

Mr. William Dunkelberg, Chairman, Global Interdependence Center: ...Don Ogilvie goes way back with our guest speaker and he's going to introduce Marty Feldstein.

Mr. Don Ogilvie: Thank you and good evening. It's a great honor to be part of the festivities this evening and I think I have the best job of all, that of introducing our guest of honor. You know, being an economist nowadays is a tough job. Express a view and your every word is dissected. Miss a forecast and your credibility is on the line. Get it wrong and suffer scorn and abuse. We mock our economists, deride them if they're wrong, ignore them when they're right. Yet when things really turn bad, we want and need to hear from our economists. We want and need to hear from people like Marty Feldstein, an economist whose perspective is valued, whose forecasts are never off the mark and whose record of expert commentary continues to earn him the respect of policy makers around the globe, a loyal readership of his Wall Street Journal column, and a busy schedule of media interviews and broadcast appearances.

Most of us here know Marty. He's the George F. Baker professor of economics at Harvard University, the former chairman of the Council of Economic Advisors, and President Reagan's Chief Economic Advisor, former president of the American Economic Association, a member of President George W. Bush's Foreign Intelligence Advisory Board, and the President Emeritus of the National Bureau of Economic Research. That latter group is sometimes known as the good news people, the ones who told us that the United States is now in a recession and has been since December of last year. Marty's a member of NBER Business Cycle Dating Committee which made that call on December 1st, the day the DOW dropped 679 points. Comedy Central's Stephen Colbert said that night, "personally, I blame the geniuses at the National Bureau of Economic Research who thought it would be a good idea to announce that we're now in a recession." "Terrible move," said Colbert. "Everyone knows you keep bad news to yourself, holding it deep inside until eventually it kills you."

Fortunately, for us, Marty Feldstein has never been one to hold up the bad news or good news, for that matter. When he went to Congress last month, for example, he told the House Financial Services Committee candidly "I'm very worried about the U.S. economy" and he pointed at a potential continuing downward spiral in housing prices as the primary condition that now threatens the economy. In March, nine months ago, Marty used his Wall Street Journal column to propose a voluntary load substitution program, one that could help reduce the number of mortgage defaults and slow the drop in housing prices without bailing out lenders or borrowers or increasing government spending. A year ago he warned of a possible recession when others were still reluctant to utter the "R" word. Good news or bad, Marty is always an illuminating voice of reason, of candor, and of resolve. In March of '06, Marty spoke at a European Central Bank conference in honor of Otmar Issing, who was stepping down as the ECB's executive board, and in speaking of his record Marty said of him, "I want to talk about something different that's not been mentioned and that I think can be crucial for successful central banking, that is courage, the courage to stick with your beliefs, your convictions, the courage to speak about them publicly even when they're not popular, and the courage to act on them even if they will cause economic pain in the short run if you are convinced that they are the right policies in the longer run."

Ladies and gentleman, as we consider the contributions of Marty Feldstein this evening, his judgment, his science, all the rest, we likewise should not forget his courage, courage to stick with his beliefs and convictions, to speak about them publicly, to act on them where necessary, and even to reconsider them in the face of changing economic times. Being an economist today is a tough job, indeed. Being a dependably good economist seems even tougher. Would you say there are fewer than a dozen in the world today, less than a handful, a few? By any measure of that number, we'll probably all agree tonight that one of them is here with us tonight and doesn't it say something about a guy who says call me Marty. Ladies and gentleman, it's a great pleasure for me to present the winner of this year's Frederick Heldring Global Leadership Award, Dr. Marty Feldstein.

Dr. Martin Feldstein: Don't thank you very much. Thank you for that very nice introduction. I'm amazed at how much research went into that and I'm certainly very honored to receive the Heldring Award and pleased to be here in Philadelphia with all of you. When Bill asked me if I would come and talk in connection with this award I offered the title How Will It End. I didn't know the answer to that question when I offered the title, but I thought it would be a useful discipline to have to think about it. So today I'll offer you my thoughts and they're thoughts still in formation because we're far from the end and I'm far from confident about how it will end.

