AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

ECONOMIC RECOVERY OPTIONS AND CHALLENGES

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED TENTH CONGRESS

SECOND SESSION

HEARING HELD IN WASHINGTON, DC, OCTOBER 20, 2008

Serial No. 110–43

Printed for the use of the Committee on the Budget

Available on the Internet:
http://www.gpoaccess.gov/congress/house/budget/index.html

U.S. GOVERNMENT PRINTING OFFICE

45–532 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
Internet: bookstore.gpo.gov Phone: toll free (866) 512–1800; DC area (202) 512–1800
Fax: (202) 512–2104 Mail: Stop IDCC, Washington, DC 20402–0001

COMMITTEE ON THE BUDGET

JOHN M. SPRATT, JR., South Carolina, *Chairman*

ROSA L. DELAURO, Connecticut,
CHET EDWARDS, Texas
JIM COOPER, Tennessee
THOMAS H. ALLEN, Maine
ALLYSON Y. SCHWARTZ, Pennsylvania
MARCY KAPTUR, Ohio
XAVIER BECERRA, California
LLOYD DOGGETT, Texas
EARL BLUMENAUER, Oregon
MARION BERRY, Arkansas
ALLEN BOYD, Florida
JAMES P. MCGOVERN, Massachusetts
NIKI TSONGAS, Massachusetts
ROBERT E. ANDREWS, New Jersey
ROBERT C. "BOBBY" SCOTT, Virginia
BOB ETHERIDGE, North Carolina
DARLENE HOOLEY, Oregon
BRIAN BAIRD, Washington
DENNIS MOORE, Kansas
TIMOTHY H. BISHOP, New York
GWEN MOORE, Wisconsin

PAUL RYAN, Wisconsin,
Ranking Minority Member
J. GRESHAM BARRETT, South Carolina
JO BONNER, Alabama
SCOTT GARRETT, New Jersey
MARIO DIAZ–BALART, Florida
JEB HENSARLING, Texas
DANIEL E. LUNGREN, California
MICHAEL K. SIMPSON, Idaho
PATRICK T. MCHENRY, North Carolina
CONNIE MACK, Florida
K. MICHAEL CONAWAY, Texas
JOHN CAMPBELL, California
PATRICK J. TIBERI, Ohio
JON C. PORTER, Nevada
RODNEY ALEXANDER, Louisiana
ADRIAN SMITH, Nebraska
JIM JORDAN, Ohio

PROFESSIONAL STAFF

THOMAS S. KAHN, *Staff Director and Chief Counsel*
AUSTIN SMYTHE, *Minority Staff Director*

CONTENTS

	Page
Hearing held in Washington, DC, October 20, 2008	1
Statement of:	
Hon. John M. Spratt, Jr., Chairman, House Committee on the Budget	1
Hon. Paul Ryan, ranking minority member, House Committee on the Budget	1
Prepared statement of	3
Hon. Ben S. Bernanke, Chairman, Federal Reserve Board	4
Prepared statement of	9
Speech given at the Economic Club of New York, October 15, 2008	13
Responses to Mr. Etheridge's questions for the record	87
Martin Neil Baily, the Brookings Institution	36
Prepared statement of	39
Iris J. Lav, deputy director, Center on Budget and Policy Priorities	44
Prepared statement of	48
William W. Beach, director, Center for Data Analysis, the Heritage Foundation	55
Prepared statement of	57
Hon. Bob Etheridge, a Representative in Congress from the State of North Carolina, questions for the record	86
Hon. Jon C. Porter, a Representative in Congress from the State of Nevada, prepared statement of	88

ECONOMIC RECOVERY OPTIONS AND CHALLENGES

MONDAY, OCTOBER 20, 2008

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to call, at 10:00 a.m. in Room 210, Cannon House Office Building, Hon. John Spratt [chairman of the committee] presiding.

Present: Representatives Spratt, DeLauro, Schwartz, Kaptur, Becerra, Doggett, Blumenauer, McGovern, Tsongas, Scott, Baird, Moore of Kansas, Moore of Wisconsin, Ryan, Garrett, Simpson, and Tiberi.

Chairman SPRATT. In the interest of time, it is important that we stick by the clock today, and, therefore, I call the hearing to order.

We will begin with some few short comments. We began this year wary of a recession. And to mitigate if not avoid it, we passed a countercyclical bill with rebates and business tax concessions, totaling about $150 billion in revenues foregone.

Before adjourning, Congress acted again. At the Bush administration's request, we passed recovery measures which included budget authority of $700 billion, a new kit of tools for Treasury and the Federal Reserve. The House also passed a $61 billion bill to shore up the economy, but faced with a veto threat, the Senate did not follow through.

We called this hearing to know Chairman Bernanke's assessment of the economy and ask whether you, sir, believe that further action is needed to boost the economy and turn it around. Our second panel will deal with specific fiscal actions that the Congress might take to counteract current economic conditions.

I would say to all the members here that the chairman is committed to leaving at 11 o'clock, and we have agreed with that understanding. And we want to proceed as expeditiously as possible. And therefore, I am holding my statement to this length and turn now to Mr. Ryan for any opening statement he has.

Mr. RYAN. All right. Thank you, Chairman. I guess I will take the cue off that, and I will ask unanimous consent that my opening statement be included in the record.

Thank you for having this hearing.

We are all concerned about a weak economy and the impacts on our families. My own hometown of Janesville, Wisconsin, is suffering particularly from the consequences of this downturn. That is why I voted for the extension of unemployment insurance. But I also want to pursue policies to ensure sustained economic growth.

The topic of today's hearing, options for economic recovery, the Democrats have already come out with their preferred option, a bloated $300 billion spending stimulus package. The advertised intent of this package is to get the economy back on track. We all want that. Yet we should not be under any illusion that this stimulus package will address the core problems of our current financial crisis and our economic weakness.

The major problem, which Chairman Bernanke is about to describe, has been that our credit markets have virtually frozen up and nearly stopped functioning. Left unaddressed, this situation poses a real threat of a financial meltdown, followed by a deep and prolonged recession.

Well, the Fed has acted preemptively and promptly to address this crisis. It has taken extraordinary and unprecedented measures to inject liquidity into these frozen credit markets and to preserve the integrity and the functioning of our financial system. We in Congress have also taken actions on a bipartisan basis, passing legislation designed to stabilize the financial markets. We have also extended unemployment insurance to soften this blow from the downturn to those individuals who are losing their jobs in this.

Now, in the interest of time, I will be brief only to say that this is the Budget Committee, and the CBO director has already told us that the deficit this year could well climb to above $750 billion. That is before this kind of a stimulus package, which, with more government spending being shoveled out the door, at best would probably give us a little pop in GDP statistics, manipulating the economic statistics, but not addressing the core problem, which is, how do we grow the economy? What are the policies we put in place to give us long-run, sustained economic growth?

I would simply close by saying this: The doctrine that is giving us this stimulus idea of spending more money here this year is a Keynesian principle, it is a Keynesian doctrine. It is well-founded and held by many people. But that same economic doctrine which is bringing this bill to this hearing says you don't raise taxes when the economy is in trouble.

Yet this Democratic majority passed just this year the largest tax increase in American history. They are already proposing tax rates on capital, tax rates on investment, tax rate increases on small businesses. In fact, the chairman of my own committee, the Ways and Means Committee, is saying we want a 45 percent top tax rate for small businesses. Seven out of 10 jobs in this country come from small businesses. The last thing Congress ought to be doing under any economic doctrine is raising taxes in a recession, yet that is precisely what this majority is proposing to do.

So shoveling $300 billion out the door, bringing our deficit up to a trillion dollars, will only serve to actually weaken the dollar, increase our borrowing costs, and not address the fundamental problems in our economy. We need policies that grow the economic pie, that grow opportunity. Raising taxes on opportunity is not the answer.

With that, Chairman, I will yield the balance of my time. And I thank Chairman Bernanke for coming here to join us today.

[The information follows:]

PREPARED STATEMENT OF HON. PAUL RYAN, RANKING MINORITY MEMBER, COMMITTEE ON THE BUDGET

PART I

Thank you, Chairman Spratt. Welcome, Chairman Bernanke.

We're all concerned about a weak economy and the impact on American families. My own hometown is suffering from the consequences of this downturn. That's why I've voted for the extension of unemployment insurance, but I also want to pursue policies to ensure sustained economic growth.

The topic of today's hearing is "Options for Economic Recovery." The Democrats have already come out with their preferred option: a bloated $300 billion stimulus package.

The advertised intent of this package is to "get the economy back on track." Yet, we should not be under any illusion that this stimulus package will address the core problems of our current financial crisis and economic weakness.

The major problem, which Chairman Bernanke is about to describe, has been that our credit markets have virtually frozen up and nearly stopped functioning. Left unaddressed, the situation posed the very real threat of a financial meltdown followed by a deep and prolonged recession.

The Fed has acted preemptively and promptly to address this crisis. It is taking extraordinary and unprecedented measures to inject liquidity into these frozen credit markets and preserve the integrity and functioning of our financial system.

We in Congress have also taken action by passing bipartisan legislation designed to stabilize financial markets.

These actions, combined with weakness in our economy, obviously entail costs. The CBO has just warned us that even without a stimulus package, this year's budget deficit could reach $750 billion. Adding the Democratic stimulus package would take the budget deficit to $1 trillion. That tells me that we are simply not serious about our fiscal situation.

A much higher level of government spending and increased deficits is going to sharply raise our debt service costs and weaken the dollar.

Although the long-run costs of the proposed stimulus are real, the long-run benefits are highly suspect. In fact, we have seen time and time again that these temporary fiscal spending packages simply provide one or two quarters of "pop" before the economy simply reverts back to its pre-stimulus trend. That is because they do nothing to change the main factors driving our long-term growth trajectory.

If higher government spending led to robust economic growth, our economy would be soaring along right now instead of entering a recession.

If Congress is going to take action, it should be through fast-acting tax policy that boosts incentives to invest and create jobs. That is the growth dynamic that leads to a bigger economic pie. Short-term actions like stimulus do not grow the economic pie; they simply transfer funds from one part of the economy to another.

PART II

The Democratic $300 billion stimulus proposal raises serious concerns about how Washington will respond to the financial crisis.

I'm afraid that this is only the beginning, and that we are going to see a lot more government intervention in the economy that will be detrimental to jobs, wages, and the financial security of the American people.

My fear is that this financial crisis, and the policy reactions it has forced us to take, could send us down a path toward a fundamentally different economic model—one of bigger government, higher spending and taxes, and heavy-handed government controls—rather than a reliance on private markets.

This would be a serious mistake. When I look back at the root causes of our current financial crisis, I don't see an indictment of our capitalist system, but rather a distortion of private markets through some of the Federal Government's actions.

First, earlier this decade the Federal Reserve set the stage for a wave of mortgage borrowing by keeping credit conditions too loose for too long. Low interest rates encouraged both homeowners and financial institutions to borrow too much and become highly leveraged, which is accentuating the pain of the massive de-leveraging we are witnessing today.

Second, the Federal government encouraged, mandated, and subsidized both lenders and borrowers to extend and accept mortgage credit to people who simply were not in a financial position to repay these loans.

Third, I've been warning for a decade that Fannie Mae and Freddie Mac posed a huge risk to taxpayers. During that period, Fannie and Freddie, at the urging of members of Congress and others, were creating and securitizing more risky loans.

In addition, Fannie Mae and Freddie Mac became the largest holders of mortgage-backed securities. In fact, by the time the government was forced to take these companies over, their combined mortgage investment portfolios had reached $1.5 trillion, which exceeds the entire GDP of countries like Canada, Mexico, and Spain.

Clearly, a variety of private actors were also at fault, but Fannie and Freddie's large purchases of mortgage-related securities, many of which were near-prime or subprime, put the government stamp of approval on a fundamentally flawed system—a system of cheap money, low risk, and ever-rising home prices.

Looking ahead, we need to modernize our antiquated regulatory system, improve transparency, and make sure those that take risks are fully accountable for the consequences.

But we should also be careful to guard against a regulatory over-reaction formulated in the heat of the current crisis that may have unintended consequences down the road.

Also, we should not mistake the urgent action we are undertaking now in reaction to the crisis as a template for a viable, long-term economic model.

Though it may be obscured by recent events, the unprecedented economic growth and prosperity we have witnessed in this country over its history has been driven by free markets—by entrepreneurship, innovation, and private risk and reward.

Government did not create this prosperity and my concern is that we will take actions that will hurt Americans ability and opportunities to secure renewed prosperity in the future.

Chairman SPRATT. I would say to Mr. Ryan, the farthest away of our intentions with this hearing today is to talk about a tax increase. And I am a little bit lost as to what he is referring to. But in the interest of time, let's proceed.

Mr. Chairman, thank you, sir, for coming. We know that your time is at a premium, that there are many demanding your attention, but we also represent the people of this country, 435 different districts. And as we have learned with the $700 billion bailout package, so-called, we need to communicate with the American people to help them understand what is being done and what purposes it serves. And I think that your coming here will enhance the public's understanding of where we stand.

The floor is yours. You can read your testimony, which will be made part of the record.

I would also ask unanimous consent at this point that all members, the chairman included, be allowed to include their opening statements.

And your statement will be included in its entirety in the record. Mr. Bernanke, again, thank you for coming. We appreciate you being here.

STATEMENT OF BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. Thank you.

Chairman Spratt, Representative Ryan and other members of the committee, I appreciate this opportunity to discuss recent developments in financial markets, the near-term economic outlook, and issues surrounding the possibility of a second package of fiscal measures.

As you know, financial markets in the United States and some other industrialized countries have been under severe stress for more than a year. The proximate cause of the financial turmoil was the steep increase and subsequent decline of house prices nationwide, which, together with poor lending practices, have led to large losses on mortgages and mortgage-related instruments by a wide range of institutions.

More fundamentally, the turmoil is the aftermath of a credit boom characterized by underpricing of risk, excessive leverage, and an increasing reliance on complex and opaque financial instruments that have proved to be fragile under stress. A consequence of the unwinding of this boom and the resulting financial strains has been a broad-based tightening in credit conditions that has restrained economic growth.

The financial turmoil intensified in recent weeks as investors' confidence in banks and other financial institutions eroded and risk aversion heightened. Conditions in the interbank lending market have worsened, with term funding essentially unavailable. Withdrawals from prime money market mutual funds, which are important suppliers of credit to the commercial paper market, severely disrupted that market. And short-term credit, when available, has become much more costly for virtually all firms. Households and State and local governments have also experienced a notable reduction in credit availability.

Financial conditions deteriorated in other countries as well, putting severe pressure on both industrial and emerging market economies. As confidence in the financial markets has declined and concerns about the U.S. and global economies has increased, equity prices have been volatile, falling sharply on net.

In collaboration with governments and central banks in other countries, the Treasury and the Federal Reserve have taken a range of actions to ameliorate these financial problems. To address ongoing pressures in interbank funding markets, the Federal Reserve significantly increased the quantity of term funds it auctions to banks and accommodated heightened demands for funding from banks and primary dealers.

We have also greatly expanded our currency swap lines with foreign central banks. These swap lines allow cooperating central banks to supply dollar liquidity in their own jurisdictions, helping to reduce strains in global money markets and, in turn, in our own markets.

To address illiquidity and impaired functioning in the market for commercial paper, the Treasury implemented a temporary guarantee program for balances held in money market mutual funds, helping to stem the outflows from these funds.

The Federal Reserve put in place a temporary lending facility that provides financing for banks to purchase high-quality, asset-backed commercial paper from money markets funds, thus providing some relief for money market funds that have needed to sell their holdings to meet redemptions.

Moreover, we will soon be implementing a new commercial paper funding facility that will provide a backstop to commercial paper markets by purchasing highly rated commercial paper from issuers at a term of 3 months.

The recently enacted Emergency Economic Stabilization Act provided critically important new tools to address the dysfunction in financial markets, and thus reduce the accompanying risks to the economy. The Troubled Asset Relief Program, or TARP, authorized by the legislation, will allow the Treasury to undertake two highly complementary activities.

First, the Treasury will use TARP funds to provide capital to financial institutions. Indeed, last week, nine of the Nation's largest financial institutions indicated their willingness to accept capital from the program, and many other institutions, large and small, are expected to follow suit in coming weeks.

Second, the Treasury will purchase or guarantee troubled mortgage-related and possibly other assets held by banks and other financial institutions. Taken together, these measures should help rebuild confidence in the financial system, increase the liquidity of financial markets, and improve the ability of financial institutions to raise capital from private sources.

As another measure to improve confidence, the act also temporarily raised the limit on the deposit insurance coverage provided by the Federal Deposit Insurance Corporation and the National Credit Union Administration from $100,000 to $250,000 per account, effective immediately.

Unfortunately, the loss of confidence in financial institutions became so severe in recent weeks that additional steps in this direction proved necessary. The FDIC, the Federal Reserve Board, and the Secretary of the Treasury, in consultation with the President, determined that significant risks to the stability of the financial system were present. With this determination, the FDIC was able to use its authority to provide, for a specified period, unlimited insurance coverage of funds held in non-interest-bearing transactions accounts, such as payroll accounts. In addition, the FDIC announced that it would guarantee the senior unsecured debt of FDIC-insured depository institutions and their associated holding companies.

In taking the dramatic steps of providing capital to the banking system and expanding guarantees, the United States consulted with other countries, many of whom have announced similar actions. Given the global nature of the financial system, international consultation and cooperation on actions to address the crisis are important for restoring confidence and stability.

These measures were announced less than a week ago, and although there have been some encouraging signs, it is too early to assess their full effects. However, I am confident that these initiatives, together with other actions by the Treasury, the Federal Reserve and other regulators, will help restore trust in our financial system and allow the resumption of more normal flows of credit to households and firms.

I would like to reiterate the critical importance of the recent legislation passed by the Congress. Without that action, tools essential for stabilizing the financial system, and thereby containing the damage to the broader economy, would not have been available. That said, the stabilization of the financial system, though an essential first step, will not quickly eliminate the challenges still faced by the broader economy.

Even before the recent intensification of the financial crisis, economic activity had shown considerable signs of weakening. In the labor market, private employers shed 168,000 jobs in September, bringing the total job loss in the private sector since January to nearly 900,000. Meanwhile, the unemployment rate, at 6.1 percent in September, has risen 1.2 percentage points since January. In-

coming data on consumer spending, housing, and business investment have all showed significant slowing over the past few months, and some key determinants of spending have worsened. Equity and house prices have fallen, foreign economic growth has slowed, and credit conditions have tightened.

One brighter note is that the declines in the prices of oil and other commodities will have favorable implications for the purchasing power of households. Nonetheless, the pace of economic activity is likely to be below that of its longer-run potential for several quarters.

As I noted, the slowing in spending and activity spans most major sectors. Real personal consumption expenditures for goods and services declined over the summer and apparently fell further in September. Although the weakness in household spending has been widespread, the drop-off in purchases of motor vehicles recently has been particularly sharp. Increased difficulty in obtaining auto loans appears to have contributed to the decline in auto sales. Consumer sentiment has been quite low, reflecting concerns about jobs, gasoline prices, the state of the housing market, and stock prices.

In the business sector, orders and shipments for nondefense capital goods have generally slowed, and forward-looking indicators suggest further declines in business investment in coming months. Outlays for construction of nonresidential buildings, which had posted robust gains over the first half of the year, also appear to have decelerated in the third quarter. Although the less favorable outlook for sales has undoubtedly played a role, the softening in business investment also appears to reflect reduced credit availability from banks and other lenders.

As has been the case for some time, the housing market remains depressed, with sales and construction of new homes continuing to decline. Indeed, single-family housing starts fell 12 percent in September, and permit issuance also dropped sharply. With demand for new homes remaining at a low level and the backlog of unsold homes still sizable, residential construction is likely to continue to contract into next year.

International trade provided considerable support for the U.S. economy over the first half of the year. Domestic output was buoyed by strong foreign demand for a wide range of U.S. exports, including agricultural products, capital goods and industrial supplies. Although trade should continue to be a positive factor for the U.S. economy, its contribution to U.S. growth is likely to be less dramatic as global growth slows.

The prices of the goods and services purchased by consumers rose rapidly earlier this year, as steep increases in the prices of oil and other commodities led to higher retail prices for fuel and food, and as firms were able to pass through a portion of their higher costs of production. These effects are now reversing in the wake of the substantial declines in commodity prices since the summer.

Moreover, the prices of imports now appear to be decelerating, and consumer surveys and yields on inflation-indexed Treasury securities suggest that expected inflation has held steady or eased. If not reversed, these developments, together with the likelihood that

economic activity will fall short of potential for a time, should bring inflation down to a level consistent with price stability.

Over time, a number of factors will likely promote the return of solid gains in economic activity and employment in the context of low and stable inflation. Among those factors are the stimulus provided by monetary policy; the eventual stabilization in housing markets that will occur as the correction runs its course; improvements in our credit markets as the new programs take effect and market participants work through remaining problems; and the underlying strength and recuperative powers of our economy.

The time needed for economic recovery, however, will depend greatly on the pace at which financial and credit markets return to more normal functioning. Because the time that will be needed for financial normalization and the effects of ongoing credit problems in the broader economy are difficult to judge, the uncertainty currently surrounding the economic outlook is unusually large.

I understand that the Congress is evaluating the desirability of a second fiscal package. Any fiscal action inevitably involves trade-offs, not only among current needs and objectives but also because commitments of resources today can burden future generations and constrain future policy options between the present and the future. Such trade-offs inevitably involve value judgments that can be properly made only by our elected officials. Moreover, with the outlook exceptionally uncertain, the optimal timing, scale and composition of any fiscal package are unclear.

All that being said, with the economy likely to be weak for several quarters and with some risk of a protracted slowdown, consideration of a fiscal package by the Congress at this juncture seems appropriate. Should the Congress choose to undertake fiscal actions, certain design principles may be helpful. To best achieve its goals, any fiscal package should be structured so that its peak effects on aggregate spending and economic activity are felt when they are most needed, namely during the period in which economic activity would otherwise be expected to be weak.

Any fiscal package should be well-targeted, in the sense of attempting to maximize the beneficial effects on spending and activity per dollar of increased Federal expenditure or lost revenue. At the same time, it should go without saying that the Congress must be vigilant in ensuring that any allocated funds are used effectively and responsibly. Any program should be designed, to the extent possible, to limit longer-term effects on the Federal Government's structural budget deficit.

Finally, in the ideal case, a fiscal package would not only boost overall spending and economic activity, but would also be aimed at redressing specific factors that have the potential to extend or deepen the economic slowdown. As I discussed earlier, the extraordinary tightening in credit conditions has played a central role in the slowdown thus far and could be an important factor delaying the recovery. If the Congress proceeds with a fiscal package, it should consider including measures to help improve access to credit by consumers, home buyers, businesses and other borrowers. Such actions might be particularly effective at promoting economic growth and job creation.

Thank you. I would be pleased to take your questions.

[The prepared statement of Ben Bernanke follows:]

Prepared Statement of Hon. Ben S. Bernanke, Chairman, Federal Reserve Board

Chairman Spratt, Representative Ryan, and other members of the Committee, I appreciate this opportunity to discuss recent developments in financial markets, the near-term economic outlook, and issues surrounding the possibility of a second package of fiscal measures.

FINANCIAL DEVELOPMENTS

As you know, financial markets in the United States and some other industrialized countries have been under severe stress for more than a year. The proximate cause of the financial turmoil was the steep increase and subsequent decline of house prices nationwide, which, together with poor lending practices, have led to large losses on mortgages and mortgage-related instruments by a wide range of institutions. More fundamentally, the turmoil is the aftermath of a credit boom characterized by underpricing of risk, excessive leverage, and an increasing reliance on complex and opaque financial instruments that have proved to be fragile under stress. A consequence of the unwinding of this boom and the resulting financial strains has been a broad-based tightening in credit conditions that has restrained economic growth.

The financial turmoil intensified in recent weeks, as investors' confidence in banks and other financial institutions eroded and risk aversion heightened. Conditions in the interbank lending market have worsened, with term funding essentially unavailable. Withdrawals from prime money market mutual funds, which are important suppliers of credit to the commercial paper market, severely disrupted that market; and short-term credit, when available, has become much more costly for virtually all firms. Households and state and local governments have also experienced a notable reduction in credit availability. Financial conditions deteriorated in other countries as well, putting severe pressure on both industrial and emerging-market economies. As confidence in the financial markets has declined and concerns about the U.S. and global economies have increased, equity prices have been volatile, falling sharply on net.

In collaboration with governments and central banks in other countries, the Treasury and the Federal Reserve have taken a range of actions to ameliorate these financial problems. To address ongoing pressures in interbank funding markets, the Federal Reserve significantly increased the quantity of term funds it auctions to banks and accommodated heightened demands for funding from banks and primary dealers. We have also greatly expanded our currency swap lines with foreign central banks. These swap lines allow the cooperating central banks to supply dollar liquidity in their own jurisdictions, helping to reduce strains in global money markets and, in turn, in our own markets. To address illiquidity and impaired functioning in the market for commercial paper, the Treasury implemented a temporary guarantee program for balances held in money market mutual funds, helping to stem the outflows from these funds. The Federal Reserve put in place a temporary lending facility that provides financing for banks to purchase high-quality asset-backed commercial paper from money market funds, thus providing some relief for money market funds that have needed to sell their holdings to meet redemptions. Moreover, we soon will be implementing a new Commercial Paper Funding Facility that will provide a backstop to commercial paper markets by purchasing highly rated commercial paper from issuers at a term of three months.

The recently enacted Emergency Economic Stabilization Act provided critically important new tools to address the dysfunction in financial markets and thus reduce the accompanying risks to the economy. The Troubled Asset Relief Program (TARP) authorized by the legislation will allow the Treasury to undertake two highly complementary activities. First, the Treasury will use TARP funds to provide capital to financial institutions. Indeed, last week, nine of the nation's largest financial institutions indicated their willingness to accept capital from the program, and many other institutions, large and small, are expected to follow suit in coming weeks. Second, the Treasury will purchase or guarantee troubled mortgage-related and possibly other assets held by banks and other financial institutions. Taken together, these measures should help rebuild confidence in the financial system, increase the liquidity of financial markets, and improve the ability of financial institutions to raise capital from private sources.

As another measure to improve confidence, the act also temporarily raised the limit on the deposit insurance coverage provided by the Federal Deposit Insurance Corporation (FDIC) and the National Credit Union Administration from $100,000

to $250,000 per account, effective immediately. Unfortunately, the loss of confidence in financial institutions became so severe in recent weeks that additional steps in this direction proved necessary. The FDIC, the Federal Reserve Board, and the Secretary of the Treasury in consultation with the President determined that significant risks to the stability of the financial system were present. With this determination, the FDIC was able to use its authority to provide, for a specified period, unlimited insurance coverage of funds held in non-interest-bearing transactions accounts, such as payroll accounts. In addition, the FDIC announced that it would guarantee the senior unsecured debt of FDIC-insured depository institutions and their associated holding companies. In taking the dramatic steps of providing capital to the banking system and expanding guarantees, the United States consulted with other countries, many of whom have announced similar actions. Given the global nature of the financial system, international consultation and cooperation on actions to address the crisis are important for restoring confidence and stability.

These measures were announced less than a week ago, and, although there have been some encouraging signs, it is too early to assess their full effects. However, I am confident that these initiatives, together with other actions by the Treasury, the Federal Reserve, and other regulators, will help restore trust in our financial system and allow the resumption of more-normal flows of credit to households and firms. I would like to reiterate the critical importance of the recent legislation passed by the Congress; without that action, tools essential for stabilizing the financial system and thereby containing the damage to the broader economy would not have been available. That said, the stabilization of the financial system, though an essential first step, will not quickly eliminate the challenges still faced by the broader economy.

ECONOMIC OUTLOOK

Even before the recent intensification of the financial crisis, economic activity had shown considerable signs of weakening. In the labor market, private employers shed 168,000 jobs in September, bringing the total job loss in the private sector since January to nearly 900,000. Meanwhile, the unemployment rate, at 6.1 percent in September, has risen 1.2 percentage points since January. Incoming data on consumer spending, housing, and business investment have all showed significant slowing over the past few months, and some key determinants of spending have worsened: Equity and house prices have fallen, foreign economic growth has slowed, and credit conditions have tightened. One brighter note is that the declines in the prices of oil and other commodities will have favorable implications for the purchasing power of households. Nonetheless, the pace of economic activity is likely to be below that of its longer-run potential for several quarters.

As I noted, the slowing in spending and activity spans most major sectors. Real personal consumption expenditures for goods and services declined over the summer and apparently fell further in September. Although the weakness in household spending has been widespread, the drop-off in purchases of motor vehicles recently has been particularly sharp. Increased difficulty in obtaining auto loans appears to have contributed to the decline in auto sales. Consumer sentiment has been quite low, reflecting concerns about jobs, gasoline prices, the state of the housing market, and stock prices.

In the business sector, orders and shipments for nondefense capital goods have generally slowed, and forward-looking indicators suggest further declines in business investment in coming months. Outlays for construction of nonresidential buildings, which had posted robust gains over the first half of the year, also appear to have decelerated in the third quarter. Although the less favorable outlook for sales has undoubtedly played a role, the softening in business investment also appears to reflect reduced credit availability from banks and other lenders.

As has been the case for some time, the housing market remains depressed, with sales and construction of new homes continuing to decline. Indeed, single-family housing starts fell 12 percent in September, and permit issuance also dropped sharply. With demand for new homes remaining at a low level and the backlog of unsold homes still sizable, residential construction is likely to continue to contract into next year.

International trade provided considerable support for the U.S. economy over the first half of the year. Domestic output was buoyed by strong foreign demand for a wide range of U.S. exports, including agricultural products, capital goods, and industrial supplies. Although trade should continue to be a positive factor for the U.S. economy, its contribution to U.S. growth is likely to be less dramatic as global growth slows.

