

THE BROOKINGS INSTITUTION

LESSONS FROM THE GREAT DEPRESSION FOR 2009

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Introduction:

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P R O C E E D I N G S

MR. BAILY: Let's get started. I'm Martin Baily here at Brookings, running the business initiative here, and Brookings is really pleased to welcome Christy Romer today. Christy is one of the nation's top economists and now Chair of the Council of Economic Advisors and a member of the Obama cabinet. I can say from experience that being the CEA Chair is one of the best jobs in the world.

Right now things are pretty tough, but I think we can all feel better knowing that Christy is bringing her knowledge and experience to the battle against the severe downturn we are now facing. One of Christy's papers is entitled "What Ends Recessions?" And I'm sure many of you will want to ask that question after her talk today.

Prior to joining the Obama administration, Christy was the class of 1957, Garth Wilson Professor of Economics at the University of California, Berkeley. Before teaching at Berkeley, she taught economics and public affairs at Princeton University. Until her nomination, she was co-director of the Program in Monetary Economics at the NBER and served as Vice President of the American Economic Association, where she was also a member of the Executive Committee. She is a Fellow of the American Academy of Arts and Sciences.

Christy Romer is known for her research on the causes and the

recovery of the Great Depression and on the role that fiscal and monetary policy played in the country's economic recovery. A most recent work authored with her husband, David Romer, shows the impact of tax policy on government and economic growth.

When Christy Romer was announced, *The Wall Street Journal* noted that the Romers, so well-regarded by their peers of both parties, that many economists are cheering that the Obama administration is going for the top minds in the field rather than those who adhere most closely to party lines.

Today Christy will talk about lessons from the Great Depression for the economic recovery in 2009, a very timely and important topic. After her talk, Christy has agreed to take some questions from the audience.

With that, please welcome Christina Romer.

(Applause)

DR. ROMER: I think I have to tell you it's such an honor to be here at Brookings, and after that kind introduction from Martin, the other things about Brookings is that it is a place with many former CEA staff and not one but at least two CEA chairs, Martin Baily and Charlie Schultz. So I feel very much back among friends.

All right, as Martin suggested, the title for my talk is Lessons from the Great Depression for Economic Recovery In 2009. I have to tell you

that in the last few months I've found myself uttering the words "worst since the Great Depression" far too often; the "worst 12 months job loss since the Great Depression"; the "worst financial crisis since the Great Depression"; the "worst rise in home foreclosures since the Great Depression."

And in my previous life, as Martin suggested I was an economic historian at Berkeley, and one of the things that I studied was the Great Depression. So I thought it would be useful to reflect on that episode and what lessons it holds to policymakers today, and, in particular, what can we learn from the 1930s that will help us to end the worst recession since the Great Depression?

To start, I think it's important that I point out that there's a current recession, is unquestionably severe. It pales in comparison to what our parents and grandparents experienced in the 1930s. Last Friday's employment report showed that the unemployment rate in the United States has reached 8.1 percent, a terrible number that signifies a devastating tragedy for millions of American families. But at its worst, unemployment in the 1930s reached nearly 25 percent, and that quarter of American workers had painfully few of the social safety nets that today help families maintain at least the essentials of life during unemployment.

Likewise, following last month's revision of the GDP statistics, we know that real GDP has declined almost two percent from its peak, but

between the peak in 1929 and the trough of the Great Depression in 1933, real GDP declined by 25 percent.

Now, I don't give these comparisons to minimize the pain that the United States economy is experiencing today, but to provide some perspective. Perhaps it's the historian and the daughter in me that finds it important to pay tribute to just what truly horrific conditions the previous generations of Americans endured and eventually triumphed over. And I guess I should say it's the new policymaker in me that wants to make it clear that we're doing all that we can to make sure that the word "great" never applies to the current downturn.

Well, what we are experiencing is less severe than the Great Depression. There are parallels that make it a useful point of comparison and a source for learning about policy responses today. Most obviously, like the Great Depression, today's downturn has its fundamental cause in the decline in asset prices and the failure or near failure of financial institutions.

In 1929 the collapse and extreme volatility of stock prices led consumers and firms to simply stop spending. In the recent episode the collapse in housing prices and stock prices has reduced wealth and shaken confidence and has led to a sharp rise in the savings rate as consumers have hunkered down in the face of greatly reduced and much more uncertain wealth.

In the 1930s, the collapse of production and wealth led to

bankruptcies and the disappearance of nearly half of American financial institutions. This, in turn, had two devastating consequences: a collapse of the money supply, as stressed by Milton Friedman and Anna Schwartz, and a collapse in lending, as stressed by Fed Chair Ben Bernanke in his path-breaking work.

In the current episode, modern innovations such as derivatives led to a direct relationship between asset prices and severe stress in financial institutions. Over the fall we saw just how -- we saw credit dry up and learned just how crucial lending is to the effective functioning of American businesses and households.

Another obvious parallel is the worldwide nature of the decline. A key feature of the Great Depression was that virtually every industrial country experienced a severe contraction in production and a terrible rise in unemployment. This past year there was hope that the current downturn might mainly be an American experience, right, so that world demand could remain high and perhaps help to pull us through.

However, during the past few months, we've realized that this hope was a false one. As statistics have poured in, we've learned that Europe, Asia, and many other areas are facing declines as large, if not larger, than our own. Indeed, rather than world demand helping to hold us up, the fall in U.S. demand has had a devastating impact on export economies such as Taiwan,

China, and Korea.

This similarity of causes between the Depression and today's recession means that President Obama begins his presidency and his drive for recovery with many of the same challenges that Franklin Roosevelt faced in 1933. Our consumers and businesses are in no mood to spend or invest; our financial institutions are severely strained and hesitant to lend; short-term interest rates are effectively zero, leaving little room for conventional monetary policy; and world demand provides little hope for lifting the economy.