As you know, we are in the midst of both a financial crisis and a major economic downturn. It's certainly the worst combination that I have ever seen and I think that it is the worst that the United States has experienced since the depression of the 1930s. It is going to be longer and more damaging, in my judgment, than any of the recessions in the post-war period. Moreover, it's really quite different from other recessions and that's what makes it so hard for us to turn it around. If you look back at the recent recessions or the past recessions, excluding the current one, they typically followed a period in which the Federal Reserve had raised interest rates substantially, raised real interest rates, in order to bring inflation under control and once they felt they had succeeded in doing that, then they were able to bring down those high real interest rates and the economy could recover and one of the engines of that recovery, one of the things that responded to the lower interest rates was housing. Well this time it's been really very different. The economic downturn was not caused by the Fed pushing the real Federal Fund's interest rate to a high level and therefore they couldn't simply reverse that by bringing down the interest rate. The fact that the interest rate has come down from over 5% to now essentially zero has really had very little traction in the domestic economy. Its primary effect in terms of expanding economic activity was through the lower dollar. I mean we're seeing that again today.

The real cause of the current economic downturn was the mis-pricing of risk, the under-pricing of risk, and the excessive leverage that followed from that. That was true of the banks, it was true of housing, it was true of the stock market. The actually triggering event that began the downturn was the level of subprime defaults that exceeded the expectations of investors in subprime mortgages and in the derivatives based on those subprime mortgages, so they realized that their expectations, they realized that their sense of the level of risk in the economy had been wrong and that the risk was much higher. That spread from the subprime to other mortgages and to other assets, but particularly to mortgage-backed securities and that was a very substantial and damaging effect because the mortgage-backed securities were securitized and spread through the portfolios of financial institutions in the United States and indeed around the world so that the

fall in the value of mortgages and of mortgage-backed securities lead to a weakening of the balance sheets of financial institutions and that in turn caused a dramatic change in confidence, a dramatic decline in confidence. Financial institutions lacked confidence in the value of the assets that they held and so they were unwilling to trade them, they lacked confidence in the liquidity and even the solvency of potential counterparties and so we saw a freezing up of financial transactions among the financial institutions, and there was a lack of confidence even in the value of their own balance sheets and so these financial institutions were unwilling to expose themselves by taking on more lending. The financial crisis and the economic downturn has become a global problem, spread through the financial markets, through trade, and through the pricing of stocks. Here in the United States, the re-pricing of risk has led to a dramatic fall in all asset prices. We've seen it in the stock market with share prices down 40%, we've seen it in the housing market with house prices down 25%. That has translated into a loss of household wealth of some eight trillion dollars because of the fall in the stock market and an additional three trillion dollars because of the fall in house prices. An eleven trillion dollar fall in the value of household wealth has enormous depressing effects on consumer spending and that then starts a business cycle in which lower consumer spending leads to lower production, lower employment, lower incomes, and then another round of lower consumer spending.

Housing, in my judgment, has been the key of this financial crisis and it holds the key to the recovery, so how it will end will depend very much on our ability to deal with the housing problem, so it's useful to understand the nature of the housing crisis that created this problem. Three things happened in this decade: A sharp increase in house prices, an increase in loan-to-value ratios, and an increase in securitization and it's worth just briefly reviewing the facts about those. House prices have been rising over time, along with incomes, but then in this decade they shot up dramatically, rising some 60% relative to the trend that they had previously been on, so we were observing a bubble and at some point that bubble had to burst. That came in the middle of 2006 and as I said a moment ago, since then house prices have come down some 25%. The experts say it will take another 15% or so fall in the price of houses to get back to that pre-bubble path. Indeed, that may not be enough. In the last 12 months, house prices have come down 16%. The important thing, though, is that there is a risk that house prices will not merely return to this pre-bubble path, but will overshoot and will overshoot dramatically. Why? Well because of what happened to the increase in loan-to-value ratios. If you go back to the not-too-distant past, the typical mortgage required a down payment of 20 or 30%, so the loan-to-value ratio at origination was 70 or 80%. But during the middle of this decade, it became very common for that to rise to 90 or 100%. Well why were the banks and other creditors willing to take on mortgage loans that were almost completely equal to the value of the underlying property? Well basically because house prices were rising so fast, rising at double digit rates, so that they could feel that all they had to do was wait a year or two and what started as a 90 or 100% loan-to-value ratio would come down to 70 or 80% and that optimistic view worked as long as house prices were indeed rising very rapidly, but when house prices began to fall that process went into reverse and we saw an increasing number of homes with loan-to-value ratios greater than 100%. Now 23% of all homes with mortgages have loan-to-value ratios greater than 100%, 23%. Those negative equity homes represent about two and a half trillion dollars of mortgages. That percentage has doubled in the past year. Now the significance of the negative equity, the significance of mortgages that exceed the appraised value of the property is that these loans are generally no recourse loans. If an individual defaults, the creditor will take the property, but will not pursue other assets that the