The prices of the goods and services purchased by consumers rose rapidly earlier this year, as steep increases in the prices of oil and other commodities led to higher retail prices for fuel and food, and as firms were able to pass through a portion of their higher costs of production. These effects are now reversing in the wake of the substantial declines in commodity prices since the summer. Moreover, the prices of imports now appear to be decelerating, and consumer surveys and yields on inflation-indexed Treasury securities suggest that expected inflation has held steady or eased. If not reversed, these developments, together with the likelihood that economic activity will fall short of potential for a time, should bring inflation down to levels consistent with price stability.

Over time, a number of factors are likely to promote the return of solid gains in economic activity and employment in the context of low and stable inflation. Among those factors are the stimulus provided by monetary policy, the eventual stabilization in housing markets that will occur as the correction runs its course, improvements in our credit markets as the new programs take effect and market participants work through remaining problems, and the underlying strengths and recuperative powers of our economy. The time needed for economic recovery, however, will depend greatly on the pace at which financial and credit markets return to more-normal functioning. Because the time that will be needed for financial normalization and the effects of ongoing credit problems on the broader economy are difficult to judge, the uncertainty currently surrounding the economic outlook is unusually large.

FISCAL POLICY

I understand that the Congress is evaluating the desirability of a second fiscal package. Any fiscal action inevitably involves tradeoffs, not only among current needs and objectives but also—because commitments of resources today can burden future generations and constrain future policy options—between the present and the future. Such tradeoffs inevitably involve value judgments that can properly be made only by our elected officials. Moreover, with the outlook exceptionally uncertain, the optimal timing, scale, and composition of any fiscal package are unclear. All that being said, with the economy likely to be weak for several quarters, and with some risk of a protracted slowdown, consideration of a fiscal package by the Congress at this juncture seems appropriate.

Should the Congress choose to undertake fiscal action, certain design principles may be helpful. To best achieve its goals, any fiscal package should be structured so that its peak effects on aggregate spending and economic activity are felt when they are most needed, namely, during the period in which economic activity would otherwise be expected to be weak. Any fiscal package should be well-targeted, in the sense of attempting to maximize the beneficial effects on spending and activity per dollar of increased federal expenditure or lost revenue; at the same time, it should go without saying that the Congress must be vigilant in ensuring that any allocated funds are used effectively and responsibly. Any program should be designed, to the extent possible, to limit longer-term effects on the federal government's structural budget deficit.

Finally, in the ideal case, a fiscal package would not only boost overall spending and economic activity but would also be aimed at redressing specific factors that have the potential to extend or deepen the economic slowdown. As I discussed earlier, the extraordinary tightening in credit conditions has played a central role in the slowdown thus far and could be an important factor delaying the recovery. If the Congress proceeds with a fiscal package, it should consider including measures to help improve access to credit by consumers, homebuyers, businesses, and other borrowers. Such actions might be particularly effective at promoting economic growth and job creation.

Thank you. I would be pleased to take your questions.

Chairman SPRATT. Thank you, Mr. Chairman. Thank you very much indeed.

Mr. Chairman, in your speech to the Economic Club of New York recently, you noted that, "In one respect we are"—and I am parsing and quoting—"better off than those who dealt with earlier financial crises. Generally, in past crises, broad-based government intervention came too late. Waiting too long to respond has usually led to much greater costs of intervention and, more importantly, magnified the painful effects of financial turmoil on households and businesses. In this case, prompt and decisive action by political

leaders," quoting from your statement, "will restore more normal market functioning much more quickly and at a lower cost." You went on to warn, "Even if markets stabilize, a broad economic recovery will not happen right away."

In a separate talk, your vice chair, Donald Kohn, said, "It is likely the economy will be subpar well into next year." One of our witnesses today, Dr. Martin Baily, has said, "I don't know if there is anything we can do in the short run to avoid a mild recession. The question is what we can do to avoid a very severe recession."

These are the concerns that caused us to call this hearing. They go to the heart of the hearing. The question is, if we are threatened with a recession, it could be deep and severe and last long after you have stabilized the financial markets. Wouldn't prompt and decisive action now be less than the costs of intervention and turmoil later?

Mr. BERNANKE. Mr. Chairman, as I indicated, I think given the uncertainties about the near term and the risks that still exist, I think that it is appropriate for Congress to be thinking about a fiscal program at this time. The size and the composition of that are obviously items for the Congress to determine in negotiation and discussion.

And I would reiterate the point that there is an awful lot of uncertainty right now, arising in part from the fact that we don't know how quickly the credit markets will return to normal and how quickly credit extension will return to normal. So, in that respect also, I think we need to be flexible and continue to watch the situation as we go forward.

Chairman SPRATT. You also stated in your speech, and you have said elsewhere, that this problem began with the problem in the subprime mortgages but it has become much broader than that. Nevertheless, that is one of the primary causes. And the first steps being taken by the Fed and the Treasury go to recapitalizing the banks of this country. The first tranche of $250 billion will be spent for that purpose.

How do we get money flowing back into the housing markets so we can both restart the housing markets and also deal with the huge number of foreclosures and mortgages in default?

Mr. BERNANKE. Well, Mr. Chairman, first of all, the steps being taken in the financial markets are directly intended to try to address the problems of credit availability not just for mortgages but more generally.

By restoring the strength of the financial institutions, by restoring confidence in the financial markets, by taking troubled assets off of balance sheets, we will restart the flow of credit more generally, which is a very important step.

Chairman SPRATT. But there is no legal requirement, as I understand it, that the banks divert a certain portion of their recapitalized funds to housing or housing modification mortgages, things of that nature.

Mr. BERNANKE. There are requirements that the banks meet standards for renegotiating and restructuring troubled mortgages. But I was going to go on to say that I think that, beyond banks themselves, which are of course one important group of mortgage lenders, there are other things that are going on and can be done.

In particular, Fannie and Freddie, the stabilization of those two companies, I think, despite some run-up in mortgage rates last week, I do think will provide more credit, more available credit for homeowners going forward.

The Congress, of course, has just passed the Hope for Homeowners bill, which allows troubled mortgages to be written down in terms of principal and then renegotiated and refinanced into the Federal Housing Administration. Further steps could be taken along those lines if the Congress wished to.

The Congress could also further support Fannie and Freddie's funding and address some of the costs that they face in order to make more credit available to the mortgage market.

Chairman SPRATT. Last question from me. You ended your testimony by saying, "Any program should be designed, to the extent possible, to limit longer-term effects on the Federal Government's structural budget deficit." You also say that we should consider measures that would improve consumer credit access, business access to credit.

Would you elaborate a little further on those, please, sir?

Mr. BERNANKE. Well, certainly.

We are in a situation where the deficit is large. That is not totally inappropriate, given the nature of the emergency that we are facing, and not totally avoidable, given the loss of tax revenues associated with the decline in the economy. Nevertheless, it is important, obviously, to maintain careful and, you know, well-managed fiscal position in the longer term. Indeed, one of the reasons that economists argue for conservative fiscal management is that precisely when times like this come around you want to have the capacity and the scope necessary to deal with the problem.

With respect to the credit markets, the Congress has a variety of tools that it might use to try to address some of the problem, which, as I said, is very central to the economic slowdown. Depending on the particular case, Congress might consider guarantees or partial guarantees. It might consider direct lending. It might consider tax credits. In the case of the housing market, it might consider things like paying the guarantee fees in Fannie and Freddie. There are other tax measures that could be taken to stimulate credit.

There is just a variety of things that could be done. And I think the right way to think about it is to look at each situation, try to ascertain the extent to which credit markets are failing or not functioning properly, and to try to find methods that will restore credit to something closer to a more normal level.

Obviously, these would have to be temporary and carefully designed. The Federal Reserve is more than happy to try to work with you on specific possibilities.

Chairman SPRATT. Thank you, sir.

[The speech referred to follows:]

SPEECH BY CHAIRMAN BEN S. BERNANKE AT THE ECONOMIC CLUB OF NEW YORK, OCTOBER 15, 2008

STABILIZING THE FINANCIAL MARKETS AND THE ECONOMY

Good afternoon. I am pleased once again to share a meal and some thoughts with the Economic Club of New York. I will focus today on the economic and financial

challenges we face and why I believe we are well positioned to move forward. The problems now evident in the markets and in the economy are large and complex, but, in my judgment, our government now has the tools it needs to confront and solve them. Our strategy will continue to evolve and be refined as we adapt to new developments and the inevitable setbacks. But we will not stand down until we have achieved our goals of repairing and reforming our financial system and restoring prosperity.

The crisis we face in the financial markets has many novel aspects, largely arising from the complexity and sophistication of today's financial institutions and instruments and the remarkable degree of global financial integration that allows financial shocks to be transmitted around the world at the speed of light. However, as a long-time student of banking and financial crises, I can attest that the current situation also has much in common with past experiences. As in all past crises, at the root of the problem is a loss of confidence by investors and the public in the strength of key financial institutions and markets. The crisis will end when comprehensive responses by political and financial leaders restore that trust, bringing investors back into the market and allowing the normal business of extending credit to households and firms to resume. In that regard, we are, in one respect at least, better off than those who dealt with earlier financial crises: Generally, during past crises, broad-based government engagement came late, usually at a point at which most financial institutions were insolvent or nearly so. Waiting too long to respond has usually led to much greater direct costs of the intervention itself and, more importantly, magnified the painful effects of financial turmoil on households and businesses. That is not the situation we face today. Fortunately, the Congress and the Administration have acted at a time when the great majority of financial institutions, though stressed by highly volatile and difficult market conditions, remain strong and capable of fulfilling their critical function of providing new credit for our economy. This prompt and decisive action by our political leaders will allow us to restore more normal market functioning much more quickly and at lower ultimate cost than would otherwise have been the case. Moreover, we are seeing not just a national response but a global response to the crisis, commensurate with its global nature.

This financial crisis has been with us for more than a year. It was sparked by the end of the U.S. housing boom, which revealed the weaknesses and excesses that had occurred in subprime mortgage lending. However, as subsequent events have demonstrated, the problem was much broader than subprime lending. Large inflows of capital into the United States and other countries stimulated a reaching for yield, an underpricing of risk, excessive leverage, and the development of complex and opaque financial instruments that seemed to work well during the credit boom but have been shown to be fragile under stress. The unwinding of these developments, including a sharp deleveraging and a headlong retreat from credit risk, led to highly strained conditions in financial markets and a tightening of credit that has hamstrung economic growth.

The Federal Reserve responded to these developments in two broad ways. First, following classic tenets of central banking, the Fed has provided large amounts of liquidity to the financial system to cushion the effects of tight conditions in short-term funding markets. Second, to reduce the downside risks to growth emanating from the tightening of credit, the Fed, in a series of moves that began last September, has significantly lowered its target for the federal funds rate. Indeed, last week, in an unprecedented joint action with five other major central banks and in response to the adverse implications of the deepening crisis for the economic outlook, the Federal Reserve again eased the stance of monetary policy. We will continue to use all the tools at our disposal to improve market functioning and liquidity, to reduce pressures in key credit and funding markets, and to complement the steps the Treasury and foreign governments will be taking to strengthen the financial system.

Notwithstanding our efforts and those of other policymakers, the financial crisis intensified over the summer as mortgage-related assets deteriorated further, economic growth slowed, and uncertainty about the financial and economic outlook increased. As investors and creditors lost confidence in the ability of certain firms to meet their obligations, their access to capital markets as well as to short-term funding markets became increasingly impaired, and their stock prices fell sharply. Prominent companies that experienced this dynamic most acutely included the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac, the investment bank Lehman Brothers, and the insurance company American International Group (AIG).

The Federal Reserve believes that, whenever possible, the difficulties experienced by firms in financial distress should be addressed through private-sector arrange-

ments—for example, by raising new equity capital, as many firms have done; by negotiations leading to a merger or acquisition; or by an orderly wind-down. Government assistance should be provided with the greatest reluctance and only when the stability of the financial system, and thus the health of the broader economy, is at risk. In those cases when financial stability is broadly threatened, however, intervention to protect the public interest is not only justified but must be undertaken forcefully and without hesitation.

Fannie Mae and Freddie Mac present cases in point. To avoid unacceptably large dislocations in the mortgage markets, the financial sector, and the economy as a whole, the Federal Housing Finance Agency put Fannie and Freddie into conservatorship, and the Treasury, drawing on authorities recently granted by the Congress, made financial support available. The government's actions appear to have stabilized the GSEs, although, like virtually all other firms, they are experiencing effects of the current crisis. We have already seen benefits of their stabilization in the form of lower mortgage rates, which will help the housing market.

The difficulties at Lehman and AIG raised different issues. Like the GSEs, both companies were large, complex, and deeply embedded in our financial system. In both cases, the Treasury and the Federal Reserve sought private-sector solutions, but none was forthcoming. A public-sector solution for Lehman proved infeasible, as the firm could not post sufficient collateral to provide reasonable assurance that a loan from the Federal Reserve would be repaid, and the Treasury did not have the authority to absorb billions of dollars of expected losses to facilitate Lehman's acquisition by another firm. Consequently, little could be done except to attempt to ameliorate the effects of Lehman's failure on the financial system. Importantly, the financial rescue legislation, which I will discuss later, will give us better choices. In the future, the Treasury will have greater resources available to prevent the failure of a financial institution when such a failure would pose unacceptable risks to the financial system as a whole. The Federal Reserve will work closely and actively with the Treasury and other authorities to minimize systemic risk.

In the case of AIG, the Federal Reserve and the Treasury judged that a disorderly failure would have severely threatened global financial stability and the performance of the U.S. economy. We also judged that emergency Federal Reserve credit to AIG would be adequately secured by AIG's assets. To protect U.S. taxpayers and to mitigate the possibility that lending to AIG would encourage inappropriate risk-taking by financial firms in the future, the Federal Reserve ensured that the terms of the credit extended to AIG imposed significant costs and constraints on the firm's owners, managers, and creditors.

AIG's difficulties and Lehman's failure, along with growing concerns about the U.S. economy and other economies, contributed to extraordinarily turbulent conditions in global financial markets in recent weeks. Equity prices fell sharply. Withdrawals from prime money market mutual funds led them to reduce their holdings of commercial paper—an important source of financing for the nation's nonfinancial businesses as well as for many financial firms. The cost of short-term credit, where such credit has been available, jumped for virtually all firms, and liquidity dried up in many markets. By restricting flows of credit to households, businesses, and state and local governments, the turmoil in financial markets and the funding pressures on financial firms pose a significant threat to economic growth.

The Treasury and the Fed have taken a range of actions to address financial problems. To address illiquidity and impaired functioning in commercial paper markets, the Treasury implemented a temporary guarantee program for balances held in money market mutual funds to help stem the outflows from these funds. The Federal Reserve put in place a temporary lending facility that provides financing for banks to purchase high-quality asset-backed commercial paper from money market funds, thus reducing their need to sell the commercial paper into already distressed markets. Moreover, we soon will implement a new, temporary Commercial Paper Funding Facility that will provide a backstop to commercial paper markets by purchasing highly rated commercial paper directly from issuers at a term of three months when those markets are illiquid.

To address ongoing problems in interbank funding markets, the Federal Reserve has significantly increased the quantity of term funds it auctions to banks and accommodated heightened demands for temporary funding from banks and primary dealers. Also, to try to mitigate dollar funding pressures worldwide, we have greatly expanded reciprocal currency arrangements (so-called swap agreements) with other central banks. Indeed, this week we agreed to extend unlimited dollar funding to the European Central Bank, the Bank of England, the Bank of Japan, and the Swiss National Bank. These agreements enable foreign central banks to provide dollars to financial institutions in their jurisdictions, which helps improve the functioning of dollar funding markets globally and relieve pressures on U.S. funding

markets. It bears noting that these arrangements carry no risk to the U.S. taxpayer, as our loans are to the foreign central banks themselves, who take responsibility for the extension of dollar credit within their jurisdictions.

The expansion of Federal Reserve lending is helping financial firms cope with reduced access to their usual sources of funding and thus is supporting their lending to nonfinancial firms and households. Nonetheless, the intensification of the financial crisis over the past month or so made clear that a more powerful, comprehensive approach involving the fiscal authorities was needed to address these problems more effectively. On that basis, the Administration, with the support of the Federal Reserve, asked the Congress for a new program aimed at stabilizing our financial markets. The resulting legislation, the Emergency Economic Stabilization Act, provides important new tools for addressing the distress in financial markets and thus mitigating the risks to the economy. The act allows Treasury to buy troubled assets, to provide guarantees, and to inject capital to strengthen the balance sheets of financial institutions. The act also raises the limit on deposit insurance from $100,000 to $250,000 per account, effectively immediately.

The Troubled Asset Relief Program (TARP) authorized by the legislation will allow the Treasury, under the supervision of an oversight board that I will head, to undertake two highly complementary activities. First, the Treasury will use the TARP funds to help recapitalize our banking system by purchasing non-voting equity in financial institutions. Details of this program were announced yesterday. Initially, the Treasury will dedicate $250 billion toward purchases of preferred shares in banks and thrifts of all sizes. The program is voluntary and designed both to encourage participation by healthy institutions and to make it attractive for private capital to come in along with public capital. We look to strong institutions to participate in this capital program, because today even strong institutions are reluctant to expand their balance sheets to extend credit; with fresh capital, that constraint will be eased. The terms offered under the TARP include the acquisition by the Treasury of warrants to ensure that taxpayers receive a share of the upside as the financial system recovers. Moreover, as required by the legislation, institutions that receive capital will have to meet certain standards regarding executive compensation practices.

Second, the Treasury will use some of the resources provided under the bill to purchase troubled assets from banks and other financial institutions, in most cases using market-based mechanisms. Mortgage-related assets, including mortgage-backed securities and whole loans, will be the focus of the program, although the law permits flexibility in the types of assets purchased as needed to promote financial stability. Removing these assets from private balance sheets should increase liquidity and promote price discovery in the markets for these assets, thereby reducing investor uncertainty about the current value and prospects of financial institutions. Unclogging the markets for mortgage-related assets should put banks and other institutions in a better position to raise capital from the private sector and increase the willingness of counterparties to engage. With time, the provision of equity capital to the banking system and the purchase of troubled assets will help credit flow more freely, thus supporting economic growth.

These measures will lead to a much stronger financial system over time, but steps are also necessary to address the immediate problem of lack of trust and confidence. Accordingly, also announced yesterday was a plan by the Federal Deposit Insurance Corporation (FDIC) to provide a broad range of guarantees of the liabilities of FDIC-insured depository institutions, including their associated holding companies. The guarantee covers all newly issued senior unsecured debt, including commercial paper and interbank funding, and it will also cover all funds held in non-interest-bearing transactions accounts, such as payroll accounts. This broad guarantee will be effectively immediately, and fees for coverage will be waived for 30 days. After the 30-day grace period, banks may continue to participate in the guarantee program by paying reasonable fees.

I would like to stress once again that the taxpayers' interests were very much in our minds and those of the Congress when these programs were designed. The costs of the FDIC guarantee are expected to be covered by fees and assessments on the banking system, not by the taxpayer. In the case of the TARP program, the funds allocated are not simple expenditures, but rather acquisitions of assets or equity positions, which the Treasury will be able to sell or redeem down the road. Indeed, it is possible that taxpayers could turn a profit from the program, although, given the great uncertainties, no assurances can be provided. Moreover, the program is subject to extensive controls and to oversight by several bodies. The larger point, though, is that the economic benefit of these programs to taxpayers will not be determined primarily by the financial return to TARP funds, but rather by the impact of the program on the financial markets and the economy. If the TARP, together

with the other measures that have been taken, is successful in promoting financial stability and, consequently, in supporting stronger economic growth and job creation, it will have proved itself a very good investment indeed, to everyone's benefit.

Stabilization of the financial markets is a critical first step, but even if they stabilize as we hope they will, broader economic recovery will not happen right away. Economic activity had been decelerating even before the recent intensification of the crisis. The housing market continues to be a primary source of weakness in the real economy as well as in the financial markets, and we have seen marked slowdowns in consumer spending, business investment, and the labor market. Credit markets will take some time to unfreeze. And with the economies of our trading partners slowing, our export sales, which have been a source of strength, very probably will slow as well. These restraining influences on economic activity, however, will be offset somewhat by the favorable effects of lower prices for oil and other commodities on household purchasing power. Ultimately, the trajectory of economic activity beyond the next few quarters will depend greatly on the extent to which financial and credit markets return to more normal functioning.

Inflation has been elevated recently, reflecting the steep increases in the prices of oil, other commodities, and imports that occurred earlier this year, as well as some pass-through by firms of their higher costs of production. However, expected inflation, as measured by consumer surveys and inflation-indexed Treasury securities, has held steady or eased, and prices of imports now appear to be decelerating. These developments, together with the recent declines in prices of oil and other commodities as well as the likelihood that economic activity will fall short of potential for a time, should lead to rates of inflation more consistent with price stability.

This past weekend, the finance ministers and central bank governors of the Group of Seven industrialized countries met in Washington. We committed to work together to stabilize financial markets and restore the flow of credit to support global economic growth. We agreed to use all available tools to prevent failures that pose systemic risk. We affirmed we will ensure our deposit insurance programs instill confidence in the safety of savings. We agreed to ensure that our banks and other major financial intermediaries, as needed, can raise capital from public as well as private sources. We further agreed that we would take all necessary steps to unfreeze interbank and money markets, and that we will act to restart the secondary markets for mortgages and other securitized assets. Finally, we recognized that we should take these actions in ways that protect taxpayers and avoid potentially damaging effects on other countries. I believe that these are the right principles for action, and I see the steps announced by our government yesterday as fully consistent with them.

I have laid out for you today an extraordinary series of actions taken by policymakers throughout our government and around the globe. Americans can be confident that every resource is being brought to bear to address the current crisis: historical understanding, technical expertise, economic analysis, financial insight, and political leadership. I am not suggesting the way forward will be easy, but I strongly believe that we now have the tools we need to respond with the necessary force to these challenges. Although much work remains and more difficulties surely lie ahead, I remain confident that the American economy, with its great intrinsic vitality and aided by the measures now available, will emerge from this period with renewed vigor.

Mr. Ryan?

Mr. RYAN. Thank you, Chairman.

I enjoyed your speech at the Economic Club in New York last week. And I am also comforted by the fact that you are one of our Nation's leading scholars on what went wrong during the Great Depression. And particularly your work on adverse feedback loops I find very telling.

You suggested that fiscal policy was not a significant factor in addressing the problems during the Depression; instead, that monetary policy and stabilizing the banking sector were the key factors.

Don't we face a similar situation today, where our economic ills are due to problems in our financial services sector and the response of monetary authorities or lack thereof?

Mr. BERNANKE. Well, as I indicated, I thought the two critical lessons learned from the 1930s were, first, to have an appropriate monetary policy. In the 1930s, the Federal Reserve allowed prices

to fall at 10 percent a year, which is obviously, you know, not appropriate. Secondly, the second lesson is to try to stabilize the financial system, not allow the credit system to break down. And, again, the authorities failed to do that from 1929 to 1933.

Some of the steps that were most effective early in President Roosevelt's first term were reversing those problems. So I think those are very important. I think that is an important reason why, you know, why we are going to control and manage the situation. We won't be making those mistakes.

Again, as I said, a fiscal package is potentially helpful and worthwhile to be considered. But the composition and size of that, there are many different ways you could go on that. I think that is up to Congress to try to figure out.

Mr. RYAN. But the core component of our efforts to prevent a prolonged downturn is monetary, is what I am taking from that, and that there might be a fiscal complement to that.

Let me ask you this question. The next session of Congress, at the end of it, we have very large tax rate increases that will occur. And it is already embedded in the current law.

And if our goal and effort is to redeploy private capital, to bring savings and investment off the sidelines and redeploy them in the economy to create growth and get out of the recession, is it a good idea at the end of the next session to dramatically increase the after-tax rate of return on investment by increasing the tax on investment?

Dividends taxes, capital gains taxes, marginal income tax rates, all are scheduled to increase substantially by the end of the next session. In fact, this majority here passed a budget resolution which all but guarantees those things will happen. We are looking at legislation moving through here possibly as early as next March that might bring the top rate, which is the one that the passive entities, small businesses, subchapter S's pay, up to as high as 45 percent.

In this time of a recession, of a downturn, is it a good idea to dramatically raise the tax on investment, the tax on entrepreneurship, risk-taking, and on small businesses?

Mr. BERNANKE. Congressman, you are addressing two issues, both of which are relevant.

Mr. RYAN. But that is fiscal, and since we are here to talk about fiscal policy, there is spending and taxing components to fiscal policy.

Mr. BERNANKE. Absolutely, absolutely. But you are alluding to two different issues, both of which I think you are making good points.

You know, first, as you noted earlier, there is the Keynesian, or demand, effects of tax and spending policies. From that perspective, generally speaking, you would not want to have a net tax increase in the middle of a slowdown, and just from a demand perspective. And so that is certainly something you want to look at.

More generally, I think that—and this is the other issue—I think everyone would agree probably on the committee that our tax system needs improvement, it needs to be made more consistent with growth, more efficient. To the extent that improvements in the tax

code could be part of this program, if you do undertake one, that is only a good thing.

So both aspects of that, I think, are relevant as you think about these issues.

Mr. RYAN. Okay.

Let me ask you just one last question about your balance sheet. The Fed's balance sheet has grown considerably during this time, from I think about $900 billion pre-crisis to about $1.8 trillion today, as it established a number of these credit facilities to extend loans to private companies.

Does the expansion of the Fed's balance sheet present any difficulties for you in terms of your conduct of monetary policy? And are there any limitations on expanding your balance sheet further?

Mr. BERNANKE. First, Congressman, a good bit of that expansion is these swaps we have done with other central banks, which allows them to make dollar liquidity available in their own economies. And I would just note that there is no credit risk to us because their counterparties are those other central banks, and they are responsible for the lending and the credit risk.

The increase in the size of the balance sheet creates operational difficulties, obviously, managing all that. Generally speaking, however, it does not have a significant effect on monetary policy or inflation risk.

And one very important contribution there is what the Congress did in the recent emergency act, which gave the Federal Reserve the ability to pay interest on reserves. By paying interest on reserves, we are able to keep the short-term interest rate close to the committee's target and, therefore, maintain our monetary policy at the same time that we provide this extra liquidity to the system.

I would also just note for clarity that providing this liquidity does not increase the money supply. The money supply has grown slowly, and there is no inflationary impact.

Mr. RYAN. You are sterilizing this as you move——

Mr. BERNANKE. We are sterilizing, meaning that we are undoing the effects of the money supply, so there is no net effect on the money supply.

Mr. RYAN. Right. So just for laymen, as you pump money through the system to these facilities over here, you are mopping up excess money over there to make sure that there is a net no increase in the money supply, correct?

Mr. BERNANKE. Exactly.

Mr. RYAN. Thank you.

Chairman SPRATT. Mr. Doggett. Three minutes, Mr. Doggett.

Mr. DOGGETT. Thank you, Mr. Chairman.

While sincerely applauding your personal commitment to right our economy, I continue to have the same concerns about the effectiveness of the bailout and its fairness to taxpayers.

As of this morning, are you personally aware of any Federal employee at any relevant Federal regulatory entity who has been fired or demoted or disciplined in any way as a result of this debacle?

And since Congress approved this $700 billion bailout, are you personally aware of any request that has been made to anyone in the private sector responsible, whether they are on Wall Street or

somewhere else, for this debacle that they be replaced or just asked to take a pay cut?

Mr. BERNANKE. Well, on Wall Street there have been quite a few high-profile firings of CEOs based on their performance in the recent period.

Mr. DOGGETT. Since the bailout?

Mr. BERNANKE. The bailout was—you know, the capital injection was only last week. But there——

Mr. DOGGETT. Well, I am talking about since it was signed into law. There really have not been any requests that Treasury has made that any of those people be replaced, have they?

Mr. BERNANKE. So, the Treasury's approach is twofold. First, we want to strengthen our financial system so that the counterparties who deal with our banks will not be worried about their insolvency and will be willing to deal with them.

Mr. DOGGETT. I understand there may be a rationale for taking that course, but I just want to make it clear that there has been no removal of anyone from any Federal regulatory agency, or discipline, or any request that anyone since the bailout was signed into law be removed or asked not to take even a bonus on Wall Street.

Mr. BERNANKE. If the Treasury undertakes to deal with a mismanaged bank that is close to failure, then its terms will be much more Draconian and tough than the case where we are just trying to broaden the base of capital throughout our economy.

In the case of the Federal Reserve, I would mention that when we made this large loan to AIG Insurance, we——

Mr. DOGGETT. Yes, sir. That was before the bailout, and you did take some action there. But that has not been copied since then.

How about just a request that the individuals not be rewarded with a bonus this year?

As you know, when Deutsche Bank's CEO and many of its leading traders have pledged that they will waive millions in annual payouts, there is a recent report that six major U.S. banks have reserved a total of $70 billion for pay and bonuses this year, a substantial portion of which represents discretionary year-end bonuses.

Isn't the American taxpayer in this bailout just being asked to subsidize those executive compensation schemes and maintaining dividend payments?

And indeed, since the bailout bill, in the short period you described, hasn't Treasury actually weakened what I viewed as political pablum in the original bailout bill on golden parachutes by saying that you don't define a golden parachute as anything that is a mere three times normal pay and bonuses?

Mr. BERNANKE. Well, Congressman, my understanding—and you can follow up with Treasury—my understanding is that all of the provisions that Congress inserted with respect to executive compensation have been applied to every recipient of capital, which was not required by the bill. So there have been applications of what was in the bill. I don't think that Treasury has authority beyond what Congress gave it to insist on other restrictions.

Mr. DOGGETT. It did define a golden parachute as three times anything these banks want to pay their executives, didn't it?

Mr. BERNANKE. Yes.

Mr. DOGGETT. Thank you.

Chairman SPRATT. Mr. Garrett?

Mr. GARRETT. I thank the chairman and I thank the ranking member for holding this important meeting today.

