



Economic Review



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Musings & Amusings:

The World's Shortest Books

Things I Cannot Afford
by Bill Gates

The Amish Phone Book

A Guide to Sportsmanlike Conduct by Mike Tyson and Serena Williams

A Primer on Congressional Etiquette by Joe Wilson

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Bernanke

September marked the first anniversary of the failure of Lehman Brothers and the rescue of AIG. In case you forgot, that's when the wheels almost fell off the global financial system. Let's look back over the past year and then take a peek ahead.

I knew something big was brewing on the evening of Sunday, September 14. We had just gotten back from dinner with friends and I turned on the TV, which had been tuned to CNBC. Up popped the weekday anchors who were talking about the imminent bankruptcy filing by Lehman Brothers and whether the government would step in as it had for Bear Stearns about six months earlier.

Lehman was allowed to go under and chaos broke loose in financial markets. The stock market plunged the next day and already wide risk premiums got even bigger. AIG, on the other hand, was rescued. Almost immediately, Treasury Secretary Henry Paulson went to Congress to ask for billions of bailout money to provide capital to the financial system and make markets for troubled securities. And the Federal Reserve stepped up its purchases of mortgage backed securities, Treasury bonds and other credit instruments. It seemed like a case of "ready, fire, aim" as the government rushed around to save the financial system. As noted by a Webster colleague, reality had outrun our ability to understand it.

Should we have rescued Lehman? This would probably have involved another financial firm taking over Lehman. Some argue that the collapse would only have happened later but on an even bigger scale if one of the banking behemoths had purchased Lehman. Should we have let AIG go under? Many experts say that its dealings in credit default swaps were so massive and complicated that many other firms would be dragged down as well.

The more important question is much more broad. Should we have pumped the hundreds of billions via TARP (the Troubled Asset Relief Program) and other rescue plans into the

financial system after the Lehman debacle? Should we have extended financial support and guarantees by the Fed and the Treasury so far into the private sector?

What would have happened if nothing was done? If you want to sound real erudite, you say we're going to discuss the *counterfactual* case. Suppose Washington let the financial chips fall where they may after Lehman? That is, no AIG bailout, no TARP, no purchases by the Federal Reserve of mortgage backed securities, etc.

My guess is that we would have found ourselves in the midst of financial chaos with economies and asset markets collapsing on a scale more in line with the 1930s than what actually has happened. One of the biggest mistakes of the 1930s was believing that the system would "right itself" once the excesses were purged. Treasury Secretary Andrew Mellon was a proponent of letting the marketplace weed out the weak banks during the early 1930s. In the end, thousands of banks failed – not just the weak, badly hurting the economy.

The problem with counterfactual analysis is that the answer is usually less than fully satisfying. Would I be somehow better off if I'd become an orthopedic surgeon instead of an economist? I can speculate on the outcome but that's all.

So what's ahead? President Obama recently reappointed Ben Bernanke to another term as Fed Chairman. Of course, he still has to be confirmed by the Senate. While various politicians will use this as an opportunity to pummel the Fed, the odds are very high that he'll get more than enough votes.

As we discussed in the last newsletter, Bernanke's big challenge – perhaps his biggest – will be to reduce the Fed's enormous holdings of public and private securities to more normal proportions. As we discussed, the risk is not so much a surge of inflation but whether the Fed can pull this off without triggering a big rise in interest rates. With the demise of Fannie Mae and Freddie Mac, the Federal Reserve has purchased billions of dollars of mortgage backed securities. If it starts selling these off, will

mortgage interest rates climb at precisely the time that the housing market is just beginning to emerge from its huge slide?

The other big job facing not only the Fed but the Congress and the Treasury as well is how to deal with the issues of “moral hazard.” This is another one of those fancy terms used to describe a fairly simple concept. If you continue to rescue me from having to pay the consequences of my risky behavior, that behavior is very likely to continue and will probably increase.

President Obama has been calling for reform of financial markets. Among the likely components will be increased capital requirements for financial firms, streamlining of the regulatory process (we currently have multiple regulators of banks), increased authority to deal with “systemic problems” as well as measures to increase transparency in financial markets.

It remains to be seen whether the Congress is capable of passing the type of complicated legislation required for regulatory reform. One problem is that there are far too many agencies regulating financial services, but politics stand in the way of putting them all under one roof such as the Fed. Furthermore, why consolidate regulation under an agency that didn't use its existing authority to help head off the current crisis?

Higher capital requirements are very likely. Banks and others will be required to set aside bigger financial cushions against future losses. Another way of saying this is that less financial leverage will be permitted in the future. Leverage increases profits on the way up and magnifies losses on the way down. High leverage helps explain why even relatively small losses on investments can quickly lead to insolvency and bankruptcy.

There's also been some talk in Congress about reigning in the Fed through periodic audits. I guess this means that Congress would have the GAO (Government Accountability Office) study whether the Fed is meeting its legislative mandates such as maintaining stable prices and reasonably full employment. While superficially reasonable, this could have disastrous results. The Fed is widely viewed throughout the world financial system as being above politics. It makes mistakes but not because it tried to serve one political party or the other. The Fed is structured in such a way as to be *insulated* but not *isolated* from the will of Congress. Governors are appointed for staggered 14 year terms by the President with the advice and consent of the Senate. The Fed is not beholden to Congress for its annual funding. Instead, the Fed pays its expenses out of the earnings on its vast portfolio of securities and then turns the rest back to Congress.

I'm convinced that increased Congressional oversight and control of the Fed would result in higher inflation, higher interest rates and a likely plunge in the foreign exchange value of the dollar as financial market participants around the world grow skeptical about the U.S. Would you want to put monetary policy in the hands of the same people who have run up those enormous budget deficits?

Those who really understand our system realize that the Fed “does the heavy lifting” and “takes the heat” in trying to stabilize the U.S. economy. Can you imagine Congress having to vote for higher interest rates to keep inflation from rising in the future? The Fed's job has been described as “taking the punch bowl away just when the party is getting going.” I can't ever imagine Congress doing that.

Let's conclude on a much more concrete note, the most recent (September) forecast survey from the *Wall Street Journal* panel of economists, of which I'm a member.

The outlook is pretty good, a case of “all things in moderation.” The vast majority of those surveyed said the recession had ended during the second or third quarter of 2009. Real GDP (gross domestic product) is predicted to grow at a moderate pace starting in the July-September quarter of this year. This is followed by reductions in the unemployment rate next year. The economists support my view that inflation isn't a problem, with the CPI (Consumer Price Index) rising less than 2 percent through the end of 2010. The expected rise in interest rates is rather small – less than a percentage point from mid-September 2009 levels. I hope we're right!

U.S. Economic Forecast: 2009 and 2010

	2007	2008	2009	2010
Real GDP % CH	2.5	-1.9	-0.7	2.8
CPI% CH	4.1	-1.0	1.5	1.8
Unemployment %	5.0	7.6	10.0	9.3
Fed Funds	4.25	0.13	0.20	1.04
10-yr Treasury %	4.03	2.25	3.81	4.37

Source: WallStreetJournal.com The GDP % change is from last quarter of previous year. CPI is from December 12 months earlier. Unemployment, Fed funds and 10-year Treasury note are for December.



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