

LEGG MASON INVESTMENT COUNSEL

INVESTMENT FORUM

**A Discussion of the State of the U.S. Economy
and the Role of the Federal Reserve**

with

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Moderated by:

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INTRODUCTION

Harry O'Mealia: Good morning everyone. We're on in all five offices, and by phone across the country, so without further ado, I'd like to welcome everybody here this morning to today's Investment Forum, hosted by Legg Mason Investment Counsel.

Today's session is going to be a very topical and very insightful discussion with an ex-Fed Governor, Bill Poole, who is one of the nation's leading economists, and who has had a distinguished career in academia, and as a member of the Federal Reserve.

Before I formally introduce Bill, I just want to take a second to thank our staff here for pulling this together. As you know, this is our maiden voyage in Legg Mason's new headquarters here in Baltimore.

I think the response that we've gotten to this event is a testament to what we've all gone through over the past year in the markets and the economy. There is a much, much greater understanding of the importance of the government, the importance of the Fed, the Treasury, and what they mean to all of us.

The heightened interest is really why we have the turnout that we do this morning. It's also why we opened up to our clients what would normally be an internal forum for our portfolio managers, our analysts, our trust officers, and our client relationship associates. This is part of a regular series of events that we hold to keep ourselves as close as we possibly can be to the rhythm of the economy and the rhythm of the markets.

There's no better person to guide us through a discussion of the state of the U.S. economy than Bill Poole, who is here today through the good work of our colleagues at Morgan Joseph, especially Eli Portnoy.

Bill Poole is currently a Senior Fellow at the Cato Institute. He is also Distinguished Scholar in Residence at the University of Delaware. He retired as President and CEO of the Federal Reserve Bank of St. Louis in March 2008, where he served for ten years. The St. Louis bank is one of 12 regional banks that implement the policies of the Federal Reserve Board. During his time at the St. Louis Fed, Bill also served on the Federal Open Market Committee, the branch of the Fed which sets interest rates, manages the money supply, and oversees the sale of government securities.

The Federal Open Market Committee just issued its latest report yesterday on the state of the economy, and its current actions on interest rates as well as its purchase of agency mortgage backed securities and U.S. Treasuries. Our Forum today actually has the benefit of being a “ripped from the headlines” event.

Prior to his career at the Fed, Bill was a long-time Economics Professor at Brown University, from 1974 to 1998. At Brown he held the Herbert H. Goldberger Chair, and was Chairman of the Economics department. From 1982 to 1985, Bill served as a member of the Council of Economic Advisors under Ronald Reagan. Prior to Brown, Bill also taught at Johns Hopkins. He is a graduate of Swarthmore College and received his M.B.A. and his Ph.D from the University of Chicago.

Bill is a native of Wilmington, Delaware, where he resides with his wife Geraldine, and where he has now returned to live after many years away.

Bill is going to make some opening remarks today on what the Fed actions and the statements from yesterday mean and then he's going to answer some questions. We have taken questions in advance from clients and from our internal people, and they cover a really great range of topics.

Before I start I am going to make a disclaimer for the audience that the views of Dr. Poole are his alone, and do not necessarily represent the views of Legg Mason Investment Counsel, Legg Mason, Inc., or its affiliates.

So, without further ado, it's an honor to introduce Bill Poole.

Introductory Remarks

Bill Poole: Thank you. I'm honored to be here today, particularly at the inaugural event in the building, but I guess that means I'm a guinea pig.

I hope after I speak for a few minutes we can have a really good back-and-forth exchange with some questions from clients and from those in the audience. I learn a lot more from hearing the questions than I do from talking straight away.

I brought with me a book that I have just started to read, and I would strongly recommend it. It's David Wessel's book, In Fed We Trust, and it is a very accurate and colorful, readable description of the financial crisis. And it's got some historical information as well.

I have seen some of the questions from the audience, and I don't think it's possible to address all of them. The final question we'll never get to if I don't start there. The final question reads, "Which did you enjoy more? Teaching students or serving on the Fed? And why?"

Well, both of these were right for me at the time of my life when I did them. In fact, I'm back teaching a little bit at the University of Delaware. I really enjoy students. I get a lot out of students, and I try to stir them up. That's one of the biggest problems with students these days. It's sometimes hard to challenge them and get them to respond and sort of think seriously about issues.

