



**Economic Policy Institute**

RESEARCH FOR BROADLY SHARED PROSPERITY

Testimony of

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Joint Economic Committee  
of the United States Senate

and

the United States House of Representatives

How Much More Can Consumers Be Squeezed by Stagnant Income,  
Skyrocketing Household Costs, and Falling Home Prices?

July 23, 2008

## *Introduction*

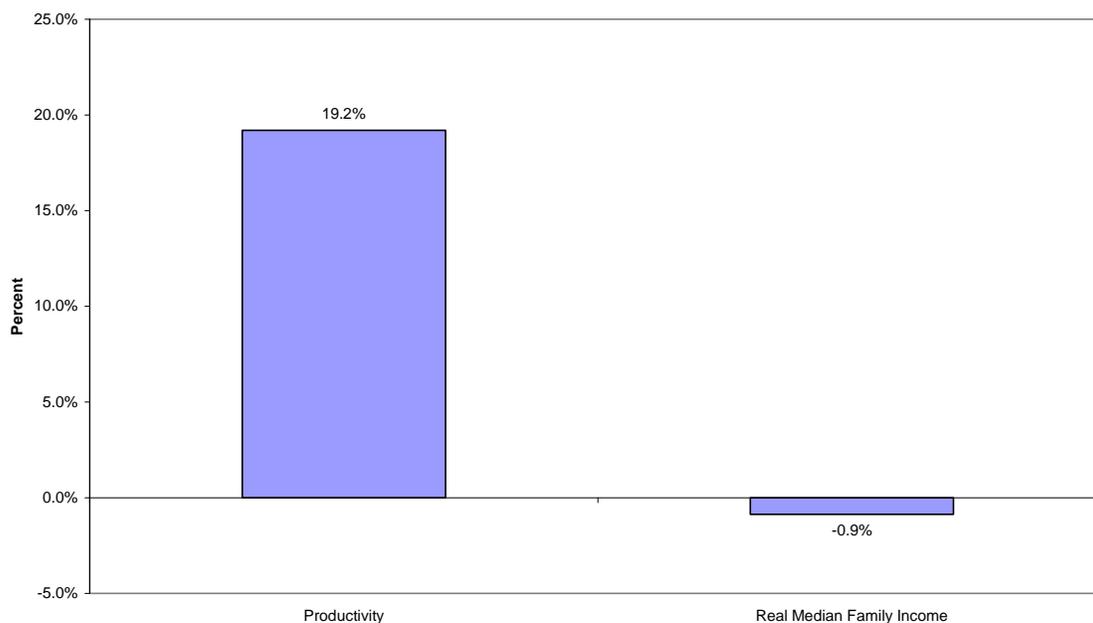
Chairman Schumer, Ranking member Saxton, I thank you for the opportunity to testify today. I particularly applaud your decision to focus on the impact of our current economic difficulties on middle-income American households.

Everyday, the nation's business pages focus report the ongoing stressors in financial markets. These difficulties are of course real and important, given the centrality of these markets and the critical importance of free-flowing credit in our economy.

Understanding the causes of these bubbles and busts is also crucial, and I will devote considerable space in this testimony to these matters, including the bursting of the housing bubble, bad underwriting, low capitalization, shadow financial arrangements, rating failures, and other distortions that helped get us where we are today.

But in today's hearing, I have also been asked to focus on the squeeze currently facing households who depend more on their paychecks than their stock portfolios. Many of these households are facing an economic onslaught for which they are ill-prepared. Though they were highly productive over the business cycle of the 2000s—the productivity of the US labor force grew by 19%, 2000-07, their incomes failed to reflect their contributions (see **Figure 1**). In fact, as my co-authors and I show in our upcoming release of the State of Working America, 2008/09, the gap between productivity growth and that of median income or compensation has never been larger. In what is arguably the most telling indictment of recent economic outcomes, for the first time on record, it appears that real median family income will be lower at the end of this business cycle than it was at the beginning.

**Growth of productivity and real median family income, 2000-07**



Source: EPI's analysis of Census and BLS data. 2007 real family income is an EPI forecast (we forecast that real family income rose 0.8% in 2007)

**Figure 1**

Meanwhile, for those who own homes, the value of that asset is falling, and falling fast. In a pointed jab at what the Bush administration called “the ownership society” the rate of homeownership is declining for the first time in years. At the same time, macro-economic weakness is taking a notable toll on the job market, and both job and real wage growth has been negative. Finally, prices of key market basket items, such as food and energy, are growing much faster than average inflation, and again, much faster than their paychecks.

These are, of course, unsettling outcomes. But one is reminded that in Japanese, the word for “crisis” is the same as the word for “opportunity.” To the extent that the problems elaborated at today’s hearing are amenable to public policies, this body is in a position to implement necessary changes. To that end, I recommend the following actions.

- In the short term, a second stimulus package is necessary. While some of the package should again include direct payments to strapped households, more of the stimulus should be targeted to direct spending on relief to states and infrastructure investment.
- In the medium term, over the next few years, a return to common-sense regulation is needed in mortgage and financial markets. Some of this involves enforcing rules already on the books but ignored, and some involves creating new rules

designed to preclude bubbles by bringing greater transparency and stability to these markets.

A second stimulus package appears quite necessary given the protracted period of below-trend growth in the macro-economy. Smartly crafted, it has the potential to help generate more economic growth until the imbalances and necessary corrections in key markets play themselves out. The regulatory agenda is ultimately targeted at the longer-term problem of what might be called the shampoo economy of the last few business cycles, with their pattern of “bubble, bust, repeat.”

The last two, and possibly three, recessions were caused by bubbles that were fairly widely recognized as they inflated. Yet key policy makers ignored the signs, in some cases even nudging the bubbles along by endorsing the practices that inflated them. The economic pain caused by the inevitable implosion was, and is, deep. It is a major contributor to the middle-class squeeze, all the more unfortunate in that this economic pain is largely self-inflicted.