Yet the United States did recover from the Great Depression. What lessons can modern policymakers learn from the episode that could help them make this recovery faster and stronger? Well, one crucial lesson from the 1930s is that small fiscal expansions only have small effects.

I wrote a paper in 1992 that said that fiscal policy was not the key engine of recovery in the Depression. From this, some have concluded that I did not believe fiscal policy can work today or could have worked in the 1930s. Nothing could be further from the truth. My argument paralleled E. Cary Brown's famous conclusion that in the Great Depression fiscal policy failed to generate recovery, not because it does not work but because it was not tried.

The key fact that while Roosevelt's fiscal actions were a bold break from the past, they were nevertheless small relative to the size of the

problem. When Roosevelt took office in 1933, real GDP was more than 30 percent below its normal trends level. The comparison most of the estimates today suggest that the U.S. economy is somewhere between five and ten percent below trend.

The emergency spending that Roosevelt did was precedent-breaking. Balanced budgets had certainly been the norm up to that point, but it was quite small. The deficit rose by about 1.5 percent of GDP in 1934. One reason that the rise wasn't larger was that a large tax increase had been passed at the end of the Hoover administration. Another key fact is that the fiscal expansion wasn't sustained, right? The deficit declined in fiscal 1935 by roughly the same amount that it had increased in 1934.

Roosevelt also experienced the same inherently procyclical behavior of state and local fiscal actions that President Obama is facing today. Because of balanced budget requirements, state and local governments are forced to cut spending and raise taxes when economic activity declines and state revenues fall. At the same time that Roosevelt was running unprecedented federal deficits, state and local governments were switching to running surpluses to get their fiscal houses in order. The result was that the total fiscal expansion on the 1930s was very small indeed. As a result, it could only have a modest direct impact on the state of the economy.

Well, this is a lesson that the Administration has taken to heart.

The American Recovery and Reinvestment Act passed less than 30 days after the inauguration is simply the biggest and boldest countercyclical fiscal action in history. The nearly \$800 billion fiscal stimulus is roughly equally divided between tax cuts, direct government investment spending, and aid to states and people directly hurt by the recession.

The fiscal stimulus is close to three percent of GDP in each of the next two years. And, as I mentioned, a good chunk of the stimulus takes the form of fiscal relief to state governments so they don't have to balance their budgets only by such measures as raising taxes and cutting the employment of nurses, teachers, and first responders. And we expect this fiscal expansion to be extremely important in countering the terrible job loss that last Friday's numbers show now totals 4.4 million since this recession began 14 months ago.

Now, while the direct effects of the fiscal stimulus were small in the Great Depression, I think it's important to acknowledge that there may have been an important indirect effect. Roosevelt's very active doing something. It must have come as a great relief to a country that had been suffering in depression for more than three years to have a president step up to the challenge and say that the government would attack the depression with the same fervor and strength it would an invading army surely lessened uncertainty and calmed fears.

Also, signature programs such as the WPA that directly hired millions of workers no doubt contributed to a sense of progress and control. In this way, Roosevelt's actions may have been more beneficial than the usual estimates of fiscal policy suggest.

If the actions President Obama is taking in the current downturn can generate the same kind of confidence effects, they may also be more effective than estimates based on conventional multipliers would lead one to believe.

Okay, a second key lessons from the 1930s is that monetary expansion can help to heal an economy even when interest rates are near zero. In the same paper where I said that fiscal policy was not key in the recovery from the Great Depression, I argued that monetary expansion was very useful. But the monetary expansion took an unusual form: It was essentially a policy of quantitative easing conducted by the U.S. Treasury. So let me give a little -- a quick background.

The United States was on a gold standard throughout the Great Depression. Part of the explanation for why the Federal Reserve did so little to counter the financial panics and economic decline was that it was fighting to defend the gold standard and to maintain the prevailing fixed exchange rate. In April 1933, Roosevelt temporarily suspended convertability into gold and let the dollar depreciate substantially. When we went back on gold at the new

higher price, large quantities of gold flowed into the U.S. Treasury from abroad. These gold flows serendipitously continued throughout the mid-1930s as political tensions mounted in Europe and investors sought the safety of U.S. assets.

Well, under a gold standard, the U.S. Treasury can increase the money supply without going through the Federal Reserve. It was allowed to issue gold certificates which were interchangeable with Federal Reserve notes on the basis of the gold it held. When the gold flowed in, the Treasury issued more notes. The result was that the money supply, defined very narrowly just as currency plus reserves, grew by nearly 17 percent per year between 1933 and 1936.

This monetary expansion couldn't lower nominal interest rates because, as I mentioned, they were already near or at zero. What it could do was to break expectations of deflation. So prices had fallen almost 25 percent between 1929 and 1933. People throughout the economy expected deflation to continue. As a result the real cost of borrowing and investing was exceedingly high. Consumers and businesses wanted to sit on any cash that they had because they expected its real purchasing power to increase as prices fell.

Devaluation followed by rapid monetary expansion broke this deflationary spiral. Expectations of rapid deflation were replaced by

expectations of price stability or even some inflation, and this change in expectations brought real interest rates down dramatically.

With a change in the real cost of borrowing and investing, it appears to have had a beneficial impact on consumer and firm behavior. The first thing that turned around in the Great Depression was interest-sensitive spending. For example, car sales surged in the summer of 1933. One sign that lower real interest rates were crucial is that real fixed investment and consumer spending on durables rose dramatically between 1933 and 1934 while consumer spending on services barely budged.

