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THE $700 BILLION QUESTION:

WHAT IS THE FATE OF THE ECONOMIC RESCUE PACKAGE?

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P R O C E E D I N G S

MR. GALE: Good morning and welcome, my name is Bill Gale; I'm the head of Economic Studies here at The Brookings Institution. I'd like to welcome you to this event, modestly entitled "The $700 Billion Question: What Is the Fate of the Economic Rescue Package?" It's probably fairly titled though.

Before we start, let me just say I was driving my daughter into school this morning and I heard on the radio that Washington was operating in the midst of a dense fog advisory, and I thought, "boy you can say that again". We are in unchartered waters here, there are a lot of people that think they know what to do, but this is not a situation that I have found in my discussions, where people feel like they know what to do.

If you talk to people about tax cuts or social security or abortion, you'll get people who are certain they know the right answer. And this issue is kind of interesting, in that there is a lot of discussion, a lot of thinking, but the level of certainty I think, even among the experts, is not as high as it is on some other issues.

So we hope to cut through the fog in the next couple of hours, and we'll do that both through our own comments, and hopefully with questions from all of you. So we'll aim to keep our comments relatively short. And to make sure that happens, let me introduce Tom

Mann, who will moderate the discussion. Tom is a Senior Fellow here in Governance Studies, he is well known to all of you as an expert on many things. One of the things is often described as the operation of Congress. I think we might want to call that this week, the non-operation of Congress. And Tom will moderate the event, so let me turn it over to you Tom. Thank you.

MR. MANN: Bill, thank you very much. Welcome everyone; it's been such a boring year, hasn't it? At the very moment we think we've got a handle on the election, on the economy, on the country, alas, everything changes once again. It's been an extraordinary 10 days since Hank Paulson and Ben Bernanke first informed the President, and then Congressional leadership that economic catastrophe was possible. The freezing of the credit markets the panic that was ensuing in the U.S. financial community, and around the globe.

And since then, we've seen an extraordinary effort, I would argue a rather impressive effort to try and hammer out a package, a legislative package to create the authority to begin to deal with this problem. We've been treated over the last day or two, to a series of banner headlines on the crisis of leadership, and the failure of leadership.

My view is that given how incredibly discredited this President now, given the record of the last years, given the divided party government, given the ideological polarization of the parties, it's really quite amazing to see that leaders have stepped up to do the right thing. Do they have great power or influence to force those members of Congress who think differently to act? No, but one way or another we got within 12 votes in the House to actually move forward, and we're now at a situation where it appears possible, maybe even likely that we will have a package approved by the end of the week.

We're going to be talking about the politics of that, but then we're going to look at the substance of what -– what is likely to be approved, what the consequences might be, what else is happening in the U.S. financial community, and around the globe. And what other steps might be called for in the days, weeks, and months ahead.

That's our plan for this morning; we'll be having a conversation on these matters initially, and then turn to your questions.

We're going to beginning -– we will begin with –- with former Congressman Bill Frenzel of Minnesota. Bill has been our dear colleague at Brookings since 1991, after retiring from the U.S. House of Representatives, where as Republican member from Minnesota, he was ranking on the Budget Committee; he was a key member of the Ways and Means Committee, and a wise and effective legislator, and thinker, and speaker for many years.

After Bill we're going to hear from Simon Johnson, who is down here on my right. Simon is co-founder of, and I want you to write this down, Baseline Scenario dot com. A website, very useful, and informative for navigating this financial crisis. He's a Senior Fellow across the street at the Peterson Institute for International Economics, and is also a Professor at the MIT Sloan School of Management.

We then turn to our own Alice Rivlin, a Senior Fellow here at Brookings, whose public service career includes services; Vice Chair of the Fed, as Director of OMB, and as the Founding Director of the Congressional Budget Office.

And finally we turn to the man who kicked off this session, Bill Gale who is Director of Economic Studies here at Brookings, as well as the R.J. and Francis Miller Chair, in Federal Economic Policy Studies, an astute wise and productive analyst of tax policy, and fiscal policy more broadly.

So, that's the team we bring to you today, and let's begin with Bill. Bill how are we recovering from the defeat on the floor of the House on Monday? My –- the general presumption is the Senate will now act first, possibly later today, with a slightly revised package, and hopefully that will go to the House, Thursday or Friday for their approval. How does it look to you now?

MR. FRENZEL: It probably looks as though there will be some sort of solution finalized, with some kind of House vote, perhaps on Friday. The Senate bill should be passed by the Senate, by significant majorities, which may embolden a few of the more quavering members of the House, who voted against it. And the extra blandishments put into the bill by the Senate. In all these cases, when bills pass the typical process is to water them up. Put in a few more goodies for whoever seems to need them, and then move the bill forward, as we will discuss later, the aspects of the Senate bill, but there are some substantial changes, that may cause movement.

The interesting thing about this, Tom, was that this was one of the very few times where you have The White House, and the joint managements of the Congress endorsing a bill with great vigor. A lot of press attention to it, and that leadership was not followed.

I don't fault the leadership, quite as much as the followership, there's –- we don't have much of that around here anymore. We have an awful lot of independent actors, working each on his, or her, own stage. The last one I remember, was the Andrews Air Force Base Summit Agreement, where the same thing happened, a majority of members of the -– of both parties voted against the bill in the House. In that case the Congress moved to the left, passed the bill with a little more taxes, and spending. In this case the Democratic majorities do not seem to be able to move to the left. They are instead moving to right, looking to recapture some of the house Republicans, who found the bill not to their liking.

And a number of the provisions of the Senate bill have been added at least partially to attract those members. I believe that when the final vote comes up in the house that they will get a few Democrats and a handful of Republicans, and pass the bill by a relatively narrow margin. But it will be passed; because we have to remember that the core opposition comes from the hard right, and the hard left. And these are ideologues who do not care for their leadership, do not care for a lot of things, other than maintaining ideological purity. Whether Rome burns or not, is a much less concern to them, then to whether their extreme philosophies prevail.

And so they're not going to be movable, there's a small group in the middle who probably are moveable, and those are the ones, that we'll be looking to change now.

MR. MANN: Bill, this was always going to be a difficult vote. One, just the resentment coming from the populous left and right, was bound to come to the fore. So we knew it was going to be tight. Pelosi and Boehner saw that from the beginning, it was just really a matter of whether with that, embrace of a Republican administration, and Democratic and Republican leadership, in the Congress, whether that would be sufficient to pull them along, but alas, the Republican support for the bill just was –- apparently was never there. That Boehner, and Blunt really over estimated the extent that, which the last minute concessions that were made, would bring them along. Do we -– I assume you expect the vast majority of those Republicans to stay in opposition and we're really just talking about incremental increases of six, eight, ten Republicans?

MR. FRENZEL: That's what –- those are the terms in which I am thinking. You're looking at a House of Representatives, the mailbag of the members, about 150 to one, against the measure. Many members were getting as many as five or six thousand communications by email, whatever in their offices. Some of them are a little frightened. The Craven Collective did not write and profiles encouraged. Edmund Burke was dead, and they couldn't pass the bill.

But Tom is right; there is a possibility to move a few in the center, but not a great possibility to move the fringes. Remember too; while all these communications were assailing the Congress, the public was being assailed by the electronic right and left fringe, who the left were saying of course that the market is unworthy of salvation, let it go. And the right was saying don't touch it, you'll ruin this holiest of values, the free market don't mess around with it, no matter who suffers, let them suffer.

And the public reacted I think the way you might expect. The public knows there's an emergency, it does not have any confidence in its government, to take it out of the emergency. The fact that the President and Congressional leaders supported this package did not mean much to the public. The President's sitting at a low approval rate, the Congress looking for opportunities to get in the single digits for approval, is not trusted at all.

And then so this complete breakdown occurred, people were very willing to communicate with their Congressmen, to tell them not to vote for this awful bill, although the public -– most members of the public had no idea whatsoever what was in the bill.

MR. MANN: You know it underscores one of the realities of Congress. That is that we see polls, there's so many polls taken. We know rough sense of public opinion, although in many cases we're measuring opinion that really doesn't exist, except in response to the polls. But those who take the trouble to send emails or call in to their offices, are not representative of the broader public sentiment, but when you get 99 to one, or 199 to one responses on one side, even if the polling information suggests the public is much more evenly divided on this. Sort of members will be responsive to that sentiment.

Now there's probably only 40 or 50 incumbents who are really worried about their reelection and it's understandable that most of them voted against the package, but where it lost really was among those who had no worry, whatsoever, and their response was I think much more ideological.

But now the communications coming into Capital Hill have switched from the resentment side, to the fear side, and as Bill suggest I think that has a good chance of changing at the margin, enough folks to make a difference.

