Testimony of Robert J. Shiller

Arthur M. Okun Professor of Economics and Professor of Finance, Yale University
Research Associate, National Bureau of Economic Research
Co-founder and Chief Economist, MacroMarkets LLC

Submitted to the Congressional Oversight Panel
January 14, 2009

Madame. Chair and members of the Panel, I thank you for the opportunity to testify today. My name is Robert J. Shiller, and I am Professor of Economics and Finance at Yale University, author of the books about the current crisis *Subprime Solution*, 2008 and (with George Akerlof) *Animal Spirits*, 2009, Research Associate, National Bureau of Economic Research, and Co-founder and Chief Economist, MacroMarkets LLC.

The Congressional Oversight Panel has an important mission, for it is in charge of evaluating Treasury's spending of up to $700 billion in the Troubled Asset Relief Program (TARP). That amount is $2300 for every adult and child in the country, and the citizens have the right to demand that this money, taken from them and spent on their behalf, is spent wisely.

The Treasury could easily squander the money. One difficulty is that the purpose of the TARP, preventing economic collapse, is challenging in many respects. Success depends on restoring a credit system that has come under great strain because of unanticipated system-wide problems, and restoring confidence.

The chief criticism of the spending of this money to date is that it has been *ad hoc*, and after-the-fact, and apparently devoid of any obvious principles. Treasury has been accused of dispensing goodies to large firms who have political muscle, and ignoring systematic allocation. They are accused of encouraging firms to rely as much as possible on government handouts, and to play games to receive such handouts. Such problems may be inevitable as we struggle to deal with a serious ongoing crisis, but we should get past them as quickly as possible.

Correcting this means that as soon as possible the interventions we have seen today should be replaced by or aligned with long-term systematic structures that are as market-oriented and apolitical as possible.

In its first report the Congressional Oversight Panel posed ten questions. Let us look at some of them here:

Is the strategy working to stabilize markets?"

"Is the strategy working to reduce foreclosures?"

"What have the financial institutions done with the taxpayers' money disbursed so far?"

I would also offer some slightly different questions:

"Is the strategy working to improve the functioning of markets to allocate risk and resources?"

"Is the strategy working to deal with foreclosures in the interest of all parties, including those who invest in mortgage securities and those who would borrow with mortgages in the future?"

"Does the financial institutions' use of the money disbursed so far indicate that they are functioning better as conduits of information and providers of intermediation services ?"

Answering such questions means addressing the allocative and incentive effects of structures that are set up to deal with the crisis. And answering such questions best takes the form of proposing specific procedures or institutions that deal with financial crises by making the responses systematic.

I want to discuss some such ideas today that are not just my own, but that have been hashed out recently by the Squam Lake Working Group, of which I am a member. This group is non-affiliated, and genuinely non-partisan, of academics who first convened at Squam Lake New Hampshire in November 14-15, 2008 and have been meeting since to come up with a method of dealing with the current U.S. financial crisis.

In my opinion, this group has particular authority in this financial crisis because of their expertise in the area of creating the proper risk management and incentive environment. They are expert in exactly the issues that informed criticism of TARP has been focused.

The problem we are facing, and which motivates much of the actions of the Troubled Asset Relief Program (TARP) is that banks, and related financial institutions, are in trouble: they do not have enough capital to lend, and so have been sharply curtailing their discretionary lending activity and support of securitization of credit instruments.

But, as modern financial theory reveals, and as described in a classic paper by Prof. Stuart Myers at the Massachusetts Institute of Technology, a "debt overhang problem" may inhibit banks' raising more capital at a time of financial crisis. When debt looms large relative to financial outlook, new providers of capital may not have an incentive to come forth because they know that a large part of the return of their investment will go just to paying off the banks debts. Hence, at a time of a systemic financial crisis, relatively little capital is provided, and, unless there is government intervention, the firms will try to restore their capital ratios by dumping their assets on the market to restore capital ratios, rather than by raising more capital. Fire sales of troubled assets occur. Though banks did raise equity in response to reported losses in the recent crisis, there is concern that banks may not do so adequately in extreme events, and that they may under-report losses to avoid raising additional equity.

The banks do not have an incentive to raise new capital. Instead, they become vulnerable, and, unless they are helped, would tend to fall into bankruptcy. Moreover, banks have little prospect of emerging as functioning organizations once they enter bankruptcy, because of the complexity of their interrelations with others. Thus, a rash of bank shutdowns threatens the lifeblood of the system.

The TARP was initially planned to buy the troubled assets, preventing their fire sales from depressing the market too much. In fact, the TARP became involved with supplying capital to the banks from the government when private suppliers were not around. These measures, while useful in the emergency situation we have been facing, are not ideal. The Treasury cannot, despite its good intentions, allocate capital the way a broad marketplace can.

The Squam Lake Group has considered a number of other ways to deal with this fundamental problem.

Notably, they have recommended that if banks issue a new form of debt that they have named "regulatory convertible debt" these securities would count as bank capital. This new kind of debt automatically converts to equity at a trigger based on systemic as well as individual bank parameters, or at the discretion of regulators during a financial crisis. It would have the regulatory capital advantages of equity and the tax advantages to corporations that debt has, until it is converted, but would serve a different function in a crisis by bolstering capital.

By encouraging banks to issue a good share of their debt in this form, regulation could insure that there is a smooth transition-with fewer systemic ill-effects, of the next banking crisis.

There may be other ways to achieve much the same end, which is to install a macroprudential regulation that is countercyclical and that results in capital requirement loosenings, rather than tightenings, in times of stress. We do not have such regulation in place today, and so we remain in a difficult situation which TARP has been trying to deal with in the best way possible.

Taking steps towards long-term solutions does, however, help the immediate problem, for it helps restore confidence and trust in our system, and encourages people to think that we are moving to a better and stronger economic system, rather than a patchwork one.

The panel can best fulfill its mission by reporting to Congress on regulatory changes, like regulatory convertible debt, that will make for a free-market system of finance that will make the measures taken to date by Treasury unnecessary in the future.

References:

Congressional Oversight Panel, "Questions about the $700 Billion Emergency Economic Stabilization Funds" December 10, 2008

Congressional Oversight Panel, "Accountability for the Troubled Asset Relief Program," January 6, 2009.

Myers, Stuart C., "Determinants of Corporate Borrowing," *Review of Financial Studies*, 5:147-75, 1977.

The Squam Lake Working Group on Financial Regulation, "Expedited Resolution Mechanisms for Distressed Financial Firms," January 2009, www.SquamLakeWorkingGroup.org