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Opening Remarks
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Thank you very much for that introduction. I think I'm going to take the 5th Amendment with respect to the Buckley observation and simply decline to comment. It was kind of you to reference the areas which I'd had a chance to work in. When I got to Washington, people would ask me "What's different about working in the Treasury Department and being a professor at Harvard?" And I would respond by saying that as a professor at Harvard, the single worst thing you could do was to sign your name to something you had not written yourself. On the other hand, as a government official, it was a mark of effectiveness to do so as frequently as possible. And then I returned to Harvard as its president and people asked me in those first three months, "What was different about being president of Harvard than working in Washington?" And I gave an answer that – in retrospect – was breathtaking in its naiveté. I said "Washington is so political. There's always an organized opposition. There are always people trying to block change. At Harvard, everybody works together to common purpose."

I'm glad to be here at SIEPR and to see so many old friends and to be with my old friend, John Shoven, who has done such a tremendous job of leading this institution. I think the kind of work that SIEPR does has never been more important.

Keynes famously observed that most everything a statesman did was the distilled frenzy of some academic scribbler. The world works more rapidly now, and most everything economic policy makers do is shaped by the economic research of the kind of leading thinkers that are gathered together at SIEPR. Both the conventional wisdom that defines so much of what takes place, and the response to immediate imperatives that is so important. And I believe we've never been more in need of serious economic policy thinking then we are right now.

My message this morning is not going to be a cheery one. I believe that we are facing the most serious combination of macroeconomic and financial stresses that the United States has faced in at least a generation – and, possibly, much longer than that. I want to do several things this morning. I want to try to describe in dimension the challenge, to draw some lessons from past financial crises, and to suggest some policy approaches going forward.

There are no certainties in economic life. But, I believe the right policy presumption is that the US economy will be judged to currently be in recession. The NBER business cycle dating group on its website cites four indicators based on monthly data that can be used in judging recession: employment, personal income, industrial production, and real sales of manufacturing and wholesale goods. All four of those indicators are now flat or declining and, with this morning's employment report, the cause for concern becomes that much greater.

While I think there is a regrettable reluctance in Washington to acknowledge the "R" word, 125 basis points of Federal Reserve cuts in eight days at the end of January and beginning of February and $160 billion dollars of fiscal stimulus suggest that there is a recognition of the gravity of the situation.

Recession, serious as it is, is a regular – although recently somewhat less regular – class of economic event. What bears considerable emphasis is the quite remarkable dislocations that we are current seeing in housing and credit markets. Consider this: Home prices are now down nationwide by close to 10%. There are futures markets from which one can infer predictions of how much further they will decline. Those markets suggest declines of an additional 15% or so, bringing the total decline to 25%. It is a matter of arithmetic to calculate the number of mortgages that will be on homes with negative equity with a 25% decline in housing prices. That arithmetic suggests that there will be 15 million such mortgages worth 30% of all the mortgages in the United States with a combined value of over $3 trillion dollars. Consistently, estimates of losses are a little bit like weathermen's estimates of snowfall as a storm comes. Revisions tend to be highly persistent. And they have been revised upwards many times in the last six months. Current estimates of mortgage losses are $400 billion dollars. And, having reviewed them carefully, I believe there is every reason to believe that those estimates are substantially optimistic.

This is infecting financial markets more generally. Borrowers who, as recently as six months ago, were regarded as bullet-proof are finding it difficult to borrow at almost any price. Student loans with government guarantees are now carrying interest rate spreads in the 100s of basis points to treasuries. Some municipalities, in order to roll over their paper, have had to pay yields of as high as 20%.

Credit markets provide a window into the perceived health of the nation's major financial institutions. That window suggests cause for concern. Many of the nation's major financial institutions now are forced to pay more than 2 percentage points above the US Treasury rate in order to borrow for even five years. These are institutions that, as recently as nine months ago, were borrowing at spreads of 30 or 40 basis points. The government-sponsored enterprises Fanny Mae and Freddie Mac, that provide such a large fraction of the nation's housing finance and operate with substantial government quasi-guarantee, yesterday had debt that was trading at 2.37 percentage points above US Treasury's. Up from a spread of less than 1/5 of that even nine months ago. We are in unusual territory with respect to recession. We are in nearly unprecedented territory with respect to financial strength.