But Bill, I have one other question to you. The package that seems to be developing is the Senate adds to the same structure, an increase in Federal Deposit Insurance, up to maybe $250,000.00, and maybe just for a year, but they also include their package of tax extenders. Alternative fuels, the alternative minimum tax, and a few research and development tax credit, but they're not going to pay for it, as the House Blue Dogs have been insisting on. Is that trade-off going to work? Will you attract more Republicans and not lose some Blue Dog Democrats in the House?

MR. FRENZEL: Well we know that Republicans have difficulty counting the votes, and include me in that number. So, I'm not sure that when you bring the Senate package or something very much like the Senate package, over to the House, that what is going to happen -– I think you will lose a few Blue Dogs, who believe very dearly that expenditures or revenue cuts have to be paid for in the system. I think you lose some of those. My guess is that you will win more Republicans, because Republicans love to cut taxes, whether –- whatever the effect is on the economy. And so I think that will be well received, and it will be important.

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I want to pick up on that point you made about the mailbag beginning to equalize. I talked to a couple of members up there, who tell me that since Monday's vote the angry letters have been coming in on the other side are the cause. And they have been more from people that the Congressmen know and trust. And they are sort of the leaders in the community, and I think that's going to have some sort of effect over in the House to at least enough to help swing that dozen or 15 votes that are needed.

MR. MANN: Well, let's assume for the purposes of the rest of the discussion that the Congress does approve a package, roughly of the shape that we see now. Alice is that a good thing? Will it succeed in diminishing the panic? Will credit loosen? Can the package be implemented successfully? What -– how should we feel about all of this?

MS. RIVLIN: Is that all you want to know? Tell me.

MR. MANN: That's all I want to know.

MS. RIVLIN: We don't know for sure what the purpose of the package is. Is to restore confidence and to get credit flowing again and I think, it will probably work. It's not going to solve the whole problem, we will still probably have some bank –- some financial institutions failing. We're probably still going to have some kind of a recession, but we -– if it succeeds in getting the credit flowing again to ordinary businesses with good credit ratings, and ordinary people with good credit ratings that's a lot. And the only thing you can say is, it might have been a lot worse, we don’t know for sure. But there’s a chance as Secretary Paulsen and Chairman Bernanke have been emphasizing, and the President. That if we didn’t do something to weigh in on a big scale that we would have a financial meltdown around the world, and subsequent really devastating effects on the real economy.

So it’s a little bit like nuclear war or something. You don’t know what the chance is, but you better do everything you can to avoid it.

MR. MANN: That’s the –- that seems reasonable, although it might not have seemed reasonable in the House of Representatives.

MS. RIVLIN: Apparently it didn’t.

MR. MANN: On Monday, but that sentiment is –- is shifting. What –- what are sort of the problematics now? What happens? Let’s assume this is signed into law by weeks end. How quickly does the Treasury get up to speed? Do they know how to actually manage this? Will we begin to see some in effect new capital put into the system, fairly quickly, or will this take months?

MS. RIVLIN: Well, it’ll start very fast. I assume that in some backroom of the Treasury there is a group of people who have been designing the first move. They have said that they will use some kind of a reverse auction. There are lots of different designs that you could do for that and they would have different effects. But some very smart people have been presumably been working on this. So the first thing you'll see is some kind –- the Treasury moving to buy a substantial slug of the so-called toxic assets, through some kind of procedure. And they'll -– they're winging it. They've never done this before. I think they will see how the first auction goes, and maybe redesign it a little bit. But you'll see action very fast.

MR. MANN: Alice, one other question, which really has to do with the health of the macro economy. Is it possible that this package enacted and implemented, will coincide inevitably with a recession that's already basically? We could be in it now, or we could be headed there inexorably and is -– what's the interaction between the efforts to intervene in the financial markets, and prop them up, and the overall state of the economy? What should we expect in the months ahead, and what kind of dilemmas does that pose for the next President?

MS. RIVLIN: Well, the next President is going to find himself facing a very weak economy. And I think that there's little doubt that when the official statistics are looked at after the fact as they are. We will find that the recession has already started. The serious question is how bad will it be?

It wouldn't have to be really bad, if we could get the financial markets functioning again. But we're very likely to have a -– several quarters of negative or only slightly positive growth, it maybe quite a long time before we have a robust economy again.

MR. MANN: I'd like to return to that question, and get others to weigh in on it. There's been some very pessimistic speculations that we may be entering into a sustained period of no or low growth that is going to magnify all of the other problems that we face now. Are you -– do you describe to that?

MS. RIVLIN: I'm not one of the pessimists. I mean there are a lot of people, who have really serious gloom and doom scenarios. But most of them do start with meltdown in the financial system around the world.

If you assume that we can stave that off, and you know we'll lose a few more institutions, and probably the Fed and the Treasury and authorities around the world are going to have to salvage a few more, or decide to let them go, one or the other.

But if we can stave off financial meltdown, I think there's no real reason to think there's something fundamentally wrong with the U.S. economy. John McCain got into terrible trouble, saying the fundamentals were strong, but if he meant that we have a highly productive economy, our exports are doing well, because the dollar has come down. American workers are quite skilled and ingenious. We have a lot of entrepreneurs, there's no reason that those positives won't reassert themselves.

MR. MANN: Simon, let's pick up, if we could on Alice's reference to fed officials, in other countries. The backdrop of the scare and panic here is the potential of global financial contagion. How -– how does what we do here, affect the rest of the globe, and how is the rest of the world now dealing with the problem, we apparently all share?

MR. JOHNSON: Thanks; I think that's a great question. That's an excellent question for this week, because really a lot of these global ramifications are what we're reading it in the newspapers and actually on the newswires.

Before I answer the question, let me be very clear. I –- my message today, and at the moment is a reassuring message. And I emphasize that because a lot of times, when people hear what I have to say, in my baseline scenario, they get a little bit scared and they think that you know very bad things are going to happen that will surprise you and will surprise you in a bad way. But I think if you think through the logic of the situation, and that's what I've tried to do with the web site, you'll see that actually, at least to some – we're certainly far beyond business as usual, but at least to some outcomes and some policy responses that are totally reasonable and we can easily handle the situation if we get our minds around it.

The reason I want to emphasize I'm being reassuring is, I think we are facing an extremely grave international situation, in part because while you may have differing opinions about the response and the delayed response of American officials, I can assure you that the Executive Branch and the legislature in the United States is way ahead of their counterparts in any other industrialized country in terms of both understanding what is going on and in terms of really getting their teeth into sensible suggestions.

I think their suggestions are not yet sufficient; I don't think the right issues are yet on the table in the United States. There are probably 12 steps to recovery from any addiction, including the one in the United States. I think the U.S. is probably on step two or step three. I think the Europeans are struggling to get their hands – struggling on step one, they're in total denial. And I think if you look at the events this week, if you look at – and I must say, I'm happy to speak frankly and freely on all of these issues, I never name particular companies or securities in a negative way, for obvious reasons, and I won't do that today, and I don't do it on my web site either.

But you can go look at Bloomberg.com or any other news where you want to see what's happening, you can look at what's happening in Italy, you can look at what's happening in Ireland, you can see the issues around the banking system, and you can see various ways in which the situation is becoming destabilized.

Of course, there are policy responses, but they're very piecemeal, they're very case by case, and I think, and I'm not going to take you through the full logic, you can – if you're interested or if you want to argue with it, you can go to my web site and take it up there, that's what the web site is for, is trying to move that debate on. In my opinion, we are far beyond the time where a case by case approach will work. Catching dominos as they fall is a very tricky business, because you tend to knock over a couple other dominos when you catch some. And that's where the Europeans are, and it's not just a problem for Europe, it comes back to the United States. Again, no names, please, but, you know, you can – I'm sure you're aware of some international banks that have big presences in Europe, big presences in the United States, big presences in other parts of the world.

Today the attention is on Europe. Most of the rest of the world is going to be drawn into this one way or another, either through their financial connections or through their trade connections. It's one world, and we're definitely not ready to deal with this kind of financial real shock.

We can get ready. Martin Wolf said in the *Financial Times* today, he quoted a very good column, he quoted Winston Churchill, who, as you remember, said that the Americans always do the right thing after they've exhausted all the alternatives.

I would add to that two things. First of all, we in the United States exhaust the alternatives really fast, so that's a good thing, right; the other thing is, I don't think Winston Churchill would have said the same thing about the Europeans. I'm not sure they do necessarily do the right thing. And if you want to worry about a serious global recession becoming much worse than that, I think you should certainly write your congressman, but I think you should start writing to the heads of European governments and get them – tell them to get with the program, because that's where the real gap is in terms of understanding, in terms of preparing for policies. I have some concrete proposals to the U.S., too, but I kick them all back to you.