I am well aware that members of this committee are interested in learning about options for correcting these imbalances that comprise our financial markets. These markets, as I argue below, are historically among the most innovative and effective in the world, and they have proven to be integral to providing credit to both the household and business sectors. But excessive deregulation and the absence of common-sense oversight threaten to undermine this vital track record, and Congress must not let this occur.

The regulatory agenda I outline is simple and commonsensical. It contains these components, elaborated below:

*Apply oversight based on what entities do, not who they are.*

*Increase capital reserve requirements.*

*Improve Transparency: Eliminate off-balance sheet entities and monitor positions/liquidity*

*Improve and enforce mortgage underwriting standards*

*Fannie Mae and Freddie Mac: Resolve the ambiguity regarding their public/private status*

*From the perspective of executive compensation, treat government bailouts as bankruptcies, clawing back bonuses and excessive compensation.*

*Create a new financial watchdog agency to implement and oversee these reforms*

***The Economic Stressors Facing the Middle-Class***

Most working-age households depend on a robust labor market for their economic well-being. About three quarters of the income of middle income families comes from their labor earnings, compared to about one-third for the top one percent.<sup>1</sup> In this regard, one of the significant problems faced by middle-income (and lower income) families in the 2000s has been the lack of opportunity in the job market. As shown below, labor demand—the creation of jobs and annual hours of work—was uniquely low in the 2000s, and this had clear negative effects on the living standards of working families.

Between 2000 and 2006 (the most recent data on annual earnings), the average annual earnings of middle-income families (summing across all working family members) fell by about \$800 in today’s dollars. This loss was largely driven by a combination of weak, but positive, real hourly wage growth, and a significant decline in hours worked. In 2006, middle-fifth families worked almost 90 hours less per year than in 2000.

In fact, the slight decline (-1%) in real family income in the 2000s is more than explained by the decline in hours worked, which shaved 2.2% off of the growth of middle incomes. Had annual hours worked simply remained flat for these groups, their incomes would have risen slightly; had their hours grown as much as in the 1990s, their incomes would have grown by 5%, an increase of \$3,800 over their actual income growth over this period.

As Professor Warren’s testimony stresses, these income losses occurred over a period when prices of goods which comprise the heart of the middle-class market basket were growing considerably faster than average inflation. Such price data are particularly revealing of American’s sour mood regarding the economy. The table below shows annual price growth from June 2000 through last month. The second line of the table shows the growth rate over the past year, to examine evidence of recent acceleration.

With the exception of food, all of these items grew faster than average prices over this period. College tuition grew more than twice as fast and the price of gas grew at almost four times the average rate. In the past year, prices have clearly accelerated across the board, but all items except child care accelerated faster than average, especially gasoline. Gasoline prices spiked in June 2008, but averaging over the quarter, they are still up 25% over the same quarter last year.

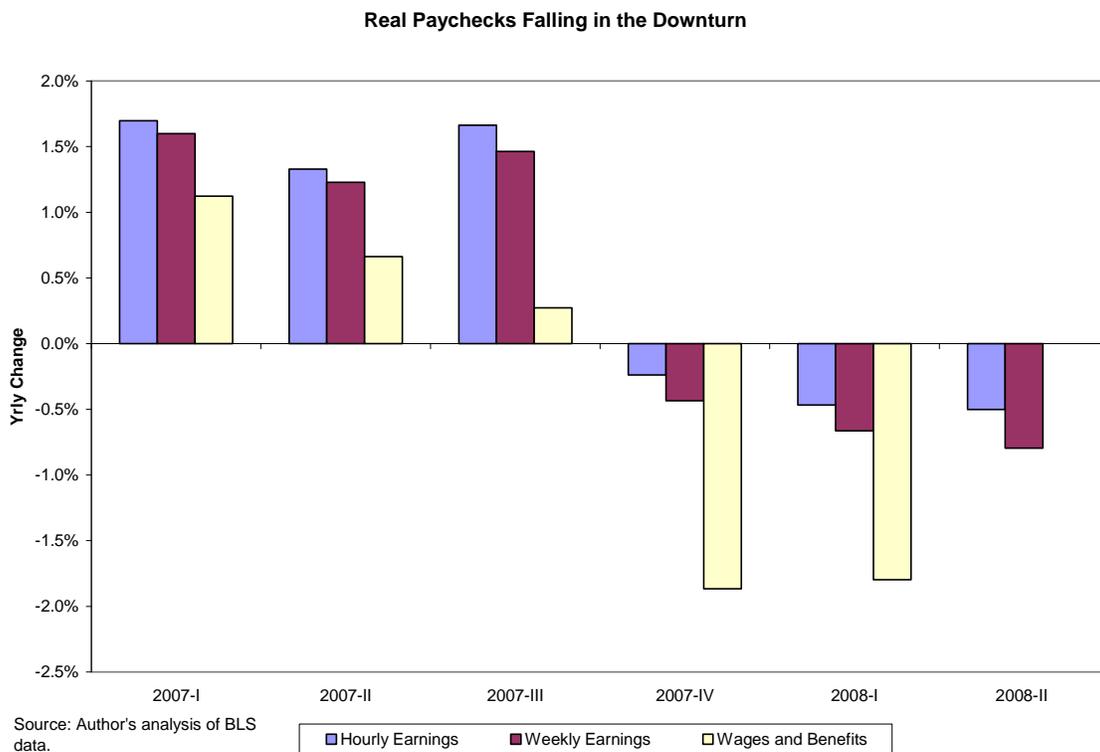
Inflation: annual growth rates, key items, 2000-08

	All Items	Food At Home	College Tuition	Child Care	Gas (unleaded)
2000-08	3.0%	3.1%	7.0%	4.6%	11.4%
2007-08	4.9%	6.1%	6.4%	4.5%	33.0%

Source: BLS, Data are for June of each year.

<sup>1</sup> State of Working America, 2006/07, tbl 1.20.

