

PUBLIC LAW & POLICY ALERT

ECONOMIC OUTLOOK

A Summary of the September 24, 2008, Joint Economic Committee Hearing

OPENING STATEMENTS

Chairman Charles Schumer (D-NY) said there was clear recognition from both sides of the aisle that there is a need to act quickly, and urged the protection of Main Street, saying tightened credit harms the ability of people to get car loans, home loans, and college loans. He also noted that both Senators Barack Obama (D-IL) and John McCain (R-AZ) agree that action must be taken now with caution to not choose a bad solution that will further exacerbate the problem. Schumer said he was puzzled by the resistance of the Federal Reserve Board and the Department of the Treasury to proposals by Senator Jack Reed (D-RI) and others that would seek a bailout-for-stock swap, saying taxpayers should be rewarded if the plan succeeds. He also said he feels industry should pay for some share of the plan themselves.

Ranking Member James Saxton (R-NJ) attributed the main cause of turmoil to a collapse of the housing bubble which was encouraged by subprime and other risky mortgages. He said some action by the government is now needed to recapitalize the banks and other financial institutions either by injections of equity or removal of toxic investments. He said it was important to guarantee the safety of accounts to assure savers and small businesses that their basic financial needs can be met without disruption.

Vice Chairman Carolyn Maloney (D-NY) asked why public sector help seemed preferable to private sector help. She said, "The idea that the private sector does not want to buy these assets and this is somehow good for the taxpayers seems dubious," and added that any plan to use taxpayer funds needs to require businesses to make sacrifices as well.

Senator Sam Brownback (R-KS) joined Schumer in questioning the terms of the Bush Administration's plan, saying there should be a provision of the plan that would give taxpayers equity in firms that sell assets to the government. Brownback also echoed Schumer's dedication to "act now" and "act responsibly." He also asked why the plan could not proceed in tranches instead of putting all of the money in up front and whether there would be any loan modifications for troubled mortgages in the plan.

WITNESS TESTIMONY

Federal Reserve Board Chairman Ben Bernanke stressed the urgent need for action by Congress, saying global financial markets were under "extraordinary stress" and the intensification of that financial stress in coming weeks will make lenders even more cautious about extending credit to households and business, which could prove a significant further drag on growth. He predicted real gross domestic product is likely to expand at a pace appreciably below its potential rate in the second half of this year, and added that the Federal Reserve will take action to promote growth as needed.

QUESTIONS AND ANSWERS

Chairman Schumer asked Bernanke why authorizations in installments could not be done, which he said would ensure the protection of taxpayers' interests and allow officials to evaluate the success of whatever program is used to buy mortgage assets. Bernanke noted that he is not part of the legislative or executive branches, and therefore has "no standing to negotiate this proposal." He expressed concern that a smaller amount of funding might "undershoot" the problem. Schumer also asked from where the amount of \$700 billion came. Bernanke responded that the amount is approximately five percent of \$14 trillion outstanding of commercial and residential mortgages and seemed "like an appropriate size" given the scale of the numbers.

Ranking Member Saxton said asking taxpayers to spend five percent of GDP is "controversial to say the least." He asked Bernanke to explain the risks associated with approving the plan and the risks of disapproving it. He also asked why Secretary of the Treasury, Henry Paulson, made changes to the plan over the weekend to allow foreign institutions to participate in the program and extended the Treasury's ability to buy assets beyond mortgage and mortgage-related securities. Bernanke responded that currently many of these assets are being sold under distressed circumstances to illiquid markets, and the government could increase liquidity and transparency, while still acquiring assets without overpaying. He said most of the value can be recouped by the taxpayers and urged Congress to look at the \$700 billion as an acquisition of assets, not as an expenditure. While there is risk to the taxpayers, he said, even with a long-term loss it will not be for the full \$700 billion.

Vice Chair Maloney asked whether preferred stock options would be better than common stock, saying they would protect taxpayers by putting them in a senior position relative to financial institutions. Bernanke responded that while preferred stock was a favored approach in previous bank crises, those were situations where banks were ready to fail and it was the only way to keep the institution going. He said this is a different situation and if the government is perceived as injecting capital, companies will have problems finding investors because investors will think that the government will come in, wipe out shareholders and take over the firm.

Representative Elijah Cummings (D-MD) expressed concern that the entire program will cost more than just the \$700 billion mentioned, up to \$1.3 trillion. While he agreed that Congress must act now, he wanted to know first how the program will affect Main Street. Bernanke said that if no action is taken, credit conditions will become worse.

Senator John Sununu (R-NH) also agreed that the most important aspect of recovery is restoring normal operation to credit markets since it is such an important part of the overall economy. He asked about the relationship between mortgage backed securities and the consumer credit markets, to which Bernanke responded that taking bad loans off balance sheets gives “more space” for banks to use their capital to make new loans.

Representative Lloyd Doggett (D-TX) asked if any alternatives other than the “Bush spin” were considered. He expressed concern about soaring debt, saying the U.S. was over-borrowing. Bernanke responded that from a fiscal perspective, the net fiscal cost will be much less than \$700 billion. Doggett responded to this by saying Wall Street should be paying for a portion of this program and that it would be irresponsible to approve this before looking carefully at the burden being placed on taxpayers. Bernanke agreed saying his three criteria are that the solution be big enough and aggressive enough, protect taxpayers and not benefit anyone unduly who was part of the problem.

Representative Ron Paul (R-TX) called the program “Socialistic price-fixing” and said the illiquid assets are illiquid because they are not worth anything. He said price-fixing is what prolonged the Great Depression and he worried the economy was set to do the same thing again. Bernanke said the intention is not to price-fix but to use market-based initiatives to find the actual price.

Senator Amy Klobuchar (D-MN) said the administration “allowed Wall Street to act like a casino” and steps taken now need to focus on minimizing exposure to taxpayers. She asked Bernanke about limits on pay for Wall Street. Bernanke responded that “golden parachutes” and issues of corporate governance may have led to excessive risk-taking and the Federal Reserve will be looking at all these issues. He said, if individual institutions feel stigmatized, the program will not gain the participation it needs to work.

Representative Kevin Brady (R-TX) asked why we do not allow the free market to correct itself, saying the actions proposed might serve only as a temporary solution. Bernanke once again reiterated that inaction will prolong the problem.

Senator Jeff Bingaman (D-NM) said the bailout program should result in some ownership by the taxpayers, just as Warren Buffet has partial ownership in Goldman Sachs. He said the current plan is being described and structured as “taxpayers buying what no one else wants” and that there might be more acquiescence if taxpayers thought the government would have something in the way of an investment when “the dust settles.”

Representative Maurice Hinchey (D-NY) said all members agree that Congress needs to act in some way. However, the situation needs to be addressed more broadly than accepting a poorly thought out proposal that does nothing to restore important regulations that would safeguard the working and middle class from suffering again at the hands of corporate greed.

Representative Baron Hill (D-IN) said he would be “laughed out of a town meeting” if he told his constituents they had to pay \$700 billion to increase the availability of car loans. He asked Bernanke whether his constituents would see a dramatic drop in their stock portfolios without the rescue. Bernanke responded that it was very likely.

Senator Jim DeMint (R-SC) said it “seems accountability risk has been removed.” He believes none of these proposals will support more free-market activity. As a believer in free markets and free enterprise, he said, no amount of government regulation can stop the corruption in a system if you take the risk out of it. Bernanke responded that what is needed is not more regulation, but better regulation.

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