Well, in thinking about the lessons from the Great Depression for today, I want to tread very carefully. After nearly two decades of opining on monetary policy, one of the key roles of my current job is that I do not comment on Federal Reserve policy. So let me be very clear: I am not advocating that we go back on the gold standard just so we can go off it again, nor am I suggesting that Tim Geithner should start conducting rogue monetary policy. But the experience of the 1930s does suggest that monetary policy can continue to have an important role to play even when interest rates are low by affecting expectations and, in particular, by preventing expectations of deflation.

All right, well, this discussion of fiscal and monetary policy in the 1930s leads me to a third lesson from the Great Depression: Beware of

cutting back on stimulus too soon. As I've described, monetary policy was very expansionary in the mid-1930s. Fiscal policy, though less expansionary, was also helpful. Indeed, in 1936 it was inadvertently stimulatory. Largely because of political pressures, Congress overrode Roosevelt's veto and gave World War I veterans a large bonus. This caused another one-time rise in the deficit of more than 1.5 percent of GDP.

An important fact is the economy responded, right. Growth was very rapid in the mid-1930s. Just to give you some numbers, real GDP increased 11 percent in 1934, 9 percent in 1935, and a whopping 13 percent in 1936. Because the economy was beginning at such a low level, even these rapid growth rates were not enough to bring us all the way back to normal.

Industrial production finally surpassed its July 1929 peak in December of 1936, but it was still well below the level predicted by the pre-Depression trend, and employment had fallen by more than 10 percentage points, but it was still over 15 percent. The economy was on the road to recovery but was still precarious and not yet at the point where private demand was ready to carry the full load of generating growth.

In this fragile environment, fiscal policy turned sharply contractionary. The one-time veterans' bonus ended and Social Security taxes were collected for the first time in 1937. As a result, the deficit was reduced by nearly 2.5 percent of GDP.

Monetary policy also turned inadvertently contractionary. The Federal Reserve in 1936 had become increasingly concerned about inflation. It was also concerned because banks were holding such large quantities of excess reserves open market operations would merely causes banks to substitute government bonds for excess reserves and would have no impact on lending. In an effort to put themselves in a position where they could tighten if they needed to, the Federal Reserve doubled reserve requirements in two steps in 1936 and '37.

Unfortunately, banks shaken by the bank runs of just a few years before, scrambled to rebuild their reserves above the new higher required level. And as a result, interest rates rose and lending plummeted.

The results of the fiscal and monetary double-whammy in the precarious environment were disastrous. GDP rose by only 5 percent in 1937 and then fell by 3 percent in 1938, and unemployment rose dramatically reaching 19 percent again in 1938. Policymakers soon reversed course and strong recovery resumed, but taking the wrong turn in 1937 effectively added two years to the Great Depression.

The 1937 episode is an important cautionary tale for modern policymakers. At some point recovery will take on a life of its own, as rising output generates rising investment and inventory demand for accelerator effects, and confidence and optimism replace caution and pessimism. But we'll

need to monitor the economy closely to be sure that the private sector is back in the saddle before government takes away its crucial lifeline.

The fourth lesson we can draw from the recovery of the 1930s is that financial recovery and real recovery go together. When Roosevelt took office, his immediate actions were largely focused on stabilizing a collapsing financial system. He declared a national bank holiday two days after the inauguration, effectively shutting every bank in the country for a week while the books were checked. This 1930s version of a stress test led to the permanent closure of more than 10 percent of the nation's banks, but improved confidence in the ones that remained.

As I discussed before, Roosevelt temporarily suspended the gold standard before going back on gold at a lower value for the dollar, paving the way for increases in the money supply. In June of 1933 just a few months after he took office, Congress passed legislation establishing deposit insurance through the FDIC and helping homeowners through the Homeowners Loan Corporation.

Now, importantly, the actual rehabilitation of financial institutions obviously took much longer. Indeed, much of the hard work of recapitalizing banks and dealing with distressed homeowners and farmers was spread over much of 1934 and 1935. Nevertheless, the immediate actions to stabilize the financial system had dramatic short-run effects on financial

markets. Real stock prices rose over 40 percent between March and May of 1933. Commodity prices soared and interest rate spreads shrank, and the action surely contributed to the economy's rapid growth after 1933. As wealth rose confidence improved, and bank failures and home foreclosures declined.

But, importantly, it was only after the real recovery was well established that the financial recovery firmly took hold. Real stock prices in March of 1935 were more than 10 percent lower than they'd been in May of 1933. Bank lending continued to fall until mid-1935 and real house prices rose only seven percent from 1933 to 1935. The strengthening real economy improved the health of the financial system. Bank profits moved from large and negative in 1933 to large and positive in 1935 and remained high through the end of the depression with the result that bank suspensions were minimal after 1933.

Real stock prices rose robustly, business failures and home foreclosures fell sharply and almost without interruption after 1932, and this virtuous cycle continued as the financial recovery led to further narrowing of interest rate spreads and increased willingness of banks to lend.

Well, this lesson is another one that's been prominent in the mind of policymakers today. The Administration has from the beginning sought to create a comprehensive recovery program. The financial stabilization plan, which involves evaluating the capital needs of financial institutions as well as

crucial programs to directly increase lending, is central to putting the financial system back to work for American industry and households. Together with the housing plan, these financial rescue measures should provide the lending and stability needed for economy growth.

The fiscal stimulus package was designed to create jobs quickly. In doing so, it should lower the faults and improve balance sheets so that our financial system can continue to strengthen.

All right, well, the fifth lesson from the Great Depression is that worldwide expansionary policy shares the burden and the benefits of recovery. Research by Barry Eichengreen, my colleague at Berkeley, and Jeffrey Sachs, shows that going off the gold standard and increasing the domestic money supply was a key factor in generating recovery and growth across a wide range of countries in the 1930s.

Importantly, these actions worked to lower world interest rates and to benefit other countries rather than to just shift expansion from one country to another. Well, the implications for today are obvious: The more that countries throughout the world can move toward monetary and fiscal expansion the better off we will all be. In this regard, the aggressive fiscal action in China and the reduction in interest rates in Europe and the U.K. announced last week were welcome news. They're paving the way for a worldwide end to this worldwide recession.