individual has or try to attach wages to help pay off the debt that was not covered by the value of the home, so individuals have a substantial incentive when they have negative equity, when they have a loan-to-value ratio greater than 100%, they have substantial incentive to walk away, to default, and that in turn leads to foreclosures and the foreclosures lead to the sale of those homes and that extra real estate on the market pushes down house prices and leads to ever increasing loan-to-value ratios, so that process, that dynamic is what is driving the risk of an ever decreasing level of homeowner equity in their houses. If house prices fall another 10%, that 23% of home owners that now have negative equity will go to 34%. If house prices fall another 20%, it will go to 52%, so given that house prices are continuing to come down at roughly 15% annual rate, we could easily see a situation in a year or 18 months, if some policy isn't taken to change this, in which half of all of the mortgages in the United States will have loan-to-value ratios greater than 100%. The third thing that happened in this past decade was a great growth of securitization. If you go back to 1990, 10% of all mortgages were securitized. By now it's substantially more than 60% of mortgages that are securitized, and that has two consequences. It means that when a homeowner has a problem or sees that they are under water, that they have negative equity in their home, they can't go to the originator of that mortgage, to the neighborhood, and try to negotiate something, because the mortgage has essentially disappeared into the securitized mortgage-back securities in which there is no single owner with whom to deal and that is the second reason why it is so important. Because, by securitization, it was possible to create very sophisticated financial products, to take subprime loans and turn them into largely AAA mortgage-backed securities which looked more secure, looked less risky than in fact they were, so this combination of mortgage-backed securities and the derivatives based on them is in my judgment really very dangerous because financial institutions cannot now price mortgage-backed securities with any confidence and therefore, as I said a moment ago, they don't have confidence in their own balance sheet or in the balance sheets of potential counter parties and the result of all of that has been a dysfunctional credit market with restricted lending and a deepening recession, so that brings me back to the motivating question, how is this going to end? What will it take to bring us to a sustainable recovery?

I think at the most basic level it will take two things. First, the government must fix the credit market so lending can resume. When the credit markets are fixed monetary policy will be effective in a way in which it is not today. And second, the government must pursue policies to stimulate aggregate spending. How is that going to be achieved? Let me start with the credit markets. Let me start by reminding what has happened until now. Federal Reserve has lowered interest rates, most recently to essentially zero, but that has had relatively little traction. Now the Fed and the Treasury, by working together, have been able to preserve credit availability. They've not expanded credit, but they've pursued a number of policies which have had the effect of preserving credit. Money market mutual fund guarantees, a large facility for commercial paper, and FDIC guarantee of \$250,000 per account instead of \$100,000, a further FDIC guarantee for long-term credit to financial institutions, wholesale credit, and specific help to particular institutions; to Bear Stearns, to AIG, and to Citigroup. I think in retrospect these policies were successes, but of a very limited sort. They prevented a further deterioration of credit, but they did nothing to expand credit and nothing to really fix the dysfunctional credit markets. The main attempt to fix the credit markets was the Treasury's seven hundred billion dollar TARP program and as you probably recall, the TARP has now gone through three phases, each of which in my judgment must be deemed to be a failure. In the end, it really didn't succeed