The Fed job came along at the right time in my life. Some people said that I must have been preparing my whole life for that job because of my years

spent in thinking about writing, researching on monetary issues. And the Fed position at St. Louis was very exciting for me.

I must say there are some real advantages in being part of the Fed in one of the Reserve banks, particularly in St. Louis, because of its tradition of fostering outspoken views, and not being so constrained politically. For example, one of the things I took on in St. Louis was the systemic risk being raised by Fannie Mae and Freddie Mac, and ultimately, a lot of people have come back to me and said, "You were right about that."

The Role of the Federal Reserve

I want to talk certainly about the monetary situation. Also, I want to talk a bit about the fiscal situation. But as a preface to both, I want to emphasize that lots of understandings have been thoroughly upset as a consequence of this financial crisis. In particular, the role of the Federal Reserve in our governmental system and in our economy has changed, and I worry that the Federal Reserve has now become involved in political disputes that will damage its independence in the future.

I had come to have serious concerns on this regard before I picked up Wessel's book. I was interested right away reading the introduction. I want to just read you two things in Wessel's introduction that speak to this issue.

First is a quote from Barney Frank. Now, I don't often agree with Barney Frank, but in this case, I do. Wessel quotes Barney Frank as saying, "No one in a democracy who is unelected should have \$800 billion to spend as he sees fit,' Barney Frank said."

And I *completely* agree with that. The Federal Reserve, through the 13.3 power in the Federal Reserve Act, an amendment that was enacted in 1932, has essentially said that if we declare unusual and exigent circumstances that the Fed can lend to anybody we want, in any amount we want, under any conditions that we determine.

I believe that that power is properly reserved for emergency circumstances such as bailouts that have to be decided, if you're going to do them, in the space of a few hours, such as the Bear Sterns and the AIG bailout. I believe it should not be used as it has been to authorize some of the other recent Fed programs such as the commercial paper program. The purchase program for commercial paper is a traditional fiscal policy-type program. It is the big company version of the Small Business Administration loans.

We have had federal credit programs of various sorts for years and years. And a program of this sort should have gone through Congress. It should have been authorized by Congress. The scale of the expenditures is really quite amazing, even though the commercial paper program has wound down to some extent. It reached a peak in mid-February, I believe around \$350 billion. Even larger is the Fed program to purchase mortgage-backed securities.

This was a program that was announced in December. I don't think the first mortgage-backs were put in the Fed's portfolio - on its balance sheet -- until mid-February. And this program is now slated to grow to \$1.25 trillion. This is not a trivial amount of money. So whatever you think about the wisdom of the program, it's a program that I believe ought to have been authorized by Congress. Congress should have debated the program and should have financed it by having the Treasury issue debt.

The budget discipline, such as it is, in Congress would have forced the legislators to address the issue of whether this was a wise use of public resources, or whether there are other ways that Federal credit could be used more effectively. Instead, the Federal Reserve decided to do the mortgage-backed securities program on its own authority. And instead of financing it by issuing debt, the Federal Reserve is financing it by creating new money. Creating new money, the Federal Reserve's balance sheet has blown out to an astonishing extent.

We have a lot of discussion in the market today about the danger of a central bank financing the Federal government's deficits. People are well aware that, historically, inflation has resulted where governments lose control of their fiscal measures. They run budget deficits which they cannot finance by raising taxes, and when confidence wanes, they cannot cover the deficits by issuing bonds, either. In that case, they resort to printing money, and that's where hyperinflation comes from.

And that concern is responsible for the Federal Reserve being careful about its program in purchasing Treasuries. The Fed announced that -- I think back in March -- a six-month program to buy \$300 billion worth of Treasuries, and yesterday they announced that the program will be extended.

This program will expire in October instead of September, but with the same \$300 billion total. And yet, there seems to be practically no public discussion of the implications of buying one and a quarter trillion worth of mortgage backed securities, financed by issuing new money -- \$1.25 trillion of new central bank liabilities.

So, at some point, the Federal Reserve is going to have to absorb all this cash that it put out in the market. If the Federal Reserve is late in absorbing all that

cash, or neutralizing the effects, then we are unavoidably going to have significant inflation come out of this. Where the Federal Reserve will end up with the technical judgment about when to do it, and how to do it, and how able they are to manage the politics of it, remains to be seen.