Finally, the last lesson that I want to draw from the 1930s is perhaps the most crucial, right? A key feature of the Great Depression is that it did eventually end. Despite the devastating loss of wealth, chaos in our financial markets, and a loss of confidence so great that it nearly destroyed Americans' fundamental faith in capitalism, the economy came back. Indeed, the growth between 1933 and 1937 was the highest we have ever experienced outside of wartime. Had the U.S. not had the terrible policy and due setback in 1973, we, like most other countries in the world, would probably have been fully recovered before the outbreak of World War II.

Well, I think this fact should give Americans hope. We're starting from a position far stronger than our parents and grandparents were in in 1933, and the policy response has been fast, bold, and well conceived. If we continue to heed the lessons of the Great Depression, there's every reason to believe that we will weather this trial and come through to the other side even stronger than before.

Thank you.

(Applause)

MR. BAILY: Thank you, Christy. I'm going to ask you a question, and then I'm going to throw it open to the audience.

The American consumer has been one of the main drivers of U.S. economic growth and even global economic growth. Right now,

households are feeling pretty battered by concerns about their jobs, and they've lost a lot of money. Total household wealth by one estimate I've seen, down about \$13 trillion by the end of '08, and probably more -- certainly more -- since then.

Do we have in place the pieces to get a revival of household consumption? And, if not, do you see the growth in '09 and '10 sustained growth coming from elsewhere, or do you think we need the consumer back on board?

DR. ROMER: That's a terrific question. I think there are many parts to the answers. I think one is to say I do think we have a lot of what we need to get the consumer back, so that's part of why we have this tax cut for 95 percent of American households was precisely to put some more money in people's pockets.

I think the other thing to say, you know, given what's happened in wealth, I would fully expect over a longer run surely Americans are going to be saving more, right? They're going to be recouping, that's going to be a natural response. There's no reason to think that that's going to happen immediately, and another way to say it is, if you think about the last 14 months, we haven't bought much, right? We haven't bought the sort of the appliances, the cars, the durable goods. I think there's a tendency we've certainly run down or depreciated these stock.

And so I still think you can get some of that normal bounce-back that you'd get from a severe recession even in the situation that we're starting from. And I guess here I'd mention might go back to the Great Depression. If there was ever a time when people had lost wealth in form of stocks, in terms of housing prices, yet nevertheless, right, we saw just an incredible surge in consumer spending and investment spending in those mid years of the 1930s.

MR. BAILY: Okay, let's take some questions. Yes? There is a microphone. If you could identify yourself and we can try to get the microphone to you.

SPEAKER: -- from the (inaudible) Office. I would like to ask you a question concerning a possibility of devaluation of U.S. dollar.

DR. ROMER: Could you speak up a little bit? I'm having trouble understanding you.

SPEAKER: Okay. Do you think that there is a possibility of devaluation of the dollar in this context, so we know that this spending is largely financed by emerging countries who buy your dollars and also treasury bonds? Don't you think that these protections measure like by American could encourage them to sell their U.S. currency and, by the way, affect the U.S. dollar?

DR. ROMER: So I --

MR. BAILY: Let me just summarize the question, because I missed a little bit of it, and maybe your ears are better than mine.

SPEAKER: Sorry for my bad English.

DR. ROMER: I will summarize. I think the question is surely right, we're doing a very bold fiscal expansion and that, certainly we're going to have to borrow to do it. And so I think part of the question was, is that going to be a problem and, especially given that it was coming from a lot of developing nations, might that be a problem?

I think -- I mean so I guess I would say certainly not in the short run is a crucial point here. You know, one of the reasons I think that, you know, we've taken some questions about in the midst of doing a financial rescue and a big stimulus package in the housing plan and financial reform, the other thing we announced last week was a budget. And it was a very bold budget. One of the crucial things was that it said we're inheriting these very large budget deficits and we're committed to bringing them down, cutting them in half over the next 10 years.

One of the reasons that we did this was for exactly the reason that you said, is that we felt for our credibility, for the fact of maintaining faith in the United States it was important, even though we needed to take some very big fiscal action now, to convey to the world we understood that our long-run fiscal situation was in trouble and we needed to make progress to dealing with

it.

So we think that that was a good move and will exactly help with the situation.

MR. BAILY: Okay. A question here?

MS. DADUSH: Yes, Uri Dadush with the Carnegie Endowment. Thank you very much for a very clear exposition of the lessons from the Great Depression.

I wanted to ask you, however, put a little bit the other side of the argument, in part because the situation we find ourselves in nobody really predicted could get so bad, even a year ago. And that is one of the things that could make this worse than the Great Depression. So I'm thinking about the very high debt levels which are even higher than they were in 1929. I'm thinking about the extraordinary sophistication and complexity of the capital markets, much of which -- some of which at least -- we don't fully fathom even today, understanding where the exposures are and which are a major source of uncertainty.

I'm thinking also of the fact that the U.S. economy is much more integrated into a global system than it was back in 1929, export and trade relations are about three times what they were in 1929, so, therefore, we are much more dependent on what's happening overseas, and you have these evaluations that are very, very complex, and it makes it much more difficult to

have a coordinated global -- a coordinated global response.

So you have some of these effects that are at work which are making things quite a lot worse, and I'm wondering whether, you know, we should have quite the same degree of confidence that we can manage this situation.

DR. ROMER: Really, that's certainly a downer.

(Applause)

MR. BAILY: We've got the right team in place, that's why.

DR. ROMER: I think, yeah, I'd put two things: One is to just come back to the comparison that I started with, right. We know the depression was horrible. One of the things I very much want to emphasize is what a better place we are today. Obviously, where we are today is not good, but the kind of -- you know, we're just orders of magnitude away from the kind of downturn that we saw in the 1930s.

