Testimony of Dean Baker
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Thank you, Chairwoman Warren for inviting me to share my views on the success of the Troubled Asset Relief Program (TARP) to date and its impact on the broader economy. My name is Dean Baker and I am the co-director of the Center for Economic and Policy Research (CEPR). I am an economist and I have been writing about issues related to finance since 1992.

There are many factors that make it difficult to assess the effectiveness of the TARP, the most important one being the fact that the TARP was carried through in conjunction with rescue efforts by the Federal Deposit Insurance Corporation (FDIC) and the Federal Reserve Board. The money made available to the financial system through these alternative mechanisms was considerably larger than the amount made available through the TARP. Furthermore, there is no publicly available information on the terms or the beneficiaries of the loans issued through the Fed's special lending facilities.

For this reason, there is no easy way to determine the importance of TARP funds in stabilizing the financial system. Clearly, the TARP did play a role in stopping the panic that was driving financial markets last year. Together with the other structures put in place, the TARP did succeed in restoring stability to the financial system.

However, keeping the financial system operating is a rather low bar. There is little doubt that the Federal Reserve Board, with its virtually unlimited ability to print money, can prevent a financial collapse. The relevant question is whether the TARP, along with the other programs put in place, restored stability in a way that best served the real economy and also can be viewed as fair by the American people. By these criteria, the TARP does not score very well.

At the point when Treasury Secretary Paulson requested TARP funds from Congress, most of the major banks were on the edge of collapse. They all had large amounts of bad debt on their books, most of which stemmed either directly or indirectly from the collapsing housing bubble. The immediate cause of the panic was the disappearance of the government's implicit "too big to fail" guarantee after the bankruptcy of Lehman. Since investors knew that all the banks could have enough bad debt to be insolvent, they were unwilling to trust their money to the banks, even for short periods of time, without demanding extraordinary risk premiums. At this point, the system could not be stabilized without large-scale interventions from the government, such as the TARP, the FDIC's emergency loan guarantee program and the Fed's special lending facilities.

While the economy clearly benefited from preventing the outright collapse of the financial system, this could have been carried through in ways that led to more broad-based benefits to society and also directly transformed the financial system, instead of restoring and reinforcing its existing structure. This point is crucial, since the country is paying an enormous price for its dysfunctional financial system. The downturn is likely

to lead to a loss of close to 40 percent of GDP (about $6 trillion) in total. If a government social program ever led to such disastrous losses, there would be a very serious accounting and undoubtedly major changes to ensure that such a disaster never occurs again. There is little reason at this point to believe that serious reforms will occur.

In terms of broader economic goals, the TARP was approved with promises to ensure that homeowners would be allowed to stay in their homes and also that executive compensation in the bailed out banks would be restrained. It has failed miserably in both areas.

Foreclosures have proceeded at a rate of close to 2 million a year in the period since the TARP was passed and most projections show this pace continuing through 2010 and into 2011. Banks were not required to modify mortgages as a condition of getting TARP money or other special assistance. As a result, few banks made serious efforts to offer loan terms in ways that provided a serious alternative to foreclosure. Only a tiny fraction of delinquent mortgages were modified in the half year following the TARP, and even in these cases many homeowners subsequently re-defaulted, since they were still unable to meet the payments on their loans.

As a result of the Obama administration's Making Home Affordable program – which directly uses TARP money as an incentive to lenders and servicers to modify loans – more than 20 percent of delinquent mortgages are now being considered for trial modifications. While this is a substantial improvement, this still means that the vast majority of homeowners are not getting modifications. Furthermore, it will be important to track the number of trial modifications that result in permanent modifications that allow people to remain in their homes as homeowners.

It would also be desirable to have reliable data on the extent to which modifications have reduced monthly housing costs and debt burdens. One of the factors perpetuating the downturn is the falloff in consumption. This decline is driven in large part by the debt burden that many homeowners now must bear as a result of purchasing homes at bubble-inflated prices. Insofar as modifications relieve this debt burden and/or reduce monthly mortgage payments, they will be freeing up money for consumption, which will be a boost to the economy.

It would have been possible to couple the TARP with a requirement that mortgages be modified according to some rule, or alternatively to temporarily alter rules on foreclosures, for example by allowing bankruptcy cramdown or granting homeowners the right to stay in their homes as renters. Such measures would not only have provided housing security to tens of millions of homeowners, they also would have gone far toward relieving the debt burden that is a main cause of the recession.

Tens of millions of homeowners are now either underwater in their mortgages or have very little equity, due to the plunge in home prices. These homeowners will be very reluctant to spend, given their extraordinary debt burden. If they could have their mortgage debt reduced either through a modification, or by a foreclosure that allowed

them to stay in their homes as renters, they would be better able to follow a more normal consumption path. The current levels of household debt are likely to leave consumption excessively constrained for several years to come. The failure to address this issue – when it would have been very easy to set conditions on banks receiving TARP money and other special assistance – has increased the length and severity of the downturn.

The other major failing of the TARP was its failure to impose conditions that required the reform of the financial structure itself. The financial structure has become hugely bloated in recent decades, accounting for more than 30 percent of all corporate profits in the years leading up to the crisis. In addition, the top executives in financial firms paid themselves hugely outsized salaries. As well as being a direct drain on the economy, these outsized salaries set benchmarks for executives in other sectors and even for officers in universities and other non-profit organizations.

