Testimony to Senate Budget Committee, hearing on "A Status Report on the U.S. Economy", 10am Tuesday, August 3rd (embargoed until the hearing starts).

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A. Short-term Prospects

1) The global economy continues to improve, although at a disappointing pace. Sharp recessions traditionally produce rapid recoveries, but the damage wrought by the disruption of global credit in fall 2008 is far in excess of anything we have seen since the 1930s. This could be the slowest recovery of the post-war period.[2]

2) Global growth, Q4-on-Q4, as measured by the International Monetary Fund was 3 percent in 2008 and, based on the latest revisions, will be probably prove to have been under 2 percent in 2009 – the worst performance since World War II. This same measure of growth around the world, which uses purchasing power parity weights, is likely to be somewhat under 4 percent for 2010 but should pick up in 2011.

3) The major risk faced by the world economy is not stagnation year-in and year-out, but rather an unstable credit cycle that produces apparent "growth" – perhaps even high recorded growth – in some years for the United States, but then leads to financial crisis, repeated recession, and very little by way of sustained growth. US GDP in real terms is currently at about the same level now as it was in 2006. (Real GDP, annualized, was around $12.9 trillion in the first quarter of 2006 and $13.2 trillion in the second quarter of 2010; see Table 3B in the July 2010 BEA report).[3]

4) Japan's lost decade in the 1990s was not a sequence of years with zero growth – there were notable expansions and contractions, with high rates of growth in particular quarters and even some years when it seemed that the corner had been turned. Lost decades are evident only in retrospect. The US is currently on track for "losing" at least half a decade of growth (from the beginning of 2006 through the end of 2010).

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[1] This testimony draws on joint work with James Kwak, including *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown* (Pantheon, March 2010) and "The Quiet Coup" (*The Atlantic*, April, 2009), and Peter Boone, including "The Next Financial Crisis: It's Coming and We Just Made It Worse" (*The New Republic*, September 8, 2009) and "Will the Politics of Moral Hazard Sink Us Again" (Chapter 10, in The Future of Finance, July 2010). 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.

[2] The current recovery is definitely slower than what followed the severe recessions of 1973-75 and 1981-82. Based on actual performance so far and projected growth through end of 2011 from a range of forecasters, the recovery of 2009-2011 might prove a little stronger than the recoveries experienced after the mild recessions of 1990-91 and 2001. See Mike Mussa's influential work for more discussion (April 2009; April 2010 versions); his latest global GDP forecast is 4.5 percent (using the same definition for global GDP as the IMF).

[3] Details of the advance US GDP estimate for the second quarter of 2010 are from the BEA website. This estimate is notoriously noisy and prone to revision.

5) The latest iteration of the unstable global credit cycle has done lasting damage to the United States. This is manifest in the following ways:

a) Long-term unemployment results in skill losses and lower productivity in the future. This undermines future growth prospects and it may shift up the "natural" rate of unemployment. So-called hysteresis in unemployment – meaning that it goes up fast but comes down slowly and not fully – has very much been a feature in the experience of other industrialized countries during recent decades. This is potentially now a major issue for the United States.

b) The credit disruption of 2008-09 is having a persistent impact on hiring decisions in the United States and Europe. Business equipment spending is recovering fast but firms are reluctant to add workers. Most of this uncertainty is due to firms not knowing if they will have consistent access to external financing. As a result, large nonfinancial firms are likely to carry less debt and more cash.

c) The damage to household balance sheets from the boom-bust in real estate will also likely persist; for example, the percent of homeowners with negative equity has stabilized, around 20 percent, but moved down only slightly over the past year. We should expect US households to save move as consequence and the personal savings rate is now around 6 percent of personal disposable income (compared with 3 percent during the early 2000s and closer to 2 percent in the run up to the crisis). This is a pattern we have seen in "balance sheet"-related recessions elsewhere.

d) There is a serious sovereign debt crisis in Europe. While the prospect of default by a eurozone country is not imminent, there is a shift to fiscal austerity across that continent, thus slowing growth further. Structural issues within the eurozone are unlikely to be resolved quickly, thus weakening the euro and limiting the potential for US exports. Resulting financial market instability can also still spread quickly to the US.

e) The financial crisis and its aftermath damaged US prestige and capacity for leadership around the world.