The other thing that -- I don't know how this is going to resonate with you -- but one other things that struck me, I asked myself why are things -- despite with all the things that you have said are absolutely true, we are very integrated, there are a lot of things going on -- and we've faced what, arguably, is the biggest mass economic shock we probably ever had. And yet why are we where we are today? I think it's partly we've had a much better policy response already, right, instead of, say, the Federal Reserve in 1930 and '31

just standing there saying: It's not my problem. Right? We've had a very aggressive response.

We have a new president come in -- right, this is not 1933, this is like the end of 1930, right? We've got the new president in place that said, "I am hitting this with everything I have." And I think that's the main reason that I think we're, one, already doing well and likely to continue to avert the problems that you talked about.

MR. BAILY: At the back there.

MR_____: Earlier in your talk you said --

MR. BAILY: Could you just stand up and tell us who you are?

MR. GRIMM: Thank you. I am Ryan Grimm with The Huffington Post. Earlier in your talk, you said -- here's your quote: "Most obviously, like the Great Depression, today's downturn has its fundamental cause in the decline in asset prices and the failure or near failure of financial institutions." That sounds like you're saying that the cause of the crisis is an asset collapse that's leading to a solvency crisis, whereas my understanding of Treasury Secretary Geithner's analysis is that it's a liquidity crisis.

Depending on how you diagnose it affects how you would treat it, so do you disagree with him that it's a liquidity crisis?

DR. ROMER: I think so. Let me be very clear, so -- no, I absolutely don't disagree with him. When I say there's a decline in asset prices,

it's done two things that have been important. I think I tried to make that clear.

One is what's happening, say, on the consumer side or the investment side in the sense that, as Martin described, as consumers see their housing wealth go down or their stock market wealth go down, naturally, they tend to save more, and we've absolutely seen that happening in the numbers.

And then in terms of the financial markets, we certainly know that what happened to asset prices put a strain on our financial institutions and is part of why they were uneasy about lending and things like that. So it's nothing on any kind of a disagreement. It's basically a sense of linkages between these movements in asset prices and the kinds of declines in spending and lending that we've seen.

MR. GRIMM: Do you think this is a money crisis rather than what Japan had, which is more of an asset crisis and a solvency crisis?

DR. ROMER: I think you -- also, you very much want to be separating between what declines in asset prices do to consumers and firms and what effects they have on banks. And it certain -- it's certainly having an effect. I will certainly take the Secretary's idea that it's affecting primarily liquidity. We know that that's been a huge problem.

We also know that banks have been having, certainly, seen their balance sheets deteriorate. That certainly can't be good for lending and the functioning of the financial system.

MR. BAILY: Yes, here?

MR. MITCHELL: Dr. Romer, Gary Mitchell from The Mitchell Report. This morning I was reading Robert Samuelson's cheery little op ad in The Washington Post, and that follows on a long list of cheerleaders like Paul Krugman and others who have --

DR. ROMER: You're going to bring me down, too, aren't you?

MR. MITCHELL: No, I'm going to try -- what I want to ask you is, leaving aside the sort of Charles Krauthammer, Newt Gingrich, you know, Communist Russia school of criticism about the fiscal stimulus, the budget, et cetera, of those criticisms from knowledgeable people who are seeking to be fair and reasonable, which of the criticisms of the fiscal stimulus and the budget, what elements of criticism that you have received thus far seemed fair and/or reasonable to you?

(Laughter)

DR. ROMER: Let me just say -- you want me to tell you what's wrong with the fiscal stimulus package. I'm so not going to do that.

(Laughter)

DR. ROMER: Let me actually tell you that certainly one of the things that, you know, one of the things I've been thinking hard about is exactly all of these criticisms for precisely the reason that I need to know if they're true. We certainly thought about them as we were designing the package, right,

because we wanted to have them the most effective.

But let me just take -- let me just take a couple of them. For example, there's a tendency to say, you know, there's one level of criticism that, for example, says: Well, why don't you do more exotic things like a temporary cut in the sales tax as a way of moving spending from one period to another? And that was something that we thought about, and then we actually said: You know what? In the forecast that we have that this is going to be a severe downturn, it might go on for a while, in that kind of a situation you don't want to just trade spending from one quarter to another or one year to another; what you need is a big fiscal stimulus, a good old-fashioned just get more spending out there.

So that's an example of a criticism we've thought about and tried to respond to.

Another one that we hear is, you know, sort of: Why don't you have -- you know, like Roosevelt had, you know, the WPA, imagine one big signature thing. Why not have just one thing in your fiscal stimulus rather than nine, you know -- lots and lots of things that there's one out of 500 that people criticize.

And one of the things that we did was to say: You know, in a world where you're trying to do \$800 billion of fiscal stimulus, you know, if you want to do smart spending, you're probably not going to be able to do all of it in

one area; that we probably have higher returns, higher marginal utility -- whatever you want to call it -- if you spread it around in a number of areas.

Or another criticism: Why didn't you do it all in tax cuts? That's been one of my favorites because David and I have some work that says, you know, tax cuts or tax changes have a big effect on output. Well, one of the things that we felt very strongly from that research is that what it shows is that fiscal policy in general has big effects and that by all our reasoning, plain old government spending probably has even more of an effect than tax cuts.

And so when we were designing the fiscal stimulus, we said it probably makes sense to have it have a range of things: have about a third of it tax cuts, about a third of it direct government investment, about a third of it dispensing to states and the people that have been hurt.

So we certainly have heard all the criticisms. I think, fundamentally, we ended up with a really good fiscal stimulus. And I think it -- you know, I'm -- probably I'm a good spokesman for it, but I think it's because I believe it, all right? I think it's really -- I think it's been well designed, and I think it's going to have very positive effects.

