

Transcript
Financial Crisis Discussion Panel
Johns Hopkins Center for Financial Economics
September 29, 2008

Note: What follows is a transcript of a public event held the evening of September 29, 2008 on the Johns Hopkins University Homewood Campus. Earlier in that day, the U.S. House of Representatives had defeated a \$700 billion rescue plan, and all major U.S. stock market indices had shown broad declines—the Dow fell about 7 percent. The transcript has been lightly edited for clarity.

Jon Faust: Thanks for coming. You'll have to excuse us all if we're a little startled--not by the recent events, we're taking them in stride--but economists are always a little startled when anyone wants to listen to what they have to say, so when people come voluntarily it's really remarkable. This has set a record in my experience.

I'd also like to welcome you to what is the inaugural event for the new Center for Financial Economics that's just getting started at Johns Hopkins. There will be many more of these events throughout the years, but hopefully they will come in times that aren't so stressful.

Well, we certainly find ourselves in exciting times. As you know a couple of weeks ago the Chairman of the Federal Reserve and the Secretary of the Treasury showed up at Capitol Hill and said that if you don't give us \$700 billion the economy is going under. That sort of thing has never happened before in US history, and people certainly noticed, and Congress duly got together and put together a plan to give the Secretary of the Treasury \$700 billion dollars. They hastily put together a vote and this afternoon: they voted “no” as most of you probably know. I think the informed people know that this isn't the end of the story, that it's just an initial gambit in the political machinations that will probably lead to some sort of legislation over the next couple of weeks. And what we'd like to talk about today is how did we get here? Does this plan make sense? Is it a good idea? Do we need it? Do we not need it? All the big questions about this crisis. What I'm going to do to kick things off is just give the most basic thumbnail sketch of what's going on.

What we are going to try and cover today is how did “we” get in this mess? We is in quotes there because some of us feel like we really didn't contribute to getting in this mess. So how did we get in this mess? Is some very large rescue package needed, if so why? Must it be done immediately, don't we have time to talk it over and get things right? And if we've got to do it immediately, why? And what are the prospects for the economy, with a rescue package and without it? So what are things likely to look like going forward? And then finally, we're going to take up the question “is this the right package--the one that was discussed today or some variant that might be discussed for the next few days?” So these are the questions we're going to try and address today.

Before bringing up some of our distinguished panel who I will introduce in a moment, I'm going to go through a little bit of very basic background on this.

So, as most of you know, around the year 2000 house prices in the US started rising and they started rising fairly rapidly. The next important thing that happened was that a few hundred billion dollars in mortgage money got lent out and it got lent out at a rate and to folks who couldn't pay it back unless house prices kept rising. So we've got a couple of hundred billion dollars in mortgage loans out there that aren't going to be paid back unless house prices keep rising. So why would anybody do that? Well, house prices in the US had never fallen generally. In certain areas there had been bad times, in

California, in the oil states when oil has trouble, but not generally.

So the other thing you might say is why did people make a \$200 billion silly decision? Well the answer you might say is that it happens with some regularity. It seems like financial markets go out of their way to do such foolish stuff like this with some regularity. While it seems kind of silly, we've got quite a few examples. You might think the stock market before the Great Depression is one example, tech stocks in the late 90's took off at an incredible rate, at a rate that couldn't possibly be justified by market fundamentals. You've got house prices in this country, housing in many countries, Japan had a decade of slow growth after they had a huge housing bubble that popped. So we don't know exactly why it happens, but it does happen with some regularity.

So let's talk about the lessons. A key lesson from the Great Depression was that if financial intermediation breaks down, then so does the whole economy. So in the Great Depression a lot of banks went under and we had a really bad time as you all know. And the lesson we learned is that "Gosh, if these banks are essential then we ought to regulate them." So we put in place all sorts of regulations on commercial banks trying to make them more prudent in how they behave. We also instituted deposit insurance for commercial banks so that folks wouldn't have any reason to take out all of their deposits in the face of a crisis. And all of that was intended to keep the commercial banks stable and, if they were stable, then the economy muddles along even when the financial markets make these big mistakes.

So throughout the past 30 years there has been rapid financial innovation, lots of new ways for money to get from people who want to lend money to people who need to borrow it. So there's all kind of new ways for money to flow from those who have it to those who want to borrow it. And a crucial thing about these new ways is that most of them are outside the commercial banking system. So innovation allowed firms to borrow money and individuals to borrow money in ways that didn't involve these banks that had this safety net of regulations.

