A Status Report on the U.S. Economy
Testimony of Richard Berner, Morgan Stanley
Senate Budget Committee
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Chairman Conrad, Ranking Member Gregg, and other members of the Committee, my name is Richard Berner. I am Co-Head of Global Economics at Morgan Stanley in New York. Thank you for inviting me to this hearing to discuss the state of the US economy, the outlook, and what policymakers can do to improve it.

**A Status Report on the Economy**

We have emerged slowly from the worst financial crisis since the Great Depression. The crisis and the credit crunch that followed are over and most financial markets are functioning.

But the legacy of the crisis is scattered across the economic landscape. One in four homeowners with a mortgage owes more than their house is worth. Lenders are still hesitant to lend to or refinance many borrowers. And while the process of cleaning up lenders' and household balance sheets is well advanced, it is incomplete. Additional, steady progress is required to assure a sustainable recovery.

Likewise, we have emerged slowly from the deepest recession since the Great Depression. Aggressive and unconventional monetary policy and fiscal stimulus have ended the credit crunch, and strong global growth has been an economic tailwind.

But headwinds from the crisis linger. GDP has recovered by only 3.2% over the past year, so it is still 1% below its peak of two years ago. Federal, state and local budgets are strained, apparently limiting the scope for additional policy action. Job and hours gains have been encouraging, but a faster pace is required to generate the household income and confidence needed to sustain recovery, and to recover sooner the 8.4 million jobs lost in the recession.

This subpar recovery leaves substantial slack in the economy. For example, housing vacancy rates and the unemployment rate are high — too high — and industrial operating rates are still low. That slack means there is a 'tail risk' that inflation will sink too low and turn into deflation. The Fed has maintained stable inflation expectations, which will limit that risk. While I see signs of a bottoming in inflation at low rates — not deflation — we cannot take the outlook for granted.

**The Outlook: Moderate Growth, not a Double Dip**

In this portion of my remarks, I'll turn to the outlook. I'll outline the reasons for our slightly above-trend growth outlook, and why I believe the odds of a renewed downturn are remote.

In my view, moderate but sustainable growth of 3 to 3½% through 2011 is likely. Yet the deceleration from 5% in Q4 to 2.4% in Q2 has reinforced the consensus outlook for sluggish, below-trend growth (Slide 1). Extrapolating that deceleration, many believe that 1-2% growth in the second half is a given. And the tail risk of deflation is a widespread concern.

We admit that 2.4% growth, if it were to continue, lies barely on the threshold of a sustainable economic recovery:

- It is only just fast enough to generate the jobs and hours needed to extend income growth for moderate gains in consumer spending.
- But it is not fast enough to continue to narrow slack in the economy — key for reducing the tail risk of deflation and maintaining operating leverage for corporate profits.

In contrast, I think a pickup in growth is coming. Four factors underpin that view:

1. The shock from the European sovereign crisis has faded, allowing financial conditions to renew their easing, which is essential to growth.

2. Global growth, especially in the big Emerging Market countries where domestic demand is strong, is still hearty. For example, it appears that the Chinese economy has slowed in response to restraints on lending and tighter monetary policy. But we estimate that it is slowing from 10% this year to 9.5% in 2011 — still strong.[1]
3. The ongoing revival in job and income gains will provide income growth sufficient to sustain 2-2.5% consumer spending growth. Friday's data should show that nonfarm payrolls and hours rebounded in July.
4. Finally, infrastructure spending, the last part of the fiscal stimulus enacted in 2009, is now gathering steam.

Five aspects of the latest GDP data support that reasoning.

First, domestic final demand accelerated to a 4.1% annual rate in Q2. That pace is not sustainable, as housing seems to be fading again. But 3% growth in overall final sales is both sustainable and likely. And we think upcoming news on vehicle sales and retailing will kick the quarter off with a bang.

Second, American consumers have rebuilt saving and balance sheets by paying and writing down debt more than previously thought.[2] As seen on slide 2, the personal saving rate, at 6.2% in Q2, has tripled from the 2005-07 bubble period norm. Most important, underlying income growth is stronger than previous estimates. Consequently, I believe consumers will spend more of their income in H2.

