

The Scouting Report – Rebuild Financial Institutions and Confidence
Live Web Chat with *Politico* Senior Editor Fred Barbash and Brookings Senior Fellow Martin Baily
December 10, 2008

12:30 Fred Barbash-Moderator:

Hello everyone. Welcome to this week's edition of the Scouting Report. I'm Fred Barbash, Senior Editor at Politico, and I will be moderating this week's chat. Joining us this week is Brookings Senior Fellow Martin Baily, an expert on U.S. economic policy. He is ready to answer your questions about restoring confidence in financial institutions. Welcome Martin.

12:30 Fred Barbash-Moderator:

How essential is it that the new Administration balances the budget in the next four years?

12:31 Martin Baily:

Nice to be here.

It is not essential that the federal budget be balanced four years from now, but it is vital that good budget targets are set and maintained. The Administration can provide a powerful signal by including declining long-run targets for future structural budget deficits as a percent of GDP as part of any short-run stimulus. OMB should be required to submit a realistic budget plan to Congress each year that is consistent with the long run targets. Any changes to the budget made during Congressional debate should be made only on a PAYGO basis. Emergency appropriations (hurricanes and such) must trigger a readjustment of either spending or taxes in future years, to hold the budget targets on track.

12:32 Fred Barbash-Moderator:

The President-elect and his new economic team are talking about a very large stimulus package – perhaps in the range of \$600 billion over two years. In addition, to deal with the financial crisis, policymakers are adding perhaps \$1 trillion or more to federal debt. Where is all this money going to come from?

12:33 Martin Baily:

The answer to that question historically has been that the Treasury issues debt and sells much of it abroad. As a nation, we have borrowed enough overseas to finance federal budget deficits and then borrowed even more to pay for the consumption binge of recent years. That will not change quickly and, undoubtedly, we will continue to borrow huge amounts from China, Japan, oil producers and Europeans over the next few years. However, there is a limit to how far we can go down this road. The United States cannot go on and on running bigger and bigger deficits and borrowing ever-increasing amounts from the rest of the world. The foreign borrowing so far has been done on terms that are very favorable to the United States, loans at low interest rates denominated in US dollars.

The rate of interest we pay will start to rise over time, however, unless there is a credible plan for fiscal stability.

12:34 Fred Barbash-Moderator:

You say there is a limit to how far we can go down this road...but what is that limit. What's the worst case possibility if we overdo it?

12:36 Martin Baily:

The worst case scenario would be a decline in the value of the dollar and a rise in US interest rate. We have not seen that happen yet - in fact the dollar has risen and interest rates have gone down. The reason we need a long run plan to reduce the budget deficit is to reassure markets that we can maintain the full faith and credit of the US government.

12:37 Martin Baily:

Other smaller countries are facing real concerns about the chances for default in their sovereign debt. There was a recent report that UK government securities are now judged to be riskier than McDonald's debt.

12:38 [Comment From Bill]

If Congress "bails out" the automakers, what's to stop, say, the telecomms from coming forward with a hand out, or some other sector that argues that it also employs millions of Americans? Wouldn't that be bad for the economy?

12:39 Martin Baily:

Bill, we are currently in an economic crisis and we have to take extraordinary measures to restore the stability of the economy. This creates the danger that everyone will come forward for a bailout so the risk you describe is a real one. We have to judge each request for support on its merits.

12:41 Fred Barbash-Moderator:

Can you evaluate the government's response to the financial crisis? How well or poorly do you think it has been handled?

12:41 Martin Baily:

Washington's response to the financial crisis has been messy and controversial and has left the majority of voters feeling they are being taken advantage of. Even more important, the problem has not yet been solved and the financial sector is still very weak. An important task for the President-elect is to explain what is being done to resolve the crisis, why it is being done, and developing a strategy that will be followed and not changed frequently—not an easy job given the complexity of the problems. Once the crisis was recognized, the Federal Reserve took aggressive steps to support the financial system and the economy. President-elect Obama should reiterate the support for Chairman Bernanke that he has given already. It is essential that Bernanke stay on the job at least until the worst of the crisis is over. The Treasury's response, however, has been more hit and miss.

12:42 [Comment From Vivien]

Following up on Bill's comment and your point about confidence level, how will the automakers be held accountable to the funding provided to them for the bail out?

12:44 Martin Baily:

Vivien, Congress is putting a number of requirements on the automakers for how they respond. They are appointing a so-called "car czar" to monitor the compliance with these requirements. Ultimately, the test is going to be whether or not they can become competitive with other global car producers.

