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My name is Peter Morici. I am an economist and professor at the R.H. Smith School of Business, University of Maryland, College Park. Thank you for the opportunity to testify. I am honored by your invitation.

The United States is beset by the most troubling economic crisis since the Great Depression and perhaps the most complex and difficult to resolve set of economic challenges in the peacetime history of our nation.

This crisis has origins in domestic and international economic policies pursued by the United States and other nations. Often well intentioned and consistent with prescriptions of the consensus of economists, these policies have interacted to create what may prove to be a perfect storm—confounding assumptions about economic policy held dear and championed by enlightened policymakers and economists, including this one, for two generations.

Effective national response that ensures prosperity and a reasonable measure of equity require that we acknowledge our mistakes—both those of well intentioned policymakers from both political parties and the community of analysts and academics that advise them. Also, effective responses require that businesses acknowledge that strategies that have served their interests in the short term have not served the public good over the long haul, and the resulting systemic calamity serves no one's interests and threatens the vibrant market economy that sustains all our wealth and the hope we all share for our children.

What Caused the Crisis?

Most fundamentally, the recession, which may now become a depression without more effective policy responses, has origins in the interaction of changes in our banking and financial systems, energy policies and trade policies, and in the actions of foreign governments.

The U.S. economy enjoyed two long economic expansions, interrupted by a reasonably benign recession in 2001. During the 1990s, the expansion was export led for most of the decade, whereas the expansion of this decade has been characterized by growing trade deficits, averaging more than five percent of GDP from 2004 through 2007 and receding, with the onset of recession, to a still high 4.7 percent in 2008.

Some critics warned of the dangers of such large deficits, while others argued that the resulting inflows of capital represented investments in the United States and confidence in quality of economic policy and future growth of the U.S. economy.

The fact is most of the money was raised by borrowing or selling off fixed assets and was not new productive investments. Much was used to prop up consumption, and some was used to leverage investment schemes that proved more speculative than productive. Much was provided by sovereigns and near sovereigns who were merely looking for hard currency parking places for cash and safe political environments in the event political conditions changed elsewhere in the world.

The largest components of these deficits were net imports of oil, principally to fuel automobiles, and a growing trade deficit with China. In 2008, those components alone totaled 96 percent of the trade deficit.

The trade deficit on oil was the result of domestic policies that neglected domestic oil and gas development and that failed to fully exploit alternatives to conventional fuels and build out energy-conserving technologies.

Those policies maximized dependence on foreign sources of oil. Coupled with rapid growth and fuel subsidies in the developing countries of Asia, U.S. energy policies helped push up global crude oil prices and the U.S. petroleum trade deficit.

China controls foreign exchange transactions and manages the value of its currency. It set the yuan-dollar exchange rate at an artificially low value in 1994 and fixed that rate from 1995 to 2005. From mid-2005 to mid-2008, China permitted some modest revaluation of the yuan; however, this was not nearly enough, and the yuan remains significantly undervalued. Since July 2008, the value of the yuan has not changed much.

The undervalued yuan provides Chinese manufacturers with a huge export subsidy and a hidden tariff on imports. China is using its currency as a development tool, but this victimizes otherwise competitive businesses and their employees in the United States.

In response to the recession, China has again frozen the level of the yuan and laid on additional export subsidies, seeking to export its recession in the worst tradition of Smoot-Hawley.

In addition, China maintains high explicit import tariffs. Through these and other regulations, it essentially requires foreign manufacturers to locate in China to service its market and for their suppliers to relocate to China, further accelerating the decline in U.S.

manufacturing. This creates a pattern of international trade, specialization and production that confounds expectations for trade based on comparative advantage—the kind of trade that was expected to follow from China's accession to the WTO in 2001.

China essentially exports products where its abundant supply of low-skilled labor offers an advantage, and it refuses to import products such as metals and automotive products, where it does not enjoy a comparative advantage. In fact, China exports some products that it would import with free trade based on comparative advantages, instead of managed trade based on its mercantilist policies.