These price data cannot be viewed absent the wage side of the equation. While the most recent data on family income go through only 2006, data on prices, wages, and compensation are available through this year. These data reveal increasing real wage losses. Weaknesses in the job market, in tandem with energy-induced spikes in inflation, are taking a toll on wage growth. **Figure 2** shows the annual growth rates in three wage series. The first bar is the average hourly wage of the 80% of the workforce in blue-collar or non-managerial jobs, the second bar is this group's weekly paycheck, and the third bar is a measure of average compensation—wages plus benefits—for all workers. As of late 2007, all three series are falling in real terms. Note that weekly earnings—the middle bar—are falling more quickly than hourly earnings, due to declining weekly hours worked. Also, total compensation is falling particularly quickly, as both wages and benefits are lagging inflation in the downturn.



**Figure 2**

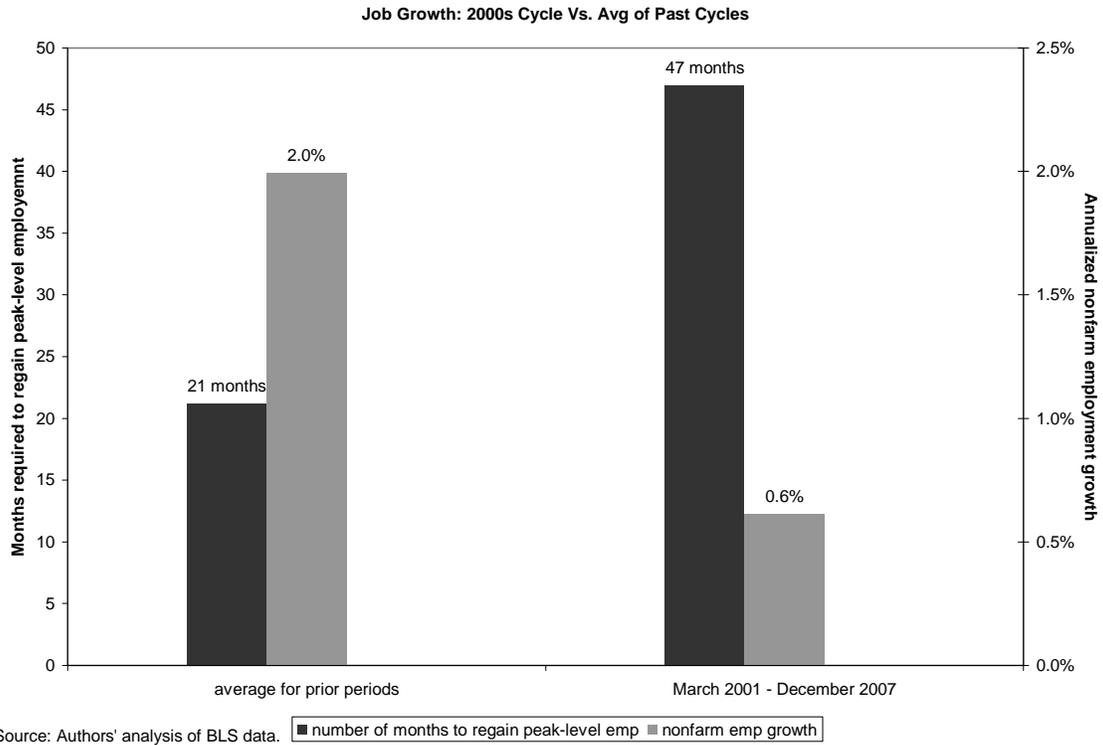
Of course, the negative pressures on wage growth are causally related to the weakening job market. So far this year, the nation's employers have shed over 400,000 jobs on net. Unemployment is up to 5.5% from its low point of 4.4% in March of 2007, an addition of 1.8 million to the jobless roles. The lack of job creation has led to longer spells of joblessness, and problem that persisted throughout this expansion. By June of 2008, 18% of the unemployed had been so for at least half of a year.

However, for two reasons, the unemployment rate is an inadequate gauge of labor market weakness right now. First, by mid-2008, many employers were adjusting their

workforces more by cutting back on hours than by layoffs. So we need a measure that takes that into account. Second, recall that the unemployment rate fails to count those jobless persons who give up looking for work. This is important in the current context, because the labor force participation rate, which does fall when such persons leave the job market, never regained its prior peak over the cycle. This decline suggests that the unemployment rate was biased down when instead of facing unemployment, jobless individuals instead left the labor market.

The *underemployment* rate adds to the unemployed a large number—over five million in mid-2008—of part-time workers who would rather have full time jobs but can't find them. It also includes so called “discouraged workers,” a group that gave up looking for work due to slack job opportunities. As of June of this year, underemployment was just below 10 percent.