Third, a wider trade gap was a drag on growth in the first half. We think that the trade gap will narrow again as global growth persists and US production indicators firm, indicating that domestic producers are satisfying more global and domestic demand.

Fourth, while the recession crushed profitability, the rebound has been equally sharp. Margins proxied by the measure in slide 3 were still below record highs as of Q1, and we think peak margins still lie ahead. So companies have wherewithal to spend and clearly have begun to invest to replace worn-out and obsolete equipment in a sustainable way.

Finally, inflation measured by the Fed's preferred inflation gauge has run at a 1½% pace over the past year — still low, but a couple of tenths higher than previously thought. With rents now firming, those revisions reinforce our conviction that inflation is bottoming and that the deflation scare is just that — a scare.[3]

Of course, there are two key risks to our scenario:

1. *Housing*. In addition to the "payback" following expiration of the first time homebuyer tax credit, the downside risks to home prices, mortgage credit availability and housing demand are still present.
2. *Policy/political uncertainty*. We think increased uncertainty around taxes and implementation of healthcare and regulatory reform is a key reason that consumer confidence slipped in the last couple of months.

**Policies to Improve the Outlook**

In the rest of my time, I'll discuss some policies that Congress might consider to improve the outlook for housing and employment, and thus the overall economy.

Chairman Conrad and members of the Committee, eighteen months ago I testified before this Committee.[4] I argued then that:

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[1] See "China Economics: Goldilocks on Track Despite Faster Moderation in Growth," Morgan Stanley Research, July 15, 2010.
[2] For comparison, see "Deleveraging the American Consumer," Morgan Stanley Research, May 27, 2009.
[3] See "Don't be Sidetracked by the Inflation Measurement Debate," Morgan Stanley Research, April 15, 2010
[4] "The Debt Outlook and Its Implications for Policy," January 15, 2009

> History suggests that financial crises take time to fix, because they result in deep and prolonged declines in asset values, and thus deep recessions (see Carmen M Reinhart and Kenneth Rogoff, "The Aftermath of Financial Crises," January 3, 2009). And as I read it, history also suggests that policies that go directly to the cause of the crisis are most effective.
>
> As you debate the size and composition of a fiscal stimulus package, therefore, keep in mind that tax cuts and stepped-up infrastructure outlays, whatever their merits, don't get to the causes of this downturn. They mainly tackle its symptoms and can only cushion the blow.

I still doubt that traditional fiscal stimulus is the right tool for the job. And I still strongly believe that we have yet to implement policies that go directly to the cause of our problems.

*Policies to Improve Housing*

I mentioned earlier that the legacy of the financial crisis still lingers for housing lenders and mortgage borrowers. As I noted in January 2009, rising foreclosures worsen the imbalance between housing supply and demand. Mitigating foreclosures is necessary to stem the slide in home prices, slow credit losses, and reduce the pressure on household wealth. Of course, not all foreclosures can or should be prevented. Offering help to the 5 million borrowers who are in serious trouble will create moral hazard by attracting the 50 million who aren't. It is hard to segregate responsible borrowers and lenders from those who weren't. Poor underwriting has resulted in redefault rates of 50% or more for modified loans.

But neglect in the past eighteen months has created two related, additional risks. The first is from accelerating "strategic defaults." Our analysis now shows that 18% of defaults over the past three months resulted from borrowers who can pay but who are so far under water that they choose to mail the keys back to the lender. In addition, many borrowers simply cannot take advantage of today's historically low borrowing rates, especially to refinance their mortgages. High loan to value ratios (LTVs), appraisal problems, unemployment, and low credit scores block refinancing opportunities.

These risks imply that the slide in home prices is not over. In our view, prices for non-distressed homes are still falling, which affects the wealth and confidence of all homeowners.