MR. BAILY: One of the -- I'm going to ask you another question myself. One of the lessons that people draw from the Great Depression is that protectionism and smooth holly were a bad idea. I'm not just talking about U.S. policy but policy around the world.

How concerned are you about a rise of protectionism, and by that other token, do you think there's any hope for progress on DOHA or the passage of a free trade agreement of stuff like that? Can you give us your view on the international trade?

DR. ROMER: Sure, but let me start by going back to the Depression, because, I mean, one of the things that we know in the Great Depression is that trade went down a lot, and a natural place to look for why that happened was we passed a big tariff increase.

I think the best research on this probably says the more important factor was the fact that incomes were falling all over the world. That's probably why trade went down. I think that's so much of what we're seeing now. Why, you know, Taiwan's GDP just collapsing is not because of trade barriers; it's because its trading partners are suddenly in the middle of a terrible recession.

So I think that's an important kind of thing to keep in mind, and just in thinking about the depression, I'd say the collapse of the money supply, the collapse of aggregate demand was affected by the much bigger -- the much bigger effect.

Coming to trade, I mean as the question that was said before, we are more integrated than we've ever been before, and I think, you know, that certainly has been an opportunity for countries. And one of the things that

I think the president has felt very strongly about is that we need to have trade, but we need to make sure that American workers have a fair shake and are treated -- are treated well. And I predict that we'll keep following exactly that plan, and we will certainly continue to work on keeping trade lines open.

MR. BAILY: Okay. Yes?

MR. YERGIN: Dan Yergin. You bring a very powerful perspective to these questions. Let me ask you a question about the lessons of the Great Recession of 2008 and 2009: Why has it been so difficult for people to foresee this? Why the great surprise?

DR. ROMER: Believe me, as one who's been surprised, that's a fine question. It's -- I mean I think part of it is, it is somewhat different, right? So I've spent, you know, my life studying business cycles, and one of the things I thought I knew in the postwar period is business cycles were caused by the Fed tightening and then that caused a recession, and then the Fed loosened and it was over. And, fundamentally, this is just a whole other animal, right? That with the world where it's collapsed in asset prices that we talked about, and lots -- you know, a financial crisis.

So I think that's probably why it's just been hard is that it is somewhat new, and it's not our usual experience. I think that's one.

I think the other is -- and I don't know if we should have foreseen this -- is the international ramifications. So I described that there

really was this talks than ran in the summer about were we going to have a synchronization? Do we have a case where the U.S. went down but the rest of the world didn't? And I think that's been the biggest -- maybe it shouldn't have been a surprise, but I think it has been the numbers that have caused basically every forecaster to shift down as we started to see statistics coming from abroad.

So maybe it's we didn't realize just how interconnected we were. Maybe we didn't realize how interconnected our financial institutions were, but I think that's probably the main source of the surprise.

MR. BAILY: Yes?

MR. SIDEMAN: Hi. Larry Sideman at the University of Delaware. I'm very heartened by your talk. I think that first point you make about the fiscal stimulus in the Great Depression was too small for the problem. I'm convinced from listening to you that you want a fiscal stimulus larger enough to handle whatever problem we get into. And I hope you're right that what we've got so far, which is large, is going to do the trick.

But I also interpret that if it does in three months look like we need more, the way I read you -- I hope this is right -- you'd take another look at it and think maybe we should raise the stimulus if it turns out we need to.

And I have one suggestion on that: One of the things that holds people back is the concern but isn't the rising in government debt going to be

too high if we have to do that? And I was extremely encouraged looking at some calculations from macrotonometric models, if you even have to doubt or even triple just the fiscal stimulus part, it would only raise the debt to GDP ratio about seven points from about 49 percent that it may be in a year or two otherwise to about 56 percent. And this is extremely manageable.

So this fear that hangs over some that we can't do any more fiscal stimulus, even if we need to, because the debt rise will be too great is not correct. And if we should get to that, I hope you'll help show the public what the facts are about how much the debt would rise.

DR. ROMER: That's a very good point, and it comes back to some of what we were discussing before about the international situation, that inherently when we think about the deficit and about the debt to GDP ratio, the things that are so important for that are the things that continue forever or that, you know, the rise in entitlements, and, we know, so much the health care that has been such a big issue on the president's agenda.

So I think your point is to the point that goes with the package we've already passed. It's just this is a very time-limited, one-time thing, and so the effect that it has on the debt to GDP ratio a ways out isn't that quite small.

On the -- on the right size of things, I think one of the things that is important to keep in mind is, we really do view this as part of a comprehensive package, right? And so in that kind of a world, \$800 billion in

fiscal stimulus is big medicine, you know. I've spent the last couple of months estimating the jobs effects, and I truly believe it's three to four million, relative to the baseline, but, well, you say, but isn't that not enough, given we've already lost 4.4 million -- we're projected to lose more -- is to say it's only one of the things that we're doing, all right?

So Tim Geithner loves to say there's more stimulus in financial rescue than in stimulus, right? That by getting our financial markets back, getting lending going again, that's incredibly important for aggregate demand and for spending.

Likewise, our housing policy is in many ways also can be thought of as a stimulus, right? We're trying to help people that ordinarily wouldn't be able to refinance get lower mortgage payments. We think they'll spend more. If we think we can prevent three million foreclosures, that's a lot of houses not dumped on the housing market, not pushing down housing prices. So we're very much -- we think there's the total of the program, we think is exactly what the economy needs.

That said, the president has from the beginning said in a very, I like to think, Rooseveltian way, we will do whatever it takes to get this economy back. And we will absolutely be monitoring it more than I think this economy has ever been monitored to make sure we're getting the results we think we're going to get.

MR. BAILY: Yes?