And I thank the chairman, as well, for your important work, as always, during these amazingly difficult times.

You know, we are here primarily to discuss the idea of a new economic stimulus package. It was back earlier this past year, this year in February is when Congress passed 5140, which was the Economic Stimulus Act of 2008; $150 billion was said to be targeted, timely and temporary. And as I have said before, I am not sure how well it was targeted or timely, but the temporary aspect we can certainly attest to by the data that came after it.

And I am all in favor of returning the proverbial tax dollars back to the taxpayer. In that case, what we basically did was send $600 checks to folks for them to spend. But the data seemed to show that what you saw after that was simply a spike in retail sales for a short period of time. That is why I would say you had a temporary effect but no real stimulating effect overall on the economy.

And I am going to get back, if time remains, to ask you your comment on what really needs to be done to stimulate an economy. Is it just getting people to have a short period of time to be able to spend money, whether it is unemployment checks or some of the other ideas that are floating around now or the past ones, or whether you need some more what I would say is job creation-type things, encouraging assets that are sitting on the sidelines to get back into the mix?

But before I get to that, let me just ask you a couple other questions with what is going on. It was in your testimony, and I think I know some of the answers on this, but I will ask you anyway.

You said you are going to be buying, in the process of buying high-grade commercial paper. And I believe the answer will be, but I will ask you, the authority to do this—maybe you said this in your testimony—would be under section 13.3 of the Federal Reserve Act. Is that correct?

Mr. BERNANKE. Correct. That is correct.

Mr. GARRETT. Okay. I assume, but I will ask you, do you have the authority under that act, if exigent circumstances dictate and you see the need to, to go beyond high-grade paper to buy other things else to try to get the markets going again and what have you?

Mr. BERNANKE. The law requires that we be adequately secured. We are not allowed to make loans without security or some guarantee of repayment.

Our plan for a repayment in this case is three-fold: first, collateral when available; secondly, endorsements, which basically is a second signature; and third, that we are charging fees and spreads on those commercial paper credit to provide a cushion for credit purposes.

In principle, we could do further, but it would be much more difficult because we would need to have better—at a lower credit rating, we would have to find stronger guarantees to protect our lending.

Mr. GARRETT. I only have a few seconds here apparently. Do you have the authority to go out and actually buy mortgage-backed securities as well?

Mr. BERNANKE. We have that authority. We also have the—that is not even 13.3. We have the authority under just ordinary open market operations to buy—sorry—GSE-guaranteed only mortgage-backed securities.

Mr. GARRETT. Only GSEs. You don't have authority under 13.3 to buy other mortgage-backed securities?

Mr. BERNANKE. No.

Mr. GARRETT. You don't.

Chairman SPRATT. Mr. McGovern?

Mr. MCGOVERN. Thank you, Mr. Chairman.

Thank you very much for being here today. I have to tell you, in light of these difficult economic times, I wouldn't want to be you for anything in the world. But there are days I don't want to be me either, when I go home and talk to some of my constituents who are angry, who are frustrated and who are hurting.

And so I want to say as clearly as I can that the frustration over the Federal response to the economy goes deep and wide. People are not just reading about the economy, they are seeing and feeling what this lousy economy means in their 401(k)s, in their pensions and their mortgages and their jobs.

I went along with the $700 billion proposal presented by the administration, by you and others, modified by the House and Senate. And we talk a lot about how that package helps people not only on Wall Street but on Main Street. But, quite frankly, we are not doing nearly enough for the people who live on Main Street or any of the side streets where economic security is growing more and more precarious.

Now, we have given billions for banks, but very little for States and localities. And this financial crisis may be global, but all the cuts and the pain and the sacrifices seem to be local. Last week, my Governor from Massachusetts announced he is going to have to make huge spending cuts. And he is doing this because tax revenues are plunging, along with the stock and real estate market meltdowns.

And behind every one of these dollars that we talk about here in Washington are real people. And I think we need desperately here in Washington to help our States. We need to provide them with direct support, especially for Medicaid, for food stamps, for unemployment benefits, and for infrastructure projects that are ready to get up and running, which provide jobs, income and revenue.

So I guess, you know, you have kind of suggested that—well, I am trying to make it clear, to be clear here. I think it would be helpful for us for you to be as emphatic in favor of an economic stimulus package that would invest in our States and our local communities as you were in terms of this rescue package that we passed.

And one final question: How are you using your new authority under the Emergency Economic Stabilization Act to help State and local governments? Have you considered using any of the $700 billion to purchase State and municipal bonds from financial institu-

tions? And would you consider making a direct investment into primary bond insurers?

Mr. BERNANKE. Let me just—first of all, I am very concerned about the average person. That is my only motivation for what we are doing. I was very emphatic about the financial rescue plan because I think if the financial system crashes the implications for everyone in the country would be quite severe. I understand the need of Congress to try and address the problems of their constituents, and I think you should do so. That is your job, that is what you have been elected to do.

With respect to State and local—I should also remind you it is the Treasury that is, of course, running this program and their decisions. The bill suggests a focus on mortgage and mortgage-related securities, and I think that is where they are starting. But, you know, I suppose that alternatives would be possible.

I mentioned earlier the importance of allowing credit to flow more freely. This might be an area where the Federal Government could assist the State and local governments at lower cost by simply helping them obtain credit at more normal rates, which is one of the problems that they are facing right now.

Chairman SPRATT. Mr. Simpson?

Mr. SIMPSON. Thank you, Mr. Chairman.

Thank you, Mr. Chairman, for being here. We appreciate it very much.

Let me ask this question. It came to me a few weeks ago, or a few days ago, talking with the bankers and the home builders and the automobile dealers and the real estate agents in my State that have some concerns about the $250 billion we are putting into the financial markets.

And then I read this article in the Wall Street Journal that I am certain that you have read, and let me preface it with these comments. It says here, Treasury essentially forced nine major U.S. banks to agree to $125 billion from the Federal Government. Mr. Yingling of the American Bankers Association said, "Most banks are well-capitalized and do not need cash infusions."

And then it says, "Analysts, investors and some bankers applauded the government's rescue. They said it would help rebuild confidence in the industry and could set the stage for a wave of consolidation in which stronger companies take over their weaker rivals." And Mr. Kansas, the former CEO of North Fork Bancorp, said, "Banks are likely to use the government's capital to retire outstanding debt that pays a higher yield than the 5 percent on the government's preferred shares. They will reduce funding costs, boosting profits. Such moves will pad banks' profits without supporting the overall economy."

How do you respond to that? And do you think that is accurate? And is that what we are intending to do with the $250 billion?

Mr. BERNANKE. Well, first of all, let me be just clear, we are not throwing $250 billion out the window. What we are doing is buying preferred shares in strong companies that will pay a return and will be repaid. So it is an acquisition of assets, not a spending program.

Mr. SIMPSON. But isn't the purpose to get that money out into the market to free up capital?

Mr. BERNANKE. The purpose is to make those institutions stronger so that people will be willing to deal with them, which they were not previously. And that is why we were on the brink of a very serious banking crisis, which looks to be in better situation right now, looks to be having been averted.

Most importantly, though, by making the banks stronger, giving them more capital, it frees up their balance sheet, gives them more capacity to lend. We need them, over and above just being well-capitalized in a regulatory sense, we need them to have the capacity to make new loans and extend credit to our economy. Otherwise, the economy is not going to be able to grow.

Mr. SIMPSON. Is there anything that requires them to lend that money, that new capital that they get, rather than use it for mergers and acquisitions of less secure banks and so forth to grow, essentially?

I noticed that you have said one of the problems that you have in this whole environment is that we have allowed some companies to become too large to fail. Are we creating more of that?

Mr. BERNANKE. I don't think so. The capital is being spread across the country, to small banks as well as large banks. When you have this capital and you no longer have these tough balance sheet constraints, if you have the capital you should go out and lend it, if you have good opportunities.

Now, we can't force them to lend, because we don't want to force them to make bad loans. We want them to make good loans that are based on their assessment of credit quality. But that being said, a bank that has lots of extra capital is passing up profit opportunities if it doesn't make loans.

Mr. SIMPSON. Thank you.

Chairman SPRATT. Mr. Scott?

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. Chairman, you mentioned the need to take troubled assets off balance sheets. There is a difference between illiquid assets and worthless assets. And this is important, because lending authority is a function of the balance sheet of the bank and the capital accounts. You can get more money into the capital accounts if you mark to fair value rather than mark to market.

What is the status of that?

Mr. BERNANKE. Well, mark-to-market accounting is the province of the SEC and the FASB and so on. There have been some clarifications that have been issued, in particular that banks need not blindly follow market prices in cases where there are very few transactions and very illiquid markets.

Mr. SCOTT. So if you have a temporarily illiquid asset, you don't have to lose all of the value by marking to market.

Mr. BERNANKE. That has been a clarification in that direction, yes.

Mr. SCOTT. In buying stock, you get value, as you have indicated. Can this be done without any significant cost to the taxpayer?

Mr. BERNANKE. Well, I believe that all the banks will pay us back with interest. And I would expect that there would be no cost on these capital programs, or very limited cost.

Mr. SCOTT. And that would get capital into the banks' capital accounts so that they could have more lending authority.

Mr. BERNANKE. More lending capacity and greater confidence in terms of being able to deal with their counterparties.

Mr. SCOTT. And is there any suggestion that overpaying for worthless assets from all over the world is better than the targeted purchase of preferred shares, as you are doing?

Mr. BERNANKE. The plan is not to overpay for anything. The plan is to use market mechanisms to try and determine the appropriate pricing for those assets; in doing so, to unfreeze markets which are not currently giving good assessments of what the longer term values of those assets are, and to create more liquidity in those markets.

If that is successful, that will be an important contribution to try to get these markets going again and bringing private money in as well. But I do think that the capital program is valuable, and I supported that.

Mr. SCOTT. Thank you. The idea that we are not going to overpay for assets was a little murky during the consideration of the bill. There was every indication that we would.

Can I get chart number one?

In the 1990s, we made the tough choices in our budget and balanced the budget, went into surplus, and were rewarded with great economic numbers. The Dow was the best in 75 years, great jobs, in stark contrast to what is going on now.

What did we do right in the 1990s that we are not doing now?

Mr. BERNANKE. Well, part of what happened in the 1990s—you mentioned two things, the budget surplus and the Dow. I mean, those two things were connected. With the very high Dow, capital gains and other income was providing lots of revenue. So your view of the 1990s depends in part on whether you think the Dow was appropriately priced at the peak in the late 1990s. To the extent that it was a bubble, then part of that prosperity was not sustainable.

Mr. SCOTT. Well, I guess the harder we work and the more responsible we are, the luckier we get.

Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Tiberi?

Mr. TIBERI. Thank you, Mr. Chairman.

Thank you, Chairman, for being here today. I know you have a very difficult job.

Knocking on doors the last 2 days in two Columbus suburbs, I heard a lot of opinions, a lot of opinions from people who are pretty upset, upset with the $700 billion, the $250 billion infusion last week.

And a common theme was the only thing we did is create a deeper hole for our children to dig out of, in terms of debt for the future. And I would like you to comment on that.

But overall, if you could speak to this committee, but more importantly to the American people, on why that $250 billion infusion is a good thing for Main Street and side streets, as Mr. McGovern said, and why the overall package is important to Main Street and the side streets in our districts. Because people aren't feeling that that is helping with their problems.

Mr. BERNANKE. Congressman, I understand the communication problem that exists here. Let me just make a couple of comments.

The first is, the $700 billion headline number is an enormous number. It does not reflect anything like what we would expect to be the actual ultimate cost of this program to taxpayers. As has been discussed, we are acquiring assets for that money. And, in particular, the capital that we have injected into these banks, as long as the banks remain healthy, they will pay that capital back with interest, and the taxpayer will not be out any money.

In terms of why this is good for the person on Main Street, you know, I have studied these issues for many years as an academic. And what we have seen in the 1990s in East Asia, what we have seen in Japan, what we saw in Sweden, what we have seen in many other cases in the postwar period is that very severe financial crises lead inevitably to deep and protracted recessions. It is, therefore, essential to stabilize the financial system as soon as possible and to get credit flowing again.

And I think that we are seeing that we have made progress, that we did address this question early rather than late. And that gives us much better prospects for getting the economy going again early.

I think since the rescue package was passed, I suspect, evidently not from all your constituents, but I suspect more people are recognizing that the credit constraints really are hitting home. And the people can't get auto loans, that there are plenty of firms small and large that can't get ordinary credit, that housing mortgage credit is harder to get. These are direct consequences of our financial crisis. And things that stabilize the financial system and get credit flowing again will have direct and palpable benefits to people on Main Street and to the economy.

Mr. TIBERI. Just one final point to emphasize what Chairman Spratt said earlier. There appears at least to be a disconnect right now, because there are people who are concerned who are still losing their home or in neighborhoods where homes have been lost. There doesn't appear to be anything, in terms of what they are feeling, to help with that home foreclosure situation. Just something to put on your radar screen.

Thank you.

Chairman SPRATT. Mr. Baird?

Mr. BAIRD. Mr. Chairman, thank you very much.

Mr. Tiberi hit the nail on the head. The public doesn't yet get that we would have had a collapse. Now, you couldn't very well come to the public and say that, probably.

But what would have happened, in your mind, had we not passed the bill we passed recently?

Mr. BERNANKE. If we had not passed that bill, we would have not had the authority to do the capital injections we did last week. The Federal Reserve would not have had the ability to expand its balance sheet, because we would not have had the interest on reserves provision.

And the risk would have been, while all the other countries in the world, in Europe and elsewhere, were taking strong measures to protect their banks and protect their markets, that we would have had a very severe financial crisis in the United States that would have resulted in the failure of major institutions and would have led to a very severe and protracted recession in this country,

and that actions to remedy that a few months from now would not have been sufficient to undo the damage.

Mr. BAIRD. So if we translate that into the average guy, lost jobs, lost businesses, lost farms, lost homes, far more than we are seeing now.

Mr. BERNANKE. Absolutely.

Mr. BAIRD. That is what we have to help people understand.

Secondly, this issue of a fiscal stimulus. I favored the last time that we should have invested in infrastructure. We are talking now about investments in infrastructure, which could actually build things, tangible assets for a long time, and create jobs.

Can you discuss briefly that issue, if we do this and put people to work and build things?

Mr. BERNANKE. So, first of all, infrastructure is a form of capital. It pays a return if it is well-invested. That is a very good thing for the economy. It is very constructive.

Now, there is a somewhat separate issue here, though, which is, will it stimulate the economy in the relatively near term? And there the question really turns on, how much extra spending and employment will you get from infrastructure projects that you would not otherwise have had? And the concern usually has been that infrastructure projects take a long time to plan and develop, and once the project starts, it takes a number of years, so that the actual implications for near-term activity are limited.

To the extent that that problem can be addressed—and I don't honestly know to what extent there are things on the shelf that can be pulled off or maintenance that could be not deferred or things of that sort; that is a question you have to determine——

Mr. BAIRD. Let me interject on that.

Mr. BERNANKE [continuing]. That could be helpful.

Mr. BAIRD. In my district, schools, roads, bridges, water treatment projects are waiting to be done—permitted, designed, ready to go. They lack the capital. And I think that is the case nationwide. And we have studied that on the Transportation and Infrastructure Committee. And to my way of thinking, if we are going to do this, I will tell you, much better than a tax cut.

And the final thing I would say is, I find it just so intriguing that my friends on the other side would suggest that tax increases are somehow going to cripple the economy and then turn around and say we are passing more debt onto our children. We are passing debt onto our children largely because of the tax deficit that has been created and because of the costs of this conflict.

Thank you, Mr. Chairman.

Chairman SPRATT. Ms. Kaptur?

Ms. KAPTUR. Thank you.

Mr. Chairman, welcome. I know you are a voice of reason in these discussions. And in my very brief time, I would like to render some opinions, perhaps that some might be able to use.

I view as most curious, uneven and incomplete the set of administration's actions being taken to address this meltdown. And what I see happening is a greater concentration toward the big banks, many of whom were wrongdoers in my opinion, rewarding the irresponsible, and new costs being imposed on community banks, for example, that very much were not a part of making the bad loans.

Number two, I view the bursting of the housing bubble as the key element in the meltdown, yet nothing is being done now to address the rising foreclosure rates in places like Ohio. And if we don't do workouts now or get a moratorium for a brief period of time, we are going to see this problem being exacerbated into this last quarter and next year.

Number three, the purchase by the government of bad loans made by bad lenders remains a bad idea. And I would urge you to use market discipline to help resolve the situation, as you well know was done in the 1930s and certainly in the 1980s.

And I would ask you to look to the FDIC—though I know you are not directly involved, you are in administration meetings on this—look to get the FDIC to use its full emergency powers to protect all general creditors of those banks with the fraud exception. That has not been done. The administration is slowly getting there, but it isn't there yet. That is the most important thing that can be done to engender confidence in the system.

Number two, urge the FDIC to employ the Net Worth Certificate Program we successfully used back in the 1980s, rather than the TARP program, which essentially rewards the bad actors.

Number three, urge the SEC to mark housing loans from an accounting perspective to true market economic value, as opposed to an arbitrary index.

Finally, I wanted to say that I think the Fed has an important role to play in sorting out the bad actors. What is surprising to me, though, through all of this, though Countrywide was a major mortgage lender, and the New York Times reported yesterday they were Fannie's biggest mortgage client, the September 2004 audit showed that in six of Countrywide's largest regions, one in eight of their loans was severely unsatisfactory because of shoddy underwriting, yet the Federal Reserve's New York office maintained them on their list of primary dealers, security dealers, for the Fed, until they were purchased by Bank of America this year.

So in 1999, 2000, 2001, 2002, 2003, 2004, 2005, 2006, 2007, 2008, the Fed was saying, Give them a green light. Frankly, I don't understand that and wonder if you could respond.

Mr. BERNANKE. Certainly.

First of all, on Countrywide, the primary dealer is a totally separate company from the mortgage lender. The quality of that dealer and its operations is independent of what the other part is doing.

On foreclosures, I agree with you that stopping preventable foreclosures is extraordinarily important. It will help the housing market, it will help communities, it will save us money in the long run; and I hope that we will look to continue ways to do that. I am very much in favor of that.

On community banks, community banks did not make subprime loans, but they do have other commercial real estate and other loans which are problematic. Some of them do need capital. Some of them will be selling to the asset program. I think it is very important that whatever we do, that it not disfavor community banks, that it maintain the diversity and strength of our community banking system; and I support that very strongly.

Ms. KAPTUR. Mr. Chairman, could I just ask the Chairman of the Fed if he could provide for the record the difference between Countrywide and Countrywide.

Mr. BERNANKE. They are two separate companies, the primary dealer and the—-

Ms. KAPTUR. There is no relationship between them at all?

Mr. BERNANKE. Not in terms of—the primary dealer doesn't make mortgage loans.

Chairman SPRATT. Ms. Tsongas.

Ms. TSONGAS. Thank you.

Mr. Bernanke, thank you for your service, as you have heard from all of us, in this time of tremendous turmoil and uncertainty.

I, too, like Mr. McGovern, just returned from Massachusetts this morning. As you know and as he indicated, our State has experienced tremendous fiscal stress with a shortfall in its budget of over a billion dollars. The governor and legislature are working to address it, but you can imagine it is a most difficult time.

My question really is, as they work to make significant cuts that will reduce services both within State government across our communities and the many organizations—nonprofit and otherwise—that are affected, if this doesn't simply serve in the end to further weaken the broader economy, wouldn't we be wise to consider some relief in the next stimulus package?

Mr. BERNANKE. From a spending perspective, to the extent that relief leads the States and localities to restore services, to conduct greater maintenance and those sorts of things, it does contribute to demand and would be part of a stimulus package. You don't want to be in a situation where you are compensating them for past spending or putting money in the rainy-day fund, because that doesn't help the current situation in terms of spending and activity.

I reiterate what I said before, which is: One way to approach this, one problem that they are facing now, as you well know, is that the municipal bond markets are not functioning well, and they are facing very high interest rates and finding it very difficult to obtain credit. Addressing that issue might be one way to be of assistance to States and localities.

Ms. TSONGAS. Well, it is my understanding, if we were to include some relief in a stimulus package, that it would address the—that there wouldn't be enough to really make up for the all the shortfall across the board, across the many State governments, so that it really would be more just a way of helping to avoid some of the really dramatic cuts that are going to have to take place.

Mr. BERNANKE. Thank you.

Chairman SPRATT. You yield back your time.

Dr. Bernanke and Mr. Chairman, we are at the 11:00 hour. I have got six more questioners. I can reduce that to 2½ minutes, and we will get you out of here in 15 minutes, if that is agreeable.

Mr. BERNANKE. Thank you, sir.

Chairman SPRATT. Mr. Moore of Kansas.

Mr. MOOREE OF KANSAS. Thank you, Mr. Chairman, for being here. I think a lot of us would agree that one of the worst political blunders here was using the term "bailout" instead of "economic rescue" or "economic recovery," because it was never, never my intention, and I think a lot of others' either, to bail out Wall Street,

but to try to protect the people on Main Street, back around our homes and in our congressional districts, who are in retirement, are nearing retirement, who have 401(k)s or otherwise invested in the stock market, who took a terrible, terrible beating here.

That is the only reason I voted for this package. Am I correct, or am I looking at this incorrectly?

Mr. BERNANKE. That is absolutely correct, and that is the only reason I supported the package.

Mr. MOORE OF KANSAS. Thank you. That answers my question. Thank you, sir.

Chairman SPRATT. Mr. Blumenauer of Oregon.

Mr. BLUMENAUER. Thank you, Mr. Chairman.

Mr. Chairman, I am curious, you referenced from the outset that part of what started this cascade appeared to be problems in the housing market, precipitous decline that led to a series of other things unraveling.

I am curious if you see an opportunity in the short term to do something dramatic to change their status vis-a-vis bankruptcy law or other Federal intervention that could help stabilize it; and, second, if you are concerned at all about further unraveling on Wall Street due to hedge funds that are having massive claims, evidently made against them for cash that might continue the downward slide over the course of the next couple of months.

Mr. BERNANKE. On the first question, we have to keep in mind how big the housing sector is—I mean, an $18 trillion sector. It would be very difficult, even for the Federal Government, to put a floor under housing prices as a general matter. I think the two best ways to address the housing issue are, first——

Mr. BLUMENAUER. May I just, if I may, we—in business and vacation homes, we allow, in bankruptcy, people to go directly to the market. The Federal Government doesn't have to do this. This is part of the bankruptcy provision, for example.

Aren't there mechanisms that could be done similar to that that get us out of that box?

Mr. BERNANKE. Well, I was going to say, I think the two best ways to approach the housing market, one of them which relates to what you are saying, is to help prevent preventable foreclosures. Steps have been taken in that direction.

I would support further steps to try to make sure that everyone who can afford to stay, who has sustained a mortgage and wants to stay in the home, is able to stay in the home. I think there are ways to address that.

The second thing is, again, part of our problem is that the mortgage markets are not working properly. Taking steps to strengthen the mortgage markets and make mortgage credit more available to the public, I think would also be an important step to try to stabilize housing.

On hedge funds: Hedge funds, a number of them have taken a lot of losses right now, but that is appropriate. They are risk takers, and as they have made bad guesses—or as many people have—of course they have lost and their investors have lost.

Chairman SPRATT. Ms. DeLauro.

Ms. DELAURO. Thank you, Mr. Chairman.

Dr. Bernanke, are we in a recession, your judgment, are we in a recession now? Yes or no.

Mr. BERNANKE. Well, I don't think it is a fair question for the following reason: A recession is a technical term that was created by academics for studying a certain pattern.

Ms. DELAURO. We have got many economists, one coming this afternoon from Brookings, who says that there is a recession. Are we in a recession now?

Mr. BERNANKE. We are in a serious slowdown in the economy, which has very significant consequences for the public. Whether it is called a "recession" or not is of no consequence.

Ms. DELAURO. Moving from there, then, to what a—in Friday's New York Times, Paul Krugman wrote the following, "There is not much Ben Bernanke can do for the economy. He can and should cut interest rates even more, but nobody expects this to be more than provide a slight economic boost."

Let's talk about the Federal Government. What size should an economic recovery package be? $150 billion? $300 billion?

Dr. Bernanke, you are an economist. Besides being the head of the Fed, you have a Ph.D. from Harvard in economics. Give us your best judgment in terms of you are also a student of the Depression. Let us know what size this ought to be.

I have got to move quickly because I have got just a few minutes. I want to talk about what should make up that in your view—not mine or my colleagues', you as an economist, Dr. Bernanke.

Mr. BERNANKE. Well, I am an economist. You will hear many other economists who will give their views.

I think that this is partly—has to do with the composition and the debate that you all will have about what is appropriate to put into this.

I cannot tell you, as Congress, what number you should pass. That is up to you.

Ms. DELAURO. What would you suggest, 150?

Mr. BERNANKE. If you undertake a fiscal package, given the slowing of the economy, I think it should be significant, but I can't give you a number.

Ms. DELAURO. Okay. The pieces of it, investing in maintaining roads, bridges, schools, alternative sources of energy, of projects as a way to create jobs and to put disposable income in the hands of a consumer. Yes? No?

Mr. BERNANKE. Those are very valuable things to do. But in terms of their short-term stimulus, as I mentioned to somebody earlier, it depends on what the timing is. Will you have these things up and running with people working in your term or not?

Ms. DELAURO. We believe they can. Is it a good thing? The answer apparently is yes.

Okay, helping States and localities to prevent cuts in services—health care, police services, construction jobs—yes or no?

Mr. BERNANKE. If it involves additional services and spending in the short term and if those are valuable services, then that would be constructive from the point of view of spending and growth.

Ms. DELAURO. Extension of the UI benefits?

Mr. BERNANKE. I think you have done that already, right?

Ms. DELAURO. No, no. We passed it in the House. It didn't pass in the Senate. The President says that, in fact, if we did that—quite frankly, he said that people would stop looking for jobs.

Mr. BERNANKE. I am quite sure that the UI benefits were extended. There is a temporary extension, emergency extension of unemployment compensation.

Chairman SPRATT. Goes from 39 weeks to 52.

Ms. DELAURO. This is a new extension we are talking about. This is a new extension, because 800,000 people, as of the end of this month, are going to lose their benefits. We did that in the past. We are now talking now, which we did pass in the House before.

Thank you, Mr. Chairman.

Chairman SPRATT. Ms. Moore.

Ms. MOORE OF WISCONSIN. Thank you, Mr. Chairman.

You had said in your speech to the Economic Club of New York that the financial crisis was much broader than subprime lending, large inflows of capital in the United States and other countries stimulated reaching for yield and under-pricing of risk, excessive leverage under the development of complex and opaque financial instruments.

My question is, is some of our economic stimulus money going to be used for what I hear, different numbers—$60 trillion, perhaps—to secure these opaque financial instruments?

Mr. BERNANKE. Are you referring to the $700 billion?

Ms. MOORE OF WISCONSIN. Yes.

Mr. BERNANKE. Well, again, a good part of that is going to go into capital, as we have already seen; and then parts that go into buying assets will be done for the most part——

Ms. MOORE OF WISCONSIN. Mortgage-related assets with underlying houses, raggedy as they may be, versus these opaque instruments.

Mr. BERNANKE. Well, unfortunately, a lot of mortgages are held in these complex instruments.

Ms. MOORE OF WISCONSIN. Okay, let me ask a question before my time runs out.

I see a lot of commercials talking about how Freddie and Fannie just have precipitated this entire financial downturn. Then I note that James Lockhart, the agency director of the Federal Housing Finance Agency, has said that of the $12 trillion in outstanding mortgages, these troubled assets, the 2 to 4 percent of them, are being held by Fannie and Freddie, versus nonbanking entities like Countrywide that were responsible for, like, 84 percent of these.

Is that correct, that 2 to 4 percent of these troubled assets are being held by Fannie and Freddie?

Mr. BERNANKE. I had not heard that number. I know they have some bad assets.

Ms. MOORE OF WISCONSIN. This is a quote by James Lockhart.

Mr. BERNANKE. I would like to see the context of that number.

I think the problem with Fannie and Freddie was, as the Federal Reserve pointed out for many years, they didn't have enough capital to bear against the amount of risk they were taking in their portfolio.

Ms. MOORE OF WISCONSIN. The risk for troubled assets or just their mortgages, period?

Mr. BERNANKE. They certainly have a lot of assets. A lot of mortgages have problems, and we discovered that when we went in and looked at the losses and evaluated their portfolios.

Ms. MOORE OF WISCONSIN. Is it a fair statement that some of these nonbanking internationals like Countrywide have been the precipitating factor in underwriting these troubled assets versus some sort of statement that Fannie and Freddie sort of led the charge into this economic crisis?

Mr. BERNANKE. I think the main contribution that Fannie and Freddie made was having insufficient capital. That was their main problem.

Ms. MOORE OF WISCONSIN. Insufficient capital versus the poor, criminal underwriting. Thank you.

Chairman SPRATT. Ms. Schwartz of Pennsylvania.

Ms. SCHWARTZ. Thank you very much.

Thank you, Mr. Chairman. I think you are going to you can hear from many of us the frustration we are expressing on behalf of our constituents about, is this working, how is it going to work in both the short-term and long term.

I wanted to follow up on the previous questions. We are certainly looking at what we can do in the short term, and we feel an obligation to take some action.

We have done some already to give you and, of course, and Secretary some authority to get us out of the situation we are in right now, some economic stabilization and, hopefully, renewed investor confidence, some capital in the markets. But what I wanted to ask about is what we can do in both the short and long term, going forward, so I want to look at not just the short term but the long term.

We have had years of failures of investments in innovation and new technologies—energy technologies, we have just done some of that. But what would you say, going forward, we ought to be doing as we look at both infrastructure in the short term, but long term—investments in education, investment in helping small businesses be able to do that innovation and new technology.