The assistance provided in a time of crisis through TARP and other special programs provided an opportunity to impose binding restrictions on financial firms that could have permanently altered their pay structures. Instead, the restrictions put in place in the legislation were virtually toothless. It is not clear that any executive has seen his or her pay reduced as a direct result of the TARP restrictions.

It is important to recognize that imposing pay restrictions as a condition of receiving TARP money and other special assistance is not interference with the market. Giving these banks money is interference with the market. The market's assessment at this moment of crisis was that these firms were bankrupt, which would have left most of their executives unemployed. The government chose to over-ride the market by giving the banks the money they needed to survive. The government could have imposed whatever conditions it chose for receiving this money.

The failure to impose serious restrictions on the banks both undermined public confidence in government and also left the conditions in place for further crises. It is very difficult to justify such an extraordinary grant of government largesse without any quid pro quo. This is especially difficult at a time when much of the country is either unemployed or facing the threat of unemployment and/or at risk of losing their home.

The crisis itself led to further concentration in the financial sector, with the largest banks all having been encouraged to buy up bankrupt competitors. As a result, the largest banks now enjoy fairly explicit "too big to fail" protection. There also has been almost nothing done to restrain the speculative practices of the major banks. Goldman Sachs, in particular, stands out by virtue of the fact that it is still acting as an investment bank (arguably, it can better be described as a hedge fund), even though it is now operating under the protective umbrella of the Federal Reserve Board and the FDIC. There does not appear to be any effort to restrain its speculative activity.

It would be useful to assess various measures of concentration in the period before and after the crisis to determine the extent to which the crisis has altered the structure of the industry. Given the mergers of several large banks, there can be little doubt that the

largest banks control a larger share of assets and deposits than was the case before the crisis. There has undoubtedly also been greater concentration in mortgage issuance, credit card debt, and other areas of banking operation. The FDIC and the Fed have data that should allow for quarterly updates on a wide variety of measures of the concentration of the financial industry.

Rather than shrinking, it appears that the financial sector has actually grown larger relative to the economy as a result of the downturn. In 2007, the financial sector's share of private sector GDP averaged 17.5 percent. This had risen to 17.8 percent in the second quarter of 2009, the most recent quarter for which data are available.[1] Similarly, the financial sector's share of corporate profits has far surpassed its pre-crisis peak. In 2005, the peak pre-crisis year, the financial sector accounted for 23.5 percent of corporate profits. In the second quarter of 2009, the share was up to 30.9 percent.[2]

In the last few months, several major banks have announced plans to make large bonus payments to their top executives and top performers. It would be helpful to have reliable data on the total amount of money that is being distributed among high earners at TARP recipients. This could take the form of a measure of the total compensation given to either some specific number of the highest paid employees (e.g. the top 50) or the value of the compensation to employees who earn above a certain threshold (e.g. $500,000). At this point, I do not know of any reliable basis for assessing the share of income in the sectors going to the highest earners, but the large bonuses announced by some institutions certainly suggest that it could be increasing.

One area in which the financial industry may have wrongly been blamed is a failure to make loans. In the months immediately following the collapse of Lehman Brothers, the financial system was not operating normally and loans of all types were difficult to secure. However, as a result of the actions by the Fed and the TARP, the system is operating more normally. Larger corporations have no difficulty issuing commercial paper and even long-term bonds at reasonable spreads against Treasury bonds. Mortgage finance appears largely normal as a result of the actions of Fannie Mae and Freddie Mac, as well as the Federal Housing Administration. The fact that there is no unusual gap between mortgage applications and mortgage issuances indicates that homebuyers are not facing any unusual difficulty in securing loans.

The one sector that clearly is having difficulty securing credit is the small business sector. While this is an impediment to recovery, this sort of credit tightening is typical of a recession. The complaints from business owners over being denied credit are not qualitatively different than the complaints that were made in the 1990-91 recession. Lenders will tighten credit to business during a downturn simply because otherwise-healthy businesses are much riskier prospects during a recession. There is no reason to believe that the tightening of credit during this downturn is any greater than what should

1 Bureau of Economic Analysis, National Income and Product Accounts, Table 6.1D, line 15 divided by line 1, available at http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=N.

2 Bureau of Economic Analysis, National Income and Product Accounts, Table 1.14, (line 8 minus line 24) divided by line 8, available at http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=N.

be expected given the severity of the recession. To press banks to make more loans in this context would be to insist that they make loans on which they expect to lose money. This would be questionable economic policy.

The housing bubble and the bubble in non-residential real estate that followed in its wake led to enormous overbuilding in both sectors. As a result, demand in these sectors has fallen off by an amount that is close to 4 percentage points of GDP (about $560 billion). The loss of $6 trillion in housing bubble wealth has led to a falloff in annual consumption of close to $400 billion. There is no easy mechanism by which the economy can replace close to $1 trillion in annual demand. (The stimulus led to an increase of approximately $150 billion a year in demand, after deducting cutbacks by state and local governments.) Under these circumstances, it is not surprising that the country would see a severe slump and high unemployment. While the financial sector may bear much of the blame for supporting the growth of a dangerous bubble, the economic wreckage that the country is seeing now is a predictable result of the collapse of the bubble and little would be changed if the financial sector had not been seriously impacted by the crisis.