

# A WEAKENED ECONOMY: HOW TO RESPOND?

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HEARING  
BEFORE THE  
COMMITTEE ON THE BUDGET  
HOUSE OF REPRESENTATIVES  
ONE HUNDRED TENTH CONGRESS  
SECOND SESSION

HEARING HELD IN WASHINGTON, DC, SEPTEMBER 9, 2008

**Serial No. 110-39**

Printed for the use of the Committee on the Budget



Available on the Internet:  
*<http://www.gpoaccess.gov/congress/house/budget/index.html>*

U.S. GOVERNMENT PRINTING OFFICE  
WASHINGTON : 2009

44-425 PDF

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## A WEAKENED ECONOMY: HOW TO RESPOND?

TUESDAY, SEPTEMBER 9, 2008

HOUSE OF REPRESENTATIVES,  
COMMITTEE ON THE BUDGET,  
*Washington, DC.*

The committee met, pursuant to call, at 2:03 p.m., in Room 210, Cannon House Office Building, Hon. John Spratt [chairman of the committee] presiding.

Present: Representatives Spratt, DeLauro, Edwards, Cooper, Schwartz, Kaptur, Becerra, Doggett, Blumenauer, Scott, Etheridge, Baird, Moore of Kansas, Bishop, Ryan, Barrett, Bonner, Hensarling, Conaway, Campbell, Tiberi, Porter, Alexander and Smith.

Chairman SPRATT. Welcome to the Budget Committee and today's hearing on our weakening economy and what productive steps we can take to avoid a full-fledged recession and pump up near-term growth.

We are pleased to have a panel that includes Dr. Larry Summers, the former Secretary of the Treasury and currently Charles Eliot University Professor at Harvard; Allen Sinai, President and Chief Economist at Decision Economics; and, finally, David Kreutzer, Senior Policy Analyst at the Heritage Foundation.

Today, CBS has released this update, it is like the consensus forecast, that shows a dim outlook on the economy and the budget. On Friday, we received the latest jobs data. We show unemployment at a 5-year high, 6.1 percent. And, over the weekend, concerns about the housing and financial markets caused the government to take radical steps to control Fannie Mae and Freddie Mac, the secondary market firms that buy three-quarters of all new mortgage loans made in this country.

Nearly 7 months ago, in response to clouds gathering on the economy's horizon, the Congress passed and the President signed a \$152 billion stimulus package of tax rebates for households and businesses. Our personal consumption and economic growth appear to have picked up as a result.

A ticker tape of economic distress signals continues to play out, suggesting that, helpful as it may have been, the stimulus may also have not been enough. The worsening in housing, in jobs, inflation, the prospect that net exports may not bail us out if the economies of our trading partners continues to slow down and the shoes that keep dropping in the financial sector keep concerning us.

While the economic statistics give us one measure of the economy, we need to keep in mind that the most important measure is Main Street America where the measure is clear, Americans are hurting economically in many different ways. And that is why we

called this hearing, to consider what else, if anything, the Federal Government can do and how we can balance short-term assistance with fiscal responsibility.

Boosting the economy and putting the budget back on track are closely linked. As OMB Director Jim Nussle himself noted today, the hike in the deficit from 2007 to 2008 is due primarily to a weakening economy, and the short-term cost of the bipartisan stimulus bill, which we passed to keep the economy from getting any worse, this and increased defense spending explain almost all the difference.

We would like today to get a sense from our witnesses of how much more of an economic storm we have to weather. What are the most effective steps we can take to boost the economy, to raise consumer confidence, and to give relief to millions of hard-working Americans who continue to struggle?

Before I turn to our panel of witnesses for their testimony, I would like to recognize Mr. Ryan, the ranking member, for his opening statement. Mr. Ryan.

Mr. RYAN. I thank the chairman. I thank you also for having this hearing. It is well timed and something we need to be focused on, given we are not going to be in session much longer this year.

This is an issue that demands our urgent attention, given the fact that we have a joblessness rate that is going up at an alarming pace. And so what we are finding here is that our economy is continuing to shed jobs, unemployment is increasing, Americans are paying more for food, energy, gas prices are high. We are finding the housing slump may not yet have reached its bottom, and we have an unprecedented bailout or conservatorship of Fanny and Freddie. Businesses are having, as a consequence, a very hard time getting access to credit.

So I think the question that we ought to be asking ourselves as policymakers is are we going in the right direction with respect to economic policy? And I would argue the answer is no.

We have a confluence of bad economic policy coming onto the American economy and the American people. You have got spending out of control here in Congress. The deficit just doubled in one year. Now some of those factors are outside of our control. But the question is, what are we doing here in Congress given that we have the power of the purse to do something about it? And the answer is, more spending out of this Congress and much higher taxes.

That leads me to the second bad economic policy that is being committed here in Congress, higher taxes. And so you have Congress spending out of control. You have Congress passing budgets promising to raise taxes. Not just raise them here, not just raise them there, raise taxes on almost every aspect and factor of our economy: raising taxes on companies, raising taxes on small businesses, raising taxes on entrepreneurs, raising taxes on families with small children. These tax increases are putting an economic cloud over our economy.

And we have loose monetary policy to boot. Loose monetary policy, which we know will have to inevitably be followed by tight monetary policy.

So when we look out on the horizon, no wonder investors aren't investing. No wonder the investment horizon is uncertain.

Congress not able to control spending, very high taxes coming into the economy, and a declared credit tightening and interest rate hikes from the Federal Reserve. So we have the confluence of bad macroeconomic policy in the form of bad fiscal policy, tight monetary policy, and Congress not only passing a budget to have the largest tax increase in American history followed by more spending but Congress not even following its own budget and spending—and passing even higher tax increases than even its budget calls for and higher spending increases. This is the direction this Congress is heading, the Nation's fiscal policy.

This is not the direction that the American economy should go. The market is sending us these signals that we ought to get serious about controlling spending, serious about reforming entitlements, serious about keeping tax rates low so we can foster innovation and economic growth and, I would argue, more sound monetary policy so we can build that foundation for economic growth. Unfortunately, that is not the direction we are headed right now.

Hopefully, the witnesses can give us a glimpse as to maybe a better path to take for this Congress and I await their testimony. I want to thank these three distinguished gentlemen for joining us here today.

Chairman SPRATT. Before returning to our panel, let me do a couple housekeeping details.

I want to ask unanimous consent that all Members be allowed to submit an opening statement for the record at this point.

[The statement of Mr. Smith follows:]

PREPARED STATEMENT OF HON. ADRIAN SMITH, A REPRESENTATIVE IN CONGRESS  
FROM THE STATE OF NEBRASKA

Good afternoon. There are a number of challenges facing our economy, and I thank you, Chairman, for holding this hearing today.

We must rise to address our economic challenges in a bipartisan fashion. Rushing to a solution, however, could prove more costly than our current situation. We must not hamstring our economy by increasing taxes to pay for more federal spending, as has been suggested.

It is important to create policies which will strengthen our economy and provide long-term stability for American taxpayers, and to promote economic policies which will foster sustained growth. An important component of that policy should be to strengthen foreign demand for our products, by aggressively pursuing new markets and breaking down barriers to trade.

In addition, we must also work to lower energy prices. For too long we have grown ever more dependent on unreliable foreign sources of energy. There has been a lot of focus on reducing our energy consumption, but that is only a piece of the energy puzzle. I support efforts to increase the supply of all forms of energy right here at home in order to decrease high energy prices for all Americans.

Chairman, I look forward to continuing to work with you to achieve real economic growth, and I thank you for your time.

Chairman SPRATT. I also want to say generically to all three witnesses that your statements have been received and will be made part of the record, and you can summarize as you see fit. Since we only have three of you today to testify, I would urge you to take your time and amplify your views, because we called you here to find out your best advice as to what the situation is and what we can best do about it.

**STATEMENTS OF LAWRENCE SUMMERS, PH.D., CHARLES W. ELIOT UNIVERSITY PROFESSOR, KENNEDY SCHOOL, HARVARD UNIVERSITY, FORMER SECRETARY OF THE U.S. DEPARTMENT OF THE TREASURY; ALLEN SINAI, PH.D., CHIEF GLOBAL ECONOMIST, STRATEGIST AND PRESIDENT, DECISION ECONOMICS, INC.; AND DAVID KREUTZER, PH.D., SENIOR POLICY ANALYST IN ENERGY ECONOMICS AND CLIMATE CHANGE, CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION**

Chairman SPRATT. Dr. Summers, we will begin with you. Thank you for coming.

**STATEMENT OF LAWRENCE SUMMERS, PH.D.**

Dr. SUMMERS. Thank you very much, Mr. Chairman, Mr. Ranking Member. I appreciate very much this opportunity to testify before this important committee at what I believe is a key juncture for economic policy.

I want to address four questions in my testimony today. First, the current state of the American economy; second, I want to make the case for further fiscal stimulus; third, I want to address the question of fiscal stimulus in the context of the necessary commitment for long-term fiscal prudence; and, fourth, I will address and make some suggestions regarding the appropriate content of a fiscal stimulus program.

First, with respect to the economy, my judgment, which I think is widely shared, is that the American economy remains in a highly uncertain state with very significant risks to the downside. Weak employment statistics, contracting credit, diminishing confidence, likely further declines in housing prices and a slowing global economy all place negative pressures on the American economy.

Even after the current downturn ends and growth resumes, the economy will be producing output significantly short of its potential. Losses in output relative to potential are likely to cost the economy \$300 billion a year or more, or more than \$4,000 for the average family over the next year or two.

Experience suggests that, even after downturns end, unemployment continues to increase. Indeed, unemployment peaked in our last business cycle nearly 2 years after the officially dated end of the recession.

All of this suggests that the balance of risks is towards a contraction and will be for some time, with particular concern surrounding the possibility of a vicious cycle in which declining economic performance exacerbates financial strains which feed back towards the economy. This judgment, that it is contraction rather than overheating, which is always an uncertain judgment, appears a more secure one today than it did 2 months ago with the weak economic statistics of the last 2 months and also the declines in commodity prices and increases in the value of the dollar. I believe, Mr. Chairman, that increased fiscal stimulus is the right response to this kind of economic downturn.

While it would be traditionally appropriate to employ monetary policy as the first tool of cyclical response, as Mr. Ryan's comments suggested, there are a number of reasons to doubt the future monetary policy stimulus is a viable option at this point. It would be dif-



difficult to lower interest rates further without putting the U.S. dollar and commodity markets at risk. In an environment where banks and other firms are constrained by lack of capital, it is not clear that lowering policy interest rates will have a substantial effect on lending or borrowing. There are, in any event, long lags between monetary policy and changes in the performance of the economy.

Given all that has happened in the housing and financial sector, many observers have been surprised that overall economic performance has not been even worse than it has been. In my judgment, this is in significant part a result of the stimulus to the economy provided by legislation passed last winter. Without this stimulus, our economic situation would likely be even worse.

If new policy is going to support the economy by raising demand for goods and services and closing that gap, it likely will have to come on the fiscal side. Indeed, in a situation of excess capacity and a situation where interest rates are likely to be relatively rigid because of financial strains, the multiplier from fiscal policy is in the short run likely now to be larger than normal. There is a strong case for the prompt enactment of further timely, targeted and temporary fiscal stimulus.

The third area I want to address is the question of fiscal stimulus in the context of the overall budget picture. While there is a strong case for new fiscal stimulus measures, which by definition increase the deficit in the short run, the long-run Federal budget situation remains a matter of great concern. Excessive accumulation of Federal debt over the next decade threatens to reduce investments in slow growth, compromise financial stability, and increase America's vulnerability and reduce its influence in the world.

It is critical to recognize that large, permanent increases in the Federal deficit, if enacted today, are likely to slow the economy by raising capital costs and undermining confidence as investors recognize that ultimately they will have to pay higher taxes to service the interest or repay the principal on debt incurred. Measures such as pre-committing now to large unpaid tax cuts or spending programs that will take effect only several years from now are likely to have adverse effects on near-term economic growth and exacerbate the current downturn. This effect is just the mirror image of the progress made in the 1990s following enactment of a credible medium-term program of deficit reduction.

It follows that in enacting fiscal stimulus measures, care should be taken not to raise projected deficits beyond a short horizon of a year or, at most, two. Beyond this horizon, it is essential that any new spending or tax cutting be offset by measures that reduce projected deficits. Indeed, at least a portion of any new stimulus enacted over the next couple of years would best be matched with a longer horizon effort to reduce deficits so that over a 5- to 10-year horizon the enacted program was budget neutral.

Finally, let me make several observations on the content of fiscal stimulus. Unlike the topics I have discussed so far, this is significantly a matter of value judgments rather than simply economic forecasting and analysis. Seems to me, however, that particularly strong arguments can be made for the following components:

Support for low-income families and for those who have been laid off is much more likely to be spent rapidly than support diffused more widely throughout the economy. Possible vehicles here include food stamps and extensions of unemployment insurance.

Second, there is a compelling case, in my judgment, for significant new commitments to infrastructure spending. While infrastructure spending is often seen as operating only with significant lags, I have become convinced that properly designed infrastructure support can make a timely difference for the American economy. Evidence from the Minneapolis bridge collapse suggests that it is possible to launch infrastructure programs where the vast majority of the money is spent within a year.

Moreover, the combination of declining trust fund revenues and dramatic—more than 70 percent in the case of highways—increases in some categories of construction costs means that there are a large number of projects that are currently on hold, slowed down or contracted and awaiting funding. Properly designed infrastructure projects have the virtue of being helpful as short-run stimulus, especially for the employment of workers most hard hit by the housing decline, while at the same time augmenting the economy's long-run productive potential.

State and local governments are facing grave pressures resulting in forced cutbacks that may compromise either very vulnerable populations or necessary long-term investments. While it is true that some State and local problems are a consequence of imprudent tax cutting during the good times, there is a strong case that properly targeted assistance, perhaps new temporary changes in Medicaid reimbursement rules, could provide valuable stimulus to the economy while at the same time avoiding dangerous cutbacks.

Other areas that should receive consideration include compensating consumers in the most affected regions for the effect of higher energy prices through LIHEAP, beginning a process of making necessary investments in energy efficiency and renewable energy and, where appropriate, responding to the adverse effects of ongoing financial turbulence.

Mr. Chairman, I can remember only a very small number of moments in the last three decades when the economy has sat at a cusp in the way that it does today. The decisions that the Congress and the President make in the next several months and make early next year will have very substantial consequences for some time to come. I believe that the balance of risks suggests a compelling case for a significant fiscal stimulus program that increases the deficit in the short run but that over the medium to long term does not increase national indebtedness. Indeed, I believe such a program, by strengthening the American economy, may actually reduce our indebtedness in the long run.

I wish you and your colleagues all the very best as you respond to what I think are a very serious set of challenges. Thank you very much.

Chairman SPRATT. Thank you, Dr. Summers.

[The statement of Dr. Summers follows:]

PREPARED STATEMENT OF LAWRENCE H. SUMMERS, CHARLES W. ELIOT UNIVERSITY  
PROFESSOR, HARVARD UNIVERSITY

#### THE ECONOMY

The American economy remains in a highly uncertain state with very significant risks to the downside. Weak employment statistics, contracting credit, diminishing confidence, likely further declines in housing prices, and a slowing global economy all place negative pressures on the US economy. While strong exports, declining commodity prices, and yesterday's actions to shore up the housing finance system are welcome developments, the preponderant probability is that we are a year or so away from a resumption of strong economic growth.

Even after the downturn ends and growth resumes the economy will be producing output significantly short of its potential. Experience in the United States and abroad suggests that downturns associated with asset price collapses and financial sector problems such as the one we are now experiencing tend to be especially protracted. Moreover, unemployment typically continues to rise well past the business cycle troughs with peak levels of unemployment occurring as in the last cycle as much as two years after recessions end.

As a consequence, the balance of risks in the American economy is now towards contraction and a vicious cycle in which declining economic performance exacerbates financial strains which feed back to hurt the economy rather than towards overheating and rising inflation. While this has been my reading of the balance of risks consistently over the last year it has been reinforced by the declines in commodity prices, increases in the value of the dollar, and increases in unemployment over the last several months.

Losses in output relative to potential are likely to cost the economy \$300 billion a year or more than \$4000 for the average family of four. The economic downturn will also place pressure on the Federal budget, reduce productive investment in plant and equipment, and delay recovery in housing. Inevitably the burdens of economic slowdown are felt most acutely by minority groups and those struggling to rise on the economic ladder.

#### THE CASE FOR FISCAL STIMULUS

There are a number of reasons why monetary policy is unlikely to provide stimulus going forwards: (i) It would be difficult to lower interest rates further without putting the US dollar and commodity markets at risk. (ii) In an environment where banks and other firms are constrained by lack of capital, it is not clear that lowering interest rates will have a substantial effect on lending and borrowing. (iii) There are long lags between monetary policy changes and changes in the performance of the economy. As the recent takeover of Fannie Mae and Freddie Mac illustrates, financial authorities will face important challenges simply maintaining adequate liquidity in financial markets in the coming months.

Given all that has happened in the housing and financial sector, many observers have been surprised that overall economic performance has not been worse. This is in significant part a result of the stimulus to the economy provided by legislation passed last winter. Without that stimulus which is wearing out now, our economic situation would likely be even worse.

If new policy action is going to support the economy by raising the demand for goods and services, it likely will have to come on the fiscal side. Indeed, in a situation of excess capacity and a situation where interest rates are likely to be relatively rigid because of financial strains, the multiplier from fiscal policy is in the short run likely to be larger than normal. There is a strong case for the prompt enactment of further timely, targeted and temporary fiscal stimulus \* \* \*

#### FISCAL RESPONSIBILITY

While there is a strong case for new fiscal stimulus measures which by definition increase the deficit in the short run, the long term Federal budget situation remains a matter of great concern. Excessive accumulation of Federal debt over the next decade threatens to reduce investment and slow growth, compromise financial stability, increase America's vulnerability and reduce its influence in the world. It is critical to recognize that large permanent increases in Federal deficits are likely to slow the economy by raising capital costs and by undermining confidence as investors recognize that ultimately they will have to pay higher taxes to service the interest or repay the principal on debt incurred. These concerns are exacerbated by our very low level of national saving, by the likely budget costs of supporting the financial sector and by the imminent beginning of the retirement of the baby boom generation.

Measures such as pre-committing now to large new unpaid tax cuts or spending programs that will only take effect several years from now are likely to have adverse effects on near term economic growth and exacerbate the current downturn. This is just the mirror image of the success the economy had in the mid 1990s following enactment of a credible medium term program of deficit reduction.