If we don't start to grow new businesses, we are going to continue to talk about how do we just get out some recovery for Wall Street? I mean, what my constituents are saying to me is how are we going to create those new jobs that really matter to them in their district.

It seems to me the only way we do that is to use some of our clout and, potentially, tax policy, as well as government funding, for investment encouragement incentives for innovation, cutting-edge technologies, new jobs of the future, educate our workforce for the future.

Do you agree with that, or do you think that what we have done is enough for us to go forward when we leave the free market?

Mr. BERNANKE. Well, what we are doing right now is trying to stabilize our short-term financial crisis and the associated effects on the economy.

But for the long term, we want to make all kinds of investments, human capital investments. Education is critically important, workforce skills. R&D technology is a critical part of our portfolio, other kinds of investments from energy to infrastructure to private

capital. So all of these things are very important for long-term growth.

Ms. SCHWARTZ. Thank you very much.

Do you want to give us some advice about how we deal with that, given the national debt that we are in and the increased national debt we are going to see this year.

Mr. BERNANKE. Well, a lot of private—a lot of capital investment takes place—can take place in the private sector.

Ms. SCHWARTZ. It should.

Mr. BERNANKE. But clearly there are going to have to be some very tough choices made.

Part of the problem here is that we have an aging population, which is going to create additional needs through entitlements and so on. You have a very tough job ahead of you.

Ms. SCHWARTZ. But, nonetheless, you are recommending that we make some of those kinds of investments in order to be able to create the jobs——

Mr. BERNANKE. Our society as a whole needs to make investments in both people and in physical capital.

Ms. SCHWARTZ. Thank you, Mr. Chairman.

Chairman SPRATT. Last member, Mr. Becerra of California.

Mr. BECERRA. Thank you, Mr. Chairman.

Mr. Chairman, thank you for staying the extra time. Perhaps on another occasion when you have the time, we will have an opportunity to flesh out the elements of what would make a good fiscal package to lead to further economic recovery. But I do appreciate the comments you have made to date with regard to the potential for a good stimulus or a fiscal and economic recovery package.

I do want to make notes that I appreciate your words with regard to the Tax Code and how improvements to it could be a very good thing. So perhaps we could flesh that out with you later on in the future as well.

I wanted to move towards this whole issue of the way the markets are reacting. It seems to me that everyone agrees that the markets always yearn for stability, some predictability. I think you would agree with that.

One of the problems that we have seen with this crisis is that they have had little sense of predictability and stability about what might happen with the financing of the different markets. But to some degree, the markets always try to anticipate what is going to happen. Maybe they are not able to do it today because they always try to forecast, and to the degree possible, factor into their investment decisions what they see ahead or what might be around the corner.

Would you agree with that?

Mr. BERNANKE. Of course, yes.

Mr. BECERRA. I know that they are constantly trying to forecast what you will do on interest rates. They certainly were forecasting what we would do with regard to this $700 billion package, and I suspect they will continue to try to forecast and anticipate what we do.

Would you agree with that?

Mr. BERNANKE. Yes.

Mr. BECERRA. When we come to this next administration, next Congress, we are going to be facing the Bush tax cuts which begin to expire at the end of 2010. The markets have known that, Wall Street has known that; we have known that in 2010 the Bush tax cuts would be expiring.

I would think that for the same reasons that the markets yearn for predictability and stability and always try to forecast and factor in what they will do with their investment decisions, given what they see ahead of them, that they must be factoring in and to some degree anticipating what might happen when 2010 arrives with regard to those Bush tax cuts.

Would you agree with that?

Mr. BERNANKE. Yes. But there are a lot of other uncertainties and factors as well.

Mr. BECERRA. I understand that completely. Nothing is totally predictable.

But to the degree that they see before them a law that is set to expire at the end of 2010, that affects much of what they do because of the taxes that are implicated, to some degree you would think that since 2001 and 2003 when the Bush tax cuts were first passed, they have had to be in the process of trying to forecast where we would head in fiscal policy here in Congress and the White House come the end of 2010.

Mr. BERNANKE. I would think so, yes.

Mr. BECERRA. I appreciate that.

Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Chairman, thank you very much for your testimony, for coming today, for your forthright answers, and not least for your forbearance. We very much appreciate it, and thank you for your input to our process.

Mr. BERNANKE. Thank you, Mr. Chairman.

Chairman SPRATT. Our next panel will explore more specifically the options before us, concrete measures that we might take.

This panel consists of Martin Baily, who is now a Senior Fellow at The Brookings Institution, but was formerly the Chairman of the Council of Economic Advisers for President Clinton; Iris Lav, Deputy Director of the Center on Budget and Policy Priorities; and William Beach, Director of the Center for Data Analysis at The Heritage Foundation.

STATEMENTS OF MARTIN N. BAILY, PH.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION; IRIS J. LAV, DEPUTY DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES; AND WILLIAM W. BEACH, DIRECTOR, CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION

Chairman SPRATT. Thank you all for coming. We look forward to your testimony.

We have your testimony prefiled and as a matter of procedure make it a part of the record, if there is no objection, so that you can summarize it as you see fit.

Let's begin with Mr. Baily.

STATEMENT OF MARTIN N. BAILY, PH.D.

Mr. BAILY. Thank you very much, Chairman Spratt, Representative Ryan and other members of the committee. I appreciate the opportunity to speak.

My own perception of the economy accords very closely with the one that Chairman Bernanke gave. I do think we are in a recession, which has declined GDP, and GDP has been declining since the middle of the year.

Some forecasters are saying this will be a mild recession, and I think it may be. There is a good deal of uncertainty about that. But increasingly we are seeing forecasts of a more severe recession, and I think that is rather likely—I say here about a 25 percent probability of what I call a very severe recession, which would perhaps involve as much as a 4 percent decline in GDP in the last quarter of this year and again in the first quarter of next year and a continuing, perhaps smaller decline in the second quarter.

I don't think that is inevitable. I think there are things that Congress could do, including the stimulus package that is the subject of this hearing to try to avert a more severe crisis. I think it is important that those things be done.

Now, obviously, as many of you have said in this hearing and elsewhere, the housing market has been at the center of this recession and the likelihood of a more severe recession. So I think it is a priority to do something about the housing market.

We have talked a lot already about the injection of capital, which I support, in the finance institutions. I disagree with the sentiments that have been expressed here that that injection and perhaps taking some of the distressed assets is a crucial part of reinvigorating the banking and financial system and is essential to the recovery of the Main Street economy. I do think it would be helpful to do something more direct on the housing side also.

I am a little unsure myself exactly how that $700 billion is going to be allocated to different uses. Of course, there was money that was put into Fannie and Freddie that can expand their mortgage lending. So whether this particular package you are considering now should include money for housing or not, I am not certain of that.

I think there need to be additional funds put into housing. If it is not available in the money that has already been appropriated, then I think some additional should be put there.

I won't go over some of the issues around exports, commodity prices; Chairman Bernanke mentioned that already, and I agree with the things that he said.

Let me go—turn my attention more to how large I think the package should be, a stimulus package and what it should contain.

I have a little sympathy with Chairman Bernanke, as you were pressing him, having been in an official position myself, I think he naturally wants to avoid trying to have a dominant role in fiscal policy; he feels monetary policy, his view. But since I am not in his shoes, I will be more specific.

I just sort of look at a kind of rule of thumb, although I am fairly familiar with the forecasting models that do this more professionally. It looks to me that a package—that Congress is looking at about the right range, $150-300 billion. The 150, I think if the

mild recession scenario is true—and, of course, a lot of dynamics of that are already unfolding—if that scenario were to be true, then I think 150 would get us back—would avoid at least a severe recession and would get us back growing again in 2009.

Since I think that mild scenario recession is a little too optimistic, I think we probably will need a package that is somewhat larger than that.

At the same time, like many of the members of this committee, I am very concerned about the amounts that we are adding to the budget deficit and the effect that will have on future generations and their ability to service that debt and repay that debt. So I would not like to see this go over the $300 billion mark and not have too many Christmas tree ornaments on it, but to keep it under that.

In fact, I proposed that perhaps there will be a package in two tranches of $200 billion that would be made now, and an additional $100 billion that would be agreed upon, but that would not actually take place unless the unemployment rate went over 7.5. I don't know exactly what the right trigger is, but I wanted to put some number out there. I think we are quite likely to see an unemployment rate over 7.5.

Now, what should be the elements in it? I have already mentioned the need for stabilizing the housing market. As I say, I find it attractive to, perhaps through Fannie and Freddie, make available mortgages at somewhere between 5 and 6 percent. That has gotten a proposal from Glenn Hubbard, who was the Chairman of the Council in the beginning of the Bush administration. I am supporting it.

Some of my colleagues at Brookings support that, making—allowing people to roll into a mortgage at roughly what we think would be a market rate if we didn't have a crisis. Glenn Hubbard said 5.25; maybe it is that, maybe it is 5.5, but somewhere in that range, so as to avoid some of the effects of interest rate resets that would take place.

Now, some of those mortgages that are currently held would involve prepayment penalties, that people have been given a low teaser rate at the beginning. So if they try to repay that mortgage, there are some penalty provisions within it.

I don't want to try to bail out people who have made bad decisions all around, but I think there were some loans that were made, that were originated, where the people did not know what they were getting into; and I think there is a case for helping them. So I do think there is a case for readjusting some of those penalties downwards, or perhaps rolling them into the next mortgage so that those prepayment penalties did not become an obstacle to acquiring a more affordable mortgage.

I do think that the tax rebates that we had last time were a good move, and I think we should do them again. One of reasons I think that is attractive is that the IRS could use the same list they used before. We could get this money out of the door very quickly. Since we are in, I think, a recession, and threatening by the fourth quarter of this year that we may be in a severe recession, I think there is a lot to be said for getting some money out as tax rebates as we did earlier.

Those tax rebates, people argue about how effective they were. I think they meant the consumption was higher than it would have been without the tax rebates. I don't think every dollar will get spent, but I do think most of it will get spent over the space of three or four quarters.

There has been some discussion here about unemployment insurance. I do think we should try to make sure that people are not losing their unemployment benefits. There is a danger with unemployment insurance where people remain unemployed, but I think in the current situation it would be a mistake to have people lose their unemployment benefits.

I am also concerned about the fact that the number, the fraction of unemployed covered by unemployment insurance, is not very high and is down compared to what it was historically. It has been low for a while, but—so I propose here that perhaps we should look at extending unemployment insurance to people who are not currently getting it.

I think part-time workers, who are often women, miss out on unemployment benefits; and I mention what was done in 1975. Some of my colleagues, I would say, say to me, we don't want to try a new program now, we have got to do this quickly. But I think I want to leave this on the table as something that should be considered.

On infrastructure, there has been a lot of mention of infrastructure. I share the concern that Chairman Bernanke had that we don't want stuff that is going to roll out very slowly. But I do think there are some maintenance expenditures and some stuff that is ready to go that is being described here that could be preserved, that would go right into preserving jobs and increasing the benefits of the Nation's infrastructure.

I mentioned a couple of other things, State aid and business tax changes, but I think I am going to go quickly to the two items that I think might stand in the way of a fiscal stimulus package. One is, would a fiscal stimulus package cause a run on treasuries or a run on the dollar? I don't believe so. I think it is reasonable to worry about that; we are escalating the deficit and the debt, and we certainly don't want to undermine the full faith and credit of the United States, but there is certainly no sign in markets that that is an issue right now. In fact, Treasury interest rates have been low. There has been a flight to quality and, actually, the dollar.

I actually welcomed the decline in the dollar that took place after 2002, because I think it made our manufacturing sector more competitive. I don't want to see the dollar go back up to where it was, but it has actually been stronger in the last few weeks than at its low point. I think it was well over 1.50 to the Euro, 1.56 or something, and know it is substantially higher than that. So we are not seeing a run on the dollar.

Then, finally, on inflation, I have a lot of confidence on the Federal Reserve that they are going to keep inflation under control. We have a weak economy, commodity prices are falling, as Bernanke mentioned, inflation expectations are easing.

So, again, while I don't like the inflationary consequences of escalating the deficit and the debt, I don't think inflation is our biggest concern right now.

Thank you.

Chairman SPRATT. Thank you, Dr. Baily.

[The statement of Mr. Baily follows:]

PREPARED STATEMENT OF MARTIN NEIL BAILY, THE BROOKINGS INSTITUTION

The author is a Senior Fellow and Director of the Initiative on Business and Public Policy at The Brookings Institution in Washington DC. He was previously the Chairman of the Council of Economic Advisers and a member of President Clinton's cabinet (1999-2001). He also served as a Member of the Council (1994-96). He would like to thank Barry Bosworth, William Gale, Robert Litan, Ezra Greenberg and Charles Schultze for very helpful comments, but the views expressed here are those of the author only.

KEY POINTS IN THIS TESTIMONY

- The steps now being taken to ease the financial crisis are the right ones and I expect to see credit conditions easing gradually.
- The Main Street economy of jobs and production is now very weak and the housing market has not yet stabilized. We are in a recession and the only question is how deep it will be.
- Policymakers are debating a fiscal stimulus package of between $150 billion and $300 billion and that is the right range to be thinking about.
- According to the Blue Chip forecast, GDP declined in the third quarter and there will be a mild recession with a further decline in the fourth quarter. With a mild recession scenario like this, a stimulus package of $150 billion would be enough to get the economy back on a growth path.
- The Blue Chip is too optimistic, however, and the chances for a severe recession are pretty high, in which GDP would decline at a 4 percent annual rate in both the fourth quarter of 2008 and the first quarter of 2009, with continuing but smaller declines until late in 2009. Under this scenario a stimulus package of $300 billion would be enough to ameliorate the recession substantially, although it would not eliminate it.
- Given the uncertainty involved, I recommend an immediate stimulus package of $200 billion and the preparation of an additional stimulus of $100 billion that is triggered if unemployment goes over 7.5 percent.
- It is vital to stabilize the housing market. Some of the funds in the financial rescue package should be used to help households directly. If more funds are needed, a portion of the stimulus package should be used for this purpose. Enabling families to move into 30-year fixed rate mortgages through Fannie and Freddie at a rate of interest between 5 and 6 percent is an attractive approach to providing this assistance.
- It is vital that a stimulus work quickly and provide as much boost to spending as possible. A further round of tax rebates to be distributed this fall would get help to the economy quickly.
- Other possible approaches include assistance for unemployment insurance, and aid to states and localities. The latter could include funds for infrastructure, provided this does not slow down disbursement. Increased maintenance of our existing infrastructure is vital and would add to jobs quickly.
- The explosion of federal debt is very troubling and must be addressed by Congress once the crisis is past. Concerns about the marketability of Treasury securities and about inflation are real but not great enough to counter the urgent need for a new fiscal stimulus.

THE OUTLOOK FOR THE U.S. ECONOMY [1]

The U.S. and global economies have been severely stressed by the crisis in financial markets. The drying up of lending has adversely impacted both the business and consumer sectors. Many economists at Brookings, along with others, have advocated the use of direct capital injection into financial institutions to recapitalize them and allow the resumption of bank lending and thanks to the actions of Con-

[1] The discussion in this section has benefitted from my work as an advisor to the McKinsey Global Institute. I have also benefited from the analysis of Macroeconomic Advisers and other forecasters. The views are the author's own.

gress, the Treasury has both the funds and the authority to accomplish this and has now started the process of recapitalization. It would have been better had this process started earlier, but I am cautiously optimistic that the steps now being taken here in the United States as well as by other countries will be enough to stabilize the financial sector. Given that this crisis has repeatedly turned out to be worse than expected, however, that may not be the case and Congress and the Administration must stand ready to do whatever is needed to restore an effective financial sector. A strong financial sector is essential to overall economic growth and the recovery of Main Street. It is reasonable to expect that taxpayers be protected as far as possible and share in any future capital gains that result from the rescue, but it would be a terrible mistake to let this sector go under, even though Wall Street has caused many of its own problems.

Even though the financial sector is likely on the right track, the housing market remains very depressed and home prices are still falling. The most important factor determining whether homeowners default is whether or not they are under water, with outstanding mortgage debt exceeding the value of the house. However, with a recession underway, families that face unemployment or loss of income for other reasons will find that it is impossible for them to pay their mortgages or credit card bills and they lose their homes. Policies have been put in place already to help homeowners, but they may not be enough. If the American economy is to move to a sustainable recovery, the housing market has to stabilize.

The economy of Main Street is headed in the wrong direction, with employment falling, unemployment rising and monthly data that suggest that GDP has been declining since mid year. GDP growth will likely turn negative when the data for the third quarter are tabulated, and the decline will be much larger in the fourth quarter of this year. GDP can be expected to fall for one or two more quarters in 2009. The biggest weight pulling the economy down has been the residential housing sector and, so far, there is no clear evidence that this has turned a corner. The data on housing starts released October 17 continue to show a pace of rapid decline and I expect to see further reductions in residential construction for the rest of this year and perhaps into 2009. The numbers on retail sales released last week were very weak especially since the figures for earlier months were revised down, auto sales are low, and industrial production is falling. Consumption is being adversely affected by the huge loss of wealth from the decline in home prices and equity prices and can be expected to decline at about a 3 percent annual rate in the second half of this year. Business investment held up well in the early stages of the crisis, but is now falling also. The U.S. economy is in a recession and the only question is how deep it will be. Unemployment tends to lag behind the business cycle and often continues to rise even after a recovery is underway. Based on the economic trends now at work, it is very probable that unemployment will hit the range of 7 to 8 percent and a deeper recession is quite possible. Unemployment hit 10 percent in the 1982 recession and, while I do not think we will reach that level in this recession, we cannot rule it out. It takes GDP growth at a rate between 2½ and 2¾ percent to keep unemployment from rising, and a higher growth rate to bring unemployment down. We may see a solid bounce back in growth in the second half of 2009, but it is more likely that it will take until 2010 before unemployment declines again.

One of the bright spots this year has been the performance of U.S. exports. After adjusting for inflation, exports grew at over 12 percent at an annual rate in the second quarter and are likely to match that pace or more in the third. In addition, inflation-adjusted imports are weak as a result of the fall in the dollar that began in 2002 and the weakening U.S. economy. Domestic demand actually remained flat in the second quarter and all of the GDP growth was accounted for by the improvement in net exports. Exports have been keeping us out of the graveyard. Looking ahead, I expect that exports will remain a positive and that imports will still be weak, but the effects of trade will not be large enough to offset falling consumption and investment. Currently, both Europe and Japan are weakening and likely will head into their own recessions, making for a slowing of U.S. export growth. The dollar has recovered some ground against the euro also, which will trim U.S. export gains.

One economic factor that is clearly helping and is likely to remain a positive is commodity prices. The price of oil fell below $70 a barrel on October 16th, less than half of the peak price it hit earlier this year. Commodity prices fluctuate greatly and it is hard to tell exactly where they are headed, but a weakening global economy can be expected to depress commodity prices, so it is unlikely that they will return to anything close to their peak levels. The United States, of course, is a producer of commodities as well as a consumer, so there are companies and workers that are hurt when commodity prices fall. On balance, however, U.S. economic growth benefits from a fall in commodity prices, especially oil and food prices which very quickly

affect the wallets of consumers. There is nothing like seeing oil at $140 a barrel to make oil at $70 a barrel look good.

In the early stages of the financial crisis it was notable that jobs and GDP were holding up rather well; in fact there was 2.8 percent growth in the second quarter. That good news about growth was deceptive, however. The financial crisis has set in motion the dynamics of an economic downturn. Even though the financial sector is probably on the road to recovery, its negative impact on growth will remain with us for a while yet.

This recession was not inevitable. Almost everyone was caught up in the belief that housing prices would keep rising and this encouraged speculation and over-borrowing by households, lax lending standards by mortgage providers and a failure to supervise and regulate banks effectively. Wall Street banks as well as foreign banks became overleveraged and took on excessive risks, credit rating agencies failed to do their job.[2] There is plenty of blame to go around. Congress, the Administration and the Federal Reserve should have done more to help and so should the economics profession. Given what has happened, there is nothing that Congress can do now that will allow us to avoid a recession, and so the goal now is damage control, avoiding a deep recession and putting in place the basis for a solid recovery.

WHAT CAN POLICYMAKERS DO TO AMELIORATE THE RECESSION?

Given the economic weakness, there is a strong case for a new fiscal stimulus package that would boost spending and offset the chain reaction of declining spending and employment. Historically, the use of fiscal policy to smooth the business cycle has had a mixed record. It is hard to assess where the economy stands, so that fiscal stimulus can sometimes have an impact when the economy is already recovering and does not need the help. That problem does not apply to the current situation. It is clear that the economy is trending down and needs help to sustain aggregate demand and private sector employment. The more serious objection to a stimulus package is that it will contribute to the budget deficit and that is indeed a valid argument, but it does not carry the day. If the economy goes into a severe recession, tax revenues will fall sharply and the impact on the budget deficit will likely be even worse than the impact of the fiscal stimulus. Even if a stimulus package creates a net cost to the deficit, that cost is worthwhile to avoid the damage of a severe recession.

How large should the stimulus package be? Assume that there is a stimulus passed this fall that injects $100 billion into the economy in the first quarter of 2009, and that around 80 percent of this amount is spent over the first three quarters of 2009—$40 billion in the first quarter and $20 billion in each of the subsequent two quarters. (I have used $100 billion as a round number to make the arithmetic easier to follow. There is a good case for a larger stimulus package than this.) Such a package would add about 1.1 percent to GDP growth in that quarter about O.75 percent to the GDP growth rate in the second and third quarters of 2009. The overall, the increment to GDP growth in 2009 would be a little under 0.7 to the growth rate for the year (averaging the quarterly effects of 1.1, 0.75, 0.75 and 0.15). A larger stimulus package, I assume, would scale up the impact proportionately, with a package of $150 billion being 50 percent larger and a package of $300 billion having three times the impact.[3]

The current Blue Chip consensus forecast says that GDP declined 0.3 percent in the third quarter of this year and will decline 1.1 percent in the fourth quarter. The Blue Chip then says that GDP will decline by only 0.1 percent in the first quarter of 2009 and will resume positive growth after that. If this Blue Chip forecast is correct, a package of $150 billion would boost growth to 1 percent in the first quarter of 2009, and as high as 2.9 percent in the second quarter. Under this scenario, a stimulus of $150 billion seems plenty.

---

[2] See the Brookings website for links to recent papers on the financial crisis and what to do about it.

[3] The U.S. economy produces and spends about $14 trillion a year or $3.5 trillion in each quarter. The first round effect of an additional $40 billion in spending, therefore, is to add 1.1 percentage points to the GDP growth rate in the first quarter of 2009. That increment to growth would drop to 0.55 percentage points in the second and third quarters. In a slack economy, a positive increment to consumer spending is likely to have a second round effect, as the increase in retail sales or other spending puts more money into the hands of the workers and businesses that provide the goods and services. I assume there would be the equivalent of about another $50 billion as a secondary effect for each $100 billion of initial stimulus. It is hard to know the timing of this secondary effect—it would likely be spread over 12 to 18 months after the passage of the stimulus package. To get a rough magnitude, I assume that the secondary impact would add 0.2 percent to growth in the second quarter of 2009, another 0.2 percent in the third quarter, 0.15 in the fourth quarter and the rest spread further into the future.

The Blue Chip consensus is too optimistic and many of the forecasters who contribute to this consensus have been revising down their forecasts. Consider a pessimistic scenario where there is about a 4 percent GDP decline in the fourth quarter of this year, about the same in the first quarter of 2009, about a 1.5 percent decline in the second quarter of 2009, about a 1 percent decline in the third quarter and a small positive growth rate in the fourth quarter. I do not think we will see a recession quite that bad, but that scenario is not out of the bounds of possibility. There is about a 25 percent probability that we will see a recession of this severity in the absence of offsetting policy actions. Suppose Congress were to enact a stimulus package of $300 billion—a number that is around the high end of the current debate. This would boost growth but even so there would be a GDP decline of 0.7 percent in the first quarter of 2009, followed by positive growth of about 0.75 in the second quarter and growth of just over 2 percent in the third quarter. The fourth quarter of 2009 would remain sluggish unless the stimulus had succeeded in reviving consumption. Under this scenario, a $300 billion stimulus would not result in buoyant growth in 2009, but it would substantially offset the severe recession.

What are the uncertainties around these estimates? I have assumed that 40 cents of each dollar of stimulus is spent in the quarter in which the money is received by families and 80 cents is spent over three quarters. Some economists will judge these numbers are too high and point to the impact of the first stimulus package in 2008 where consumption fell in the second quarter and is expected to fall in the third, despite the rebate checks. The difficulty with that view is that we do not know the counterfactual, what the situation would have been without the tax rebates. Very likely, consumption would have been significantly lower. Given that American consumers on average have been spending nearly all of their disposable income for many years, I find it hard to believe that they will save a huge fraction of any additional income from a new stimulus package for more than a few quarters. Initially, the 2008 tax rebates went into savings accounts or to pay off debts, but this strengthening of consumer balance sheets is allowing them to weather the economic conditions of today with smaller cutbacks in spending.

It is quite possible, however, that the lags will be longer than specified in this example. A stimulus package passed this fall might not get money into people's hands until the second quarter of next year and the impact of that on spending might be lagged into the latter half of 2009 or into 2010. If the Blue Chip forecast turned out to be correct and, in addition, it took a while for the stimulus to work, we could find that the policy had over-stimulated an economy that was already well into recovery. My own judgment is that this recession is likely to be prolonged, so I am not too worried about that possibility. In addition, monetary policy could act to slow the economy if it turns out that it is overheating.

Given the dangers the economy is facing, I view $150 billion as being about the minimum amount that will have a serious impact on economic growth in 2009. Given the concerns about the budget deficit that I articulate shortly in this testimony, I would not exceed a $300 billion package. My specific proposal within this range of numbers is therefore to prepare a stimulus package in two tranches. The first to be enacted immediately would be for $200 billion. The second tranche for an additional $100 billion would be ready to go and would be enacted on the basis of a trigger. One possible trigger would be that if the unemployment rate moves over 7.5 percent, the second tranche is released.

WHAT FORM SHOULD THE STIMULUS PACKAGE TAKE?

The important factors to consider are well-known to this committee and I recommend the analysis of stimulus design provided this spring by the Congressional Budget Office. In order to alleviate a recession that is already underway, it is important to get the money into the hands of Americans quickly and that this addition to income translates into additional spending as close to dollar for dollar as possible. Given the problem of the exploding budget deficit, it is important that the changes be temporary and do not contribute unduly to the worsening of the deficit in the long run.

• Stabilizing the Housing Market. The economy will not return to sustained economic growth while the housing market continues to fall. And there is a two-way interaction between these two factors because supporting economic growth will help stabilize the housing market. Congress has already agreed to a substantial investment of capital into the GSEs to support the mortgage market. And the terms of the $700 rescue package allow for the purchase of mortgages as well as mortgage-backed assets. Since I do not know how much money it will take to recapitalize the banking system, so I am not sure how much is available for direct support of the housing market. If there is not enough money already approved, then I would urge

the Committee to support additional funds for families facing default. It is very hard to do this without rewarding past misbehavior by either lenders or borrowers, but I find attractive the proposal from both Republican and Democratic economists to allow households to roll existing mortgages into new 30-year fixed rate mortgages available through Fannie and Freddie at an interest rate between 5 and 6 percent. These would particularly be valuable to families caught in interest rate re-sets to high levels, and the pre-payment penalties could be adjusted and rolled into the new mortgage, or eliminated altogether. The program would be restricted to owner-occupied properties.

• Tax rebates. I urge the committee to pass quickly a new tax rebate package. If this were done very quickly, the IRS could use the same taxpayer list that was used earlier this year and the money would be released this fall. Having the rebates be refundable ensures that low and moderate income families get a benefit. The IRS got the rebate checks out quickly earlier this year and using this approach is simple and quick.

• Unemployment Insurance. This program has traditionally been a backstop for the economy, serving as an important automatic stabilizer. With the job situation deteriorating there are many workers reaching the point where benefits are exhausted and it would make sense to extend the duration. Over the years, the fraction of the unemployed receiving benefits has declined and women seem particularly disadvantaged because they often work part-time. In 1975 Special Unemployment Assistance was enacted by a Democratic Congress and signed by President Ford to help persons that were not eligible under the usual rules. I would support such a program again now, particularly to help single mothers or fathers who have lost jobs but are not eligible for standard UI benefits and who will find it difficult to qualify for welfare. This program should be funded by the federal government and not by the states (the program was federally funded in 1975).

• Infrastructure. Many House members are concerned about the deplorable state of the nation's infrastructure and would like to devote some fraction of the stimulus package to infrastructure investment. I share the concerns about the state of our roads and bridges, but I am also aware of the objection to using infrastructure investment as a stabilization policy because it can be too slow to work. There are two ways in which this problem could be overcome: First, there is great need for improved maintenance of the infrastructure, including crumbling roads that need repair and bridges that may age prematurely or even collapse because they have not been looked after. Looking after the existing infrastructure is not as exciting as cutting ribbons on new projects, but it could generate jobs quickly and meet an important need. Second, there are state and local projects that are being cancelled because of the short term budget pressures. Sustaining such projects would avoid layoffs that would otherwise take place.

• Aid for States and Localities. There are many states and localities that are feeling tremendous budget pressures because of the weak economy and the decline in property tax revenue. Providing assistance to them would prevent or ameliorate the cutbacks in spending that would otherwise occur.

• General budget assistance, targeted perhaps to states with high unemployment and mortgage default rates

• Assistance to sustain Medicaid spending. Some states are finding it difficult or impossible to sustain support for health care because of budget pressures.

