Testimony submitted to the Senate Budget Committee, hearing on "Crisis and Aftermath: The Economic Outlook and Risks for the Federal Budget and Debt," Tuesday, February 9, 2010 (embargoed until 10am).

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A. Main Points

1) In recent months, the US economy entered a recovery phase following the severe credit crisis-induced recession of 2008-09. While slower than it should have been based on previous experience, growth has surprised on the upside in the past quarter. This will boost headline year-on-year growth above the current consensus for 2010. We estimate the global economy will grow over 4 percent, as measured by the IMF's year-on-year headline number (their latest published forecast is for 3.9 percent), with US growth in the 3-4 percent range – calculated on the same basis.

2) But thinking in terms of these headline numbers masks a much more worrying dynamic. A major sovereign debt crisis is gathering steam in Europe, focused for now on the weaker countries in the eurozone, but with the potential to spillover also to the United Kingdom. These further financial market disruptions will not only slow the European economies – we estimate growth in the euro area will fall to around 0.5 percent Q4 on Q4 (the IMF puts this at 1.1 percent, but the January World Economic Outlook update was prepared before the Greek crisis broke in earnest) – it will also cause the euro to weaken and lower growth around the world.

3) There are some European efforts underway to limit debt crisis to Greece and to prevent the further spread of damage. But these efforts are too little and too late. The IMF also cannot be expected to play any meaningful role in the near term. Portugal, Ireland, Italy, Greece, and Spain – a group known to the markets as PIIGS, will all come under severe pressure from speculative attacks on their credit. These attacks are motivated by fiscal weakness and made possible by the reluctance of relatively strong European countries to help out the PIIGS. (*Section B below has more detail*.)

4) Financial market participants buy and sell insurance for sovereign and bank debt through the credit default swap market. None of the opaqueness of the credit default swap market has been addressed since the crisis of September 2008, so it is hard to know what happens as governments further lose their credit worthiness. Generalized counter-party risk – the fear that an insurer will fail and thus bring down all connected banks – is again on the table, as it was after the collapse of Lehman.

[1] This testimony draws on joint work with Peter Boone, particularly "The Next Financial Crisis: It's Coming and We Just Made It Worse" (*The New Republic*, September 8, 2009) and "The Doomsday Cycle" (forthcoming), and James Kwak, including *13 Bankers* (forthcoming, March 2010) and "The Quiet Coup" (*The Atlantic*, April, 2009). Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments for the global economy.

5) Another Lehman/AIG-type situation lurks somewhere on the European continent, and again G7 (and G20) leaders are slow to see the risk. This time, given that they already used almost all their scope for fiscal stimulus, it will be considerably more difficult for governments to respond effectively if the crisis comes.

6) In such a situation, we should expect that investors scramble for the safest assets available – "cash", which means short-term US government securities. It is not that the US has anything approaching a credible medium-term fiscal framework, but everyone else is in much worse shape.

7) Net exports have been a relative strength for the US economy over the past 12 months. This is unlikely to be the case during 2010.

8) In addition to this new round of global problems, the US consumer is beset by problems – including a debt overhang for lower income households, a soft housing market, and volatile asset prices. The savings rate is likely to fall from 2009 levels, but remain relatively high. Residential investment is hardly likely to recover in 2010 and business investment is too small to drive a recovery.

9) On a Q4-on-Q4 basis, the US will struggle to grow faster than 2 percent (the IMF forecast is for 2.6 percent). This within year pattern will likely involve a significant slowdown in the second half – although probably not an outright decline in output. The effects of fiscal stimulus will begin to wear off by the middle of the year and without a viable medium-term fiscal framework there is not much room for further stimulus – other than cosmetic "job creation" measures.

10) The Federal Reserve will start to wind down its extraordinary support programs for mortgage-backed securities, starting in the spring (although this may be delayed to some degree by international developments). The precise impact is hard to gauge, but this will not help prevent a slowdown in the second quarter.

11) On top of these issues, there is concern about the levels of capital in our banking system. The "too big to fail" banks are implicitly backed by the US government and for them the stress test of early 2009 played down the amount of capital they would need if the economy headed towards a "double-dip"-type of slowdown; the stress scenario used was far too benign. In addition, small and medium sized banks have a considerable exposure to commercial real estate, which continues to go bad.

12) Undercapitalized banks tend to be fearful and curtail lending to creditworthy potential borrowers. This may increasingly be the situation we face in 2010.

13) Emerging markets are also likely to slow in the second half of the year. Twice recently we have assessed whether these economies can "decouple" from the industrialized world (in early 2008 and at the end of 2008). In both cases, emerging markets – with their export orientation and, for some, dependence on commodity prices – were very much caught up in the dynamics of richer countries' cycle.