My concern is that the Fed's going to have to start to act probably next year. I don't know exactly when. They're going to have to start to rein in the balance sheet, or neutralize all the reserves that are out there -- we'll talk about that in a minute -- and they're going to have to do it at a time, if the employment rate is still high, while the economy may still be recovering. The unemployment may be falling, but it will still be high for a long time to come.

The inflation rate will continue to be low, possibly even lower than it is now. But the lags in the monetary policy process are perhaps two years from monetary expansion until it shows up in inflation. So, the Fed is going to have to act ahead of the inflation, if we're going to avoid the inflation. And they're going to have to act at a time when it's going to be politically awkward to do so. And that's why I believe that we ought to have substantial concern about Federal Reserve independence.

One other thing that Wessel says, which I absolutely agree with, and which I had concluded before I picked up the book. He says that Ben Bernanke in the early part of this financial crisis did not act terribly vigorously. He goes on, "Once Bernanke did step up, the Fed became such a whirlwind of activity that it took President George W. Bush, Treasury Secretary Paulson, and the U.S. Congress off the hook, allowing them to avoid timely but politically uncomfortable measures that might have prevented some of the worst of the damage."

So, the Federal Reserve, by running with the ball so to speak, did take Congress off the hook, but Congress is not going to be off the hook permanently. Congress will want to take control. In fact, if you read the U.S. Constitution, the Federal Reserve has assumed authority to spend money that the President, himself, does not have the authority to do.

Again, this is being done under the 13.3 clause in the Federal Reserve Act, and under another provision that allows the Federal Reserve to buy any obligations that are guaranteed by the Federal government, which is the situation with the mortgage-backed securities. So, I think we're going to see a lot of this ahead.

The Economic Outlook Today

Let me talk a bit about the economic outlook. I'm not a professional forecaster. It would be silly for me to try to compete with a staff such as Macroeconomic Advisers, a company with which I have some contact. Larry Meyer, who started the firm, is a person I've known for a long time, and he was a Fed Governor. He left the firm and became a Federal Reserve Governor, and I have great respect for his forecasting ability, and the others in the firm, which is based in St. Louis.

The Macroeconomic Advisers outlook represents a conventional view today: the economy is probably close to the trough now. Maybe when we look back, even July might be the trough month. Maybe it's August, or maybe it's September, or in the third quarter sometime. It's a pretty good guess we're close to the bottom, and that the growth over this third and fourth quarters might average 2% GDP growth. Next year we might see 3.5% growth, or something like that.

What's important to understand about economic forecasts though -- and, of course, there are a lot of jokes about this -- is that there are forecast errors. There have been a substantial amount of formal studies of forecast errors. And averaged over many years, we conclude that the standard error of a forecast is about 1-1.5%, over a period four quarters ahead in GDP forecast.

So, that says that if we're forecasting 3% growth for example on average over the next four quarters, if you were in the scientific world, you would state that as +3% or -1-1.5%. That's going to make a big difference as to whether it's 1.5% or 4.5% GDP growth. Those are very different outcomes.

The case for a slower-than-consensus outcome is that the financial disruption is not over and it's not going to be back to normal. There are a lot of firms with impaired capital, a lot of risk aversion in the market place, a lot of potential borrowers who are in a shaky situation. And so, it could be that the normal process of expanding credit in the early stages of the expansion will go more slowly than usual in the typical rebound from a recession.

The case for a stronger-than-consensus outcome is that this has been a deep recession, much more like 1981-82 than like 1990-91, or 2001. Those recoveries were very shallow, as well, but the reason for that was that the recession ahead of them was also very shallow. I think we're much more likely to have a bigger snap back than we are to have a long period of very slow recovery.

There's been an enormous amount of inventory liquidation. If you look at the data, you'll find that typically, the peak-to-trough decline in GDP is accounted for 33% to 50% by inventory liquidation alone. I haven't looked at the numbers this time, but there has been a very large inventory liquidation this time. When the inventory liquidation comes to an end, that means that

production catches up with sales quickly. And we would anticipate that once the recovery gets underway, there will be some inventory building.

My sense is that a lot of companies have pretty lean inventories. My sense is also that a lot of companies are quite lean in their staffing now. That would show up or be consistent with the productivity numbers that we've observed. We've seen good productivity growth, that is, output has grown with, or fallen less rapidly than, the labor input. So the ratio of output to hours of labor input -- which is productivity -- has done very well. Companies have shed a lot of workers. Generally, companies are fairly lean, and they will not be able to expand production significantly without adding staff.