MR. MANN: Well, listen, I'm delighted to hear the defense of the U.S. leaders, given the beating we've taken, they've taken in Washington and around the globe. We've been lectured to by a number of prime ministers in recent times, but you're suggesting both executive and legislative leaders have chomped onto this and are very much engaged in it, more so than others around the globe, that's very reassuring to hear. What else needs to be done beyond this particular package?

MR. JOHNSON: A lot needs to be done. We're only just beginning really to think about the issues seriously. I think there's four things that are going to be on the agenda very soon; the first one is obviously extending and making clear the true nature of deposit guarantees in the United States. This is a tremendously important point. The FDIC never lets people down. And I can tell you from the – and I would like to emphasize from personal experience, experience from my own family when Indy Mac went out of business and was -- by the FDIC, you didn't lose contact with your money for even one split second, okay.

Somehow people have got the idea that dealing with the FDIC is like going to renew your driver's license, you'll have to stand in line and you go to three different windows and waste half a day, it's not, it's completely painless, and you should absolutely trust in the FDIC and in all your retail deposits.

And as far as I know, the FDIC, on a defacto basis, has always paid off on all deposits, not just – not only deposits below $100,000. This is a key point that all politicians need to get together on and communicate right now, okay.

Retail depositors have to be reassured that the system that protects them is completely sound, that's very, very important now, and that's a job for today and tomorrow, by the way. Now, assuming we get past this, and again, I believe in American politicians, I believe we will, I think there's three issues that have to be tackled soon. And let me be clear, I think there are now 34 and a half days until the election, and I would much rather deal with these issues now, but I'm told that some Congress people want to go off and campaign.

So I think the Fed and Treasury can get us through to the election, and I think Congress should come back right away and deal with these three issues. The first is recapitalizing the banking system. Now, this is not rocket science, this is not something new in the world, it's been done many times in different countries, it's been done in industrialized countries, it's been done well, it's been done badly, and another time or on my web site we can talk through the details of how to do it properly.

I see an emerging consensus on this issue, that it has to be dealt with through a form of injection of capital by the Treasury, the Treasury receives preferred shares, there's a lot of protection for the tax payer on the down side, and there's good participation on the up side. I think people, when they look at the details of those schemes, when they get focused again, they get pretty comfortable. But that's a conversation we have to have. I think we need a new approach to restructuring mortgages. I think that what we've been pursuing so far, which is very hands off, very much a voluntary approach, it needs to shift gears. There are people out there, there is technology, there are actually people, because they work for Fannie Mae and Freddie Mac, they actually now work for the government, who are really good at this, they're really good at reducing the loss of value.

When a house goes into – when a mortgage goes into foreclosure, and the same people can be applied to the problem of limiting the conversion of foreclosure into delinquencies and getting ahead of the problem of upshinarms (?) which are obviously going to – many of them are going to go into delinquency unless you do something about it.

It's a voluntary debt restructuring approach. It can be done – you have to get very micro, it's somewhat labor intensive, that's fine, I think we need the jobs right now, and the point is that corporate bankruptcy -- the way to sell this is that corporate bankruptcy in the United States is a very efficient institution. You lose very little value when a corporation goes bankrupt, okay. You continue to operate, you continue to operate your airline, but when a house defaults on a mortgage, you lose about half the value of the property, it's extremely inefficient. So there are many ways to address that. Again, we can go through them in another context, my web site, or your web site. You should all set up your own web sites with your proposal. We really need the debate and the engagement.

The third thing is a fiscal stimulus package. But I have to emphasize, and be careful which sound bite you take, that's why I have my web site also, so don't take me out of context. The fiscal stimulus will only make sense if you also recapitalize the banks and also deal with the underlying mortgage problem.

Do not, please, make the mistake of Japan in the 1990's, of throwing in fiscal resource here, a fiscal resource there, dribs and drabs. I'm a very firm believer in at least one version of the Powell Doctrine, which is that when you show up, you show up with overwhelming force, and you do it all and you do it right, and that's the time when we use the fiscal stimulus. And the good thing about the fiscal stimulus is, you'll need it at that point. It's also quite fair. So renters who didn't take out sub-prime mortgages will also benefit from the fiscal stimulus, and that is a very good thing, will be a very good thing. Now, I understand we're a long way from any of you being convinced about this, we're a long way from the practical – that's totally fine. I think my job is to put these ideas out to you, to explain the logic, to take you through the comparative experiences, and that's what the documents on the web site are supposed to do.

I think, if I might just venture one further suggestion, prompted by what Bill and Alice were saying, you know, last Friday, when I heard the candidates punt on the first question of the debate, what do they think about the crisis package, my feeling was, well, that's okay, they want to play it safe and they don't want to make any mistakes, I don't feel that way anymore.

I think the situation is so grave and it's moving so fast that they should hold another debate, they should schedule another debate, a special debate on the crisis, how we got here, but particularly what they would do to get us out of it.

I think this will be the dominating issue, domestic issue for the next president for at least the next two to three years. And I think it will be good for all of us to know where the candidates stand on this and what their ideas are. And I think this would greatly accelerate the debate and the discussion in the country and with Congress. Sorry to go on.

MR. MANN: Simon, one final question. How should we think about the public funds being pumped into the system now in a variety of ways, often times, you know, through recapitalization, guarantees of various kinds, purchasing mortgage backed securities? Are we likely to find ourselves five or ten years from now of having expended those dollars and more, or are we likely to have achieved enough stability in the markets that real assets held by the government will end up making the dollar commitment not very important on our balance sheet, but that we will have used the guarantees to stabilize the system; how should we think about that?

MR. JOHNSON: Well, the rough bottom line way to think about this is, when you throw the kind of party that the U.S. has had in the past five – ten years, it usually ends up costing you five – ten percent of GDP one way or another. Now, that’s not a disaster, the U.S. can easily afford that. My point would be that if you go in with a piecemeal – and I want to say stop – measures, the point of putting your finger in the dike is to wait for the other people to come with the big bulldozers and fix the dike, okay, I'm all in favor of that, don't get me wrong. But that's not the solution to the problem. And I think, you know, a piecemeal approach will end up costing you a lot more than coming in with decisive force and a comprehensive solution.

I understand we, the American people, are not ready for that yet, that conversation has only just started, and I think that's the point of having a democracy, it has to be a conversation, we've got to bang these ideas around, but we have to do it pretty quickly, let's say a month, and there are stop gap measures that will get us through a month; maybe it's two months, maybe it's three months, I'm not sure, that's fine.

But after that, you know, at the very best it starts to cost you a lot more, the piecemeal approach, in my view. And at the worst, you come under a lot of pressure and a lot of your stop gap measures start to unravel.

I think the central banks have done a brilliant job, for example, in their liquidity operations over the past year around the world. But we see these liquidity operations getting bigger and bigger and bigger even this week, right. This is not heading in the right direction. They can keep it going for a bit longer, but ultimately you're going to have a problem if you continue to rely exclusively on stop gap measures. So let's start the conversation on a comprehensive and decisive approach.

MR. MANN: Alice.

MS. RIVLIN: Well, I think there's been a lot of misunderstanding of what the tax payer cost of this might be. People talk about this $700 billion as though it all might be spent tomorrow, and it was like doubling the defense budget or something like that. This isn't of that nature. It is the Treasury buying some assets, which will eventually have some value.

Now, you don't know exactly what value they have, but it will be – it should be thought of the way a loan is thought of, a government loan, that you don't know how well it's going to be paid back. There's some contingent liability there, and you have to figure out roughly what that is, and nobody really knows, but it isn't like spending that money right away.

And then the other point is, compared to what. If we don't do this, what will the bill to the tax payer be in terms of having a much more severe recession then we would otherwise have had and losing a lot more than is probably going to be lost if we do this kind of thing, and even the kinds of things that Simon is suggesting, more stimulus and other things to make sure that the recession is not a total meltdown.

MR. MANN: All right. Bill and I were discussing before we came up here the likely close vote that we'll see in the House again. Some people are bothered by that, but we were reminiscing about how we usually see Congress doing the wrong thing when it acts unanimously. Beware of unanimous votes. Serious steps taken to deal with a problem usually involve close votes, and that's what we're likely to see here. Well, Bill, you've heard what we think is likely to transpire on Capital Hill, you've heard the reactions of two of your economic colleagues; what does it look like to you?