So the real rub here is that the very institutions that have made themselves crucial to how the economy works, in the way that banks were in the Great Depression, these very institutions happened to be the ones holding the \$200 billion of bad mortgage debt. These institutions may at one level be crucial to the functioning of the economy, and they also took part in this big foolish decision. And that's what ultimately brought the Secretary of the Treasury and the Chairman of the Fed to the Capitol to say "We have to bail out these institutions because, like happened in the Great Depression, they're crucial to the economy and in their weakened condition the economy can't continue to operate smoothly." Thus maybe we need a rescue.

That's a very thumbnail sketch, and now to get a little more into the detail let me introduce our panel and then we'll move into more concrete analysis of these questions. First we have Bob Barbera. Bob Barbera is the chief economist at ITG Inc. and holds a Hopkins PhD in economics and he's also a fellow of the Economics Department and lectures regularly on economic forecasting. Chris Carroll is a professor in the department and he's also a former staffer at the Federal Reserve Board so he has some experience at the Fed. John Driscoll who we have right here is currently an employee of the Fed and the reason he's here with us is that he regularly teaches in the department and we asked him to join us and share some of the Fed's perspective. My name is Jon Faust and I'm the Director of the new Center for Financial Economics and for about 18 years I was at the Federal Reserve Board myself. I ended as the Assistant Director of the International Finance Division, and in the Financial Division we spent most of our time trying to put out financial panics in one country or another. We have Olivier Jeanne who just recently, this year, joined the department. He's a professor of economics in the department and

he was formerly Assistant Director of Research at the IMF. And Olivier, even more particularly, worked on this problem of banking crises and what they do to the economy for lots of countries other than the US and, surprisingly, some of the ideas might apply to us as well! We have Jonathan Wright who is a professor in the economics department, who just joined the department this year, and up until a few months ago he was a Deputy Associate Director at the Federal Reserve Board. He was involved in the key Division at the Fed that actually decides how monetary policy is made - should we lower the interest rate or raise the interest rate - and he may have some perspectives for us as well. And finally we have Matt Zaft who is vice president of investments at the Moy/Zaft group in Washington. And Matt is also a Hopkins grad and can bring a little of the market perspective. So that's the panelists and we're going to start then with John Driscoll. He's going to talk in a little more detail about how we got in this mess.

John Driscoll: Well thanks very much Jon and I'm very pleased to see a lot of my macro theory students here. I should issue a disclaimer at the outset. Usually when a Federal Reserve employee is speaking externally he is asked to note that his views do not necessarily represent those of the Board of Governors or the staff. Normally that's about some very dry economic topic, on which no one really cares if the board has a view or not, but that's not true here today and so that disclaimer applies twice or triple.

So let me, as Jon said, expand a little on what he said about how we've gotten here. And I'm going to try to restrict myself further to non-controversial facts. So, as Jon mentioned, the issues that we face today do arise from the mortgage market. As Jon also mentioned the supply of mortgages issued by banks increased a lot over the last few years and a lot of that increase was given to people who wouldn't have been able to afford mortgages a few years ago. When banks issue mortgages of course one thing that they're worried about is whether people can pay it back or not, and that in turn depends on things like people's income, their credit rating, and it also partly depends on whether the price of their property is going to increase. And that latter factor has two effects. First, if you expect house prices to increase, the value of equity that the borrower has in the house is rising and so he or she is less likely to walk away from the mortgage if there's a problem. And second, even if the borrower does walk away, the bank will get more from the property if it has to repossess it.

So that was an important factor in boosting home ownership rates and mortgages. Another factor, as has been done for decades, is that mortgages are packaged together by Fannie Mae and Freddie Mac and essentially sold as a bond or security on capital markets. And this has allowed banks to diversify away some of the risks. So the mortgage market expanded fairly rapidly and a lot more people are getting to buy homes than before, which is all to the good. But as house prices began to moderate and the economy itself began to slow sometime last year, it became apparent that many people were not going to be able to repay the mortgages that they'd taken out. Once that outcome became apparent investors started to become concerned about financial institutions, both the original banks who issued the mortgages (if the mortgages were still on their books) but also investors who had bought these mortgage backed securities that are based on the original mortgages that the banks had. As a result, these concerns about banks' balance sheets, these institutions started to lose stock market value and more importantly other financial institutions became reluctant to lend to these financial institutions. All financial institutions need to borrow in the short term to fund their activities. The way that banks and other financial institutions work is that they lend out money for the long term and they satisfy demand for consumer withdrawals and for other business activities in the short term. So when I teach this to undergraduates, my favorite way to explain this is to point to *'It's A Wonderful Life'* in which there's a scene in which Jimmy Stewart's bank is about to fail. He tells the people coming in who want to get their money back that "The money's not here. It's in your house, and your house, and your house." So