in reviving the credit markets. It began with the notion that the Fed would buy back, through reverse mortgages, existing impaired securities from financial institutions. For a variety of reasons that I will spare you, I think that was never going to work and it took the Treasury about two weeks after they had the authorization from Congress to arrive at that same conclusion and so they dropped that plan and moved on to TARP version two in which their idea was to infuse extra capital into the financial institutions, so the Treasury spent about two hundred and fifty billion dollars by buying preferred shares from a number of financial institutions. It was never clear, I think even to the Treasury, what the purpose of this was. The press and the members of Congress thought that those infusions of capital into the financial institutions, that the purpose of that was so that they would lend that money out, but in fact the financial institutions were very eager to have the liquidity, to have the funds and were not eager to lend it out and they didn't. The Treasury apparently hoped that they capital infusion would make the receiving institutions more credit worthy so that flows of credit between the major financial institutions would resume, but the scale of what they were doing was all wrong for trying to achieve that. Think about Citigroup with a two trillion dollar balance sheet and the government infuses twenty five billion dollars more of capital, what institution that was unwilling to lend to Citigroup before that twenty five billion dollar infusion would feel that now they were so reassured about the health of the Citigroup balance sheet that they would be prepared to do so? So it really did not bring back additional interbank lending and the Treasury gave that idea up, as well. They have finally moved on to saying well we're not going to do anymore capital infusions, we're not going to try to buy back impaired securities, what we'll do instead is to provide loans or guarantees with the help of the Federal Reserve. The Treasury will back up the Federal Reserve in providing this for credit cards, for student loans, and for auto loans, but I think that was really a response to the political pressure that too much of that TARP money was being used to help float Wall Street and not enough to help Main Street and so they stopped the Wall Street programs, which weren't working anyway, and declared that they would move on to help individual borrowers in the way I just described, but in fact nothing has happened along that way. So I think, as I said a moment ago, the Treasury has really failed to fix the underlying problem and the underlying problem is this fear of a downward spiral in house prices driven by this process of default and foreclosure that hangs over financial institutions.

What can be done about that? There are a number of plans out there to deal with the foreclosure problem and essentially they are designed to help individuals who are on the verge of foreclosure and to provide them with financial assistance so that they will not actually have that foreclosure occur. The one that was legislated, the proposals, the so-called Help for Homeowners, the Barney Frank and Chris Dodd legislation, has turned out to be a colossal failure. The sponsors hoped that it was going to help two million homeowners avoid default. The Congressional Budget Office said that was too optimistic and estimated three hundred thousand. The actual reality is fewer than 200, not two hundred thousand, but 200. So that didn't work. There are a variety of other proposals, which I won't take the time to comment on in detail, but none of them tries to deal with the systemic problem of a downward spiral in house prices caused by this process of default and foreclosure. Instead, they are aimed at helping individuals who are on the verge of a foreclosure and that will have some small impact on this broader systemic problem, but will not actually deal with it. In my judgment, the key to doing that is to introduce some recourse in order to remove the incentive to default. Every country around the world has mortgages with recourse. We are the outlier in that and I don't know the history of how it came

to be that mortgages in this country are generally without recourse and I have proposed, and Don Ogilvie referred to it, I have proposed in a couple of articles in the Wall Street Journal how the government could set up mortgage replacement loans, which in effect gave individuals low interest loans with full recourse as a kind of barrier, as a kind of firewall so that even if house prices come down another 10 or 15 or even 20%, individuals who now have positive equity will not be pushed into negative equity, while individuals who today have negative equity could, by a combination of actions of the creditors and the government, be brought back to loan-to-value ratios of 100% and then given a mortgage replacement loan with a low interest rate which would serve as a barrier so that if house prices continued to come down, if this is done then I think we will see a way out of the credit market problem. If we can fix the problem and stop the problem by which the needed additional declines in house prices, 10, 15% do not start a wave of further defaults and foreclosures and even further downturns in prices, I think we can bring confidence back to the financial institutions because they will know that that particular risk, that important risk has been removed.