MR. HALL: Kevin Hall, McClatchy Newspapers. I want to go back to the gloomy question and try not to be as gloomy but narrow on going forward with these sophisticated financial instruments. Your housing program seems to be limited by mortgage servicers who don't answer to lenders but actually to investors who have contrary interests to both the home owner and the lender, and credit false swaps that are keeping people from reorganizing debt and kind of forcing them into bankruptcy.

How much is that -- I know you're limited about how much you can say, but can you talk a little bit about how these instruments are tying the hands?

DR. ROMER: Well, I think you bring up a good point which is, you know, when we think about, you know, here we've just talking about what Franklin Roosevelt did, and, you know, when you say, gee, Phil, would this do the same thing, the first thing I say is, you know, he was dealing with Bailey's Building & Loan, and we're dealing with CitiGroup, right? So this is the kind of institutions and the kind of instruments, as you pointed out, are just infinitely more complicated.

And that's, you know, that's part of why this is hard. That's part of why coming up with a financial stabilization plan isn't a one-week thing; it's a monumental task.

And without going into specifics, it's absolutely all of the modern innovations. We know they are a complicating factor. I mean a crucial thing that we spend a lot of time doing is figuring out how to deal with that and how can we nevertheless do a successful housing program given the situation that we're in. And it is a complicating factor, but I think one we will just power through.

MR. BAILY: Yes?

MR. _____: I want to ask a question about the recapitalization of the banking system.

DR. ROMER: Um-hmm.

MR. _____: I was talking to some senators this weekend, and they were saying two contradictory things: One, that to get the banking system on its feet is going to require a massive injection of public money.

Secondly, they cannot see the votes available to pass that. This is the most unpopular aspect of the whole recovery package.

So a two-fold question: One, can we get the banking system going without an injection of public money? And secondly, how do you get it through the Congress?

DR. ROMER: Two excellent questions. I think on the recapitalization, I think the first part is to say we're in that process, right, so the whole thing that we are in the middle of the stress test, which is precisely aimed

at really checking the books of banks to get a sense of what kind of a capital infusion do they need, if any, to be stable and able to lend again. So I think before we know that, I don't want to speculate on will we have enough.

And going through Congress, I mean I will say I was having confirmation hearings right at the time, you know, right around the Tarp reauthorization, and very much there is a hostility that is unques- -- you know, it's a very unpopular program. And I mean I guess I have an overarching faith both in Congress, the American people, and the ability of people to explain. I said that if we're in a situation where that's needed, I just think we'll all step up. You know, I think we'll step up.

And I think, you know, it's not a pleasant argument, you know. One of the things that we -- situations hit me -- I would want us to say, you know: Conditions would have been so much worse if you hadn't done what you did before. And no congressman likes to have to go back to his or her constituents and said, "I know you don't see much, but it would have been much worse."

But that's the truth, right. That is what every economist, I think, will say, and so I guess I'm going to say if we find we need more, I think the American people, the American Congress, and certainly we'll be working as hard as we can to explain this, and I think we'll just -- again we'll have to power through. These are difficulties, but I have great faith.

MR. BAILY: Okay, let's take one at the back there, and then about 10 more minutes if you're willing to go to 2:30.

MR. JAFFE: Hi, I'm Matt Jaffe at ABC News. Some of your economic forecast assumptions have been caught a little bit too rosy -- sorry to be more doom and gloom -- but, you know, one of them was unemployment. That's already at 8.1 percent, and I think that that was the forecast for the end of the year. So is the White House thinking about revising the assumptions.

And also, just to follow up on a question earlier, what are your specific views on the need for a second stimulus?

DR. ROMER: So the first thing I'd say is, our forecast when it was done was completely in the middle of the pack, so I think that's an important thing to realize, that it was inherently -- I mean we know if we've talked about there's been some bad news, certainly, in the last month, the last month and a half. And I think that's caused a lot of forecasters and that's just, you know, the way life is.

In terms of redoing the forecast, I feel the decision is that we're so far along in the budget process, better to just leave it as it is. We'll obviously revisit it, there's always a mid-session review, and that would be a good time to obviously do another very serious forecast.

On the second stimulus, I feel we absolutely need to let this one work, right? It is just the text that's just now going out the door. Withholding

tables are just now being changed.

And so I feel very strongly we need to -- we need to let the medicine work for a while to see if it does the trick. And I think, you know, that the piece that I think Martin -- the very first question about consumers, if you talk to most forecasters, including a lot of the Wall Street guys that are certainly, you know, saying, "Boy, this first quarter's going to be very bad," they actually are starting to say, "You know, that fact that the personal consumption expenditures rose a little bit in January, maybe we're getting to the bottom. I think at the same time that the very short-run forecast gotten more negative, and people are perhaps seeing some light at the end of the tunnel.

So I was very struck by even the blue chip numbers that just came out. A lot of the forecasters are still talking about an upturn in the second half of the year, and I think both. I think we should wait and see. I mean we certainly -- as I mentioned, there is going to be monitoring of this -- this stimulus package in this economy like we've never had before, and we're just going to have to watch it and see if we're getting the kind of results we hope and feel we will.

MR. BAILY: Bob Soloman, you had a question?

MR. SOLOMON: Thank you. Your excellent presentation makes it clear that Keynesian economics is back in style. And I wonder, can we expect that something similar will happen in Western Europe and the

European Union?

DR. ROMER: (off mike) to say. One is I love when people say, "Oh, you're a Keynesian."

I say, "No, I'm a good empirical economist," and that's always the research that I have done with my very talented husband behind me has led to that conclusion; that when you look at changes in monetary policy, changes in fiscal policy and measure them correctly, they do matter. And I think that's the perspective that I bring to the White House.