he manages to persuade them not to withdraw as much money as they had wanted. Most banks don't have a charismatic figure like Jimmy Stewart persuading depositors not to withdraw money so they have to borrow on the interbank market and since last August the interbank market has been showing signs of stress.

And I must say a little bit about the consequences of that, this is not just something that has the potential to impact the banking market or Wall Street, it has the ability to impact upon ordinary consumers and firms because it's the rate on these interbank markets that in part determines the rate consumers are able to get on loans and the interest rates that firms are able to get on loans. And it also helps determine the availability of credit to consumers and firms. In the past couple of weeks or so that market had further deteriorated and, moreover, there were other signs of potential trouble with the economy. So for example people became very concerned that money market mutual funds--a fairly conservative type of investment that's mostly an investment usually in some kind of safe paper, safe securities from firms and treasury securities--might be encountering problems. And it was concern by, I think, Secretary Paulson and Chairman Bernanke that the lending markets between financial institutions were going to start to break down, and that people were going to flee from formerly safe investments to even safer ones, that led them to believe that credit markets themselves were going to completely freeze up, as they put it. And that, I think, is part of the impetus for the current rescue plan. Now as for more on where we are, I'm going to turn it over to one of our other panelists.

Olivier Jeanne: I'm Olivier Jeanne. I'm a professor of economics at the Department of Economics at Johns Hopkins University since September 1, so it's very recent. And before then I was at the International Monetary Fund where I spent 10 years in the research department doing some research on different topics including financial crises and bailouts. So I think my role in the panel is to talk about the current situation, a little bit of a diagnosis, and to discuss what are the main risks now and looking forward.

And I would like to distinguish between two risks, which are related, but I think it's interesting to make this distinction because the two have different policy implications. The first one is what economists call a credit crunch. So to put it simply, a credit crunch is what happens when banks realize that they have lent too much. So they cut on the flows of lending - so this is about flows, flows of credit. And the second risk is something we read about in the newspapers or hear about on TV and that's the risk of systemic bank collapse of Great Depression proportions. This would threaten the integrity of the payments system. So one way to think about it is that when in a credit crunch you go to your bank and you realize it's much more difficult than before to obtain credit. In the second case you go to your bank and the door is closed and you don't have access to your money so you can't make transactions anymore. So the risk of the second is an order of magnitude more worrying than the first one.

What is the distribution of the risks, what are the probabilities? Here I'm not claiming to be talking on behalf of the panel, I think the panel will broadly agree with what I'm going to say but obviously the other members of the panel can dissent. I think the probability of a credit crunch looking forward is fairly high. And the probability of a systemic bank collapse is very low. Now so we are talking about two events, a credit crunch which can have a high cost in terms of output but not necessarily so - there are different varieties of credit crunch. To some extent it is part of the credit cycle, so we observe a large number of credit crunches across countries and in the US. The last severe one was in the early 90's following the savings and loans debacle.

Now, systemic bank collapses are another matter. Now why is the probability of a systemic bank

collapse probably low? Well in part because some institutions have been created in the US following the Great Depression to prevent systemic bank collapse, for example the Federal Deposit Insurance Corporation. So as you know, your deposits are insured, at least up to \$100,000 and maybe more if you put some beneficiaries to your account. We might disagree about how low this probability is and the fact is that US banks also have uninsured short-term liabilities so that bankruptcy is certainly a possibility. And we might also disagree about the propensity that the monetary authorities would have to make a mistake and not to rescue an institution that might be systemically important. But overall there is a low probability of a catastrophic event.

Now, another distinction is the timing - the timing of the problem and the timing of the policy response. Systemic bank collapse is about the stock of assets or liabilities freezing up and this can happen in one or two days so one has to respond to it extremely quickly. Here there is a range of policy tools that can rescue insolvent institutions. By contrast, a credit crunch is something that builds up over time. It's something that's about flows, flows of credit. So one has more time to respond to that - to study the situation, to get information. Now there is a risk of waiting for too long; a credit crunch can drag on if there is no clear policy framework, there is no clear time frame. This what happened in Japan in the 90's. But establishing this policy framework should not be a matter of days. It should be a matter of months.