Unfortunately, I think that fixing the credit markets by itself is no longer enough to stimulate aggregate demand. The amount of the stimulus that would be needed to do so is too large for us to depend just on fixing that, so fixing the credit markets in my judgment is necessary, it will bring back a more effective monetary policy, but we're looking at such enormous hole in consumer demand and in the resulting demand that follows from that; just to give you a sense of the numbers, an eleven trillion dollar fall in household wealth would probably reduce consumer spending year after year by some four hundred billion dollars. Four hundred billion dollars is just a little shy of 3% of GDP and that's just the direct, the immediate impact because as I indicated earlier, that in turn would lead to less production, less employment, we're certainly seeing that and therefore lower incomes and even less consumer spending. So there is a major gap that needs to be filled and that is the challenge that the Obama administration now has to take on. How to increase domestic spending probably by a number on the order of four hundred billion dollars a year, enough to offset the direct and indirect effect of this sharp fall in consumer household wealth and what are the ways in which that can happen? How can we see an increase in domestic spending? Well basically there's what the Federal Reserve can do and what can be done by fiscal deficits. Ben Bernanke has made it clear in the most recent statements of the Federal Reserve that they will do everything that they can to stimulate the economy, but I'm afraid that at this point that will not be enough. The short-term interest rate is already down to zero and even the 10-year bond is down to just 2%, so even buying long-term securities, long-term bonds and promising to hold the short-term interest rate down for a considerable period, as the Fed has said, will not do enough to provide a financial stimulus, an interest rate stimulus to the economy. The big question is whether what is called quantitative easing will have an independent effect that goes beyond the impact of lower interest rates. My own sense is that it would have an effect, but not a large enough effect to actually bring back a level of economic activity that brings us back to the pre-recession levels of economic activity.

So that brings us to fiscal policy as the primary tool for bringing the downturn to an end. It pains me to say it, because I am a fiscal conservative, I think that large budget deficits are a bad thing, I think that increased government spending of the sort that we're going to see is a bad thing, but I think at this point we have no choice. We have to do those things if we want to bring the economy back to full employment. The historic record in using fiscal policy for countercyclical

stabilization is certainly not very encouraging. Government borrowing to finance fiscal deficit has in the past crowded out private borrowing and therefore the net increase in economic activity was very small. I don't think that's likely at this time to be a significant problem because of the dysfunctional private credit markets and the very accommodative monetary policy. We've also seen historically that a temporary tax cut is likely to be saved rather than spent. Indeed, earlier this year when the government provided a hundred billion dollar tax rebate, a one-time tax rebate, the actual increase in consumer spending was estimated to be less than twenty billion dollars, so one-time tax rebates are not an effective tool and the past attempts at using infrastructure spending often raised outlays only after the recovery was well underway. I think that is less likely to be a problem this time. Past recessions from peak to trough averaged only 12 months. This time it's going to be much longer, probably twice as long or longer than that. Moreover, once this recovery begins, probably a year from now, once this recovery begins I think the upturn is going to be very slow because consumers are going to need to increase their savings, in other words not increase consumer spending as fast as incomes rise, because they have to rebuild the wealth that was lost as house prices came down and as the stock market came down so fiscal policy is likely to be more effective even if it's not strongly felt in 2009.

Well what specific forms can fiscal policy take? Let me start briefly with taxes and then look at the spending side. President-elect Obama promised a permanent \$500 per person, per employed person tax cut that would amount to seventy billion dollars, probably about fifty billion of that would be spent, so it wouldn't make a big dent in the four hundred billion dollar shortfall, but it would do something. Some form of a temporary investment tax credit could stimulate business investments, especially if it's an investment tax credit that is not subject to recapture. A larger research and development credit could help to offset the predicted declines in research in the private sector. Lowering the corporate income tax, so that our corporate income tax rate became in line with that of other countries, would encourage more business investments and more employment in the United States. The President-elect has already said that he's going to postpone the increase in taxes on high-income individuals meaning not have it take effect until 2011, but it would certainly be very good if he could instead reassure higher income individuals that he will postpone it indefinitely because he recognizes that even a tax increase two years ago for forward-looking, high-income individuals would have a negative effect on the economy today, as well as then. And finally the taxes on dividends and capital gain are also scheduled to rise in a few years and a promise not to do that would have the favorable effect of increasing share prices, which would lead to increases in consumer spending and by lowering the cost of funds to businesses to increases in business investments. But while better tax policy could make a contribution to this recovery, I think the heavy lifting is going to have to be done by increases in government spending. That spending, to be effective in this context, has to be big, it has to be quick, and it has to be targeted at increasing demand and employment. How big depends on the form of the spending and on the timing, but annual outlays of three hundred to four hundred billion dollars seem like a reasonable target for 2009 and 2010. A project that begins in 2009, but continues to spend at a high level in 2011 and 2012, is certainly not as desirable as one that spends quickly and is then finished. Technology projects that involve large amounts of imported equipment are clearly inferior to ones that use American-made goods. Bottlenecks are a particular problem. While there's no doubt a need to rebuild bridges and do other infrastructure projects, there are probably only a limited number of design engineers and companies that are capable of doing that kind of work. The press reports that there will be reduced government