Once demand conditions improve, companies will be out there racing to make better utilization of their physical facilities. They'll want to hire labor, to take advantage of the markets that are open to them. So, I think it's very important not to concentrate - or not to obsess anyway - with the consensus forecast. And, as I said, the standard error is 1.5% real GDP over four quarters. Under current circumstances, standard error is more likely to be larger.

The big forecasting errors come around turning points. So the standard errors - - that 1.5% average -- include the standard error from periods when the economy is growing pretty smoothly and predictably. The much bigger errors come about at turning points, both on the way down and on the way up. So, there's a great deal of uncertainty about the outlook over the next year or next 18 months.

I am fundamentally an optimist on the U.S. economy. I believe that we have markets that operate more effectively than in most parts of the world. We have an entrepreneurial environment that is unmatched in the world. There's no

place, no country in the world, that is a better one in which to start a business than the United States.

Permitting requirements, sources of capital, venture capital: all of those things are here -- we have an abundance of these, and it gives us an enormous advantage over many other countries. Relative to some of the emerging countries, this would certainly include China and India. We have a pretty honest, uncorrupt civil service and court system that makes the U.S. a much safer place to do business than in much of the world.

Let me talk just for a moment about fiscal policy. The budget before President Obama came into office was seriously out of balance in terms of the long-term situation. The government has been unable to address the Social Security and Medicare issues. The estimates that Larry Kotlikoff from Boston University offers is that the present value of the difference between the Medicare and Social Security obligation and the tax revenues that come in to those programs is in the neighborhood of \$60 trillion dollars.

That present value totally swamps the explicit on-balance sheet debt of the United States government. And the Obama administration has aggressive programs being designed -- not yet enacted -- for healthcare, obviously, and for the environment and for education; those are the three big ones.

And I do not believe that we have the tax resources really to finance these programs all at once. We have a substantial budget deficit obviously left over from the economic crisis that has depressed activity and tax revenues. It's going to be several years, maybe even three or four years, maybe five years, before we get back to full employment. We have a very, very large fiscal imbalance.

Now, the way in which fiscal balance will be resolved is ultimately that we are going to have to find a way to scale back obligations. I don't believe that the country has the tax resources to finance the new programs without seriously damaging our economic growth prospects. Therefore, we're going to have to decide to do less of something than is already in the law in other programs that the administration would like to pursue.

I don't know how that's going to work out. The optimistic side of me says the United States, over the course of its history, has always managed to generate the leadership to produce a good outcome. There's been a lot of muddling through, but we've been through some very difficult periods in history. The Founding Fathers had a very difficult situation to deal with setting up the new country. Through the Civil War, the post-Civil War period, World War I, World War II, the Great Depression, we have somehow come through these very stressful periods looking pretty good on the whole.

In fact, my colleague at the Cato Institute, Bill Niskanen, likes to put it this way, as he said to me when we were colleagues at the Council of Economic Advisors: "We have terrible problems in the United States, but I would not trade our problems for those of any other country in the world." We have a history of dealing with our problems. That's the optimistic side of me. I don't know how we're going to do it, but that's the optimistic side.

The pessimistic side of me says that our problems are going to accumulate faster than we generate the political will to deal with them, and we will end up with a great deal of pressure on the Federal Reserve to monetize the budget deficit. And we would then end up with a period of rising inflation. If I had to make my guess on that score -- and as I like to put it, I will not bet my brand new house on that, but I will bet my 11-year old SUV on it -- I'm guessing

that we're going to end up four or five years from now with an inflation rate in the 4% to 6% range.

The expansion has already taken place. The difficulties of unwinding this expansion, the politics of it, are huge. I hear some of my academic colleagues and others say, "Well, you know, the inflation rates have sort of been averaging around 2% or a little bit less recently. 4% doesn't sound so bad." And then I say, "Well wait a minute. That means another 200 basis points on long-term interest rates."

That means that long bonds, instead of being in the neighborhood of 4%, are going to be around 6%. In fact, that might happen fairly quickly as the market expectations of inflation develop, and that's going to be a very, very uncomfortable time in the bond market if that's what happens. But, there is an enormous amount of uncertainty about where this is going to go, and we do have these problems. I'm hoping that we get the political leadership to lead our way through them.