It follows that in enacting fiscal stimulus measures care should be taken not to raise projected deficits beyond a short horizon of a year or at most two. Beyond this horizon it is essential that any new spending or tax cutting be offset by measures that reduce projected deficits. Ideally, at least a portion of any new stimulus enacted over the next couple of years would be matched by actions with a longer horizon to reduce deficits so that over a five or ten year horizon the enacted program was budget neutral.

#### THE COMPOSITION OF STIMULUS

In many ways the composition of a fiscal stimulus program is a decision that goes to value rather than economic judgments. It seems to me however that particularly strong arguments can be made for the following components:

Support for low income families and for those who have been laid off is much more likely to be spent rapidly than support diffused more widely throughout the economy. Possible vehicles here include food stamps and extensions of unemployment insurance.

There is a compelling case for significant new commitment to infrastructure spending. While infrastructure spending is often seen as operating only with significant lags, I have become convinced that properly designed infrastructure support can make a timely difference for the economy. Evidence from the Minneapolis bridge collapse suggests that it is possible to launch infrastructure programs where the vast majority of the money is spent within a year. Moreover, the combination of declining trust fund revenues, and dramatic (more than 70 percent) increases in some categories of construction costs mean that there are a large number of projects that are currently on hold, slowed down, or contracted and awaiting funding. Properly designed infrastructure projects have the virtue of being helpful as short run stimulus, especially for the employment of the workers most hard hit by the housing decline, while at the same time augmenting the economy's productive potential in the long run.

State and local governments are facing grave budget pressures resulting in forced cutbacks that in many cases compromise either very vulnerable populations, or necessary long term investments. While it is true that some state and local problems are consequences of imprudent tax cutting during the good times, there is a strong case that properly targeted assistance perhaps through temporary changes in Medicaid reimbursement rules could provide valuable stimulus to the economy while at the same time avoiding dangerous cutbacks.

Other areas that should receive consideration include compensating consumers in the most affected regions for the effects of higher energy prices through LIHEAP, beginning a process of making necessary investments in energy efficiency and renewable energy and where appropriate, responding to the adverse impacts of the ongoing financial turbulence.

Chairman SPRATT. Now Dr. Sinai, Allen Sinai.

#### STATEMENT OF ALLEN SINAI, PH.D.

Dr. SINAI. Thank you, Mr. Chairman. I am happy to be here testifying on the difficult set of problems confronting the U.S. economy now and in the future.

The four sections to my remarks: First, a backdrop sketch of problems confronting the U.S. and global economies. They are intertwined. Closer look at the U.S. situation, and then some of the policy challenges and some general perspectives. Not much detail on policies.

In summary, the U.S. economy is in some sort of a recession. Technically, I think it is in recession and will be declared to be that way. And it feels like a recession for most Americans. It does appear to be getting worse. It does appear to be spreading. At the moment, it is focused on the American consumer more than anything else.

The global economy is moving toward recession. More and more countries are dropping into recession or near recession, and that later on will impact on what is a very strong part of the U.S. economy now. Exports, our exports will soften.

Almost all countries around the world are seeing at the same time high or rising inflation. In fact, startlingly high in the last 6 or 8 months the number of countries, particularly the emerging world, which creates its own set of problems for policy. That is, the United States, besides having to deal with a weak and weakening economy, we think a prolonged situation of essentially stagnation.

We also have to deal with inflation. It is a kind of stagflation. It is not the stagflation of the 1970s and 1980s, but it really is that. And the information and data, as one looks around the world, shows stagflation to have emerged around the world as well.

Energy and oil prices and food prices are part of that, and that complicates policy even more because it is going to be impossible to deal with any one problem with only one kind of policy without taking account of other policies that deal with other problems and how they all interact. It is hard enough to deal with one policy and to use it effectively and at the right time to deal with a particular economic problem, let alone the multitude of problems that require an ammunition approach of many policies, all of which have by-products and side effects in interacting with one another. I think if we come to thinking about it like that here in Washington and elsewhere, that will be very new in macroeconomic policy thinking.

The prospect of stagflation in the United States and a weak economy and sticking high inflation creates a tough problem for policy short or long run. It is near impossible for the Federal Reserve to sort that one out, given the dual mandate; and fiscal policy is made much more difficult in that kind of situation as well.

To add to the list of problems, we have a financial crisis in the United States. Our financial system is not functioning in anywhere near its normal state. The financial institutions are contracting, consolidating, deleveraging. Some are failing. More will fail. And we just witnessed an extraordinary intervention in the private sector economy by our government with regard to the changing of the way in which the GSEs will operate. That is meant to be transitory, but the policy problem in the future will be to figure out how we handle and support, structured mortgage finance and housing in the U.S. without the government running the function forever, which I don't think any of us want.

The policy guidance comments I might offer would be, one, monetary policy can't do much more than it has done. The Federal funds rate is very low. Some think it is too low. Some in the Federal Reserve think it is too low in real terms.

The central bank has opened its window to all the primary dealers and is making liquidity amply available. It is the financial system itself that is not pumping that liquidity out. It is absorbing liquidity much as the Japanese institutions did in prior years not because of the risk-averse situation and because borrowers from the demand side don't want to borrow as much. So that means fiscal policy will come to the forefront. I think in this kind of situation, monetary policy is relatively helpless from here on in.

And fiscal policy, in terms of certain kinds of necessary support that we have always done as a country, the support for extended unemployment benefits, for food stamp enhancement and extension for the poor and, in some situations, help for States and localities, I think that is all that most economists could come to a consensus about. And our society can handle quite easily the overall costs of such actions in the short term, would not be that great.

But I think the economy is going to need further fiscal stimulus both for the short and long run, and the kinds of tax and spending measures that are discussed and debated is where there will be considerable controversy.

At the same time, we have to maintain long-run budget discipline. I would extend the notion of PAYGO to a multi-year notion. If we tried to apply PAYGO to every fiscal measure of stimulus in a time when the economy needed stimulus, we would never get the stimulus that the economy needed; and so we have to open up the horizon for PAYGO and think of it, somewhat dangerous, as balance the budget over a multi-year period. The danger is of course, if we open up that door and don't stick to a PAYGO discipline, then we may never get the fiscal discipline that we need.

The alternative, though, is that by its very nature fiscal stimulus is going to be used to stimulate the economy. It almost necessitates some initial taking of an increased deficit to do that.

We will need to keep separate I think what we do cyclically and what we do for measures to deal with longer-run issues confronting the economy, such as health care, such as energy and energy independence, such as the long-run budget deficits at the heart of which are runaway costs and rising beneficiaries in the older segment of America which drive Medicare and Medicaid costs sky high.

Dealing with that problem, which is at the heart of the—I think many scholars would say the long-run structural budget deficits—is different from dealing with how to get consumers spending more money if the spending growth of consumption is far below potential and is dragging the economy down as well as having other effects, negative ones on business, tax receipts for State, local governments, negative effects on other countries, and then other countries' exports diminishing, whose economies then, if they diminish, will hurt the U.S. economy.

The details of these more general comments that I made can be found in the material that I have submitted. I just want to highlight a few of these general comments in some of the specific information. First, about the United States and its position, the reason for the current delays, the financial crisis that exists and the difficulty for the U.S. economy to mount any kind of sustained or sustainable recovery on its own in any reasonable length of time, and then some of the policies, short and longer run, that would be more specific to our country.

We are judging the U.S. economy to be in recession now. We are not making that judgment based on real GDP, which on the latest numbers were revised up to a 3.3 percent annual rate in the second quarter. Some of that increase in real GDP came from increases in retail sales and consumption, which came from temporary tax rebates. The help is welcomed, but those tax rebates are now essen-

tially over. We won't get that help anymore. That is a problem with temporary stimulus and temporary tax policy. You do not get permanent help; and if nothing else comes along to lift the economy up after, in this case the tax rebates have expired, then we are back where we were at the start, with an economy which now looks like it is going to go down in real GDP terms perhaps in the fourth and first quarters. To us, that would be an extension of a recession that already exists, the widening of it and not the beginning of a new recession.

On the monthly indicators, key ones that describe the U.S. economy, it is very clear that we do have some sort of recession. And it is these monthly indicators, at least as much, perhaps more so, than real GDP that calls the tune in terms of describing what is really going on in the U.S. economy. Whether it is nonfarm payroll, industrial production, personal income, less transfers adjusted for inflation, real business sales, all of those monthly indicators are below their previous peaks which occurred in the fourth quarter and in the case of nonfarm payroll in December.

It is only real GDP that tells a different story and sings a different song. I tell our business clients, our financial clients, for decisions in reality, forget real GDP. At certain times it will totally mislead you as to what is going on. I can tell you, none of our clients in the financial world or in the business world rely on real GDP to make their bottom-line decisions; and I think it is dangerous down here in Washington for you to rely on that as well.

So I want to underscore, recession, mild so far in the U.S. It is getting worse. The global economy is sinking. That will impact on us in the future. And we have as part of the recession not just a housing bust, not just the bursting of an asset price bubble in residential real estate, very unique events and very negative, but more than anything at the moment we are watching consumer spending growth about 2 percentage points less than historical trend. And although positive in producing a positive, real GDP, if you are in business or you are a country that exports to the American consumer and consumer spending on average is running 2 percentage points lower than what its historical trend has been, your business is bad.

Consumer spending is 71.5 percent of real GDP. If it is positive, real GDP is going to be positive. But if it is growing at 1.5 percent per annum now, and that is about the average rate over the last five quarters, and its historical trend is 3.5 percent per annum, that 2 percentage points difference is really a big deal and that tells the character of the economy. And if the unemployment rate, which is now 6.1 percent and in March, 2007, it was 4.4 percent, that is a 1.7 percentage point increase, even though we haven't lost as many jobs as we typically do during a so-called recession, guess what, that is a recession, and it is getting worse.

The financial crisis that is upon us, very unusual in our history, involving many more financial institutions and commercial banks because of the growth of so many nonbank financial intermediaries over the past 5, 10, 15 years and the use of capital market-centric lending and asset-based and balance sheet financing for so much of what went on in the U.S. and world economies. That part of our system essentially is imploding, contracting. It was triggered by

the housing downturn, the unwinding of the housing boom into a bust. I think it is fair to describe it as a bust. It is classic.

And the unprecedented declines in residential real estate prices. Basically, asset price deflation. So that all of the paper securities and debt and businesses geared to residential real estate are going through a major downturn. Deflation and the financial balance sheets of financial institutions heavily levered and involved in this are all contracting. And we have seen an explosion of write-downs in subprime mortgages, a need for restructuring and recapitalization, attempts to recapitalize through the market, sell stock, all the things that the financial institutions have to do in order to squeeze down to meet and fit a much smaller financial world in the future.

In addition, part of the bubble in this set of activities certainly came from what was a benign, to put it mildly, regulatory and unsupervisory environment which allowed and permitted a large range of old and new financial institutions to invent products, to sell them off, to originate and distribute, to not bear the risk of using the borrowed money that they used to invent these products, and then really the oldest game in the world, using other people's money to take that and carry that to an extraordinary extent.

We are going through an unwinding of that now. None of us knows how big that will be, how long that will be. But I can say it is far from over at this point.

And it is one of the reasons why the temporary tax rebates, which did help for a couple of quarters, didn't do the trick because other parts of the economy that had been hoped for to come on stream to help out, like a viable, strong financial system, did not deliver. But there is no reason why it should have delivered, because the unwinding of the huge boom in debt, credit and finance is going to take a long time. I think we are only partway through, and we have a long way to go in terms of the failures that we are going to see in financial institutions before all of this ends. That is an impediment to a quick and sustainable recovery in the U.S. economy.

The malaise of the consumer may be another impediment, but it has been decades since the American consumer has hunkered down, spent less, borrowed less, saved more. We now are observing five quarters of subpar growth in consumer spending. That is very rare. Consumer spending could be negative in real terms in the third quarter. The third quarter of this year will be the sixth quarter. That is about as long as any period of time we have had with weak, anemic subpar consumer spending.

We judge all of the fundamentals around the consumer, ranging from job and income to household wealth, to the financial position of households, to the inability to get money out by tapping the equity in their homes, to a credit crunch, credit tightness, to the sentiment of the consumers. All the fundamentals are negative, and our thought is we are going to see something we haven't seen in decades, consumer spending weakness that will last a long, long time.

And then third on the impediment list of course are the high prices of oil and energy. Yes, they have come down. But they are still quite high. Crude oil was \$19 a barrel back in November of 2001. We have been turning up for a long time.



So what is the response to this kind of fairly grim outlook, a stagflation situation of some sort, and the impediments, the three that I have mentioned?

I think a second fiscal stimulus is worth getting going even though you have only days left before you recess because of how long it takes to get fiscal stimulus going and in process in Washington and the lags before a fiscal stimulus can impact on the economy.

The one—a suggestion I would make is that you need to think a little bit about the longer-run fiscal stimulus that you wish to apply in devising short-run fiscal stimulus, and I would just throw out the following suggestion: Cut taxes, income tax rates for middle- and lower-income families. Do it permanently, that is, beyond the tax rates that now exist under the existing legislation, and finance that by doing something I think we are going to do anyway, longer run, which is to return tax rates on the upper-income families toward the rates that prevailed in the Clinton years. Use some other tax increases to finance the middle- and lower-income family tax cuts and get what we are going to do anyway I think in the longer run going, and get some stimulus into the thinking of middle- and lower-income families where consumption, in our judgment, is a major source of weakness in the U.S. economy.

The tax cuts—

Chairman SPRATT. Dr. Sinai, could you sort of wrap up? We have got a vote on the floor is the reason I am asking.

Dr. SINAI. Of the other tax cuts in the Bush administration, I think you will need to take a look at that and see in the face of a difficult economy what you want to do with those. And capital gains taxes at a 15 percent rate and dividend taxes on qualifying dividends, 15 percent rate I would—there is nothing wrong with keeping that.

And the other two big issues to start to work on: energy, energy independence. There is a whole set of tax policies that can be used to deal with that. Some of them are very painful. And of course the other one is dealing with the financial system crisis and what the rules of our financial system will be in the future once we get through with the current problems.

[The statement of Dr. Sinai follows:]

PREPARED STATEMENT OF ALLEN SINAI, PH.D., CHIEF GLOBAL ECONOMIST,  
DECISION ECONOMICS, INC.

After approximately six years of economic expansion in the U.S. characterized by booms in housing and mortgage finance, credit and debt, financial services and financial markets generally; strong economic growth or booms in a number of non-U.S. countries; relatively low inflation globally until six-to-nine months ago; and improving jobs and falling unemployment rates, the U.S. and Global economies now are in the midst of very difficult economic and financial stresses that pose great challenges to economic policy.

What are they? For the U.S., there is a witch's brew of problems and issues, ranging from recession and inflation to disarray and turmoil in the financial system and financial markets; to high and rising energy costs and the increasingly unacceptable long-time U.S. dependence on fossil fuels; rising federal government deficits and increasing U.S. Government debt relative to GDP; although improving, continuing imbalances in foreign trade and on current account; the inefficient provision of health care and reining in of its high inflation and rising costs; the financing of Social Security and retirement saving; a need to rebuild savings to rebalance imbalances in

the financial positions of financial institutions, households and government; and the rebuilding of U.S. infrastructure to help increase productivity and public welfare.

In addition, the unwinding of what was an incredible housing, mortgage finance, debt, derivatives, structured investment product, credit and debt boom has led to financial turmoil and financial instability in the U.S. financial system and financial markets—characterized by a housing boom that has bust, a bursting housing asset price bubble, credit crunch, and unprecedented contractions in the balance sheets of numerous bank and nonbank financial intermediaries—posing yet another difficult policy challenge.

Financial instability, a portion of what might be called the financial business cycle, always has been integral to real economy downturns; indeed, especially the most severe and long-lasting ones. Crunches and financial instability typically present at the upper turning point of the U.S. business cycle, integrated in the structure and processes of the U.S. macroeconomic system.

In the global economy, U.S. economic weakness and financial instability are impacting other countries through diminished export growth. Higher oil, energy, food and derivative prices, many set in world commodities markets but exogenous to individual countries, are providing a negative economic and inflation shock, much as in the 1970s and early 1980s. While endogenously determined by aggregate global demands and supplies, crude oil and food prices present themselves as exogenous to oil-consuming countries, essentially much of the global economy.

Currently, an increasing number of countries are experiencing incipient recession, recession-like conditions, or appear headed for them. Financial turmoil in the U.S. and elsewhere is preventing the normal economic responses to the lower interest rates and increased liquidity provided by the Federal Reserve and other central banks, and is being overshadowed by risk-averse financial institutions who are absorbing liquidity but not lending nor investing much. Previously, strong-growing economies are slowing. Boom economy countries are settling-down to lower growth. As measured by DE, some 55% to 60% of the global economy probably is in, or about to enter, some sort of recession. A global recession-of-sorts perhaps is becoming a reality!

Presently, as shown in Table 1, 11 countries are forecasted to be in or very near recession, 8 countries headed for recession, 14 that were solidly-growing now weakening and 7 countries previously booming, now slowing. 7 countries still seem strong or stable.

TABLE 1.—POLICY CHALLENGES: U.S. AND GLOBAL “RECESSION?”

	Countries In-or-Close to “Recession”		Countries Headed for “Recession”		Solid Growth Weakening		Boom Countries Slowing		Countries Still Strong or Stable		Total
	Country	Pct. of Total <sup>1</sup>	Country	Pct. of Total <sup>1</sup>	Country	Pct. of Total <sup>1</sup>	Country	Pct. of Total <sup>1</sup>	Country	Pct. of Total <sup>1</sup>	
1.	U.S.	25.6	Spain	2.6	Brazil	2.2	China	5.8	Russia	2.2	
2.	Japan	8.6	Australia	2.5	South Korea	1.8	India	2.0	Indonesia	0.8	
3.	Germany	6.1	Mexico	1.7	Switzerland	1.7	Argentina	0.5	Austria	0.7	
4.	U.K.	5.0	Netherlands	1.4	Belgium	0.8	Hong Kong	0.4	Poland	0.7	
5.	France	4.6	Sweden	0.8	Turkey	0.8	Venezuela	0.4	Israel	0.3	
6.	Italy	3.8	Taiwan	0.7	Greece	0.7	Columbia	0.1	Egypt	0.2	
7.	Canada	2.5	Portugal	0.4	Norway	0.6	Peru	0.1	Jordan	0.03	
8.	Denmark	0.5	Hungary	0.2	South Africa	0.5					
9.	Ireland	0.5			Finland	0.4					
10.	New Zealand	0.5			Thailand	0.4					
11.	Singapore	0.3			Chile	0.3					
12.					Czech Republic	0.3					
13.					Malaysia	0.3					
14.					Philippines	0.3					
15.	<b>Total(s)</b>	<b>58.0</b>		<b>10.3</b>		<b>11.1</b>	<b>9.3</b>		<b>4.93</b>		<b>(?)92.93</b>

<sup>1</sup> 2007 end-of-year data, with conversion to nominal GDP in dollars; percent of global total.