This has deprived the United States of the macroeconomic benefits of free trade with China, driving down U.S. living standards. In recent years, living standards were propped up by borrowing from China and others, creating a false sense of national economic security, but the depth and length of the current recession has now exposed that fallacy.

Along with similar policies elsewhere in Asia, China's mercantilism has given rise to a global imbalance in production and consumption. China, other Asian countries and the Middle East oil states often produce more than they consume, and the United States and other western countries consume more than they produce. Surplus countries amass reserves of dollars, Euros and other hard currencies, and invest those in western capital markets.

Until recently, western banks recycled those savings into the hands of U.S. and western consumers by letting them borrow on their homes and through unsecured or weakly secured credit card and auto loans. Foreign funds were also recycled into the hands of hedge funds and private equity firms, who frequently made foolish investments with cheap capital—consider Cerberus' purchase of Chrysler.

In the United States, rising trade deficits should have caused one of two things to happen. Either the value of the dollar should have fallen to facilitate an increase in exports and decrease in imports, or inadequate aggregate demand would have caused a recession. The foreign exchange value dollar could not adjust to adequately redress the trade deficit; because Middle East and other oil exporters price petroleum in dollars, and China simply intervened in foreign exchange markets, buying more and more dollars, to keep its currency from rising in value as it should have. And foreign borrowing permitted Americans to consume much more than they produced and for the U.S. economic expansion to go on much longer than it should have. Foreign borrowing delayed the recession that should have happened sooner, and if it had, would have been much more benign than the crisis we now confront.

Essentially, a 5 percent trade deficit requires Americans to spend 105 percent of what they produce and earn to sustain aggregate demand for what they produce. Without exchange rate adjustments that rebalances trade or massive foreign borrowing, that deficit in aggregate should have caused inventories to mount and produced a recession.

Foreign private investors should not have been expected to provide such credit, because foreign investors should have expected the bonds and loans of an economy consuming so much beyond its means to eventually default and for the values of its real assets (stocks and real estate) to drop in value. In fact, that is what eventually happened in the United States when the reckoning arrived.

Much of the credit was provided by China and other sovereigns and near sovereigns whose motivations were not merely to obtain safe returns on fixed income assets when they purchased U.S. bonds, bank deposits and property but rather to facilitate export-led growth and park money in politically safe places. That is one important reason why Americans were permitted to borrow so recklessly, and why the recession did not happen sooner and the recession is now so severe.

Role of Banking Policy

Changes in the U.S. banking system permitted American consumers and investors—hedge fund and private equity managers, corporations engaging in leveraged buyouts, and others—to enjoy access to inexpensive financing that would have not been possible three decades ago.

The Savings and Loan Crisis of late 1980s and early 1990s was caused by the deregulation of interest rates (principally, repeal of regulation Q), the growth of nonbank depositories (principally, brokerage depositories and venues for medium-term deposits that compete with bank CDs) and changes in U.S. tax laws that limited deductions on rental property held by private individuals.

In a nutshell, banks were caught with long term mortgages on their books, whose rates reflected lower, regulated deposit rates of years past. They were compelled to compete for deposits and pay higher interest rates than the mortgages on their books were paying.

Correctly, banks concluded that without regulated rates on deposits and those of competing non-bank depositories, banks could no longer, as much, lend long and borrow short. Hence, they could no longer hold on their books as many long-term mortgages financed solely by deposits and CDs.

After the Savings and Loan Crisis, banks turned increasingly to securitizing loans. The banks wrote mortgages, auto and other loans and sold those to money center banks, which in turn bundled those loans into bonds and sold the bonds to fixed income investors, like life insurance companies, pension funds, private investors, and foreign sovereigns.

Those investors could better bear long-term interest rate risk than banks. However, securitization resulted in a disconnection between those who wrote the loans and those that held the loans and bore repayment risk. That created subtle and for a long time unnoticed changes in the incentives for those agents who actually take mortgage applications.