Questions from LMIC Clients

1. The Federal Reserve vs. Congress

Harry O'Mealia: We have quite a few questions, but I'll start with a comment. It comes out of what you just talked about, your concerns about the Fed getting beyond its charter and sort of being a renegade or a rogue agency, instead of having our elected Congress solve these problems. And then, you wondered about whether the political will exists in this country to actually address long-term issues.

Given the fact that Congress is elected every two years, how do you sync those two comments when you have a group that's being re-elected frequently and who is therefore much more subject to popular or populist currents, versus a more independent agency that actually can make a decision that's not based upon getting re-elected and who therefore might make a more thoughtful decision?

Bill Poole: Of course, this is a long time argument about how democracy works. And my sense of it is that Congress is simply *not* going to delegate matters of huge importance to be decided by independent agencies. One way or another, Congress will take control. And part of it is that the independent agencies make judgments that produce an enormous political reaction.

Now, we've got that going on right now. The popular outrage at the bailouts, and then the bonuses and compensation that are being taken down in many of these major firms...a lot of that outrage is really justified. We have quite a situation here.

There's a question here about "too big to fail" and maybe we can address that in this context. "Too big to fail" is an abomination. It cannot be a permanent part of the way in which our capital markets operate. You will find across the spectrum of economists, people who say that it is unacceptable to have socialized risks and private gains. And the private gains are the compensation that gets taken down by employees, and also perhaps shareholders, so one of the dangers in our situation is that there is nothing in place to address "too big to fail."

I fault the Federal Reserve for lack of leadership on that front. I do not believe that a strengthened regulatory apparatus will do the job. I just don't believe it. We have the danger that members of Congress will appeal to this popular

discontent. And it will be essentially impossible electorally for Congress to continue to bail out the large firms.

Now, I happen to think that that would be a good outcome, because we cannot have a stable situation in our capital markets where the bigger firms are operating under a federal umbrella and have access to capital more cheaply than the smaller firms. That cannot be a satisfactory, permanent situation. And it has the potential for real disaster because, eventually, the bigger companies will take risks given this access to capital and the assumed federal protection that goes with that.

Companies will take risks. They will get into trouble. And the political consequences of bailing out these big companies will be such that they will *not* be bailed out. There will be an expectational disconnect that is the seed of the next financial crisis. So, we've got to fix this situation.

If I could use an example here, a very recent example: Lehman Brothers had every right, and Lehman creditors had every right, to believe that they would be bailed out, if necessary, after Bear Sterns. And the real issue here is not to me whether Lehman should've been bailed out, but whether Bear Sterns should've been bailed out. But, once you start bailing out companies, it is very difficult to get out from under it.

I think that there are certain things that Congress can delegate, and certain things that Congress won't delegate because the electorate won't stand for them being delegated. And it's up to the Federal government, in this case the Federal Reserve and the Treasury, to show some leadership in getting us out from under the too big to fail regime that we are now in, and are likely to be in for some years to come. It's a tough, tough area.

2. The Issue of "Moral Hazard"

Joe Healy: The next question is from a client who said, "Is "moral hazard" no longer an operative concept?"

Bill Poole: No, unfortunately, it is very operative. "Moral hazard" explicitly covers the 19 largest banks. The Fed and the Treasury have said that they would not allow any of the 19 largest to fail. Now eventually, they're going to have to back off from that. Having rescued AIG, it could well be that this would extend to the large insurance companies. And we had this discussion just a few weeks ago as to whether it extended to CIT.

CIT was a great example. CIT came running to the Federal government for help. Fortunately, the Federal government said no, and then CIT found that it could negotiate with its creditors after all, and that's exactly the way that ought to be handled. So no, "moral hazard" is a very, very serious problem, and it's going to be with us for a long time to come I'm afraid.

3. The Stimulus Package

Harry O'Mealia: We had a number of questions on stimulus and inflation. I'll put several questions together. If the economy is on the mend and yet only 15% of the stimulus money has been spent, is it necessary to spend the balance? Will there be any leadership call to *not* spend money? Can the Fed effectively remove the stimulus without causing a double-dip recession?

Bill Poole: I think the way to answer those questions is to look at some of the details of the stimulus package. Much of the stimulus package had stuff in it that was

not very short-term in nature. And some of it was in just rebates, like tax rebates, that have already gone out.

The public works part of the stimulus package for highways and some of the other programs that were part of efforts to aid state and local governments -- it would be very unlikely that those plans would be reversed. It's not an accident that a lot of those programs assisting state and local governments are also assisting the union employees of state and local governments.