<sup>2</sup> Rounding and omitted countries approximately 7% of the global total.

Source: Decision Economics, Inc. (DE).

Less jobs growth and rising unemployment are already occurring in a significant number of countries; where not, probably to-come. In the U.S., the bulk of the reductions in the workforce and biggest part of rising unemployment probably are still on the horizon for well into 2009.

The countries in or near recession account for about 58% of the global economy, as measured by Decision Economics, Inc. (DE). The seven countries counted as headed toward recession represent 10.3% of total world output. The 21 countries where economic growth is slowing from the previous pace represent about 20.4% of the global economy. And, of the remaining countries forecasted and analyzed, seven of them are still growing nicely or not slowing, representing 4.93% of global output.<sup>1</sup>

Why this slippage globally?

The U.S. is at the epicenter of the downmove in economic activity that is rippling-through much of the world, with now a “hunkering-down” by the American consumer to far below historical trend growth spreading-out to reduce the export growth of numerous countries, although less exposed to a U.S. downturn than previously, still exposed, particularly to the demands for their exports from U.S. consumers and businesses. With intra-global regional trade more pronounced than ever before within Asia, the Eurozone and Emerging Europe, the Americas and the Middle East, those countries whose exports to the United States are weakening are also seeing trade flows and trade-related businesses with each other weaken.

The financial turmoil and financial instability in the U.S. also are significant, operating to impact other countries indirectly through depressed housing activity, declining housing prices, and the negatives surrounding aggregate consumption and business spending. But the U.S. financial turmoil also is directly a factor, negatively impacting on global equity markets and taking away support for global economic activity by U.S.-based companies who are cutting-back and some damaged globally-based financial institutions whose balance sheets are contracting.

A future risk to the U.S. lies in a current area of strength, exports, and to the companies whose businesses have become increasingly tied to revenues and earnings generation from outside the U.S.. Currently, U.S. exports are over 13% of real GDP, more than four times the now depressed real residential construction, so that as the global economy weakens, with lags U.S. exports will themselves weaken and then through export multipliers negatively affect the economy.

At the same time and over the past six-to-nine months, inflation almost everywhere has surged higher, in part a consequence of large rises in crude oil prices, in energy prices, and in food inflation. The high and rising inflation that has occurred is squeezing domestic purchasing power in many countries, particularly for consumption, so that along with worsening trade is creating recession or recession-like conditions.

Over 40 countries are showing high, or rising, inflation rates—some double-digit, some mid- to high single-digits, or high low single-digit—that have exceeded, or some exceeding, the limits set by central banks. In many countries, wage inflation is on the rise as well, threatening to pass into higher prices through rising unit labor costs then back perhaps into wages again, then prices, etc., although at the current time not the United States.

Table 2 indicates the ranges of inflation and countries assessed to be in each range; also whether price inflation has been Accelerating (A), is Stable (S), or Decelerating (D).<sup>2</sup>

<sup>1</sup>Decision Economics, Inc. (DE) forecasts and analyzes some 47 countries in the global economy, which account for approximately 93% of total global output. The rankings of these countries in the global economy are obtained by converting local currencies to nominal dollars using country exchange rates. Thus, the calculations relating to expansion and recession and for the rankings of the economies involved may differ from others, such as the IMF. For example, a U.S. recession is defined by standard NBER criteria, which includes growth in real GDP but more importantly relies on a wide range of readings, relative to previous peaks, for a number of monthly economic indicators. A global recession on the DE figures is less than 2% real GDP growth and is based on a diffusion index approach to growth versus historical potential rates of growth. Monthly economic indicators also are used for individual countries, although in many nowhere near as reliable as is the U.S. monthly indicator information.

<sup>2</sup>The overall CPI was used for these assessments. “Core” inflation, generally CPI inflation Ex-Food and Energy, also was examined and is on the rise in numerous countries, including the United States. But, for most, readings on core CPI, originally meant mainly as a classificatory measure, present the lowest possible readings on inflation when energy and food prices are rising and even when they are not. If the increases are exogenous or transitory, then taking-out food and energy prices can make policy sense. If not, then policymakers that use it run the risk of thinking that inflation might be low, arguably the situation that has existed before in the United States. Crude oil and energy prices have been rising, on average, for years, hardly a transitory phenomenon; volatile yes, transitory no. The very low interest rate regime chosen by the Federal Reserve in the early and middle part of this decade reflected a core inflation focus,

Inflation has moved up quite sharply in a large number of countries, particularly over the past six-to-nine months. Of the 47 economies analyzed and forecasted by Decision Economics, Inc. (DE), the inflation indicated has been high or rising in 41 of the countries, in part from the same forces that have been driving U.S. inflation higher—rising oil, energy and food prices—but also from the demand-pull of strongly-growing economies and increased costs of production. Inflation targets or the desired ranges of central banks are being exceeded in more than half the countries where applied.

Central banks can be hamstrung when there is both recession and too high inflation, or “stagflation,” not sure which to deal with, the “stag” or the “flation.” The combination of a weak or weakening economy, high or rising inflation, and rising unemployment presents an extremely negative backdrop for the U.S. economy. The circumstances being seen now have few parallels—perhaps the downturns of 1973-75, 1979-80, and the early 1980s.

But none of these downturns had some of the other challenges now confronting the U.S.—1) contraction and crisis in the financial system with a degree of risk-averse behavior and deleveraging not seen since the 1930s or in

TABLE 2.—POLICY CHALLENGES: U.S. AND GLOBAL—“INFLATION”

Countries with Double-Digit Inflation (10% to 35%) <sup>1</sup>			Countries with Inflation (6% to 9.9%) <sup>1</sup>		Countries with Inflation (3% to 5.9%) <sup>1</sup>		Countries with Still Low (Below 3%) Inflation	
Country	Accelerating (A), Stable (S), or Decelerating (D)		Country	Pct. of Total <sup>1</sup>	Country	Accelerating (A), Stable (S), or Decelerating (D)	Country	Accelerating (A), Stable (S), or Decelerating (D)
1.	Venezuela	A	Chile	A	Taiwan	A	Japan	A
2.	Egypt	A	Thailand	A	South Korea	A		
3.	Jordan	A	Malaysia	A	Peru	A		
4.	Russia	S	Columbia	A	U.S.	A		
5.	South Africa	A	Czech Repub.	S	Mexico	A		
6.	Turkey	A	Hungary	S	Belgium	D		
7.	India	A	Singapore	D	Spain	A		
8.	Philippines	A	China	D	Greece	S		
9.	Indonesia	A	Hong Kong	S	Israel	D		
10.	Argentina	A	Brazil	A	Poland	A		
11.					New Zealand	A		
12.					U.K.	A		
13.					Ireland	D		
14.					Sweden	A		
15.					Finland	S		
16.					Norway	A		
17.					Australia	A		
18.					Italy	S		
19.					Denmark	A		
20.					Austria	S		
21.					France	A		
22.					Canada	A		
23.					Germany	S		
24.					Netherlands	A		
25.					Switzerland	A		
26.					Portugal	D		

<sup>1</sup> Latest, Year-over-Year; CPI Overall.

Source: Decision Economics, Inc. (DE).

Japan during the 1990s; 2) increasingly fragile U.S. government finance, with increasing burdens thrust on the Federal Reserve and U.S. Treasury of weak asset collateral and risks to the full faith and credit of U.S. sovereign debt from failing financial institutions; 3) the unknown effects of a huge deleveraging, contractions in asset-based lending, investments, and financial intermediary balance sheets a large number of financial intermediaries responsible for the greatest amounts of funding to the U.S. economy ever; and 4) a global inflation reflecting increased costs-of-production in non-U.S. economies, especially developing, that for a long time

undoubtedly contributing to the boom in housing, credit and debt, and indirectly the excesses that grew up around these areas of activity.

provided considerable deflation and disinflation. Cost-push sources of rising inflation from this source are numerous.

The collapse of the U.S. commercial banking system and in credit during the 1930s now is widely, and correctly, seen as a major reason for the Great Depression. But the large number of nonbank financial institutions that have been involved in asset and balance sheet-leveraged financing now dwarfs the commercial banking system in size and amounts, having operated through capital markets to fund much of the economic expansion, now contracting and presenting unknown potential downside consequences.<sup>3</sup>

#### U.S. ECONOMY PROSPECT: RECESSION AND IMPEDIMENTS TO RECOVERY

The state of the U.S. economy is a recession or recession-like conditions; if recession so far “shallow,” but spreading and intensifying, complicated by the high and rising inflation that has mainly stemmed from increased oil, energy and food prices, and increased costs of production, domestic and global.

This recession episode is unlikely to be short, instead “Shallow and Long” or “Deep and Long.” The shortest U.S. economic downturns previously were six months in 1980 and in 1991 and 2001 eight months each. The longest were in 1973-75 and 1981-82, each sixteen months, when crude oil and energy prices were rising sharply.

The current episode appears most similar to the late '70s or early '80s, with an unusually negative combination of elements; some new, some old: 1) a severe housing downturn (“Bust ”); 2) a bursting housing asset price bubble (biggest declines in home prices since the Great Depression); 3) a credit crunch within and outside the financial system (Financial Crisis); 4) contractions in the assets and balance sheets of commercial banks and now large number of nonbank financial intermediaries such as Investment Bank/Broker Dealers, Private Equity, Venture Capital, Hedge Funds, and off-balance sheet subsidiaries of Commercial Banks (Financial Crisis); 5) a potentially considerable “Failure Fallout” of failed banks and other financial institutions, with consolidation and absorptions (Financial Crisis); and 6) the rises in oil and energy prices that have adversely affected economic activity and inflation in all oil-consuming nations. Major oil-producing countries are net beneficiaries.

The downturn and its extent and severity cannot be seen in quarterly real GDP, a measure many look to as the main summary statistic for the U.S. economy, e.g., the most recent upwardly revised 3.3% annualized rate of growth in GDP for the second quarter. Temporary tax rebates helped raise consumption, although in real terms only 1.7%, annualized, raising real GDP but probably only temporarily, along with strong growth in exports off a strong global economy and previously weaker dollar, and very strong real federal government spending.

But this quarterly summary statistic can be misleading and is not the only one used to technically define a recession.<sup>4</sup> Other important monthly measures—personal income less transfers adjusted for inflation, real business sales, nonfarm pay-

<sup>3</sup>See Tobias Adrian and Hyun Song Shin, “Financial Intermediaries, Financial Stability and Monetary Policy,” presented at the Federal Reserve of Kansas City Symposium, Maintaining Stability in a Changing Financial System, August 22, 2008, Jackson, Wyoming. The authors present evidence on the growth in asset-backed lending and capital markets-centric nature of lending and investing by financial intermediaries rather than the deposit-based lending and investments of commercial banks that previously characterized the financial system. Left out of the authors’ calculations are the asset-based and balance sheet-levered activities of the now very large number of bank-like financial intermediaries such as Private Equity, Venture Capital, Hedge Funds and Sovereign Wealth Funds that have been so important in the intermediation of funds from all sources everywhere, and in energizing economic activity in the U.S. and around-the-world.

<sup>4</sup>The National Bureau of Economic Research (NBER) defines a recession as “a significant decline in activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and wholesale-retail sales,” in The NBER’s Business-Cycle Dating Procedure, Business Cycle Dating Committee, National Bureau of Economic Research, June 18, 2003.

The Committee maintains a monthly chronology and refers to a variety of monthly economic indicators to choose months of peaks and troughs. Particular emphasis is placed on Personal Income less Transfers, in real terms, and Employment, measured by nonfarm payrolls. In addition, the Committee refers to two indicators with coverage primarily of manufacturing and goods. These are Industrial Production and Manufacturing and Wholesale-Retail Sales, adjusted for price changes. Real GDP is viewed as the single best measure of aggregate economic activity but is available only quarterly and with lags; also often is revised. Considerable weight is placed on this Bureau of Economic Analysis (BEA) measure. The NBER definition thus encompasses a wide range of economic data, mostly monthly, not quarterly, economic time-series, and not just, or mainly, real GDP. In particular, two consecutive quarters of negative growth in real GDP is not the definition of a recession; nor does it make technical sense that it be so.

roll employment and industrial production—show peaks back in October 2007, December 2007 and January 2008, and currently stand below them. Though the declines from the peaks have been relatively small so far, the expected course for the economy suggests that its recessionary thrust will deepen and be prolonged at least until mid-2009, likely taking a turn for the worse in the third and fourth quarters and first quarter of 2009.

The expectation is for a transitory lift in real GDP during the second and third quarters from the temporary tax rebates and their positive effects on consumption spending, then after the rebates further retrenchment by consumers with no particular stimulus coming from any source that can be currently seen (essentially flat real GDP or declines in the 0.5% to 1% range).

Ripple effects into U.S. business sales and profits from the consumer retrenchment; cutbacks in production, spending and employment; weakness in state and local government spending from declines in tax receipts; depressed commercial real estate activity; and continuing financial system disarray suggest a long period of economic weakness accompanied by a decline of inflation but not necessarily to acceptable levels. Weak U.S. consumption, averaging only 1.6% per annum over the last five quarters against an historical trend rate of growth of 3-1/2% per annum, can be a depressant on the export growth of numerous non-U.S. countries, in turn feeding back negatively later on the currently booming U.S. export economy.

The U.S. prospect looking forward is thus stagnant economic growth and sticky-high inflation—a generic “Stagflation” with a weak, or recessionary, economy and high inflation moving somewhat lower for awhile but not enough to represent a significant downtrend. The unemployment rate is expected to rise unevenly to a range of 6-1/2% to 7% by mid- or late-2009.

There are numerous impediments to quick and sustained recovery for the United States.

1) Crude oil and energy price inflation are negatively affecting oil-consuming economies—reducing economic growth and raising inflation. Most of the global economy falls into this category with particular exposure to rising oil and energy prices in the developed Asian world including Japan and South Korea, emerging Asian countries except to some extent China and India, much of the Eurozone, the U.S. to a significant degree, some other industrialized nations, and the majority of Emerging Europe. The oil producers of the world economy are in relatively good shape, although not all of them, e.g., Venezuela and perhaps Norway. In Latin America, Brazil and Argentina are relatively immune to higher oil and energy prices. Brazil is now a producer. So is Russia, a leading oil and gas producer, the second largest for crude oil, many oil-producing countries in the Middle East, Australia and New Zealand. But the Brazil, Argentina, Australia and New Zealand economies still are weakening from higher inflation and other sources. Economic weakness in non-U.S. countries can later negatively affect U.S. exports.

2) The bust in U.S. housing and crunch in mortgage credit, not just for Subprime and Alt-A loans, but generally throughout mortgage finance, as well as the inability of consumers to draw on home equity for various purposes, continues as a major drag on the economy. The end may be in sight here as housing sales and starts appear to be bottoming-out; although not, however, for falling home prices. For awhile, the best that can be expected in house prices is less deceleration.

3) The U.S. financial system, beset by a housing bust after an incredible boom, now is dealing with its own kind of “bust,” an unwinding of the huge residential real estate asset price, credit and derivative financial products booms and in the businesses of the financial institutions associated with derivative securities, structured investment products, and financial business development in a benign regulatory environment. Excesses in leveraged balance sheet expansion, unprecedented in scope for the numbers of financial firms involved and the amounts, suggest an uncertain timeline for the adjustment on the recapitalization necessary at many bank and nonbank financial intermediaries. This is particularly so at commercial banks, investment bank/broker dealers, private equity, venture capital and financial firms performing similar functions, collectively now the primary credit and financial intermediary channel for the economy. Tight credit in commercial real estate, for the consumer in various dimensions of borrowing, and increasingly for nonfinancial businesses is a result, as well as a drying-up of new IPOs and private equity financing.

Writing down values from eroding or hard-to-estimate asset prices, raising and shoring up capital, cutting expenses, and tight credit are characteristics of the unwinding, the likes of which in a necessary deleveraging probably have not heretofore been seen. How long this process lasts and the time it takes to repair and rebuild the U.S. financial system are extremely important for determining the length and depth of the U.S. downturn—and extremely difficult to know at this

time. Extreme risk aversion by financial institutions and in the economy at-large are preventing the massive injections of liquidity by the Federal Reserve from lifting economic activity.

4) An overhang of debt and credit for households, businesses and even states and localities, and the necessary adjustments given a recession and declining asset values are other impediments to a sustained and sustainable pickup in economic activity.

Aggressive and widespread debt-financed expansion has left households, businesses, financial institutions and governments with excessive debt and credit relative to secure collateral, vulnerable to an extended period of subpar economic activity, and in need of restoring balance sheet stability through less spending, less borrowing, less lending, and more savings.

5) The biggest impediment may well be the American consumer, usually ebullient and boomy in expenditures and borrowing, as indicated by the historical trend rate of growth for aggregate consumption, adjusted for inflation, of 3-1/2% per year over the past 45 years. Given that trend rate of growth, even a reduction to a positive 1%-or-2%, although not necessarily bringing about a decline in real GDP, would be a major depressant. Inflation-adjusted consumption is now near 71-1/2% of real GDP. Significantly less growth in consumption could alter the business cycle in a fundamental way.

Here is where the downward momentum of the U.S. business cycle is currently focused. All the fundamental determinants of aggregate consumer spending appear negative—1) growth in real disposable income, depressed by an increasingly weakening jobs market, low growth in nominal and real wages, and high price inflation; 2) huge reductions in real household net worth on declines in real estate and stock prices, somewhere between \$3 trillion and \$4 trillion over the past year and at a DE-estimated six cents of consumption, with lags, on a dollar of “permanently” lower real net worth, representing nearly two percentage points of lost economic growth this year; 3) consumer confidence depressed to levels previously seen only in the deepest part of recessions; 4) the inability to tap and use housing equity for spending and investing, reversed now because of foreclosures, delinquencies, and negative home equity; 5) on DE measures the most deteriorated household financial conditions since the early '80s; and 6) tight and tightening mortgage finance and consumer credit.