So to conclude and to anticipate some of the discussions that we are going to have, I think this distinction is relevant because to some extent the bill and the way the debate was framed in the US and the way bill was designed, bundled all of it together--talking about the risk of a credit crunch for the real economy but also presenting the need for action as something extremely urgent because of the risk of a collapse in the payments system. And this might not have been a good way to engage the debate. I don't want to elaborate on that because I think some of the other panelists are going to talk about what to do.

Jonathan Wright: My name is Jonathan Wright and, like Olivier, I'm new to the department. I started just three weeks ago and before that I worked at the Federal Reserve Board in Washington.

So if the government took no action in response to the current crisis there is a risk of an implosion of the payments system, and the banking system and financial intermediaries as a whole, but I think this risk is low given the institutions in place. Notwithstanding events this afternoon I think, facing into the abyss, Congress, the Treasury and the Fed will do what it takes to avoid that catastrophic doomsday scenario. Even without thinking about a collapse of financial intermediation, economic prospects seem pretty bleak with, and especially without, a rescue package along the lines of what has been talked about. The availability of credit has tightened that in many ways has been unprecedented and it's not going to recover for a long time. The Fed has lowered the federal funds rate to 2 percent but that's not really helping very much for households and businesses because that's not the rate that they borrow at and mortgage rates and corporate lending rates remain quite high.

The root of the problem is in falling house prices and the housing market is a market unlike other markets -- prices don't adjust quickly to equate supply and demand and so prices will be sluggish for long periods. Inventories of unsold houses are high which indicates prices are going to grind lower for some time. Though we don't have examples of an extended housing price contraction at the national level there are many examples at the regional level, for example California had high foreclosures and declining house prices from 1990 up until 1997. In the house price bubble, the ratios of house prices to rent reached astronomical levels and they're still high--they've come down but they're still high by

historical levels. Generally in the wake of a bubble the natural tendency is to over correct on the other side particularly when mortgage availability is so limited. So there are lots of reasons to think that house prices have further to fall causing, in turn, losses to financial institutions. One little measure we can look at is that actually there is a futures market; relatively illiquid but it predicts over the next couple of years another 20 percent decline in one particular index.

There's already been 500 billion dollars of reported losses in sub-prime mortgages, that's a staggering sum. Early in this process of a credit crunch people were saying there's only been a total of \$100 billion or \$200 billion of losses, and that's got to be small relative to the size of the US economy, its a tiny relative proportion, and that's true. And \$500 billion is also small, but it's getting to be a large amount. The direct effects are coming to be potentially more important, particularly if you think of other credit markets and other mortgage markets--like the prime mortgage market--are starting to have losses going forward as well. And in many states in the US, a mortgage is a non-recourse loan, that is to say that the mortgage holder can default on the loan and the mortgage originator can ruin their credit but can't come after their other assets. That gives, in states like California, a built-in mechanism that has the potential to cause high foreclosures when house prices are falling. The labor market is weak but not terrible, unemployment is at 6 percent and payrolls are down a good bit this year but GDP continued to expand in the second quarter--probably that's an artificial effect coming from the effects of the tax rebate checks. So looking at the rear view mirror, the economy, the labor market spending is poor but it's not horrible. But going forward when -- economists have a poor track record in forecasting, but -- going forward, the effects of financial intermediation seem likely to cause a slow burn scenario. Financial intermediaries have a long way to go to reduce their leverage, they'd taken leveraged bets and that's going to be something that has to work off slowly.

I think a likely scenario is a slow burn scenario with a recession that may well have already begun. And incorporating an adverse feedback loop where house prices fall and that causes more losses on these mortgage securities and that causes further tightening of credit, which weakens the economy and makes house prices fall further. The relatively benign scenario is a repeat of, say, the early 1990's in the US where there was a period of financial headwinds and an extended period of limited availability of credit slowing growth. The less optimistic scenario is something more along the lines of what Japan faced in the 1990's where an asset price bubble had burst and that led banks to face losses that they, however, refused to recognize. They were kept going, which in turn meant that they were not in a position to take advantage of profitable opportunities to lend. And as a result Japan faced a decade of stagnation. And the rescue measures that are being talked about here are really designed to improve the odds of the relatively benign scenario relative to the lost decade of Japan and something big, something along the lines of what has been proposed, seems likely to me to improve those odds quite a bit.