• Business Tax Changes. The marginal rate of corporate tax is higher in the United States than in many other countries with whom we compete internationally. At the same time, corporations do not pay a lot of tax—the average rate of taxation is pretty low. As part of a long run package of tax reforms I support the idea of broadening the base of corporate tax and lowering the rate. In my judgment, however, adjusting business taxes now is not attractive as a response to the recession. Capital gains taxes are already low. Investors are staying on the sidelines of the stock market because they are concerned about market risk and volatility, not because of concerns about the taxes they might pay on capital gains. In the past several years, non-financial corporations have improved their balance sheets and added to their cash holdings. It is much more important to get the balance sheets of the financial sector into better shape and free up lending to businesses and consumers. The fiscal stimulus package is sufficiently important, however, that if business tax changes are necessary to obtain bipartisan support for the package, I would support them on that basis.

THE THREAT OF INFLATION AND THE FISCAL CHALLENGE: $700 BILLION HERE, $300 BILLION THERE AND PRETTY SOON WE ARE TALKING ABOUT REAL MONEY

A year or so ago, when the economy was still growing it was clear that the problem of chronic budget deficits was real and urgent. We have known for years that the population is aging and living longer and that Medicare, Medicaid and, to a lesser extent, Social Security were going put pressure on the budget for years to come. I support fiscal discipline and believe that the federal budget should be balanced on average over a period of years. Can we really afford to pay for a fiscal stimulus package over and above the $700 billion for the rescue package together with the funds for Fannie, Freddie, AIG, and Bear Stearns? There are two possible economic arguments for why we might find it unwise to expand the deficit for a stimulus package. The first would be that it caused a flight from U.S. Treasury securities and perhaps a run on the dollar. The second is that it would result in inflation. It would take more space than is available to go into these issues in depth, but the simple answer is that neither concern is large enough to prevent passage of a fiscal stimulus.

Investors here in the U.S. and around the globe know the fiscal situation of the federal government and anticipate the likely expansion of the national debt. Despite that, there is no shortage of buyers for U.S. Treasuries. The interest rate on 10-year notes is under 4 percent and the U.S. dollar has appreciated against the euro in the past year and stands now at about $1.34. There has been a "flight to quality" recently as a result of the crisis and the benchmark of quality remains U.S. Treasury securities. I am deeply troubled by the persistence of federal deficits, the over dependence on foreign borrowing and the lack of a national debate about how to pay for federal spending and how to moderate its growth. But letting the economy go into a deep recession is not going to solve the long run fiscal challenge facing America. Global financial markets will let us borrow to pay for the stimulus package and we should go ahead and do that.

There is a working model of inflation that has guided policymakers over the years and its first ingredient is that inflation will increase when commodity prices go up and will decrease when these prices decline. Commodity prices are set in global markets and are only partly under the influence of the state of our own economy or our monetary policy. The second ingredient is that inflation will increase when there is excess demand in the economy, production capacity is strained and labor is in short supply. It will fall when there is slack in the economy. The third ingredient is linked by most economists to inflation expectations, so that when higher inflation is expected it can actually cause higher actual inflation. Of these three ingredients, the first two are pointing to an easing of inflationary pressures: commodity prices have come down and seem likely to stay well below their peak. The U.S. economy already has slack capacity and will have much more in the year ahead. For the third ingredient, there have been signs of an upward adjustment of inflation expectations, something that has troubled the FED in the past year. That seems to be fading, however, as the other drivers of inflation ease off. Adding huge amounts to federal borrowing is not a good thing for inflation, but that concern is not enough to change the case for the stimulus. I am old-fashioned enough to think about wage-price spirals as much as expectations, and on this score, there is little sign of the kind of wage price spiral that was so difficult to deal with in the 1970s. With good productivity growth, businesses are not facing an upward push of labor costs.

CONCLUSION

The American economy is in trouble and the balance of risks strongly favor a substantial fiscal stimulus. I urge Congress to act on this proposal as soon as possible.

Chairman SPRATT. Now, Iris Lav from the Center on Budget and Policy Priorities.

STATEMENT OF IRIS J. LAV

Ms. LAV. Thank you for the opportunity to be here today.

My testimony is focused on why Federal fiscal relief for the States is particularly necessary and an effective part of the stimulus plan at this time. Now, it doesn't mean that I don't think any other things should be part of a stimulus plan or would be effective—and I could discuss those in the Q&A. But I think the issue

of the States is particularly critical, and I would like to explore that fairly fully with you, if I may.

So State finances are in pretty dire straits. There are about 36 States at this moment that are experiencing fiscal stress. If I could have my first slide, please.

So the stress comes in a couple of pieces. There are 29 States that, when they enacted their fiscal year 2009 budgets, which started on July 1 in most States, they closed gaps, deficits of $48 billion that were about 9 percent of these States' budgets, huge. Those are the light blue and the orange States there.

But the budgets have soon fallen apart. The revenue estimates they used in enacting those budgets turned out to be much more optimistic than what is actually happening with the economy. So we have 22 States that are again in trouble with midyear deficits that most of them have to do something about. Those are another $11 billion. Those are the orange and the dark blue States, the orange being the ones that have both initial and midyear deficits.

We also have been tracking collection numbers for some of the larger States. We have new collection numbers. If I could have the next slide, please.

They are really pretty bad. These are adjusted for inflation. You can see that sales tax revenues in particular, as consumption has fallen off, have dropped in a lot of States—you know, in the 8 and 9 percent range. Florida has had a 12 percent drop in sales tax collections. Income tax revenues are also down in a large number of States.

I think most of the States, even though I said there are 22 States with midyear gaps, these are numbers that have really just come out. The September numbers are the ones that really drove those down, and they have not taken them into account. So further down, those revisions are pretty much inevitable.

Now, of course, that is this year, and we are not going to be done with this problem, with the economic problems, at the end of this year. Pretty soon, we get to—governors are right now putting together their fiscal year 2010 budgets, and they will begin to be debated in January and February. That situation looks very bleak. I think that there are 16 States that have already announced 2010 deficits, but that number is low because most States don't—you know, aren't talking about it yet or haven't projected yet.

If we want to try and think of what is going to happen next year, one thing we can do is look what happened in the recession in the early part of this decade—if I could have the next slide, please.

Deficits started at about $40 billion in fiscal year 2002, but rose to $75 billion in fiscal year 2003 and $80 billion in fiscal year 2004.

Now, in this downturn, economic conditions are worse than they were then. That was a relatively mild recession; for unemployment, then, peaked at 6.3 percent. It is already 6.1 percent; pretty much, most forecasters are talking about it trending toward 8 percent at this point in time.

When unemployment goes up, it obviously reduces State income taxes. People also lose their health insurance, they also come on to Medicaid. They need other services, and that is likely to be even greater than in the past. Although, you know, there were 6 million

new people that came on to the Medicaid rolls in the earlier recession, I would anticipate a lot more than that now.

Second, the decline in the stock market this time has matched the decline in the last recession by some of the measures of markets. It is unclear where the bottom of the market is, whether we have reached it, whether we have not. Of course, no one knows, and that affects income taxes as well through capital gains taxes.

Third, and very important, is that in the last recession consumers used home equity loans—the housing market was strong—and other sources of credit to bolster their consumption. That is not available to consumers now, to say the least. So consumption expenditures and sales taxes are likely to fall more steeply. I just showed you how steeply they are falling right now.

So I would estimate—I had made an estimate that, given deterioration of revenue and given the history of the last recession, that we are looking, going forward, at about $100 billion in deficits, something in that neighborhood for 2010, the upcoming fiscal year.

Now, those deficits are particularly problematic, because unlike a Federal deficit, when a State has a deficit, it leads directly to spending cuts and tax increases, which leads to reduced demand which further harms the economy. You know, all States but one have a requirement to balance their budget, so they have to take action. When these revenues go down and the demand for services go up, they have very few choices. Under the balanced budget requirement, they can do one of three things, they can draw down reserves, they can cut spending, or they can raise taxes.

Now, States have been pretty prudent on reserves. They entered this, this economic weakness, with the largest reserves they had ever had, $69 billion, or 10.5 percent of their general fund budgets. They have used down quite a lot of that, and they are on the road to being depleted, given this year's actions for the purposes of budget balancing.

Of course, all the reserves are not matched, necessarily, in all the States. There is a big chunk of that in Alaska which isn't going to have a problem.

But the other two options States have to balance their budgets are cutting spending and raising taxes. As I said, both of those intensify the economic downturn. They lay off employees, they cancel contracts, they eliminate payments to businesses and to nonprofits that provide direct services, cut benefits to individuals. Then those people who, in turn, lose their jobs have less money to spend on consumption; and you get a decline in the economy greater than the budget cut in the first place.

Tax increases, of course, also remove demand from the economy, because people in businesses have less to spend.

Obviously, the Federal Government doesn't have this constraint, so it makes great sense, in our federalist system, for the Federal Government to try and prevent these economically damaging actions. So you will recall, of course, that in May of 2003, just before the beginning of State fiscal year 2004 there, you enacted a $20 billion fiscal relief package. It provided two types of assistance to the States; half of it was in the form of an increase in the Federal share of Medicaid, technically known as the FMAP, and the other part was general grants to States, $10 billion of each kind.

That was very important in the last recession, but it was not enacted until a million people had already lost eligibility for Medicaid as States cut back, and States had already made deep cuts in K-12 education, raised tuition in public universities and community colleges and done a lot of other damaging things. In the best of all worlds, it would have been enacted before some of those demand reducing cuts were enacted. It was criticized by the GAO primarily because it was too late.

So States have already begun cutting their budgets now. About half the States have made budget cuts in public health insurance programs, services for the elderly and the disabled, K-12 education, et cetera. Eighteen States have cut their workforce, and States are poised to make far more drastic cuts as they deal with their mid-year deficits and enact their 2010 budget. This is about one of the best forms of stimulus you can do, preventing these procyclical cuts.

I would think this time around that more than $20 billion in relief will be necessary. In fact, I would suggest that about $50 billion is the right number to be thinking of right now. It would be about half the expected deficits for 2010, or you can think of it as a third of the combined 2009-2010 deficits—however, less than a third, however you want to look at it. And I would say the majority, perhaps about two-thirds of it, should be in the form of increased FMAP, increasing the Federal share of Medicaid. That can be used right away. It is immediately put to work. We know there are going to be people coming rapidly onto the Medicaid rolls. It is the new spending that Chairman Bernanke was talking about.

If you don't do that, and people lose their private health insurance, it looks like we might trend to a somewhat shameful 50 million people uninsured in this country.

I think the other piece of it should be available, again as a block grant, both to prevent cuts in education and programs like that; but also one of the things that States cut is aid to localities. Local governments also have been having problems, and we really don't want the States to be cutting aid to localities at this time.

So people often—when I say this, or when people say this, people often raise the question, aren't we creating a moral hazard? If the Federal Government goes ahead and helps the States, doesn't that give the States license to be less responsible with their own fiscal house in good times, knowing that the Federal Government might bail them out? I think the answer is a very clear no, that is not true.

The evidence of what has happened before and the evidence of what States have done is pretty clear. Between 2001 and the today, or even before this downturn started, the beginning of this downturn, States have reduced expenditures as a share of the economy. States are not bulking up their expenditures in any way. They also—you know, their taxes are about the same, and States did build up these very substantial rainy-day funds that I mentioned.

So I think that States have a lot of reasons to themselves be responsible. We are not talking about the Federal Government giving the States everything they need. They are still going to have to make very painful cuts.

I mean, $100 billion is like $1 in every seven States' pay—spent from their operating budgets. So it is a huge amount, and that is if it was evenly distributed, which—you know, it will be more than that in some States.

I would suggest that this, of course, be temporary, that States should be allowed to use the fiscal relief over a 15-to-18-month period to make sure it is coming in immediately as stimulus.

Finally, I would just say the hallmark of a good stimulus is that it is well targeted, temporary and timely. That is sort of the same thing I think that Chairman Bernanke said at the end, that you really have to make sure it is being spent right away and that it is getting where it needs to be and that it is temporary.

Federal fiscal relief fits perfectly into those criteria. For this reason, any number of economists have called for fiscal relief to the States as the key part of the stimulus package, and they include people such as Mark Zandi, Paul Krugman, Larry Summers, Jared Bernstein, Alan Blinder and many others.

So I thank you for your consideration.

Chairman SPRATT. Thank you very much.

[The statement of Ms. Lav follows:]

Prepared Statement of Iris J. Lav, Deputy Director, Center on Budget and Policy Priorities

Thank you for the opportunity to discuss with you today why federal fiscal relief for states is a particularly necessary and effective part of a stimulus plan at this time.

State finances are in dire straits. At least 36 states are experiencing fiscal stress.[1]

- There are 29 states that closed shortfalls of $48 billion in enacting their fiscal year 2009 budgets (for the year beginning July 1, 2008 in most states). The shortfalls equaled 9 percent of these states' general fund (operating) budgets.
- Since fiscal year 2009 budgets were enacted, budgets have fallen out of balance producing new, mid-year deficits in 22 states and the District of Columbia that total more than $11 billion or 4 percent of budgets.
- The latest revenue collection numbers suggest that the situation is rapidly worsening. Third quarter 2008 sales tax and income tax revenue are coming in well below prior year levels and well below states' initial projections in most of the states that have released figures. These latest figures have not yet been taken into account in most states' budget forecasts.
- At least 16 states have announced that they are expecting deficits for state fiscal year 2010 that so far total $18 billion, but that number is very low because it is very early in the year for most states to make such a projection and because revenue collections continue to weaken. Deficits during the downturn in the early part of the decade reached $75 billion and $80 billion in the second and third year of that fiscal crisis, and economic conditions are now projected to be significantly worse than they were then. Judging from the rate at which revenue is deteriorating and the history of prior recessions, the 2010 gaps are likely to be in the $100 billion range.

These state deficits are particularly problematic because, unlike the federal deficit, they lead directly to spending cuts and tax increases that reduce demand, which further harms the economy.

Whenever the national economy stagnates or falls into recession, state revenues also stagnate or decline. This happens just at the very time that states face upward pressure on their budgets as residents lose jobs and income and health insurance and become eligible for Medicaid or other safety net programs. This produces deficits.

These state deficits are not like the increase in the federal deficit that typically also occurs during a recession. This is because all states but one have a requirement to balance their general fund (operating) budgets. States with flagging revenues

[1] This includes states with deficits that were closed in enacting their fiscal year 2009 budgets, states with mid-year gaps, and three states (Kansas, Oregon, and Washington) that did not have fiscal year 2009 deficits but are projecting deficits for fiscal year 2010.

cannot provide even the normal level of services—let alone meet the increased demand for services and supports.

Under balanced budget requirements, states have three primary actions they can take during a fiscal crisis: they can draw down available reserves, they can cut expenditures, or they can raise taxes.

Most states do keep "rainy day funds" and other reserves to try to anticipate this problem. States entered this period of economic weakness with the largest reserves they have ever had, totaling $69 billion or 10.5 percent of their general fund budgets at the end of fiscal year 2007. But those funds are on the road to being depleted for the purpose of budget balancing—and that was before the events of the last four weeks that undoubtedly have weakened fiscal conditions in the states.

The other two options states have to meet their balanced budget requirements are tax increases and budget cuts. These options both are pro-cyclical. That is, they intensify the economic downturn rather than help the economy recover.

The spending cuts and tax increases states make when they must balance their budgets under conditions of falling revenue can further slow a state's economy during a downturn and contribute to the further slowing of the national economy, as well. When states cut spending, they lay off employees, cancel contracts with vendors, eliminate or reduce payments to businesses and nonprofit organizations that provide direct services, and cut benefit payments to individuals. In all of these circumstances, the companies and organizations that would have received government payments have less money to spend on salaries and supplies, and individuals who would have received salaries or benefits have less money for consumption. This directly removes demand from the economy.

Tax increases also remove demand from the economy by reducing the amount of money people and businesses have to spend.

In contrast to the states, the federal government can run a deficit, and it does not have to take the actions damaging to the economy (and to low- and middle-income families needing state services) that state balanced budget requirements force on states during recessions. Thus, one of the best ways to stimulate the economy in a downturn is for the federal government to provide short-term, additional funding to states.

You will recall that in 2003, you enacted a $20 billion fiscal relief package for states. It provided two types of assistance to states: 1) a temporary increase in the federal share of the Medicaid program; and 2) general grants to states, based on population. Each part was for $10 billion.

While extremely important, the 2003 fiscal relief package was not enacted until after 1 million people lost eligibility for Medicaid because of state cutbacks, and deep cuts had been made in K-12 education, child care, state workforces, and a variety of other areas. In the best of all worlds, it would have been enacted before those demand-reducing cuts were made.

States already have begun cutting their budgets; about half of the states have made cuts in public health programs, services for the elderly and disabled, K-12 education, or universities and colleges. At least 18 states have cut their workforce. And states are on the verge of making far more drastic cuts as they deal with their mid-year deficits and begin to enact fiscal year 2010 budgets.

There is the opportunity to prevent many of these damaging actions through providing fiscal relief. Preventing these pro-cyclical state actions is among the best forms of stimulus you could provide, because it both prevents budget cuts to programs that are needed by people who are losing jobs and incomes in this recession, and prevents state actions from worsening the economy.

This time around, however, it seems that much more than $20 billion in relief will be necessary.

- To stop the most damaging of the budget cuts, fiscal relief of approximately $50 billion would be needed. This would be about one-half of the expected deficit for state fiscal year 2010 (or less than one-third the combined deficits for state fiscal years 2009 and 2010).
- The majority of the fiscal relief ($30 billion to $35 billion) would be most effective as an increase in the federal share of the Medicaid program (FMAP), accompanied by a ban on states reducing eligibility in that program and thereby driving up the ranks of the uninsured. Without such assistance, the number of uninsured in this country could rise to 50 million.
- The remainder of the relief could be made available to prevent cuts in education and other critical state programs, as well as to lower the likelihood that states will cut aid to localities.

Federal fiscal relief of $50 billion would provide a substantial stimulus by averting that amount of pro-cyclical actions by states that otherwise would be inevitable. It would be sufficient to prevent many of the state budget cuts that would be most

harmful to low- and moderate-income households, including the newly unemployed. But, relative to the size of the deficits, it would not create a "moral hazard" that could in any way induce states to be less responsible with their own finances. The need to amass substantial "rainy day funds" and other reserves during strong economic times would remain.

I would stress that the payments to states would be temporary. States should be allowed to use fiscal relief over a 15 month or 18 month period after enactment.

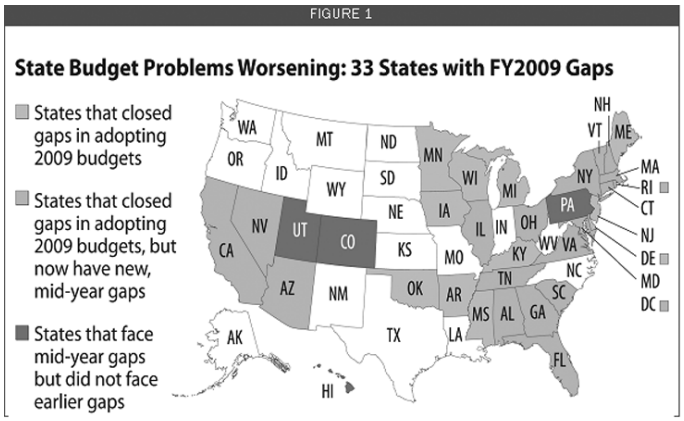
The hallmark of a good stimulus is that it is well-targeted, temporary, and timely. Federal fiscal relief to the states fits well on all of those dimensions. For these reasons, a number of economists have called for fiscal relief to the states to be a key part of a stimulus package, including Mark Zandi, Paul Krugman, Laurence Summers, Jered Bernstein, and Alan Blinder, among others.

The following reviews some of the details of the current situation and the case for fiscal relief.

STATE FISCAL CONDITIONS

When states project deficits—gaps between projected revenue and projected spending—for an upcoming fiscal year, they have to take action to close those deficits. As noted above, 36 states are already experiencing fiscal stress. Twenty-nine states closed shortfalls of $48 billion in enacting their fiscal year 2009 budgets. In many states, however, the revenue estimates used to project their budget shortfalls were still far too optimistic; the economy has seriously deteriorated since those budgets were enacted. As a result, budgets have fallen out of balance producing new, mid-year deficits in 22 states and the District of Columbia that total more than $11 billion or another 4 percent of budgets[2] (See Figure 1.) And that is a snapshot of the situation last week. Virtually every day, additional states are announcing shortfalls or increasing their estimate of the size of their shortfalls.

FIGURE 1



States are just beginning to release revenue collection data for the 3rd quarter of 2008 (which is the first quarter of fiscal year 2009 in most states). The sales tax data certainly reflects the slump in retail sales and consumption, while the income tax data reflects, among other factors, the increase in the unemployment rate.

There are revenue declines in most of the states that have released data. For example, sales tax revenues for the third quarter 2008 compared to the third quarter 2007 are down 8.8 percent in California, 12.1 percent in Florida, 8.0 percent in Georgia, 7.3 percent in Massachusetts, and 8.5 percent in Missouri, after adjustment for inflation. (See Table 1.)

[2] The gaps are 4 percent of the budgets of the 20 states that have provided specific estimates. There are no estimates for California and Illinois.

TABLE 1

Percent Change in 3rd Quarter Sales and Income Tax Collections: 2008 vs. 2007

	Revenue Source (inflation-adjusted dollars)	
State	Sales Tax	Income Tax
California	-8.8%	-5.3%
Florida	-12.1%	X
Georgia	-8.0%	-7.3%
Illinois	-2.5%	-1.3%
Massachusetts	-7.3%	-2.0%
Minnesota	-8.4%	0.8%
Missouri	-8.5%	-2.8%
Tennessee	-6.9%	X
Texas	1.9%	X

Source: CBPP calculations based on data from state revenue departments, adjusted by the Consumer Price Index (CPI-U).

Looking ahead to 2010, it is difficult to overstate the fiscal problems states will face. It seems increasingly likely that this recession will be more severe than the last recession, and thus state fiscal problems are highly likely to be worse than they were in 2003 when fiscal relief was last enacted.

This is true for at least three reasons:

• Unemployment, which peaked after the last recession at 6.3 percent, has already reached 6.1 percent, and many economists expect it to rise to 7 percent or even 8 percent. This would reduce state income taxes, and increase participation in Medicaid and other services, to a greater degree than in the past.

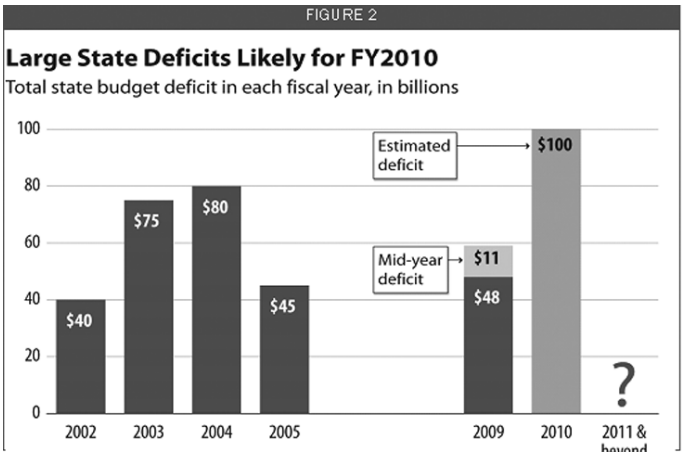
• The decline in the stock market now has matched the decline in the last recession by some measures and may yet fall further. This affects states' capital gains taxes, which in many states are a major component of income taxes.

• Consumers' access to home equity loans and other sources of credit is far less than it was in the last recession, so consumption expenditures and therefore sales taxes are likely to fall more steeply than in the past.

Even though this recession and fiscal crisis is likely to be considerably deeper than the one at the beginning of the decade, it is still instructive to look at what happened in that prior recession. That recession was relatively short and mild, yet created large state fiscal deficits over a four-year period. The fiscal year 2002 deficit was $40 billion, but it rose to $75 billion in 2003 and $80 billion in 2004.

This year, the deficit for the first year of the fiscal crisis, fiscal year 2009, is $59 billion and still growing.[3] (See Figure 2)

[3] This includes the deficits states closed in enacting their 2009 budgets and the mid-year deficits for which there are estimates.



Some 16 states have already announced that they face deficits they will have to close in enacting their fiscal year 2010 budgets.[4] Ten of those states have estimated the size of those gaps for a total of $18.2 billion. As additional states announce gaps, and the size of the gaps are reevaluated for deteriorating economic conditions, the size of the 2010 gap will grow substantially. The 2010 gap is likely to be in the range of $100 billion—or even more if the economy experiences additional deterioration between now and then.

Under state balanced budget constraints, deficits of this size inevitably mean very large cuts in Medicaid, education, and other vital programs. If the deficits were evenly spread over the states, $100 billion would represent about 14 percent of state general fund expenditures.

BUDGET CUTS

In the last recession, 1 million people lost health insurance because of cutbacks in Medicaid and SCHIP in 34 states. In addition, one-third of the states cut child care subsidies or otherwise limited access to child care, two-thirds cut per-pupil expenditures for K-12 education, and most raised tuition at public colleges and universities. Aid to local governments for functions other than education also was cut in many states, which led local governments to scale back services on which low- and middle-income people rely.

The worst of the budget cuts generally come in the second or third year of a state fiscal crisis, and that pattern is likely to hold this time around. That is because in the first year of an economic slowdown, states can draw down rainy day funds and reserves. They also can take actions such as instituting hiring and travel freezes, as well as finding items in their budget that are more marginal to their core functions.

So far this year, about half the states have enacted budget cuts that affect low- and moderate-income people—reductions in funding and services in public health programs, services for the elderly and disabled, K-12 education, or universities and colleges. While these reductions are quite serious to anyone who is hit by them, they are not yet at the devastating level seen in the last recession or the even deeper cuts in some previous recessions.

For example, in enacting its fiscal year 2009 budget, Rhode Island eliminated health coverage for 1,000 parents and will require 7,800 low-income families to pay higher monthly premiums for public insurance (which is likely to result in some who cannot afford the premiums becoming uninsured). States such as Arizona and California are reducing their Medicaid rolls by increasing the frequency with which some recipients must reapply for benefits, which research suggests will cause eligible people to become uninsured. On another front, tuition at state universities and community colleges has been increased in at least 11 states, with increases ranging from 4 percent to 15 percent. Rhode Island, for example, hiked community college

[4] They are Alabama, Arizona, California, Connecticut, Florida, Hawaii, Kansas, Maine, Maryland, Minnesota, New York, Oregon, Vermont, Virginia, Washington, and Wisconsin.

tuition by 14.3 percent. Tuition increases such as these affect the ability of students with limited means to attend college.

As states cope with the reality that the economic assumptions they used in enacting their fiscal year 2009 budgets were too optimistic, they are poised to make another round of budget cuts for the current fiscal year. Cuts are in the process of being made in Maryland, Massachusetts, Virginia, Utah, and Georgia. Another set of states are getting ready to consider cuts, including South Carolina, New Jersey, Connecticut, New York, New Hampshire, Florida, Nevada, Arizona, and California. These states either have scheduled special legislative sessions after the elections to make additional cuts, or will be doing so through executive powers.

It will not be long, however, before states will begin to deliberate their fiscal year 2010 budgets in early 2010. It is in those budgets—as states cope with what is likely to be $100 billion in deficits after they have already taken all of the "easier" actions—that the most damaging cuts will occur. Since portions of state budgets, such as courts, corrections, public safety and homeland security, and others cannot be cut or cut much, states budget cuts typically fall on health care, education, and aid to local governments.

Some of the deepest cuts are likely to occur in state health programs, particularly Medicaid and SCHIP, as they did in the last recession. Medicaid is often high on the list when states need to make budget cuts. Unlike aid to schools, for example, which generally is committed at the beginning of the school year, Medicaid is a program that is spent monthly. A change in Medicaid in any month will affect expenditures for the remainder of the fiscal year. And since Medicaid costs generally rise rapidly as enrollment is boosted by people losing jobs and income, it becomes a target for cuts. With the number of uninsured already 46 million in 2007, the combination of people losing jobs and some businesses dropping health insurance to try to stay afloat, the number of uninsured could reach 50 million if public program cut eligibility or cannot finance insurance for those newly eligible for Medicaid and SCHIP.

Education is also a major concern. In the last recession, we saw new or higher fees for textbooks and courses, shorter school days, reduced personnel, and reduced transportation. States or school districts took actions that resulted in teacher layoffs and larger classroom sizes, or eliminated offerings such as music, enrichment programs and the like—all of which arguably affect the quality of the education children receive. And, as noted above, when tuition at universities and community colleges are increased, it reduces the ability of students from low- and moderate income families to access higher education.

SIZE OF STIMULUS

We estimate that federal fiscal relief to states should total about $50 billion. This would be about one-half of the expected deficit for state fiscal year 2010 (or less than one-third the combined deficits for state fiscal years 2009 and 2010 and probably an even smaller fraction of total deficits states will face, since fiscal problems are likely to continue into sates fiscal year 2010).

The number $50 billion sounds like a lot, particularly compared to the $20 billion provided in the last downturn. This downturn is likely to be considerably deeper than the one in the early part of the decade, with higher unemployment, greater drops in consumption, and the additional factor of the housing sector weakness. Deficits will be larger, and more aid is needed.

Some people raise the issue of whether a large federal payment to the states raises the specter of "moral hazard." Some may ask whether, if the federal government provides aid to states in a recession, this will create a moral hazard problem in which states overspend, cut taxes too much, and/or fail to build up "rainy day" funds during periods of economic growth because they expect the federal government to bail them out when an economic downturn comes.

It is highly unlikely that the $50 billion would create a moral hazard, because it would be far from the total amount of deficit states have to close. They still will have to take actions that negatively affect their residents—actions most policymakers are quite loathe to take. The need for such actions provides a significant incentive to states to be prudent and save funds during the next economic expansion.