The repeal of Glass Steagall in 1999 made possible the completion of a reorganization of the ownership of banks. Increasingly, large money center banks, which underwrite mortgages and securitize regional bank loans for sale to fixed income investors, combined with brokerages, securities dealers, investment banks, private equity, and even hedge funds. Historically, those nonbank businesses compensated executives at higher salaries than banks—simply, dealmakers and salesmen are paid better than other executives in most branches of the economy.

Unfortunately, folks that performed heretofore conventional banking services began to expect to be compensated by bonus systems that paid much more than traditional banking entities paid. It is simply not possible to pay those in the chain of lending and securitization—from the mortgage broker in Topeka, to the regional aggregator in St Louis, to the New York banker that securitizes loans—the kinds of salaries paid many others in the financial sector by borrowing at 5 percent and lending at 7 percent, without writing irresponsible mortgages and creating derivatives that cannot deliver on their promises. However, that is exactly what happened for at least three sets of reasons.

First, bond rating agencies did not effectively evaluate the collateralized debt obligations (CDOs) and mistook credit default swaps for real, effectively-collateralized insurance. Payment systems for bond ratings contributed importantly to blinders at these institutions, as well as simple moral failure by executives and their economists and finance specialists.

Second, a good deal of the money flowing into U.S. and other credit markets was provided by sovereigns and near sovereigns (Middle East royals and other private actors with easy access to very cheap funds) who often do not look at financial instruments with the same discerning eye as someone who needs to answer to shareholders or private individuals putting up nest eggs to retire, educate children or leave a legacy.

Third, a good deal of the money was put at play by U.S. investment managers incentivized to take big risks—through heads I win, tails you lose bonus schemes—and that created an appetite for credit that should have made banks wary but did not.

At banks, moral failure resulted when the culture of hedge-fund and private equity fund risk taking infected their assessment of risks along with the adoption of bonus based compensation schemes.

The expansion of the U.S. economy and trade deficits through the middle and latter half of this decade should have resulted in a much sharper devaluation of the U.S. dollar than experienced from late 2005 through mid 2008 and in a very different structure of devaluation against other currencies. Such currency realignments would have substantially curtailed imports of oil and goods from China and elsewhere in Asia; *or* a recession would have happened much sooner than it did.

Instead, foreign sovereigns and U.S. banks helped American consumers, businesses and investors become overleveraged. Eventually, the preposterousness of many of the loans became apparent and those loans failed, setting off a chain reaction that has been euphemistically called deleveraging and the negative feedback cycle.

As importantly, the largest and most important U.S. banks got stuck with many of their own poorly written CDOs and loans on their books when the collapse came. The latter were often insured by credit default swaps that lacked adequate collateral, such as those written among major securities dealers and banks and by AIG.

The bad judgment that bankers had recommended their investor customers embrace became the noose that hung them too. In a tragedy of the legal system and manifest inequity, bank stockholders have been ruined, while bank executives have been protected by the indemnity of employment contracts and escaped with their fortunes.

We have heard a lot about the moral hazard that could be created by forgiving mortgage debt. However, the sense of betrayal among ordinary people engendered by the great escape of bankers' fortunes may fray faith in honest work far beyond measure. Economists may not like to talk about this, because they can't reduce it to a number; however, the disruption of national confidence in markets and capitalism propagated by the escape of bankers' fortunes may prove to the worst legacy created by the current Wall Street morass.

Getting Out of this Mess

The evidence mounts daily that the United States is in the greatest economic crisis of our times, and the ultimate place of this crisis in the history of economic disasters is yet to be determined.

The country needs more effective stimulus packages and programs to assist the banks than policymakers have been pursuing—a plan to stabilize conditions and avoid a complete meltdown.

More importantly and lacking from the proposals of the Administration and Congress, the nation—the government, individuals and private business—need to correct the structural problems that created this crisis if it is to resurrect American growth and prosperity.