And when you think of the severity of a period of 5 years or 10 years of slow growth it seems to me that it's got to be worthwhile doing something large along those lines. The mechanisms whereby the rescue works, or one mechanism, is that it recapitalizes banks. That's one mechanism in which it could improve the prospects for the relatively benign outcome. Another mechanism is that there are very illiquid assets on banks balance sheets that are dragging them down--that maybe are currently priced by the market below their fair market value. So in either of these mechanisms we could envision a large rescue package as greatly improving the odds of the credit crunch being less rather than more severe. Now there's plenty of reasons to be angry about the decisions made by many in Wall Street, but under this scenario it seems daft to bring the whole economy down to teach them a lesson and to make a point. And so there is a natural reason why its good public policy, notwithstanding the foolish decisions that were made, not to make the whole economy suffer.

Jon Faust: So that's kind of a broad sketch by the pointy headed academics, me and some of the others. So what we thought we'd do next is get some opinions from guys who deal with these sort of investments all the time and who deal with market issues all the time. And so now we're going to have our two panelists who fit that description talking generally about what they see out there in the market and whether this discussion makes sense from that perspective.

Matt Zaft: Thanks Jon. I'm Matthew Zaft and I'm from the Moy/Zaft group and we're part of Merrill Lynch's global wealth management. And basically what I do is manage peoples money - high net worth individuals, institutions, and spend basically every day focused on the markets, both the stock and the bond markets and try to make my clients money and try not to lose them too much. And so what I wanted to talk a little more about was the market perspective because, as we've all heard in the debates, there's Wall St and then there's Main Street -- well I'm part of Wall Street. And unlike what seems to be the perception out there, Wall Street does affect Main Street, and we're not two different entities and everyone from the smallest investor to the biggest investor has a big stake in this. And so what I wanted to talk about is what we're seeing in the markets, how we're positioning things and hopefully leave you today with a little bit of confidence because believe it or not, I'm actually very positive. I'm confident in the market as a whole. I'm positive and hopefully by the time I'm done you might be too.

The analogy I've been using with my clients lately is that if you go to the supermarket and you get home and you're unpacking your groceries and the apples are rotten, you throw the apples away but you put the steak in the fridge, the milk in the fridge, the ice cream in the freezer and the cereal in the cabinet. What's been going on in the market is you're getting home from the supermarket, the apples are rotten and you're throwing everything away. And we think that's going to change. We truly believe that there's going to come a realization that yes, the financial markets are rotten, yes there's a lot of things that have gone on wrong there, but things are going to change. Hopefully we're going to learn from our mistakes, we're going to get regulations. We do believe there will be something coming from Congress, maybe not exactly was agreed upon the weekend, hopefully something better.

But when it comes to the rest of the market things are pretty good. This last quarter one of the worst quarters in the history of the market, but the consumer staples and health care sectors were actually positive for the quarter. There are good apples out there and what we believe in is recognizing that; recognizing that the quality companies like a Coca-Cola doesn't really have to worry about sub-prime mortgages. Now, yes, there is a domino effect. There is an over-arching effect when it comes to credit crunch. There is an effect when it comes to the consumer, which is why it's important to be in the right companies. But ask yourself no matter what happens in the economy, are people going to stop smoking? Are people going to stop drinking beer? Are they going to stop eating at fast food restaurants? In fact, they're going to do more of all those things. Are people going to stop getting their medications? No. Are you not going to go to the doctor? No. And that's where this comes in and we look at three events coming up to basically bring us back to a little sense of normalcy in the rest of the market.

And I'm not going to talk about financials, but the rest of the markets as we look at it over the next few weeks, we're going to get third quarter earning announcements. We truly believe that the estimates are extremely low, the expectations are low, when we get these reports of third quarter earnings companies are going to be better. They're going to do better than what people are expecting and people are going to remember "Oh yeah, IBM doesn't have sub-prime mortgage exposure." And that's going to be what lifts us forward- in those areas. And again this is not a broad based scenario, this is specific industries

and specific companies. We think that's going to lead us to the election. We are positive on the election regardless of who is elected, despite what you might think from a Wall Street. guy, we actually think an Obama victory gives you a better market bounce than a McCain victory. We feel that international money is going to come back in once we know who the president is. And the international money, a lot of people don't realize a lot of the time, more than half the market is owned internationally- foreign investors. That money needs to come back in we need their confidence restored. I think it will be.

