Speeding Up the U.S. Economic Recovery

Lawrence J. Lau[1]

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1.Introduction

Thank you so much, Michael, for that most generous introduction. First of all, I would like to thank, on behalf of Ayesha and myself, the conveners of this wonderful occasion: Michael Boskin, K. C. Fung, Nicholas Hope and Dale Jorgenson. Unfortunately, Nick cannot be with us today. I am most honored by the presence and the kind words of my teachers, colleagues, collaborators and students, who have come from both near and far. It has been a great day for me, and for Ayesha as well. I really cannot thank all of you enough!

Two individuals, one here and one not here tonight are responsible for my becoming an economist. I entered Stanford University as a freshman in 1961, almost fifty years ago, and took my very first economics course from Jack Gurley. I still remember him talking about Economics being a SAD subject, concerned with Stabilization, Allocation and Distribution. I was so inspired by Jack that I decided to double-major in Economics and to do graduate work in Economics at the University of California at Berkeley after my graduation in 1964. The other individual is Dale Jorgenson, whom I met at Berkeley, yet another inspiring teacher and mentor. I learned from Dale, through his words and deeds, what an economist should be. Dale taught me the importance of integrating theoretical analysis with empirical research: that every empirical study must begin with a rigorously derived theoretical model, that such a model must have empirically observable implications that can in principle be used to validate the model or to improve the efficiency of the estimation. But equally important is the precise definition and empirical measurement of

[1] The author is Ralph and Claire Landau Professor of Economics, The Chinese University of Hong Kong and Kwoh-Ting Li Professor in Economic Development, Emeritus, Stanford University. These remarks were prepared for presentation at a Conference Honoring Lawrence Lau at Stanford University, December 4, 2010.

economic variables, for they can affect the outcome of the empirical analysis as well as its interpretation. Dale paid meticulous attention to the proper measurement of critical economic variables such as the cost of capital, and his approach has now been adopted by many national statistical agencies around the world. Dale and I collaborated closely on studies of production and consumer demand for many years. I wish we had continued—and my lifetime professional output would have been at least doubled what it is today.

My return to Stanford as an Acting Assistant Professor in 1966 was quite serendipitous. I was 21 then, happily enjoying my second year of graduate study at Berkeley, when I received a telephone call from the late Prof. Edward Shaw, offering me the position of an Acting Assistant Professor, with the responsibility for the field of the Chinese economy, but with no teaching duties in the first year. I had no clear idea what I was getting into, but the salary was much better than my fellowship, and no teaching duties sounded good, and so I accepted. Thus began my long career of 40 years at Stanford, until my formal retirement in 2006. I did construct the first econometric model of China in 1966, but did not really focus on the Chinese economy until much later, when China began its economic reform and opened up to the World in 1978.

It is fair to say that my entire professional career as an economist was at Stanford. (During my years as President of the Chinese University of Hong Kong, I did not really have time to do much research—I believe Sir James Mirrlees is the only other person from the Chinese University here tonight—thank you, Sir James, for coming.) At Stanford, I had the opportunity to learn from the leaders of our profession: Moses Abramovitz, Takeshi Amemiya, Theodore Anderson, Kenneth Arrow, Paul David, Mordecai Kurz, Ronald McKinnon, Melvin Reder, Henry Rowen, Tibor Scitovsky, Michael Spence, Joseph Stiglitz and Lorie Tarshis, to name only a few. Bert Hickman introduced me to Project LINK, a project led by Lawrence Klein, to link together the individual national econometric models of the World, based on the perfectly unexceptionable idea that one country's exports must be another country's imports and hence cannot be treated as entirely exogenous. Bert recruited me to participate in Project LINK and for many years I had the responsibility for maintaining and updating the econometric model of China.