The essential policy problem is to manage a combination of what some would call positive feedback mechanisms – what others would call vicious cycles – that threaten to magnify instability.

The first is the traditional Keynesian vicious cycle: People spend less; therefore, other people and firms have less income. They, therefore, spend less, leading to less income, and the cycle goes on. That is the mechanism that has been dominant in economists' thinking about recessions historically.

A second mechanism is probably more serious in the current instance. It is what I would call the Liquidation vicious cycle. If I might talk as a professor of economics for just a second, economics hinges heavily – at least in its traditional versions – on the idea that supply curves slope upwards; that when the price of something goes up, more of it is sold. But, if you think of it as a security that is bought on margin, when its price goes down there are margin calls which force liquidations and more of it is sold. And so a falling price is not a stabilizing mechanism, but it is potentially a de-stabilizing mechanism. This process is multiplied many times over when the falling prices of financial assets lead to reductions in the level of capital in banks; lead to a situation where even if they wish to maintain a constant leverage ratio, and in a more threatened environment, they wish to maintain a lower leverage ratio – they are forced to sell the assets that have gone down and to sell any other assets that are liquid and available.

The third vicious cycle, beyond the Keynesian vicious cycle and the Liquidation vicious cycle, is what might be called the Credit Accelerator vicious cycle that comes from the interaction of these two cycles. A deteriorating economy leads to deteriorating asset prices and declining credit quality, which leads to reduced lending which leads to a deteriorating economy and so forth. All three of these mechanisms are now operating strongly in the US economy. I believe for the first time – surely since the 1970s and possibly at this degree of virulence since the second World War.

We do not have enormous experience, fortunately, in the United States with simultaneous financial and cyclical problems of this magnitude, but certainly they have been the experience of a number of other countries in recent years and during my time as Secretary of the Treasury and at the Treasury Department we were fortunate in the stability during that period of the American economy, but had ample opportunity to address very substantial and other serious problems in other economies in Mexico, Asia, Brazil and Russia. I would suggest three general lessons from those experiences which can usefully inform our policy approaches going forward.

First, it is a grave mistake to believe in the self-equilibrating properties of the economy or markets in the face of large shocks. It has been amply demonstrated that with respect to small shocks, with respect to normal experiences, there is tremendous resilience in market economies. The American economy weathered September 11th. It weathered the LTCM shock. It weathered the 1987 stock market crash and much more. But, it is also clear that markets balance fear and greed. And when fear takes over, the capacity for self-stabilization is not one that can be relied on.

The second lesson of experience is a paradoxical one. And that is that the very measures that should have been pursued to prevent financial crisis are often counter-productive once financial crisis comes. Put simply, the problem in the United States eighteen months ago was too much greed and too little fear. The problem today is too much fear and too little opportunistic buying. If the priority was to restrain imprudent lending eighteen months ago, the priority going forward has to be to try to stimulate and push the economy forward.

Third, confidence is essential and confidence depends on a perception of transparency and a perception of credibility. Confidence will not return in any environment where there is an expectation that heavy, but unknown, shoes will drop soon. Indeed, it was my observation in working with each of the crisis economies that the moment when recovery became established was the moment when policy makers issued their first forecast that proved to be too pessimistic rather than optimistic. Denial as policy in support of confidence is counter-productive.

What, then, should be done? I'm going to make suggestions in a number of areas going forward. I do that, in part because they represent my best guesses as to what should be done, and in part to stimulate thought. Whether you agree with my suggestions or not, I hope you will carefully consider my main message today that we are dealing with a situation of very considerable gravity; that we cannot rely on to be self-correcting and it is likely to become much more difficult to correct if it is allowed to deteriorate substantially further.