Consumption spending has grown significantly below trend for five consecutive quarters now, averaging only 1.6% growth, at an annual rate, and may even turn negative in the third quarter. This is despite a \$108 billion injection of temporary tax rebates over April-to-July, or \$432 billion, at an annual rate. This weakness in consumer spending is striking given the historical propensity for a much higher rate of spending and few periods in history where the consumer has spent weakly for any length of time.

How long this consumer weakness lasts and whether the consumer stays “hunkered-down” are keys to the timing and degree of any economic recovery.

6) Finally, financial markets themselves, particularly an equity bear market, present impediments to a sustained pickup. Declining stock prices negatively affect consumer sentiment and household wealth, thus consumer spending. A bear equity market presents an impediment to raising funds for new enterprise and for corporate balance sheets. Declining stock prices raise the aftertax weighted average cost-of-capital, increasing the cost of new projects. This reduces the transactions and IPOs that can support economic activity.

Stock prices go down on expectations of a weaker economy; lower stock prices act to weaken the economy; a weaker economy reduces earnings growth; stock valuations decline; the economy weakens, etc.; that is, a negative feedback loop occurs. Once the economy downturn bottoms out and declines in earnings growth begin to reverse; in the presence of low, or falling, interest rates the stock market can start to gain and the negative feedback loop be broken. The U.S. is not near this point at the current time.

A long period of adjustment is thus suggested, very likely prolonged economic weakness or recession-like conditions—the “stag” part of stagflation—with sticky-high inflation rates overall and for the “core” (ex-food and energy), the “flation” side of stagflation.

#### WEAK OR WEAKENING ECONOMIES AND HIGH INFLATION

The pattern of economic growth and inflation that is showing in the U.S. and globally is one of stagflation. The “Stagflation Footprint” appears in Table 3, with recent patterns and expectations of growth and inflation shown for several key countries and global regions. 2008:2 already is essentially known, in particular virtually



all of actual inflation. Second quarter results on real GDP still are not available for a number of countries.

Weak economic growth and high or rising inflation represents two parameters that can define Stagflation. Others are jobs and the unemployment rate and the presence of pass-through from initial exogenous, or endogenous, sources of inflation such as energy inflation, wages, and nonlabor costs. The long-term presence of rising crude oil prices and lately food prices also are markers of Stagflation, certainly present in other historical episodes that have been so characterized. Crude oil prices, on average, have been rising since \$19/barrel for light crude in November 2001 and particularly so over the past year where the increases do not appear to be solely endogenous. Exactly why crude oil prices have recently risen so far, so fast, is a puzzle. But, the effects on global inflation and on the inflation rates of a large number of countries are clear in the data.

In many countries, wage inflation also is accelerating. This is particularly true in the emerging or developing world, where booms have occurred and unemployment rates moved to very low levels. Costs-of-production are rising sharply in these countries. And, given the global nature of production and consumption, as well as the ability technologically to produce, distribute, and ship almost anywhere, the price and wage inflation of the emerging world must be regarded as a potential source of inflation everywhere.

For many countries individually, the rises of inflation appear as exogenous, rather than endogenously driven through the demand-pull of a strong economy; for example, crude oil and food prices. Cost-push to individual countries has come from rising oil, energy, food and commodity prices and generally as part of global demands and supplies, but in many countries now appears to be part of the inflationary process.

Table 3 shows a rather pervasive pattern of slowing real economic growth and rising inflation in the U.S., several key countries, and the major global regions of the world economy.

Inflation appears to have picked up significantly in the U.S. and elsewhere sometime in the fourth quarter of 2007, a little earlier in the U.K., the U.S. and Eurozone, a little later in Japan. Pronounced global regional economic weakness is more recent and has intensified in the last six months.

The rising inflation over the past six-to-nine months and its pervasiveness are striking (Tables 3, 2, and 4 below), with the number of countries showing quite high inflation, year-over-year, 6%-or-more, at 20, and 26 countries exhibiting year-over-year inflation between 3% and 5.9%. Only one country has a running inflation rate less than 3%, Japan. Table 3 also demonstrates that the more sharply rising inflation is recent and, except for the U.S., much slower growth very recent.

TABLE 3.—GLOBAL AND GLOBAL REGIONAL “STAGFLATION?”

	2008:3F	2008:2F	2008:1A	2007:4A	2007:3A	2007:2A
<b>Global:</b>						
Real GDP Growth (Pct. Chg. Year Ago) .....	2.3	3.0	3.5	3.7	3.9	3.7
CPI Inflation (Pct. Year Ago) .....	5.0	4.7	4.2	3.8	2.8	2.7
<b>U.S.:</b>						
Real GDP Growth (Pct. Chg. Year Ago) .....	1.2	2.2	2.5	2.3	2.8	1.8
CPI Inflation (Pct. Year Ago) .....	4.8	4.3	4.2	4.0	2.4	2.6
<b>U.K.:</b>						
Real GDP Growth (Pct. Chg. Year Ago) .....	1.0	1.4	2.3	2.8	3.1	3.3
CPI Inflation (Pct. Year Ago) .....	4.3	3.4	2.4	2.1	1.8	2.6
<b>Japan:</b>						
Real GDP Growth (Pct. Chg. Year Ago) .....	0.6	1.0	1.2	1.4	1.8	1.8
CPI Inflation (Pct. Year Ago) .....	2.2	1.4	1.0	0.5	-0.1	-0.1
<b>EU:</b>						
Real GDP Growth (Pct. Chg. Year Ago) .....	1.0	1.5	2.1	2.2	2.6	2.6
CPI Inflation (Pct. Year Ago) .....	4.2	3.6	3.2	2.8	1.9	2.0
<b>Eurozone:</b>						
Real GDP Growth (Pct. Chg. Year Ago) .....	0.8	1.5	2.1	2.2	2.6	2.6
CPI Inflation (Pct. Year Ago) .....	3.9	3.6	3.4	2.9	1.9	1.9
<b>G-7:</b>						
Real GDP Growth (Pct. Chg. Year Ago) .....	0.7	1.9	2.1	2.0	2.5	2.0
CPI Inflation (Pct. Year Ago) .....	4.0	3.4	3.1	2.9	1.8	2.0
<b>OECD:</b>						
Real GDP Growth (Pct. Chg. Year Ago) .....	1.3	2.0	2.4	2.5	2.8	2.4
CPI Inflation (Pct. Year Ago) .....	4.4	3.7	3.3	3.1	2.0	2.2

TABLE 3.—GLOBAL AND GLOBAL REGIONAL “STAGFLATION?”—Continued

	2008:3F	2008:2F	2008:1A	2007:4A	2007:3A	2007:2A
<b>Latin America:</b>						
Real GDP Growth (Pct. Chg. Year Ago) .....	4.7	5.1	5.3	5.7	5.4	5.1
CPI Inflation (Pct. Year Ago) .....	8.4	7.5	6.4	5.7	5.3	5.1
<b>EMG-Asia and Developing Countries (Ex-Japan):</b>						
Real GDP Growth (Pct. Chg. Year Ago) .....	7.6	8.2	9.4	9.9	10.1	10.7
CPI Inflation (Pct. Year Ago) .....	8.5	7.9	7.2	6.0	5.8	4.2
<b>EMG-Europe:</b>						
Real GDP Growth (Pct. Chg. Year Ago) .....	7.5	6.9	5.7	4.4	4.5	4.8
CPI Inflation (Pct. Year Ago) .....	8.5	7.7	7.0	6.2	5.1	6.4

F = Forecast.

A = Actual.

The classic “Stagflation Footprint” presents itself as a recession or stagnation that could be prolonged; stubbornly high, or rising, inflation, overall and in the “core;” pass-through to prices of higher cost inflation through wages, unit labor costs, lower productivity growth and/or nonlabor costs; and rising unemployment. Exogenous price, wage, or productivity shocks also can be present, from economic or geopolitical sources, or both. Permissive or accommodative monetary policy has been yet another characteristic. Rising expected inflation, if possible to measure, presumably also should be present.

The policy choices, fiscal and monetary, going forward are difficult, for the U.S. and elsewhere in the global economy.

If only recession, the policy choices will be simple—easier monetary policy, perhaps aggressively so, and fiscal stimulus. But high and rising inflation in the U.S. and many other countries prevent this and present yet another challenge—how to reduce the inflation. If only inflation, the policy choices would be easy—for monetary policy higher interest rates and tighter credit, and/or fiscal restraint. The latter is notably difficult to implement in any country, however, at any time.

For monetary policy, the simultaneous appearance of recession and inflation presents difficult assessments and choices—whether for a central bank such as the Federal Reserve and perhaps the Bank of Japan (BOJ) that operate under a “dual mandate” of maximizing sustainable economic growth and price stability, or central banks focused on price stability with a “soft” inflation target such as the European Central Bank (ECB) and Bank of England (BOE), or by law an explicit “hard” inflation target, e.g., the Bank of Canada (BOC) and Reserve Bank of New Zealand. Which challenge to deal with, recession or inflation, and in what sequence are major questions.

#### WHY U.S. “STAGFLATION” AND WILL IT PERSIST?

Charts (1) and (2) indicate that several defining parameters of stagflation are present for the United States—a weakening or declining economy, perhaps a recession, at least on a number of monthly economic indicators, rising inflation, sharply so since 2007:3, and a rising unemployment rate. Sharply higher crude oil, energy, and food prices since mid-2007 after years of increases, on average, for crude oil and energy prices and rising expected inflation, on average for some measures, also are defining characteristics.

Chart 1  
U.S. GDP, CPI Inflation and Unemployment Rate  
(Pct. Chg. from Quarter One-Year-Ago for GDP and Inflation)

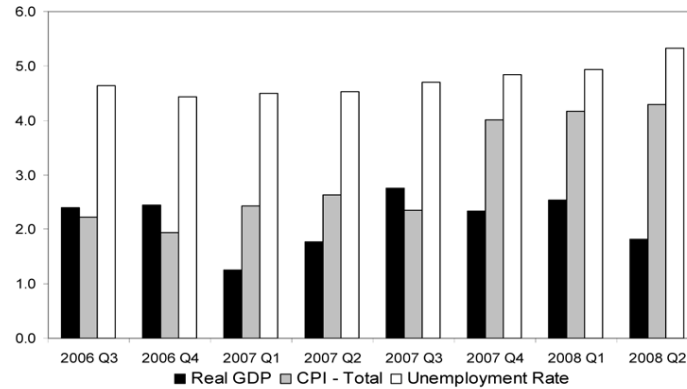
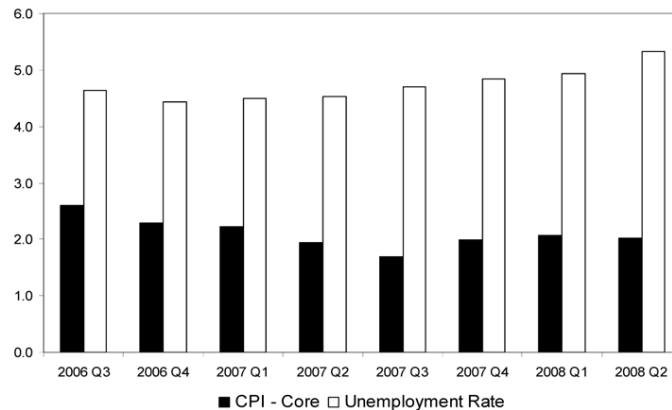


Chart 2  
U.S. "Core" CPI Inflation and Unemployment Rate  
(Pct. Chg. from Quarter One-Year-Ago for Inflation)



Even "core" inflation and the unemployment rate have been rising together, yet another stagflation sign. Real GDP growth is estimated to have been only 1-1/4% to 1-1/2% over the past year and core inflation, as measured by the PCE Deflator, currently stands at its cyclical high, 2.4%. Core CPI inflation is 2.5%, year-over-year. The unemployment rate, at 6.1%, compares with 4.7% a year ago and the low of 4.4% in March 2007.

Why a U.S. stagflation?

One reason is the pronounced cyclical downturn in housing, unprecedented declines in residential real estate prices, resulting financial turmoil and instability, and negative effects on consumption through deteriorating consumer confidence, reductions in household real wealth, declines in jobs, and less growth of real incomes. Deteriorated household financial conditions and the failure fallout of delinquencies and bankruptcies are other reasons for weak consumer spending. The need to rebalance imbalances in household balance sheets and existence of tight credit conditions suggest a lengthy process of adjustment for consumers.

Second is the squeeze on consumer purchasing power, also in many other countries, brought about by sharply higher oil, energy and food prices, which adds to inflation but reduces real incomes, real wealth, and real consumption.

A third reason is sharply higher crude oil, gasoline, heating, energy and food prices, which have added to overall inflation and spilled over into costs-of-production, in turn passed on into prices in order to maintain business profit margins.

Fourth is the aggressive easing of the Federal Reserve because of the U.S. financial crisis and potential risks to the financial system and the economy. Federal Reserve monetary policy has been easier than otherwise, has helped keep the dollar lower, and affected the expected inflation of U.S. consumers, global financial market participants, and businesses. Exactly how expected inflation enters actual inflation is unclear, but its rise has been correlated with rising actual inflation.<sup>5</sup> Inflation will be higher than otherwise when a central bank follows an easy monetary policy.

Fifth is the American consumer, likely to stay cautious in spending and borrowing given so many negative fundamentals. Consumption spending drives the U.S. economy; if weak, the economy must largely remain weak.

Sixth, much of the business cycle downturn looks still to-come. As yet, business capital spending has held up. Exports are booming. With business sales and earnings growth declining, indeed for the latter falling in levels, additional cutbacks in production, employment, capital spending, and new business ventures can be expected.

Seventh, as the global economy contracts, U.S. exports likely will weaken, softening what has been a significant strength.

Finally, neither monetary nor fiscal policy is being set for lasting stimulus. Too high inflation prevents the Federal Reserve from easing any more; instead, its next move on interest rates probably is up and, at some point, the huge liquidity and backstop financing that has been put-into-place will have to be withdrawn.

Why will U.S. Stagflation persist?

A stagnant economy, at the least low and subpar real economic growth, likely will continue given relatively weak consumption and continuing restraint stemming from the necessary adjustments in the U.S. financial system and private sector.

But what about inflation? With lags, shouldn't a subpar economy, rising unemployment, and lower oil and commodities prices take down inflation?

Certainly, for a time this seems likely later this year and next, if only arithmetically, on a year-ago basis when the much higher inflation rates that have already appeared will provide downward base drift for price inflation in the U.S. and elsewhere.

But, how much deceleration of inflation is the question. And, whether pass-through of higher prices into wages and then through costs back to higher prices will occur is another. So far, U.S. laborers are accepting losses of jobs and a squeeze on real incomes in return for job security. However, this may not necessarily persist, even with a much higher unemployment rate. And, the global nature now of the inflation process and its structure suggest that other costs, for import goods, nonlabor, and energy-derived could prevent increased economy slack from taking down price inflation to acceptable levels.

Thus, a reasonable expectation is that the U.S. economy will grow slowly, on average, if at all, with sticky-high inflation, although lower than currently, with both persisting for quite some time.

#### THE ROLE OF ECONOMIC POLICY IN THE CURRENT CIRCUMSTANCES

For U.S. policymakers, much effort has been expended to cushion the economic downturn and to prevent financial system disarray from taking the economy down further.

With a difficult near- and intermediate-term cyclical situation in prospect, it is tempting for policymakers to look for quick solutions, using short-run and temporary measures. However, the current U.S. cyclical downturn and perhaps to emerge in the world-at-large reflects deeper, long-run problems that require longer-run policy actions for relief.

So far, the measures taken by the Federal Reserve and other central banks and on fiscal stimulus have not resulted in much improvement, although certainly preventing even worse results from occurring. This may be because of lags in the effects of policy. Or, it may be that the excesses of the U.S. situation and adjustments necessary to correct them are so large, and require so much time, that short-run temporary measures will not prove curative nor provide anything other than temporary relief.

Such is probably the likelihood for the "temporary" tax rebates tried in the United States. The rationale made sense, to bridge a possible downturn with help for the

<sup>5</sup> Expected inflation is a right-hand-side variable in most forms of the expectations-augmented Phillips Curve inflation paradigm that lies at the heart of current mainstream macroeconomic analysis. But, how these expectations are formed and affect price inflation, by how much, and over what timespan remains murky. A rise of expected inflation should increase actual inflation, according to this framework. But, the mechanisms by which this occurs have not been clearly spelled-out.

consumer until low interest rates and increased liquidity could lift up the financial system and the economy. Some of what was intended has happened. But now with the rebates essentially done, all things considered, the motion and process of the current business cycle is likely to work against any further lift. There is too much to go yet in the U.S. and global business cycle downturns and in the contraction of the financial system and in credit to allow easier monetary policy to produce the hoped-for significant upward response in economic activity. The contraction in credit and retrenchment of the financial system are likely to make the lags in monetary policy much longer-than-average, perhaps as long as in some other long episodes, at near 24 months or about two years. The collapse in housing activity will abate and come to an end over the next year, but housing probably will not show a significant upturn. Two years would take the U.S. economy into 2010.

For the consumer, beset by the most negative set of economic fundamentals in several decades, the outlook is problematical. The excesses and imbalances of the household sector need to be worked off to prepare for the next upturn. How long consumption stays subpar is a key.

Thus, the prospects for help from policy are daunting. The tax rebates have lifted consumer spending, but given the fundamentals surrounding consumption probably only temporarily so. As the end of the effects from the tax rebates approaches, there appears to be nothing fundamental, nor exogenous in source, that can lift the growth of consumer spending to any major degree.

#### WHAT THEN, FOR FUTURE POLICY? SHORT-RUN HELP IN THE CONTEXT OF A LONG-RUN REBUILDING OF AMERICA

In difficult economic times, it is essentially irresistible and almost politically impossible not to try and use policy for improving short-run economic performance, particularly when jobs and the economy are at stake and in an episode like the current one where the U.S. financial system is contracting so much. This is especially true in a Presidential election year, regardless of the party in power.

But, history teaches how difficult it is in the short-run to devise appropriate and properly-timed macroeconomic policies, even in the best of circumstances. The “rush-to-help” should be disciplined by consideration of the nature of the problems and in the context of the longer-term.