6) It is hard to provide effective stimulus to the US economy in this situation. The longer term budget needs credible consolidation, which is mostly about reforming Medicare and implementing meaningful tax reform (see section C below). These are not difficult in technical terms but the potential for a political impasse threatens long-term interest rates – depending on exactly how the post-crisis adjustment process plays out in other major economies, as this affects relative demand for US government debt. Over the shorter term – i.e., the next decade or so – high levels of systemic risk in the financial sector continue to generate large contingent fiscal liabilities (section B below).

B. Contingent Liabilities from the Financial Sector

1) The scale and severity of the recent recession was due to the nature of excessive risk-taking at the heart of the world's financial system, in the United States and Western Europe.[4]

2) A series of efforts are underway to change the behavior of major global banks and to prevent them from loading up on risks during the next cycle. These are unlikely to succeed. As Jamie

[4] We cover this issue in detail in *13 Bankers*.

Dimon, CEO of JP Morgan Chase remarked in January 2010, "[a financial crisis is] the type of thing that happens every five, ten, seven, years" – and another crisis within that time frame should not surprise us.[5]

3) To see the fiscal impact of the finance-induced recession, look at changes in the CBO's baseline projections over time. In January 2008, the CBO projected that total government debt in private hands—the best measure of what the government owes—would fall to $5.1 trillion by 2018 (23% of GDP). As of January 2010, the CBO now projects that over the next eight years debt will rise to $13.7 trillion (over 65% of GDP)—a difference of $8.6 trillion.

4) Most of this fiscal impact is not due to the Troubled Assets Relief Program – and definitely not due to the part of that program which injected capital into failing banks. Of the change in CBO baseline, 57% is due to decreased tax revenues resulting from the financial crisis and recession; 17% is due to increases in discretionary spending, much of it the stimulus package necessitated by the financial crisis; and another 14% is due to increased interest payments on the debt – because we now have more debt.[6]

5) In effect, a dangerous financial system – prone to major collapses – creates a hidden contingent liability for the federal budget in the United States.

6) The Dodd-Frank financial reforms of 2010 are a modest step towards making the financial system safer, but these are unlikely to solve the problem of systemic risk. By all accounts, the internationally coordinated process of raising capital standards – and thus creating greater shareholder buffers against losses – is not making much progress; there will be little real change, much delay in implementation, and far too much "low quality" capital at the end of the day.[7]

7) As long as massive financial institutions continue to take on huge amounts of risk, there remains a strong possibility that governments in the US and other countries will once again face unexpected liabilities and collapsing tax revenues in a financial crisis – pushing up debt by another 40% or so of GDP.

8) Discussion of this risk was largely absent from the recent debate on financial reform and is not currently quantified by the Congressional Budget Office.[8]

9) In this regard, the IMF's first ever detailed assessment of the US financial sector (known as a FSAP), released last week, is not reassuring. Our financial system remains undercapitalized, according to the – rather mild – stress tests reported there. The veiled warning in this report is

[5] In his memoir, Hank Paulson makes a statement about the frequency of crises very much along the lines of Mr. Dimon. Larry Summers, in his 2000 Ely Lecture to the American Economic Association, uses similar language.

[6] See also the May 2010 edition of the IMF's cross-country fiscal monitor for comparable data from other industrialized countries, http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf. The box on debt dynamics shows that mostly these are due to the recession; fiscal stimulus only accounts for 1/10 of the increase in debt in advanced G20 countries. Table 4 in that report compares support by the government for the financial sector across leading countries; the US provided more capital injection (as a percent of GDP) but lower guarantees relative to Europe.

[7] For a broader discussion of capital requirements and the state of play in the Basel III negotiations, see http://baselinescenario.com/2010/07/29/required-intellectual-capital/.