MR. GALE: And I've heard Simon's very positive, uplifting comments that everything is going to be great. A couple of comments; one is, we talk about the bailout plan. It's important to understand, there's no plan. What the legislation would do, would say to Paulson, you deal with this, we don't know how you're going to do it, but we're giving you some money to deal with it. It's not like, you know, we're saying we're going to do this, we're going to pass this law, we're going to change this regulation, we're going to change this tax, et cetera. All we're debating is whether we just hand over the authority to Paulson or whether something else ought to happen.

And you'll notice, there's nothing – there's no other something else on the table, it's only do we hand over the authority to deal with this to Paulson. That's not a bad thing, it's just different from other debates that we've had.

The second point is, there's been a lot of talk about Congress having oversight, that we don't want to just hand the Treasury Secretary a blank check with no administrative review, no legal review, et cetera. I think it's right to think about that, but I think it's also a fact that whatever happens, the oversight is not going to be very strong.

For some of the reasons that I think Simon mentioned, you need to go in and deal with these loans. It's almost a retail operation, and you can't constantly be coming back to some congressional board for oversight or approval for something like that. Mainly what's going to happen is, Treasury is going to do it and they'll report back to the public now and then. But I just don't see a strong role for oversight in all this despite what people say. And the third issue is, I don't think that's such a bad thing. Larry Summers has said this several times, and I think he's right, that the risk of – it's related to what Simon said, too – the risk of under reacting here is much bigger than the risk of over reacting, and the risk of not giving the Secretary enough authority is much bigger than the risk of giving him too much authority.

So it's one of these situations where I'm telling you all these things that are wrong or are concerns, and then I'm saying, well, but maybe it's not so bad because there's no better alternative. So it's sort of the compared to what point that Alice made, and I think that's an important thing to shadow this whole discussion.

Let me add a couple of comments on the package itself; one is, there is no guarantee that this is the last thing we have to do. It feels kind of like family vacations, where you build sand walls, you know, walls of sand, and then the tide – you think that's going to stay there, and then the tide – 50 minutes later the tide knocks it out, you go ten feet up the beach, you build another one, and that's going to be there, and then the tide comes and knocks that out. And so there's no guarantee that this is the bailout that ends all of this, for a couple of reasons; one is, it might not solve the current issues in the mortgage market, and I'll come back to why in a second; and the other is, there are other issues looming, you know, student loans, credit card debt, auto loans are all out there and all sort of are headed in the same way that the mortgage market is.

On top of that, there are these, even within the mortgage market, there are these negative amortizing loans that don't really kick in until 2009 or 2010 that are basically time bombs waiting to happen.

And so there will be more bumps along the way, even if this thing works. Whether it works or not is something I've thought about. And I've got two concerns and I've got a potential answer.

One concern is basically what is being proposed is that we create an investment bank in the government. What investment banks do, what investment banks used to do is, they borrow peoples' money and make investments with it, right, and that's basically what the government wants to do, it wants to borrow up to $700 billion and buy a bunch of assets with it. So it's not clear to me that the government is going to be a better investment bank than investment bankers are, but that's the model; maybe Paulson will be. The second issue, though, is, this is a really bad way to form an investment bank or a hedge fund, it's only buying one type of asset, and it's a bad asset to begin with, so it's not diversified. You know, if a hedge fund were going to do this, they would buy a whole bunch of assets, one of which might be bad housing loans.

So I'm worried about how the plan is supposed to work. And someone mentioned there are probably people in the basement of the Treasury, you know, working out the details. What I was thinking was, when physicists get to some data pattern that doesn't make sense, they say, oh, gee, this would make sense if only this new element existed or this new, you know, quirk or dark matter and it had the following features, and they defined all the features, and then it all works, and then they go out and look for that element.

So if you do that here, what's that element? Let's call it Paulsonite. I think the element of Paulsonite here is that if this gets passed, Paulson is going to go to the financial leaders and say, look, we are in a real mess, you're in a mess, I'm in a mess, we have to work this

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out, I understand what it says on paper, but, you know, we're going to create this sale, you are going to put up assets, you're going to sell them for the price that we say you're going, you know, there's got to be something like that going on that will make this whole thing work, otherwise, I'm really scared. Yes, Simon.

MR. JOHNSON: There is a term raiding the financial markets which is called market to Paulson.

MR. GALE: Well, maybe that's what it is. So those are my comments on the package itself. Now, let's step ahead in the long term, which Simon described as a – now, a little longer than that maybe. There are two issues that we really, really need to come back to; one is the tax subsidies for debt in this system.

If you take a 30,000 foot view, we subsidize debt all over the place, on the mortgage side, on the investment side, et cetera, and we have these enormous leverage ratios in the system, which may not have been the sole cause, but certainly helped create the situation we're in, and it's worth going back and saying, do we really want to design a tax system that very heavily subsidizes leverage. There's some advantages, but there's some obvious issues, too. The other issue has to do with regulation. There are a lot of people right now who routinely oppose strengthening regulation, tightening oversight, et cetera, who are now saying we have to jump in and do something, all right. And we need to remember this after the seas calm down, because we're going to have another debate about regulation, and the winning argument I think ought to be, if you're going to jump in at the end and bail them out, you have not only the right, but the responsibility to regulate from the beginning.

And I think with this experience in mind, we might be able to start the regulation debate over, not from a punitive perspective, but from a more informed, balanced view rather than, you know, the standard argument that the market is always right, you know, self-regulation is the best, et cetera.

So I think those are two debates that we could use to learn from this experience, but that's not this month or even next month, that's maybe next year looking ahead.

MR. MANN: All right. Here's a question for you all. How strong is the U.S. balance sheet? That is to say, are we in a position to do what we need to do to stabilize our financial markets and have a positive impact on the global financial markets in light of the fact that we've added greatly to our national debt, that we have moved from surpluses to deficits, and they are now projected, the new President will probably face a $550 billion plus deficit in the first budget he has to deal with, that our current account deficit is in bad shape? Are we still in a position to call on our resources and our reputation to deal decisively with the problems we face? Alice.

MS. RIVLIN: Yes, I think we are, although we must treat this whole thing as a wake up call. There are serious problems with the U.S. federal government's balance sheet in the long run, and the long run isn't that long. And we have to do something about the fact that we've put our federal budget on an unsustainable track for the next several decades because we've made promises under entitlement programs that we cannot fulfill on any sensible set of taxes, and we're going to need tax reform.

That said, and I think it's important to say it first, yes, I think we can do this. It's partly because we do have a very productive economy, that's what this is all based on. And our securities are, perhaps a little strangely, regarded as better than gold. It's a curious thing with this kind of looming federal debt crisis out there in the next couple of decades that when anything happens, everybody around the world wants to buy treasuries, and the interest rates go to zero because there is the confidence that this instrument is the safest thing in the whole world. And we've got to use that credibility right now, but then make it true later, make sure that after we get past this crisis, which will escalate the deficit, but probably not off the charts in terms of the percent of GDP. After we get through this crisis, then we've got to worry about the long run.

MR. MANN: Simon, what would you add or subtract?

MR. JOHNSON: Again, I would like to be reassuring and absolutely reinforce what Alice is saying. U.S. treasuries are better than gold for a very, very simple reason. When you hold gold, you don't put it in your basement, somebody has that gold for you, there's a counterparty risk, that's the essence of the problem right now. You hold U.S. treasuries, that's a claim on the U.S. government. I can absolutely assure you that whatever happens, the U.S. government will pay its debt, the U.S. government will not lose its Triple A credit rating, we are not in a situation like that, even in my risk scenarios, which I must admit I don't publish because you wouldn't like them, even in my risk scenarios, the U.S. government doesn't lose its Triple AAA credit rating, that's a really important point. And remember, all U.S. debt is in U.S. dollars, so you don't get the kind of difficult debt that makes other country experience from the issue of debt in another currency.

Now, having said that, I would point out to you that in speech last – the televised address last Wednesday night, President Bush had a paragraph at the beginning of his speech where he said, we got into this problem, in part, because of the foreign capital flows coming into the United States and the way in which those were handled, and there's absolutely an important element of truth to that.

I thought there was a paragraph missing from the end of his speech which would tell you where do we go from here with regard to

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these foreign capital flows; are they going to continue to come in, if so, how do we prevent a recurrence of some sort of problem like this. If they're not going to come in or if they're going to come in at a reduced level, which is possible, for example, the global economy slows down, how are we going to make adjustments within the U.S. economy? Now, these are not devastating or particularly, you know, difficult questions, but they are, again, questions that need to be on the agenda right now. And, of course, Alice is absolutely right to remind us always that there's longer term issues related to entitlement programs and related to social security, which we must not lose track, even though we have to keep putting back a little of it the moment when we actually do deal with those properly.

MR. MANN: Bill.