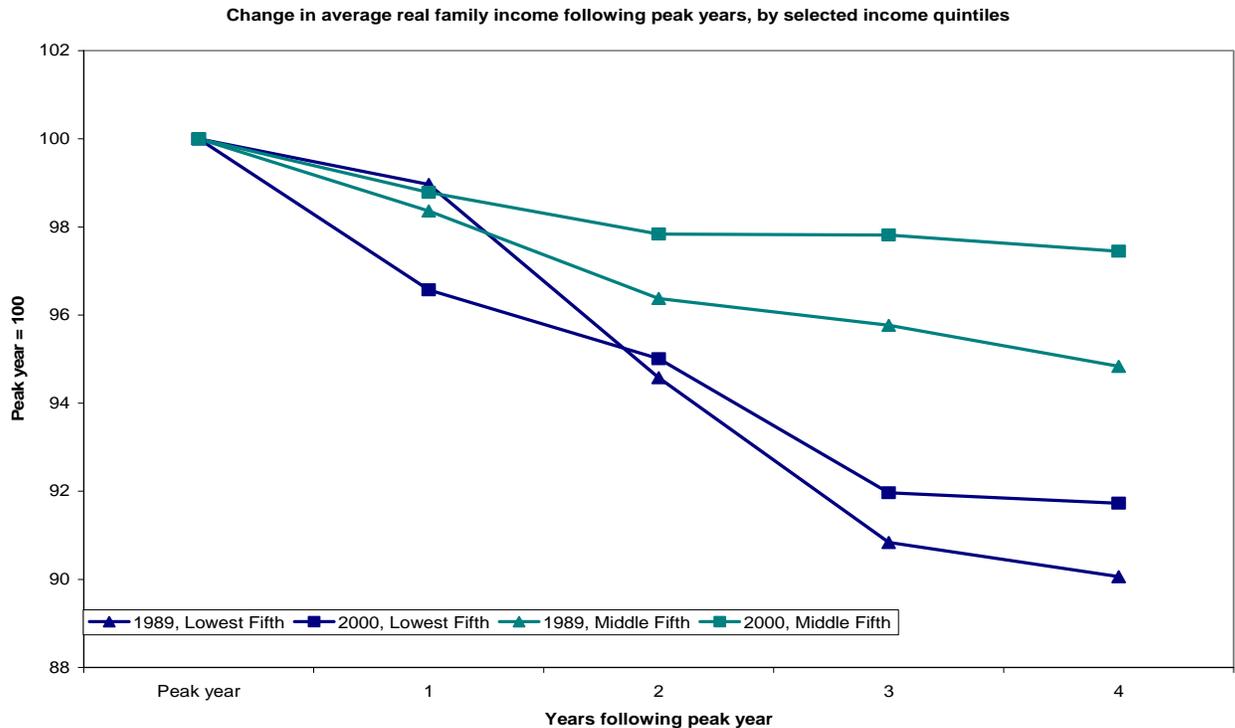
In order to appreciate what's behind the uniquely weak income results for middle income families in the 2000s, it is necessary to place these recent labor market results in some historical context. First, the recovery began in late 2001, but there ensued a period dubbed the “jobless recovery” and payrolls did not begin to grow until the autumn of 2003. **Figure 3** shows two measures of this weakness: the number of months it took to regain the prior payroll peak, and the yearly rate of job growth. The figure shows that prior to the 2000s, it took an average of 21 months to regain peak-level employment after a recession, but that during the 2000s recovery, it took over twice that long – nearly four years. It also shows that prior to the 2000s, average employment growth over a business cycle was 2.0% per year, but that in the 2000s, employment growth averaged only 0.6% a year, well below the growth needed to generate any tautness in the job market.



**Figure 3**

The previous analysis provided a retrospective look at middle class incomes over the business cycle of the 2000s. But what might we expect in coming years, particularly given the ongoing economic downturn? **Figure 4** makes the important point that in the last two downturns, middle and low real incomes did not just fall in the recessions, but continued to slide in the ensuing recoveries. It is widely recognized that both of the last two recoveries began with protracted “jobless” phases, but it is less well known that real incomes for many families continued to fall as well.

The figure plots the percentage losses for low and middle-income families in the first few years including and following the last two downturns. The x-axis marks the years out from the peak; thus, for the 1990-91 (2001) recession, “peak year” represents 1989 (2000), 1: 1990 (2001), etc.



**Figure 4**

Both low and middle income families lost ground through year four of these cycles, with larger losses for low-income families than for middle income families. In the early 1990s downturn, average income fell 10% for the bottom fifth over these years (1989-1993) and about half that for the middle fifth. In the 2000s (2000-04), the pattern was similar, with real income losses of about 8% for the lowest fifth and 3% for the middle.

Episodes like these have enabled economists to quantify the relationship between rising unemployment and falling real incomes for the various income classes shown in the previous figure. Applying those estimates to the unemployment forecasts in the current downturn (we expect unemployment to be in the mid-sixes—6.5%—by the end of next year) reveals real predicted income losses that follow the historical pattern, with bottom fifth real incomes down about 5%, middle incomes down about 4%. For middle-income families, that constitutes a loss of over \$2,000 in today's dollars.<sup>2</sup>

In sum, when it comes to the economy, middle-income families are being hit from many sides. Despite stellar productivity growth, their real incomes were stagnant in the 2000s, in part due to persistent weakness in the job market. Economic inequality is an obvious factor here, and the share of income accruing to the top one percent of households was higher in 2006 than in any year since 1913 except one: 1928. Meanwhile, prices of key goods and services, from energy to medical care, have risen much faster than average inflation. More recently, the weakening job market in tandem with these price spikes is

<sup>2</sup> See forthcoming State of Working America, 2008/09, Chapter 1, for details.

driving real compensation down. And, as discussed in greater detail below, homeowners are experiencing significant price declines in their primary asset, as housing prices continue a long correction from the bursting of the housing bubble.

### *Near Term Relief: Stimulus II*

Members of this committee are acutely interested in taking steps to ameliorate these negative trends. The question is: what are the most effective interventions? Both fiscal policy and regulatory interventions must be undertaken with serious concerns regarding market forces, the use of taxpayers' dollars, and deficit/debt implications. There are also distributional concerns to consider: the federal government has repeatedly shown its willingness to commit its resources—our resources—to financial institutions deemed “too big to fail.” Fairness concerns militate that struggling households are also considered to be viable targets of policies to offset the economic pain they're experiencing.

The first round of economic stimulus was designed with this in mind. Over \$100 billion in payments to households were sent out in recent months, and early indicators show that some share of these payments have found their way into the economy. Retail sales and personal income reports, for example, showed fairly clear evidence of the impact. Both of these measures factor directly into gross domestic product, and forecasters generally agree that stimulus package will raise real GDP by something between one-half and one percentage point in the middle months of this year.

The recent extension of unemployment insurance benefits should also be viewed as a potent stimulus, as well as an important policy intervention to meet the needs of many hurt by the recent labor market trends noted above. Research by Moody's economy.com finds that since unemployed persons typically spend their checks to meet basic needs, the program yields a particularly large “bang for the buck:” a dollar spent on the UI extension yields \$1.64 in terms of GDP growth.<sup>3</sup>

Unfortunately, some of the initial stimulus package was not spent so wisely. Accelerated depreciation of business expenses, for example, generates only \$0.27 extra GDP per dollar spent, the smallest multiplier in the cited study (see previous footnote).

While direct payments to individuals, referred to as rebate checks (though since they are not tax rebates, this title is misleading), have considerable political and economic appeal, given the current economic climate, they may not be the most effective form of stimulus. For one, with the price of oil so elevated, more of these expenditures are liable to leak out of the country through spending on imported oil than would otherwise be the case. Second, the overleveraging of American households in a period when home prices are falling suggest the possibility that the checks will also be used to deleverage. Of course, while this may be a fine and responsible thing for check recipients to do with their money, the domestic economic multipliers connected to these activities are surely low.