[8] The CBO routinely assesses the budget impact of other contingent liabilities, including future health care costs and the likely cost of US commitments to the International Monetary Fund.

that the US faces severe fiscal risks going forward, arising directly from our continued inability to rein in the dangers posed by the financial sector.

C. Risks of a Fiscal Crisis

1) Seen in a comparative perspective, our budget issues are serious but not severe and – relative to other industrialized countries currently under pressure – we have plenty of time to deal with them. Fears of an immediate budget crisis in the United States should not be exaggerated, although we do need fiscal consolidation over the next decade – a combination of tax reform and changes to future Medicare spending.

2) Most other industrialized countries also have to engage in a process of fiscal adjustment and for similar reasons.[9] Compared with other countries at roughly our income level and with similar demographics, the United States has a major advantage in the sense that we collect relatively little in taxes; in addition, our tax system is relatively antiquated and would benefit from modernization. Using the IMF's numbers – which are for "general government" (i.e., the entire government sector, including federal, state, and local) – the US collected 31.8 percent of GDP in 2000 (compared with the UK at 38 percent, Germany at 46 percent, and France at 50 percent).[10] In both 2009 and 2010 the US collected 30.4 percent of GDP; over the cycle, our revenue relative to other leading industrialized countries remains about the same.

3) Under the CBO's "alternative fiscal scenario," which includes policy changes that are politically likely, government debt in private hands will grow to 185 percent of GDP by 2035 as Social Security, Medicare, Medicaid, and other health care programs grow to consume almost all tax revenues. This should not be a surprise: in 2000, the CBO already projected that these programs would grow to over 16 percent of GDP by 2040—a figure virtually identical to current estimates. This was predictable because it rested on two simple trends: changing demographics and, more importantly, high health care cost inflation.

4) For some commentators, the only possible response for the US is immediate austerity; this is the course being taken in the United Kingdom and parts of the Eurozone. If we continue to spend, the argument goes, markets will lose faith in our ability to repay our debts, interest rates will skyrocket, the dollar will collapse, and our way of life will be at an end. While this argument is plausible in the abstract, there is no reason for panic or precipitate action *now*.

5) The US Treasury Department can currently borrow money at historically *low* interest rates. Investors around the world like saving in a safe currency, the dollar has traditionally been seen as the safest of currencies, and recent developments in Europe and the rest of the world have done nothing to change that.

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[9] See Table 6 in the IMF's May 2010 Fiscal Monitor for budget deficit financing needs across advanced countries (http://www.imf.org/external/pubs/ft/fm/2010/fm1001.pdf). The US has relatively short maturity debt (4.4 years by this measure), but it is broadly comparable with other industrialized nations on this and other deficit measures. Table 11 in the same report provides estimates of effects from raising revenue in various sources across the advanced G20 economies. Again, the US is in the middle of the pack – there is nothing unusually difficult (on paper) about the adjustment required.

[10] Statistical table 5 in the IMF's May 2010 Fiscal Monitor has general government revenue as a percent of GDP since 2000 and forecast through 2015.

6) It is true that markets can suddenly lose confidence in a country, with severe economic repercussions. But there is no magical threshold that suddenly makes a country a poor credit risk; Japan's net government debt relative to its economy is roughly at Greek levels, yet Japan can still borrow money cheaply. A country's ability to borrow is determined by its economic fundamentals, its position in the international economy, and the credibility of its political system – relative to other systems.

7) While an extra dollar of spending today is an extra dollar (plus interest) of debt later, what really matters are policies that affect taxes or spending year after year. By contrast, $34 billion for extended unemployment benefits—a temporary program that will become smaller as unemployment falls—has no appreciable impact on our structural deficit.

8) The things that do matter are taxes and entitlements. Therefore, the upcoming debate over the Bush tax cuts is of real importance. According to the CBO, extending the Bush tax cuts would add $2.3 trillion to the total 2018 debt. The single biggest step our government could take this year to address our structural deficit would be to let the tax cuts expire. Such a credible commitment to fiscal consolidation should reduce interest rates today, helping to stimulate the economy.

