The Economic Crisis and American Foreign Policy

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Thank you, Mr. Chairman and Members of the Committee. It is my honor to be here to discuss the current economic crisis and its impact on American foreign policy.

Let me begin by stating the basic principle that underlies my thinking. I believe that America is a Cause as well as a Country. From our inception as a new nation, we have been a champion of the cause of both economic and political liberty. Many generations of American patriots have given their lives to not only defend our own freedom, but to end tyranny abroad. They did so not only because they believed that it was the right thing to do, but also because our own freedom and our own security are inextricably linked to the success of liberty around the globe.

I therefore believe that the biggest threat from the current crisis is the threat that it poses to liberty as governments react to events. Economic distress makes it easier for demagogues to come to power who are not friendly to either America the Country or to the Cause we represent. Even in the world's established liberal democracies there is a risk that elected leaders adopt narrow self-interested parties that might seem to be a short term remedy to a domestic political problem, but actually exacerbate a global downward spiral.

Therefore, if we truly want to bolster the cause of American security we must by our own actions work to continue the advance that liberty has made around the world over the past quarter century. There are a number of specific things that this Congress can do in this regard.

First, we must stop thinking and speaking of the current global crisis as one that originated in America. We demean ourselves by doing so and only encourage those who wish us ill. America played its role and made its share of mistakes, and the fact that we are the largest economy on the planet means that our mistakes were quantitatively larger than that of any other country. But an examination of the facts suggest that we did so not because we are Americans, but because we are humans, and humans just about everywhere on the planet were doing the same thing.

Consider the first two charts attached to this testimony. The first chart shows house price appreciation around the globe during the recent bubble from 1997 to 2008. We all know that one of the root causes of the current crisis was very rapid and unsustainable appreciation in real estate prices. But America does not stand out as at the top of this list; house price appreciation here was less than in most other places. The only two exceptions to rising house prices over this period were Japan, which was suffering from the ongoing collapse of its earlier bubble, and Hongkong, where it made a transition from governance as a British territory to its current status as a Special Administrative Region of China.

The second chart shows that the excess leverage which contributed to our house price appreciation was also not an American phenomenon, but a human phenomenon. Our mortgage debt to GDP ratio was not exceptionally out of line with that of other countries.

It is, and always has been, comforting for politicians in other countries to blame their own problems on America. There is nothing we can do about this since their only alternative is to blame themselves. But we shouldn't encourage it. This was not an American created crisis – it was a globally created crisis.

Some of the blame lies with the economics profession which developed a wrong headed consensus view that *inflation targeting* was the right way to conduct monetary policy. Unfortunately, their definition of inflation was focused on goods and services prices and left no room for the incorporation of asset prices. The Federal Reserve was a part of this process and the bulk of the American economics profession also held to this view. But it was a global consensus within the economics profession, and not just the American economics profession.

Not everyone shared this view. We debated this issue on the Federal Open Market Committee while I was a Governor, most notably at our meeting on September 24th, 1996. (1) In his famous Irrational Exuberance speech later that year Chairman Greenspan specifically warned of the risks inherent in not incorporating asset prices into our calculations, saying on December 5th:

"But how do we know when irrational exuberance has unduly escalated asset values which then become the subject of unexpected and prolonged contractions, as they have in Japan over the past decade? And how do we factor that assessment into monetary policy? We as central bankers need not be concerned if a collapsing financial asset bubble does not threaten to impair the real economy, its production, jobs, and price stability. Indeed, the sharp stock market break of 1987 had few negative consequences for the economy. But we should not underestimate or become complacent about the complexity of the interactions of asset markets and the economy."[1]

But it was not just a consensus within the economics profession that was supportive of "inflation targeting" while simultaneously ignoring asset prices. Politicians around the world and of all political persuasions were also quite supportive of a monetary policy that let their constituents' assets rise in value in an unlimited way as long as goods and services inflation stayed under control.