Moreover, the evidence suggests that the federal fiscal relief provided in the past did not have this effect. The federal government provided such relief in the last downturn, and states have not overspent or slashed taxes since then in the expectation that they would be bailed out during future downturns. On average, state expenditures as a share of the economy at the beginning of the current downturn were lower than they were in state fiscal year 2001, while state taxes as a share of the

economy were at about the same level. In addition, states built up substantial "rainy day" reserve funds to draw upon in a downturn; at the end of 2006, those reserves were actually a little larger, as a share of annual state expenditures, than before the recession at the start of this decade.

The problem is that recessions can have such large effects on state budgets that they tend to wipe out rainy day reserves and produce sizeable shortfalls. For example, states began this decade with reserves equaling 10.4 percent of annual expenditures, a quite substantial amount. But these reserves closed only about one-quarter of the state budget gaps that opened up through state fiscal year 2003. Rainy day fund and other reserve balances in the current economic crisis are no where near enough to plug the deficits.

FORM OF STIMULUS

The majority of the fiscal relief would be most effective as an increase in the federal share of the Medicaid program (FMAP), together with a ban on states from reducing eligibility in that program.

Cuts in Medicaid not only hurt people who become uninsured, but also generally result in reductions in payments to providers—which in turn can lead to reduced staffing and reductions in demand for goods and services in the state. An increase in the FMAP tied to maintenance of effort provision can avert the most damaging of such cuts.

An increase in the FMAP also provides particularly timely and effective stimulus. States, most of which will have rising Medicaid costs as people losing jobs and income come onto the rolls, can immediately use the funds from an increased FMAP to pay those costs. There is no need to develop projects, go through an appropriation process, or even have the legislature in session. This makes the FMAP a particularly good vehicle for stimulus.

Going forward, states could probably absorb $30 billion to $35 billion in enhanced FMAP. $30 billion would represent approximately 20 percent of state Medicaid spending.[5] In the last recession, Medicaid enrollment increased by 17 percent and arguably would have increased by about 20 percent if states had not drastically cut enrollment prior to receiving federal fiscal assistance.[6] Since this recession is likely to be deeper and more prolonged than the one at the beginning of the decade, $30 billion to $35 billion seems like a reasonable number to assist states in handling increased caseloads and costs, to prevent large-scale increases in the number of uninsured, and to avoid the fiscal drag on the economy.[7]

The other $20 billion (or $15 billion) should be provided as a flexible block grant. This could prevent cuts in education and social services—which lead to reductions in employment in the government and nonprofit sectors and create a drag on the economy. It also could lessen the tendency of states to cut their aid to local governments in recession. A number of local governments also have revenue problems or soon will because of declining housing values and property taxes and are likely to impose cuts on public services.

Earlier this year, when fewer states were facing fiscal stress, the Center has released reports suggesting that fiscal relief might be targeted on states that are experiencing the most economic stress, as measured by changes in employment, foreclosures, and food stamp rolls (as a proxy for changes in poverty).[8] In particular, it was clear that energy- and commodity-rich states were benefiting from extraordinarily high prices for those goods and were not experiencing fiscal problems. These states included West Virginia, Louisiana, Texas, New Mexico, North Dakota, Montana, Wyoming, and Alaska. As U.S. and world demand has weakened in the last month, however, it appears that those high prices will be declining; the price

[5] State Medicaid spending in federal fiscal year 2008 is estimated to be roughly $156 billion in fiscal year 2008. $30 billion is just under 20 percent of state spending. CBPP calculations based on CBO March 2008 Medicaid baseline.

[6] Enrollment was 35.7 million in December 2001 and 41.8 million in December 2004—a 17 percent increase. If one adds back the approximately 1 million people who lost eligibility for Medicaid prior to enactment of the fiscal relief, the increase would be 20 percent. Data from Kaiser State Health Facts.

[7] Two factors cause Medicaid to increase during a downturn. As unemployment rises, more people need Medicaid. The Urban Institute estimates 1 percent point increase in the unemployment rate equals 1 million additional Medicaid enrollees. Jon Gruber estimates it at 1.2 million enrollees. In addition, the increase in health care costs continues to erode employer-based insurance, especially when businesses have low profitability or losses, which adds to the Medicaid rolls.

[8] See, for example, Iris Lav, Jason Levitis, and Edwin Park, House Stimulus Plan Effectively Targets Fiscal Relief to States, Center on Budget and Policy Priorities, September 26, 2008. *http://www.cbpp.org/9-26-08sfp.htm*

of oil has already dropped from a peak of $145 a barrel to the $70 range. As a result, it is likely that fiscal distress will ultimately reach most states if present trends continue. It may no longer be necessary to use the type of targeting we had earlier suggested, or it may make sense to target one type of the assistance but not the other.

TIMING

In the last recession, federal fiscal relief for states was enacted at the end of May, 2003, just before the beginning of state fiscal year 2004. As the year-by-year deficit chart shows, states had already been coping with deficits and enacting budget cuts for two years before the federal fiscal relief was enacted. By the time federal relief was enacted, for example, 1 million people had already lost eligibility for public health insurance programs. The relief specified that no further eligibility reductions could be made, so it undoubtedly prevented additional deterioration.

It would be far better to enact fiscal relief now, before states make the deep cuts that otherwise will be inevitable as they enact cope with mid-year deficits and particularly as they enact their state fiscal year 2010 budgets (for the year beginning July 1, 2009 in most states) in the first part of 2009.

Chairman SPRATT. Dr. Beach. Thank you for coming.

STATEMENT OF WILLIAM W. BEACH

Mr. BEACH. Thank you very much, Mr. Chairman, Mr. Ryan, members of the committee, it is a pleasure to be with you this morning.

My name is Bill Beach, and I am the Director of the Center for Data Analysis at The Heritage Foundation.

We are at an odd moment in the evolution of these economic challenges. There is great hope, but little evidence, that the credit market fixes will work. There is increasing concern, but again, little evidence to date that the financial crisis will push the general economy into a severe recession.

My own sense is that we have passed into a recession that could become significantly worse and long lived if Congress and other governments make wrong or ineffective policy moves. Recessions that start in credit markets last longer than those that stem from shocks to aggregate demand or supply. This one looks like it could be with us for a long while unless we do highly effective things to reduce its impact.

The question now is, what should Congress do. Congress obviously should do nothing to harm the economy. I always say that in my testimony.

It should let the Federal Reserve lead the effort to stabilize economic activity. It should keep its focus on crafting long-term, pro-growth economic policy. Most importantly, Congress should make no change to basic policies that would signal increases in risk either through raising taxes or through increasing burdensome regulations.

It also should be extremely wary of any legislation that could in any way be interpreted as America withdrawing from international product or capital markets. Congress can ill afford to repeat the awesome errors of its predecessor in the early days of the Great Depression and retreat from the world economic stage.

I recommend that Congress address economic policies in three interrelated areas, all of which affect near- and long-term economic performance. I will speak about the first two of these three—tax policy, energy policy and long-term spending.

There are areas of economic policy where congressional action can be timely and targeted, though it may not intend to be short range in focus at all. Those areas involve the reduction of investment risk.

What can increase risk? Many factors, of course, but public policy commonly looms large. Tax increases, especially if they land on capital, increase the cost of capital and lower investment returns. When investors are uncertain about whether taxes will go up or stay the same, they still can act as though taxes have risen if they judge the risk of an increase to be nearly equal to an actual increase. Rising uncertainty can have the effect of driving down investments in riskier takings.

So here is what I recommend on the tax side, and I know that this is something that can be timely and targeted, but I don't know temporary. Make the tax reductions of 2003, 2001 and 2003, permanent. Thus, among the first things that Congress can do to address the current slowdown is to pronounce definitively on the tax increases scheduled for 2009 and 2011.

There are projects, new businesses, expansions of existing businesses that would be undertaken today if Congress signaled that taxes would be lower in 3 years. Since nearly all major capital undertakings last beyond this 3-year period, it is likely that making all or more of the Bush tax deductions permanent would stimulate economic activity today, as well as in 2011.

Accelerated depreciation: In addition, we know from past experience that accelerating the tax depreciation of capital equipment and buildings for—or 1-year expensing of business purchases that otherwise would be depreciated over a longer period of time is a good way to stimulate the economy. This was certainly the record in the last slump. Democrats and Republicans have commonly supported this approach.

Look at taxes on capital gains and dividends: We also have recent experience with reducing the tax rate on long-term capital gains and dividend income. If Congress were to reduce these tax rates by 50 percent or more in the next 2 years, the cost of capital to businesses would fall and investment stability would be enhanced. Indeed, if Congress were to approve a temporary zero capital gains tax rate on new stock issues, troubled banks could raise more of the capital they desperately need without having to go every day to the Treasury Department.

Lower the corporate profits tax: In one area of fundamental public policy there is now universal agreement that our Federal business taxes are far too high. The tax rate on corporate profits is the second highest in the world.

Why is it not the firm policy of this committee and this government and this country to make certain that the corporate profits tax is always below the average corporate income tax of other industrialized companies. Such a policy would enhance our competitive standing worldwide and significantly reduce the incentive for U.S. firms to relocate to lower countries—lower-tax countries.

If Congress were to make the tax reductions of 2001 and 2003 permanent and lower the corporate profits tax from 35 to 25 percent, I estimate the following economic effects would ensue. This is

done from a model of the U.S. economy which is in widespread use throughout the government and the private sector.

More jobs: By making the 2001 and 2003 tax deductions permanent and reducing the corporate profits tax by 1,000 basis points, an annual average of 2.1 million more jobs would be created. Indeed, over the 10-year period for which these forecasts apply, 3.4 million more jobs would be created above baseline—current-law baseline in 2018.

These tax moves would dramatically increase the level of national output. The growth rate of the economy would increase by a full half percentage point in 2011 and 2012 when taxes will otherwise increase under current law. The annualized growth rate jumps by three-tenths of 1 percent, and, on average, gross domestic product averages $284 billion more over the forecast window.

These tax changes dramatically improve household income, partly because the economy is so much better and partly because the average tax burden falls. The average household would have an additional $5,138 to spend or save after paying taxes. By 2018, that amount rises to $9,700 additional after-tax dollars.

Let me just say something quickly about energy policy because it is also related to getting the economy moving. Rapidly increasing prices for gasoline and petroleum-based energy generally slowed the economy and made the economy more vulnerable to the economic setbacks that we are having today. If Congress acts to expand energy supplies, looking—the forward-looking prices will fall and economic activity will shed off the drag that stems from that sector.

Let me illustrate in closing. Economists working with me in my Center for Data Analysis at Heritage estimated the economic effects of a $2 increase in retail unleaded gasoline. We have just experienced such an increase over the past 14 months. We found that total employment falls by 586,000 jobs, after-tax personal income falls by $532 billion, personal expenditures consumption fall by $430 billion, and significant personal savings are spent to pay for the increased cost of gasoline. Those are the damages that were done when the gasoline prices were rising rapidly upward.

A resumption of world economic growth might again fuel those increases. So look to the energy policy as one handle that you can use in stimulating the economy.

Thank you very much.

Chairman SPRATT. Thank you very much.

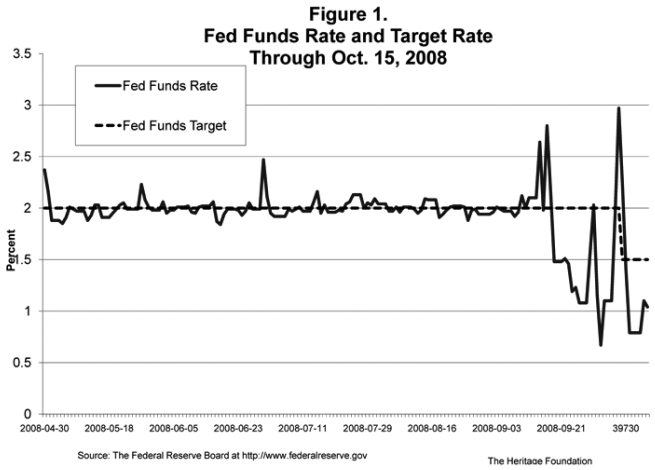
[The statement of Mr. Beach follows:]

PREPARED STATEMENT OF WILLIAM W. BEACH, DIRECTOR, CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION

The stock market turmoil that has captured everyone's attention is rooted in the ongoing crisis in credit markets and aggravated by the slowdown in general economic activity that stems from the ills of the financial sector. It is all the more spectacular by the extraordinary highs and lows that equity markets are recording. It almost seems that the only thing truly predictable about today's investment markets is just how unpredictable they have become.

Yet, the current situation on Wall Street and in bourses all around the world is not altogether new territory. We have seen amazing changes in stock market indexes before, and we have seen recovery in each instance. What is new to everyone except the very few who can remember market activity during the early 1930s is the high level of risk aversion that surrounds virtually every transaction. The LIBOR/Fed funds spread, a reliable measure of risk, has reached record levels in

the past four weeks; and the Federal Reserve lost all control of their Fed funds target rate in the middle of September and has failed so far to recapture it. (See Figures 1, 2 and 3 attached). Despite some of the boldest moves ever made by the government of the United States to tame these fears, a high intolerance to risk continues.



We're at an odd moment in the evolution of these economic challenges: there is great hope but little evidence that the credit market fixes will work; and there is increasing concern but, again, little evidence that the financial crisis will push the general economy into a severe recession. My own sense is that we have passed into a mild recession that could become significantly worse and long-lived if Congress and other governments make wrong or ineffective policy moves. Recessions that start in credit markets last longer than those that stem from shocks to aggregate demand or supply. This one looks like it could be with us for a long while unless we do highly effective things to reduce its impact.

There also is an increasing awareness that the roots of the current crisis are firmly planted in public policy mistakes, which includes excessive liquidity produced by decisions by the Federal Reserve. The engaged public appears to understand that staunching the current flow of bad economic news requires that the root causes of this crisis be dealt with. Congress and the past two administrations bear responsibility for expanding the spectrum of home mortgages into segments of the population that were not ready for the financial responsibilities of mortgage credit. The Fed bears responsibility for fueling the feverish pace of speculation surrounding mortgages, and regulatory bodies must own up to their failure to rein in these market excesses.

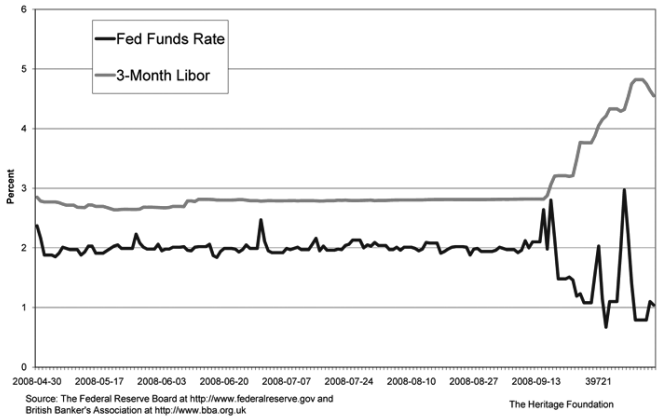
Congress also finds itself at the center of debate over how best to respond to the deepening economic slowdown. Indeed, there is widespread expectation that the House and Senate will send the President legislation very soon to stimulate the economy. Many who find themselves out of work or have seen their incomes or businesses decline doubtless look forward to congressional action. The question now is, what should Congress do?

As I will argue later in my testimony, Congress obviously should do nothing to harm the economy; it should let the Federal Reserve lead the effort to stabilize economic activity; and it should keep its focus on crafting long-term, pro-growth economic policy. Most importantly, Congress should make no change to basic policies that would signal increases in risk either through raising taxes or through increasing burdensome regulations. It also should be extremely wary of any legislation that could in any way be interpreted as America withdrawing from international product or capital markets. Congress can ill afford to repeat the awesome errors of its predecessor in the early days of the Great Depression and retreat from the world economic stage.

Congress should take this moment of slow growth to do what it does best: set broad economic policy. In this instance, Congress should concentrate on signaling to investors and workers alike that its principal focus will be on improving pro-

growth economic policy, mainly in the areas of tax, regulatory, and spending policies. Serious work by the Congress in these areas will create greater predictability for investors and business owners and assure workers that they will have a better chance of improving their wages through increased productivity. Efforts to enhance the long run may very well have immediate, short-run benefits as economic decision makers reduce the risk premium they place on starting new businesses or expanding existing enterprises.

Figure 2.
3-Month LIBOR (U.S. $) and the Effective Federal Funds Rate
Through Oct. 15, 2008



I recommend that Congress address economic policies in three interrelated areas, all of which affect near- and long-term economic performance: (1) tax policy, (2) energy policy, and (3) long-term spending.

Nearly every significant general slowdown in economic activity is a good time for congressional policymakers to ask: Are we doing everything we can to support long-term economic growth? That is, slowdowns are good times to get back to policy fundamentals and make certain that everything Congress can do to allow the economy to grow has been done.

I am convinced the Congress is not the best policymaking body for addressing the short-run challenges of the economy. That role is better played by the Federal Reserve System. So much of what Congress does is tied to the budget and appropriation processes, which take time to reach legislative results. Moreover, Members of Congress frequently do not have the time or background for keeping up with financial markets, the ebb and flow of economic data, and the actions of economic institutions the way the Fed does, or even as the economic agencies of federal and state governments do. These institutional factors explain why congressional action often occurs after the need for action has expired and why the actions it takes often are not as targeted as they need to be.

However, there are areas of economic policy where congressional action can be timely and targeted, though it may not intend to be short-range in focus at all. Those areas involve the reduction of investment risk.

Investors are driven, in general, by comparative rates of return when making investment decisions between various opportunities. If two business opportunities are possible but one has a better rate of return than the other, then the investor will go with the superior opportunity—the one with the higher rate of return. Suppose, though, that outside factors intervene (a flood, war, regulatory changes) and this otherwise superior investment now carries more risk than the inferior one. The investor discounts the rates of return for the greater amount of risk, and if the rate of return on the first opportunity is still superior, the investor goes with that same opportunity. If, on the other hand, the risk is too great to go with the otherwise superior opportunity, the investor may take the more cautious approach of avoiding risk and placing funds in the opportunity with the otherwise lower rate of return.

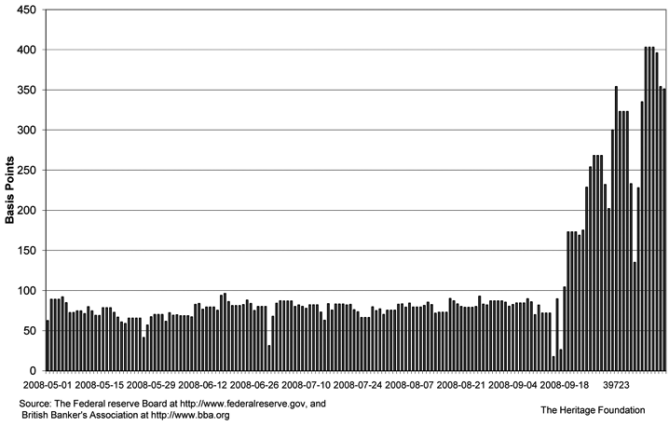
TAX POLICY CHANGES

What can increase risk? Many factors, of course, but public policy commonly looms large. Tax increases, especially if they land on capital, increase the cost of capital

and lower investment returns. When investors are uncertain about whether taxes will go up or stay the same, they still can act as though taxes have risen if they judge the risk of an increase to be nearly equal to an actual increase. And rising uncertainty can have the effect of driving down investments in riskier undertakings.

Make the tax reductions of 2001 and 2003 permanent: Thus, among the first things Congress can do to address the current slowdown is to pronounce definitively on the tax increases scheduled for 2009 and 2011. There are projects, new businesses, and expansions of existing businesses that would be undertaken today if Congress signaled that taxes would be lower in three years. Since nearly all major capital undertakings last beyond this three-year period, it is likely that making all or most of the Bush tax reductions permanent would stimulate economic activity today as well as in 2011.

Figure 3.
LIBOR Over Fed Funds Rate Spread
Through October 15, 2008



I am probably not the only one here today who knows of businesses that are preparing now for higher taxes in 20ll. They are preparing themselves by reducing their riskier projects and providing for stronger cash flows in 2010. It is altogether possible that there are projects being cancelled today that would otherwise go forward if taxes were not scheduled to rise in 2011. At times like the present, the speech of policymakers is as important as the policy actions they take. The decision makers in business and investment are watching Washington closely to discern the direction Congress will take in responding to this crisis. If that direction includes tax increases, then investors will find more favorable economies to support and business owners will, as much as they can, locate their expanded activities in places with more favorable tax regimes.

Thus, Congress should signal today what it plans to do on taxes in two or three years. For my part, I urge the Congress to make permanent the key provisions of the 2001 and 2003 tax law changes. Maintaining lower tax rates on labor and capital income will encourage both labor and capital to work harder now when we need that greater activity.

Accelerated depreciation: In addition, we know from past experience that accelerating the tax depreciation of capital equipment and buildings or one-year expensing of business purchases that otherwise would be depreciated over a longer period of time for tax purposes can help during periods of slow growth. This was certainly the record in the last slump.[1]

Taxes on capital gains and dividends: We also have recent experience with reducing the tax rate on long-term capital gains and on dividend income. If Congress were to reduce these tax rates by 50 percent for the next two years, the cost of capital to businesses would fall and investment stability would be enhanced. Indeed, if Congress were to approve a temporary zero capital gains tax rate on new stock

[1] Matthew Knittel, "Corporate Response to Accelerated Tax Depreciation: Bonus Depreciation for Tax Years 2002—2004," U.S. Department of the Treasury, Office of Tax Analysis, Working Paper No. 98, May 2007, Office of Tax Analysis, U.S. Department of Treasury.

issues, troubled banks could raise the more of the capital they desperately need without having to go to the Treasury Department.

Lower the corporate profits tax: In one area of fundamental tax policy there now is nearly universal agreement: our federal business taxes are far too high. The tax rate on corporate profits is the second highest in the world. Why is it not the firm policy of the government of this country to make certain that the corporate profits tax is always below the average corporate income tax of other industrialized countries? Such a policy would enhance our competitive standing world wide and significantly reduce the incentive for U.S. firms to relocate to lower tax countries.

The current high rate affects the location decisions of businesses that end each tax year with taxable income and every business decision by taxable and non-taxable corporations who estimate the costs of buying new equipment and expanding operations. Congress should follow the lead of its Ways and Means Chairman and decrease the income tax on corporations. In fact, it should dramatically drop that rate.

If Congress were to make the tax reductions of 2001 and 2003 permanent and lower the corporate profits tax from 35 to 25 percent, I estimate the following economic effects would ensure:

- More jobs: By making the 2001 and 2003 tax reductions permanent and reducing the corporate profits tax by 1000 basis point, an annual average of 2.1 million more jobs are created. Indeed, 3.4 million jobs above a current law baseline are created in 2018 by newly energetic businesses.
- Overall economic activity more vigorous: These tax moves dramatically increase the level of national output. The growth rate of the economy increases a full half percentage point in 2011 and 2012, when taxes will otherwise increase under current law. The annualized growth rate jumps by .3 of a percent, and Gross Domestic Product averages $284 billion more over a 10-year forecast window than would prevail under current law. By 2018, GDP is $321 billion higher.
- More after-tax household spending: These tax changes dramatically improve household income, partly because the economy is so much better and partly because the average tax burden falls. The average household would have $5,138 dollars more to spend or save after paying their taxes. By 2018, this amount is $9,750 (after subtracting inflation).

Do not depend on demand-side stimulus: Demand-side stimulus (tax rebates, the child tax credit, and the 10 percent tax bracket) do little to change the course of the sluggish economy. Certainly for tax rebates, we have just passed through a laboratory experiment of sorts. President Bush signed legislation earlier this year that gave each taxpayer a $600 tax rebate ($1,200 for married taxpayers). Congress hoped that these rebates would stimulate consumption and prevent the economy from falling into a recession. While the jury is still out on this experiment, initial and supporting evidence for this view looks very thin.

More than likely, the tax rebate of 2008 will join those of 2001 in falling well below expectations as a way to stimulate the economy or move it from a prolonged sluggish growth trend. Indeed, the contraction in investment and thus job creation did not begin to improve until after the 30 percent partial expensing in the 2002 act and the 50 percent partial expensing in the 2003 act, which also cut the tax rates on dividend and capital gain income. Congress has enacted depreciation and expensing stimulus plans under Republican and Democrat majorities.

ENERGY POLICY

Rapidly increasing prices for gasoline and petroleum based energy generally slowed the economy, helped bring on our current recession, and their effects continue to impede job and income growth. If Congress acts to expand energy supplies, forward looking prices will fall and economic activity will shed off the drag that stems from this sector.

Let me illustrate. Economists working with me in the Center for Data Analysis at Heritage estimated the economic effects of a $2.00 increase in retail unleaded gasoline.[2] We have just experienced such an increase over the past 14 months. We found that

- Total employment falls by 586,000 jobs.
- After-tax personal income falls by $532 billion.
- Personal consumption expenditures fall by $400 billion, and

[2] See Karen A. Campbell, "How Rising Gas Prices Hurt American Households," Heritage Foundation Backgrounder, No. 2162, July 14, 2008. A copy of this report is attached to this testimony as Appendix 1.

• Significant personal savings would be spent to pay for the increased cost of gasoline.

These national level results reflect the economic effects of price changes. That is, disposable income falls because the economy slows below its potential. In addition, households have to spend more in gasoline.

We looked at the economic effects on three types of households. Let me describe the effects on one of these: a married household with two children under the age of 17. For this household, disposable income falls by $1,085; purchases of goods and services falls by $719; and $792 is taken out of personal savings just to pay the gasoline bill.

Some analysts argue that gasoline consumers can adapt to higher prices by changing their driving patterns and their automobiles. However, new research by Jonathan Hughes, Christopher Knittel, and Daniel Sperling (all from the University of California-Davis) shows that families today have little opportunity to quickly adapt to higher prices. Most working families have two income earners who commute by automobile to work. They live in suburbs away from mass transit opportunities. Their children have extensive after-school activities to which they are transported more often than not in an SUV. Today's short-term price and income elasticities are a full ten times smaller than those estimated using data from 20 years ago.[3]

These lower elasticities mean that consumers have a much harder time adapting to gasoline price shocks today than two decades ago. Pretty much all they can do is reduce their consumption on other items and take funds out of savings to pay for the higher priced gas. Doing so, of course, slows the economy and makes everyone else worse off.

There are many economic problems facing Congress, from slowing global economic activity to persistently bad news from our financial sector. Congress can act on some of the economic fronts before it, but its ability to affect the nation's economic future is limited. On energy, however, its actions to increase supplies in the short and long run could do some good, particularly for workers looking for jobs and families hoping to keep their children in violin lessons and little league baseball.

I am a free trader who believes imports are central to our economic vitality and future economic strength. However, our heavy reliance on foreign oil producers (imported oil now constitutes over 60 percent of our daily petroleum demand) has made us subject to price variations due to supply disruptions, supply extortion, and booming world demand. I believe that increasing the domestic production of petroleum and refined oil products would have a positive effect on our domestic economy, largely through more jobs and income.

In another study prepared by economists in my Center, we asked what would be the economic effects of increasing domestic production of petroleum by 10 percent. The U.S. currently consumes 20 million barrels per day, of which around 65 percent come from foreign sources. If domestically sourced petroleum increased by 2 million barrels per day, what would be the economic effects.

Our analysis indicates that such an increase would

• Expand the nation's output as measured by the Gross Domestic Product by $164 billion.

• Increase employment by 270,000 jobs.

Congress exercises enormous authority over petroleum mining, largely through its regulation of off-shore and federal land oil reserves. Authorizing more oil mining in these reserves today would begin to wean the U.S. from the economically harmful reliance on so much foreign petroleum.

One of the more tragic features of recent energy policy actions by Congress is how often it has failed to increase access to energy resources on the grounds that doing so would not have any effect on supply or price for years. While possibly correct from an engineering standpoint, this excuse for inaction makes no sense economically. If Congress were to announce greater access to proved reserves, mining activity would immediately begin, capital and talent would leave other parts of the world and travel to the United States, forward pricing markets would feel the downward pressure on prices that impending supply increases make, and ordinary Americans would not discount their own economic futures as much as they do today.

---

[3] See Johanthan E. Hughes, Christopher r. Knittel, and Daniel Sperling, "Evidence of a shift in the Short-Run elasticity of Gasoline Demand," National Bureau of Economic Research Working Paper, w12530 (September, 2006).

SPENDING POLICY

Increase confidence in the U.S. economy by addressing long-term spending challenges. While the attention of most policymakers will be on immediate responses to the current slowdown, everyone should attend to a factor that's increasingly important to confidence in the U.S. economy: the seeming unwillingness of Congress to seriously address the enormous financial challenges from entitlement spending. Many investors and organizations that play key roles in the future of the U.S. economy are worried about long-term growth given the fiscal challenges posed by Social Security's and Medicare's unfunded liabilities. The Financial Times recently reported that the lead analyst for the U.S. at Moody's warned that the credit rating agency would downgrade U.S. treasury government debt if action was not soon taken to fix entitlements.

Thus, at a time when the economy is slowing and the speech as well as the actions of Congress can affect economic activity, policymakers should take concrete steps that will announce their intention to address unfunded liabilities in these important programs. While reforms in these programs may be beyond what this Congress can do, it is possible to signal change by reforming the budget rules.

Currently, the federal budget functions as a pay-as-you-go system, with a very limited forecast of obligations and supporting revenues. We just do not see in the official budget what may happen over the next 30 years. The five and ten-year budget windows do not permit Members or the general public to sense the obligations that are coming beyond that ten-year time horizon.

A good first step in addressing the long-term entitlement obligations of the United States would be to show these obligations in the annual budget. This could be done by amending the budget process rules to include a present-value measure of long-term entitlements. Such a measure would express in the annual budget the current dollar amount needed today to fund future obligations. Such a measure has been endorsed by a number of accounting professionals, including the Federal Accounting Standards Advisory Board.