The best options for relief continue to be simple, act quickly, and spread the pain broadly among borrowers, lenders, and taxpayers. Unfortunately, the scope of the Home Affordable Modification Program (HAMP) has shrunk. Only about 350,000 permanent HAMP modifications are in place, and more than twice that many borrowers have fallen out of the HAMP trial modification program. At this rate, HAMP will hardly reach the 3-4 million borrowers that the administration targeted.

Two policy changes announced on March 26 – a new "earned principal forgiveness" initiative in HAMP, and the short refinance program through the FHA – could help reduce the risks of foreclosure. "Earned principal forgiveness" gives the borrower a strong incentive to stay current on modified payments by turning a portion of initial principal forbearance into principal forgiveness for each year the borrower stays current. The new short refinance program is meant for currently performing but underwater mortgages and provides for FHA refinancing of such mortgages after the lender agrees to principal forgiveness.

These programs should be strengthened. They aren't working because the language in the principal-forgiveness modification rules is weak, and the FHA short-sale program continues to be advertised as being de minimis, with lenders pushing back on both.

Another proposal to enable borrowers to refinance government guaranteed mortgages comes from my colleague David Greenlaw.[5] The government has guaranteed the principal value of a very large portion of the mortgage market — specifically, the 37 million mortgages that are backed by Fannie, Freddie and Ginnie Mae. There would be no credit risk for a mortgage originator who agreed to refinance these mortgages if the government guarantee was extended to the refinanced loans. That could lower rates for borrowers and streamline the refinance process. Dave estimates that households would save $46 billion

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[5] See "Slam Dunk Stimulus," Morgan Stanley Research, July 27, 2010.

annually if the mortgage rate could be reduced by 125 basis points on 50% of the outstanding volume of such mortgages. At the very least, regulators could waive the so-called "put back" authority for refinancing of agency-backed mortgages. This would help to unclog the refi pipeline at zero cost to the government.

Eighteen months ago I noted that

> The economic cost of further declines in home values would likely exceed the cost of mitigation. More ominously, letting foreclosures fester may erode the sanctity of the mortgage contract for an increasing number of borrowers, who will decide that making payments is optional. If many borrowers walk away from their houses and their obligations, losses to lenders will rise dramatically and the availability of credit will dry up.

That is still true today.

*Policies to Improve Employment*

Private nonfarm payrolls have been flat over the past year, compared with a 2.3% average gain in the first year of the past seven recoveries. Diagnosing the causes of the exceptional weakness in employment is critical before recommending remedies. Clearly, much of that weakness is cyclical, reflecting the sub-par rebound.

In our view, however, four structural culprits are also at work: Rising benefit costs; mismatches between skills needed and those available; labor immobility resulting from negative equity in housing; and uncertainty around policies in Washington. Each has both a long-term structural and a shorter-term cyclical element. For each, we first discuss the problem and the long-term solutions. Then we turn to what policymakers can do to help the economy and the labor market improve as quickly as possible.

*Obstacle 1. Cost of labor resulting from escalation in benefits.* The problem: Thanks to the high "fixed" costs of health and other benefits, and of taxes on labor to pay for the social safety net, our labor costs are out of line with other countries when adjusted for living standards. I say "fixed" costs because benefit costs don't vary with hours worked; they are paid on a per-worker basis. As employers seek to cut the cost of compensation, these benefit costs drive a growing wedge between total compensation and take-home pay. Unlike in other countries where healthcare benefits are not directly part of compensation, these rising costs likely have intensified employers' efforts to boost productivity by cutting payrolls.[6] The recession made the wedge between compensation and wages bigger, as cost-cutting private-sector employers cut take-home pay while leaving benefits intact. So relative labor costs go up versus other countries while median pay suffers.

*Long-term solutions* include implementation of healthcare reform to save costs and innovation to boost productivity and labor skills. The Affordable Care Act includes a series of reforms aimed at cost savings for Medicare, but more work is needed to reduce the soaring costs of healthcare for employers and employees alike. Policies that boost worker productivity will reduce labor costs and will be a win-win for employers, employees and overall living standards, because real wages will rise.