spending on research and on the military because, according to those stories, because of the weakness of the economy. I think that has the sign wrong. Because of the weakness of the economy the government should be spending more on research, it should be spending more on the military. Additional research grants through the National Institute of Health and the National Science Foundation could fund useful research that is not being funded now because of tight budgets. The war fighting activities of the military over the last half dozen years have depleted supplies and have increased the wear and tear on military equipment, so both supplies and equipment will need to be replaced at some point in the future. Now is certainly the right time to do it when resources are more readily available. More generally, maintenance and replacement schedules in both the military and the civilian departments should be revised so that we get an increase in early maintenance and early replacement while there is substantial slack capacity in the economy. I think increased military recruiting and training would also be a good idea while there are large numbers of unemployed young men and women. In short, I think budgeting has to go beyond the business as usual and respond to the need for increased Federal spending by changing the priorities.

So finally back to the question how will it end? I think it is going to end slowly. I think it's going to end hesitatingly. I think a year from now we will be lucky if we have seen the bottom of this recession, but we will still be far away from the level of economic activity before the recession began, so the new administration and the Federal Reserve have a major challenge in the year ahead. Thank you very much.

Dr. Dunkelberg: So we do have a few minutes for questions. Marty, being a good professor, can pick his own...I'll let you pick them out.

Dr. Feldstein: I can't see most people because of these wonderful bright lights.

Dr. Dunkelberg: We have microphones if you didn't have....

Mr. Craig Carnaroli: Good evening Dr. Feldstein. Congratulations on your award.

Dr. Feldstein: Thank you.

Mr. Carnaroli: My name is Craig Carnaroli. I'm the Executive Vice President at the University of Pennsylvania and a student of The Wharton School, so my question relates to I was surprised to not hear you reference Fannie Mae or Freddie Mac in your remarks and I was wondering what role you saw them playing in stabilizing the housing market, as well as what you see the future of those institutions given their current weakened state?

Dr. Feldstein: There are a lot of things I didn't say in the limited amount of time that I had, but I wouldn't have referred to them in terms of stabilizing the housing markets. I would have talked about their role in destabilizing the housing markets. I think they were an anomaly, a mistake. The idea of institutions with a five trillion dollar balance sheet, either literally on their books or guaranteed by them with an effective government guarantee so that creditors didn't have to look too hard at what they were doing because they knew, and it turned out to be true, that the Federal government would stand behind their debt and yet they were for-profit organizations,

shareholder-owned organizations, so while they had a mandate they thought to make bad loans to people who should be getting those loans and the creditors didn't care because there was this Federal government backstop, they could do all of those things and be quite profitable until the whole thing fell apart and it's just an impossible situation. So I think going forward the ideal arrangement would be to gradually phase down these institutions. We don't need them. The evidence on the impact of Fannie and Freddie on the cost of funds to most homebuyers is very, very small. If we want to have special programs for low income potential homebuyers, we should separate that out from an institution which is now doing more than 80% of all of the new mortgage lending and focus it on a public policy home lending bank for low income individuals if that's a desirable goal in itself.

Mr. Dave Cohan: Has the economy been permanently damaged by this episode? Will our long-term growth rate be permanently lower?

Dr. Feldstein: Assuming there won't be growth, I think the answer is it will be damaged for a long period of time. It will not be permanently damaged. A lot of human capital is being destroyed, a lot of skills that are not going to find the same kind of jobs going forward, but ultimately our ability to generate productivity through research and development, through investment, through the kind of high quality labor force that we have, I think that will all return and so if you asked me, looking a decade ahead, do I have reason to think that the growth rate at that point will be lower? No, I don't.