While at Stanford I also had very fruitful collaborations with many colleagues such as Michael Boskin, Dean Jamison and Pan Yotopoulos. In fact, Michael and I are still working on a research project that we first started almost thirty years ago. We believe the end is in sight. Last but not least, I should also mention the late Ralph Landau, who was both a colleague and a staunch supporter of our Department and a great personal friend of mine and many others here (Claire Landau endowed the professorship that I currently hold at the Chinese University of Hong Kong). Ralph was an exceptionally creative chemical engineer. He had this "can-do" attitude: he believed that every problem has a solution and our job is to find it. In my talk tonight, I would like to propose several ways, with varying degrees of seriousness (after all, we are supposed to have fun tonight), through which the U.S. economic recovery could have been or be speeded up more effectively.

2.The Causes of the Financial Crisis

I do not wish to go over the causes of the global financial crisis, which are probably well known to all of you, in any detail. The global financial crisis occurred principally because of (1) easy money in the United States; (2) failures of regulation and supervision; and (3) defects in the institutional design of the financial sector. The principal source of market failure--that the market failed to self-regulate and stabilize itself, is uncontrolled moral hazard. Many institutional features of the financial market, such as the lack of residual liability for originating mortgage lenders, allowing off-balance-sheet activities, virtually unlimited leverage of financial firms, and unrestricted trading in credit default swaps (which is equivalent to allowing everyone to buy fire insurance on houses that he or she does not own or otherwise has an insurable interest), encourage moral hazard. Controlling moral hazard is important for averting a future financial crisis, but does not in itself help speed up the economic recovery. We therefore turn to the question of how to speed up the economic recovery more effectively.

3.More Effective Acceleration of the Economic Recovery

By "more effective" I mean that given the U.S. Government is going to be intervening in the market in various ways, is going to be either spending hundreds of billions of dollars or printing hundreds of billions of dollars worth of money, and imposing new regulations, could there be better ways of achieving the same objectives?

Resolving the Mortgage Loan Crisis

In addition to moral hazard, economists often worry about self-selection as a source of market failure, especially when it comes to insurance markets. But can we use self-selection to our advantage? The Troubled Asset Relief Program (TARP) was initiated by the U.S. Department of the Treasury to take care of the non-performing mortgage loans and the derivative mortgage-backed securities. Now, a couple of years later, the non-performing mortgage loans have remained non-performing and no resolution is in sight. The sad but true fact is that a successful resolution requires that both the lender (or the owner of the mortgage loan) and the borrower share the loss in the value of the mortgaged property, but there is no ready mechanism for them to do so. What could the Treasury have done differently?

The Treasury could have announced that it would purchase, on pre-specified dates, mortgage loans or mortgage-back securities with the TARP funds, up to a limit, say US$100 billion each time, from qualified financial institutions. However, each potential seller would have to tender its mortgage loans or mortgage-backed securities, indicating how much of a discount ("haircut") that it would be willing to accept from the face value of the loans. The Treasury would accept, at each date, those tenders with the highest discounts first, up to the limit specified for that date. Potential sellers that need the money more urgently, or whose mortgage loans are of poorer quality, or whose mortgaged properties have fallen proportionately more in price, or who are otherwise more realistic, would offer higher discounts. Those who fail to offer sufficiently high discounts would not be able to sell to the Government and would have to continue holding their mortgage loans or mortgage-backed securities. They could, of course, tender again at the next date, but everyone would also know that the Treasury would not have enough money to purchase all of the non-performing mortgage loans or mortgage-backed securities and that it would be first-come, first-serve for those willing to offer the highest discounts. (The Treasury always has the right not to accept any tenders if it considers all the discounts offered to be insufficient.)

The advantage of this approach is first, the Treasury needs to pay less than the nominal value of the mortgage loans, but second, and more importantly, any new direct or indirect owner of these mortgage loans, including the Government itself, would have some room to devise a work-out plan with the individual mortgagees, for example, through a reduction in the amount of the mortgage loan owed in return for continuing servicing of the (now reduced) outstanding debt. Thus, not only do the lenders, but also the borrowers would benefit from TARP. And once the problem of the non-performing home mortgage loans can be resolved at the household level, the life as well as the finance of the households can gradually return to normal, lifting their moods and expectations. And the overhang on the housing market will also be removed. All of this would augur well for a rise in household consumption. It is still not too late to try some variation of this idea.