*Short-run remedies:* A refundable payroll tax credit, perhaps for firms that increase their payroll, would be among the most effective short-run remedies. CBO estimates that a well-designed credit could boost employment by about 9 years of full-time equivalent employment per million dollars of budgetary cost. [7]

[6] See Sarah Reber and Laura Tyson, "Rising Health Insurance Costs Slow Job Growth and Reduce Wages and Job Quality," Working paper, University of California at Los Angeles, August 2004; Katherine Baicker and Amitabh Chandra, "The Labor-Market Effects of Rising Health Insurance Premiums," NBER Working Paper 11160, February 2005; and Richard B. Freeman and William M. Rodgers III, "The Weak Jobs Recovery: Whatever Happened To The Great American Jobs Machine?" November 2004, Revised January 2005.

[7] See Congressional Budget Office, "Policies for Increasing Economic Growth and Employment in the Short Term," February 2010.

*Obstacle 2. Skills mismatch.* The problem: For years, employers have complained that they don't find the skills they need in today's workforce. Worker skills have greatly lagged technical change and tectonic shifts in the structure of our economy. Immigration restrictions and massive dislocations in several industries in recession have magnified that mismatch as workers who have been trained for one occupation lose their jobs. A May 2010 Manpower research survey showed that even in recession, 14% of firms reported difficulty filling positions due to the lack of suitable talent available in their markets; in 2006 the same survey reported that 44% of firms couldn't find the skills needed. That speaks to the depth of recession; it is clear that a large portion of the long-term unemployed lack requisite skills. And even in healthcare, an oasis of job growth, there is a growing nursing and nursing skills shortage that requires new training facilities.[8]

*Long-term solutions* include policies that keep students in school and improve access to education, reorientation of our higher educational system towards specialized and vocational training and community colleges, and immigration reform.

*Short-term remedies:* Our current unemployment situation demands income support through unemployment insurance for those seeking but unable to find a job. Jobless spells degrade worker skills just when workers need re-training. One remedy would pair training in basic skills that are needed for work with such income support. Two other groups seeking employment — newly minted college students and unemployed teachers — could be an ideal nucleus for a Job Training Corps that would empower job seekers with new skills. As is the case with Teach for America, the Job Training Corps would build a pool of training advocates who then go on to work in other occupations with the perspective and conviction that come from helping others to acquire needed skills. [9]

*Obstacle 3. Labor immobility resulting from the housing bust.* America's workers have always been footloose. Even in the Great Depression, they looked for work wherever it was. Today, however, the housing difficulties I discussed earlier mean that one in four homeowners is trapped in their house, so they can't move to take another job — until they sell or walk away. Unlike in the Depression, when homeownership was less prevalent, negative equity among a nation of homeowners leads to substantially lower mobility rates. Owners suffering from negative equity are one-third less mobile according to one study.[10] The wave of "strategic defaults" and foreclosures is undermining the economic and social fabric of communities and reducing job opportunities.

*Long-term solutions:* Financial and mortgage regulatory reform are essential to restore the health of housing finance; much remains to be done. Significantly improving financial literacy is equally important.[11]

*Short-term remedies:* Local efforts to stabilize communities plagued by foreclosure are essential, but they are not enough.[12] Beyond the proposals outlined above, efforts to establish a protocol for short sales and/or principal reduction should be a useful tool in avoiding costly foreclosure and strategic default.[13]

*Obstacle 4. Policy uncertainty is a negative for the economy and markets.* America's long-term challenges — healthcare, budget and tax reform, financial regulatory reform, retirement saving, infrastructure, education, energy, and climate change — are not new. Solving them is imperative, and major legislation to

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[8] See Bridget M. Kuehn, "No End in Sight to Nursing Shortage: Bottleneck at Nursing Schools a Key Factor," JAMA 2007; 298:1623-1625.