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<sup>3</sup> See Moody's economy.com, *Assessing the Macro Impact of Fiscal Stimulus*, 2008.

Based on past experience, most economists assumed that two-thirds of the payments would be spent, with perhaps 10-15 percent of that leaking out as imports. In the current case, we might see considerably less spent—maybe 50 percent—and a larger share—perhaps 25 percent—of that on imported oil.

So, while stressed households arguably need another round of direct payments to offset the toll on their budgets from high fuel and food costs amid weak jobs and wages, I urge the JEC to emphasize grants to states and infrastructure spending in the next stimulus package.<sup>4</sup>

According the Center on Budget and Policy Priorities, “at least 29 states faced or are facing a combined \$48 billion in...budget shortfalls.”<sup>5</sup> These states typically must balance their budgets. Thus, in the absence of help from the federal government, they will be forced to draw down rainy-day reserves or take actions that would exacerbate the negative macroeconomic cycle (tax hikes or service cuts). The CBPP reports that states are actively tapping their reserves, but that these funds “generally are not sufficient to avert the need for substantial budget cuts or tax increases.”

Thus, a second stimulus package should contain considerable aid to states. The two mechanisms through which such grants are typically made are a temporary increase in the federal government’s contribution to the state’s Medicaid program or general grants to the states. Following the last downturn, each of these programs received \$10 billion. CBPP analysts note that these grants had their intended effects of preventing state actions that would deepen the negative cycle. But they also point out that “The major problem with that assistance was that it was enacted many months after the beginning of the recession, so it was less effective than it could have been...”

Most analysts, myself included, view the current downturn as likely to be protracted, in part because housing corrections can take considerably longer than those in other markets. In this regard, we have often warned of an “L-shaped” cycle, where GDP falls and remains below trend for numerous quarters. This cycle has been underway all year, and given the recent deepening in labor, financial, and housing market stressors, is likely to continue for a number of quarters going forward. Thus, states are unlikely to recover in the medium term and would be likely to put any federal stimulus dollars to good use.

The other area left out of the last stimulus package was infrastructure investment, and I urge this body to strongly consider its inclusion in a second package.

Three facts motivate this contention. First, American households are highly leveraged, and may well be poised for a period of enhanced savings and diminished consumption. In this context, public investment should be viewed as an important source of macro-economic stimulus and labor demand—the creation of new, and often high quality jobs—which is clearly lacking from our current labor market.

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<sup>4</sup> Relief for homeowners facing foreclosure has also be mentioned as part of a stimulus package. I support this idea but since this legislation appears to be moving on a separate track, I exclude it from this testimony.

<sup>5</sup> <http://www.cbpp.org/1-15-08sfp.htm>

Second, there are deep needs for productivity-enhancing investments in public goods that will not be made by any private entities, who by definition cannot capture the returns on public investments in roads, bridges, waste systems, water systems, schools, libraries, parks, etc. Three, climate change heightens the urgency to make these investments with an eye towards the reduction of greenhouse gases and the conservation of energy resources.

One area of particularly significant job loss has been in construction. Jobs in residential building and contracting are down 480,000 over the past two years, and when we include other jobs related to housing, such as real estate, we find a decline of over 600,000 jobs since June 2006. In other words, there exists considerable labor market slack that will certainly deepen if the economy is in or near recession.

In this regard, infrastructure investment serves a dual role of deepening on investments in public capital while creating good jobs for workers that might otherwise be un- or underemployed. One common argument against such investment in the context of a stimulus package is that the water won't get to the fire in time, i.e., the implementation time lag is too long to quickly inject some growth into the ailing economy. However, research by EPI economists has carefully documented current infrastructure needs that could quickly be converted into productive, job-producing projects (Mishel et al, 2007).

Take, for example, the August 2007 bridge collapse in Minneapolis. The concrete for the replacement bridge began flowing last winter, and the bridge is now halfway done, with full completion expected by December. The American Association of State Highway and Transportation Officials claim that according to their surveys, "state transportation departments could award and begin more than 3,000 highway projects totaling approximately \$18 billion within 30-90 days from enactment of federal economic stimulus legislation."<sup>6</sup>

The following are other relevant examples identified by these researchers:

- There are 772 communities in 33 states with a total of 9,471 identified combined sewer overflow problems, releasing approximately 850 billion gallons of raw or partially treated sewage annually. In addition, the Environmental Protection Agency (EPA) estimates that between 23,000 and 75,000 sanitary sewer overflows occur each year in the United States, releasing between three to 10 billion gallons of sewage per year.
- According to a survey by the National Association of Clean Water Agencies, communities throughout the nation have more than \$4 billion of wastewater treatment projects that are ready to go to construction, if funding is made available. Funds can be distributed immediately through the Safe Drinking Water and Clean Water State Revolving Funds and designated for repair and construction projects that can begin within 90 days.

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<sup>6</sup> <http://www.transportation.org/news/96.aspx>

- The National Center for Education Statistics (NCES) put the average age of the main instructional public school building at 40 years. Estimates by EPI find that the United States should be spending approximately an [additional] \$17 billion per year on public school facility maintenance and repair to catch up with and maintain its K-12 public education infrastructure repairs.
- According to a 1999 survey, 76% of all schools reported that they had deferred maintenance of their buildings and needed additional funding to bring them up to standard. The total deferred maintenance exceeded \$100 billion, an estimate in line with earlier findings by the Government Accounting Office (GAO). In just New York City alone, officials have identified \$1.7 billion of deferred maintenance projects on 800 city school buildings.
- The U.S. Department of Transportation has identified more than 6,000 high-priority, structurally deficient bridges in the National Highway System that need to be replaced, at a total cost of about \$30 billion. A relatively small acceleration of existing plans to address this need—appropriating \$5 billion to replace the worst of these dangerous bridges—could employ 70,000 construction workers, stimulate demand for steel and other materials, and boost local economies across the nation.
- The House Committee on Transportation and Infrastructure has identified more than \$70 billion in construction projects that could begin soon after being funded. An effective short-term stimulus plan could include \$16 billion directed at projects for roads, rails, ports, and aviation; only projects that can begin within three months would be considered.