Also, it is important to coordinate policies in- and over-time, both for multiple fiscal actions that might be taken and their interactions and effects, and how current policy actions can dovetail with longer-term policies to achieve national objectives. This is similarly so for monetary policy and its interaction with fiscal policy. Macroeconomic policy effectiveness, in this sense, would be enhanced in a cost-efficient way if there were more coordinated planning and policy actions than the piecemeal, separate, approach that is normally the case.

Temporary tax reductions and hurry-up programs of government spending do not have a good history of success in U.S. economic policy. Both monetary and fiscal policies, though well-intentioned, often have erred and been mistimed. It is very difficult to design optimal policies for the short-run that can also work to achieve long-run economic objectives such as maximum growth and price stability, especially in those circumstances when the two objectives are in conflict or where there is a negative tradeoff between them.

The United States has perhaps the longest list of economic problems and backlog of societal issues in decades. Years of not facing up to big, long-run issues like energy conservation, energy independence from oil and oil derivative products, rising structural federal budget deficits, reforming and restructuring the tax system, social security and health care, and now the stabilizing of the economy and inflation have left staggering policy challenges for the future. Added to the list, given the current financial crisis, is maintaining financial stability along with updating and changing the regulatory and supervisory framework for the U.S. and global financial systems.

One possible approach is to design short-run stimulus in the context of longer-run objectives—that is, measures or stimulus now as a step or downpayment on longer-run policies to achieve long-run objectives.

Of the many longer-run economic issues the country ultimately has to face, there are at least eight worth noting that are highlighted and dovetailed with the immediacy of the current situation. The comments here represent only a few of the possibilities on taxes, the role of the federal government, and for Congress.

These are:

- The Economy and Jobs. The U.S. economy is suffering cyclically and is at risk secularly, with supportive fiscal and monetary policies necessary in the short-run and for the long-run. Monetary policy has done about all it can safely do under the current circumstances. For fiscal policy, if a Pay-Go framework is applied, tax reduc-

tions for middle and lower income families financed by increased taxes on the highest income families and by reduced growth in government spending would serve to support consumption and the household balance sheet in a permanent way if the tax reductions were themselves permanent. There are other ways to accomplish this and to do so within a context of longer-run multi-year federal budget balance. The consumer is the policy lever here given the current situation and prospect.

- Energy Independence and Energy Conservation. Measures to reduce the demand for oil, gasoline and other energy derivatives as well as policies to stimulate supply and to develop alternative energy sources, both for crude oil and the refining of gasoline, are indicated with a “Call to Mission” sense of national urgency. Had the U.S. tackled the “Energy Problem” 30 years ago, the inflation part of today’s stagflation might not be present. The dependence on crude oil by so many countries is a major source of the current economic malaise facing many of them and of too high inflation.

For the U.S., lower crude oil and derivative energy prices would go a long way toward freeing-up discretionary income for spending, reducing business costs-of-production, and make much easier the task of the Federal Reserve in stimulating and sustaining maximum economic growth. Because of the connection between the “Energy Problem” and the “Stagflation Problem,” the leverage of a big visionary program with tangible actions to reduce demands and increase the supplies of oil and energy would be very high.

Here, a Bipartisan Task Force charged with developing a National Energy Program is called for, with a charge and sense of urgency and call for response and, if necessary, sacrifice by the America people from our national leaders—that is, Washington!

- The Infrastructure of America—loosely defined as capital infrastructure as well as education infrastructure—needs much attention. Programs to increase infrastructure spending at the federal or state and local government level in-line with a longer-run program to Rebuild America’s Infrastructure would be appropriate. Such programs need to be carefully planned and executed, however. There is stimulus to the economy and jobs in the short-run from infrastructure spending but it can be fleeting, misdirected, and wasteful. Planned and well-targeted infrastructure spending can enhance long-run productivity.

- The U.S. Financial System. Measures taken so far by the U.S. Treasury and Federal Reserve to deal with a financial crisis probably serve only as a stopgap and raise the risk of underwriting future inflation. Constructive proposals on regulation and supervision in a New Financial World have been put forth in the U.S. and abroad, but little more than the measures already taken seem possible over the near-term. The regulatory side needs reform and a careful restructuring. Although there is a role for the federal government, especially since there have been market failures, care should be taken so that the federal government does not depart far from its principal public sector functions and inject itself too much into the private economy and financial markets along with whatever private financial institutions are doing to self-correct and consolidate.

- Rebuilding Housing and Restructuring Mortgage Finance. Policy measures to enhance the demand and supply of housing, cushion the fallout of the current housing crisis, and enhance the support functions for mortgage finance were included in the Frank-Dodd bill passed by Congress. Although a step in the right direction, the measures in it can only deal with a small part of the imbalances in the supplies-and-demands for mortgages and of housing, where price erosion of residential real estate is at the heart of the financial distress. Measures to directly affect the demand and supply of housing involving the federal government are worth examining—including something like the Reconstruction Finance Corporation used in the early 1990s when the savings-and-loan industry collapsed. So is trying to determine the appropriate private sector financial institutions and intermediaries to support mortgage finance and housing. The governance structure of the current GSEs, their future role, that of others, the provision of mortgage finance to housing needs to be reexamined especially in light of the recent emergency actions taken by the U.S. Treasury and new GSE regulatory agency.

- The U.S. Health Care System has to be Rebuilt and Reformed, with health care inflation and the aging population major sources of federal government budget deficits and growing U.S. indebtedness in future years. More than any other factor, rising numbers of health system beneficiaries, the rising costs of health care, and a chaotic system of providing medical care services is a major drain on future government financing. How to handle the societal, economic, financial, and inflationary problems created by health care needs to be figured-out.

A Bipartisan Commission on this great national problem, charged with getting results and taking actions, is one way to proceed. Here, as in so many of the economic

and societal issues faced by the nation, strong leadership is needed—if not the federal government then some sort of public-private partnership to deal with the problems.

- Household Savings and the Household Balance Sheet. Here, a rebalancing and rebuilding of currently fragile household financial conditions is necessary. Years of dissaving, wealth created principally by rising prices of residential real estate, and heavy use of credit and debt have left many households in considerable financial distress. The household sector financial imbalances engendered by heavy spending, borrowing, and use of new, innovative ways to finance and tap equity in homes have left the financial condition of households in the most deteriorated state since the early 1980s. With a stagnant or slow-growing economy and rising unemployment, household financial fragility is made worse. Tax policy can play a role by providing savings incentives and through stimulus to the economy to support equity and real estate markets, the biggest base of household net worth.

- The U.S. as a Debtor Nation. Debt has been a way-of-life in the U.S. no matter who the borrower or lender. Now, the U.S. finds itself a large net debtor, relatively poor compared with much of the rest-of-the-world, and where currently asset collateral values are eroding. This makes the burden of debt much higher. There appears to be more debt accumulation relative to assets than less and the exposure varies across individual families, businesses, and government. The evolving nature of the U.S. recession, growing global economic weakness, continuing tight credit, and the need to retrench on debt and credit make the prospect for adequate future economic growth appear hard-to-reach. The accumulation of debt can become a burden relative to assets and to income, with debt payments, across all sectors, private and public, too onerous. The exposure of households on debt and squeeze on financial conditions facing households is considerable. Similarly so, for the federal government and international fronts.

Rebuilding America means Rebuilding and Reforming the Financial System, Rebuilding Infrastructure, Reforming and Restructuring the Tax System, Building an Energy Program that achieves Energy Independence, Rebuilding and Reforming Health Care, Restoring and Maintaining Financial Stability, and most importantly Rebuilding the Economy and Jobs to make sure that enough jobs are created at low enough inflation to sustain, and maintain, full employment.

Chairman SPRATT. Mr. Kreutzer, we have a vote on the floor. There is 12 minutes remaining. And is it Dr. Kreutzer?

Dr. KREUTZER. Yes.

Chairman SPRATT. Let's start with you. You can take 5 minutes and then we will go vote and come back.

#### **STATEMENT OF DAVID KREUTZER, PH.D.**

Dr. KREUTZER. That is fine with me.

Mr. Chairman, I want to thank you and the other members of the House Committee on the Budget for this opportunity to address you concerning responses to a weakened economy.

Energy is critical to the operation of our economy and the maintenance and improvement of our standard of living. Restricting access to energy, as higher prices do, hurts the economy, drives down income and, of course, drives up prices of other goods.

For the past several years, I have seen a dramatic increase in the price of petroleum and petroleum products. The price of petroleum doubled in the last year, although it has eased in the last two months. The resulting increases in gasoline, diesel fuel and heating oil prices not only directly impact household budgets, they reduce jobs and income as well.

Just using the example of gasoline, the cost to the average household of a \$1 per gallon increase in the price of gasoline reduces what they can spend on everything else by \$1,100 per year. But the damage to the economy doesn't stop there just with household budgets. Producers must adapt to higher fuel costs as well. They can't pass their higher fuel costs on entirely to consumers. So they

must cut production and, therefore, employment. In turn, these conditions put downward pressure on wages and salaries.

The effect of higher petroleum prices in the U.S. is a weaker economy. The cause of higher petroleum prices is changes in supply and demand. In the past decade, worldwide demand for petroleum has grown faster than supply and has virtually erased spare capacity worldwide. When there was spare capacity on the order of 3 to 5 million barrels a day, which wasn't too long ago, the demand of a new car owner in the developing world could be met with additional lifting. In essence, the price of petroleum in this environment reflected the cost of getting the oil from the deepest well.

With little or no spare capacity, as we have now, when a new car driver emerges in the developing world, price now has to go up high enough to get some other driver in some other part of the world out of their car. And that is a much higher price increase. In this situation, slight changes in demand can lead to large changes in price—and we have seen that. Similarly, slight changes in supply can also lead to large changes in price.

An obvious way to counter the high cost of petroleum is to produce more of it ourselves. This will reduce energy expenditures, reduce the balance of trade deficit, and expand economic activity.

The impact of increased production on world petroleum prices depends on the market conditions into which the additional petroleum is supplied. In a July 2, 2008 letter, Guy Caruso, Administrator of the Energy Information Administration, estimated for each additional million barrels of oil per day we produce we would drop the price of petroleum by \$20 per barrel.

Now this is consistent with research showing what economists call a short-run elasticity of demand by .05. And what that means is that, in the short run, a 1 percent change in supply or demand will lead to a 20 percent change in price.

What then would be the impact of increasing domestic petroleum production?

The Center for Data Analysis at the Heritage Foundation analyzed the economic effects of increasing domestic petroleum production by 1 and 2 million barrels a day. Increasing domestic production by 1 million barrels per day will reduce imported petroleum costs by \$123 billion per year, generate an additional \$7.7 billion in economic activity, cost an additional \$25.6 billion as we produce the oil ourselves, leading to a net gain to our economy of \$105 billion per year. In addition, the impact on unemployment will be an increase of 128,000 jobs.

Applying the same analysis to a 2 million barrel per day increase in domestic production yields net gains to the economy of 270,000 jobs and \$164 billion per year.

We have untapped resources. The Arctic National Wildlife Refuge and the Outer Continental Shelf are estimated to contain 30 billion barrels of petroleum. The 10 billion barrels that are estimated to be in the Arctic National Wildlife Refuge are enough to fuel all the vehicles for 7.4 million households for 50 years. I would note that only two States, California and Texas, have more than 7.4 million households.

While bringing an additional 1 to 2 million barrels per day of petroleum out of these reserves is not a trivial enterprise, it should



be noted that a single platform in the Gulf of Mexico, Thunder Horse, is slated to produce one-quarter of a million barrels per day within the next year. I recommend that Congress proceed expeditiously to open up the Outer Continental Shelf and the Arctic National Wildlife Refuge to safe, clean, modern drilling so we can get critically needed petroleum without jeopardizing the environment.

Chairman SPRATT. Thank you very much.

[The statement of Dr. Kreutzer follows:]

PREPARED STATEMENT OF DAVID W. KREUTZER, PH.D., SENIOR POLICY ANALYST IN ENERGY ECONOMICS AND CLIMATE CHANGE, CENTER FOR DATA ANALYSIS, THE HERITAGE FOUNDATION

My name is David Kreutzer. I am Senior Policy Analyst in Energy Economics and Climate Change at The Heritage Foundation. The views I express in this testimony are my own, and should not be construed as representing any official position of The Heritage Foundation.

Mr. Chairman, I want to thank you and the other members of the House Committee on the Budget for this opportunity to address you concerning responses to a weakened economy.

Energy is critical to the operation of our economy and the maintenance and improvement of our standard of living. Restricting access to energy, as higher prices do, hurts the economy, drives income down and, of course, drives up prices of other goods.

#### PETROLEUM PRICES HURT ECONOMY

The past several years have seen a dramatic increase in the price of petroleum and petroleum products. The price of petroleum doubled in the past year, though it has eased in the past two months. The resulting increases in gasoline, diesel fuel and heating oil prices not only directly impact household budgets; they reduce jobs and income as well.

For example, the EPA estimates that the typical light vehicle travels 12,000 miles per year and averages about 20 miles per gallon. Doing the division indicates that the typical vehicle uses about 600 gallons per year. Further, the Department of Transportation data show that the average household owns nearly two cars. Therefore, the cost to the average household of a one-dollar-per-gallon price increase is about \$1,100 per year. But, the damage to the economy doesn't stop there.

Higher petroleum prices squeeze the production side of the economy from both the demand and costs directions. Consumers' demand for output drops as they divert expenditures from other items to gasoline and heating oil. In addition, petroleum products are inputs to both the production and distribution of many goods and services.

Faced with these higher costs, producers try to raise their prices. But the lower demand prevents the prices from rising enough to completely offset cost increases. This leads to production cuts and, therefore, to lower employment. In turn, these conditions put downward pressure on wages and salaries.

The effect of high petroleum prices in the US is a weaker economy; the cause of the high petroleum prices is a change in supply and demand. In the past decade world-wide demand for petroleum has grown faster than supply and has virtually erased spare capacity. Over five million barrels per day as recently as 2002, spare capacity has dropped below two million barrels per day in the past couple of years. When supply is pushed up against its capacity constraints, as it is now, additional demand in one part of the world can be met only with demand reductions elsewhere.

When there was spare capacity on the order of three to five million barrels per day, the demand of a new car owner in the developing world could be met with additional lifting. In essence, price in this environment reflects the cost of getting oil from the deepest well. With no spare capacity, fuel for a new driver can be provided only when the price rises high enough to force drivers elsewhere out of their cars. In this situation, slight changes in demand can lead to large changes in price. Similarly, slight changes in supply can also lead to large changes in price.

#### WHAT IF PETROLEUM OUTPUT ROSE?

Among other things, the Center for Data Analysis at the Heritage Foundation has the capability to analyze broad, economy-wide impacts of changes in energy prices. This past spring we analyzed the impacts of higher energy costs that might result

from policies to restrict carbon dioxide emissions. This summer we analyzed the impacts of higher gasoline prices on employment, income and household budgets.

Last week the Center analyzed the economic effects of increasing domestic petroleum production by one million barrels per day and two million barrels per day. Because the United States consumes 20 million barrels per day of petroleum and petroleum products, these increases correspond to five percent and ten percent changes on the mix of domestically produced versus imported petroleum. In other words, the additional domestic production would reduce imports from their current level of 65 percent to 60 percent and then 55 percent.

Increasing domestic production of petroleum will affect the economy two ways. First, it will reduce the amount we spend on imported oil. Second, it will lower the price of petroleum. The two effects work together to reduce energy expenditures; to reduce the balance of trade deficit; and to expand economic activity.

The impact of increased production on world petroleum prices depends on the market conditions into which the additional oil is supplied. In a letter dated "July 2, 2008" to Representative Jack Kingston, Guy Caruso, Administrator of the Energy Information Administration, estimated each additional million barrels of oil would lower world price by \$20 per barrel.<sup>3</sup>

This price impact is consistent with recent research showing a short-run elasticity of about 0.05.<sup>4</sup> Adjusting consumption of gasoline, heating oil and other petroleum products is difficult for consumers to do in the short-run. As a consequence, a one percent increase in price reduces consumption by only 0.05 percent. So, a one percent change in supply requires a 20 percent change in price to bring markets back into balance. It is understood that the price impact would be smaller over time once the world economy fully adjusts to the increased production.

We are comfortable using this elasticity since it seems probable that world petroleum markets, which are not currently in long-run equilibrium, will continue to see strong demand growth, especially over the long-run.<sup>56</sup> Nevertheless, we note that should the world petroleum market ease significantly by the time this increased production comes on line, the price and economic impacts will be less pronounced. Of course, this reduced impact would occur in a world that already had significantly lower petroleum prices.

#### THE ESTIMATES

Increasing domestic production by one million barrels per day will reduce imported petroleum costs by \$123 billion; generate an additional \$7.7 billion in economic activity; and cost \$25.6 billion in additional oil production costs. The net gain to the economy will be \$105 billion. The impact on employment will be an increase of 128,000 jobs.

Applying the same analysis to a two million barrel per day increase in domestic petroleum production yields net economic gains to the economy of 270,000 jobs and \$164 billion.

#### UNTAPPED RESOURCES

The Artic National Wildlife Refuge and the Outer Continental Shelf are estimated to contain 30 billion barrels of petroleum. The 10 billion barrels estimated to be in ANWR are enough to fuel all the vehicles for 7.4 million households for 50 years.

While bringing an additional one to two million barrels per day of petroleum out of these resources is not a trivial enterprise, it should be noted that a single platform in the Gulf of Mexico is slated produce one-quarter of a million barrels per day within the next year.

I recommend that Congress proceed expeditiously to open up the Outer Continental Shelf and the Artic National Wildlife Refuge to safe, clean modern drilling so that we can get critically needed petroleum without jeopardizing the environment.

Chairman SPRATT. Now we have 6 minutes to make this vote. We have a vote right behind it, and we will be back as quickly as we possibly can. We appreciate your forbearance.

[Recess.]

Chairman SPRATT. I call the hearing back to order, and we will begin with questions.

Dr. Kreutzer, first of all, were you finished with your statement?

Dr. KREUTZER. I was finished. Yes, sir.

Chairman SPRATT. Thank you, sir.

Beginning with questions of the panel, Dr. Summers, there has been analysis of the effects of the first rebate or stimulus program that indicate that only a small fraction of the rebate was actually spent. Martin Feldstein, among others, even though he was one of the original adherents, now wonders whether or not the stimulus, particularly the rebates, had their intended effect. What is your view of that?

Dr. SUMMERS. I think it is difficult to judge, Mr. Chairman, because it is difficult to construct a counterfactual. On the one hand, there is evidence that the savings rate rose when the rebates were given. On the other hand, consumers were buffeted with a lot of bad news at the same moment that happened. So you don't know what would have happened to spending if the rebates had not come.