[9] http://www.teachforamerica.org/mission/mission_and_approach.htm

[10] See Fernando Ferreira, Joseph Gyourko, and Joseph Tracy "Housing Busts and Household Mobility," forthcoming in the *Journal of Urban Economics.*

[11] Efforts by the Federal Reserve and others are especially encouraging. See http://www.federalreserve.gov/consumerinfo/foreclosure.htm and http://www.mymoney.gov/

[12] See http://www.stablecommunities.org/ for examples

[13] See for example, Larry Cordell, Karen Dynan, Andreas Lehnert, Nellie Liang, and Eileen Mauskopf, "Designing Loan Modifications to Address the Mortgage Crisis and the Making Home Affordable Program," Brookings Institution, October 2009.

address them represents important steps toward those ends — e.g., promoting increased access to healthcare and a safer financial system. But the uncertainty around the costs of those policy changes and the uncertain magnitude of prospective tax hikes that will be required to address our fiscal problems is weighing on business and consumer decisions to hire, expand, buy homes and spend.

Recent work confirms this intuition, underlining how uncertainty produces negative growth shocks. Nicholas Bloom shows how a rise in uncertainty makes it optimal for firms and consumers to hesitate, which results in a decline in spending, hiring and activity. In effect, the rise in uncertainty increases the option value of waiting as volatility rises. Moreover, this line of reasoning suggests that uncertainty reduces the potency of policy stimulus.[14] That's because the uncertainty can swamp the effects of lower interest rates, transfers or tax cuts. In effect, uncertainty raises the threshold that must be cleared to make a business choice worthwhile, and as uncertainty declines, the threshold falls with it. This notion squares with our long-held view that policy traction from easier monetary policy, improving financial conditions and fiscal stimulus was lacking through much of last year, but improved as uncertainty fell.

Market participants are used to thinking that political gridlock is good, that it prevents politicians from interfering with the marketplace. The financial crisis clearly exposed the flaws in that reasoning with respect to appropriate financial regulation, whose absence allowed abuses. Indeed, gridlock today is more likely to be bad for markets and for the economy, as our long-term economic problems are partly the result of past policies and can only be solved with political action.

*Long-term solutions* involve bipartisan leadership to tackle these complex problems one-by-one, in steps that are fair and call for shared sacrifice and benefits. That means setting priorities, making hard choices, communicating the game plan, and getting buy-in for it in advance. Mr. Chairman, Ranking Member Gregg, your work as Commissioners on the National Commission on Fiscal Responsibility and Reform is critical. I know you agree that crafting a long-term credible plan to restore fiscal sustainability will ease concerns and uncertainty about future tax hikes and the potential loss of our safety nets.

*Short-term remedies:* In addition, reducing policy uncertainty now could be a tonic for growth. That won't be easy or come quickly, given the political backdrop in this election year. But even some incremental clarity on policies in any of these areas would offer investors a chance to assess the fundamentals again. For example, we assume that Congress will agree to a 1-year extension of all expiring tax cuts. That should reduce uncertainty as well as sustain fiscal stimulus. Obviously, the sooner such action is implemented, the sooner the reduction in uncertainty can be achieved.

Mr. Chairman and members of the Committee, we have many challenges ahead. Our short-term challenge is to enhance the odds for a more vigorous, sustainable recovery. Our long-term challenges are to promote a sustainable fiscal policy and to reform our entitlement and other programs that represent long-term claims on our future resources. I thank you for your kind attention today and for the opportunity to offer advice. I would be happy to answer any questions you may have.

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[14] See "Policy Uncertainty Redux," June 25, 2010 and Nicholas Bloom," The Impact of Uncertainty Shocks," Econometrica, vol. 77(3), pages 623-685, 05, May 2009