1. A stimulus package is needed because the demand for goods and services is insufficient. Aggregate demand is insufficient because, near term, consumers and businesses are deleveraging and many banks are dysfunctional.

   Longer term, the economy suffers from a structural shortage of demand for goods and services. As long as the economy has trade deficits that are five percent of GDP or more when it is growing, Americans will have to consume more than they produce to have adequate demand for U.S. goods and services.

   As currently formulated, the stimulus package will give the economy some lift and restore some employment, but once its effects are through, aggregate demand will prove inadequate. Without fundamental changes in the current structure of U.S. trade—massive imports of oil and consumer goods from Asia that are not fully paid for with exports—either Americans will have to borrow as consumers, businesses and investors from the rest of the world and create another credit and asset bubble, *or* the U.S. government will have to borrow on their behalf and run successively larger budget deficits.

Unless the United States resolves the problem of the structural trade deficit, the U.S. economy will require ever larger private borrowing and excessive spending, or ever larger stimulus packages and federal budget deficits, to keep the economy from melting down.

2. The bad assets on the books of the banks are so huge, that no solution short of nationalization—which I oppose—is possible without removing those bad assets through some kind of bad bank or aggregator bank that performs the services provided by the Resolution Trust Corporation during the Savings and Loan Crisis. Without such a vehicle, the amount of preferred shares or noninterest bearing common shares the government will purchase from the banks to help them cover losses will constitute *de facto* nationalization. With the bad assets removed through a bad bank or aggregator bank, the banks could then be recapitalized privately and then pay back their TARP funds.

To resolve the structural trade deficit, the United States will have to have very different approaches to energy and trade policies than in the past.

On the energy front, the nation needs to build out many of the alternative energy sources and embrace many of the conservation measures the environmental community advocates, but the nation must also do many things environmentalists oppose. These include aggressively developing domestic sources of petroleum and gas and building out nuclear power quickly.

Policymakers should not be fooled into believing higher energy prices alone will provide needed results. If higher gas prices would do the trick, then the German automakers would be leaders in hybrid autos and battery powered vehicles, and they clearly are not.

Similarly, a CO2 tax would disadvantage U.S. industry vis-à-vis foreign rivals in China and elsewhere. It would merely encourage more manufacturing to relocate to these places and raise global CO2 emissions. Every time a manufacturing job leaves Indiana for Shanghai, global emissions go up, because China uses fossil fuels so much less efficiently than does the United States. That is why with a GDP one-third the size of the United States, China emits more CO2 than the United States.

A CO2 tax in the United States without a CO2 tax in China will make Americans poorer and the problem of global warming worse. Such a tax without absolutely comparable policies in China and other major developing countries is absolute folly.

Regarding nonenergy trade, no solution is possible without addressing the trade deficit with China, and its manipulated exchange rate and other mercantilist practices. And given the role of the trade deficit in the nation's macroeconomic problems and sovereignty problems foreign borrowing creates for the United States, no public policy problem is more urgent.

Americans need to recognize that China is hardly a market economy in a western sense and is still highly state managed. Its financial system may not be able to sustain an unmanaged floating exchange rate; however, China can manage the value of the yuan at 4 as easily as it does 6.8. In fact, it would be a lot easier to manage a value closer to balance of payments equilibrium.

Simply, the United States should give China the opportunity, with a hard deadline, to manage down its trade surplus with the United States, either through meaningful and complete currency revaluation—complete means raising the dollar value for the yuan to a level that reduces China's trade surplus with the United States by one third each year and to zero after three—or through other domestic means of Beijing's choosing.

If China declines, the United States should simply tax dollar-yuan conversion in proportion to its official and surrogate currency market interventions. The United States should impose a tax equal to the quarterly value of China's intervention divided by its exports of goods and services. China would then have a strong incentive to reduce and then stop intervening.