MR. GALE: It's a very simple question with a very sort of – raises a very complicated set of issues. It's true that we've had massive fiscal deterioration in the last eight years, on the order of six or seven percent of GDP in the long term forecast and in the short term forecast, and that's not good for a lot of reasons that Alice mentioned.

But I don't think we'd be in much better situation relative to the financial world right now if we were running a balanced budget. It's just – it's not – it's the long term issue here that's important, the structural long term gap that's important. I am logically worried about the current account aspect of this, the capital inflows, because when you say, well, it's foreign capital inflows that cause some of this, and I'm not saying Simon is saying this or the President was saying this, it makes it sound like it's foreigner's fault. And there are things that have to match up in the economic system, which is that if we buy more from overseas, that has to be financed by capital inflows. So when we say there have been massive capital inflows into the country, that's saying the same thing as we are living beyond our means, we are consuming way more -- and it's the government has an issue, but I don't see that turning around anytime. It seems to me we're utterly dependent right now on the willingness of foreign capital to come in and we need it because if we don't our capital markets would really dry up. Which means that the terms of trade, the interest rates that need to get paid not on U.S. government securities but on private market securities could actually go up a lot. Again we're in unchartered waters, but over the next 5-year horizon I worry a lot more about that than about the fiscal situation.

MR. MANN: I have one final question I'm going to pose to Bill Frenzel, but then I'm going to be turning to the audience and we'll have mikes to bring to you. So prepare yourselves for questions to our panelists.

Bill, in many respects this has been a very upbeat panel, we're going to get this package through this Congress, it's not a panacea but it starts to restore confidence to provide some flexibility in the credit markets and the U.S. is actually ahead of most of the rest of the world in thinking and coping with this. In that spirit, I want to ask you something about the state of play of politics. I think you and I would probably subscribe to the view that our politics have suffered in recent years from the bane of ideological, that a sort of ideological rigidity has gotten in the way of sensible thinking and policymaking. I'm just wondering if you agree with that, A. And B, if you think coming out of this experience and now with the election proceeding as it is whether we may be turning the corner on this and seeing a little less ideological purity and a little more pragmatic policymaking.

MR. FRENZEL: For the last 5 years I've been predicting that and have been totally wrong, so I don't think I'm in a good position to predict it for the future. It looks to me like a continuation of a real struggle between the hard right and the hard left and perhaps not an exacerbation of the collapse of the center, but I don't see any signs of a restoration of the center in American politics, and of course that's going to take an enlightened public to make that happen.

In addition, when you get the right and the left in such extreme conflict, you get that extra level of animosity on Capitol Hill and both ends of Pennsylvania Avenue that make it doubly difficult to get things done. I don't see any relief for that in the future but I pray for it every night.

MR. MANN: Alice?

MS. RIVLIN: I'm a little more optimistic than Bill is. I think we may see a resurgence of the center, I certainly hope so, but I think one place to watch is in the area that Bill raised, namely, we've got to do something about the modernization of regulation of financial markets. Regulation of financial markets has been sort of on hold because every time somebody said maybe we're overleveraged and we should do something about it, maybe we should think about hedge funds and investment banks, people on the far right said less regulation is always better. Let's not do anything. So regulation of financial markets fell way behind the curve. There was an enormous amount of innovation and superstructure that just didn't get coped with in any way, and even on the subprime mortgage front a lot of this could have been avoided if we had sensible lending standards on subprime mortgages. That's not rocket science and we know how to do that, and I think we will do that kind of thing and the center will triumph.

MR. MANN: Let me follow-up on that and weigh in on my own question, because as Bill framed it, it was a struggle between the ideological poles against the center, and my view is a little different. My view is that these things happen sequentially and historically and not at the same time. The Democrats moved to the left occurred in the 1960s and 1970s and it's been a Republican move to the right in more recent years, as witnessed by this vote: 60 percent of Democrats ended up voting for this package and 33 percent of the Republicans did. The two-party caucuses or Republican conferences are really quite different and it seems to me in the spirit of what Alice just said, unless you can get beyond the purity on taxes and regulation and begin to deal with both of them pragmatically, you're going to have a hard time restoring centrism and that means primarily rejecting a view that has been at the center of Republican philosophy for some time. I think it will take substantial presidential leadership to try to begin to restore that political center and we will learn after the election whether that is delivered. Bill?

MR. : I always hesitate to comment on political issues after you've spoken, but I do want to make a point. The nature of this discussion has been either you have ideology or you have centrism and that it's a zero-sum gain, either you move out or you move in. There are other options which might fall into the category called chaos. You had the "Wall Street Journal" editorial page a couple of days ago criticizing the Republican right wing and criticizing the right-wing think tanks to encourage people to vote against the bailout bill. You don't see many Nancy Pelosi "Wall Street Journal" alliances. So the politics of this are very odd and I'm not sure that getting the ideologues calmed down means that the center wins.

MR. MANN: A prudent note I think. Let's start with the questions right here, please. Identify yourself.

MR. ODEE: Anthony Odee. I teach at Georgetown. I hear two competing narratives about how we got all this toxic debt. Story one says the politicians made us do it, legislation pushing banks to lend, Andrew Cuomo supposedly telling Freddie and Fannie to lend more to the subprime. Story two says clever profit-seeking bankers found new ways they thought to make a lot of money inventing new mortgages, securitizing them. What percentage of the story do these two narratives explain?

MR. MANN: Alice, start us.

MS. RIVLIN: Both are right. All of the above. But let's not forget the fundamental thing that got us into this mess was that almost everybody including probably most of the people in this room believed something that couldn't have been true, namely, that housing prices would keep on rising forever and that was the basic fallacy. When you think the price of any asset is going to go on rising forever, the people find ways to make money on this and they began doing all of these fancy things that were opportunities to make money. But the fundamental thing was the asset on which all of this was based was bound to turn down at some point and when it did we were in trouble.

MR. MANN: Bill?

MR. : I agree with the statement that it was both, but I want to qualify that in an important way. I think it was 95 percent the second story, that is investment banks figuring out ways to make money and 5 percent politicians forcing Fannie and Freddie to invest in local markets. First of all, if you live and work in Washington, you know that nobody pushes Fannie and Freddie around, or at least didn't for the last 30 years. Maybe they do now. But they were the absolute strongest lobby it would seem to me for years and years and the notion that they were being pushed around by the politicians just seems ludicrous to me.

Second of all, they made tons of money for tons of years. They just overextended, and not because of their political mandate to do two things, but because they overextended. The third thing is they actually thought that the dual purpose under which they were chartered made it impossible for them to make money, it seems to me it would have been their duty to report that to Congress and encourage Congress to dissolve them under their current situation. The last thing, there are problems all across the mortgage market, not just in the subsidized sector, so the notion that this was politicians forcing Fannie and Freddie to make these loans is I think misguided. Yes, it was both, but 95 to 5, in the same ways that investment banks were financed by both debt and equity but they had 50 debts for every 1 of equity. I think it's that kind of ratio we're talking about.

MS. RIVLIN: I agree on Fannie and Freddie. They came late to the party. This was in full swing before Fannie and Freddie got into very much at all.

MR. : Also can I clarify one thing about what qualifies as toxic debt? It isn't toxic because it's not worth much. An asset that's not worth much just gets sold for not much money. It's toxic because no one can figure out what it's worth. There isn't a market right now and that's what makes it toxic because the banks can't unload it and get cash for it.

MR. MANN: Simon?

MR. JOHNSON: I think there aren't two competing narratives, it's one narrative, special-interest lobbies got rules turned in their favor, went crazy, had a party, and you're going to pay for it now. That's the story. On a reassuring note, it happened in Europe, too, so you're not alone.

MS. RIVLIN: But not as much.

MR. JOHNSON: I don't want to name specific countries, but you know what I know, Alice, so it's a varied picture.

MR. : And it isn't just Wall Street and Washington, it's the whole country was involved in this jumping at greed.

MR. MANN: As an amateur in this whole business, how should we think about hedge funds in this context? Have they been forces for good in the economy as well as for ill? And what's the balance between good and ill?

MR. : I personally think they've been very much a force for good. I don't know how far we want to get into this, but they serve a very important role in the financial markets and they serve it pretty well. If you look at who's going under, it's not the hedge funds. It's not even leveraged buyout firms. I'll follow Simon and name them, but you know who they are and they're not hedge funds.

MR. JOHNSON: Within hedge funds you've got to make a very clear distinction according to their degree of leverage. So there are some things we call hedge funds where they have a very little amount of capital and they borrow enormous amounts of money and that creates a lot of risk for them, but the way they set up their incentives it actually plays out quite well. It's attractive. It turns out it creates a lot of risk for the system as well.