A solid second step would be to convert retirement entitlements into 30-year budgeted discretionary programs. Such a move recognizes that mandatory retirement funding programs for millionaires that crowd out discretionary spending programs for homeless war veterans make no sense at all. If we are to contain entitlement spending and reform the programs driving those outlays, then a paradigm shift likely will be required. Recognizing Social Security and Medicare as discretionary programs helps to force attention on changes that will assure their survival well into the 21st century.[4]

Chairman SPRATT. Mr. Ryan, would you like to lead off?

Mr. RYAN. Sure. Can you bring up chart 14, please.

About 5 months ago we passed a stimulus package, a demand-side stimulus package. If you take a look at chart 14, if you look at personal consumption expenditures, that is about 17 percent of GDP, gross domestic product. Look at what happens. We basically got a one-quarter pop in GDP statistics. Then we gravitated back towards the pre-stimulus trend.

So the concern I think some of us have in doing this fast, demand-side stimulus is they might give you a pop in a quarter in which they take place, but then you go right back down. The question is, what is it we can we do to build in the long-term, sustainable growth, grow the economic pie so that we might create new and lasting job growth and permanently reduce unemployment. That is point one.

Point two is, look at our fiscal situation we are in right now. We are looking at easily a $750 billion deficit next year alone. You throw a stimulus thing on this, $300, we are over a $1 trillion, a $1 trillion budget deficit.

Now the question is—I think you can have good disagreements about this—what does that do to the value of our dollar? What does

[4] See Stuart M. Butler, "Solutions to Our Long-Term Fiscal Challenges," Testimony before the Committee on the Budget, United States Senate, January 31, 2007.

that do to our borrowing costs? More to the point, what does that do to the signals we send to the markets, to the global markets, on America's ability to borrow and our borrowing costs? All of these borrowing costs put an enormous tax rate increase on future generations. It speaks to the ability of our economy to grow in the future or not.

The one thing I think we often forget here is global competitiveness. You know, we used to just take it for granted that the American economy is always going to be the fastest growing economy, the marvel of the world. We are number one, we always will be.

Well, the oceans don't separate our economies anymore. With technology today, with globalization, it is just so integrated. That is why our relative economic and tax policy relative to our competitors matters so much more than it ever did before.

So going into the next session of Congress with this notion that we are going to dramatically increase tax rates on investment, on capital, on small businesses, especially relative to our foreign competitors, to me, is just like the economic equivalent of shooting yourself in the foot.

So I will just start with you, Dr. Beach, because you focus on econometrics and modeling. Give us your sense of modeling—I know you cut your testimony short—on what kind of job increase would we have using a model on this, just if we actually produce some more of our own energy, say 2 billion barrels of oil produced in America versus overseas?

What kind of job increases would we see if we lowered the after-tax rate of return on capital by doing some of the tax things you mentioned? What are the job implications of lowering the corporate income tax versus keeping it where it is, which, as you mentioned, is the second highest in the world?

So, what are the job implications for these kinds of fiscal decisions that we are about to make?

Mr. BEACH. Well, all of those things you just mentioned in isolation have a positive effect on unemployment, particularly private sector employment. Of course, that should be the objective that you should be looking at this point.

I was at one time, Congressman, I guess, one of the principal revenue planners for the State of Missouri back when I was young. That happened to be in the early 1980s when we were facing significant contractions in our revenue sources, almost identical to those, but multiplied by twice, that Iris Lav put up for you.

At that time, we thought the best thing that we could do and what the Federal Government could do would be to look at their fundamental tax policy. There are ways we could cut bridges, we could close operations which were no longer needed; and because we had shortfalls of revenue, we did all of that.

But we also spent a lot of time looking at our business taxes, both short-term business taxes, like having a zero tax rate on small business income for a period of 18 months that would then lead to a little higher rate when they fully recovered. That is not a bad idea at the State level, not a bad idea at the Federal level.

Looking at fundamental tax reform: The corporate business tax rate matters a great deal on location. The State of Missouri was trying to get people to move from Iowa and Illinois, Kansas, Mr.

Moore, into Missouri. I think all of the things that you have mentioned are significant.

A lot of people think energy production won't produce jobs. It is just, you know, energy production in Saudi Arabia, now it is in the United States. But we were amazed to learn in our models that that was actually a very positive thing to do. We were looking at half a million jobs to 800,000 jobs over about a 5-year period, just from increasing energy production by 10 percent in the United States.

So you can do that as part of the stimulus package. You can do that as part of your long-term growth.

Mr. RYAN. I appreciate the indulgence, we don't have a clock in these two positions here, chairman or ranking, but I will just ask one more question for each of you. This is something, I think, we on each side of our aisle are concerned about, have to be concerned about.

Are we building the seeds of too many too-big-to-fail institutions in this country? We are getting through this crisis, and we are doing it by seeing mergers, by seeing financial institutions grow, in order to take the balance sheet problems. But what is it we ought to do after we get through this crisis to assure that we don't have too many too-big-to-fail institutions which, down the road, if we do not manage risk properly, do not supervise and regulate effectively, what kind of seeds are we planting for ourselves and how do we best prevent that from really being a problem down the road?

I will just start with each of you. Thank you.

Mr. BAILY. Thank you.

We are creating too many institutions that are too big to fail. I am not sure what we can do about it over the next short period of time.

There are advantages to having large financial institutions. They operate in global markets. The problem is that when they get into trouble, we have to go rescue them.

I am not enjoying this rescue package. I am sure you are not. It is putting money into companies that have made bad decisions. I think we have to do it to preserve the financial sector.

I think, going forward, we need to take a hard look at our regulatory system and supervisory system, which I think failed, to make sure that those institutions that are large—because we are going to continue to have large financial institutions—are being regulated in a way that is effective.

I don't think that necessarily means more regulation. There were rooms full of regulators in some of these large banks. We need to be more effective in our regulation to make sure that they don't fail.

I share your concern. We are creating some moral hazards.

I would make one more quick comment, and that is the one-quarter pop; I wish it had been more of a two- or three-quarter pop. But given that we are expecting GDP to decline in the fourth quarter and probably in the first quarter of next year, I think getting a short-term stimulus out there, even if it only gives us a two- to three-quarter pop, would be worthwhile.

Ms. LAV. I mean, I am not an expert on these financial institutions, but I think the answer is to let—worry a little bit less about

size and a little more about how do we make sure they don't fail; how do we make sure that these institutions are responsible to people, they are responsible to the laws, and that the regulations are right, to make sure they can't have these kinds of excesses.

I mean, lots of people could see that there was something wrong going on in the mortgage market, for example. It wasn't that nobody saw it. It is just that it wasn't—you know, nothing moved forward to try to fix it. So I think that is the answer, you know, to be proactive.

Mr. BEACH. Congressman, I think moral hazard is going to be harder to manage that than the money supply. I think that is going to be on your desk for a long, long time.

I supported the bailout—excuse me, the rescue plan like you did. I did so with my eyes open, that we are creating policies now, which will be in the boardroom as business parameters. Well, we can make that investment. We can do those things because, after all, a few years ago, the Federal Government spent an enormous amount of money to make sure that we didn't fail.

You have got to do something in public law that will reverse that tendency; otherwise, we are going to be here, I would guess, in a few years with the health care industry, because we are probably going to create another bubble out of this that will move into another part of our economy.

Just let me also say that bailouts, rescue plans, oftentimes result in the revaluation of a country's sovereign debt; and that is reflected by a downward pattern in the valuation of their currency. That won't happen right away, but the sooner, the closer we get to the generation, my generation retiring—and that is just a few years, of course—we are going to be looking at debt revaluation issues. I think they will be related to the policies which are being worked out now.

Chairman SPRATT. Just to engage in our battle of the charts here, let me put two up as a historic reminder, something that we as Democrats are proud of, namely, the real economic growth rate of the Clinton administration, 1993 to 2000, versus the Bush administration, 3.7 percent versus 2.4 percent of the policies that you have just been discussing.

In addition, with respect to jobs, if we could have that chart, the average number of jobs created during the Clinton administration was 237,000, the Bush administration, 52,700.

Mr. RYAN. Does that include the recession that President Bush inherited as it came into office?

Chairman SPRATT. That includes the entire period of time. That is just for the record.

Now, Mr. Doggett.

Mr. DOGGETT. Thank you, Mr. Chairman. I don't believe it is reasonable to launch a large new expenditure without considering how the last $700 billion that Congress approved is being used. With nobody taking personal responsibility for any part of this financial system fiasco either in Washington or on Wall Street, and with some of the people who contributed to the crisis actually getting rewards instead of penalties, we don't have a formula for preventing a reoccurrence of these excesses.

Going forward, we have essentially the same Federal regulatory personnel, the same Wall Street directors, the same executives running the same show as they were running before the Bush administration made its urgent plea of bailout or bust. And I believe the American people would be better served by our seeking more accountability, more transparency and a better return on their investment.

While I am very pleased that direct investment in banks, an approach that so very recently Secretary Paulson was in this Congress condemning as what he called an admission of failure, that that was used as the first choice of the Treasury. I don't believe that there is adequate public understanding of the terms of that investment.

Treasury acted not as the lender of last resort, but as the lender of best resort, offering banks a far sweeter deal than the terms Warren Buffet required, a far sweeter deal than the British banks got. Indeed, about the same similarity with the Buffet deal and the Treasury deal is the name applied to the stock, which in Treasury's purchase amounts to essentially a below-market 5 percent loan.

Mr. Buffet got twice as much in dividends as taxpayers are to receive, and he got more than 85 percent more common stock rights than taxpayers will get. And now, according to Chairman Bernanke's speech last week in New York, the Treasury will return to the purchase of toxic securities—what Nobel Prize-winning economist, Joseph Stiglitz, has called the "cash-for-trash plan."

Most folks, seeing so much money being spent now out of the $700 billion, have good reason to wonder how much of it will be available when the new President is sworn in in January. And all of this comes with an understanding, I think by everyone, that this $700 billion is not about stimulating our economy out of the current economic recession. It is only the necessary and expensive medicine for preventing a financial system shutdown.

Against that backdrop and recognizing that the Bush administration is responsible for adding literally trillions of dollars of additional national debt and recognizing, as several of you said, that sooner stimulus is better than later stimulus, isn't the more prudent approach for us immediately for when the Senate reconvenes on November 17th to simply approve in its current form, or something very similar, the bill that the House has already approved to provide $60 billion, approximately $61 billion, in immediate stimulus to try to get this economy moving again without prejudging what action may be necessary when we reconvene in January?

Dr. Baily, if you would lead off.

Mr. BAILY. Thank you. I appreciate your concern about what has happened. I think it has been a rather sad episode in history.

Mr. DOGGETT. Indeed.

Mr. BAILY. There are a lot of people to blame I think on this. I think there will be some accountability; we do have a legal system which is going to hold some people accountable. There are a lot of people who have lost money.

But this is certainly a sad episode. And I think we are doing this rescue package because we really need to do this rescue package, not because we like it——

Mr. DOGGETT. Sir, I wouldn't disagree that action was needed; it was a question of responsible action.

But as my time dwindles, let me just ask you specifically, isn't the most responsible thing to do now, as far as a stimulus for our economy, to have the Senate approve the bill the House has already approved in about 3 or 4 weeks, and then consider what addition is needed when we reconvene next year?

Mr. BAILY. Well, as an economist, I would like to see a stimulus get out there as quickly as possible. So I don't want to comment on all the specifics and details, but to get a stimulus that, as Iris said, was quick and temporary and had the most effect on the economy.

Mr. DOGGETT. Is there any element of the stimulus that we approved, which included some increase in the Medicare matching right, an increase in food stamp benefits, an extension of unemployment benefits and some modest infrastructure investments, that you would be opposed to, in what we have already passed?

Mr. BAILY. No, I support those measures. As I said in my testimony, I would like to see a round of tax rebates done quickly.

Mr. DOGGETT. And, Ms. Lav, my time is up, but do you agree with the package Congress has already approved as at least a first step to trying to get our economy righted?

Ms. LAV. I think it has all the right elements in it. It is good for that.

I think I would like to see it be bigger. And so that the politics this year is about how you can best get to there. But I think the time is now for something bigger if it is politically possible to do that.

Mr. DOGGETT. Thank you, Mr. Chairman.

Chairman SPRATT. Mr. McGovern. Mr. Scott.

Oh, I beg your pardon. Mr. Garrett, I beg your pardon. I almost got away with it.

Mr. GARRETT.

Mr. GARRETT. Thank you.

Dr. Baily, if I heard you right—and correct me if I heard you wrong—you said that where we are now with a weak dollar is a good thing. I would always think just the opposite, that we should be trying to strive with the monetary and fiscal policy to get a strong dollar.

And at the same time you made that comment, you were also making the comment part of the rationale there is because of the low cost of borrowing and the flight to treasuries. But isn't that just because we are in a tight credit market right now, and that is just the market where they are going to go into? And if everything goes through with this $700 billion bailout, which I did not support, but if it all goes through, as we hope that it will, that that credit situation will change, liquidity will flow again and the interest rates on those treasuries will not be these historic low numbers, and we will be in a worse situation than we are now?

Mr. BAILY. I think we need a dollar that is appropriate, that makes our manufacturing sector competitive. I don't want to see a weak dollar. There are costs to us for a weak dollar, so I wouldn't use that word at all.

I don't think we should have an overvalued dollar; and I think the dollar had become overvalued by 2002, and that is why I think some adjustment of the dollar is appropriate.

I actually think the China currency should be adjusted up against the dollar because I don't think they are at the market equilibrium. I want to see markets work right in terms of making our economy more competitive.

Mr. GARRETT. Thank you.

And, Ms. Lav, you made the comment—I just went back to your notes—your comment says three ways that a State can deal with a situation. It seems to me, at least in my own State, in the State of New Jersey, we have found a fourth way to deal with our economic problems, and that is the same as what the Federal Government does, and that is called borrowing.

We don't raise taxes, we don't cut—well, actually New Jersey does. We raise a lot of taxes in New Jersey; and cut spending—well, we never do that. But we borrow despite the fact the constitution doesn't allow it. So isn't that really the fourth category? Isn't that what sort of skews some of the numbers out there?

Ms. LAV. Most States absolutely can't borrow. Although some of them can do things like borrowing from the future in the sense that they can sort of sell a future stream of earnings, which is a sort of borrowing from the future, but it is actually a sale, like when they securitize their tobacco settlement revenue and that sort of thing.

So New Jersey has kind of a large overhang of debt that it has acquired for various purposes in the past.

States balance their operating budget and then they borrow for other things. They certainly borrow, that is what—they would sell bonds, they borrow for infrastructure. Infrastructure in States has nothing to do with their operating budget; by and large, that is a separate part of the budget that is not covered by balanced budget requirements, and they borrow to do those things. And that is a lot of the way that New Jersey has—you know, it has floated bonds. And it has got a larger debt than most other States, there is no question about that; and the interest rate comes onto the general fund budget and is a problem for it.

But most States are not entirely in the same situation as New Jersey.

Mr. GARRETT. And I don't know—I have to delve into it more—some would argue that New Jersey at least—not to pick on New Jersey, but they have used it more just for infrastructure, but they also actually have used it in the past for operating expenses.

Ms. LAV. They have through switching around. There are a couple of States that do that—New Jersey, Illinois and California, but very few others.

Mr. GARRETT. Mr. Beach, you made the comment you supported the bailout, and you worry about the moral hazard in the boardroom that they sort of put that out there and they said, now we can anticipate the Federal Government stepping in and relieving us of some responsibilities, I guess—your words, not mine. But what we need to do now is have the Federal Government step in to rectify that.

You have been around here for a while and looked at how the Federal Government works. You have seen how we have come up with solutions to problems before, such as in Sarbanes-Oxley, which basically was supposed to provide us with all the transparency in the world with absolutely no cost to the economy or the business system. Of course, we know it did have a tremendous cost, and it may have actually made our Wall Street market move overseas in a lot of ways because of that.

I understand what you are saying, what needs to be done, but knowing the history of the way the Federal Government operates, do you have any pleasant view that that is actually what is going to occur now, that we are going to come up with a proverbial world-class regulator, which we obviously could not get in place prior to the demise—almost demise of Fannie and Freddie, that actually solves these problems?

Mr. BEACH. Now that I am the old hand here, let me just say that usually the policy-making bodies of the Congress don't get it quite right the first time. And that is because of the way that you operate with your elections and with your committee structures and so forth. That is not a criticism, because what is great about the system is that you do return to the same issues time and time again.

Once the regulatory bodies have settled on their rules, one of the things you notice is, they rarely return to take a look at the rules. They wait for you to push them. So I am hopeful on the second go-round of this—and I am confident in the next Congress you will have second and third go-rounds—that you will find ways of putting strictures, rules in place that will make it extremely difficult for this moral hazard thing to propagate into yet another real problem that you have to solve.

Mr. GARRETT. I am sure there are going to be a lot of strict rules.

Mr. BEACH. I agree. Regulation is probably going to be the least of the problems you have.

Mr. GARRETT. Thank you.

Chairman SPRATT. Mr. Scott.

Mr. SCOTT. Thank you, Mr. Chairman.

Dr. Baily, you mentioned the troubled assets on the banks' books. And I was actually surprised to hear Chairman Bernanke talk about not overpaying for assets, because in discussions—there is nothing in the bill to restrict buying worthless assets at overpriced—overpriced; and in my discussions with people before the bill is that is exactly what was intended.

If the intention now is to purchase these so-called "troubled assets" at a good-faith estimate of fair value, even when there is technically no market, they are temporarily illiquid, but at a good-faith estimate of fair value, what does the government purchase of the asset do that marking to fair value wouldn't have done for free?

Mr. BAILY. I was puzzled by the top when it first came out. It seemed to me, the need was to recapitalize the banks. And my understanding was that they would probably overpay for the assets relative to what those assets could command in the marketplace, and the difference would then be used to recapitalize the banks.

I think it is much better what they are doing now, which is to inject capital directly into the banks.

Mr. SCOTT. Rather than buy worthless assets from all over the world, a small percentage of which would actually land in the capital account of banks that we are aiming at?

Mr. BAILY. Right. So I think that is a better plan.

I do think there was a rationale towards creating more of a market for some of these assets. So I actually think that using some of the $700 billion to buy some of these assets, using this reverse-auction technique, might allow greater liquidity in those markets for assets that hopefully are not worthless, but that do have some value when held to maturity, and we can create greater liquidity in that market.

I understand the dangers of overpaying. But I think that is a legitimate part of this rescue package.

Mr. SCOTT. But if it is at fair value, you could have accomplished most of what we are aiming at just allowing mark to fair value rather than marking to market?

Mr. BAILY. Well, the idea, I think, is that if you can create an effective market for these assets, that it improves the liquidity of the banks and allows them to sell assets, but I understand the concern.

Mr. SCOTT. Is there any thought that we might actually buy enough of these assets to create a market?

Mr. BAILY. Well——

Mr. SCOTT. I mean, there are tens of trillions of dollars out there, and we are talking about $700 billion.

Mr. BAILY. I think it could help. I think it could help. I recognize your concerns, Congressman.

Mr. SCOTT. Helping home owners, now that we essentially own Fannie Mae and Freddie Mac, what would be the ultimate cost of doing one of these loans at a commercial rate 5.25, 5.75, for those that can actually pay?

Mr. BAILY. Well, if you are issuing the mortgage at what will be—once this crisis is passed, will be a fair market or a commercial rate, then the cost to taxpayers—there wouldn't be a cost to taxpayers.

Mr. SCOTT. You can essentially help the taxpayer at no cost to the taxpayer?

Mr. BAILY. Well——

Mr. SCOTT. Excuse me, the homeowner at no cost to—at probably no cost to the—there is no guarantee here?

Mr. BAILY. There is no guarantee.

Mr. SCOTT. But you would——

Mr. BAILY. There may be some cost to the taxpayer, but I think you can minimize that cost while maximizing the help to the home owner.

Mr. SCOTT. You also mentioned a prepayment issue.

What would your reaction be to legislation to prohibit prepayment penalties as inherently unfair, especially when some of these mortgages can reset at draconian rates?

Mr. BAILY. I think we would have been better off without these mortgages that started at the low interest rates and then were pushed up, because I think they ended up being deceptive.

If you do offer a homeowner a mortgage with a very low rate of interest, that is not a market rate. You are losing money in the

first few years. And so that is why they put in some of these prepayment penalties.

But I do think that the Federal Reserve has put out guidelines for mortgages that are more stringent than the ones that were in place.

Mr. SCOTT. What would your reaction be to a prohibition against prepayment penalties?

Mr. BAILY. I think at this point it is probably a good thing. I think it is a good thing.

Mr. SCOTT. Bang for the buck on the kinds of things you can do for a stimulus: Capital gains tax cuts, what kind of bang for the buck do you get on government expenditure resulting in actual stimulus to the economy if it is capital gains tax cuts versus extending unemployment benefits, food stamps or direct aid to States?

Mr. BAILY. I believe you would get more bang from the buck from the other things than you would from a capital gains tax cut.

Mr. SCOTT. Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Simpson.

Mr. SIMPSON. Thank you, Mr. Chairman.

Do you believe that too, Mr. Beach?

Mr. BEACH. No. That is actually not what the literature shows. When you reduce the taxes on capital, you get a much faster reaction in productive markets than when you reduce the taxes on labor.

What you should do is, you should look after the needs of people who are hungry and unemployed because it is the right thing to do. And there will be plenty of those people and will be plenty of opportunity for you to pass that kind of legislation.

If you want to get the economy moving again, then focus like a laser beam on what causes the economy to move; and it usually, in the short run, is capital costs. So that is why the Chairman was looking at any way that you could unfreeze credit from your side—he has his side—but from the legislative side. Look at accelerated depreciation, bonus depreciation, full expensing as a short-term stimulus for 2 or 3 years.

But the literature clearly indicates that it is just the opposite. You go after capital first and labor second if you are going to look at growing the economy out of an immediate problem. Do the right thing for people and then be hardheaded about the economy.

Mr. SIMPSON. My study of the Depression of 1932—I hate to call it the Great Depression, because I hate to use the word "great" with "depression"—was if there were two mistakes that they made, and they did many things right trying to address it and stuff—this isn't a criticism. But if they did two things wrong, it was that they raised taxes and, two, that they became more protectionist and isolationist.

Is that a fear that we have, that we are going to do the same thing? I mean, we have got some free trade agreements before Congress now that should pass, I think.

Mr. BEACH. You certainly don't want to do the opposite. And the literature, the history of that period, does assign three public policy mistakes, one of which was a tax increase to balance the budget because at that time even Franklin Delano Roosevelt, prior to his

election as President, believed in balancing budgets at the State and the Federal level.

We kind of know a little bit differently now. Ultimately, it is the right thing to do in the short run. It may not be the right thing to do.

Secondly, a protectionist attitude that led to the passage, prior to the Democrats taking over, of a very bad international trade law.

And thirdly, what the Chairman was talking about this morning from this side of the table what the Federal Reserve failed to do in terms of its own responsibilities.

Those three things have generally been figured out as the three triggers that made a recession into a very serious and, hopefully, unprecedentedly bad and never-to-be-repeated depression.

Mr. SIMPSON. Mr. Baily, I will tell you, just for your purposes, information, I agree with Mr. Baird. I will tell you, I have talked to my transportation departments. Both local, State, and everyone else, they have projects that have been engineered and ready to go that are on the board.

I voted against the economic stimulus package because I didn't think it was an economic stimulus to give people $600 checks so they could buy TVs made in China. I thought we could actually employ people and we would get something out of that in the end, and that would be an improvement in our infrastructure, and there would be a value there.

To the extent that we do that, that makes sense to me. And it is not slow; there are things out there ready to go. So I just thought I would throw that out.

But last, Ms. Lav, when I read your testimony and I heard your testimony, I kind of get the impression that you feel the purpose of State government is to employ people.

The purpose of State government is to deliver services. To the extent we employ people to do that, that is a good thing. But when I read that we ought to be bailing out States, and that it doesn't present a moral hazard to those States that we are going to be bailing out—we have got States that do a good job. We do things differently. We administer our services differently. Some States do it more efficiently than other States.

I was in the State legislature in 1987 when we went through some very difficult times. We had to make tough choices. And now we are going to prevent some States from making difficult choices by doing that.

The governor of Idaho just a couple months ago, or a month ago, ordered a 1 percent holdback across the board, told them to be prepared for a 2 percent; and when he talked about it, he said, As we create this new budget, we are going to have to make priority decisions. What is wrong with that?

I read in your thing that States take action such as instituting hiring freezes and travel freezes, as well as finding items in their budget that are more marginal to the core function. Isn't that a good thing?

Ms. LAV. I said in my testimony that what they have done up until now, that those things are mild and that that is nothing

against what is coming. So I characterized the things you just said as "mild."

And most States can find a 1 percent or a 2 percent cut. I mean, during good times things tend to expand maybe, you know, or be a little less efficient than they have to be. So 1 percent, 2 percent, 3 percent usually is a possibility. But what I am talking about is, on average, 14 percent, which will be 20 percent in some States. And that is—and of course, the purpose of States is to provide services. That is why I am talking about putting the majority of the fiscal relief through Medicaid.

In the last recession there were 6 million additional people who needed Medicaid. There would have been more if States hadn't—at least another million if States hadn't cut eligibility.

Mr. SIMPSON. But in your testimony one of the things is, you say that you don't believe States ought to be able to adjust their requirements for Medicaid if you give this relief. Isn't that what the States do? They make decisions, different States, based on different needs in their State or what the State legislature perceives? Some States are much more generous.

In SCHIP, you saw some States giving up to 400 percent of income poverty levels; other States chose not to do that. In Idaho, it was 185 percent. Are we saying that 400 percent is the appropriate level? And I voted for the SCHIP improvement.

Ms. LAV. I am not saying any level at this point is appropriate. I mean, a lot of States have prioritized health care as private employers have dropped, and so they have made those choices.

But what I am saying is, while you are giving the Federal money, you don't want the States simply to substitute the money you give them for some other expenditures because that is not stimulus basically. You want it to be additional stimulus; and so, therefore, you don't want them to reduce eligibility, back out the money and use it for something else. You want them to use it for Medicaid, which is why there is that—for new people coming onto the rolls, which makes it forward-looking stimulus.

And in answer to your question, you get about, according to Moody's Economy.com you get about $1.36 in stimulus for every dollar you spend in State fiscal relief.

Mr. SIMPSON. Let me tell you what my State will—and I have not talked to them yet, but I will guarantee you what my governor and what my State legislature will tell me.

If you are going to bail out the States for whatever, the problems that they currently face, whether it was through their own inactions or wasteful spending or whatever, and that Idaho is going to get somebody that says, Keep it, we will solve our own problems; you have got a big enough problem of your own in Washington with a $450 or $1 trillion deficit.

Thank you.

Chairman SPRATT. Mr. Baird.

Mr. BAIRD. I thank the Chair. I thank our witnesses.

As I listened to the debates over the last few weeks and today I think about how we have labeled generations these days. There is the Greatest Generation and there is Generation X and there is a new generation. I have got two 3½-year-old boys, and they are part of Generation M; and the reason I say "M" is, I am thinking

of Mercutio in Romeo and Juliet whose dying words were "A plague on both your houses."

And sometimes I listen to the Dems and Republicans, and I have got to tell you, we are passing onto these kids unconscionable, unconscionable, crushing levels of debt and deficit. And there are good ideas on both sides, Dems and Republicans, and there are really bad ideas on both sides. But this level of deficit is not sustainable, and this level of debt is not.

We talk about targeted and temporary and whatever—timely. Man, I would be much better with prompt and paid for and permanent. I would rather see us do things that we pay for that leave us a permanent asset.

And hence, when Mr. Simpson—I appreciate his acknowledgement. We share this agreement about the last stimulus; we got nothing tangible out of that. We didn't get a road, a bridge, a water treatment infrastructure. We got nothing that we could point out to our kids and say, Look, this not only put people to work, it gave you cleaner water, more efficient roads, safer bridges, improved schools, et cetera. So if we are going to do something on this, I hope we will do something that is paid for and leaves us something lasting.

The other thing that strikes me is, we have to streamline the economy as well. Just throwing more money at it is like putting more fuel in a very boxy automobile. We have all kinds of regulatory structures, requirements, et cetera. It takes 10 years from inception to construction for highway projects now, 10 years.

We are translating documents into multiple languages, we are doing multiple levels of EIS, we have got umpteen Federal agencies. That costs money in the financial sector.

Do you want to help our banks? Tell us they don't have to send us those lousy privacy notices every month that nobody reads, or every year. There are all sorts of things that we ought to be looking at, top to bottom, to say, Where is their drag-wind resistance on an economy that has to get going? And we haven't talked about it at all today, but that is a structural issue.

I worry, Mr. Beach, about the permanency of the tax cuts. Because I don't doubt that you can create all the jobs, et cetera. I could create a lot of jobs today by taking my credit card out and buying all kinds of stuff, but there are deficit implications to that.

And I worry, Ms. Lav, about the issue of bailing our States out. I think there is moral hazard. Some States step up to the plate, maintain their infrastructure, care for their kids' health care. We have seen it in our State. We have much higher coverage of our kids. SCHIP comes along, we don't get the benefit; the States that did lag get the benefit.

Mr. Baily, I appreciate your acknowledging infrastructure, but I am really concerned about this one more helicopter drop of money having lasting impact. So I put that out there.

Mr. Beach, are you concerned about the deficit? And I will put that in the context that Doug Holtz-Eakin testified almost exactly 2 years ago before this very committee, maybe exactly 2 years ago, that the so-called "stimulus effect" of tax cuts doesn't generate revenue to exceed the cost of the tax cuts. He modeled it eight or nine different ways.

Now, are you concerned about that at all?

Mr. BEACH. I am very concerned about it. I have been testifying for years for a balanced budget amendment to the Constitution. I think it is extremely important. But now I am on another jihad, and that is that, take your $700 billion rescue plan and imagine it as a bucket—I know we are not talking about a bailout today, but just imagine it that way—and then imagine what it is going to take you just to rescue Social Security when your children are 25. And—that will be about 56 of those buckets, and that will be money you are going to have to raise.

