might protect them. Their central bankers had a different regulatory philosophy, and they had different institutional structures and different systems of accountability. They all performed far better, some in even more adverse situations. Before the crisis, experts in regulation had, for instance, praised some of the practices of these other central banks; their superior performance was predictable and predicted. It was not just an accident.

One aspect of the institutional structure of several of these banks is worth noting: they were not as independent. Independence of central banks has been treated by some as essential for a well-performing central bank. Central banks are public institutions, and they should be held accountable and subject to public scrutiny. They should not be exempt from the Freedom of Information Act, though there may need to be narrow exceptions carved out. The world did not fall apart when it was disclosed who got the AIG bailout money; as is so often the case, secrecy appeared more part of a cover-up. Transparency provided the beginning of a meaningful discussion of what went on. Whatever one might say about the necessity of central bank independence in setting interest rates, when they are engaged in effectively spending public money—as ours was—lack of transparency and accountability should be viewed as totally unacceptable.

Today, everyone talks about the importance of accountability. Accountability means that there have to be consequences for one's actions. The Fed failed to regulate our banks and our financial system. We should not forget the cost of this failure. It is not just the cost to our budget, deficits that have reached unheard of levels, actions necessary because of the failure of the Fed. The higher level of debt will have an impact for years to come—investments in human capital, infrastructure, and technology will be squeezed, not to mention cutbacks in basic services. Ten years from now, our GDP will be substantially lower than it would have been had the Fed done its job. The loss in GDP from what it would have been had the Fed done its job even over a narrower time frame—say just 2008 to 2011—is literally in the trillions of dollars. It would seem strange to respond to such failure simply by giving more power to the Fed, which failed to use the powers that it had. As I testified earlier, I believe that it is essential to create a new Systemic Regulator.

Concluding Comments

I want to conclude with three general comments. The first is that the agenda of economic reform needs to be far broader. Our tax laws encouraged excessive leverage and risk taking. What kind of society says that speculation should be encouraged at the expense of hard work? That is what we are saying when we tax earned income far higher that capital gains. Flawed bankruptcy laws and corporate governance too contributed to the crisis.

Secondly, we need to keep in mind that the real cost of an economic downturn caused by a bubble—an economic downturn of the kind that we are now experiencing—occurs after the bubble breaks. Crises don't destroy the assets of an economy. The banks may be bankrupt. Many firms and households may be bankrupt. But the *real* assets are much as they were before—the same buildings, factories, and people; the same human, physical, and natural capital. In the run-up to a crisis, resources are wasted—putting money into building houses, for instance, rather than to more productive uses. But this is water over the dam—bygones are bygones. The key question is, how will resources be used after the bubble is broken? This is typically when most of the losses occur, as resources fail to be used efficiently and fully and as unemployment soars. This is the real market failure, and one that is avoidable if the right policies are put into place.

What is striking is how often the right policies are not put into place, and the losses during the bubble are compounded by the losses after it bursts. Something is wrong when we simultaneously have homeless people and empty houses and when we have unmet needs and firms and workers willing to produce more.

We are a rich country. We can afford to squander hundreds of billions of dollars. But there are limits for even a rich country. The combined effects of unbridled spending on unproductive wars, on corporate welfare, and on poorly designed bank bailouts inevitably will exert their toll. But when these effects are compounded by macro-economic mismanagement, leading to an economy operating for years below its potential, the consequences are even more worrisome.

This crisis has put to the test our economy and our political system. Financial institutions are essential to the well-functioning of any economy. Our financial system didn't function as it should have, and we have all suffered. But this is not the first time that our banks have had to be bailed out. It has happened repeatedly. The S&L bailout was the last large bailout of American banks because of bad lending here at home, but the myriad of bailouts abroad, with names like the Mexican, Indonesian, Korean, Thai, Brazilian, Argentinean, Russian bailouts, were all bailouts of American banks arising from their failure to assess creditworthiness. We should not forget that. The only period in history when there were no banking crises was the short period after the Great Depression, before the deregulatory movement that began in the late 70s and early 80s.

We have seen how important trust is to the functioning of a financial system. Financial institutions lost trust in each other, and our credit system froze. We all understand the basic reasons for the failures, including lack of transparency, excessive leverage and risk taking, and a misalignment of private rewards and social returns. Unfortunately, to too large an extent the rescue has been marked by much of the same. There has been a lack of transparency and a socializing of losses and risk, combined with privatizing of returns and profits, what I call ersatz capitalism. I am a strong believer in the virtues of a market economy; I know of no economist who believes that this new ersatz capitalism is likely to produce an efficient, dynamic, or fair economy. As we went about the rescue, we had no vision of what kind of a financial sector or what kind of economy we wanted to emerge after the crisis. We cannot and we should not go back to the world of 2007. Our financial sector was bloated and distorted. It will have to be downsized. But the question is, what parts should be downsized? We should be strengthening the venture capital firms and the banks that lend to small and medium sized banks.

Many in the public have sensed that something went awry in the rescue. They have seen their jobs and wealth destroyed while some in the financial sector walk away with huge bonuses. The financial sector has lost the trust of the American people, but now, there is a risk that government too will lose that trust. Active programs to promote jobs and to regulate effectively the financial sector are important steps in restoring that trust.