As for Western Europe, I -- do I say that's above my pay grade? I couldn't tell you. I certainly hope so. I mean I do -- I do feel that, as I described, I think the more we all expand the better the world will be and the faster we'll all get out of this.

MR. BAILY: John -- John is doing his bit.

DR. ROMER: He is doing his bit.

MR. BAILY: And expanding. Let me just ask you -- and I don't want to get into a methodological discussion -- but you've talked about the effect of monetary fiscal policy. but there is, I'm old enough to have learned, business cycle theory, the old Samuelson Moth Block accelerator, the inventory cycle, and all of that stuff.

Do you think there's going to be also contributing a natural bounce-back to the economy coming from those forces even, you know, which

existed well before we had a stabilization policy in the economy?

DR. ROMER: I mean it's a crucial issue, and it's one -- again I'll tell you, you know, I talk about it with a person that does forecasting in my office -- very much, the crucial -- a crucial sort of stylized fact is the worst the fall the faster the rise. And so that's, you know, that is a kind of a historical pattern that if you look at, you know, the biggest postwar recessions had the biggest GDP growth in the two following those recessions.

And so a real question is, how different is this one? So this came back to this one. It's a, you know, we're used to monetary-driven cycles and things like that. Will we get the same response this time? I think that's where forecasters are differing.

One other thing that's very interesting is people have very similar forecasting how bad the first quarter is going to be; they have a pretty similar forecasting when we're going to turn the corner, and the real question is, as we got kind of with the business is, how fast do we grow, say, in 2010 and 2011? And I think there the real issue is, do you think you get the bounce-back? Do you think you get consumers immediately going to high savings rates, or do you think they say, you know, firms say I need to restore my inventories? Consumers say, "God, I haven't bought a car for two years. I think I'll buy a car." I think that's where the question is.

And whether we can answer this before, or whether we're just

going to have to wait, that I'm not sure. But I would guess we'll start to get some indications, and that's going to be important.

MR. BAILY: So maybe a couple more questions. In the middle there?

MR. MOYER: My name's Dmitri Novik. I represent myself. My question is this: Whether is manmade disaster or it's natural? Some fundamentals in the system.

MR. BAILY: Okay, let's leave that. We're not onto that question.

DR. ROMER: Boy, that's a manmade or natural effect, you know, rock pay -- anyway. Well, I think what is -- what is surely true, that we know that lots of things have gone on, right, so we had all of these technological changes, that we had regulatory changes, we had a run-up in housing prices that sure looks like it might have been a bubble. So whether you want to call that manmade, right, because those are a lot of things that we've done, or are they just, you know, sometimes economies like a bubble in housing prices, maybe that isn't something one, you know, do you have a bubble, you can't really predict it or know why it happens.

So I'm not sure that's necessarily the right way to break this down. I think what I'd like to say is whatever caused it, we've got to fix it, and that's basically where we are. And I think I feel very strongly we need the

government to play a crucial role to fix it. But I think we were headed on just a terrible trajectory, and it's just absolutely crucial that we've had this massive policy response because it deserved it, and the American deserve it.

MR. BAILY: I'm going to give the last question to Bill Gale.

MR. GALE: Thanks very much for that great talk about the depression compared to now. Two of the things we didn't try to do in the 1930s was reform the health care system and tax carbon. And those are equally -- those are important elements of the Administration's agenda. I wonder if you could just comment on them in the context of the recovery and all that.

DR. ROMER: Oh, I think I was thinking about, you know, some of the intensive lessons in the Great Depression. I spoke of some of the sort of macro-ones like fiscal policy and monetary policy. I think I'll angle for another invitation, because I think we could absolutely have a good discussion, right.

There were huge regulatory changes, there were huge labor market changes in the depression as well that probably have lessons. And your point about we didn't try to do health care; we did do Social Security, right? So I think one of the things that -- I mean President Obama at the health care summit that we had I thought was incredibly eloquent. He got exactly the same question, and people said, you know, All the things you're doing, how can you take on health care?

And the first thing he said, "How can we not if we know it is the thing that is going to bankrupt the government? It's going to bankrupt business, it's going to bankrupt households. We just have to deal with it."

And when you say, well, why do it now? Can't we do it next year? And his response was, "Well, we didn't do it in peacetime; we didn't do it in prosperity; we didn't do it in wartime; when are we going to do it?"

And I think part of, you know, maybe again this is coming from the outside, but a bit of me says maybe the middle of a crisis is the right time, 'cause we're all focused on the economy, we know the problems that we face, and maybe this is the time we can all pull together and actually get it done.

So I think -- I think he was compelling that it was something that just had to be dealt with. And a little bit goes back to the question about a long-run fiscal health. We are in the midst of all of this. We know we inherited a huge deficit and huge projection of deficits. Your papers scare me every time I get one, and so we absolutely -- it's something we're going to absolutely have to deal with. And I think part of saying, listen, we've got a comprehensive program for now and that's going to be great, but to reassure everyone that we also have a plan for when we get out of this, I think is also ultimately important for, obviously, for doing well in the long run.

But I even think it may help us today, right? It helps us with making sure we don't have any trouble borrowing from abroad. It may help us

in terms of, you know, getting that consumer bounce back, right? One way, you know, consumers might say, if you're just running a big budget deficit with no plan of dealing with it, gee, I'm going to be nervous. Maybe I shouldn't spend.

And precisely, by saying, listen, we're cutting your taxes, we're doing all this, but we also have a plan for making sure that we deal with the economy in the long run, I think that may be important to confidence and important to getting the kind of multiplier effects that we think we can have and absolutely need. I think that's a great thing to be doing.

MR. BAILY: Well, Christy, thank you so much for being here.

(Applause)

MR. BAILY: That was terrific, and I think we're all going to sleep a little easier knowing that you're at the White House. Congratulations.

DR. ROMER: Thank you.

(Applause)

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