The political reaction to the Greenspan speech was extremely negative, coming from members of both political parties. As a guest interested in adhering to good manners, I will not quote any of the reactions of members of the Congress to the Greenspan speech. Those interested in researching the issue can easily do a nexus search of the topic. And I would add that there were plenty of members from both parties in both the Congress and in the Clinton and Bush Administrations that opposed any actions that might have interfered with the asset price advance of the past few years.

So, it is an issue of a mistaken view of the economics profession any more than it is a mistaken view of Americans that led to the current crisis. It is a human phenomenon: everyone loves the kind of party that occurred. In fact, the response among European decision makers was even more supportive of this asset-price inflating doctrine than here in America. When then Chancellor of the Exchequer Gordon Brown established the rules

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[1] The transcript of that meeting reports that I said, "Everyone enjoys an economic party, but the long term costs of a bubble to the economy and society are potentially great. As in the U.S. in the late 1920s and Japan in the late 1980s, the case for a central bank to ultimately to burst that bubble becomes overwhelming. I think that it is far better that we do so while the bubble still resembles surface froth, and before the bubble caries to the economy to stratospheric heights. Whenever we do it, it is going to be painful, however." A very interesting analysis of the FOMC's approach to this issue is provided in <u>Bubble Man</u> by Peter Hartcher of the Sydney Morning Herald.

that gave the Bank of England independence from Her Majesty's Treasury, he explicitly made inflation targeting the sole objective of monetary policy. Moreover, he explicitly made the British Retail Price Index, similar to our Consumer Price Index, the measure of inflation that the Bank of England was to use. Like our CPI, the British RPI excludes asset price changes from its calculation.

When the political leadership of Europe negotiated the Treaty that established the European Central Bank they also created a single mandate of inflation targeting. Moreover, they chose an inflation index that also did not incorporate asset prices in the calculation. As a result, the European Central Bank has been far slower to react to the developing economic crisis than has the Federal Reserve. In addition, loans that supported asset prices that European banks made, particularly to Eastern Europe, were at least as egregious as those made in America.

But a second set of policy mistakes that led to this current crisis were decidedly non-American in origin. During the 1990s, many of the world's newly developing countries, most notably China, managed their currencies in a way designed to increase exports and build foreign exchange reserves. We used to call such policies Mercantilism, but diplomacy got in the way of the modern usage of that term. During the 1990s China actually devalued its currency in the face of rising exports. America's efforts in the current decade to get China to adopt less Mercantilist policies were slow to bear fruit. The small improvements that occurred in 2007 and 2008 have begun to be reversed in recent months.

The reason that this contributed to the Bubble and its Crash is that the result of a currency managed to maximize exports is a build-up of reserves which much find a place to be invested. China purchased hundreds of billions of dollars of U.S. Treasury and Agency securities, driving down our interest rates and facilitating the development of the housing bubble. The world saw the perverse economic result of Chinese workers and peasants being underpaid by their own government in order to finance the building of McMansions in America.

But this result had its positive geopolitical side. After the fall of the Berlin Wall, a foreign policy consensus developed that the best way to incorporate China into a peaceful global community was to promote prosperity in that country. The argument was advanced that richer nations have more of a stake in both maintaining the peace and in preserving the existing world order. Chinese Mercantilism, though economically inefficient, was a relatively painless and diplomatically acceptable way of advancing that cause because it led to rapid industrialization and capital formation.

This observation about the relationship between the Bubble and Geopolitics leads to a very important second point we must bear in mind. As painful as the current crisis is, it follows at the end of a very long boom that brought tremendous gains to literally hundreds of millions of people on this planet. Perhaps half a billion people in Asia have joined the global middle class in Asia alone during the last 10 years. The same is true for perhaps 200 million people in the former Soviet Empire and a similar number in Latin America. Hundreds of millions of children who would never have received anything more than the most rudimentary education now have acquired the skills to provide both for themselves and for future generations. Health care and life expectancy have increased tremendously. On a very real human level the past 25 years have meant improvements for the human condition on an unprecedented scale.

Closer to home, real per capita disposable personal income in America grew 68 percent between 1980 when we began our experiment with open capital markets, free trade, and less regulation While America the Country has been partially responsible for this, the real credit goes to the Cause that America represents: economic and political liberty for the individual. Our foreign policy must keep this in mind as a central abiding principle and we must continue to assert American leadership in these areas.

