To: President-elect Obama

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Re: Rebuild Financial Institutions and Confidence

The Situation

The economic crisis facing the nation as you take office is more challenging than the set of economic conditions facing any President since World War II. Today, the U.S. economy is in recession and expected to experience further declines in employment and production over the next several quarters. The financial problems that originated in the United States have now spread to Europe and Japan, and many emerging market economies are also hard-hit. It falls to you, at the beginning of your Administration, to mitigate the ongoing recession, restore confidence in the U.S. financial system and lead the world economy back from the brink.

Your Stance

During the campaign you spoke forcefully about the need for immediate assistance for homeowners, not a bailout for irresponsible mortgage lenders. Your specific recommendations – including modifying the terms of mortgages, further assurances for credit to banks and additional asset purchases – were all substantively correct and well received.

Washington's messy response to the financial crisis has left most taxpayers feeling exploited. Even more important, the underlying problem has not yet been solved, and the financial sector is still very weak. The key tasks now are to show what is being done to resolve the crisis, explain why it is being done and develop a strategy that will be followed resolutely—not an easy job given the complexity of the problems.

Recommendations

Beyond passage of an immediate stimulus package there is much to be done to rebuild both the financial markets themselves and confidence in those markets.

Dealing with the Financial Meltdown: Overall, the Federal Reserve gets a very good grade for its handling of the crisis. You should reiterate your support for Chairman Ben Bernanke, because it is essential that he stay on the job at least until the worst of the crisis is past.

The Treasury response has been more of hit and miss. It is possible that the $700 billion designated for the economic rescue package will not provide enough funding to deal with the problems that have developed in the large global banks. Some analysts are saying that the amount eventually needed will top $1 trillion. Whatever the number, you must lay out a clear plan to Congress for how to spend the second $350 billion that the current Treasury team has not yet requested. Or, if necessary, you must make the case for an even larger allocation of funds. Restoring the solvency and liquidity of the financial sector is essential to getting the economy back on its feet.

The TARP strategy also was aimed at increasing price transparency in the market for bank assets, partly to stabilize the equity prices of financial institutions. The par or book value of mortgage-related assets is now well above their real worth, given their likely default rates. However, the fire-sale price for these assets, if institutions were forced to sell them quickly, is too low. So what is the right, Goldilocks price that stands between these two numbers and represents their underlying economic or hold-to-maturity, value?

To arrive at the right number and provide stability, there may be ways of leveraging TARP funds, together with liquidity provided by the Fed, to provide back-up liquidity to buyers of distressed mortgage securities. The Federal Reserve Board is approving such an approach for providing liquidity for securities backed by auto loans and possibly other consumer loans. Some variation on this strategy could be used for real estate, both residential and commercial, to increase the volume of trading of these securities and narrow uncertainties about their value. Another way to provide clearer valuations is to commission independent experts to estimate the values of the distressed securities.

The Treasury now says that it is willing to inject equity capital into a wide range of non-banking institutions: insurers, finance companies and financial affiliates of commercial companies. To qualify, however, non-banks must own a bank or thrift institution. In response, some insurance companies are looking around for small thrifts to buy in order to access the capital—which seems a dubious way to run things. It would be better to develop criteria specifying which non-bank financial institutions may access government funds and when government aid will stop.

Dealing with the Mortgage Problem: The continued decline in housing prices puts ever more homeowners "upside down" on their mortgages, inducing more to walk away from their homes and dump them on an already saturated market. Moody's estimates that 4 million Americans will lose their homes between 2008 and 2010, about a million a year more than in normal times.

A few large banks commendably have modified mortgages on their own, realizing that this is less costly than foreclosure. But the hard job is to persuade entities servicing mortgages held in securitized pools to act similarly. Contracts governing these servicers generally prohibit them from modifying mortgages without the approval of a super-majority of the securities holders, which can be difficult to achieve.