I think the fact that we're going to have, and I know you're sick of this term, change, that change is going to lead to confidence. That sense of change is going to lead to a clarity of where we're going. And that, we think, is going to lead us into the beginning of the year. We're going to get fourth quarter earnings reporting, and it's the same story I just told you about third quarter earnings - we think they're going to be good. We think they're going to come back- those companies are going to do well. That gets us to the inauguration day and that's when my crystal ball gets all cloudy. So beyond that check back with me later, but I hope what you realize is that, yes, this is a tough time. There's no one here who is trying to sugar coat that, there's no one here is trying to say "Oh this is nothing. Forget about it." Remember this is the worst day in the market since '87. We've got issues, but they're not all the way.

And what I'd like to say is that this is not the time to be pulling your money out and putting it under the mattress, this is not the time to be running for the hills, certainly not the time to be moving to Canada. Long-term viable strategies work in the market - take advantage of this and don't be afraid to stay the course. That would be the gist of what I'd like to say.

Robert Barbera: OK, what I'm going to try to do is summarize what some of the previous people spoke about and then talk about how things might change bigger picture wise. Jon Faust led us off by saying that the giant miscalculation was that housing prices always go up. Now house prices went up from 1962 until 2002 and so you can be a super rocket scientist, left brain right brain, use all those mathematical models but you didn't realize there was an underlying assumption that was driving all of them. And that was that if everything was predicated on house prices always going up you had an inverted pyramid and if they went down 3 percent then, since all the models assumed they couldn't go down, you got an adverse feedback loop that said if they go down 3 percent, they're going to go down 30 percent.

John Driscoll tried to explain to us why that house price was so important. As long as its price is going up, the person who lives in the house wants to stay in the house because its rising in value. And as long as its going up, if the person gets thrown out of the house then when the bank gets the house it's worth more than the mortgage. What we find out when the house price is going down, there's a predisposition to put the house to the bank. If you bought it for \$100,000 and its now worth \$60,000 and you owe \$90,000 on it and the bank only gets the house if you walk away, you're predisposed to walk away. And if you walk away that means the bank has a house worth \$60,000 and a mortgage that's \$100,000 and on their balance sheet, a balance sheet balances right? So on the left hand side you have assets, on the right hand side you have liabilities. If the assets are supposed to be 100 and they're now 60 and the liabilities are still 100 that means you owe 100 and you're assets are worth 60 then now you're a bank with a problem and people don't want to lend to you. And all of a sudden you've got a situation where banks don't want to lend to each other.

So we end up with rising bank costs, which gets us to Olivier Jeanne, who said you've got two issues- we've got a bank that has big problems, many banks have problems, and that can elicit one of two

dynamics for the economy. We can have a credit crunch--a credit crunch says well if the bank is in trouble the bank doesn't want to lend. And if the bank doesn't want to lend that puts further pressure on the economy over the intermediate term. But the more immediate problem is the modern day bank run. The bank run in the old school is that you all line up and you say I want my money. In the modern day bank run, you're all on your screens punching in saying "I want to move money from here, there and everywhere" and that can create the problem. This is the immediate issue, as Olivier pointed out, that we need to address in the short run. We didn't address it today in the House of Representatives and the stock market was down a record in terms of numbers but not a record in terms of percentage, just remember it was down 7 percent. I worked at E.F. Hutton, and when I was at E.F. Hutton the market fell by 500 points. But at that time it was 25 percent, so we had a one day 25 percent decline. I actually should point out that I worked at E.F. Hutton, and I worked at Shearson and I worked at Lehman. And they're all gone. Now the very good news associated with that is they're all gone but we're still all here.

So the predisposition to have financial crises is there. I agree with the other panelists, I do think cooler heads will prevail. Republicans will come to it with some hemming and hawing and some Democrats will capitulate. We'll get something in the way of a big fix that deals with the issue of a run, a modern day bank run, and the liquidity squeeze. But the credit crunch is there and the credit crunch will have adverse effects on the economy. Now, in that regard, I have some very good news. On the recession, you don't have to worry about a recession, because you're nine months into one. Only PhD's don't know that. If you're out there and you're trying to find a job or you're working, you know that housing is down 50 percent, autos are down 35 percent, that the unemployment rate has gone up from 4.4 to something well above 6. All these numbers are reasons why consumer sentiment surveys are down to levels in the *middle* stages of recessions. By the time they get rid of the benchmark revisions and they've adjusted all the data, the official data will tell the models what, viscerally, most people already know - we're already into a recession.