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Chief U.S. Economist
Co-Head, Global Economics
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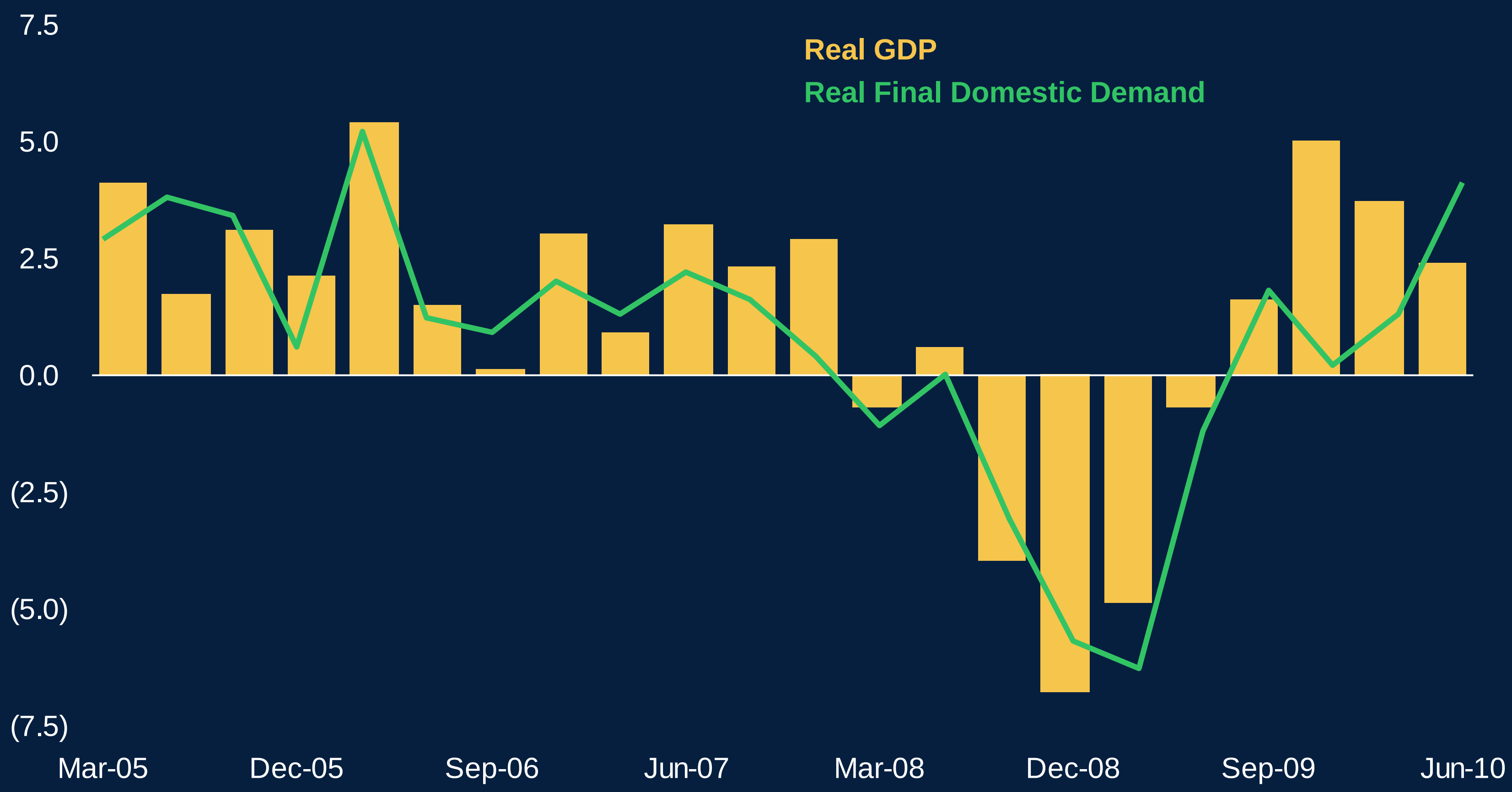
# Final Demand Accelerating on Schedule