To Save or Not To Save Lehman Brothers?

There continues to be a debate on whether Lehman Brothers could or should have been saved, and if so, how to save it. I do not believe that the U.S. Government should have bailed out the shareholders. However, in retrospect, it might have been cheaper overall, had the Government assumed responsibility for the outstanding Lehman Brothers bonds. As long as there was no default on the Lehman Brothers bonds, AIG would not have to pay off on the credit default swaps (CDSs) that it had sold on the bonds, and could have easily survived and might even have made a handsome profit, without any assistance from the Government. This is because the nominal value of the CDSs outstanding was tens of times of the nominal value of the outstanding Lehman Brothers bonds. Saving AIG has turned out to be much more expensive than saving the holders of Lehman Brothers bonds. This is a purely mathematical consideration. I do not believe the Lehman Brothers bondholders deserved to be saved either.

However, there was indeed a cheaper way of averting a default of the Lehman Brothers bonds. It is a well-established technique for a private firm to buy back its own debt from the market when it is priced by the market way below its face value. Lehman Brothers could not have done it in this instance because its credit had all but dried up in the days before its collapse as the CDS on Lehman Brothers bonds soared in value. However, the Federal Reserve Board could have loaned Lehman Brothers the money specifically to buy back its bonds, for say 20 cents on the dollar. Or, better still, the Federal Reserve Bank of New York could have gone into the market itself and bought up the Lehman Brothers bonds at a deep discount (or authorized an agent to do so). During those last days, other bondholders would only be too happy to sell. And if the Federal Reserve Bank of New York wound up owning all or most of the outstanding bonds, it could have negotiated an orderly takeover of Lehman Brothers without triggering a default. In this way, U.S. Government, and U.S. taxpayers, could have saved a great deal of money.[2]

Of course, this is water under the bridge now. However, this technique could be considered in the future, if, God forbid, another financial institution too big to fail is on the brink of failure. And this same technique may well have an application in the PIGS (Portugal, Ireland, Greece and Spain) crisis being played out in Europe right now.

Making Quantitative Easing II Work for the U.S.

Quantitative Easing II is a reasonable idea. In order to try to encourage people to invest, it is not enough to have low short-term interest rates—one must also have low medium- to long-term interest rates. However, this condition is necessary, but not sufficient. If expectations about the future are negative, then even low interest rates may not induce firms to invest. Moreover, there is no guarantee that the funds raised with these low interest rates will be used for investment in real economic activities, instead they can go into assets, real and financial. If they go into financial assets, yet another bubble may be created. Furthermore, there is also no guarantee that the funds will be deployed in the U.S. If they are deployed elsewhere, they will not do the U.S. economy much good. But even if all the money can be made to stay in the U.S., which is doubtful, there is still no guarantee that U.S. firms will undertake new investments. It all depends on their expectations of the future.

I am personally supportive of the U.S. Federal Government undertaking large public infrastructural investment projects at this time, not because they are necessarily the most productive, and not because they augment domestic demand and create employment in the U.S. but more importantly because this may be one of the few ways in which we can engineer a change in the public expectations about the future of the economy (I shall return to this

[2] Even more money could be saved if the Federal Reserve Bank of New York also shorted the CDSs on Lehman Brothers Bonds simultaneously as it purchased the Lehman Brothers bonds at a deep discount. However, it is not clear whether it would be allow to make short sales and in any case I am not in favor of trading of CDSs—they should be restricted to buying by owners of the underlying bonds, as is typical of insurance.

subject a little later). U.S. public infrastructure has actually begun to deteriorate over the past years so that such a program will not be a total waste, especially considering that the opportunity cost of the currently idle resources is likely to be low. However, there are many hurdles—legal, legislative, environmental and regulatory—to overcome for the Federal Government to be able to do so.

