Moral Capitalism *at Work*

Business and Public Policy Round Table
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University Club of St. Paul

"How Can We Restore Economic Growth to America?"

Introductory presenters: Gary Stern, former President, Ninth Federal Reserve District

Chair, facilitator and rapporteur: Steve Young, Global Executive Director, Caux Round Table

Participants: Stuart Albert; Jerry Brennan; Norb Conzemius; Chuck Denny; Mike Harris; Louis Hill; Ed Lotterman; Bob MacGregor; Dick Primuth; Joe Selvaggio; Paul Siebrasse; Tony Yankauskas

Summary of comments:

The U.S. is now two years into recovery from the fall 2008 collapse of credit markets. The rate of growth and job recovery has been disappointing.

While recovery of employment was slow after the 1991 and 2001 recessions as well, it is today falling short of many expectations. The collapse of the housing market, with its large inventory of unsold houses, has removed many jobs.

The bursting of the housing bubble had a more deleterious effect on jobs than did the bursting of the tech stock bubble in 2001. The fall in tech stocks affected primarily the wealthy, but the collapse of housing affects mostly middle and low income Americans. It impacts the family balance sheet, creating a serious negative "wealth-effect."

Limited hiring by state and local governments has also reduced job creation. With every recession, local revenues decline, driving reductions in local government spending. This recession brought about a greater severity of revenue decline and ensuing budget reductions.

Recovery from financial crises, like that of 2008, always takes a long time. But, in the current atmosphere, low growth will persist a while longer.

Quantitative easing was not a game changer. The fiscal stimulus was not a big deal. There are not a lot of macro tools available to promote economic growth.

Uncertainty over implementation of Dodd-Frank and health care legislation is holding back investment. Uncertainty always plays a role in decision-making and should be reduced if possible.

The Dodd-Frank reform of financial markets is still under way. There is a broad menu of rules that need to be written. It might lead to more stability, cost-savings for customers and ensure that future financial downturns will be less severe.

Much will depend, however, on the will of regulators. They have more than enough tools to improve stability of markets. Regulators won't prevent future financial crises, but they can reduce the probability of crises and their severity. We don't want a straight-jacket put on the financial sector.

A concern should be the resolution plans for liquidation or bankruptcy of systemically important financial institutions. Each one has thousands of sub-entities; there is mind-numbing legal complexity; there won't be a fast, orderly write-down of assets; they won't agree to simplify their structures.

The cause of financial crises is in the nature of financial intermediation: you borrow short and lend long. But, the error made by regulators was to underestimate the spillover potential of the sub-prime debt to general asset values and quality of balance sheets. It was not seen as big enough to trigger a serious crisis.

Problems were recognized with Fannie Mae and Freddie Mac, but reform efforts went nowhere.

Prior to 2008, a supplemental banking system evolved in the shadows of regulation. Congress abstained and regulators did not do all that they could. There were some bad actors, but not that many. Most responded to incentives put forth by access to funds at a low rate. There was a mistake in pricing: price of risk was too low and too much was taken in the form of assuming debt obligations.

But, those "too big to fail" institutions have grown bigger. The precedents have exacerbated the moral hazard problem – creditors seem to be fully protected. But, the next time around, there should be more preparation on the part of regulators to deal with the fallouts of failure.

Secondly, the fiscal situation of our federal policies is unsustainable in the long-run. Economist Herbert Stein had a law: "If it can't be sustained, it won't be." Good intentions to provide for people are being undermined by an aging population, generous levels of benefits and increasing life expectancies.

There are only 3 ways to attain sustainability of federal programs: 1) raise taxes; 2) cut benefits; 3) borrow, or some combination of these three alternatives.

The country is deeply divided between supporters of big government and supporters of small government. The center is not passionate, but would support scaling back entitlements and raising taxes on some. Congress is not incompetent, but the country is divided and the politicians follow the will of the people. Maybe the next election will bring a majority consensus. In our democracy, tensions are to be resolved by elections.

We fixate on the wrong question, that being the 'size of government.' The more important question is: what is effective? We should decide on what public goods we want and then decide how to pay for them.

In the long run, productivity drives wealth.

A rising debt will increase interest rates, which will depress investment in plant, equipment, software, education and human capital - the drivers of increased productivity and output.

The limit on raising taxes is the incentive issue: if you tax enough, you can discourage anything. A progressive consumption tax would encourage savings and can be as progressive as you want it to be.

The U.S. is perhaps becoming more like Western Europe. Europe has a relatively high standard of living and positive economic growth, but due to labor laws and other factors, high unemployment. As people get wealthier and older, they tend to want a bigger role for government.

Optimistically, the U.S. has a flexible and resilient economy. A system that has thrived for 230 years is not an accident. It needs only to avoid major errors. It does not and never has depended on outstanding leaders, but on the soundness of the system.