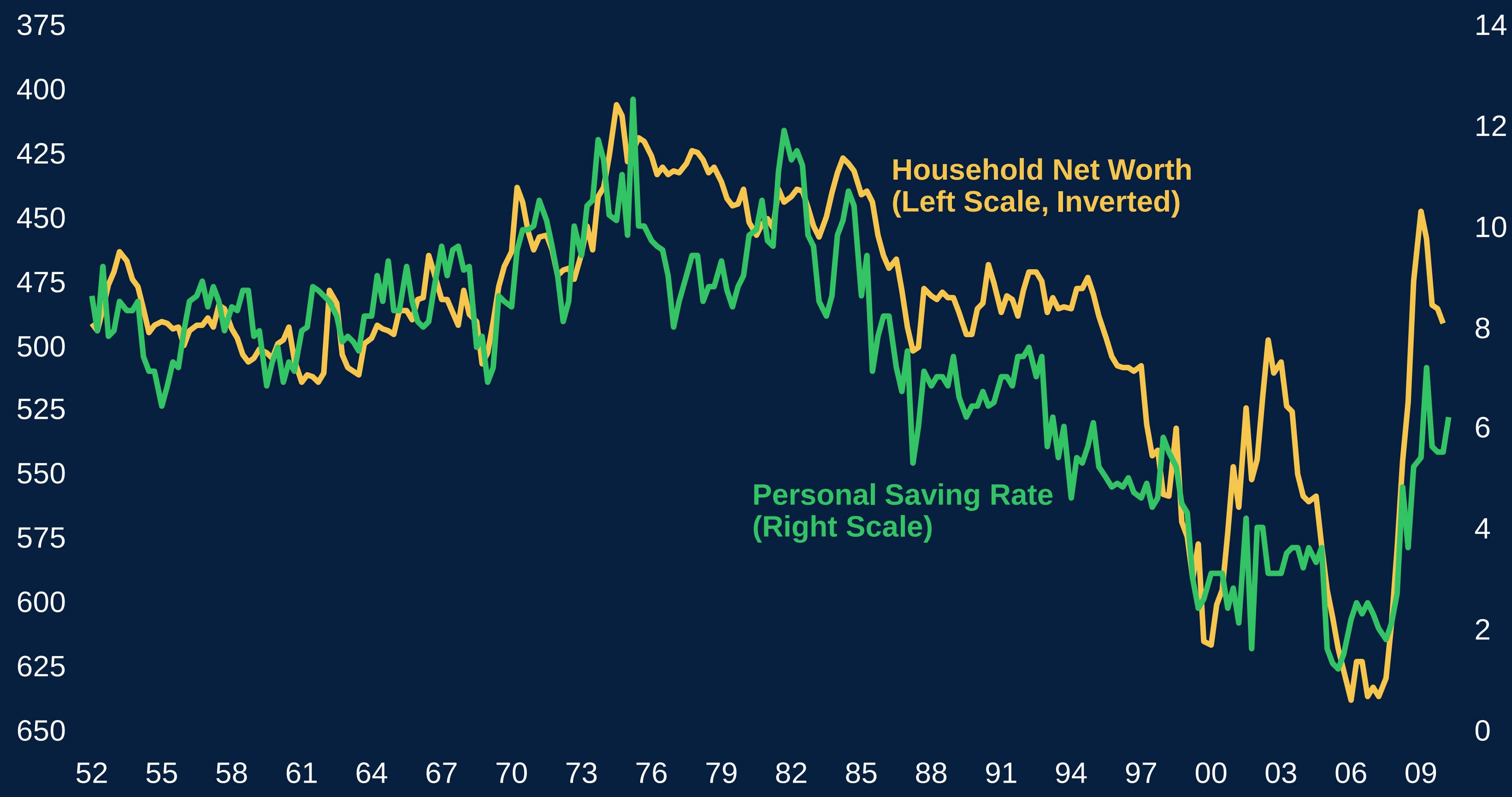
**Quarterly % Change, Seasonally Adjusted Annual Rate**