FDIC Chair Sheila Bair's proposal to have the TARP fund bear half the loss of any mortgage modification might not prove very effective. Reportedly, some of the borrowers of IndyMac (the failed thrift that the FDIC is now operating in conservatorship) whose loans were modified have already *re*-defaulted. Trying to keep people in homes they really cannot afford is going to fail.

The best approach to stabilizing the housing market may be to lower the mortgage interest rate. Regardless of the mechanism used to help borrowers facing foreclosure, government must find cost-effective ways of bringing overall mortgage rates down, especially for borrowers who qualify for conforming loans from Fannie or Freddie (or for loans of lower amounts, such as those insured by FHA). Lower interest rates increase the value of houses and thus, more than any other measure, could put a floor under housing prices. This would change consumer psychology and start the economy's healing process.

According to the Freddie Mac survey, the average interest rate on a 30-year fixed rate conformable mortgage in the week of November 20, 2008, was 6.08 percent with 0.7 percent points. In the same week, the benchmark 10-year Treasury bond rate was below 3.2 percent. This low Treasury interest rate has not translated into lower rates on conforming mortgages because, in part, the spread between the yield on Fannie and Freddie bonds and Treasuries has widened, as Fannie and Freddie investors are still demanding a substantial risk premium to hold their bonds.

To get mortgage interest rates down closer to the Treasury rate, Congress should explicitly enable the Treasury to guarantee current GSE bondholders against default and include in the guaranty all those who purchase GSE bonds during the next 18 months. Making clear that this debt is guaranteed could bring down

interest rates on conforming mortgages by at least a percentage point and provide a needed positive jolt to the housing market.

Further Recommendations: Facing the Fiscal Challenge

The past eight years of federal deficits have caused the national debt to soar. Even more important, however, is the aging population. Social Security faces substantial shortfalls in the future as benefit payouts start to exceed tax receipts, and Medicare and Medicaid will swallow the federal budget unless something drastic is done to control their growth.

Congress and the Bush Administration are adding $1 trillion or more to the federal debt. Some fraction of this may be paid off, as the assets the Treasury is buying generate returns, but taxpayers certainly will face increased interest payments as a result of the support given to the financial sector.

In addition, you are suggesting a very large stimulus package, perhaps in the range of $600 billion over two years, along with tax relief for most Americans, added infrastructure spending, investments in new energy technologies, broader health insurance coverage, and aid for states and localities.

Granted, a substantial stimulus package should be passed quickly to halt the current economic freefall. But the question of long-run fiscal stability also must be addressed.

Historically, to raise money, the Treasury issues debt and sells much of it abroad. As a nation, we have borrowed enough overseas to finance federal budget deficits and then borrowed even more to pay for the consumption binge of recent years. That is not going to change quickly; undoubtedly, we will continue to borrow huge amounts from China, Japan, oil producers and Europeans over the next few years. However, there is a limit to the sustainability of this strategy. The United States cannot go on running bigger and bigger deficits and borrowing ever-increasing amounts from the rest of the world.

The foreign borrowing so far has been done on terms favorable to the United States. But, the rate of interest we pay will start to rise over time, unless we have a credible plan for fiscal stability.

Your Administration can provide markets with a powerful signal of long-run fiscal prudence by including as part of any short-run stimulus a set of declining long-run targets for future structural budget deficits, as a percentage of GDP. (The structural deficit adjusts for the impact of cyclical ups and downs). You can submit a realistic budget plan to Congress each year that is consistent with the long-run targets. Any congressional changes to the budget should be on a PAYGO basis. Emergency appropriations (hurricanes and such) must trigger a readjustment of either future spending or taxes. It is not absolutely essential that the federal budget be balanced four years from now, but it *is* vital that good budget targets are set and maintained.

Conclusion

Without a commitment to long-run fiscal soundness, there is significant risk that investors here and abroad will lose confidence in the nation's ability to manage its financial affairs. Should that happen, the U.S. government and the private sector will have to pay much higher interest rates on any debt issued, threatening the economic recovery in the short run and our economic growth over the long run. That risk we must not take.

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