Policy and Economic Outlook

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Origins of the Economic Crisis

Trade Deficit

Lousy Banking Practices

Banking and Credit Crises

Trade Deficit

- Large Trade Deficits Since 1980
- Trade Deficit Increased from 3.6 % of GDP in 2001 to 5.1% of GDP in 2007
- Oil, Chinese Consumer Goods and Automobiles Deficits Equal 100 Percent of Entire Trade Deficit
- Financed Mostly by Selling U.S. Treasury and Other Securities to Foreigners – U.S. Owes $7 Trillion to Foreign Creditors
- Major Sources of Finance: Oil Exporters, Japan, China, Other Developing Countries that Buy Dollars to Keep Their Currencies Cheap

Broken Exchange Rate System

- Large Deficits on Oil, Consumer Goods from China, and Cars Should Cause the Value of the Dollar to Fall Against Middle East Currencies, the Chinese Yuan, and Japanese Yen and Korean Won
- Oil is Sold in Dollars
- China, Japan and Others Have Manipulated Currency Markets by Buying Dollars and Investing in Treasury Securities and Other U.S. Debt Instruments
- Destroys High Paying Manufacturing Jobs, **Pushes Down U.S. Wages and Family Incomes**
- Growth Has Been Sustained by Borrowing

How We Maintained Growth

- Our Income Equals What We Produce - GDP
- If We Spend 100 Percent of Our Income, But We Import 5 Percent More Than We Export, *Then* Domestic Purchases Will Fall Short of What We Produce by Five Percent and Unemployment and Recession Should Result
- However, Through September 2008 We Consumed 105 Percent of Our Income by Borrowing from the Rest of the World

How We Consume More Than We Produce

- We Borrow on Credit Cards and Against Our Cars, Homes, and Anything Else We Can Mortgage
- Banks Bundle Those Loans Into Bonds, and Sell Those Bonds to Chinese, Saudi and Other Foreign Investors
- This Scheme Requires Rapidly Growing Incomes and Home Values to Sustain Ever Larger Consumer Debt and Mortgages *or the Loans Cannot Be Repaid*
- Banks Should Have Not Permitted This But They Became Involved in Bad Lending Practices

Origins of Banking and Credit Crises

Savings and Loan of the Late 1980s
End of Glass-Steagall in 1999

Savings and Loan Crisis

Significant Causes

- Deregulation of Interest Rates,
- Growth of Money Market Funds
- Legacy Mortgages
- Tax Reform Act of 1986

Significant Results

- Securitization of Loans – Mortgages, Credit Cards Debt, Auto Loans
- Growth of Credit Default Swaps Industry

Repeal Glass–Steagall - 1999

Permitted Banks to Become Part of Financial Supermarkets, Housing Commercial Banks, Investment Banks and Securities Dealers

Historically, Commercial Bankers Received Salaries, and Investment Bankers and Securities Dealers Received Bonuses and Commissions Based on Volumes of Business

Compensation of Commercial Bankers Became Driven by Volumes of Loan and Derivatives

Credit Default Swaps Ponzi Scheme

- Bankers Create Progressively More Aggressive Mortgages and Loans, Bundled Those Into Bonds to Sell to Insurance Companies, Pension Funds and Other Fixed Income Investors
- Faulty Bond Ratings
  - Bond Rating Agencies' Special Franchise
  - Faulty Rating Methodologies
- Under Priced Credit Default Swaps—these are Contracts that Insure the Bonds (AIG)

How Borrowing Sustained Growth

- Foreign Purchases of U.S. Securities Keeps Long Interest Rates Low, No Matter What the Federal Reserve Does to Federal Funds Rate
- Banks Loaned Home Buyers, Home Owners, Auto Buyers Ever Larger Shares of Personal Income
- Housing Prices Soared
- Another Round of Borrowing, Sustains Consumer Demand, More Imports, More Borrowing

Crash and Burn

Trade Deficit Moves Workers from Export and Importing-Competing Manufacturing to Non Tradable Services Where Incomes Are Lower

Housing Values, Mortgages and Debt Outrun Income

Mortgages Default - Mortgage Backed Bonds Drop in Value

Banks Crash and Lending Ceases Up

Housing Construction, Auto Sales and Other Consumer Spending Declines

Unemployment Rises

Negative Feedback Cycle Begins

Forecast
GDP Growth, Unemployment Rate

	08QII	QIII	QIV	09QI	QII	QIII	QIV	10Q1
GDP	2.8%	-0.5	-5.0	-5.0	-1.5	-1.5	3.3	2.8
UR*	5.4%	6.0	6.9	7.7	8.3	8.8	8.6	8.4

*Unemployment Rate

Policies for Growth

- Stimulus Package: $300 Billion a Year (2 percent of GDP) to Get People Back to Work
- Fix the Trade Deficit and the Banks
- Lessons of the Great Depression and Japanese in 1990s—If We Don't Fix the Structural Problems—the Trade Deficit and the Banks—Ever Larger Stimulus Packages Will Be Necessary
- Eventually the Rest of the World Won't Lend Us Any More Money

Smart Growth Policies

- Stimulus Package – Three Years at Two Percent of GDP or $300 Billion Focused on Infrastructure, Not Tax Cuts
- Banking Reform
- Better Energy Policies

Stimulus Package

Spending on Roads, Bridges, Schools, Internet, Energy, etc. Will Boost GDP and Jobs More Than Tax Rebates

Infrastructure Leaves a Legacy of Productive Investments

Banking Reform

- Mandatory Compensation Reform at FDIC Insured Institutions and Depositories with Implicit Government Guarantees (Money Market Funds)
- Reform Mortgage and Loan Origination
- Reform Bond Rating Agencies
  - Force Fundamentals Based Rating
  - Limit Agency Activities to Bond Ratings
  - Regulated Compensation and Fees
- Restart Securitization Loans by Creation of Plain Vanilla Bonds

Better Energy Policies

Higher Mileage Standards

Other Measures to Conserve Energy—Green Buildings, Windmills, etc.

Domestic Oil and Gas Development—Offshore and Arctic Drilling

Expand Electrical Grid with Nuclear and Clean Coal Technology

Accelerate Adoption of Hybrids, Plug-ins, etc

Auto Policies

New Technology Development Grants to Manufacturers and Suppliers, Conditioned on Locating First Production Runs in the United States, and Patent Sharing at Fair Value

Clunker Trade in Subsidy: Newer and Larger Vehicles Eligible for Biggest Trade in Subsidy but Only if Those Go to the Crusher

Fixing Trade Policy

Tax on Dollar-Yuan Transactions at a Rate Equal to the Value of Chinese Currency Market Intervention Divided by Chinese Exports and Imports

Put Exchange Rates into Trade Agreements

Require Full Reciprocity