Finally, while I have discussed these infrastructure needs in the context of recession and stimulus, it is important to recognize that a) these are all necessary and productivity-enhancing investments that should be made regardless of the state of business cycle, and b) recent history suggest that it is a mistake to think that labor market slack will no longer be a problem when the recession officially ends.

This last point deserves a bit of elaboration. Much of the current recession/stimulus debate has stressed that recent recessions—the ones in 1990-91 and 2001—were both mild and short-lived, and perhaps the next recession will follow the same pattern. It is critical to recognize that these claims are based solely on real output growth, and not on job market conditions. The allegedly mild 2001 recession, wherein real GDP barely contracted, was followed by the longest “jobless recovery” on record. Though real GDP grew, payrolls shed another net 1.1 million jobs. The unemployment rate rose for another 19 months and for just under two years for African-Americans. The pattern was similar, though not quite as deep, after the early 1990s recession.

Part of the explanation for this disjuncture has to do with the way recessions are officially dated by the committee at the National Bureau of Economic Research, as they have apparently given less weight to the job market and greater weight to output growth. But policy makers are likely to give greater consideration to working families whose employment and income opportunities are significantly weakened as unemployment rises

and job growth contracts. Thus, from a stimulus perspective, these investments will be still be relevant well after the recession is officially ended.

### ***Regulating Excesses in Financial Markets***

The US hosts some of the largest, most innovative, and deepest financial markets in the world. Access to credit, equity financing, and investors' ability to hedge through future's markets have long been hallmarks of our system, both for businesses and households. US entrepreneurialism is world renown, and no small part of that deserved reputation is due to our historically safe and deep markets for credit and equity.

Yet, every aspect of these markets is in trouble. At the heart of the recent upheaval is the inability of financial markets to accurately and reliably price risk, and in any free-market economy, faulty price signals are problematic. When these price signals are particularly distorted for extended periods, with the bias going in one direction—the underpricing of risk—investors and households are prone to buy into bubbles. And large bubbles have proven to be the source of very serious economic instability in recent years.

The current case has been and will be discussed in many other Congressional hearings, and I will not go over the details here. For a variety of reasons, including new forms of securitization and the increased distance between mortgage originator and ultimate debt holders, existing underwriting standards were ignored, and not simply in the subprime market. As George Soros has emphasized, the process fed on itself: irresponsible lending practices fed the housing bubble, leading banks to ratchet up their lending with appreciating real estate as collateral.<sup>7</sup>

At the same time, deregulatory changes, particularly the ending of Glass-Steagall firewalls between commercial and investment banks, meant that more borrowing was financed by non-commercial entities that faced less regulation regarding transparency and capital reserve requirements. Rating agencies gave undeservingly high ratings to risky debt, in some cases because of poor evaluations, but in others, conflicts of interest were invoked as the raters were too often hired by lending institutions. Finally, for reasons that appear to be as much ideologically motivated as anything else, the Federal Reserve ignored early warnings regarding potential problems in the subprime market.

It was a perfect storm, and we will be buffeted by its winds for many months, perhaps years, to come. There are, however, lessons that should be learned, rules that should be changed. I emphasize that the ideas I am espousing here can be heard in many circles. These are not liberal or conservative ideas. In fact, some of the most vocal critics of the current crunch, those calling for changes like those below, are long-time market investors established (Wall) “street cred.” The Federal Reserve and the Security Exchange Commission are actively discussing many of the measures discussed below.

### ***Applying oversight based on what entities do, not who they are***

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<sup>7</sup> <http://www.georgesoros.com/crediterisis08>

Before Glass-Steagall was repealed, most lending by American households was from commercial banks, which are more heavily regulated by the Federal Reserve. Since the repeal, the majority of borrowing is from non-commercial entities, including investment banks and mortgage lenders. Yet, these institutions face relatively lax requirements.

Now, in the wake the collapse of Bear Stearns, the Federal Reserve has accorded investment banks the same borrowing privileges of commercial banks. It is also clear that taxpayers may be called upon to save these institutions if they face insolvency. Based on these new relations, lending institutions should be regulated based on what they do, not who they are. Clearly, this approach would result in apply some of the same regulations that apply to commercial depository institutions to non-commercial entities. Some examples follow.

### *Capital reserve requirements*

A basic principle of risk management is that as an institution's exposure to market risk increases, so should its capital reserves. Obviously, it's necessary to seek balance, because resources kept on reserve cannot be used to finance potentially productive ventures. But it remains the case that the vast majority of bank failures come as a result of violating the principle of holding adequate reserves. This concept is especially important to hedge funds, which make highly leveraged deals with considerable exposure, and, contrary to their names, often without much of a hedge in case things go badly. Yet, in the US we have turned this principle on its head: the greater the portfolio risk, the lower the reserve ratios. Overleveraging must be a target of the new approach to regulating today's financial markets.

As investment advisor Michael Lewitt has written, "Allowing investment banks to be leveraged to the tune of 30 to 1 is the equivalent of playing Russian roulette with 5 of the 6 chambers of the gun loaded. If one adds the off-balance sheet liabilities to this leverage, you might as well fill the 6th chamber with a bullet and pull the trigger."<sup>8</sup>

The question is how should non-commercial bank reserve requirements be set and at what levels. So-called "tier one capital ratios," wherein the Fed judges banks to be adequately capitalized, tend to be in the range of five to ten percent, depending on the size and structure of the banks. This is well below the Bear Stearns or especially Fannie/Freddie reserves, which were said to be in the range of three percent or less (some reports found that Fannie and Freddie had debt to capital holding ratios of 65 to 1).

The Federal Reserve guidelines for depository institutions have generally worked well, but given the more complicated dealings of investment banks, it will take more research to determine whether these guidelines are practical for non-commercial settings. I return to this question below and suggest an initiative to answer the question as to what constitutes adequate reserve requirements.