First, the traditional tools of macroeconomic policy. Perhaps the most encouraging cooperative development of Washington in the last several years was the coming together the President and Congress to act quickly to pass a timely, targeted and temporary program of fiscal stimulus early this year. That stimulus will give significant impetus to the economy in the middle of this year. Despite its presence, consensus forecasts today are darker than they were before it was enacted. It may well be necessary, and planning should begin now, to enact further fiscal stimulus measures. If this proves necessary, high priority should be attached to supporting heavily strapped state and local governments so as to be able to maintain their level of spending. Monetary policy faces complex challenges at this moment. I was struck to discover this morning on my Bloomberg that five-year index bonds in the United States are now trading at a yield of negative 15 basis points and the yield on shorter-term index bonds is considerably more negative.

We have already engineered negative real interest rates. There is probably further to go. But, in a world with excess capacity - and in a world where the constraint on the provision of credit is not that borrowers cannot afford it, but that suppliers are reluctant to provide it because of the losses they have recently suffered – we should not exaggerate the potential benefit of further reductions in interest rates appropriate as they are.

Macroeconomic policy can make a valuable contribution. It can address that Keynesian vicious cycle and, perhaps to some extent, mitigate the Credit Accelerator vicious cycle. But, it cannot and will not, in and of itself, address the positive feedback coming from cascading liquidation.

The second area where we need more aggressive policy is with respect to the housing and mortgage markets. Here, policy continues to be behind the curve. The much-discussed issue of avoiding resets is largely a non-issue. The vast majority of those facing resets are not affected by the proposed measures. In any event, given the reductions in interest rates that have taken place, resets are actually quite small. The typical sub-prime mortgage had a teaser rate in the 8% range. The rate to which it resets is ___ or plus 600, which is a number in the 8-1/2% to 9% range. Given the reduction in interest rates that has taken place, those resets are not very large. And study after study has now confirmed what common sense should have suggested: that the key determinant of foreclosures is the behavior of house prices and the decline in the value of house prices, rather than the income and cash flow circumstances of the borrowers.

The essential policy dilemma is this: Foreclosures are enormously costly. The evidence suggests that a foreclosure – directly in terms of transactions – costs on the order of 40% of the mortgage being foreclosed is eaten up by the cost of the foreclosure. When a house is foreclosed, the value of the house next door and the other houses on the block goes down. Even if it goes down a very small percent, if 20 houses go down 3% each, that's another 60% of the value of the mortgage. So the value destruction associated with the foreclosure process is very, very large and it is worth very large investments to avoid the foreclosure process. That is why there is emphasis on voluntary write-downs. That is why there are proposals to purchase mortgages.

The dilemma here, though, is this: On current projections, we expect that there will be on the order of 15 million houses with negative equity and on the order of 2 to 3 million foreclosures. Now, many people with negative equity will continue to pay their mortgages on a regular basis in order to avoid foreclosure. If, however, there is an excessively generous program of support for those facing the possibility of foreclosure that enables their mortgages to be written down, it is not difficult for an individual to contrive a situation where he is facing the possibility of foreclosure. And so the policy challenge is to find ways to target foreclosures without inducing potential non-payment. After quite extensive review, I have concluded that a modest set of changes in the bankruptcy law – to permit a treatment of owner-occupied homes in bankruptcy - that precisely parallels the current treatment of vacation homes and family farms, and that allows in situations where an individual is prepared to go bankrupt, an adjustment of the unsecured portion of his mortgage would be constructive in promoting these adjustments. It does strike me as ironic and probably inappropriate that our bankruptcy law is currently contrived so that a wealthy person with a second house receives more protection from his creditors on the second house than a less-wealthy person with only a principal residence receives from his creditors. And I believe that change in this area would be appropriate.

I am sure that it would be desirable to provide substantial funding to state and local governments to permit them to purchase foreclosed homes, convert them into rental housing so as to save potentially distressed neighborhoods and so as to allow them to experiment and see whether there are schemes in which they can provide financial support or guarantee authority to enable reductions in the level of foreclosure. I believe careful study should be given to a number of proposals that are now out there for repurchasing mortgages, writing down their value, and passing the benefit on to homeowners to see if they can be carried out in a way that is financially responsible and will be productive, rather than counterproductive. I do not believe the experience of the Great Depression – when almost every home was under water and when it was clear that the housing market had hit bottom – is enormously probative in suggesting the value of such schemes.