There are hedge funds with much less leverage, in fact, some hedge funds use hardly any leverage, and they I think will play a stabilizing role because they're the kind of people who come in and buy and are more able to hold onto things for example when there are buying opportunities. So I think the question as we were discussing a moment ago is going to be what do you think about leverage going forward and some investment banks or some commercial banks have operated by highly leveraged hedge funds. The labels we have to rethinking, thinking about how much leverage are you comfortable with. And also the idea that somehow you can have unregulated entities that have a lot of leverage and that will okay, it won't hurt the system. Again I think we have to go back and look at that. If something is unregulated and it gets big with a lot of leverage, that's system risk.

MR. MANN: Alice?

MS. RIVLIN: And I think there's a basic point that has to be remembered and the hedge funds are only part of it and may not be the worst part of it, but the whole financial services sector got way out of line, way overextended. They weren't just financing the rest of the economy, they were making enormous amounts of money buying and selling to each other. Some of that was useful, but there are going to be an awful lot of really smart people looking for work because this sector has got to come down.

MR. MANN: Bill?

MR. : I have the same feeling Bill does, that hedge funds have been useful and positive. I do not think that any part of the financial sector should be immune from regulation. I think we need to look at that. And included in that is how their managers are subjected to taxation.

MR. MANN: Bill? A mike is coming.

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MR. : I get somewhat disturbed when you say the wrong is that people make money. When you said that I think Bill Gates did something and he made a lot of money, or Warren Buffett makes so much money he gave $5 billion to Chase and he makes 10 percent a year on that, and the whole American country is based on the fact that people will make money. I think that the problem here was you had two very good public servants, one Hank Paulson and the other, the chairman of the Fed, saying we got a problem, Mister President and they convinced the president, he sends up to the Hill something not more than 10 pages, 3 pages, and -- but instead of that the Congress got involved in something, most of them didn't know what the hell they were doing. And even more important, you had the press the same thing, that each day they would criticize something -- recognize they had a problem, let them work it out, I think we'd all be better off than what we have now.

MR. MANN: I would take great exception to that, Bill. I think in fact the document sent up by Paulson was simply untenable in a democracy to simply concede all of this authority with no opportunity to check it, to oversee it, to ensure its transparency, and my sense is that Congress acted in a remarkably responsible fashion in accepting what Paulson had put together. The basic structure is there and every element of change is something Paulson and the president agreed to and felt would not be harmful. In a democracy it seems to me it's essential that

Congress reflect some broad and defensible public reactions and that's what they did. Alice?

MS. RIVLIN: I agree with that, but I think Paulson misjudged the situation. He's a deal maker. He's done deal all his life. So he put his opening offer on the table and expected it would be taken as an opening offer. It was taken as an outrage. He knew he was going to have to negotiate with the Congress. He couldn't not know that. But the Congress was outraged by the opening offer.

MR. MANN: Bill and then Bill.

MR. : When the Japanese bombed Pearl Harbor, Roosevelt said we got to go to war not only with Pearl Harbor with the Japanese but also with Germany, but the Republicans didn't want that and said, no, just the one war, but yet they backed off and we went to war with both of them. Plus it helped the fact that Hitler in the meantime declared war on us.

MR. MANN: Bill, I'm glad you have such trust in the second branch of government. I'm a fan of the first branch of government.

MR. : I'm a fan of the first branch too, but I'm with Coleman. When you serve up simple things to the Congress, they tend to get complicated and screwed up, they tend to be fiscally distorted. We tend to pay off every lobbying interest for miles around. And occasionally it is better to grant very large authorities to competent groups like the

Federal Reserve board which has a whole lot of assets, a whole lot of authority, and in this case I would have been much happier giving the Treasury a blank check than trusting 435 people whose record has been considerably worse than that of the U.S. Treasury.

MS. RIVLIN: He's still getting the blank check.

MR. MANN: He's still getting the blank check.

MR. : I agree.

MR. MANN: Just with some whistles and bells on it.

MR. : But I just wanted to respond to the first part of the comment. I don't know that I or anyone else said that making money is a bad thing. I thought I just said that hedge funds were -- for good. So we can talk about that later, but I don't think anybody implied that making money is bad.

MS. RIVLIN: If any of us thinking money was a bad thing, the Brookings Institution would not exist.

MR. MANN: I had a question right there in the back about the fifth row.

MS. : I have a question for Mr. Johnson.

MR. MANN: Speak up a little louder, please.

MS. : Just a comment on the suggestion you about possibly another debate on the economy. I just feel that it would be more detrimental than it would actually be helpful just because I feel like there

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would be two problems with that. One, the presidential nominees don't know much about what's going on and I feel like what are they going to debate, the fundamentals of what's happening or propose solutions? They both tried that and we didn't get anything out of it. Two, you said it might engage the public, but at the same time I feel like fear is also another fundamental problem in what's happening now and all that would make is it would increase the fear in the public and I just think those who may be helping bounce around ideas about what could possibly be the solution are already doing that. I assure you that discussions are going on amongst everyone. Communication media are still there bounding around ideas and I just feel like it would increase the fear in the public versus --

MR. MANN: If you would paraphrase that.

MR. JOHNSON: Absolutely. It's a very good question, and the question is would it really be a good idea to have an additional among the presidential candidates regarding the crisis and particularly how to get out of it, and you're worried about two things. First of all, that the presidential candidate don't know very much about the situation and what to do. And the second, that having this discussion in the open and having them lead the discussion would be frightening to people and would further undermine confidence.

It certainly would be frightening if they turned up to the debate not knowing what was going on. That would be disconcerting, but that wouldn't happen. You have to take into account the speed of American politics and the speed with which these very competitive, very smart people who run presidential campaigns can adapt and update. I'm not comfortable with having the presidential election being about whatever set of issues you finally come down to because I'm sure based on what we see today, and I think we're agreeing, that the big issues you're going to have to deal with at least initially and I think for quite a while are going to be around and coming out of this crisis that we've got here. I think the presidential candidates will get up to speed or the people who brief them will get up to speed and there are plenty of ideas out there and there's plenty of time to shape plans and put them together. And I think the frightening thing is when the people in charge of the country don't tell you what's going on and don't tell you what they think is going on.

I think the reason we're frightened is the most trusted public servants with regard to economic policy, the Secretary of the Treasury and the Chairman of the Federal Reserve, 2 weeks ago told the American people, were continuing to tell the American people, that the economy was fundamentally sound and they didn't mean long-term productivity, by the way, they meant really it's fine we're going to avoid a recession. Two days later they showed up and they asked for 5 percent of GDP in small unmarked bills to be placed in a paper bag outside Mr. Paulson's office, no questions asked. That is an unbelievable shocker. If you can tell me when that happened before in the American democracy, I take the point about Pearl Harbor, it's a very good one, but everyone understands that the U.S. was attacked, that was a very visible, clear thing, nobody understands, very few people understand, what is happening in this country today.

Nobody understands what credit default swap spreads are, nobody understands what -- is, nobody understand why problems in money market banks in far away places are of any concern to you. The entire financial system is in jeopardy and people don't get it because the people who run the economy didn't give them any warning signs. They knew, by the way, a lot more, not everything, there are some shocks here, but they knew a lot more, they didn't explain it, we didn't have any discussion, didn't have a debate, and we now have to catch up. The good thing about the United States is that we can catch up and the good thing about it being election season is there's a lot of incentive to catch up because if one guy proposes let's have a debate, I want to talk about my solutions, I don't see how the other person can stay away from that debate.

MR. MANN: Just on a reassuring note, Simon, it's inevitable that the financial crisis will be front and center in the three remaining debates of the campaign, so there will be no shortage of public talk about it. I do think the notion of presidential leadership of public opinion, the educational role, is the essential and the sad fact is our current president is so politically discredited that people don't listen and it will have to come from the next president. That's an essential role. But what they say specifically now is probably less important than the measure we take of them in terms of their temperament, their decision-making style, the people they turn to for advice. I'd like to know who their Secretary of the Treasury would be. That would probably be as instructive as anything else. So there are questions to asked that wouldn't scare the rest of the world that would probably quite informative for American voters. Bill?

MR. : Simon earlier made the point that you really need a separate new debate on this subject. In the first place, there are none of the moderators that have appeared in any debate that are capable of handling this kind of a discussion or leading it or drawing out the answers that are required. I believe that we should have it, but I think it really does need to be a separate event and it has to have a special kind of moderator with some economic credentials that the people in the press unfortunately do not have.

MS. RIVLIN: We could lend them Tom Mann.