There is other more micro-evidence the scholars at the Chicago Federal Reserve Bank have developed looking at individual consumers that suggests some potency to the rebates.

My judgment is that they had a constructive impact. I think we are in better shape than we would have if they had not been enacted. I do, as my recommendations suggest, believe that a subsequent stimulus probably should contain a number of significant measures on the expenditures side where the propensity to spend is likely to be greater than it is in association with the rebates.

I would highlight, Mr. Chairman, because it is a point that is often I think overlooked in these discussions, that if one provides rebates and if those rebates are not spent, by definition, they are saved. And from an overall macro point of view, if the increase in the Federal deficit is matched by an increase in private saving, you don't have adverse impacts on interest rates. And so there is at least the offsetting consideration with respect to rebates that—or tax cuts—that if they are not spent, they are saved. And in some sense, therefore, what one is concerned about as the negative side of this in terms of increased debt also materializes less.

On balance, some of them were spent, some of them were saved. We are better off having done it than we would have been if we hadn't; and we would be better off doing further stimulus, though not all on the tax side. Some in areas where we know it will all be spent.

Chairman SPRATT. But in your testimony you do not recommend a second round with rebates included.

Dr. SUMMERS. I didn't. And I did refer to increasing the LIHEAP program, which has some of the same—which has some of the same character. I don't—I could go either—I could go either way on that.

I think the suggestion that Dr. Sinai made that if, as has been much discussed in the last year, there was going to be sustained middle-class tax relief, one way of turning that into fiscal stimulus would be to phase it in in a way where the tax cuts took effect prior to the pay-fors; and that would be an alternative way of achieving the objective of near-term fiscal stimulus.

But, on balance, Mr. Chairman, I would prefer rebates to inaction. But I would assign a higher priority to support for those with low incomes, to infrastructure spending and to relief for State and

local governments. But I wouldn't have trouble with rebates as an element of the package.

Chairman SPRATT. Would you subscribe to the argument that some of the cost of the rebates, stimulus plan was in effect recouped in terms of a lower deficit because the impact on the—because of the alleviating impact on the economy?

Dr. SUMMERS. I think that was the argument I was rather clumsily attempting to—rather clumsily attempting to articulate a moment ago when I suggested that, to the extent that the rebates are saved, any adverse deficit impact of them is naturally offset by the increased household saving. So I think one can't have it both ways in criticizing the rebates. That is, to the extent that they are ineffective, they are also not depleting of the Nation's supply of savings. Insofar as they are only depleting of the Nation's supply of savings insofar as they are effective in stimulating consumption.

Chairman SPRATT. Finally, you said from the first time you expressed concern about this I believe in the Financial Times that the stimulus program should be targeted, timely and temporary. In terms of targeting, what would you target in our infrastructure?

Dr. SUMMERS. I would target things where it is likely to be spent. And I think that infrastructure seems to me to be a high priority. I have become persuaded that it is possible to move a fair amount of infrastructure funding relatively quickly. And I think in the long-run context, there is a strong case for increased infrastructure spending.

State and local governments, the easiest funds to move quickly are reversing what are otherwise cutbacks, and there is so much cutting back at the State and local government that I can believe that, properly targeted, that would be availing. And then I think there is also a case for targeting those with low incomes and those with incomes that have declined.

Chairman SPRATT. In terms of being timely, if we don't get something adopted, say, in September before we adjourn and come back for a lame duck session in late November, or don't come back at all and don't really reconvene until January, have we missed the boat?

Dr. SUMMERS. In the unfortunate event that something doesn't happen in the next several months, we will have a chance to revisit that question in January. My best guess is that while it would be better to do fiscal stimulus now, it will still be necessary in January. I hope I am wrong. And I think it is possible that I will have a different view come January. But my fear is, frankly, that the case will look that much more compelling in January because we will have gone through a weak economic period.

Chairman SPRATT. Thank you very much.

Mr. Ryan.

Mr. RYAN. Thank you.

Let me start with you, Dr. Summers. You and I had a few conversations back in 1999, 2000, when you were Treasury Secretary, along with your Under Secretary, I think his name is Gary Gensler, about Fannie Mae and Freddie Mac. And at that time you warned us of the moral hazard contained within the construction of these GSEs. You urged Congress to take action to restrain their activities. The Bush administration, subsequent to your tenure,

echoed your same concerns, and yet Congress in both parties didn't do anything about that. So you were right. And I want you to get the credit you deserve for having been right at the time 10 years ago in more or less foretelling the fate that occurred.

Now that it has happened, now what we see happened 2 days ago, what is your recommendation for once the dust settles, we wind down these portfolios, what should these things look like in the future? Should they be totally privatized? Should they be sort of nationalized, broken up into bite-size regional things like regional Ginnie Maes? What do you think the structure of these entities ought to be once the current turmoil has passed?

Dr. SUMMERS. I hesitate to make a—thank you for your kind words, Congressman. I hesitate to make a definitive recommendation without a lot more study and without a lot of consideration, without a lot of study of what happens in the housing finance markets over the next year or two. I would just make these comments, though.

First, I think the future of these institutions has to be thought of in the context of our whole mortgage finance system in this country, and that system has shown itself to be much more severely flawed than most people recognized even a few years ago. You pointed to the flaws in GSEs. Certainly if one looks at what has happened in the subprime market area and the jumbo market area, in those areas where responsibility has been purely private, we have also observed substantial amounts of predatory, unsound lending. We have also observed substantial amounts of cascading financial failure. So I think it would be a mistake not to recognize that the experience of the last months hardly bears out the case for a kind of fundamentalist laissez faire, free-market approach.

My sense is that what the authorities will have to do is—Congress, the President, the new administration—will have to do is recognize that the model where the same company is supposed to be working for both the public interest and its shareholders and is relieved of normal regulatory burdens because it is supposed to be working for the public interest and with the knowledge that there is an implicit but not an explicit guarantee, these fuzzy-line arrangements that we have had have shown themselves to be deeply suspect, and I think we will have to move beyond them.

I suspect that what will be necessary is a clearer division of labor than the one we have now between explicitly public institutions that will take on certain explicit public responsibilities and private institutions that cannot rely on a general government financial backstop, or, to the extent that some government guarantee authority is appropriate, pay an explicit fee in return for that government backstop, just as banks pay an explicit fee to the FDIC. And I suspect there will be an active debate as to just how those divisions between public and private responsibility should be drawn.

It seems to me, for example, that there is a much stronger case for the government to be involved in the guarantee of mortgages than it is for the government to be involved in providing credit support for the direct purchase of mortgage-backed securities. It seems to me there is a clearer case for the government's role with respect to low- and middle-income families than with respect to higher-income families.

I also think that there will be a need for a careful examination if there are to be such entities as to what number of such entities is appropriate.

One of the several critiques that we also had occasion to discuss a decade ago was that when you had a situation of duopoly in the conforming mortgage market, whatever benefits were being provided were not likely to be hugely passed on to consumers. And so to the extent that there are government benefits, I would hope there would be more scope for competition in taking advantage of those benefits as they are passed on to consumers.

What I think is absolutely clear is that we need to move past the “heads I win, tails the public loses” model in which we have operated. And this is not a feature of just the U.S. experience. I remember, and it is, frankly, part of what stimulated my concern about this issue as we studied the lessons of the Asian financial crisis, realizing that no small part of the Asian financial crisis resulted from a combination of high leverage, government guarantee or quasi-government guarantee and close political connection, and all three of those elements are here.

I don’t want to conclude, though, without saying that there have, I think, over the last years been a variety of breakdowns in the regulation of the financial system, the letting of new mortgages in all kinds of unsound ways, and the judgment, frankly, that these institutions were well capitalized after that was a reasonable reading of the facts. And I think that contributed to bringing us to the point we have reached.

Mr. RYAN. Thanks.

Dr. Sinai, let us talk quickly about inflation and tax policy. You are kind of warning us of a specter of a new sort of 21st century version of stagflation; not quite 1970s version, but a new type version. If you can give us kind of a little bit more of exactly what you mean when you say that. Are we going to see the kind of inflation we are seeing overseas in emerging markets coming to our shores? If so, what should we do? What should the Federal Reserve do if you were the Chair?

And also, second, in January you reported that the 2001-2003 tax relief laws played a significant role in boosting the economy. Do you believe that the uncertainty of the extension of those tax laws—and you inferred a little bit to this in your testimony—do you believe that the closer we get to the end of the decade where we are going to have a snapback of tax rates, and we have a dramatic decrease in the after rate of return on capital is putting sort of a cloud over the economy? Is the uncertainty premium increasing in the employment investment? Are investors beginning to inhibit the way they make investments because they are uncertain about the after rate of return on capital given these large tax rate increases that may or may not occur, whether it is marginal tax rate increases or capital taxes like gift dividends and capital gains?

Dr. SINAI. Thank you for the questions. Stagflation, that is weakening economies, rising unemployment, high or rising inflation, I think it is a fact of life now. It is here and now. And I will just refer you to the testimony, table 3, I think, in that. And in the United States it is a little more controversial because a lot of people don’t think we are already in a recession. But the unemploy-

ment rate has gone up, overall inflation in the CPI is 5.6 percent year over year, core inflation excluding energy—

Mr. RYAN. So are we in stagflation right now?

Dr. SINAI. I think we absolutely have it in this country right now. Now, that makes the policy choices of, say, the Federal Reserve extremely difficult because—and we see it in divided, legitimately divided, views in the Federal Reserve. If you worry about recession, financial instability, the effect of financial instability to create more recession, then you want to have easy monetary policy, but you can't do that because you have high inflation.

Mr. RYAN. Are we at that point where the Fed is out of bullets, and we are not in a price of money problem, but a solvency, a money solvency problem now, and the Federal Reserve needs to go back and shore up the value? Where are we?

Dr. SINAI. I think the Federal Reserve is conflicted enough that they can't help us out anymore in terms of any more actions in the financial side of the economy. The solution and the eventual evolving getting out of our financial crisis, I think, will be more private-sector oriented and private-sector developed than otherwise. So they are out of bullets in that sense, in my view.

You asked about the tax cuts, and we did find that the tax cuts lower marginal tax rates across the board for low- and higher-income families, as well as the tax reductions for capital gains taxes and dividends had a very positive—all by itself had a very positive effect in lifting the U.S. economy indirectly, the world economy, over the years from 2000, the early part of this decade, to about 2006. They have faded in their impact now. So I would not favor, especially given the prospect for the economy that I have described, tax—the ending of the expiration of all of the tax reductions.

Mr. RYAN. Raising the rates.

Dr. SINAI. In effect, in your words, raising the taxes.

There was one exception, which I noted in my testimony. Because the consumer side of it is the weak part, and we know that middle- and lower-income families spend more out of an extra dollar of income than do higher-income families, I favor permanent tax reductions that can come in the form of ending the AMT, not just doing a patch every year for middle- and lower-income families and leaving them in for the families that they were originally intended for, which were highly affluent families. Some, I would say, could pay the higher tax rate or the minimum tax rate implied by the AMT. But if we want to stimulate consumption, then I think we need to reduce marginal income tax rates for middle- and lower-income families. And middle income to me is much larger than \$50,000 or \$60,000. If you look at the tax data, and you combine a family of two young—two professionals with two or three children, you are talking about \$200,000—to \$300,000 of income. So in the modern U.S. economy, the notion I have of the middle-income families is at higher income levels than we used to think.

But if we have to finance it, if we have to finance it, and I think we do for reasons of the long-run budget responsibility, we have to get the funds from somewhere. And so I think it is easier, if we want to generate more spending, to let the tax rates go up for higher-income families. But I would not say that for capital gains and the dividend tax exclusion, because in my work I find that those

tax rate reductions help a lot in the funding and the flow of savings that goes into the economy to support new business private-equity transactions. But on income tax rates I have a definite view that we need to finance that by raising taxes, and that is the only place that I would suggest we raise taxes in the future, given the economy we have now.

Mr. RYAN. Well, in the interest of time, I could follow up for quite a while on that, but I want to—

Dr. SINAI. Just one more thing. The uncertainty of whatever the tax decision is going to be definitely is a negative for the stock market. It probably will get resolved after the election when we know who wins, and it might even get resolved before, because the candidates aren't that different in terms of some aspects of tax policy as they relate to investments in the stock market. But there is always that uncertainty that lingers until you are done with an election, and almost every election year can be a negative for markets. It is a negative now.

Mr. RYAN. I will say there is a difference between these two candidates on tax rates on capital, but I don't want to get into it.

Dr. Kreutzer, just quickly, we are talking about inflation. Energy is obviously a major component of inflation right now. We are also talking about jobs, four-tenths of an increase in the joblessness rate from the last measurement. And you have done some modeling on this.

To what factor are energy prices a contributor toward our measurement of inflation, number one? Number two, how many jobs—will you repeat this—how many jobs would we create in this country if we actually opened up domestic energy production and exploration? And number three, what would the revenue estimates be to the Federal Government?

You hear all these ideas about money for tax policy, money for spending, but we don't have money. We have a Federal deficit that just doubled this one year over the next. How much revenues would we receive over, say, a 5- or 10-year horizon through the royalties and leases and the income the Federal Government gets if we opened up all of these areas to oil and gas exploration?

Dr. KREUTZER. Doggone it, I don't have an answer to that question. We didn't model that. We looked at the change I mentioned. Actually I don't have the whole number on the trade deficit. That would be the obvious one. If you are importing 1.4 million barrels fewer at \$115 or \$90 or whatever it is dollars per barrel, that is a huge savings there. That could have an impact on the value of the dollar if you changed the supply and demand.

The jobs number I gave was 128,000 jobs for a 1-million-barrel-per-year increase in domestic production, and in my written testimony I mentioned that this would be the case if we have as tight a market as we have now. And the International Energy Agency is projecting that spare capacity will grow a little bit in the next couple of years, but then get very tight again. And so when you have that situation where somebody in China buys a car they never had before, you have got to kick somebody else out of a car, and that takes a really high price, and that is why we use this short-running elasticity over a period of time that you might not



otherwise use it. So the 2 million barrels per day, we are talking about 270,000 jobs; 1 million barrels per day, 128,000.

Mr. RYAN. In the price reduction—so you are saying you can achieve a two-for, sort of You can achieve addressing one of the root causes of inflation, high fuel prices, and joblessness in this country through greater domestic energy production. What is the price?

Dr. KREUTZER. The price elasticity is .05, which is a number that should not mean anything to anybody here, but it tells us that a 1 percent change in supply or demand will change the price by 20 percent. And so that is 1 million barrels per day on the world market would change it by about \$20 per barrel starting at \$100 per barrel. That analysis was done last winter, though the letter was written in July.

Mr. RYAN. So a significant change?

Dr. KREUTZER. It is a significant change. Even—I was talking during the break. Even if you want to use the long-run elasticity, and I think there are reasons for not using that, you would still get tens of thousands of jobs and tens of billions of dollars. That would be on the low end. And I think it is more likely to be the hundreds of thousands of jobs, hundreds of billions of dollars.

Mr. RYAN. Thank you.

Chairman SPRATT. Mr. Edwards.

Mr. EDWARDS. Thank you Mr. Chairman.

Dr. Summers, Mr. Ryan, my colleague, gave you credit, deservedly so, for being right back in 1999 and 2000 predicting some potential housing market problems if we didn't better regulate Fannie Mae and Freddie Mac. I personally think you were right in having in place the Clinton administration fiscal policies that about the time you left, I believe, created the largest surpluses in American history, which, since the Bush administration tax policy has been put in place, has been turned into the largest deficits in American history. I think the time you left as Treasury Secretary, there were predictions about paying off the entire national debt, which at that time I think was \$4 trillion or \$5 trillion by the end of this administration. Instead we are going to have over a \$9 trillion, perhaps a \$10 trillion, national debt. So I think you have been right on a lot of economic policies.

Let me ask you your views about the short-term impact of domestic drilling on today's economy. What are your views on that issue?

Dr. SUMMERS. You know, I have been following political and economic debates here for 15 or 20 years now, and on most of these questions, like the questions of tax policy that you referred to or the questions of the GSEs, I have my views, and they are reasonably strong views. But I understand the logic and the rationale through which other people can have different views, though they wouldn't precisely be mine.

I would have to say that the recent political debate over drilling is one that I find very hard to understand. As I understand it, the demand for oil, the price of oil, is set by demand and supply. I am aware of no serious observer anywhere who believes that any of this, any of the policies that are under discussion, will have any impact on that supply for at least 5 years and any substantial im-

fact for more than 10 years. So I understand that the political appointee who heads the energy agency has judged these issues to have a negligible impact on energy prices going out for a matter of several decades.

Now, I don't know precisely what the right configuration is. As I understand the debate, and again I am just an economist, I am not engaged in the political struggle right now, there are, I think, two positions that are held. There are some who favor seeing this issue entirely through the prism of drilling and who focus on drilling as the central policy. And I don't think that there is any case that is going to do anything for gasoline prices or home heating oil prices during the term of the next President. And there are others who recognize that it may be appropriate to have a compromise to do some exploration around those issues, but favor doing it in the context of a wide-ranging program that emphasizes energy efficiency, emphasizes renewables. And I guess it seems to me that it is pretty clear that the second approach is much larger—much more likely to have the kind of impacts that we favor.

So the kinds of statistics that were presented, you know, economists distinguish between a short-run elasticity and a long-run elasticity, and to use a whole model based on a short-run elasticity to describe an event that is going to take 5 to 10 years to happen just doesn't seem to me to be a reasonable basis for doing these kinds of analyses.

Mr. EDWARDS. Thank you for that answer. In fact, let me put into the record a statement that agrees with that. The projections in the OCS access case indicate that access to the Pacific, Atlantic and eastern gulf regions would not, would not, have a significant impact on domestic crude oil and natural gas production or prices before 2030. That is not my statement, that is the statement of the Bush administration's Energy Information Agency in its report presented in 2007.

Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Porter.

Mr. PORTER. Thank you, Mr. Chairman. I appreciate our guests being here today.

I just wanted to point out some things that are happening in my community in the State of Nevada. As you know, we are a tourist destination, one of the top in the world, and we are very proud of that, from entertainment to shopping and gaming. We have seen a huge impact on our visitor volume and our, of course, return on investment.