Macroeconomic policy. Housing policy. The government needs to promptly and aggressively address the problems of the municipal market and the student loan market. It should be prepared, if necessary, to provide, for a period, government guarantees of loans in both of these sectors for an appropriate fee. It is not clear at all that the markets will be self-correcting in the near term, and there are very substantial macroeconomic and human costs. While students who wish to go to Stanford will not be interfered with in their ability to borrow – either with government guarantee or without – next summer who are planning to enroll in September, unless something is done, large numbers of students with far greater needs attending community colleges, vocational schools, and other institutions that are much less well-endowed with resources to provide financial aid than Stanford or Harvard, will not have that opportunity. It is also crucial - in order to maintain a substantial flow of credit - that the government carefully review current policy with respect to the government-sponsored enterprises. Much of the rationale for their existence is to be in a position to respond strongly and vigorously at a moment like the current one. As the credit spreads I cited earlier indicate, they are not currently in such a position. A combination of very substantial capital infusion – even if it means dilution of existing shareholders and expansion of their authorities to provide loans – would potentially be constructive.

Fourth: Regulatory policy. Regulation has not been a success over the last decade in this sphere. It is, to me, less obvious than to many others that the right general conclusion is that this is a warrant for more regulation rather than for less. The institutions that have behaved the most imprudently – I think of many of the major banks – are the most heavily regulated institutions, and prudence has been somewhat greater on the part of other institutions that are less-heavily regulated and carry less of the positive aura associated with being regulated. But the question of overall financial regulation is a question for tomorrow. The question for today is what to do about the financial institutions that are currently under such stress. I would suggest that history has demonstrated again and again, most recently in the rather unfortunate discussions of the so-called Super SIV that took place in the fall, that policies that have as their premise seeking to maintain asset values by avoiding market-to-market in order that institutions will in an accounting sense have more capital and, therefore, lend more vigorously, are policies that are usually overwhelmed by history, as they were for many years in Japan in the late 1980s and early 1990s. I regard the efforts to achieve a triple A for the mono-lines, as if a triple A is a mythic achievement, independent of the spread at which they can borrow, which even with their triple A is measured in excess of 500 basis points as illusory. Far better to promote transparency to engage in capital forbearance explicitly, if that is judged to be the right policy so as to encourage lending – as it may well be – and to place urgent emphasis on insisting on the raising of the new capital that is the only mechanism through which this Liquidation vicious cycle can ultimately be controlled.

New capital into existing financial institutions.
Government support to ensure that the flow of lending continues in key sectors.
Facilitating an orderly write-down in housing values that avoids foreclosure.
Stimulative macroeconomic policy.

These measures, pursued aggressively, thoughtfully and in conjunction, I believe offer the best prospects for containing the threats we face.

Three final thoughts:

The fiscal stakes here are not small. Past financial crises have, in the end, been resolved at costs of several percents of GNP. Government fiscal costs, far greater than anything that is on anyone's fiscal horizon right now. I hope that that will never prove necessary with respect to this crisis. I believe it is more likely not to be necessary if policy moves forward aggressively.

I have talked – and I suspect we will talk later in this conference – of these issues as an abstraction. As a Recession. As a Cyclical Down-Turn. As Declining Asset Values. Make no mistake, there will be millions of people who have never heard of a CDO or a CLO and who think triple A refers to the American Automobile Association, whose lives will be very much affected by the wisdom with which macroeconomic financial policy is made in the weeks and months ahead. The individuals for whom this will be the difference between staying in a home and the humiliation of a Bailiff removing one's kids from one's home. The individuals for whom this will be the difference between having a job and not having a job. Between being able to afford to borrow and not being able to afford to borrow. The stakes are not small.

Finally, I would suggest to you the stakes are not small for our country. At a moment when, with all of our tremendous and profound strengths, we are in a difficult period. A period when errors of hubris going back 10 or 15 years have cost us very substantial good will in the world. At a time when failure to achieve stated objectives in the Middle East and in New Orleans has dented our perception for competence. Much of our strength derives from the strength, resilience, and vigor of our economy which, in turn, depends on the successful and effective functioning of our financial markets. With that in doubt, it is critical that there be a bias towards aggressive and effective action.