MR. MOODY: Jim Moody, former colleague of Bill's. I want to get back to the discussion about the right-left-center mix in Congress and tied to this discussion about financial literacy on the part of the public. When would see potentially the conservative Republican wing of the

House and of the Senate come back to grips with their former touchstone of belief, namely, deficits do matter and that long-term issues that Alice raised with entitlements and so forth are the looming problem that are the mother of all -- much more serious than anything we're going through right now and if we don't cope with that -- do we see economic literacy in the public mind ever getting to the point where they would coax that right-wing right side of the Congress to begin to deal with that because right now deficits don't matter, the dictum of Dick Cheney seems to still prevail.

MR. MANN: Are you encouraged or discouraged?

MR. : No, I am not. I grew up in a period when deficits did matter and fiscal sobriety was very important to Republicans of all coloration, right, left, and center. Nowadays it seems to have been abandoned and in favor of certain social doctrines and the idea that taxes must be cut and regulations must be dispensed with no matter what the conditions are. Those aren't the philosophical directions that I particularly want to go, but I don't see them changing. I don't want to get into a huge political discussion here, but there are problems with the way districts are drawn that tend to make them slaves to the right or left parts of the constituency, that is very safe districts -- there is a problem in my judgment or part of the problem has to do with the way the press works now particularly the electronic press, the gossip stations, seem to be fascinated with the extremes of the right or the left.

I hope it's something that we will phase out of, but I simply don't see much change occurring and at least I see the faction that you're talking about in my party growing stronger.

MR. MANN: The irony is that the losses in the Republican Party certainly in 2006 and likely in 2008 will come from the more moderate wing of the party, strengthening the hand of the Republican Study Committee and making it less likely that they will lose or move away from the ideological underpinnings of their efforts. So it would probably take a sequence, a series of electoral defeats and some other entrepreneurial politicians arguing a better way to succeed and get back into the majority as through a different set of ideas and a very different public philosophy. Alice?

MS. RIVLIN: I just wanted to weigh in on Jim's question which implied that the problem was all on the right. It's not. It's the denial on the left that we've got a long-run budgetary problem and we have to face up to it and do something is certainly part of this situation.

MR. MOODY: The right used to have that as the firm bedrock of their view.

MS. RIVLIN: They used to, but not too intelligently. They said deficits were always bad and as Simon and others pointed out, that's not true.

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MR. : Jim, it used to be that the Republican Party was the party of protectionism and the Democrats were the free traders, but things change.

MR. MANN: Right.

I think -- I'm very encouraged by the speed with which financial literacy is changing right now in the United States. You know, we talk about someone's internet time, living on internet time now? We're living on financial market time. I've talked to radio show hosts from regional stations who've asked me the best questions I've heard. And I said to them how come you're so up on this stuff? And they've said to me, three separate ones have said to me, that's all we've talked about on our show for 10 days, all right? And I think this is a very good point made by the previous questioner, which is people are talking about this enormously. There're great resources out there on the internet. I think people should look at the Brookings website. There's a lot of useful information here on -- about this and about the crisis in general. Peterson Institute for International Economics has a crisis watch webpage, and I have my webpage, and we're happy to link to -- I mean, seeming not for Brookings but for Peterson. And from my webpage we'll be happy to link to other places where there's very good information, ideas, out there. Calculated Risk is another rather famous webpage where they go through a lot of the details of how did the mortgages get into this kind of a situation. There's a lot of analysis out there. It's accessible to people in a way that wasn't before, and people are very focused on this. So, I agree, we're starting from a low level and there's a long way to go, but the rate of acceleration is quite impressive.

MR. MANN: Right here. Mike is on the way.

MR. TAYLOR: Thank you. My name is Bill Taylor. I'm a civil rights lawyer. I'm glad to hear the discussion focusing to some degree on what got us to where we are because that may determine what lessons we take out of all of this. And there seems to be some consensus that what's euphemistically referred to as the housing bubble is a part of what got us where we are, but you know, which has to do with speculation, with manipulation of the markets, with predatory lending, and with the subprime, the development of the subprime mortgage market. Now I hear the right of the republican party attributing the housing problem to the fact that through civil rights laws and through community reinvestment, we let some people into the -- have access to housing who have been denied by discrimination. So if that's the lesson that's taken away -- I don't think it will be, we'll be worse off -- but I'm also concerned about this center that you're talking about. The people who are in charge of Fannie Mae, in charge of other regulatory institutions, were eminently of the center. They were both democrats and republicans, and they didn't blow the whistle on what was happening. And I only know two people who really were responsible for finally calling this -- bringing this to public light. So what confidence can we have that the center, which we would like to think is the stabilizing force in our society, will come away with some regulation that we need in the future?

MR. MANN: Bill?

MR. FRENZEL: Thanks. That's a good question. I have sort of three comments on how we got into this. The metaphor that I like is if you're flying an airplane regular speed, regular altitude, a little turbulence is not a big deal. Right? If you're flying the plane at a speed of mach 2 ten feet off the ground, and then you hit a lot of turbulence, all right, you're in a really bad situation. And we definitely hit a lot of turbulence. That's the housing bubble and the decline in house buying that's occurred since then. But there's a lot of, you know, going very close to the ground, flying very close to the ground, in terms of the financial markets, what people were doing, underwriting standards, et cetera. So it's a combination of those two, and one of the reasons the situation is so important right now is there was a lot of input from both of those sources.

A second issue that you raised, which is the goal of home ownership as a policy goal, and what I'm going to say may not be what you want to hear, but I mention two things we need to rethink. One is the role between leverage and taxes. The second is regulation. The third thing I think we need to rethink is the kind of religious -- I mean that not in a hard right kind of way -- but in a taking on faith, the taking on faith that getting somebody into a home is the right thing for them. And there are few areas in the economic literature where there is less evidence to support a notion that is held widely across the spectrum. And I really think we need to reexamine that we're not doing anyone a favor if we put them in a house that they do not have the wherewithal or the resources to pay for. So I agree there were lending issues, but I think there's also this just massive push to get people to be homeowners that is not necessarily justified and will have to be revisited.

The third thing is about the center. You're absolutely right. I don't think it's so much an issue of center versus the wings. We need good people. We need leaders. We need vision, and frankly, we haven't had that for awhile, and I think we're paying the price.

SPEAKER: I think democracy needs a right and left and a center, and I don't think anybody has a monopoly on the good ideas or truth or fact. I think my regret now is that we're woefully short in the center in our principle legislative branch, and I'd like to see that improved a little bit. But I give no guarantees that it's going to find better or nicer solutions. I still believe that the legislative branch should concentrate on the large policies, whether to commit $700 billion or not, and we also need a good executive branch to carry out the detail, as Bill Coleman suggested earlier.

MR. MANN: Yep, right here please.

MS. BREMNER: Hello. I'm Faith Bremner with Gannett News Service. Wanted to ask you folks what you think of this proposal that's apparently going to be in the Senate rescue bill that would change or weaken the mark-to-market accounting roles. Is that a good idea to let banks leave some of this bad debt I guess off their books? People applying for car loans and mortgages wouldn't be allowed to do that.

MR. MANN: Okay. Mark to market. Who would like to start? Simon.

MR. JOHNSON: Yeah, I'll take that. I think it's somewhere between being a bad idea and a very bad idea. For exactly the reason you said, which is, you know, if we start doing that, why shouldn't we all? I actually have a lot of stuff in my basement that really isn't marked to fair value. I mean it's junk, right, but you know if we start, you know, getting into this sort of games -- you can't really go there. And if you look at other countries that have tried to do this, sort of fudged around fair market value, I don't think you come away feeling good about that. I would defer to Alice to speak about what happened with the savings and loans when there was some movement on this issue. I don't know how she feels about it. I don't think that was --

MS. RIVLIN: Wasn't exactly a comparable situation, but I don't know.

MR. JOHNSON: Changing the accounting rules to try to cut the borrower some -- cut the financial institution some slack, take the pressure off, I think generally turns out to be a mistake. It generally helps them dig themselves into a bigger hole, and when you have to go get them in the end, it's more expensive.

MR. MANN: Bill.

MR. GALE: This is a really good question, and it's an example of the sort idea that there are no good options here. If you mark the market, then you get better valuation of the firm's assets, but if then the government goes out and makes the market -- the mortgages -- it turns out those things aren't worth much, then everybody's got to write down the value of their existing mortgages, and that could send some firms into insolvency. Right? If you don't mark to market, then you know, without exaggerating they can basically make up whatever they want. Yeah, there are rules, but there are, you know essentially they can do whatever they want, and that's not a good situation either. And so that comes back to the -- something I said at the very beginning I think where there are -- nobody seems to know exactly what the right thing to do is. There are risks and uncertainties and contingencies with all of the options, and we're just trying to balance, you know choose the best one. And I agree with Simon, in a regular -- under normal circumstances, I wouldn't want firms not to mark to market. However, if we're in a particular short-run situation where marking to market makes it much worse, then I don't know. It's a tough one.