In regards to the cost of energy, United Airlines has determined they are going to cut 150 cities out of their routes. U.S. Air is cutting flights into our community to a point where they tell us they can't even start up their airplanes to break even because of the cost of energy. We have families in Nevada that are hurting. And I know you have heard the arguments probably time and time again today, but I just wanted to give you my firsthand experience.

In Nevada, not only is it about the cost of energy, cost of gas going to and from work, and the impact on families and kids, but we have some of our major properties that are cutting back on their projects. The Boyd Group has cut back a \$4 billion construction project, and part of it is already above ground, so there is a

skeleton there of a facility. MGM Grand has cut back on one of its major projects.

So I certainly appreciate your expertise, and I am sorry I wasn't here for all of your testimony, but I have read the background. But whether it is 30 years out or 5 years out or 1 year out, we need to restore confidence to our country that we are doing something. And what I hear right now from my constituents is that, yeah, it may take a year or 2 or 5, but if Republicans and Democrats sit on the steps of the Capitol and say, we are going to work on this, and we are going to do renewable, and we are going to conserve, it would add some confidence.

And I, of course, look back through the years at opportunities prior Congresses had and decisions were made. I can't tell you why they were made. But 10 years ago ANWR had an opportunity, and it was vetoed. My point is from an economic standpoint the number one thing right now impacting Nevada families is the cost of energy and the lack of ability of this Congress to take steps.

Now, let us take it a step further. I used to be mayor of a small community in Nevada. We had our own public utility. So I had a chance to meet with utilities in Nevada and those across the country, and what I hear from the small and large utilities separate from the cost at the pump is that there is not a comprehensive energy plan for them to invest in energy for the future, whether it is nuclear, or whether it is natural gas, or whether it is coal, so they are having to buy less product to provide for lower cost of energy into our homes.

So my point is we are here today, and we are talking about a weakening economy and how to respond. We certainly can have differences of opinion. But I am sharing with you firsthand families that are struggling because of the cost of gas, and they haven't gotten their power bills yet. And look out, with energy up 10, 20 and 30 percent. So I would appreciate, as, again, you are the experts, I think you need to add to your research firsthand what is happening with our families.

And again, I don't really have a question; I just want to say thank you for being here, and I want to let you know that there are families that need help, and they need it now, or at least they need the confidence that we are going to take some steps. And it is really all of those different energy sources working together. So thank you.

Mr. Chairman, thank you.

Chairman SPRATT. Dr. Sinai.

Dr. SINAI. On this topic, please look at page 25 of my testimony. It is energy independence and energy conservation. It really is an economist with a cry-out for leadership coming from Washington, a call to arms, call to mission.

There are lots of pieces that go into dealing with energy independence, renewables, carbon, all of the problems you are discussing. And my suggestion is a bipartisan commission and whoever is the leader of this country to put it number one, because it is a huge lever on what I described as stagflation. That is the high oil and energy prices hurts growth, raises inflation, complicates the Federal Reserve's already difficult problems, makes it very hard to devise normal fiscal policies that will help it out, and those costs

get sometimes stuck in the inflation system, and we are with them for long times, as we were in the 1970s and 1980s.

Now, as a citizen, I believe that if we had come to grips with it in the way we should have some several decades ago, and I do look myself to Washington for leadership—I make contributions, Washington is the leader on this, our executives are—that is where it has to come from. And the country will respond, the country will respond.

Mr. PORTER. As we did in the 1970s?

Dr. SINAI. Well, the country will respond. This time the country will respond.

Mr. PORTER. Thank you. I appreciate your comments very much.

Chairman SPRATT. Dr. Summers.

Dr. SUMMERS. Congressman, I have a trip scheduled to Nevada in a week or two, so I look forward to the chance to learn it. And I, in planning that trip, came to appreciate what you have said about airline schedules which have changed, so I certainly share your concerns.

It seems to me there are sort of two crucial policy aspects where I would have hoped that people would be able to come together. One is on the question of tax policy, where insofar as there is tax relief to be provided, it seems to me there is a very compelling case towards focusing that tax relief on the families that are bearing the burdens that you describe through some kind of across-the-board credit of a kind that has been discussed in the Presidential campaign. And I think that is a very constructive step. It seems to me that it is a much less constructive step to focus tax relief on the companies that are the beneficiaries of all of this. Because of much higher oil prices, they are receiving much, much larger profits than they ever would have expected. And so I think there is some crucial questions of tax priority that come out of this.

And then the second piece is it seems to me that what everyone is in favor of is finding some kind of bipartisan approach. My understanding is that those who are less enthusiastic about the oil exploration aspects that were emphasized in the testimony here are prepared to accept a certain amount of that as part of an overall program that also emphasizes energy efficiency, and that also emphasizes renewables, and that also emphasizes making sure that families are protected.

So I would hope that the political debate could leave what seems to me to be the very sterile territory of drill or not drill and move to a much broader focus on what I think are the two imperatives here: helping the families that are in trouble in the very near term, and in a balanced and across-the-board way addressing all the different aspects of energy policy.

You know, an issue like the kind of automobile fleet that we have and its fuel efficiency and whether there is support in developing a better automobile fleet will have a much larger impact on the demand for oil if you use models like the ones we have heard described in the next several years than anything about ANWR or the Outer Continental Shelf. So I would reject some kind of religious opposition about ANWR and the Outer Continental Shelf, but to somehow elevate that to being the single totem of discussion on energy policy just seems to me to be selling the country short.

Mr. PORTER. I think one of the problems is that—and I am getting into politics and not policy—but on the Republican side what I hear Republicans asking for as they vote, and to include all of those things that you are talking about. And I think that will send a message to the country that we want to work together, Democrats and Republicans. I think my colleagues across the aisle have some great ideas, and I think we have some great ideas, and I think we can find a solution to this.

There are economic challenges to the country, lots of them. This is one thing that Congress can control. And if nothing else, working together will send a message to the world, and I believe that we can do it. I think that we are agreeing. We need to include all of the above, and I think we can do that. Thank you.

Chairman SPRATT. Let's move on. Ms. Schwartz.

Ms. SCHWARTZ. Thank you, Mr. Chairman.

And I appreciate the last two questions, because this is where I wanted to go on this also to have a greater discussion about energy. And I think what we might all agree that we want to have all the options on the table.

There has been, as was pointed out, very serious discussion that somehow domestic drilling is the answer. And I did want to just follow up on Dr. Kreutzer's testimony. And you referred in both your written and oral testimony to a letter that EIA Administrator Caruso sent to a colleague of ours, Congressman Kingston, and you said that Mr. Caruso estimated—and you said this orally again—that 1 million barrels of oil will lower the world price of oil by \$20 per barrel. You made a clear statement of that. You did make note that that was a part of a letter, and so you referred to the letter, and we got a hold of the letter, which was written on July 2nd.

And I just say that neither your written nor your oral testimony really gives a full explanation of the context of that short-term assessment. And I think that one of the things we do have to be clear with the American people, because they are struggling on energy prices, and they would like to see the price at the pump go down as quickly as possible, to not mislead them into thinking that either drilling is the single answer or a silver bullet, or that, in fact, it is going to happen in the short run. And your language in your oral testimony in particular suggested that this could happen immediately.

And so I really want to ask you very specifically, and I would like a really short answer on this, Mr. Caruso actually says that the estimate requires an unanticipated new productive capacity of 1 million barrels of oil a day, and in addition that this—an addition of this size would typically take years of planning and development activity. That is what his letter says. So my question to you is, immediate—and this was suggested by Dr. Summers—is immediate, in your mind, 5 years, 10 years? It is certainly not—most Americans think of immediate like next week. What do you suggest is actually immediate, in your mind? Five or ten years or a number of years would be a good answer.

Dr. KREUTZER. That is not going to answer the question.

Ms. SCHWARTZ. Well, I have a follow-up question, so start with that.

Dr. KREUTZER. In my written testimony I also pointed out there were other sources that gave the .05 short-run elasticity. And the reason it is not legitimate to use a long-run elasticity is because it depends on how the market adjusts over that 5- or 10-year period. Where will we be in 5 or 10 years? If, anticipating this additional development, we have spare capacity of 3 to 5 million barrels a day, as I said, the markets will have eased, we will get a much smaller response.

The International Energy Agency doesn't see that. Neither do I. I have talked to other energy experts. They say the critical thing is the spare capacity. Are we going to be—in 5 years when we get this additional, or 10 years when we get additional oil on the market, are we going to have the tight situation we have now that when one more person in China buys a car, somebody in the U.S. or in Europe has to get out of the car? If so, we get that \$20-per-million-barrel price response.

Ms. SCHWARTZ. So you are saying it is about 5 to 10 years. I appreciate that. But you are also being honest about that.

I think that we have to understand, and I think many of us would agree, that drilling and, in fact, increased production, U.S. production, could be helpful. But certainly if you are looking at drilling, it is going to take some time. That doesn't mean we shouldn't start doing it. It just means that let us be realistic about what we can do.

But let me also, just following up on that, you say that it depends what the market does. And so even if we were to put our own U.S. capacity—increase our U.S. capacity, which certainly we want some more energy independence, but if we specifically just relate it only to oil, what is to say that the other oil-producing nations won't actually reduce their production in order to keep the supply down in order to keep the demand and the price up? In fact, President Bush did ask the Saudis and said, wouldn't you please just increase your production? We could use it, and we would like to see more supply so our costs go down. And do you know what? They didn't do it. So what is to say that they won't actually say, you know, we are not crazy about the U.S. market increasing production; we are going to reduce our production, and we are going to see increased costs for consumers, businesses and families.

Dr. KREUTZER. Because at \$110, \$120, \$115 a barrel, they are maxed out. That is what I was saying. The Saudis, no matter who begs them, no matter what happens, no matter what type of expectations, they are pumping at the limit. All of OPEC is pumping at the limit.

Ms. SCHWARTZ. Right. I am suggesting the opposite: that they will stop pumping in order to—

Dr. KREUTZER. Right. That would happen if we have prices down to \$60, \$70, \$80 a barrel, which I mentioned in my testimony.

Ms. SCHWARTZ. That Americans might like.

Dr. KREUTZER. Of course they would. And if we are in that situation, then indeed we are not going to get that \$20-per-million-barrel increase. I said that explicitly in my testimony. I was told we had 5 minutes to talk. I am sorry I shortened mine to exactly 5 minutes. That is what I was prepared to say. I mentioned other things in my written testimony.

Ms. SCHWARTZ. Well, I appreciate that. And I think that for the record we should include the entire letter that was written to Congressman Kingston, because it does explain that, in fact, you took some of the language out of context.\*

Ms. SCHWARTZ. And I appreciate your saying that given the length of your testimony, you could only say so much.

But I think the point of all of this is that we should be really clear with Americans that we are not going to mislead them into thinking they are going to see a change of price at the pump. And I think, as suggested by Mr. Porter earlier, that there is not any single solution; that while we might increase drilling, to suggest that drilling alone is going to change the cost at the pump is really simply not correct.

Dr. KREUTZER. No, it is correct. Changing supply will change the price at the pump. The question is how much. And I tried to be clear on that in how long it takes.

Now, so what you are saying is it is a good idea if it happens now, but it will be a bad idea if it doesn't happen for a long time. It doesn't cost the government anything. We can open up ANWR. All the problems that we hear from the other two witnesses are we would like to do this, but then we would have to raise taxes here; we would like to do that, but it is going to cost us. This doesn't take anything. This is a no-brainer. Even Paris Hilton was in favor of it. That was the no-brainer part.

But anyhow, the Alaska pipeline was built in 2 years. The investment in Detroit depends on what is going to happen to gas prices 4 or 5 years from now. Are we going to expand? So there are all sorts of things that can happen in the short term.

Ms. SCHWARTZ. Let me just say, there are a number of things long term, you would also grant. There is a limited capacity of fossil fuel, certainly of oil, even on the Outer Continental Shelf, and that what we need to do even if we do expand the opportunities for drilling for the oil industry, we have to be clear with the American people that we don't want to be in the same place certainly a month from now, but not a year from now, not 5 years, not 10 years from now unless we do things that we also know we can do very fairly quickly, which is to increase production of biofuels that produces, we know, about—almost immediately about 140,000 jobs; that we have to improve automobile efficiency; and we have to have more alternatives and options for Americans. And all of that together will actually create a reduction in the cost of energy, and that is what we ought to be looking at.

So the suggestion—and because you only talked about drilling, I want to make it absolutely clear that this is not a short-term solution. Even though you used the term “short term,” it is a long-term part potentially of what needs to be a much broader comprehensive energy policy. That is very different than what we are doing right now.

And I yield back.

Chairman SPRATT. Mr. Doggett.

Mr. DOGGETT. Thank you, Mr. Chairman. And I appreciate the testimony of each of our witnesses.

\*As of March 13, 2009, the correspondence referenced has not been received by the committee.

I have some questions for Secretary Summers, but before asking them, let me just say that in response to some of the comments that my colleagues have made that the Bush administration has presided over the largest fiscal deterioration in this country in its history, and has proceeded on the notion that if we just let government be permissive enough to our corporate misconduct, and if we just let it be irresponsible enough with regard to providing the revenues to fund essential public services, that everything would work out okay. And as a result of that ideology, what we have is a disaster that has threatened the world economy, that has caused tremendous pain to many people who are losing their homes, and it has caused tremendous pain across the world to our economy, and now taxpayers are having to pick up much of the expense. And while I applaud the efforts of Chairman Bernanke and Secretary Paulson, much of what is being done now is an attempt to put in place a regulatory structure to take care of damage that has already occurred. So maybe it will prevent some of this damage in the future, but the regulatory structure and the regulations and the laws that were already in place were not effectively used to avoid the tremendous amount of abuse that led to the problems that we have right now.

As for the discussion that my colleague from Pennsylvania was just engaging in, and that my colleague from Texas spoke to earlier, this is just the latest election-year gimmick. When you are so desperate having created so much damage to our economy, you have got to come up with some gimmick like drill everywhere yesterday. The energy policy we have is the natural result of the Bush policy on energy, Vice President Cheney's secret energy task force, combined with President Bush's holding hands with the Saudis, and it shouldn't be any surprise that we are in the predicament we are in now.

The question is how to get out of it, and drilling has to be part of it in a comprehensive energy policy. But to make it the exclusive gimmick for the election is a serious mistake. And it is much more important to move away from the addiction to oil, just as the President said, but failed to support any policies to help us avoid that addiction.

Mr. RYAN. Will the gentleman yield?

Mr. DOGGETT. After my time is used with the Secretary, I will be glad to.

Mr. Secretary, your testimony with reference to how we get out of this mess, whether it is now if we can get enough bipartisan support for it or it is in January, is not dissimilar from the testimony that you gave us about the first stimulus, and which I must say almost every single economist seemed to share your view that if you want the maximum stimulative effect, you try to get the dollars as quickly and efficiently to the people that have been left desperate enough by these Bush economic policies in the form of food stamps; extended unemployment compensation; perhaps, given the disastrous energy policy, the LIHEAP that you talk about today, the people that will literally be in the cold this winter because of those policies if we don't have adequate assistance for heating, the same problems my folks in Texas will face in the summer. Those



are going to be the kind of stimulative policies that will give us the most stimulation and do it the quickest; is that not right?

Dr. SUMMERS. As far as the—

Mr. DOGGETT. As far as short-term stimulus.

Dr. SUMMERS. In terms of the analytical judgments that targeting spending to those who have low incomes or incomes that have sharply declined or being burdened by new expenditures or to government purposes where money can be expended quickly will have the greatest fiscal impact, I would agree completely with that judgment.

Mr. DOGGETT. And your testimony also is—and we have PAYGO not just over 5 months, but 5 years, as was the testimony earlier in the year—that if we provide that short-term stimulus, there is a way to do it and pay for it over a longer range of time so that you don't aggravate our long-term national debt problems.

Dr. SUMMERS. I believe that would be best. The choices involved in paying for it are more painful than the choices involved in providing it.

Mr. DOGGETT. They always are.

Dr. SUMMERS. But that is certainly what I believe would have the best impact. And just to reiterate a point that I made in my testimony, I believe that to commit now to actions that would substantially increase the budget deficit in 2011, 2012 out through the remainder of the decade, such as proposals to extend the tax cut permanently, I believe those would not just be dangerous in the future because of the debt, but would also, because of their impact on interest rates and confidence today, inhibit the process of economic recovery.

So I believe that such proposals would be quite counterproductive from the point of view of stimulus and would emphasize that if you look at any discussion of confidence, enormous emphasis is placed on the question of government indebtedness and the closely related question of the country's international indebtedness. And so to pursue policies that compromise that objective by several trillion dollars, as some suggest, would, I think, have the likely consequence—you can't quantify how much, but would have the likely consequence of inhibiting the process of recovery.

Mr. DOGGETT. Thank you very much.

Chairman SPRATT. Mr. Etheridge.

Mr. ETHERIDGE. Thank you, Mr. Chairman. Let me thank you for holding this hearing and for our panelists for being here today. And being with us this extended period of time, we really appreciate it.

Let me, as interested as I am, and as important as it is dealing with the energy piece, and now let me come back to another piece to get it in. If I have a chance, I will come back to the energy and the long-term piece. But last week I held, as I do quarterly in my district—I had a meeting with our bankers, with our small-business people and others and talked about some issues. Mr. Secretary, I am going to start with you on this one because you would have had some background in this. You didn't create it, but maybe you can give me some understanding, because what I heard from the bankers, as well as from the business people, was as follows.

Number one, from the bankers, liquidity is a real problem in the banking community right now, as it was with them moving money,

as you know, from bank to bank. And then they are reaching out to the business community and saying to home builders, to any business person who has some money, who has a line of credit, especially if that line of credit is tied to real estate or something else, by the way, we have just cut it in half, or we are drawing it in because it may not be affecting this economic market, but because of the size of the reach of this institution, I have got problems in another part of the country.

So my question, I think, is this: How can we—or how can we encourage at some level—because if this keeps happening, it becomes a self-fulfilling prophecy because we have all these housing units out here that are unsold—get your financing for. So I would be interested in your thinking. Originally, remember, in the previous stimulus and we put together a package, and we said for the first time, homebuyers, we are going give you an incentive to buy. We didn't have the rest of the inventory stock that is now really pulling the market down in the whole communities. They had raised the issue of finding a way to move this inventory, in some way to get the market so these folks can get back to work and get liquidity in the market.

Dr. SUMMERS. I would address that in three ways, Congressman. I thought what you said from your community bankers track very well my impressions studying the economic statistics. I think there are three important aspects. First, if we provide the right kind of fiscal stimulus, it will stimulate spending, that will stimulate traffic in the restaurants, that will stimulate buying in the stores, that will make all those institutions more creditworthy that will feed back to help the banks. Helping the banks will enable them to provide more credit to others.