**Source:** Bureau of Economic Analysis

# A Bigger Saving Cushion

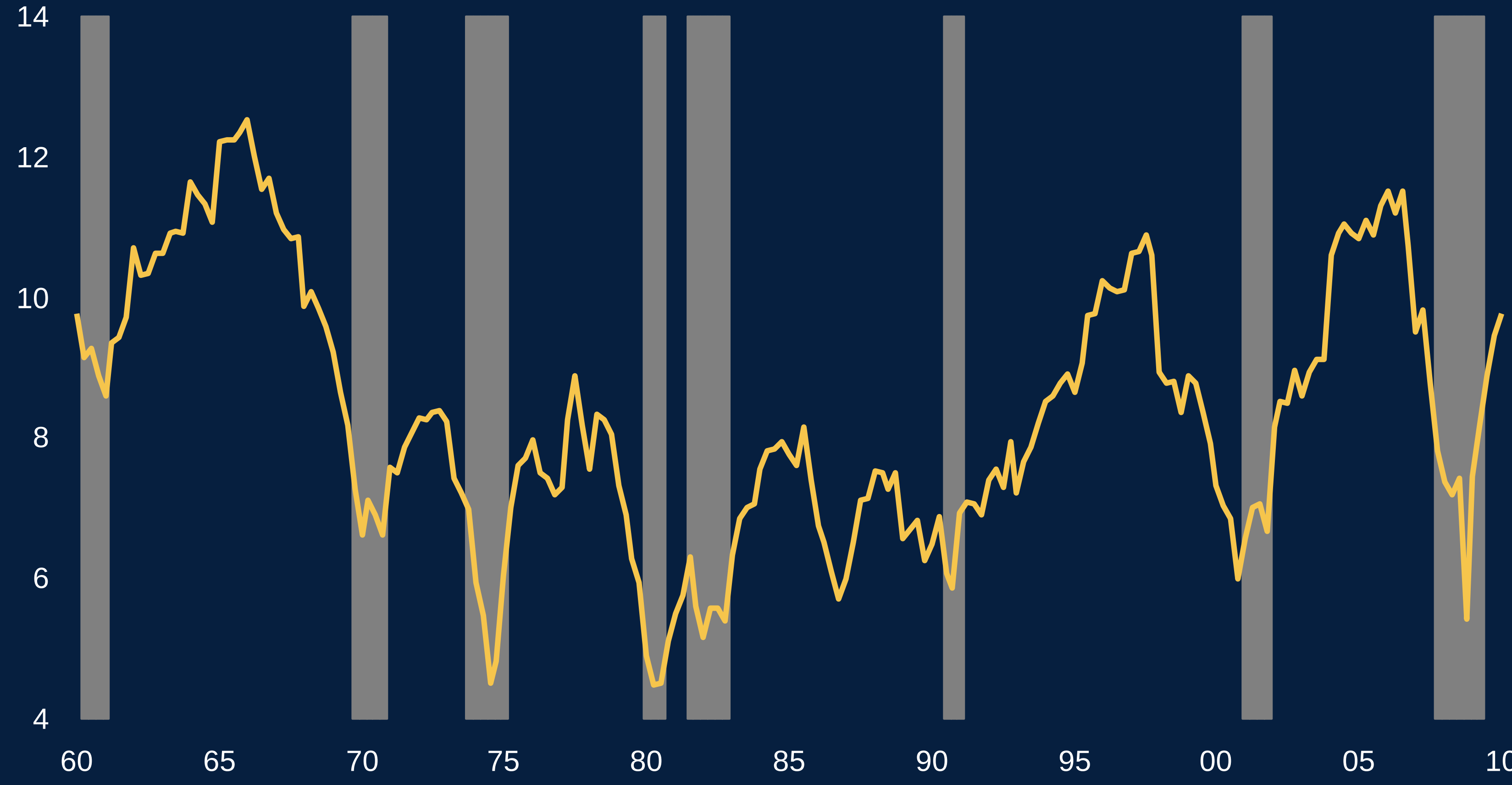
## % of Disposable Personal Income




**Source:** Federal Reserve Board, Bureau of Economic Analysis

# Margins: Deeper Recession, No Peak Yet

## After Tax Corporate Profits as a % of Corporate GDP




**Source:** Bureau of Economic Analysis

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