12:46 Martin Baily:

The real question is who the "car czar" will be, what their background is, and whether Congress can really enforce the requirements of the bailout package.

12:46 [Comment From Joan (NY)]

How badly was confidence in the US financial systems hurt by the recent collapses and subsequent bailouts?

12:48 Martin Baily:

Confidence has been very badly shaken and still has not been restored. The bailouts raise problems but a failure to support financial institutions would have created even worse problems. In fact, Joan, letting Lehman go bankrupt was a substantial mistake and worsened the financial crisis.

12:49 Martin Baily:

This crisis has spread around the world, financial problems in Europe may well be worse than those in the US, developing countries have been hard-hit and have had difficulty borrowing to continue trade.

12:50 Martin Baily:

Countries such as Iceland, Ireland, Switzerland and even the UK have very large financial sectors and not adequate resources to deal with the current problems.

12:50 [Comment From Arnold]

Whatever happened to good old capitalism? My granddad ran a hardware store for 30 years and never asked government for help. If a company is failing, let it fail!

12:52 Martin Baily:

Arnold, if you had asked me 2 years ago whether the auto companies should be bailed or whether the banks should be bailed out, I would have said no. But the current crisis is so severe, it threatens even good companies and the overall economy.

12:53 [Comment From Katie]

It is obvious we are in a recession. Would you say we are in the beginning, the middle of it or near the end of it?

12:54 Martin Baily:

We're in the middle of the recession. Things will get worse before they get better. The economy should start to turn around by the middle of 2009.

12:55 [Comment From Nick]

What's the most important thing Barack Obama can do (once inaugurated) to help the economy recover?

12:57 Martin Baily:

The Fed is doing the right things to restore confidence. Injecting capital into the banks is necessary, a fiscal stimulus is essential, as FDR famously said, in a crisis, the only thing we have to fear is fear itself. So Obama has to show strong leadership and communicate to the American people that his policies are the right ones and will resolve the crisis.

12:58 [Comment From Tom]

Do you think Congress will have to intervene in the markets again before Senator Obama takes office?

12:58 Martin Baily:

I hope Congress passes a stimulus package as quickly as possible, Tom.

12:59 [Comment From Gene]

If we are in the middle of the recession, as you say, then what signs should we look for to indicate that we've turned the corner?

1:00 Martin Baily:

The housing market must stabilize. There are some positive signs -- the inventory of unsold houses is declining; consumption represents 2/3 of the economy, so we need consumer confidence to improve.

1:00 [Comment From Sharon (dc)]

How do we design a system which benefits long term goals? At the individual level both executive and workers compensation seems far too focused on short term data. Why should a banker write fewer good quality loans when they will get much greater compensation for writing more loans regardless of quality? Why should an executive invest long term money when it will adversely affect the company's short term numbers? We can all see the benefits of these long term goals but while all the reward focuses on the short term gain then the system is broken. We do this in all aspects of society, both private and public. So again how do we rebalance to start to favor long term versus short term goals? Note, I am not trying to undervalue short term data I just think we over emphasize its importance compared to the big picture.

1:02 Martin Baily:

One of the reasons we got into this crisis is that mortgage brokers and Wall Street executives were given incentives to take very large risks, betting with other people's

money. Banks did not follow their own risk-management rules. This is an area that will need to be reformed to avoid another crisis.

1:02 [Comment From Amanda]

What's the basis of your projection for the beginning of a turnaround in 2009?

1:03 Martin Baily:

This is a time of great uncertainty, Amanda, and I don't think anyone knows where the economy is going. Once the housing market stops falling, that will be a major plus for economic growth. We look at past business cycles in order to make the best estimate for when this economy will turn around.

1:03 [Comment From Tom]

As a follow up to my earlier question: what kind of stimulus bill? Are roads and bridges the way to go? And how do we make sure spending is short-term and doesn't balloon the deficit?

1:05 Martin Baily:

The stimulus package should get money out there quickly and avoid waste. There are some infrastructure projects that are ready to go and should be funded. I am concerned about spending too much on infrastructure quickly and building Bridges to Nowhere. I would like to see tax rebates as part of the stimulus package.

1:06 Fred Barbash-Moderator:

On tax rebates....If there are tax rebates, what should Americans spend the money on in order to boost the economy?

