Testimony of

Martin Feldstein

Professor of Economics, Harvard University

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Thank you, Mr. Chairman. I am pleased to testify today about the Treasury's Troubled Asset Relief Program and about other steps that I think are needed to deal with the current economic situation.

The Problem

I am very worried about the U.S. economy. The financial crisis and the economic downturn are mutually reinforcing. Without further action by the Congress, the current recession is likely to be longer and more damaging than any that we have seen since the 1930s.

The fundamental cause of our current problems was the underpricing or risk and the resulting excessive leverage of both individuals and institutions.

But the primary condition that now threatens the economy is the expectation that house prices will continue to decline, leading to more defaults and foreclosures. And those foreclosures will put more houses on the market, driving house prices down further.

This potential downward spiral reflects the fact that in the United States – unlike every other country in the world – home mortgages are "no recourse" loans. If someone stops paying his mortgage, the creditor can take the home but cannot take other assets or look to the individual's income to make up any unpaid balance. This no recourse feature gives individuals whose mortgages exceed the value of their homes an incentive to default and to rent until house prices stop falling.

Because defaults are now rising rapidly and are expected to go on increasing, financial institutions cannot value mortgage-backed securities with any confidence. That's what stops interbank lending and lending by financial institutions that cannot judge the value of their own capital.

<u>The TARP</u>

The actions of the Federal Reserve and the FDIC have done a lot to prevent a run-off of funds from the banks and the money market mutual funds and to maintain the commercial paper market. In contrast, I believe that the TARP itself has not done anything to resolve the basic problems of the financial sector.

The Treasury's original plan to buy impaired loans as a way of cleaning the banks' balance sheets simply could not work. Even $700 billion is not enough to deal with the more than $2 trillion of negative equity mortgages. The plan to buy impaired assets by a reverse auction also could not work because of the enormous diversity of these securities. And even if the Treasury had succeeded in removing all of the toxic assets from the banks' portfolios,, they would have done nothing to stop the flow of new impaired mortgages and the fear of more such toxic assets in the future. It was good that the Treasury abandoned this asset purchase plan.

Injecting capital into selected banks is also not a way to resolve the problem and get lending going again. A bank like Citigroup has a balance sheet of some $2 trillion. Injecting $25 billion of government capital does not provide a significant amount of loanable funds. Nor does it give anyone confidence that Citi would have enough capital to cover any potential losses on its mortgage-backed assets. Although it raises Citi's tier one capital, that is not the binding constraint on lending by Citi or on its ability to attract funds. It was good that the Treasury abandoned this equity infusion plan as well.

Last week the Treasury announced that it will now concentrate on propping up credit for student loans, auto loans, and credit cards. I do not know how it plans to do this. But doing so will not stop the lack of confidence caused by the expectd continuing meltdown of mortgage-backed securities that is driven by the process of defaults and foreclosures.

In light of this record, the Treasury's announcement yesterday that it will not seek any of the remaining $350 billion of the initial $700 billion TARP funding seems quite appropriate.

What Needs to be Done?

Stopping the financial crisis and getting credit flowing again requires ending the spiral of mortgage foreclosures and the expectation of very deep further house price declines. Doing this requires a new government policy that deals with homeowners who have positive equity and a different government policy for homeowners with negative equity. Here is a possible way of dealing with these two groups.

Consider first the problem of stopping homeowners with *positive* equity from falling into negative equity as house prices decline to the pre-bubble level. Earlier this year I suggested that the government offer all homeowners the opportunity to substitute a loan with a very attractive low interest rate, but with full recourse, for 20 percent of the homeowner's existing mortgage. This "mortgage replacement loan" would establish a firewall so that house prices would have to fall more than 20 percent before someone who now has positive equity would decline into negative equity. Since the mortgage replacement loan is essentially a swap of the homeowner's IOU for the government loan, it would involve no actual government spending and therefore no increase in the budget deficit. (For more details, see my Wall Street Journal article of March 7, 2008 "How to Stop the Mortgage Crisis.")

The key to preventing further defaults and foreclosures among the current *negative* equity homeowners is to shift those mortgages into loans with full recourse, allowing the creditor to take other assets or a fraction of wages if the homeowner defaults. But the offer of a low interest rate loan is not enough to induce a homeowner with substantial negative equity to forego the opportunity to default and escape the existing debt.

Substituting a full recourse loan requires the inducement of a substantial write down in the outstanding loan balance. Creditors have an incentive to accept some write-down in exchange for the much greater security of a full recourse loan. The government can bridge the gap between the maximum write down that the creditor would accept and the minimum write down that the homeowner requires to give up his current right to walk away from his debt. (For more details, see my Wall Street Journal article of November 18, 2008 "How to Help People whose Home Values are Underwater.")

If these things are done, the financial sector would be stable and credit would again begin to flow. But while that is a necessary condition for getting the overall economy expanding again, it is not sufficient.

To achieve economic recovery the nation needs a program of government spending for at least the next two years to offset the large decline in consumer spending and business investment. To be successful, it must be big, quick, and targeted at increasing production and employment

I am a fiscal conservative. I generally oppose increased government spending and increased fiscal deficits. But I am afraid that that is now the only way to increase overall national spending and to reverse the country's economic downturn.

If these two things are done -- stopping the incentive to default on home mortgages and increasing government spending –- I will be much more optimistic about the ability of the economy to begin expanding before the end of 2009.

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