I have an alternate proposal—instead of having the Federal Government do it, we should let the fifty state governments do it. But where would they get the money? Many states, for example, California, are in dire financial straits. My proposal is that with the funds earmarked for Quantitative Easing II, the Federal Reserve Board should purchase bonds from all fifty states approximately in proportion to each state's population, bonds that are specifically designated for new public infrastructural projects within that state. The state governments must use the funds to finance new public infrastructural projects within their respective states, creating GDP and employment, and cannot use them for recurrent expenditures. For example, California will be able to use its share of the US$600 billion—approximately US$100 billion, to build a high-speed railway from San Francisco to San Diego. In this way, we are able to keep the money working in the U.S., and at the same time induce new real economic activity.

4.Changing Expectations

Bubbles are often sustained, if not caused, by self-fulfilling expectations; so are many economic recessions. If firms and households expect that an economic boom is at hand, and act accordingly, there will be an economic boom. If firms and households expect that there will be an economic bust next year, and act accordingly by reducing investment and consumption, there will be an economic bust next year. The realization of these self-fulfilling expectations further confirms that these expectations are correct and sustains them. However, there is a potential asymmetry in such self-fulfilling expectations—bubbles will always burst eventually but contractions may never stop. Left alone, expectations can turn around only when economic conditions deteriorate to a point when everyone agrees that they cannot possibly get any worse. And that may take too long. For example, the Japanese economy has been on this rut for two decades.

I believe the key to speeding up the economic recovery lies in changing expectations of households and firms about the future from negative to positive, and that can only be achieved by a new initiative that is significant enough. And the government is the institution that is uniquely positioned to take the lead in changing expectations. President Herbert Hoover did not succeed in changing the expectations about the future of the economy during his administration. President Barack Obama has not succeeded in changing the expectations so far. A large (it will have to be large) multi-year nationwide public infrastructural investment program may just do the trick. But one should understand that it is not just the public infrastructural expenditures themselves per se, but the change in the expectations that they may cause, that will ultimately speed up the economic recovery.

5.Concluding Remarks

The United States is the most innovative country in the World. And its society is also more flexible, open and pragmatic than most others. I am fully confident that the U.S. economy will be able to recover from this crisis and resume growing in time, but the sooner, the better.

Is there a silver lining shining behind the dark clouds? Did anyone benefit from the global financial crisis? Some might say that Wall Street did. I have to declare that I am also an unintended but significant personal beneficiary of this crisis. Soon after the collapse of Lehman Brothers, in October 2008, Mr. Donald TSANG, the Chief Executive of the Hong

Kong Special Administrative Region, appointed ten Hong Kong residents to a Task Force on Economic Challenges (TFEC) to advise him on how to deal with the global financial crisis. Amongst the members was a young lady named Ayesha Macpherson, Partner in Charge of Tax, Hong Kong Special Administrative Region, KPMG China, who is also here today. It is through the Task Force that Ayesha and I first met. And then we met again when I gave a public lecture and she came up afterwards to point out my mistake—and she was right. The rest, as they say, was history. We were married in a simple private ceremony in Hong Kong last January. Had Lehman Brothers been saved, Ayesha and I might have never gotten together!

My original plan , after my retirement from the Chinese University of Hong Kong, was to return to Stanford. However, Ayesha is an indispensable Partner of KPMG China. We have therefore decided to make Hong Kong our permanent home. And I have in the mean time accepted an appointment as non-executive Chairman of CIC International (Hong Kong) Co., Limited (a wholly-owned subsidiary of China Investment Corporation, the sovereign wealth fund of China, as well as a part-time appointment at the Chinese University.

Once again, Ayesha and I want to thank all of you for being here today, especially those who were speakers and who spent the entire Saturday afternoon with us. We extend to all of you a standing invitation to visit us whenever you come to our part of the World. We look forward very much to seeing you in Hong Kong. Thank you very, very much.