A more prosperous world has helped make America a more secure place. Indeed, the greatest increased threat to our security comes from one of the few parts of the world in which real per capita incomes have not increased since 1980: the Middle East. (There are a few exceptions to this in some of the smaller countries of the Arabian peninsula.) Our long term global interests require us to continue to advance the causes which have led to global prosperity. If I could sum them up briefly these are the free movement of goods, capital, and ideas.

Today many of those causes are under assault. Some mistakenly interpret these objectives as the cause of our current crisis. Some merely oppose these ideas to advance their own power or their own special interests.

Since the end of World War II America has led the movement toward freer movement of goods across borders. This accelerated rapidly with the Kennedy Round of Trade negotiations in the 1960s, with the adoption of NAFTA under the leadership of Presidents Bush and Clinton, and the extension of that principle to a host of new free trade agreements.

Today free trade is under assault. Congress recently, and probably inadvertently, set off a trade war with our second biggest export market, Mexico with a provision in the just passed stimulus bill regarding access to America by Mexican trucks. Europeans have objected strenuously to the Buy America provisions in the Stimulus package. By themselves these are relatively small measures. The great worry is that they might become part of a trend toward protectionism. We learned the hard way during the 1930s when ill-advised legislation – the Smoot-Hawley tariff – ignited a global trade war. We must not do it again. America should continue its historic leadership in promoting global free trade.

There is also an attack on the free movement of capital and ideas. Our own government has been guilty of this in both the case of the Dubai Ports case and in the matter of the purchase of Unocal by a Chinese oil company. Again, taken by themselves these are relatively minor matters. The risk is that they develop into a trend. But other countries are already beginning to do the same, placing limitations on foreign ownership of not only corporations, but also farm land. Isn't it simple common sense that two countries that invest in each other are much less likely to go to war with one another than two countries without such cross-border investment? Obviously domestic security issues and intellectual property protection are essential. But shouldn't those issues be addressed regardless who happens to own a particular company or sit on its Board of Directors?

The free movement of capital and ideas is also under assault by some who are now proposing increased restrictions on a variety of global financial intermediaries including private equity firms and hedge funds. European politicians in particular argue that financial intermediaries such as hedge funds are to blame. But no hedge funds have been bailed out in this crisis. The bailouts have gone to regulated financial institutions such as banks and insurance companies.

These regulated institutions often erred by taking risks that only hedge funds and private equity firms should take, but their mistakes led to bailouts because they lack the discipline that hedge funds have in having their limited partners, not depositors or contract holders, suffer whatever losses they might incur. Because they lacked that discipline, these regulated institutions actually took on greater leverage than the hedge funds and private equity firms they were trying to emulate. If we are going to have a prosperous global financial system going forward then we need to make sure that we regulate those firms, such as banks and insurance companies, who are betting the funds of innocent people like depositors and holders of insurance contracts.

I believe that the most straightforward way of doing so is to reinstate minimum leverage ratios for these institutions that are in addition to the supposedly more sophisticated risk-based capital rules that are in place. Risk weightings and even supervisory judgments are inherently linked to the recent performance of the particular asset class in question. Recent experience has taught us that recent performance is not necessarily a fool proof guide to future results.

But we must also make sure that we leave a lightly regulated sector that can actually take the risks inherent in any economy that are inappropriate for the more heavily regulated sector. The tradeoff for little or no regulation is that it is the investors in those funds, and not the general taxpayer, enjoy the benefits of success and bear the burden of losses. In various global forums, the United States should defend the rights of financial intermediaries to operate with relatively light regulation provided that they do not possess any claim on the taxpayer.

Our security as a nation depends crucially on a resumption of the path we have been on for the last quarter century toward ever greater global prosperity. But that prosperity requires a continued effort by the American government to promote the Causes that have made America great: economic and political freedom in particular. That may not be the politically popular thing to do in times of economic stress, but putting the long term security and prosperity of America and the world ahead of short term political popularity is what leadership is all about.