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<sup>8</sup> <http://www.harchcapital.com/Pdfs/how%20to%20fix%20it-%20welling.pdf>

***Improving Transparency: Eliminate off-balance sheet entities and monitor positions/liquidity***

The fact that investment banks are allowed to maintain investment vehicles that are not required to show up on their balance sheets is, simply put, a recipe for failure. Whatever rationale there might be for hidden liabilities, policy makers should unequivocally recognize that the benefits are not worth the costs.

But this common sense elimination does not go far enough. The fact that investment banks voluntarily submit to SEC monitoring of their positions has demonstrably failed to provide adequate oversight. The new commission that I propose below should have regular access to the books and balance sheets of all types of lending institutions of significant magnitude, from non-commercial lenders to hedge funds. Once again, the rationale here is that any firm that is so interconnected to the financial system such that their failure would threaten the integrity of that system is arguably too big to fail, and, in the interest of taxpayers, must be monitored.

***Improve and enforce mortgage underwriting standards***

In this area, along with a need for new regulations, there is an obvious concern that existing regulations were under-enforced, especially by the Federal Reserve, which has a clearly articulated mandate to regulate mortgage lending. The Fed is required, for example, to “prohibit acts or practices in connection with a) mortgage loans that the board finds to be unfair, deceptive, or designed to evade the provisions of this section; and b) refinancing of mortgage loans that the board finds to be associated with abusive lending practices, or that are otherwise not in the interest of the borrower.”<sup>9</sup>

As regards the subprime market in particular, these basic guidelines were ignored. Yet, as home prices fall such that their market value is below that of their outstanding debt, higher quality loans are also in danger of default. Again, a detailed review of needed reforms is beyond my scope, but the most egregious practices are obvious: “no doc” and “low doc” loans, fudging the incomes of borrowers, and quick and sharply resetting ARMs are clearly responsible for both the housing bubble and our current difficulties.

But beyond these practices, Congress needs to look at the process of mortgage backed securities. This process of bundling mortgage debt into bonds comprised of tranches of varying quality was designed in part to diversify, and thus reduce, risk of default. But it clearly had the opposite effect, such that bad debt infected that of higher quality debt in ways that eluded both rating agencies and investors. Part of this problem, as noted, stems from the larger distance that now prevails between the original lender and the ultimate debt holder. This development requires stricter lending standards, because market discipline once again is unlikely to punish careless lenders when they’re not holding the loan.

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<sup>9</sup> This section was quoted in a New York Times editorial, <http://www.nytimes.com/2007/12/19/opinion/19wed1.html?scp=5&sq=greenspan+mortgage+subprime&st=nyt>, Dec 19, 2007.

Clearly, these lax lending standards fed into the housing bubble in ways discussed above (see Soros reference). In fact, since real estate is susceptible to the self-reinforcing process of price increases leading to over-leveraging, it is a common source of bubbles. Moreover, real estate bubbles can be particularly damaging, because once they burst, they take longer than other bubbles to deflate. In this regard, I raise monitoring of real estate bubbles as one responsibility of the new oversight board recommended below.

***Fannie Mae and Freddie Mac: Clarify their public/private status***

Sticking with real estate regulation, the near-insolvency threat from these giant mortgage financiers may turn out to be the most recent casualty of the housing bubble. If the federal government comes to their aid, it could well be at a cost of hundreds of billions of taxpayers' dollars.

Given the magnitude of these companies, any changes involving their regulatory oversight or their status will be the source of considerable discussion by this body. I will thus only add these broad guidelines that I view as integral to arriving at a workable solution to the challenge they pose.

The problem facing Fannie and Freddie is that by dint of their implicit government guarantee, they create deep moral hazard. As economist and columnist Paul Krugman recently noted, "This implicit guarantee means that profits are privatized but losses are socialized."<sup>10</sup> Given discussions underway regarding an infusion of credit from the Federal government, this implicit guarantee may well soon become explicit.

If that occurs, ending the amorphous status of Fannie and Freddie seems highly desirable. The fact that they are private "on paper" but public in the minds of investors is highly distortionary. Their indistinguishable status has conferred upon them considerable advantages relative to other actors in the secondary mortgage market, and this unfair advantage has distorted the market. Together, Fannie and Freddie hold or guarantee about 20 percent of household debt, and they have sold much of that debt to banks throughout the world. Virtually all commentators have agreed that their magnitude and global linkages render them too big to fail.

Given that reality, if the firms do face insolvency and a government bailout, I recommend this committee consider one of two paths: ratchet up the regulatory oversight to protect taxpayers, lower the firms' competitive advantages, and avoid moral hazard, or, preferably, change Fannie and Freddie into public institutions.

Congress was wise to initially sponsor these companies, as they have contributed to a robust and liquid primary mortgage market. But at this point, their status is clearly such that the government will not allow them to fail. Thus, the only way to offset the moral

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<http://www.nytimes.com/2008/07/14/opinion/14krugman.html?scp=1&sq=krugman+fannie+freddie&st=nyt>

hazard that this guarantee requires is either strict regulation of a private entity or the simpler, more transparent option of making them explicit public entities.<sup>11</sup>

The regulation discussion is already underway, as the Treasury Department has proposed a new regulatory agency to oversee Fannie and Freddie. However, Congress will want to carefully scrutinize this new regulator, since its existence will presumably diminish their authority. Early reports suggest the new regulator may not have the necessary power to provide needed regulation, such as setting adequate reserve standards.<sup>12</sup>

The nationalization strategy—making Fannie and Freddie agencies of the Federal government—has been raised by various parties. There are of course downsides—equity would be lost, and taxpayers would then hold much more debt. But even under worse-case scenarios, the vast majority of the debt held by the companies is high quality and should be viewed as new national assets under this scenario. Most importantly, this change would end the deeply harmful ambiguity of Fannie and Freddie’s semi-public status. In other words, nationalization is the most sure-fire way to shut down the moral hazard caused by the firms’ implicit government guarantee.

