Testimony before the Senate Budget Committee

of

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Thank your, Chairman Conrad and the other members of the Committee, for the opportunity to comment on the U.S. economy and the risks for the federal budget and debt. I am currently a professor in the Department of Economics at the University of Maryland. I suspect that I was invited today because, for more than a decade, my research has focused on various types of financial crises, including their fiscal implications and other economic consequences. One of the main lessons emerging from this work is that across countries and over time, severe financial crises follow a similar pattern.

In a paper written over a year ago with my coauthor Ken Rogoff from Harvard University, we examined the depth and duration of the slump that invariably follows financial crises. The recessions following severe post-World War II financial crises tended to be protracted affairs. Asset market collapses were deep and prolonged. On a peak-to-trough basis, real housing prices declined 35 percent on average, stretched out over six years. Equity price collapses averaged 55 percent, but the recovery from the bottom was quicker. In the present downturn, real housing prices have fallen 36 percent from their February 2006 peak.

Not surprisingly**,** banking crises are associated with profound declines in output and employment. The unemployment rate rises an average of 7 percentage points over the down phase of the cycle, which lasts on average over four years. We are following this track: the U.S. unemployment rate bottomed at 4.4 percent in December 2006; by its recent peak level in October 2009, the unemployment rose 5.7 percentage points.

Historically, these conditions produced a marked deterioration in budget deficits. Correspondingly, the real value of government debt soars, rising an average of 86 percent in the major post–World War II episodes. The main cause of debt explosions is not the widely cited costs of bailing out the banking system. Nor is it fiscal stimulus, as many countries in the sample did not implement such policies. In fact, the critical factor is the collapse in tax revenues in the wake of deep and prolonged economic contraction. Our estimates of the rise in government debt are likely to be conservative, as they do not include increases in government guarantees, which also soar.

Government debt has been soaring in the wake of the recent global financial maelstrom, especially in the epicenter countries. In related work that Rogoff and I completed only a few weeks ago, we calculated the increase in (inflation adjusted) public debt that has occurred since 2007. For five countries with systemic financial crises (Iceland, Ireland, Spain, the United Kingdom, and the United States), average debt levels are up about 75 percent. Even in countries that have not experienced a major financial crisis, debt rose an average of about 20 percent in real terms between 2007 and 2009.

Our main focus is on the longer-term macroeconomic implications of much higher public and external debt. We examine the experience of forty four countries spanning up to two centuries of data on central government debt, inflation, and growth. Our main finding is that across both advanced countries and emerging markets, high debt/GDP levels (90 percent and above) are associated with notably lower growth outcomes. Above 90 percent, median growth rates fall one percent, and average growth falls considerably more. In addition, for emerging markets, there appears to be a more stringent threshold for total external debt/GDP; when external debt reaches 60 percent of GDP, annual growth declines by about two percent and for higher levels, growth rates are roughly cut in half. Seldom do countries simply "grow" their way out of deep debt burdens.

Why are there thresholds in debt, and why 90 percent? While the exact mechanism is not certain, we presume that at some point, interest rate premia react to unchecked deficits, forcing governments to tighten fiscal policy. Higher taxes have an especially deleterious effect on growth. We suspect that growth also slows as governments turn to financial repression to place debts at sub-market interest rates.

Of course, there are other vulnerabilities associated with debt buildups that depend on the composition of the debt itself. One common mistake as debts soar is for governments to "play the yield curve", shifting to cheaper short-term debt to economize on interest costs. Unfortunately, a government with massive short-term debts to roll over is ill positioned to adjust if rates spike or market confidence fades.

Even aside from high and rising levels of public debt, many advanced countries, particularly in Europe, are saddled with extraordinarily high levels of external debt, or debt issued abroad by both the government and private entities. In the case Europe, the advanced country average exceeds 200 percent external debt to GDP. In the United States, private debts amount to 283 percent of GDP, their highest level since 1916 when the data were first collected. Historically, private debts often end up as public debts. Current high private domestic and external debt burdens would also seem to be an important vulnerability to monitor. Downgrades usually follow debt.

Given these risks of higher government debt, how quickly should governments exit from fiscal stimulus? This is not an easy task, especially given weak employment, here in the United States and elsewhere. In light of the likelihood of continued weak consumption in the U.S. and Europe, rapid withdrawal of stimulus could easily tilt the economy back into recession. To be sure, this is not the time to exit. It is, however, the time to lay out a credible plan for a future exit. The sooner our political leadership reconciles itself to accepting adjustment, the lower the risks of truly paralyzing debt problems down the road. Although most governments still enjoy strong access to financial markets at very low interest rates, market discipline can come without warning. Countries that have not laid the groundwork for adjustment will regret it.

This time is not different.