MR. MANN: Apparently the SEC made some regulatory change on this yesterday? Is that -- Simon, is that right?

MR. JOHNSON: I must admit I have to go check the details on that. I'm not -- that's all I'm doing 24 hours a day. I'm not able to stay up with every one of these changes, so I have to check exactly what the SEC did, and I wouldn't want to comment until I've reviewed those details.

MR. MANN: All right. Fair enough. Gary, yeah, and then Tony, and then Hannah. Lots of questions.

MR. MITCHELL: Thanks. Gary Mitchell from the Mitchell Report. I want to -- I've been sitting here listening to this conversation and thinking about Alice's point of view in Washington about whether the process is the problem or the problem is the problem. And I know that Alice, you're -- you always weigh in on the notion that the problem is really the problem and not the process. But in this situation I question whether process is ultimately where the success or failure in relative terms of whatever it is that we -- or however we describe this issue -- will come to bear. Bill Gale has said that there is no plan, and that legislation will be passed and over it goes to the Department of Treasury. And if we think about that, I want to come back to the question of whether there is a process in place that involves the Congress, not to, you know, to be doing the fine tuning, but what assurances in between the passage of whatever legislation we get at the end of this weekend and a project of this scale and this magnitude, where's the role of Congressional oversight? And isn't some form of oversight, some form of reporting back to the public so that there is this growing public support for this thing, critical?

MR. MANN: Bill was skeptical of efficacy of oversight under these circumstances. I'm actually a bit more upbeat about it. I think the Board that was designed -- if appointments of the caliber I expect follow -- looking over their shoulders along the way and sort of discussing it, I think that's a really important step. I think building in GAO inside the operation to track and monitor and analyze and report is another very useful thing, and as I believe the sort of normal Congressional oversight is. I think the steps they took were perfectly reasonable ones. The concerns about, for example, hiring all kinds of financial firms to help manage this process raises questions of conflict of interest and the rest, and there are various requirements regarding transparency and other things that are useful. They tried to build in some accountability into this process while still allowing for some free-form experimentation with the program itself because they're not sure exactly how it's going to run. How the auctions will be designed and how they will work. I thought they found a pretty reasonable balance on this, but Alice, you may disagree.

MS. RIVLIN: No, I don't disagree. I think they got it about right and I think Bill's sound bite that there is no plan should be taken with a grain of salt. There's a fairly specific plan. We're going to have the Treasury buy a specific set of assets. Now exactly how they're going to do that is yet to be worked out and is fairly technical, but reporting back in periodic intervals to this Congressionally-established Board seems to be about right.

SPEAKER: I think it's a useful way to do it, but I would not rely ever on Congressional oversight to save the world. Congressional oversight is almost oxymoronic on its face. It's either a witch hunt or a white wash. But here you have a separate Board and in Congress you have capable people, particularly good staff people that are going to spill out facts and ideas and provide the transparency that Tom referred to. I think it's a better way of doing it than relying on Congressional committees to do the oversight because that just becomes an exercise in fun and games.

MR. MANN: The only ones who are tougher critics of Congress than former members of Congress are current members of Congress. That's another -- Tony.

MR. DOWNS: I'm Tony Downs and a senior fellow at Brookings and the world's leading authority on real estate. One of the things that you haven't discussed at all is transparency. And it seems to me that one of the principle reasons we got into all this trouble was the lack of transparency in the instruments at almost every stage, not only in the mortgage lending but especially in derivatives and in the securities. When securitization was packaging up mortgages and selling them to people all over the world, most people had no way in the world of knowing what they were buying except through credit ratings made by credit agencies. And the credit -- there was no transparency in those credit ratings either. So the tremendous amount of confusion arose because there was no transparency, and there's still not much transparency in this process that you've just described. How can we change the rules to increase transparency so people will at least know what they're buying?

MR. MANN: Yes. Good question.

MR. JOHNSON: It's a fantastic question, and just to address it within the context, I have a proposal to deal with this exactly on this context. It's a little bit technical because you really -- to get transparent, you really have to get down into the pricing mechanism, into how the price is set. And you need it to find out what would be the closest to a sort of true market value at that moment, right, when people's exact views of the overall macro economy and the value of these securities is changing. So I have a proposal of how you would design that auction process on very general terms, which is on my website and I could send you my website baselinescenario.com in case you didn't get it already.

And so I totally agree that this is a huge political and ethical and practical question. I think you have to go -- all the proposals -- so I guess I wouldn't cover these in the presidential debates, but all the proposals have to be posed at a very technical level. We need to have that discussion.

MR. MANN: Alice. Tony, yeah.

MR. DOWNS: And securitization itself -- a lot of the securities were sold all over the world to people who had no chance of verifying what was in them by going to find out about the properties since they were in Indonesia and the property was in California. So they had to rely on some third party. Now the third party has been totally discredited. So there is no confidence in the value of these things or how you can establish a value. I think securitization has, therefore, been crippled in terms of ability to distribute these securities all over the world.

MR. JOHNSON: There's no question. Not only is the third party discredited, the first party is discredited. The investment banks who originated these things, who did the bundling, didn't understand them, didn't understand the risks, destroyed their businesses. It's incredible. The answer is that when the Treasury buys them, you need to establish a counterpart private auction. So for example, you can have the Treasury buy them and then re-auction a small part of them. And we know there are investors out there. We know there are hedge funds and other private equity funds who are not damaged. They're waiting to buy. And once they feel that there's a market being established, they'd be willing to come in. So one way to do it would be through re-auctioning, so then you'd have a sense of how much did the Treasury pay relative to what the private market's willing to pay, for a small charge to this, with the same rather unclear characteristics perhaps at this moment in time. And that would give you -- that would let you get pretty close -- that would give you a sense of how much you're going to overpay. And I think there's a point that we haven't really stressed, and I'm not sure everybody would agree with this, but in my view the Paulson scheme at its heart really -- and I think at some times last week they were more clear on this that other times -- but at its heart it involves overpaying. I mean again, exactly what that means, see my website. But basically overpaying relative to what the market would pay for these things, that's how it works. And you get backdoor recapitalization through that, too, which might help a little bit. But it's -- I agree with you completely, when people really start to think about that and think about the transparency, exactly in the terms you frame it, how did we get into this? And we're getting out of it through a nontransparent transfer? Why is that a good idea?

MR. MANN: Alice and then Bill Gale.

MS. RIVLIN: A couple of points on transparency. Tony mentioned the rating agencies. I think we're going to have to rethink the rating agencies, and in a basic sense they ought to be paid by the "buy side," not the "sell side." And we've got to figure out how to do that, but it's manifestly not working to have the rating agencies paid by people who want to sell the thing that they're rating. That doesn't make sense.

But I want to come back to Bill Taylor's point earlier as to how do we -- we do learn from experience. And we had a dreadful experience in the 1930s. We've learned a lot from it, and some of the institutions that have -- that were built in that period are the ones we're relying now on. Simon gave accolades to the FDIC. Well, that's what we learned out of the bank runs. I think we're going to learn something out of this and come up with a better set of institutions.

MR. MANN: Bill?

MR. FRENZEL: I just want to follow up on Tony's question and Gary's question because they're related. The transparency issue, Tony, you pointed out the irony that we got into this problem because there was no transparency, and now we're trying to get out of it in a manner that has no transparency, and you know, how does that work? The problem is actually deeper. We got into it because the private sector bought bad mortgages and finances with debt, and now the solution is the government's going to do exactly the same thing, right? So at some level you've got to think how is that actually going to work? And this is the manner in which there's no plan, and this is what I meant. All -- normally the Devil is in the details. Here all, you know, the whole enchilada is in the

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details. Pardon me for horribly mixing metaphors. But are they going to subsidize the purchase? Is it sort of a backdoor way to give money to the financial sector? If it is, that's a fundamentally different answer than if they're paying market value. You know, how are they going to set up the auctions? Well, that's what I mean. Let me just finish. How they set up the market, how they reveal market value, what they buy, what they won't? That is the difference between 1 percent and 99 percent on this. If all you've said was we've given the Treasury authority to buy mortgages and resell them, okay, that's nice, but it doesn't get at any of the important details of the plan. And that's the sense in which I meant there isn't a plan out there.

MR. MANN: Listen, we really have to call this. It's been a very interesting session. I believe I've learned a great deal from my colleagues. I hope you have found it useful. Thank you for coming. We are adjourned.

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I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

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