1:07 Martin Baily:

It's impossible to mandate how people are going to spend the money, but ideally they should spend it on goods and services produced in the US.

1:07 [Comment From Sally]

I'm most interested in how home owners will be helped by the federal government. Do you think mortgages with lower rates will be available soon?

1:09 Martin Baily:

Some programs have been passed to help homeowners -- but none of them appear to be working all that well. I would like to see the mortgage interest rate reduced and this could be accomplished by providing federal guarantees on Fannie and Freddie debt, or by rolling that debt over into Treasury securities. Unfortunately, there are some homeowners who just can't be helped because they are in homes they cannot afford.

1:10 [Comment From Paula]

How important is it for President-elect Obama to have most of his appointments announced or in place when he takes office in January? And what three things can he do to ensure the transition of power goes smoothly, given the great uncertainty of our times?

1:13 Fred Barbash - Moderator:

While Martin is typing, I'd like to know what everyone thinks of Obama's cabinet selections so far. We'll post answers as they come in.

1:13 Martin Baily:

As I said earlier, it's very important that Obama try to re-establish confidence in the US economy. Announcing his economic team is an important step forward. He has chosen highly competent and talented people. The new Treasury Secretary, Tim Geithner, and the new head of the NEC, Larry Summers, both well-known to Fed Chairman Ben Bernanke, and Geithner has worked closely with the Treasury. I expect the transition to be a smooth one.

1:13 [Comment From John Quinn]

In CQ Today it was mentioned that the Auto Bill that is being contemplated by the Congress also has provisions that the bill would "guarantee financing deals for transit agencies." Is this a good or bad idea and why? Sen. Grassley appears to be against it b/c he says that it would help foreign banks, while Rep. Van Hollen is for the idea b/c he mentions that it, in fact, would help protect US tax payer dollars. Seems like there is very basic disagreement over the actual provisions in this bill and their effects. Any comments?

1:14 Martin Baily:

I am against putting so-called Christmas tree ornaments on any legislation, despite this being the holiday season.

1:15 [Comment From Tom (dc)]

One of the things that strikes me about this crisis is that the root causes can really be summarized as a lack of ethics. Lack of ethics for mortgage brokers, consumers, our politicians and a host of others. Our current crop of leaders were taught that government is the problem and profits trump everything. Each generation resets these values to its liking but one of the outcomes of this mess has to be a new moral order governing business. The CEOs responsibility should still be the shareholder but we should also temper that with some basic rules about honesty and social responsibility. My question is how much talk have you heard about such a new governing philosophy and what are the chances we will openly design a new set of morals to guide us to a better future?

1:16 Martin Baily:

Tom, the way we regulate financial markets is to make sure that people have their own money at stake and therefore assess the risks, and we have regulators to look over their shoulders. Ethics is very important in business, but it's not something the government can rely on.

1:16 [Comment From Don in DC]

Do you think that the government's response to the current financial crisis will result in a larger long-term government role in regulating and directing the U.S. economy?

1:17 Martin Baily:

The deregulation movement that started in the 1970s and continued into the 80s has provided important benefits to the US economy. We need to re-examine financial sector regulation and make it better and more effective. We don't need more regulation.

1:18 Martin Baily:

There is a danger that the pendulum will swing back and we will get over-regulation. But the Obama economic team understands the importance of markets and will resist the temptation to over-regulate.

1:19 Fred Barbash - Moderator:

Alright folks, we have time for just one more question.

1:19 [Comment From Ed, DC]

If Congress bails out the auto industry, is it even possible to not raise taxes? Where will the money come from?

1:20 Martin Baily:

Ed, bailing out the auto industry is small relative to the problem with the federal deficit. Once the economy recovers, it is essential that we face the long-run deficit problem, especially Medicare and Social Security.

1:20 Fred Barbash - Moderator:

Alright, that about wraps it up for today. Thank you everyone for all your great questions. And thank you to Martin for your thoughtful answers.

1:22 Martin Baily:

Thank you, Fred. For those who are local to the DC area, you may be interested in attending a Transition Event we are having tomorrow at Brookings at 10am, where I will present a Memo to the President on what he should focus on to "Restore Confidence and Rebuild Financial Institutions."

1:22 Fred Barbash - Moderator:

And don't forget to check back next week for another edition of the Scouting Report. We'll have Brookings fellow Vanda Felbab-Brown on hand to discuss foreign policy issues in Pakistan and Afghanistan. Thanks for participating!