14) The IMF projects global growth, 4^{th} quarter-on-4^{th} quarter within 2010 at 3.9 percent, i.e., the same as their year-on-year forecast. We expect it will be closer to 3 percent.

15) Over a longer time-horizon, we will probably experience a global economic boom, based on prospects in emerging markets. With our current global financial structure, this brings with it substantial systemic risks (*see Section C below*).

B. From Greece to the US: The Globalized Financial Transmission Mechanism

1) The problems now spreading from Greece to Spain, Portugal, Ireland and even Italy portend major trouble ahead for the US in the second half of this year – particularly because our banks remain in such weak shape.

2) Greece is a member of the eurozone, the elite club of European nations that share the euro and are supposed to maintain strong enough economic policies. Greece does not control its own currency – this is in the hands of the European Central Bank in Frankfurt. In good times, over the past decade, this helped keep Greek interest rates low and growth relatively strong.

3) But under the economic pressures of the past year, the Greek government budget has slipped into ever greater deficit and investors have increasingly become uncomfortable about the possibility of future default. This impending doom was postponed for a while by the ability of banks – mostly Greek – to use these bonds as collateral for loans from the European Central Bank (so-called "repos").

4) But from the end of this year, the ECB will not accept bonds rated below A by major ratings agencies – and Greek government debt no longer falls into this category. If the ECB will not, indirectly, lend to the Greek government, then interest rates will go up in the future; in anticipation of this, interest rates should rise now.

5) This spells trouble enough for an economy like Greece – or any of the weaker eurozone countries. Paying higher interest rates on government debt also implies a worsening of the budget; these are exactly the sort of debt dynamics that used to get countries like Brazil into big trouble.

6) The right approach would be to promise credible budget tightening over 3-5 years and to obtain sufficient resources – from within the eurozone (the IMF is irrelevant in the case of such a currency union) – to tide the country over in the interim.

7) But the Germans have decided to play hardball with their weaker neighbors – partly because those countries have not lived up to previous commitments. The Germans strongly dislike bailouts – other than for their own banks and auto companies. And the Europeans policy elite loves rules; in this kind of situation, their political process will move at a relatively slow late 20th century pace.

8) In contrast, markets now move in a 21st century global network pace. We are moving towards is a full-scale speculative attack on sovereign credits in the eurozone. Brought on by weak fundamentals – worries about the budget deficit and whether government debt is on explosive path – such attacks take on a life of their own. We should remember – and prepare for – a spread of pressure between countries along the lines of the panic that moved from Thailand to Malaysia and Indonesia, and then then jumped to Korea all in the space of two months during 1997.

9) The equity prices of weaker European banks will come under pressured. Fears about their solvency may also be reflected in higher credit default swap spreads, i.e., a higher cost of insuring against their default.

10) US Treasury and the White House apparently take the view that they must stand aloof, waiting for the Europeans to get their act together. This is a mistake – the need for US leadership has never been greater, particularly as our banks are really not in good enough shape to withstand a major international adverse event (e.g., Greece defaults, Greece leaves the eurozone, Germany leaves the eurozone, etc).

11) We subjected our banks to a stress test in spring 2009 – but the stress scenario was mild and more appropriate as a baseline. Many of our banks – big, medium, and small – simply do not have enough capital to withstand further losses.

12) As the international situation deteriorates – or even if it remains at this level of volatility – undercapitalized banks will be reluctant to lend and credit conditions will tighten around the US.

13) If the European situation spins seriously out of control, as it may well do in coming weeks, the likelihood of a double-dip recession (or significant slowdown in the second half of 2010) increases dramatically.

C. Longer Run Baseline Scenario

1) In terms of thinking about the structure of the global economy there are three main lessons to be learned from the past eighteen months.

2) First, we have built a dangerous financial system in Europe and the U.S., and 2009 made it more dangerous.

    a. The fiscal impact of the financial crisis was to increase by around 30-40 percent points our federal government debt held by the private sector. The extent of our current contingent liability, arising from the failure to deal with "too big to fail" financial institutions, is of the same order of magnitude.

    b. Our financial leaders have learnt that they can bet the bank, and, when the gamble fails, they can keep their jobs and most of their wealth. Not only have the remaining major financial institutions asserted and proved that they are too big to fail, but they have also demonstrated that no one in the executive or legislative branches is currently willing to take on their economic and political power.

    c. The take-away for the survivors at big banks is clear: We do well in the upturn and even better after financial crises, so why fear a new cycle of excessive risk-taking?

3) Second, emerging markets were star performers during this crisis. Most global growth forecasts made at the end of 2008 exaggerated the slowdown in middle-income countries. To be sure, issues remain in places such as China, Brazil, India and Russia, but their economic policies and financial structures proved surprisingly resilient and their growth prospects now look good.