Now, that said I do think in talking about what John Wright said I would take a small disagreement in terms of a slow burn. I think if you look back it is recessionary data but of a relatively mild nature over the last 8 months. It's more likely to be of a breathtaking nature over the next six because of that credit crunch. So I would expect, GDP was actually mildly positive in the second quarter, I think it will be significantly negative in the third quarter and we'll have that type of tough decline.

If we talk about Matt, I would sum up his presentation, very short, which is that the sun will come out tomorrow. And in fairness, if you take the long view he's turned out to be right more times than not, but we all know what Keynes said about the long run right? In the long run we're all dead. But in this case what we're arguing is that the government is going to come to the rescue so that in the short run we're not dead. But it is a crunch, the economy is going to do poorly. It's a good time to stay in school or go to grad school, don't be thinking about trying to get a job in May.

The last serious note I would make and then I'll sit down - I think this is not the end of the world but it is the end of an era. And it's the end of an era because what we had from 1980 through 2000 was really a celebration of unfettered free markets, that markets get us to the right place, and the less intervention the better, the less government the better, and the less the Fed does on an activist basis the better. And as you look back at that sweep you discover we did have a crisis in '87 with the stock market crash, we did have the S&L bailout in 1990, we did have Asia collapse and Japan collapsed before that, we had the tech bubble burst and now we've got this, very, very tough, the sort of mother and father of all of it, in terms of the squeeze for housing. And so a more interventionist, activist government will be the legacy of this event. It's not the end of the world but it is the end of an era. Thank you.

Chris Carroll: So I'm Chris Carroll. I'm guess since Jon didn't lump me with the pointy headed academics, I must be a round headed academic. I'm a professor in the economics department and, as Jon said to begin with, a former Fed staffer. I started out my career making forecasts, the consumption forecasts, at the Fed. And what I have been doing, pretty much obsessively over the last week as my wife can tell you, is reading everything I can find online about the views of my fellow economists about what's going on. And what I think I can fairly report is that virtually every economist whose views I have been able to find, who is not associated with Wall Street, and who has expressed a view--liberal, conservative, libertarian, wacko nutcase whatever their predispositions -- pretty much everyone thought the Paulson plan was pretty deeply flawed from the get-go. This was because its core, its core, was that the taxpayer should buy up these toxic sub-prime asset-backed securities out there that the markets have now decided are pretty much worthless. Maybe they really are worthless in which case the Paulson plan would have essentially been a pure bailout for Wall Street.

So my way of characterizing what happened two weeks ago when Secretary Paulson came to Wall Street was that he basically said to the Congress "It's my way or the highway and the highway, that's a highway to hell." So Congress was pretty scared by that and they moved with what might not have seemed like a great deal of speed to Secretary Paulson but what is world-record speed for the US Congress in producing a bill; but maybe they should have acted with a little less speed and a little more deliberation. The key question is really whether Paulson pretty much was right--that it's his way or the highway--or whether there is a better approach that the Congress ought to consider as a substitute for what secretary Paulson was proposing.

I think there is a substitute that would be a lot better than the Paulson plan and I think that actually Speaker Pelosi got the rhetoric right of what the better plan would look like on Sunday. Unfortunately, she didn't change the substance of the bill, she just changed how it was described. She said that what we need is a buy in and not a bail out. So what exactly would that be--a buy in not a bail out? Well its pretty much what all of these economists have been saying for quite a while. The details of the plans that people have put forward--Alan Meltzer is a conservative, Brad de Long is the economist-blogging, lots of other economists, Luigi Zingales from the University of Chicago--pretty much all have been saying we need to do a buy in not a bail out. And that has some backing behind it in the form of a recent comprehensive survey of 124 bank crises around the world over the last 40 years. Reading the US news you might think there has never been another bank crisis anywhere else in the world, in any other country, because you rarely read any reference to the vast experience that the rest of the world has had of these things. But looking at 124 bank crises around the world it looks like buy-in approaches have worked a lot better on average than the bail out kinds of approaches.