Male: I was hoping maybe having been an insider in Washington you might be able to give us some insight into the institutional failure of the Fed and Treasury to address this issue. I mean as far as systemic crises go every since the '80s, this is one of the simplest to fix. Every third world finance minister would kill to have something this easy. There's no debt crisis, there's no currency crisis. It's very simple...

Dr. Feldstein: No, I don't think that's true. I think it was a very difficult problem. I think the Fed did everything in the standard playbook and then a lot more in terms of both bringing down interest rates and then putting a patch where there were credit failures, but it really didn't have the ability to do the kind of systemic fix on the mortgage market that was needed. Now you could ask well why didn't the Treasury do that. That's a harder question and I don't know the answer to that, although I've talked with the people there. They certainly thought when they went to the Congress for seven hundred billion dollars that what they had to do was to somehow buy up what was called toxic securities, these impaired mortgage-backed securities, ignoring the fact that even if they could have bought all two and a half trillion dollars worth of them that wouldn't stop the process by which others were going to come along and re-infect those balance sheets, so I think they made a series of mistakes and frankly I think they made them because they didn't think about the systemic effects of what they were doing, they didn't look at this larger question, but thought in terms of a series of deals which turned out, even in their own eyes, not to be adequate.

Frank Schaller: My name is **Schaller**. Unemployment's around 6% now...

Dr. Feldstein: 6 ½% officially.

Schaller: and I was wondering, and it may be an academic question, but hasn't it be redefined and isn't it much higher and a practical question that I have is, more like I've heard 12%, more practical question is what do you foresee the future of unemployment in the next 12 to 18 months? Thank you.

Dr. Feldstein: You don't have to apologize for asking academic questions to an academic. There are different ways that you can measure unemployment. The way we measure it that produced the 6 ½% number has not changed significantly. Some people say well we ought to count the people who would like to work, but aren't looking for work. If you don't look for work you're not counted as unemployed. You may be a "discouraged worker," so you can expand the definition and get a bigger number, but if you want this number to be comparable to the numbers that we've seen in the past, I think it is. Where is it going to go going forward? I think we are very likely to see a number beginning with an 8. I think there's a chance we will see an employment rate beginning with a 9. I wouldn't rule out the possibility of an unemployment rate beginning with a 10, so we are, I think, in a very serious labor market situation.

Male: Are you concerned about the size of the Federal Reserve's balance sheet and the quality of the assets that are finding their way there?

Dr. Feldstein: Yes yes. I think that the Federal Reserve has the technical capability of shrinking the balance sheet, of shrinking the rapidly growing money supply when the time comes. I worry more about the question of whether the political pressures at the time on the Federal Reserves, a different bunch of characters, a different time, an economy that's been in recession for several years, that's recovering very slowly, and a lot of pressure to do something about it, to keep interest rates lower than they should be at that point and that could bring back inflation. I worry about a third thing which is as the Fed takes on new responsibilities it leaves Congress to think here's yet another problem. Maybe we could get the Fed to deal with that and Congress did ask the Fed to deal with the auto problem and fortunately Chairman Bernanke said thanks, but no thanks.

Mr. Joe Blake: Yeah, can I just ask you...my name is Joe Blake and I'm a member of the CFA Society. Amity Shlaes has done some interesting work on the new deal, as you well know, and one of the issues coming out of that historical area is that Roosevelt kind of did everything wrong, depending upon your viewpoint, of course, but one of the things that they did is they just increased regulations, which was in hindrance to growth, notably the Wagner Act and social security and the SEC and so forth. This administration that's coming in is committed to healthcare reform, a variety of labor changes, and so forth. Would you venture an opinion about what the impact on growth is of a lot more government regulation given all the other shall we say challenges out there?