9) Critics say that this amounts to increasing taxes at a time of high unemployment, and instead the tax cuts should be extended as a stimulus measure. This overlooks the fact that tax cuts are an inefficient form of stimulus, because many people choose to save their additional income instead of spending it. If the goal is to boost growth and employment immediately, it would be better to let the tax cuts expire and dedicate some of the increased revenue to real stimulus programs. Alternatively, if some tax cuts are extended, there should be provisions to eliminate them automatically when unemployment falls to a preset level.

10) Complete elimination of the Bush tax cuts is highly improbable. The most likely outcome is that the tax cuts will be extended for families making less than $250,000 per year.

11) Additional tax revenues will also be necessary in the medium term, and at least three plausible ideas are on the table.

a) The first is comprehensive tax reform, to better align our tax policy with desirable economic incentives. We should consider the value-added tax (VAT) favored by Greg Mankiw (former chair of the Council of Economic Advisers under President George W. Bush), among others. A VAT is a tax on consumption, and therefore could reduce the overconsumption that helped feed the recent credit bubble, encouraging savings and investment instead. Although a simple VAT is regressive, it can be made progressive by combining it with a partial rebate or by exempting necessities. Also, as Martin Feldstein and Len Burman have suggested, we should look hard at tax breaks that act like hidden spending programs. One place to start is the mortgage interest tax deduction, currently available on mortgages up to $1 million, which is part of our excessive package of incentives to buy houses—a policy eschewed by most other industrialized countries.

b) The second is carbon pricing, whether auctioning emissions allocations or taxing carbon directly, at rates that start low and rise over the next decades. Politically speaking, it would be easier to pass a carbon pricing bill by rebating the proceeds back to households (or handing them to energy companies in exchange for political support). But given the large potential revenues from carbon pricing, it would make sense to dedicate a portion to cushion the impact of higher energy prices on the poor, while applying the rest to our fiscal balance.

c) The third is a tax on the financial sector, in the form of a Financial Activities Tax on big banks that enjoy implicit government guarantees. This tax would aim to eliminate the funding advantage that large banks enjoy over their smaller competitors and limit the incentive for big banks to become even bigger. As the International Monetary Fund has argued, across the G20 this would help constrain the worst features of our financial system and reduce the competitive distortions created by the megabanks.

12) After taxes, there is the issue of entitlements—which is mainly an issue of health care costs. According to the CBO's alternative fiscal scenario, growth in Social Security is comparatively modest, from 4.8 percent of GDP in 2010 to 6.2 percent in 2035. A relatively small change in the parameters of this program could lower its future costs, as was done in the 1980s. At the same time, however, Medicare, Medicaid, and other health care programs will more than double from 4.5 percent to 10.9 percent of GDP.

13) There are two ways to reduce the government's health care outlays: reduce the *amount* of health care the government buys or reduce the *cost* of health care. The simplest solution is to mandate that the government buy less health care—by raising the eligibility age for Medicare, capping benefits for high-income beneficiaries, etc. The problem with this approach, however, is that Medicare is not particularly generous to begin with (hence the market for Medigap supplemental policies). In addition, the rest of the nation's health care system is also in sorry straits; if Medicare were to increase its eligibility age, it would simply push people back onto their employers, resulting in higher health care costs for all working people.

14) In other words, cutting Medicare expenses shifts costs from the government onto individuals, many of whom will simply go without decent health care. If we fail in our attempts to control health care cost inflation, this may be the only option. But the better solution is to figure out how to reduce health care costs.

15) A top priority should be to preserve and expand the cost-cutting provisions in this year's Affordable Care Act (ACA). Another obvious step to consider is phasing out the tax exclusion for employer-sponsored health plans, which will not only increase revenue but also end the distorting effects of employer subsidization of health care.

16) Reshaping our health care system to focus on successful outcomes and quality of life, rather than on employing the newest and most expensive technology, is a challenge for which no one yet has a proven solution. But it remains, more than any other single factor, the key to long-term fiscal sustainability.

17) Fixing our long-term fiscal problems will not be easy. But there is no need to panic. And there is no shortage of possible solutions.