So what do I mean more concretely by a buy-in approach? Well the simplest way to describe it is to say that, basically, the taxpayer should do with respect to the financial sector as whole what Warren Buffet did with his investment in Goldman Sachs a few weeks ago or a few days ago. That is to say that, basically, every dollar the taxpayer spends should purchase an ownership stake in the financial sector or in a financial firm, rather than purchasing the sub-prime assets--the "toxic waste" assets as they have been called--directly. The taxpayer should get an ownership share of financial firms. And this should be coupled with things like saying if you want to participate in this buy-in plan then you can't pay any dividends until you're back on healthy footing and other restrictions on your activities- you cant make any of these wildly risky investments that you've been doing for a while. And I'd just like to emphasize again that this is not really some crazy crack pot, ivory tower idea. For example Sweden had a plan like this 15 years ago when they faced a financial crisis and it worked out pretty well for the Swedish taxpayer, at least compared to bank crises of similar scale in other countries where it seems like the cost

to the taxpayer ended up being a lot more than the cost to the Swedish taxpayer. If you want more details on this there's a post to it on my web page I wrote a little opinion piece posted online with a title that might appeal to almost everyone. The title was 'Revolting Economists', about the fact that basically the entire profession has revolted against the Paulson plan and thinks there are better ways to go. Just google "revolting economists" and my name and you will find my views.

So you might wonder if this is such a great idea, why did Secretary Paulson come up with so many economists think is a pretty terrible idea. And I must say, this is a puzzle to me and the other economists. My best guess is that Paulson spent his whole life working in Goldman Sachs, on Wall Street, and he has a visceral, gut level, understanding of why it is that handing over a huge amount of money to Goldman Sachs and to firms on Wall Street would cause a big wave of relief on Wall Street and would get us beyond the crisis panic stage. So Paulson I think feels very strongly in his gut that his solution would end the panic stage of things, which doesn't mean that its the best solution out there. It especially doesn't mean that its the best solution out there for the *taxpayer*, and it doesn't mean that other people don't have a gut too that tells them there are other solutions that might work just as well as what Secretary Paulson has proposed.

So let me close with an account that I heard from an insider who was on Capitol Hill last week when Secretary Paulson was having closed door discussions with the congressional leadership. This person said that the situation sort of felt like being in a hostage situation--that Wall Street, in the person of Henry Paulson, was basically saying "Give us this exact bailout, this very minute or the economy gets it." That was pretty scary to the Congress and when I talked to my friend his guess was that the Congress was pretty much inclined to go along with what Secretary Paulson was saying because they were frankly terrified. But the problem with the whole situation and the feeling that its a hostage type of situation is that, to put it in those terms, Congress can basically rescue the hostage without caving into those ransom demands. I think the Congress can capture the kidnapper, set the hostages free by pursuing what I described earlier as the Buffet plan, the Warren Buffet plan. But, of course, the kidnapper only wants the ransom plan considered so the kidnapper gets the suitcase full of unmarked bills. That's a pretty extreme description of things but I think it has the emotional resonance for the person who was telling me the story. Now I could be persuaded that there's something wrong with this description, but among all of the things I've read online I haven't seen any persuasive case that this is really an unfair description of the situation.

There is one objection, there is one reason why Congress might be reluctant to go along with this buy-in plan which is that it might have a higher sticker price than the Paulson plan. I know \$700 billion sounds like an awful lot of money but its not an infinite amount of money and its possible that the buy-in plan might have a higher sticker price. But if that's the objection, I believe it's a deeply misguided objection because it's sort of like saying that you would rather personally, yourself, spend \$700 for a steaming heap of toxic waste than spend \$1000 for say a used car. Given this situation, it's true that the sticker price for the used car is more--its \$1000 instead of \$700--but I'll buy the used car any day over a potentially steaming heap of toxic waste.

Let me conclude on actually an optimistic note which is that I'm confident that Congress will fairly quickly, sometime in the next couple of weeks, pass a some bill which prevents really serious long term damage from the excitement that we're currently going through. Let me just remind everyone what other things we've been through before. On September 11th the World Trade Towers were completely destroyed, that was where a lot of Wall Street activity took place in the World Trade Tower buildings. There was some temporary disruption in financial markets but no really long term lasting damage. There was the East Asian crisis a decade ago which was very dramatic and led to a lot of hyperbole.

There was the LTCM crisis in 1998, there was the market breach in 1987, and in the end none of those events produced another Great Depression. I think that's for the reasons that Jonathan identified, we have a political system that's accountable and that understands its job is to prevent another Great Depression and in the end the political system will accomplish that goal. So I'll stop there.

Jon Faust: Thanks everyone. Your presentations were very informative and I hope we all learned something from that exchange of views.