4) Third, the crisis has exposed serious cracks within the euro zone, but also between the euro zone and the U.K. on one side and Eastern Europe on the other. Core European nations will spend a good part of the next decade bailing out the troubled periphery to avoid a collapse. For many years this will press the European Central Bank to keep policies looser than the Germanic center would prefer.

5) Over the past 30 years, successive crises have become more dangerous and harder to sort out. This time not only did we need to bring the **fed funds rate** near to zero for "an extended period" but we also required a massive global fiscal expansion that has put many nations on debt paths that, unless rectified soon, will lead to their economic collapse.

6) For now, it looks like the course for 2010 is economic recovery and the beginning of a major finance-led boom, centered on the emerging world.

7) But this also implies great risks. The heart of the matter is, of course, the U.S. and European banking systems; they are central to the global economy. As emerging markets pick up speed, demand for investment goods and commodities increases – countries producing energy, raw materials, all kinds of industrial inputs, machinery, equipment, and some basic consumer goods will do well.

8) On the plus side, there will be investment opportunities in those same emerging markets, be it commodities in Africa, infrastructure in India, or domestic champions in China.

9) The Chinese exchange rate will remain undervalued. Our reliance on Chinese purchases of US government and agency debt puts us at a significant strategic disadvantage and makes it hard for the administration to push for revaluation. The existing multilateral mechanisms for addressing this issue – through the IMF – are dysfunctional and will not help. There is a growing consensus to move exchange issues within the remit of the World Trade Organization but, without US leadership, this will take many years to come to fruition.

10) Good times will bring surplus savings in many emerging markets. But rather than intermediating their own savings internally through fragmented financial systems, we'll see a large flow of capital out of those countries, as the state entities and private entrepreneurs making money choose to hold their funds somewhere safe – that is, in major international banks that are implicitly backed by U.S. and European taxpayers.

11) These banks will in turn facilitate the flow of capital back into emerging markets – because they have the best perceived investment opportunities – as some combination of loans, private equity, financing provided to multinational firms expanding into these markets, and many other portfolio inflows. Citigroup, for example, is already emphasizing its growth strategy for India and China.

12) We saw something similar, although on a smaller scale, in the 1970s with the so-called recycling of **petrodollars**. In that case, it was current-account surpluses from oil exporters that were parked in U.S. and European banks and then lent to Latin America and some East European countries with current account deficits.

13) That ended badly, mostly because incautious lending practices and – its usual counterpart – excessive exuberance among borrowers created vulnerability to macroeconomic shocks.

14) This time around, the flows will be less through current- account global imbalances, partly because few emerging markets want to run deficits. But large **current-account imbalances** aren't required to generate huge capital flows around the world.

15) This is the scenario that we are now facing. For example, savers in Brazil and Russia will deposit funds in American and European banks, and these will then be lent to borrowers around the world (including in Brazil and Russia).

16) Of course, if this capital flow is well-managed, learning from the lessons of the past 30 years, we have little to fear. But a soft landing seems unlikely because the underlying incentives, for both lenders and borrowers, are structurally flawed.

17) The big banks will initially be careful – although Citigroup is already bragging about the additional risks it is taking on in India and China. But as the boom progresses, the competition between the megabanks will push toward more risk-taking. Part of the reason for this is that their compensation systems remain inherently pro-cyclical and as times get better, they will load up on risk.

18) The leading borrowers in emerging markets will be quasi-sovereigns, either with government ownership or a close crony relationship to the state. When times are good, investors are happy to believe that these borrowers are effectively backed by a deep-pocketed sovereign, even if the formal connection is pretty loose. Then there are the bad times – remember Dubai World at the end of 2009 or the Suharto family businesses in 1997-98.

19) The boom will be pleasant while it lasts. It might go on for a number of years, in much the same way many people enjoyed the 1920s. But we have failed to heed the warnings made plain by the successive crises of the past 30 years and this failure was made clear during 2008-09.

20) The most worrisome part is that we are nearing the end of our fiscal and monetary ability to bail out the system. In 2008-09 we were lucky that major countries had the fiscal space available to engage in stimulus and that monetary policy could use quantitative easing effectively. In the future, there are no guarantees that the size of the available policy response will match the magnitude of the shock to the credit system.

21) Much discussion of the Great Depression focuses on the fact that the policy response was not sufficiently expansionary. This is true, but even if governments had wanted to do more, it is far from clear that they had the tools at their disposal – in particular, the size of government relative to GDP is limited, while the scale of financial sector disruption can become much larger.

22) We are steadily becoming more vulnerable to economic disaster on an epic scale.