Labor unions today are primarily representing government workers, state and local groups like teachers' unions, postal workers. I think it's only 7% of the private labor force that is currently unionized. So, given the politics of this situation, I think it would be very unlikely that the Obama administration would back off from the infrastructure support at the state and local level.

A lot of these projects, like the road building projects, cannot be stopped once the contracts are final. I would be surprised if any substantial part of these programs are rescinded. I think that if the economy gets going, and particularly if inflation concerns arise, then there will be some concern in the Congress over the budget deficit, and then maybe other things may get pulled back. But, I'd be surprised if that stimulus bill is affected, the stuff that's already in there.

Incidentally, I let me make one other observation- a lot of this is political discussion. You understand that I'm an economist. I'm not a political expert, and so I want to put that footnote in there. I'm doing the best I can to understand the politics of what's going on today. I've been following these things a long time, but I regard myself above all as being an economist and not a political expert.

4. The Value of the Dollar

Joe Healy: In terms of the stimulus and the dollar, what is your general thought process there? And, in terms of the Fed, what is their accountability for the value of the dollar?

Bill Poole: A lot of the concern about the value of the dollar comes about because of the knowledge that there are very large holdings of U.S. assets, particularly the U.S. government's obligations, that are held abroad. And the argument is that if the foreign investors come to distrust the United States, then they will try to flee those assets, and the effort to do so will drive down the value of the dollar.

The point I want to emphasize here, though, is that there is a worldwide investment community, and the investment calculations that are made abroad, let's say in London, are not fundamentally different from those that are made in New York. So, we have as much to fear from the U.S. investment community, if you will, as we do from investors abroad.

The issue here ultimately comes down to the stability of the purchasing power of the currency. As long as the dollar retains a high degree of purchasing power, that is the rate of inflation remains low and stable, U.S. dollar assets will be in demand by investors all around the world, both here and abroad.

Another very important point to recognize is that the foreign exchange rate is the ratio of one currency to another. So, if you take the Euro rate, for example, what goes on in Europe is every bit as important as what goes on in the United States. And Europe's got its own set of problems, and other countries have

their problems, so I would regard the international climate as being just as important to the exchange rate for the United States.

Therefore, you need to ask this question with regard to policies in Europe as well as the policies in the United States. I would note that the imbalance from the social programs in Europe is every bit perhaps more severe than and the ones that we have. I refer to Medicare and Social Security here. The entrepreneurial environment in Europe is much, much weaker.

Europe has had chronically higher unemployment in the last 25 years relative to the United States. There are a lot of rigidities in Europe that have damaged economic growth prospects. Where that's all going to come out depends both on Europe and on the United States.

5. Liabilities at the Municipal Level

Harry O'Mealia: I've got one new question, from a client listening in to the Forum, and I think it goes back to "too big to fail." And it's a good question because it's something we don't focus on right away. The question is, "Regarding 'too big to fail,' what about the municipalities around the country? Do you believe that we will begin to see growing defaults on municipal obligations?" With tax receipts down with obligations up, and the fact that municipalities can't print money, what will happen?

Bill Poole: Right. The situation in the municipalities obviously differs from one to the next, and I have no particular expertise there.

And the situation on municipal liabilities also depends on the state governments, because local governments get tremendous fiscal resources from state governments, and so some of the issue in California, I gather, is that the

State of California has cut back significantly on the education budget. The municipalities in California are responsible for running the schools, and yet the state government is cutting back on funding.

How this works out depends on the interplay of the state and the municipalities. Obviously, the Federal government is also involved here, and the Federal government has lots of programs that funnel money into the municipalities. I think that one of the biggest single threats here is one that surfaces from time to time, and that is the abysmal state of accounting for pension obligations in the state and local government area.

For example, I was told when I was in St. Louis, at the time I was leaving the Fed, that the local municipality was something like \$300 million underwater in its pension funding...it's probably a lot worse now, given what's happened to the market. And I know New Jersey is in a terrible situation with its pension obligation.

Liabilities differ a lot from state to state, and I do not know the extent to which we have adequate data for understanding how big the holes are county by county, town by town. This is presumably a place where the investment expertise of your firm [Legg Mason Investment Counsel] could be of substantial service to your clients, to understand which municipalities are in deeper trouble than others.

