Statement before the Financial Services Committee

Humphrey Hawkins Hearing on Monetary Policy

July 16, 2008

Mr. Chairman, today we find ourselves on the verge of an economic crisis the likes of which the United States has not seen in decades. Our economy is very clearly in a recession, and every time someone tells us that the worst has passed, another serious event takes place, as we saw once again last week and early this week. Everyone now realizes that the situation is dire, yet either no one understands the cause behind the credit crisis, or no one is willing to take the necessary steps to ensure as orderly an end to the crisis as possible. Instead, we hear talk of further bailouts. The Fed-brokered takeover of Bear Stearns, a supposed one-off incident, has now been joined by a potential bailout of the Government-Sponsored Enterprises, Fannie Mae and Freddie Mac.

The two GSE's have been disasters waiting to happen, as I and many others have warned over the years. It was bad enough that Fannie and Freddie were able to operate with significant advantages, such as lower borrowing costs and designation of their debt as government debt. Now, the implicit government backstop has turned out to be an explicit backstop, just as we feared. The Greenspan reflation of the economy after the dot-com bust pumped additional liquidity into an already-skewed housing market, leading to an unsustainable boom that from many accounts has only begun to unravel. With a current federal funds rate of two percent, and inflation at over four percent, the Fed is currently sowing the seeds for another economic bubble.

At the heart of this economic malaise is the Fed's poor stewardship of the dollar. The cause of the dollar's demise is not the result of a purely psychological response to public statements on US dollar policy, but is rather a reaction to a massive increase in the money supply brought about by the Federal Reserve's loose monetary policy. The policies that led to hemorrhaging of gold during the 1960's and the eventual closing of the gold standard are the same policies that are leading to the dollar's decline in international currency markets today. Foreign governments no longer wish to hold depreciating dollars, and would prefer to hold stronger currencies such as the euro. Foreign investors no longer wish to hold underperforming dollars, and seek to hold better-performing assets such as ports and beer companies.

Every government bailout or promise thereof leads to moral hazard, the likelihood that market actors will take ever riskier actions with the belief that the federal government will bail them out. Bear Stearns was bailed out, Fannie and Freddie will be bailed out, but where will the line be drawn? The precedent has been established and the taxpayers will end up footing the bill in these cases, but the federal government and the Federal Reserve lack the resources to bail out every firm that is deemed “too big to fail.” Decades of loose monetary policy will lead to a financial day of reckoning, and bailouts, liquidity injections, and lowering of the federal funds rate will only delay the inevitable and ensure that the final correction will be longer and more severe than it otherwise would. For the sake of the economy, I urge my colleagues to resist the temptation to give in to political expediency, and to oppose loose monetary policy and any further bailouts.