Dr. Feldstein: Well the way you put the question makes it easy. If we have a lot of additional regulation, particularly bad regulation, it will hurt economic growth, it will hurt the economy long-term, but I don't think we want to judge what this administration is going to do until they do it. They can do a lot of things in the healthcare area which will not involve, to take an example, not involve increases in the kinds of regulations that hurt economic growth. I think the team that is there, as you probably gather I'm a Republican, I supported John McCain, but I must

say the team of economists who have been recruited by the President-elect is a first rate group. They are technically sophisticated, they are experienced in government and in the Federal Reserve, so I have high hopes that they will give good advice and will know the experience of how certain things in the past have hurt us, but of course ultimately it's the political process and it remains to be seen.

Male: Thank you very much. [Applause]

Dr. Feldstein: You're very welcome.

Dr. Dunkelberg: It was a great honor to have Marty here to talk and it's also a great honor for me to introduce to you the founder of the Global Interdependence Center, Frederick Heldring. Fred, with some co-conspirators, one of whom I'll introduce in a moment, founded the Global Interdependence Center in 1976 and we periodically give this award to people who I'll read in here, to individuals who have demonstrated an exemplary commitment to the development of international relations, trade, and global citizenship in their lifetimes. Fred was a visionary back in those days. We were much more of an isolationist country. He saw how important the global neighborhood was and he founded GIC and he was the Chairman of GIC until 2000 when I was asked to take over. We have a couple of past award winners. Bill Poole, who was the president of the St. Louis Federal Reserve and now is a Fellow at the Cato Institute. Bill, just stand up there for a second. [Applause] And President Constantine Papadakis, known as Cocky. We honored him and we're glad to have him here. [Applause] Drexel University is our top supporter and we're delighted to have you here and somewhere is [unintelligible]. I don't know where...there he is, right there in the second row. [Applause] We haven't given him an award yet, but we love him and finally I would like to introduce a Nobel Prize winner, Dr. Lawrence Klein, Larry Klein. He was the cofounder of GIC with Fred Heldring and we're delighted to have him here tonight. [Applause] So I'm going to ask Fred just to say a few words and present the award to Marty.

Mr. Frederick Heldring: Thank you Dunk. Today's world is an increasing world and increasing interdependence. We now know that the hiccup in the remote corner of the world has implications on Main Street of America. Thirty two years ago we were just entering this era of intense globalization. We were just beginning to digest the importance of global interdependence as we watched the ripple effects of a severe global recession in the mid-1970s. Those of us who were involved in the founding of the Global Interdependence Center in 1976 did so in the bullion times of this country's bicentennial, but also in the uncertainty of exceptionally strong inflationary forces and rising unemployment. As the country struggled to put the economy on paths of recovery it was recognized that U.S. interests did not stop at our shores, but that most other major countries in the world were also suffering from what was then the most serious recession of the 1930s. In that year of bicentennial celebration, we crafted the vision of the Global Interdependence Center, a vision which asked that we declare our interdependence with the peoples of all nations and that we embrace those principles by building the types of institutions which would enable mankind to survive and civilization to flourish. GIC has kept that vision alive, using it to direct the contents of its programming, but as we stand in the midst of the financial crises and on the cusp of a new economic paradigm, where do we take that vision? How do we raise the visibility of GIC? Can we become an organization known for something that no one else does? One thing is clear on the global stage, where there are two

players whose independence run deep, that is the United States and China. China will play a key role in America getting through this worsening economic crisis. China has been financing the American consumer while the American consumer has fueled China's export growth. Where is the dynamic headed and how can we exit this global economic meltdown that is clearly now the worst since the 1930s? I don't have the answers to these questions, but somehow GIC will play a critical role in the discourse. Someone who may have the answers is Martin Feldstein. Martin currently is the George F. Baker Professor of Economics at Harvard University and President Emeritus of the National Bureau of Economic Research. He has served as president and CEO of the NBER from 1977 to 1982 and also in 1984 to 2008. From 1982 through 1984 he was Chairman of the Council of Economic Advisors and President Reagan's Chief Economic Advisor. Mart has a long history of work on global economic issues and we are delighted to honor him tonight and to hear his views on how will it end. Actually, we already asked that question, so just to reflect. Anyway, it's my pleasure to present Martin Feldstein with the Frederick Heldring Global Leadership Award.

[Applause]

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