Obviously, to the extent that some of the municipalities go into bankruptcy, they will break the promise to constituents for many core services. And it's a question of whether they can break the promise without going through bankruptcy. But, just as some corporations have found it desirable to shed their obligations by going through bankruptcy – some airlines, for instance, have done this several times, and there are also automobile companies who

have done so more recently – this might become a necessary option for some municipalities.

But here again, the political issue has to do with the fact that the labor unions that represent the teachers and the government workers are very important political forces. And that makes the political calculus quite difficult in knowing how all this might come out. Keep in mind also that there is always a great effort to try to get Uncle Sam to chip in, as well. And I can well imagine that some of the earmarks that we hear about are actually a disguised way of funneling money into particular municipalities.

It's also too *sub rosa*, and you would have to be digging very deep into the political process to understand how much of this is going on.

6. The Housing Market and the Savings Rate

Harry O'Mealia: Let's move over to the consumer side of the economy. A major topic for several questions we received is the housing market. And, as a related topic, is it possible for America to become a nation of savers, or is this just a consumption economy that lives for the moment?

Bill Poole: Let me take up the saving question first. The savings rate has gone up, and it's gone up for many households quite involuntarily, because their access to credit has been cut off. Ronald Reagan used to have a famous comment when he was talking about the Federal budget. He said, "Every parent knows how to control a teenager's expenditures: you cut off the allowance." And, of course, that's what the credit markets have done for many households. Households are no longer able to refinance their mortgage and extract equity, and that's one of the big reasons that the savings rate is going up.

It would be highly desirable for our economy if the savings rate would be permanently higher than it has been in recent years. It would be better for many households if they are not overextended, and not encouraged to become overextended.

We will continue to have a lot of mortgage foreclosures because many homeowners are still under water, and that process is continuing. I haven't actually looked at the house price data recently. I just have a gut feeling from what I read that house prices on a national average basis are probably getting down pretty close to where they're going to settle for a while.

Unless we have another letdown in the economy that destroys some of the purchasing power for housing prices, my guess is that we're getting sort of close to the bottom. There will be some revival of home building and credit will be more readily available for households that have reasonable credit standings.

Another area to note in this discussion is consumer durables; obviously, that is the part of the consumption spending that has the biggest amplitude over the business cycle. And automobiles are the largest part of durables spending. Automobile production has dropped well below the scrappage rate as the stock of cars has been declining.

Of course, the "Cash for Clunkers" program has pushed that rate higher, as well. We're taking cars that operate fine, destroying the engine, and sending them to the junk yard. So, the scrappage rate remains higher, and at some point, current production has got to catch up because the stock of automobiles is not going to go down indefinitely.

As the economy bottoms out and as people begin to return to work, they will have a better chance of getting a car loan. When you have a job, you can get a car loan; if you don't have a job, you might not get a car loan. That process is part of the normal recovery phase of the business cycle. It's also true that in the recovery phase, you would anticipate some increase in the saving rate when households are not so hard-pressed, and are not drawing down the savings that they have to finance current expenditures.

So, I think the savings rate will rise. We need a Federal policy, though. If we're going to change an area of current consumption, we need to add more of something else. One of my big disappointments with the stimulus legislation that was passed in February is that there was nothing in there to stimulate business fixed investments.

What we need in our economy is a smaller consumption share. As far as I'm concerned, we don't need a larger government share, but if we're going to have a smaller consumption share, we need a larger share from something else. And what it ought to be is business fixed investment, because that helps to drive productivity and economic growth.

The two most successful stimulus programs in history were the Kennedy-Johnson program and the Reagan program. The Kennedy-Johnson program had it right from the beginning: provide a stimulus to business investment. In 1962, there were changes in the depreciation tax law to allow accelerated depreciation. And then, I think it was in October of 1962, there was an investment tax credit to stimulate business investment, and they were both very successful.

The Reagan program, the 1981 Economic Recovery Tax Act, or ERTA, had both accelerated depreciation and an investment tax credit. And it would be

highly desirable that we have these again as part of our stimulus legislation. We didn't get them in February, and I think that is unfortunate.

7. Key Economic Indicators

Harry O'Mealia: We're drawing toward the end. A quick question - this is for Bill Poole, citizen. And pretend that you're us now, and you're reading through the data. What specifically are you looking for that makes you either optimistic or pessimistic about the direction of the economy? What are a couple of key data points that you as a citizen might look at to help guide you on how the U.S. is doing?