***From the perspective of executive compensation, treat bailouts as bankruptcies.***

The job of bankers, hedge fund managers, mortgage brokers and dealers is to manage risk. Any person in this occupation can make a mistake, but when those mistakes are systematic, there is compelling evidence of negligence. In the absence of federal interventions to save these institutions from insolvency, market discipline would be enough to punish such negligence.

But when the Feds come to rescue of these firms, as in the cases of Bear Stearns and Fannie and Freddie, such discipline is precluded and moral hazard is invoked. The taxpayer foots the bill, often taking on the same bad debt that got these bad actors into trouble in the first place. Yet, too often, the bailout also saves these managers’ compensation packages.

Were these officers to undergo bankruptcy-like proceedings, certain components of their compensation, such as earlier bonuses, would be subject to repayment. Congress should consider amending these rules to clawback more of their compensation over the period proceeding the bailout.

***A new financial watchdog agency to implement and oversee these reforms***

There are, of course, many, if not too many, agencies in Washington whose task is to oversee some dimension of financial markets. Various policy makers have proposed consolidation, and certainly some amount of this would be useful. Most recently, the

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<sup>11</sup> This transition will be facilitated if near-insolvency leads to the extreme dilution or wiping out of equity held by Fannie and Freddie’s shareholders.

<sup>12</sup> <http://www.nytimes.com/2008/07/21/washington/21fannie.html?ref=business>

Federal Reserve and the SEC have pledged to work more closely is overseeing the risks to the system.

However, simply consolidating agencies without adding necessary new functions would not be adequate to the task of re-regulating financial markets. Therefore, I urge the members of the committee to consider an idea put forth by various members of Congress, most recently by Senator Obama in a speech on these matters given last March:<sup>13</sup> the creation of a new, financial market oversight commission.

The commission would have a few very specific mandates. It's overarching goal would look across markets (mortgage markets, bonds, equities) for signs of systemic risk. That is, the commission would not be responsible for the basic functioning of these markets; that role would remain with current oversight institutions. Instead, the members would have access to information on capital reserves, assets and liabilities, liquidity positions, and so on, in order to spot potential trouble spots. Part of this role would be one of "transparency cop." If commission members were unable to clearly assess the balance sheets of the firms they oversee, corrective action would need to be taken.

For example, one explicit role of the commission would be to identify bubbles. Clearly, this is as much an art as a science, but a few economists using simple metrics have consistently identified bubbles in recent years. For example, in the early 2000s, economist Dean Baker raised warning signals of the housing bubble when he noted that home prices were rising much more quickly than rental prices. Other economists, including Alan Greenspan, warned of the IT bubble in the latter 1990s. Another explicit role of the commission would be to identify over-leveraged firms, such as those with low reserves given the riskiness of their positions.

The explicit focus here would be on the "too big to fail" institutions, and this too implies a new, important role for this commission: tracking the interconnections between financial institutions, such that decisions to provide public aid to firms facing insolvency is clearly warranted. As currently practiced, it is not clear to outsiders what criteria the government is using to define those firms that should be allowed to face market discipline and failure, and those that are interconnected to the point where that fate threatens the overall system.

Such a commission, in its initial stages, could also be tasked with questions raised in the above discussions, such as what are appropriate metrics and levels for reserve requirements for investment banks and hedge funds. Both in these initial matters and in its later oversight work, the commission would report to the president and Congress.

### ***Conclusion***

As members of this committee are well aware, many of America's working families have far too little to show for an economic period characterized by impressive productivity

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<sup>13</sup> [http://www.nytimes.com/2008/03/27/us/politics/27text-obama.html?\\_r=1&pagewanted=print&oref=slogin](http://www.nytimes.com/2008/03/27/us/politics/27text-obama.html?_r=1&pagewanted=print&oref=slogin)

growth. The 2000s may well be the first business cycle on record where real median family income is lower at the end of the cycle than it was at the beginning. Now, as the 2000s cycle appears to be over, weakness in key markets—housing, labor, financial—is taking a further toll on these already stressed families. Prices of key items, such as energy and food, are rising much more quickly than average inflation, and more to the point, much faster than their earnings. These weaknesses are also leading to the net loss of jobs, and payrolls are down by over 400,000 so far this year.

In addressing these economic challenges, I have recommended short and medium term responses. In the short run, a second stimulus package is warranted. It may be useful for this second package to focus less on payments to individuals and more on state fiscal relief and especially, infrastructure improvement.

In the longer term, recent stressors in financial markets require legislators' attention, and new regulatory solutions are necessary. Regulators always walk a fine line, particularly in financial markets, where innovation and leverage have long played important and useful roles. It is also the case that when disaster strikes, the tendency among policy makers can be to become too zealous and overcompensate, imposing regulations that go too far in restricting the freedoms that yield optimal outcomes.

Yet few objective observers would disagree that the pendulum has swung much too far in the direction of unregulated markets, and the results have been costly. They can be measured in macro, micro, and financial terms. Lending institutions are in the process of writing off hundreds of billions of dollars in failing debt. Millions of homeowners face foreclosure, and tens of millions face “underwater” debt burdens. The spillovers from the bursting housing bubble helped pave the way for what will likely be labeled a recession, one for which working families are uniquely unprepared, given their failure to benefit from much of the growth over the 2000s business cycle.

In fact, I would argue forcefully that to not make some version of these changes would pose a greater threat to financial markets than those posed by the recommendations themselves. Michael Lewitt puts it well:

“[One] often hears the argument that too much regulation will force business offshore and render the U.S. financial industry less competitive. Our response to that argument is that institutions and fiduciaries in the end will gravitate to the system with the strongest and wisest regulatory protections. Moreover, we should be pushing the most reckless practices out of our markets and into other markets. We should be creating global competition over best regulatory practices, not worst ones.”

Our system of borrowing, lending, and financing investments by both businesses and households is a national treasure, one which we have squandered in recent years. Excessive deregulation has thwarted the transparency that is integral to creating appropriate price signals. Risk has been consistently underpriced, contributing to bad

underwriting, negligent risk management, and deeply damaging bubbles. When we ignore these dynamics, as we have in recent years, we put our economy at great risk.

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