If China does not reduce and eliminate intervention and chooses for the United States to tax currency conversion, then the benefits from a revalued yuan of higher prices for Chinese imports that should go to Chinese businesses would instead go into the U.S. Treasury. If China reduces and then eliminates one-way intervention and lets its currency rise to a value that balances trade, Chinese businesses would capture those benefits in the form of higher dollar prices for their goods.

Eliminating the trade deficit with China by eliminating or at least redressing currency manipulation would have a much greater stimulus effect on the economy than the package just approved by Congress. It would inspire a renaissance in manufacturing and restore American growth and wages in a manner and magnitude no public policy this Congress could implement could ever achieve. Simply, it would permanently increase aggregate demand for U.S. goods and services, while raising revenue for positive public purposes; it would restore incentives for the efficient use of labor and capital that free trade should normally provide.

Redressing the trade deficit with China in this manner would not be protectionist. China's actions now are protectionist, and constitute a modern day Smoot-Hawley. China's policies are about as protectionist and predatory as could ever be conceived by the most skilled Seventeenth Century mercantilist, and are an absolute threat to U.S. prosperity and sovereignty.

I am not advocating protectionism—let China stop rigging its currency and trade and the United States can and should compete. I am advocating the United States abandon a policy of appeasement in commerce and embrace self defense and self preservation.

All countries practice the equivalent of Buy American and in most cases more aggressively than does the United States. The WTO Procurement Code provides for exchange of national treatment for certain purchases, and that is the extent of U.S. international obligations. It does not apply to developing countries, like China, that have declined to sign the code.

Americans should not expect much of China's stimulus package to be spent in the United States owing to its protectionist policies, and given China's contribution to the current mess here, it would be folly not to apply Buy American to U.S. purchases that might otherwise go to China and other countries that have not signed the Code, or whose actions in the current crisis do not warrant national treatment.

Regarding the banks, the Treasury needs to take the following steps: initially, it needs to organize a bad bank or aggregator bank to sweep all the questionable mortgage-backed securities from the books of the banks and require the largest banks, including securities companies with bank status, to undertake aggressive and sweeping management reforms and changes in compensation schemes for professionals engaged in commercial banking and securitization activities. Such changes should be required for any institution enjoying bank status under the TARP, at the Federal Reserve discount window or FDIC insurance.

With these in place, the banks should be able to raise private capital and repay TARP funds, and the Congress should reconsider the segregation in ownership of banks and near banks, meeting the above criteria, from other financial institutions.

The bad bank or aggregator bank could be capitalized with $250 billion from the TARP, and it could raise additional capital by selling $250 billion in shares to private investors and another $500 billion to $1.5 trillion by issuing bonds. The commercial banks could be paid for their securities with 25 percent in special common shares and the rest in cash. These special shares could only be redeemed after TARP financed shares, private shares and bond holders were paid.

This entity could purchase all of the questionable mortgage-backed securities from commercial banks at their current market-to-market values on the books of the banks and purchase those in the hands of other investors too. If 2 trillion in TARP and private money is not enough, then the above dollar figures could be scaled up proportionately and even doubled.

The bad bank or aggregator bank could determine the number of defaults by performing triage on mortgages—deciding which homeowners if left alone will pay their mortgages, which if offered lower interest rates and moderate principal write downs could reasonably service new loans, and which must be left to fail.

Implementing those standards and necessary mortgage modifications across the entire market would, at once, limit the number of defaults and determine how much housing prices will ultimately fall. That is something the individual banks cannot accomplish acting independently.

By sweeping all the mortgage-backed securities off the books of the banks and limiting losses on those securities, the bad bank or aggregator bank would earn money by collecting payments on the majority of mortgages that ultimately pay out and sell off repossessed properties at a measured pace. Like the Savings and Loan Crisis Resolution Trust, and the Depression-era Home Owners' Loan Corporation, it would likely make a profit.

Relieved of the mortgage backed securities, the banks would not be trouble free—they still have auto loans and credit card debt to repent. However, having huge deposits and vast networks of branches, they would be worth a lot to investors again, and could raise new capital, repay their TARP contributions and write new mortgages.