Bill Poole: The most important single indicator released every month is the employment report. And the employment report includes data on both household employment and payroll. There are two separate surveys. The market pays most of its attention to the payroll survey because the sample is a lot larger, but I think it's worth paying some attention to the household survey, as well.

There are other reports that give us some advance indication, particularly the ADP report, of what the employment survey will look at. There is a whole steady stream of data. You know, there's a release at 8:30 in the morning almost every day about an economic data point, and if you're in this business, you follow all of these reports.

The tricky part is to look at these reports and filter out cases where there are anomalies. Sometimes you look at these reports and there are inconsistencies, anomalies, and you say, "There's something screwy here, so we need to put less weight on this particular report than we ordinarily would because it's anomalous."

A really good example that is easy to understand is the employment report released after Hurricane Katrina. It was not very helpful because there were so many businesses that were destroyed, it was not clear what was really happening to employment in a wide area in the South. So, you had to discount the employment report at that time.

But, I would say that the people who follow the data really closely look at a whole variety of things. Certainly, housing starts and permits are important because of the cyclical amplitude of housing. In terms of financial data, there are various interest rate spreads you look at to understand what's going on in the financial markets.

I pay more attention than most to the money stock numbers that appear on this St. Louis Fed release. If you look at the latest report, you'll see that money growth in the last few months has actually been pretty slow. But, I would look at those data points as very important.

The other thing I would pay a lot of attention to in the financial world is the spread between conventional Treasuries and index Treasuries. That's a spread that reflects inflation expectations. And as long as inflation expectations remain well contained in the market, that means that the investment community does not fear inflation. But, if we start to see those numbers going up, then that is probably going to be an important component driving the inflation process up itself.

Pricing decisions depend a lot on forward expectations about where wages and prices are going.

8. The Federal Reserve as a Policy Maker

Harry O'Mealia Let's bring it back to the Fed for a final question. Alan Greenspan felt that it wasn't the Fed's job to manage bubbles. What's your view on that? And given what we've had after the current housing debacle, should the Fed rethink their position?

Bill Poole: Well, there's a lot of rethinking, but I remain adamantly opposed to the Central Bank trying to deal with asset prices. And to me, the issue is really pretty simple. The Federal Reserve essentially has one policy instrument, and that's called the Federal Fund Rate. If you have one policy instrument, you're not going to be able to reach multiple objectives with that one instrument.

So, in my view, and I think most monetary economists would agree, the most important single responsibility of the Central Bank, using its one policy instrument, is price stability. If you have the Federal Reserve adjusting the Federal Funds Rate, there is some other purpose. You are saying that you are willing to give up price stability because you have this other objective. And I think once we lose price stability, then all sorts of other bad things happen.

If you were trying to depress or deflate the stock market bubble from the late '90s, or the housing price level from recent years, what you would be doing is saying, "We're going to raise the Federal Funds Rate, and try and knock this bubble down. And we are going to accept a period of recession, or subprime performance, and perhaps even falling prices." If you just take recent prices as we come out of this recession, we may initially still have a pretty low inflation rate. That's the first point I would make.

The second point I would make is in some ways even a more fundamental point. A market economy depends on the markets making the judgment on

capital allocation and the pricing of capital assets. Let me imagine that we got around this problem of only one policy instrument. Imagine we had another policy instrument - I don't know what it would be, but just call it "X". You want a policy instrument -- if it's to be successful -- to be accurate. You want to know the connection between moving "X" and the target variable.

The best possible situation would be if "X" has a perfectly predictable effect on, say, the stock market. That would be the best possible position from the point of view of monetary control. Do you want any government agency setting the level of stock prices? And my answer to that is unambiguously no. It is inconsistent with the way a market economy functions. You do not want the Federal government setting asset prices. So, I think it's a dead end to say that the Federal Reserve ought to have multiple targets of which one of them is asset prices.

And I fail to understand the arguments of some economists who believe otherwise. It seems to me they just do not follow the logic to the end that I just took you. I'm reminded of Milton Friedman, under whom I studied at Chicago. He was a brilliant debater, and I can remember a number of debates where his debating opponent would say, "Milton, that's pushing logic too far." And his response was, "That's the only place you can push logic."

CLOSING

O'Mealia That's terrific. Thank you very much. Thanks Bill. And thanks to everyone for participating from around the country, on the phones. So, thank you so much for coming, Bill. You were terrific.

Bill Poole: Thank you.