As far as taxes are concerned, I came today to talk to you about making the Bush tax cuts or those reductions permanent. That is one idea. I would much prefer you to take the entire Tax Code apart and make it more efficient. If you decide that you need to have more revenue, fine, or less revenue, fine; but a more efficient Tax Code, regardless of whichever way you go, will do wonders for the economy. I don't know that you have time to do it now, but whatever you do on taxes, make that your objective.

Mr. BAIRD. So the efficiency and streamlining argument could be vastly superior to just throw more money at it?

Mr. BEACH. It is vastly more superior. And the deficits we are talking about now, Congressman, from this or from anything that you are going to do in the next Congress are simply minor tiny little pebbles compared to what we are looking at in the tsunami debt coming our way.

Ms. LAV. We have looked very carefully at whether it is State policy or the economy that is causing these deficits. And the States that have the deficits, we looked at three factors; we have got a lot of research on this.

The States that are having problems, the States that are having the highest foreclosure rates, we looked at three factors. There is nothing the States did wrong; it is not the States' fault. The States that are having the highest increases in poverty measured by food stamp rolls, that is nothing the States did, that is what is happening in the national economy.

And the States that are having the greatest declines in employment. That matches almost exactly with the States that are having deficits now.

So I think that whatever the differences in State policies, they are swamped by what the economy is doing to the States now.

Mr. BAILY. Can I make a quick comment?

First of all, I agree with you entirely about the need to do something about the deficit in the long run. I don't have young children anymore, but I do have a grandchild now, and I am quite concerned about what we are passing on to her.

I think it is just unrealistic, the discussion, the debate we are having about taxes and spending. I mean, we need to make reforms on Medicare. Social security is not so much of a problem. But we need to make some of these reforms, and then we need to think about how we are going to pay for all that spending.

In terms of a helicopter drop, I understand why you have some concern about that. I am more concerned about making sure we get enough money out there quickly that we turn this economy around, because things are looking very ugly right now.

Mr. BAIRD. Thank you.

Chairman SPRATT. Ms. Kaptur.

Ms. KAPTUR. Thank you, Mr. Chairman, for this hearing. And I thank the witnesses for coming.

I am one of the Members that voted "no" on both bills before Congress. I would do so again. I feel that the Congress passed something that would not be effective, but would be fast.

And I believe that criminal prosecutions need to proceed—the FBI is underfunded to do that—to show that in the decade of the 1990s and in this decade there was willful intent by very powerful financial institutions in this country to create money where there was no underlying asset. And people knew exactly what they were doing.

I would like to place on the record, and I will read these very quickly, the list of the primary government securities dealers that the Federal Reserve maintains in New York:

As of October 1, 2008, Bank of America, which just bought Countrywide; BNP Paribas Securities Corporation; Barclays Capital; Cantor Fitzgerald; Citigroup; another one of the troubled institutions, Credit Suisse Securities; Daiwa Securities; Deutsche Bank Securities; Dresdner Kleinwort Securities; Goldman Sachs, another company that just came under the bank holding—a company that—for which they paid nothing for the FDIC insurance that they are now eligible to use; HSBC Securities; J.P. Morgan Securities; Merrill Lynch Securities; Mizuho Securities; Morgan Stanley, another company that just came under the umbrella of the FDIC; and UBS Securities, LLC.

The Congress gave the administration the green light, and now they behave like Wrong Way Corrigan. Rather than bringing to task some discipline inside this market, we have essentially allowed the administration to reward the irresponsible financial institutions. Why haven't the people in the administration used the full powers of the Federal Deposit Insurance Corporation to resolve this situation, as we have in the past, including the use of the net worth certificate program?

I disagree with Dr. Baily. I don't think that we should be taking taxpayer money and placing it in these institutions. I think we should be using the net worth certificate program and the tried and true mechanisms of market discipline to work out, bank by bank, what needs to be done to make the consumer as whole as we can make them.

We can do the mortgage workouts there as well. We don't have to do it in this backward way. In fact, back in August when the Congress passed that housing legislation, it was supposed to stem, give some help to do workouts at the local level so we wouldn't exacerbate the foreclosure situation.

We are exacerbating it. In places like Ohio foreclosures are getting worse, not better. And there is nothing happening now immediately to not make it worse and to precipitate a much deeper and longer recession.

So if anyone from the administration is listening, I hope they will look to the FDIC to use its full powers, to look to the net worth certificate program, to look to the fair value accounting and to using the true value of the asset rather than arbitrary indexed

value through SEC accounting standards, use the market discipline that we need to use rather than taking more money from the taxpayers.

The question I really have of you is—and frankly, I am somewhat in shock in what the Chairman of the Federal Reserve said to me, there was no relationship between the Countrywide that sits on the Federal Reserve's board of primary security dealers up in New York and the Countrywide institution which made most of the loans, subprime loans, that got us into all this trouble to begin with. And I want to place some information about Countrywide on the record here today.

I would like to ask you, which businesses benefit from debt? As America becomes deeper and deeper in debt, which businesses broker in that debt and earn money off the debt, the growing debt of the American people?

Mr. BAILY. You are opposed to the rescue package. I respectfully disagree. I think when the ship hits the iceberg, you can go back and say, as they have apparently done, that there were defective rivets and defective steel.

Ms. KAPTUR. But the ship is headed in the wrong direction, Doctor; the ship is headed in the wrong direction. They have injected some capital into some of the biggest institutions in this country, but it hasn't stopped the hemorrhage.

What they have done is one way of going about this problem. A better way would have been to use the FDIC's full emergency powers, much better way to go about this.

Mr. BAILY. Well, Sheila Bair and the FDIC, I think, are doing an outstanding job now.

Ms. KAPTUR. They could do better. They could do better. They could use their full powers.

Mr. BAILY. Well, that is probably true. I think they are doing the right thing at this point.

Ms. KAPTUR. But who benefits from debt?

Mr. BAILY. The U.S. Treasury debt?

Ms. KAPTUR. The American people's debt.

Mr. BAILY. The American people's debt?

Ms. KAPTUR. As brokered through the Treasury. Who benefits from debt? Who is making money off the American people's debt?

Mr. BAILY. Well, we have spent more than we have received in revenue. And many Americans that have received the benefits of that spending, whether it is Medicare spending or Social Security spending—and Social Security has actually been sold, I shouldn't put them on the table—but other kinds of spending that we haven't paid for. So in some sense we, the American people, are having to pay the passing on the bill, but we have actually benefited in the short term. Other institutions use U.S. debt.

I don't think anybody is making excessive returns on holding government debt.

Ms. KAPTUR. Who makes money off the U.S. debt, sir? This is not a complicated question. Aren't they the very institutions that are benefiting from the capital infusion by the American taxpayers?

Mr. BAILY. Yes. They earn an interest return on holding that money, yes.

Ms. KAPTUR. And what is their interest return that you estimate?

Anyone on the panel, how much money do they make in a year? How much money will——

Mr. BAILY. Well, the total interest on the debt, I don't have that number at my fingertips, but it is certainly very large.

Ms. KAPTUR. It is billions of dollars?

Mr. BAILY. Yes.

Ms. KAPTUR. Yes. Thank you.

And I wonder if any of your organizations could provide for the record which institutions are benefiting from the growing debt of the American people? Do any of you have that?

Mr. BEACH. I would be happy to supply some information to you on that, Congresswoman.

Ms. KAPTUR. I thank you. We will make it a part of the record, Dr. Beach. Thank you.

Chairman SPRATT. Ms. Moore.

Ms. MOORE OF WISCONSIN. Thank you so much. I would like to pursue some questions that have already been raised, and I raised earlier with Chairman Bernanke.

I am very concerned about the $700 billion investments. And I think as long as we are trying to make capital infusions in banks or trying to strategically purchase troubled assets where there is an underlying mortgage, I think perhaps we are heading in some direction where we can recover taxpayers' dollars.

I am really, really concerned about these tranches and about these CDOs and other kinds of products—I think Ms. Kaptur just referred to it—where we have foreign investors and overleveraged dollars.

What strategy do we have to just abandon the purchase of those troubled assets and let the markets work? I mean, let investors belly up, let them—you know, the market forces work here. To what extent do we have—do you think we will be able to accomplish that public policy imperative?

Maybe I will ask Mr. Beach that.

Mr. BEACH. Congresswoman, that is a great question.

Let's suppose that all public policy responses fail. You know, the evidence is not completely there that this is going to work, okay? So one of your contingency plans should be that everything fails, everything the Congress does fails. Then what markets will do, they will clear; and they will ruin companies, and they will wipe out debt, and the market mechanisms will work. And what will happen is that on the other side a smaller, but very efficient market will be present.

I think what the Treasury Secretary and the Chairman of the Federal Reserve were thinking a couple of weeks ago was that that was too great a price to bear, and you had to buy these weights inside the portfolios that were not performing, the troubled assets. You had to make the infusions because the ruthlessness of market clearing would be a bloody thing to watch.

So I have no doubt that the market will be very efficient and ruthless in getting its house in order. And maybe that is what we have to have. But on the other hand—you know, right now the jury is out on that.

Ms. MOORE OF WISCONSIN. Mr. Beach, let me ask you another question. You made a compelling argument for making the tax reductions of 2001 and 2003 permanent, accelerate depreciation, reducing the tax rate on long-term capital gains and dividend income.

Are you concerned at all in terms of our recovery about the lack of revenue that is coming in? You say that we shouldn't really position ourselves to worrying about the demand side, consumer side. You don't seem to have much sympathy for consumer spending as being an answer.

Mr. BEACH. That is very important. Right.

Ms. MOORE OF WISCONSIN. Do you worry about the lack of revenue?

Mr. BEACH. As a former revenue planner, I can see that your revenues are going to be way short, based on the current tax system that you have in place. So what I am suggesting is that now you can make moves to essentially increase revenues or to decrease the rate of fall in revenues. And the actions which I have laid out are actions which I believe would be effective.

If you do nothing, your revenues are going to fall and they are going to fall precipitously because of the contraction which is going on. So you should join your fellow Democrats and Republicans who have in the past said, accelerated depreciation, 1-year expensing, corporate rate reductions. Those are good things to do to increase revenues.

Ms. MOORE OF WISCONSIN. I have only 45 seconds left, and I am very intrigued with this line of questioning.

You know, timeliness is one of the three parts of the three-legged stool: targeted, timely and temporary. So certainly extending the tax cuts permanently would not meet the temporary thing.

What about timely? How fast would increasing these tax reductions, making them permanent, have an impact on Main Street?

Mr. BEACH. I just love that question. And the reason why this is the fastest thing you can do, it is the moment you begin to hold hearings and markets begin to judge that the Ways and Means and finance committees are going to do this, they actually begin to price it in.

So it has an effect even before you pass the legislation, whereas spending is something that requires the dollars to get into the hands of governments or of businesses or of individuals in order for it to have that effect.

So the fastest thing you can do by far, light speed, is on the tax side.

Ms. MOORE OF WISCONSIN. Okay.

Can I just follow up tolerance?

Chairman SPRATT. One more question.

Ms. MOORE OF WISCONSIN. If, in fact, this has been a great strategy, these tax cuts are in place now and they have been in place since 2001, why aren't they working?

Mr. BEACH. That is a great question, and that is one—that is an absolutely great question.

First off, the tax reductions of 2001 were intended to react to a recession which we stemmed over between administrations. In my view, the 2001 tax reductions were far too demand-side oriented to actually do any good, they did a little bit of good. But in the end,

by 2002 and 2003, this Congress had done what I said it does oftentimes, go back at it and do it again; and you passed some really fine tax reductions that moved this economy forward.

And then I think we have had a number of things that have buffeted public policy. We have not had several policies competently executed by both Congress and the administration. On top of that, we have had this building bubble.

So I honestly think, if you take a look at the tax cuts that are pro-growth tax cuts, those have performed well and you would be in pretty hot water right now had they not been in place.

Chairman SPRATT. Ms. DeLauro.

Ms. DELAURO. Thank you, Mr. Chairman.

My understanding is, Dr. Beach, you talked about an economic recovery program a size between $150 billion to $300 billion, depending on circumstances.

Mr. BAILY. I am Dr. Baily.

Ms. DELAURO. Ms. Lav, what is your sense of an economic recovery package as we begin to think about putting this together? Just give me size.

I have three other questions so I want to just kind of move quickly.

Ms. LAV. It depends on what the pieces are.

Ms. DELAURO. Well, you said $50 billion?

Ms. LAV. $50 billion. And I think that I would associate myself with Mr. Baily.

Ms. DELAURO. And my understanding from you, Mr. Beach, is, you don't believe in having an economic recovery package?

Mr. BEACH. Oh, contrary. No.

I have laid one out for you. It is just different than the one you have been talking about.

Ms. DELAURO. Right. It is my understanding with regard to the capital gains that while this improves cash flow—people can spend it on salaries, they can spend it—it doesn't necessarily stimulate the economy.

Bonus depreciation can do that at the outset; it is a question of timing. But that was probably stuff that was going to be done already so it is not an increase in stimulus.

Ms. Lav, let me go back to you for a second. I read your report very, very carefully, particularly because the shortfalls have opened up in the budgets of at least 21 States, including my own State of Connecticut. So clearly, in my view, an economic recovery package can help prevent cuts to health care coverage, public safety, education resulting from a State budget crisis. And I am there and will be supportive of those kinds of efforts.

I want to ask you a question with regard to the infrastructure projects, and it adds capital budgeting, and I understand that with regard to States. But to what degree do you believe the economic and fiscal situation in these States is having on their ability to move forward with infrastructure projects?

Ms. LAV. I think what is holding up the infrastructure projects is the bond, the liquidity issue, the ability to sell their bonds, because that is how it is that they, the States and localities, fund infrastructure.

I would like to say—I think it is probably appropriate, just as the Federal Government is moving in to buy commercial paper—that bonds are a great investment. They are fine; State and local bonds are great.

There are two kinds of bonds: the ones that are just cash flow bonds, like California, like Governor Schwarzenegger made a big fuss about and ultimately sold on the private market; but the infrastructure bonds, they are having to pay a lot of interest and so forth.

So that would be one of the better things you could do to move infrastructure along.

Ms. DELAURO. And do you believe—how helpful do you believe infrastructure funding will be in any economic recovery? How can it be helpful to States recover through job creation? Do you think there is a link?

Ms. LAV. Yes, as long as you can do it fast enough. And I think if they are ready to sell their bonds, it is ready to go, so that is good.

Ms. DELAURO. Rising interest rates on bonds for these investments limiting investor interest, if you can believe issuing Federal bonds—you just answered that—at low interest rates for these projects could significantly help the States?

Ms. LAV. Right. And that is a good way to target.

Ms. DELAURO. I have another question which I would like to ask, if I can just throw this out there.

As part of a financial recovery package we passed last month, we lowered the child tax credit threshold to $8,500 benefiting 13 million children, 2.9 million who would become newly eligible for a benefit, 10.1 who would see their credit increase due to this provision. That is according to the Tax Policy Center, something I have advocated for for a very, very long time.

In fact, I believe the threshold should be dropped to zero, and something which we set the stage for with $300 child tax credit, including in the stimulus package that we passed with other tax rebates earlier in the year.

As we try to get a grasp on what would be most effective in stimulating the economy, providing long-term growth, what, if any, additional tax relief do you believe should be provided for the middle class? Do you think we should continue with an $8,500 threshold for the child tax credit or, in fact, expand it further in 2009? Should we, as well, expand the earned income tax credit, offer income tax rate cuts and rebates and so on?

Ms. Lav, let me have you start.

Ms. LAV. I think that—you know, I am a little unclear whether tax rebates or something are the best thing to do right now. But I suspect that if you do them, they should be not only for the middle class, but they should go, as the last ones did, all the way down. Because you want to put the money in the hands of the people that are going to spend it the fastest, and those are the people who need it the most and who you are sure are not going to put it in their savings account, which is not going to help the economy right now, or pay down a credit card. Well, they might do that.

So I think that money put into the hands of the people who need it right now, that is a good thing. That was great with the child

tax credit. We are very happy. It could go down a little lower. I am not sure about zero; as you know, we don't think that.

So I think there are things that need to be done with the EITC improvements, expansion. That also would be very good, particularly for people who don't have children living with them. I mean, that is a sort of a forgotten group of people who really would also be quite stimulative to give them additional funds.

Mr. BAILY. I think the EITC is a great program. It was started many years ago.

Ms. DELAURO. By Ronald Reagan, I might add, who said that the best way to lift people out of poverty was through the EITC.

Mr. BAILY. It was greatly expanded in the Clinton administration, which I was a part of, and I think we were very proud of that. I think it is a great program.

I do think some of these issues need to be addressed in sort of long-term tax policy which addresses the issue of revenue and all of that. I don't know that all of these things can be addressed in the short-run stimulus package.

Ms. DELAURO. On the infrastructure question that I asked Ms. Lav about, it leading to job creation increase, albeit we can posit that these things all need to be done, they have to be ready to go; we are there on that issue.

But just your view as to that link between the infrastructure piece and job creation and quickly putting money into the hands of consumers.

Mr. BAILY. If we can get that done quickly—and it is really incremental spending, not just displacing other spending—it certainly would add to jobs. It would be a very immediate stimulus to jobs under those circumstances.

And I did mention in my testimony, also, the need for maintenance. I remember in the 1975 recession an economist from Pittsburgh saying, we could use all the unemployed filling in the potholes in Pittsburgh. I think there are some maintenance things that could be done.

Ms. DELAURO. Oh, schools, without question. Maintenance is a very, very big part of that, and I appreciate your saying that.

Mr. BEACH. Let me just add one thing to the comments of my fellow panelists that I am very pleased to be with.

A lot of the middle class, broadly defined, is involved in small businesses, millions upon millions of small businesses. We can't forget those. In all of our discussion I think we need to keep them in our focus.

And so what I threw out this morning in just oral testimony—and I will throw it out again—what is wrong with a temporary tax rate for small businesses? It is targeted. You could do it on a timely basis. Those that have a corporate form could get a 25 percent rate; those 25.2 million small businesses that file through the 1040 as a personal, the sole proprietors, partnerships and sub-Ss, LLCs could see a temporary reduction in their tax rate as well.

That is middle class, par excellence. It also is directly related to job creation, and it could be done in an extremely rapid way.

Ms. DELAURO. I would say to you, Mr. Beach, that I am pro doing something for small businesses. And I like them to be defined and determined as small businesses and not what normally hap-

pens in this institution where it emanates up the chain to the very, very big corporations and the very wealthiest, both with individuals and corporations.

Quick last question, Ms. Lav: Should the Medicaid funds be targeted to particular States versus the across-the-board percentage increase to all the States?

Ms. LAV. Well, we had been advocating targeting until, I think, very recently when we are now seeing a plunge in the—you know, it was really the energy States and the commodity States, and everybody else was in trouble.

As I said, 36 States are in trouble, so there are about a dozen that aren't. And now that the price of oil has dropped and we are going to see demand weakening around the world, I am not so sure that we need to do the targeting anymore. I think it is right on the cusp of whether we should or not right now. If we do block grants, maybe we should target because that has been a criticism in the past.

If I could just make one quick comment, I think the best thing we can do for small businesses is to stimulate demand because they are not going to pay taxes if they don't have any profits, and if there is no demand, they cannot make a profit.

Ms. DELAURO. Thank you.

Mr. Chairman, thank you.

Chairman SPRATT. One last question from me, if you will—Dr. Baily in particular.

This doesn't strike me as your garden variety business cycle recession. It started with the phenomenon of subprime mortgages, but as Dr. Bernanke pointed out today, it has broadened considerably beyond that.

As I look at the proposals that are in place for addressing the primary source of the problem, namely, distress in the housing market, reverse-wealth effect as values plummet, I don't really see the pathway by which these billions of dollars flow from the major banks to individual borrowers, particularly those who are in default.

I can see them using this to make new loans, but I wonder how the money gets to defaulted mortgagors.

And secondly, having been in the business before, I know it is very individualized. There is no debtor who has exactly the same problem as his neighbor. So there is no cookie-cutter solution, no wholesale solution. It is going to have to be retail banking. And that is going to take a lot of people across this country. And I just don't see it coming together.

First of all, the $250 billion is going to the capitalization, recapitalization of banks. The $100 billion that follows that won't come for some time, because they will have to come back and there will be a comment period before the money is approved by the Congress. We could be months away before real money is available for the homeowners who are in distress, and by that time they may be beyond help.

Have you given any thought to how this will work with the structure we have in place with the Economic Stabilization Act? Any other ideas about how it could be made to work?

Mr. BAILY. This is not a garden-variety recession, I agree. The 1982 is the worst one we have had since World War II. This one is of a different character and is certainly, in its effect on housing and household wealth, is probably more severe than that one, or certainly comparable to that one. So I agree with you on that point.

Second, I agree that what is being done on the banks is indirect. You are trying to rescue the banking system; you are not putting money directly into homeowners or families. And I think that is one of the reasons we are here today, is to think about what is the right way to get money directly into the hands of Americans and stimulate demand.

I think we do have to recapitalize the banking system. I don't think there is any choice. You can look across countries, you can look in U.S. history, and we have to recapitalize the banks.

I think it is also important that we devote some of this money to working out the mortgage problem. I mentioned in my testimony the suggestion of allowing people to roll into 30-year, fixed-rate mortgages in order to reduce the number of foreclosures. We have obviously had other legislation and other programs that have helped homeowners. But I agree with you completely, we need to target some of these funds back to the homeowners.

Chairman SPRATT. Not the least of our problems is that the Federal Government or any other creditor can't really move in until they have sued to judgment their claim against the mortgage-backed security. Then they have to dis-assemble it and take out the individual mortgages. That assumes that they are buying the whole package, because I understand these packages have been sold in slivers, and that could be a problem too. So it is a Byzantine, bramble-bush legal nightmare.

Mr. BAILY. It is. It is. And that is why it is so hard to unravel this thing. I do think the suggestion of allowing homeowners to roll into new mortgages would help resolve it. But I agree with you, it is a bramble bush.

Chairman SPRATT. Well, let me just say what has happened. So you have to close a new mortgage. In the meantime, these folks haven't made their house payment. By definition, they almost will not have made other payments as well, because the house payment comes first and the car payment comes next.

When you go to search the title in order to take a clear first lien on the property, guess what? The hospital has a judgmental lien against them; the other creditors as well, credit cards. Then you have a bigger problem than just the mortgage debt, with all of the accumulated administrative costs and legal fees. You have these other liens that have to be cleared off the record.

Mr. BAILY. That is right. In my home State of Maryland, they have had a program to try to help mortgage owners that are distressed. And it has been fairly expensive, and they haven't helped a lot of mortgage owners. So it is a difficult problem to solve, precisely because of these legal structures that you describe.

I don't have a—I don't have a full answer for you, Congressman. I think it is going to take a while to play that out, and that is why we need to try to keep the rest of the economy going.

Chairman SPRATT. I think there is a fair amount of improvisation in what they are doing right now.

Mr. BAILY. Absolutely.

Chairman SPRATT. And this has yet to be improvised.

Iris Lav or Bill Beach, do you have any further comments?

Ms. LAV. No.

Chairman SPRATT. Okay.

Mr. BEACH. Thank you very much, Chairman. I think they are improvising.

Chairman SPRATT. Thank you all of you for coming.

Mr. BEACH. Thank you.

Chairman SPRATT. I very much appreciate it. Your answers have been extremely helpful to us, and we are grateful to you for your contribution.

Mr. BAILY. Thank you for having me, sir.

Chairman SPRATT. I ask unanimous consent that those members who did not have the opportunity to ask questions of the witnesses be given 7 days to submit questions for the record.

We don't have any legal process by which we can compel answers, so don't worry. [Laughter.]

Thank you very much.

The meeting is hereby adjourned.

[Questions for the record submitted by Mr. Etheridge follow:]

QUESTIONS FOR THE RECORD SUBMITTED BY MR. ETHERIDGE

I would like to thank Chairman Spratt for holding this important and timely hearing. I regret that due to previously scheduled meetings in my district, I was unable to attend. Like everyone, I am concerned with the deteriorating state of our financial industry and our economy as a whole. We are continuing to see negative economic indicators throughout the economy, like rising unemployment and decreased quarterly growth, at the same time, the effects of the crisis on Wall Street are beginning to be felt on Main Street. I look forward to a continued discussion of possible stimulus measures that can get our economy back on track, and I thank you for the opportunity to have Federal Reserve Board Chairman Bernanke address my questions.

1. Chairman Bernanke, I have heard from several small business owners throughout my district who are concerned by the continued decrease in small business lending. As you know, Congress passed the Emergency Economic Stabilization Act earlier this month to increase liquidity in the lending industry, and last week Secretary Paulson announced a plan to use $250 billion of that authority to provide capital to banks by purchasing equity in those that choose to participate. Outside of the nine major banks that have already announced participation in this plan, how many banks do you expect to participate in this program? In addition, if regional and local banks choose to participate in this program, what guarantees are there that they will use this money to make more loans for small businesses? How long will it take for local businesses to feel the effect of Treasury's actions?

2. In addition, I am concerned that the Small Business Administration (SBA) has mistakenly been awarding small business contracts to large firms as reported in the Washington Post. This is precisely the time that SBA could be picking up the slack in lending to small businesses, and using their government backed guarantee to provide confidence in the marketplace. Are there any provisions to increase capital for SBA or to give them an increased role during this financial crisis?

3. Beyond the steps that have already been taking, what action can the Federal Reserve, Treasury Department, or Congress take to improve liquidity so that small business can grow and qualified consumers can get credit to keep our economy on track?

[Responses to Mr. Etheridge's questions follow:]

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

December 5, 2008

The Honorable Bob Etheridge
House of Representatives
Washington, D.C. 20515

Dear Congressman:

Thank you very much for your letter of October 23 expressing your concerns about the effects of the ongoing financial crisis on small businesses. The Board shares your concerns about the vitality of small businesses and fully appreciates the importance of small business to the U.S. economy. Indeed, on November 20, Governor Kroszner testified on behalf of the Board before the House Committee on Small Business on many of the issues that you raise in your letter, and I enclose a copy of his statement to this response. However, you also asked about some issues not covered in Governor Kroszner's testimony, and I will address these briefly.

Regarding the Treasury Department's Capital Purchase Program (CPP), as you know the Treasury and the federal bank and thrift regulatory agencies have strongly encouraged all eligible financial institutions to participate in this voluntary program. The program is designed to encourage participation by a broad range of institutions while maintaining the ability of participating firms to raise private capital. Up to $250 billion has been committed to the CPP. Participation to date has been encouraging. For example, as of early December about 400 banks had applied for capital injections and the Treasury had approved almost 140 of these applications. Approved institutions include community, regional, and very large banks located in a wide spectrum of geographies. With time, these actions should, along with other programs instituted by the government in recent weeks, strengthen the banking system and stimulate credit flows to a broad range of small business.

With respect to your questions regarding the Small Business Administration (SBA), I believe that agency is best qualified to address those issues. However, I will address one issue regarding SBA-guaranteed loans that was discussed briefly in Governor Kroszner's testimony and that has been subsequently acted upon by the Federal Reserve.

The Honorable Bob Etheridge
Page Two

On November 25, the Board announced (copy enclosed) the creation of the Term Asset-Backed Securities Loan Facility (TALF), a facility that will help market participants meet the credit needs of households and small businesses by supporting the issuance of asset-backed securities (ABS) collateralized by new and recently-issued student loans, auto loans, credit card loans and loans guaranteed by the SBA. As you know, the ABS markets have historically funded a substantial share of consumer credit and SBA-guaranteed small business loans. Continued deterioration of these markets could significantly limit the supply of credit to households and small businesses and thereby contribute to further weakening of the U.S. economy. Federal Reserve staff is currently working with market participants to fine tune the program, and our goal is to make the TALF operational in February.

How small business access to credit will evolve over the coming months will be strongly influenced by the degree of success of these and other recent policies undertaken by the Federal Reserve, the Congress, and other policy institutions aimed at improving the functioning of financial institutions and markets, rebuilding confidence in the financial system, and stimulating economic activity. Given the current financial and economic environment, the sizes and timing of the effects of recent policies on both the economy and small businesses are highly uncertain. For these reasons, the Federal Reserve will continue to monitor evolving financial market and economic conditions and their effects on small business access to credit as part of its broader efforts to restore the health of the U.S. financial system and our economy.

Sincerely,

Enclosures

[The statement of Mr. Porter follows:]

PREPARED STATEMENT OF HON. JON C. PORTER, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF NEVADA

On Monday October 20, 2008 the House Budget Committee held a hearing on the options and challenges involved with our economic recovery efforts. While I was unable to attend due to previous engagements, I would like to commend my colleagues on the Budget Committee for holding a hearing on this matter.

In the State of Nevada, my constituents have been particularly hit hard by our current financial crisis. Economic events of the past several months have shaken the foundations of our financial systems and have led to the failure of a number of banks and lending institutions, three in Nevada alone. Furthermore, my constituency is suffering from one of the nation's highest foreclosure rates as well as an es-

calating unemployment rate. The matters under discussion today before the Budget Committee are of vital interest to me and my constituents, and I look forward to additional conversations with the panelists as we continue to navigate through this trying time and ensure that our recovery efforts are done in a timely and appropriate manner.

At this critical moment in our financial future, while we are working as cautiously and expeditiously as we can to help stabilize the economy in a manner that protects taxpayers and homeowners, we also need to learn from this situation to protect us in the future. With this in mind, I introduced legislation calling for a special commission of inquiry into this crisis that would investigate the origins of the crisis as well as provide recommendation to guard against future crisis.

We must have a full understanding of what led to this crisis in order to prevent it in the future. I remain committed to working with my colleagues on both sides of the aisle, and in the administration, to ensure that the public does not face the same situation in the future.

[Whereupon, at 1:01 p.m., the committee was adjourned.]

○