So you don't fill a flat tire through where the leak is, and in the same way, whatever the source of our economic problem, I believe fiscal stimulus that supports the real economy will have an important impact.

Second, I think while I regret very much that they were necessary, the set of actions undertaken over the last weekend, if they are pursued aggressively, have the potential to make a real contribution to the housing situation. If one looks at mortgage rates today, it appears that mortgage rates in the 2 days since those plans were enacted have declined by as much as 3- or 4/10 of a percentage point. That is not a trivial move in terms of what it means for the cost of carrying a house or what a given family can afford.

Third, I think it is an open question for financial policymakers whether we are going to need to engage in further involvement in supporting the financial housing system. The legislation that the Congress passed in July that Congressman Frank was very involved with, directed at providing mortgage relief and reducing foreclosures, frankly I wish it hadn't taken the Fannie Mae emergency to serve as an engine for passing that legislation. It was another case of better late than never, but it was late. And I am not sure whether further programs of that kind may well prove necessary. Ultimately we are going have a significant number of financial institutions in quite serious trouble, and it may well be that we are going to need a more comprehensive approach to supporting those financial institutions and to supporting the financial system

than we have had to date. I don't think it is quite time yet, but I would hope that the responsible authorities are extensively involved in contingency planning.

Mr. ETHERIDGE. One follow-up as we look at the right type of stimulus time line in getting it in place.

Dr. SUMMERS. Sooner is better than later. It would be better if you passed it before you went out in September. If you didn't pass it in September, it would be better if you passed it during a lame-duck session. And if you didn't pass it during the lame-duck session, most likely it would be better if you passed it very quickly after you came back.

You know, none of us know. It is possible that the economy will recover more rapidly than we expected, and you will not have succeeded in passing a stimulus, and we will come back in January and it won't look necessary. I don't preclude that possibility. It is not what I would expect.

Mr. ETHERIDGE. Thank you, Mr. Chairman. I yield back.

Chairman SPRATT. Thank you.

Ms. Kaptur.

Ms. KAPTUR. Thank you, Mr. Chairman.

I wanted to ask Dr. Summers, what do you think of this idea on infrastructure? If we take the 18-cent gas tax and we were to issue \$200 billion worth of bonds guaranteed by the repayment of those over a period of time with that 18-cent gas tax, how do you think the markets would react to that?

Dr. SUMMERS. I think that, frankly, Congresswoman Kaptur, while we have a lot of economic problems, I think the Federal Government's debt really is relied on as safe and trustworthy. So if the government issued an extra \$200 billion of bonds, I don't think it would make much difference whether they were in some sense secured by future gasoline tax revenues or they were not secured by future gasoline tax revenues.

I tend to be an enthusiast of larger fiscal stimulus, but I think I would be surprised if we could invest quickly \$200 billion in infrastructure in an effective way. Over the next decade we are going to have to invest considerably more than that. But I don't think the primary problem is with the financial engineering and how you issue the debt. I think the challenge is identifying the right projects, avoiding bridges, if I might, bridges to nowhere, while meeting the most crucial needs.

Ms. KAPTUR. If the gentleman would kindly yield. In my district we got the projects on the shelf. We need water systems, we need sewer systems, we need street systems. It isn't very complicated what we need. And those projects are ready to go, and, I would venture to say, all over the country. But I appreciate your opinion on that.

Dr. SUMMERS. By the way, in my testimony I emphasized exactly that point, that there was a large volume of projects that were on hold, being slow-walked, or contracted, but not quite ready to go.

Ms. KAPTUR. Thank you very much. I know I don't have very much time. Thank you, Doctor.

I wanted to ask anyone on the panel if they could give me a benchmark year. At what point in, let us say, the last 15 years did the sale of mortgage-backed securities to international—into the

international marketplace accelerate as opposed to being sold predominantly in our own market? And if you could pinpoint a year or approximate period. And where—can you pinpoint where and which institutions in our country provided the impetus for this activity? And can you name three or four firms that were most aggressive in designing these instruments?

Dr. SINAI. I will check the data for you, Congresswoman, but my sense is 2003 approximately, the investment banking/broker-dealer community, and then other nonbank financial intermediaries as well. And it all kind of took off like a topsy.

But I really want to hesitate to guess at any individual firms. I just don't think that would be quite appropriate. But the phenomenon which your questions really get to really came because of the housing boom and what turned out to be the housing bubble. It is like bees flocking to honey. In the financial community everybody flocks to it, those businesses around it, and then it exploded. And they sold it to lots of financial institutions.

Ms. KAPTUR. And I am very interested in the progress, because the largest fine in American history imposed by the FDIC was on a bank from Illinois called Superior Bank, a \$450 million fine, the largest ever. Now, they were involved in subprime loans for autos back in the late 1980s, early 1990s, and then they accelerated into the housing market. There had to be some leaders out there in the marketplace. I am very interested. This wasn't just spontaneous combustion.

Dr. SINAI. It is really collective movement toward what appeared to be attractive businesses. I don't think there was anything illegal or unethical.

Ms. KAPTUR. But there had to be certain leaders, and I would be interested if anyone could provide that for the record.

I wanted to ask Dr. Summers as the former Secretary of Treasury, can you estimate how much money has been expended to date by the Fed to bail out private brokerages and Wall Street banks, not including the current proposal for Fannie Mae and Freddie, which I guess is about at least \$200 billion minimum?

Dr. SUMMERS. Well, I think it is \$200 billion maximum. In fact, the Fed has, in effect, taken over \$30 billion of assets on a basis where JPMorgan will bear the first billion dollars of losses. The ultimate cost would be \$29 billion if all of that money was lost, but there is no reason to expect any outcome like that. Depending on what happens, if there is sort of middling performance, the cost won't have been anything to the Fed. If the assets recover well, the government will actually turn a profit. If the assets perform poorly, the government will take a loss. But I think most experts would say even in relatively negative scenarios, the loss would be a small fraction of the \$30 billion. The Fed is also, as you know, engaged in lending operations to a range of financial institutions.

There are some risks associated with those operations, although they are—the Fed is careful to take collateral and require adjustments to collateral as market conditions warrant. So I think it is difficult to make an estimate of what the cost to taxpayers is, and based on what has happened so far, it is not certain that there will be any positive cost to taxpayers.

Ms. KAPTUR. Well, you know, Mr. Chairman, I just wanted to place on the record, as this committee knows, we are over \$10 trillion in debt. The ceiling on the mortgage mess is \$2.4 trillion. Now, maybe it won't be that bad. So we are adding to an already essentially bankrupt situation in terms of revenue inflows, and that means we are borrowing from someplace to fund all this. And the American taxpayer becomes the insurance corporation for Wall Street.

I did not vote for the elimination of Glass-Steagall. Some people supported that. And now the chickens are coming home to roost. And I have to say that I don't like the fact that the American people are now going to be looked upon as the cash cow for three generations hence to try to fund the mess that some very powerful individuals and companies in this society have placed our society at this precipice.

So I just wanted to place that on the record. And I thank you, gentlemen, for your testimony. And I vehemently oppose the taxpayers of this country becoming the glue to hold Wall Street together. And I oppose the elimination of Glass-Steagall today, as much today as I did in the late 1990s when others gladly supported it.

Dr. SUMMERS. Congresswoman, I think we can all agree that the function of tax dollars is not to bail out speculators. I would just caution on the subject of Glass-Steagall that what Glass-Steagall was directed at primarily was codifying a set of regulatory arrangements that had already taken place that allowed combinations between investment banks and commercial banks. To date there have been no taxpayer costs for the institutions where commercial banking and investment banking have been combined. Where investment banking stood alone, as in Bear Stearns, is where the problems came. And indeed, many observers have suggested that central to that problem was that if Bear Stearns had been willing to accept capital from a commercial bank at an earlier point, the need for the taxpayer bailout might have been attenuated.

So one can have different opinions as to the merits or demerits of Glass-Steagall reform and of the regulatory changes that preceded Glass-Steagall reform, but I think it is almost impossible to make the case that the unfortunate events that we have seen recently can be traced back at—certainly those at Bear Stearns can be traced back to Glass-Steagall.

Ms. KAPTUR. I think the legitimate question can be raised, sir, going back to that change, what is a bank? And the blurring of the line between banking and commerce is a very serious blurring. And right now we are in a situation, however it was caused, that the American people become the insurance company for these very large institutions.

So I know my time has expired, Mr. Chairman. I thank you very much.

Dr. SINAI. Just one comment for the Congresswoman, because what you say reflects the feelings of my contacts, lots and lots of Americans. It is almost a sense of outrage at what has happened. My sense is that—and I am not really blaming anyone here. The players in each sphere play by the rules. There are rules in Washington. There are rules on Wall Street. There are rules set by

Washington for Wall Street. I think Washington didn't keep up with the players in, quote/unquote, Wall Street, and a lot of the things that happened should not have happened.

That is history. You are going to get another opportunity to reset the rules of the game for those private-sector agents that in some sense have misbehaved. But we will have to see if they get convicted, if any go to jail on any of the particular kinds of things that have happened.

I encourage you to enthusiastically get involved in resetting the rules, because all over the world now we are examining the new set of rules for the U.S. and global financial system in light of what has happened, and that will be your chance to get into that debate. And it is absolutely essential—

Ms. KAPTUR. Well, sir, you are looking prospectively. I am also looking retrospectively. And I want to lock a lot of people up, and I want a lot of fines placed on those who put the American people in this position. And I don't just buy looking forward. I want to go back with that hook and get those people that put us—and a lot of them walked away with millions and millions and millions of dollars, and we are acting like they didn't exist. History didn't just start in 2003.

Thank you very much.

Chairman SPRATT. Ms. Kaptur, would you take the gavel? Be careful with it. And the Ranking Member has a couple of questions he would like to put before the hearing is over. And I have some constituents.

Let me say to all our witnesses before leaving, you have been forthcoming and forbearing, and we very much appreciate it. We have gained a great deal from today's hearing, and we appreciate your participation. Thank you very much indeed.

Mr. RYAN. Thank you for yielding, Chairman. I will be fairly brief. I won't take a full 5 minutes here. I simply want to follow up and finish up with what I think is a little bit of a mischaracterization of some of the views on this side of the aisle.

Number one, the legislation we are trying to get to the floor is not just drill, drill, drill. It is drill and do all of the above. That is why it is called the "all of the above" Energy Act. Conservation, research, renewables, solar, wind, biomass, nuclear, all of it. Get out on the supply side right away.

Another point is—and I don't want to directly refute Ms. Schwartz. I wanted to, but she is not here to defend herself, so I won't go down that path. Only to say I think we have to look at how the markets worked, the law of supply and demand, and how the futures markets worked. And in the opening statements, just because of the vote, each of our first two witnesses had plenty of time to go through their full testimony. And, Dr. Kreutzer, you only got 5 minutes. Therefore, you had to kind of truncate your remarks. So I am concerned that some of your testimony was taken out of context in a narrow viewpoint. So I wanted to give you an opportunity to fully expand on your points and your remarks, given the fact that you just haven't had that opportunity as some of the other witnesses did.

Dr. KREUTZER. Okay. Yeah. I will say that I truncated my statement because I was told we had 5 minutes.

Mr. RYAN. That is because we had a vote.

Dr. KREUTZER. I am new at this.

I was not trying to mislead anybody, and I think in my written testimony I didn't. There is no intent. If I did, I apologize.

Start at the bottom of page 2. "It is understood that the price impact would be smaller over time once the world economy fully adjusts to the increased production. We are comfortable using this elasticity"—that was the discussion I have had with Dr. Summers and with Congresswoman Schwartz—"since it seems probable that world petroleum markets, which are not currently in long-run equilibrium, will continue to see strong demand growth, especially over the long run. Nonetheless, we note that should the world petroleum market ease significantly by the time this increased production comes on line, the price and economic impacts will be less pronounced."

Okay. I would go on and say that we are having an argument over whether it is a really, really, really good idea or just a really, really good idea. Okay. That is, would creating 40,000 jobs and adding \$25 billion to the economy be a bad idea because it is not 128,000 jobs and \$105 billion? No. What if it takes 10 years? It is still a good idea. That is the point I am trying to make. I am not presenting this as the answer to all energy problems or answer to all economic problems. We have something very simple. It doesn't cost the Federal Government anything. You have to release in the budget some money to allow the exploration and the geologic testing. That is pretty trivial. Okay. Beyond that it doesn't cost anything. You don't have to raise any taxes. You don't have to take money from somebody else. The drilling technology now is very safe. We are not going to be killing wildlife. Okay.

So that is why I said it seems to be a no-brainer. It is not the answer to all problems. It will have an impact on price. Though the market may ease, what we will have then will be the \$70-, \$80-dollar-a-barrel petroleum. We should all be happy that we have that. The International Energy Administration is saying we are still going to have that very tight spare capacity. So I am taking that, and that is what we have seen. We were surprised by China. The markets are responding where we let them. The number of drill rigs operating in North America is more than any time since 1985. They built seven drill ships between 2001 and 2007. They are building 15 this year and 25 next year.

But we are not letting markets do all they can. That is all I am asking. Let them go where we have resources. We know we have them, 30 billion, 20 billion, maybe much more than that. Who knows? Let us find out. There is no cost there. That is my only point. It will help the economy.

Mr. RYAN. So is it not axiomatic that with China and India going through their version of the industrial revolution, surging demand increasing worldwide, would it not be better for our economy, for our national security that we get our supply here rather than depend on such foreign sources? Now that we have got new drilling technologies, now that we have new discovered reserves in the gulf, now that we can get the shale oil, the oil out of shale, which we couldn't 15 years ago, and there is something like 2 trillion barrels in the West, aren't these good ideas that just passing the author-

ization of this, showing this new future supply coming on line in the economy at some point time in the future, would not that just new supply coming in the future reduce the price in the futures market in a short period of time?

Dr. KREUTZER. It could if there were excess capacity. There is plenty of theory that says that the Saudis and the other OPEC members can say, we can sell the petroleum now, or we can sell it next year, or we can sell it in 20 years. If there is going to be a lot of extra supply in 20 years, hmm, then the present value of that petroleum is not so high, we ought to sell it now. That is the argument.

Right now they don't have the capacity, but the Saudis can expand their capacity much more rapidly than we can with the Outer Continental Shelf. So you might have a link. We say, hey, we are going to the Outer Continental Shelf, 5 years, 10 years, 15 years, 20, 30. Thirty is—I think is just an exaggeration. That is not believable then. That number has been quoted earlier. That number is in print. So seeing that that is coming on line in 20 years, their reserves that they are going to have then won't be worth as much. They can expand now much more rapidly. There is oil in Saudi Arabia and the Middle East that they can expand in the next couple of years.

One more point. Even if it doesn't change the price at all, that is \$45 billion a year less petroleum that we have to import for each million barrels that we produce domestically. Forty-five billion dollars.

Mr. RYAN. So from a trade deficit standpoint, from a U.S. jobs standpoint, all the better?

Dr. KREUTZER. Yes.

Mr. RYAN. Dr. Summers, let me ask you something. I want to make sure I understand what you said a minute ago about the tax changes that are coming to effect. At the end of 2010, the beginning of 2011, marginal income tax rates are going up across the board. Tax rates on capital gains dividends are going up, so higher tax rates on income, higher tax rates on capital. Are you saying that in order to maximize economic growth, it is necessary, right and good that those tax increases occur?

Dr. SUMMERS. With respect to dividends and capital gains cuts, I would favor raising the capital gains rate back to the Clinton era—the 20 percent capital gains rate. And I think if the dividend rate was at 20 percent, you would still have lower capital costs, lower capital taxes than we had through the spectacular market boom of the 1990s.

With respect to the increase in rates, I believe that the extra confidence that would come from a lower deficit, that would come as a consequence of making clear that those upper income rates would be repealed, that the confidence that would come from greater fiscal responsibility would have benefits that would far exceed any possible costs associated with the increase in tax rates, and would simply cite the rather dramatic difference in the quality of economic performance during the 1990s and in recent years as evidence calling into question the reviews of those who somehow think that the difference between 35 percent marginal tax rates and 39 percent marginal tax rates on work incentives is very large. We can



in a sense run this—run this as an experiment, and I think we have seen the answer quite clearly in terms of rates of growth. And, of course, if you look to what I believe should be the touchstone for economic policy, which is what happens to middle-income families, then if you look at median family income, or if you look at real wages, the difference between the performance and the pre-tax-cut regime and the post-tax-cut regime is really very, very dramatic.

Mr. RYAN. So the premise of that requires that that—the revenues—the additional revenues supposedly raised through that be applied to deficit for your projection to materialize, correct? Meaning this extra tax revenue goes to the deficit, and therefore it is good.

The problem we are having here in Congress is every new tax revenue coming in goes to spending. The sunset of those tax cuts, those revenues coming in are not being applied to the deficit. They are already being called for in new spending in the current baselines in the budget resolution that has passed.

So I would simply say, let us control spending, work on the deficit that way, lock in a more credible spending-control budget and regime, and keep tax rates low. That way we can have our cake and eat it, too. We can have low tax rates on income, low tax rates on capital, better income incentives at the margin, and a credible Congress actually cutting spending and reducing the deficit. You know, that way we can satisfy both philosophies, both agendas, and actually achieve the results we are all trying to achieve, which is better and higher economic growth.

Dr. SUMMERS. I would say a couple things, Congressman. First, as one who takes some pride in his time in government service, I think the record in containing the growth of spending, whether you look at what actually happened to spending or you look at the President's budget proposals, was rather more favorable between 1993 and 2001 than it has been in the last 8 years.

Second, I know that it is common to assert that extra tax revenues always get spent, and that if you cut taxes, that will lead to cuts in spending. But in a sense we have had a very strong test of that proposition. We cut taxes by several trillion dollars on a 10-year basis in 2001. We were told by the advocates of those tax cuts that it wouldn't exacerbate the budget situation. And somehow \$3 trillion of tax cuts were associated with, depending on how you choose the interval, \$6 trillion of deficit deformation. In contrast, in the early 1990s, when tax revenues were increased, we were told that that wouldn't lead to deficit reduction, but, in fact, for 16 half years in a row, CBO was revising its budget forecasts to show larger surpluses.

So, yes, these are matters of theory, and you can make different arguments, but I would argue that the empirical evidence is actually relatively clear.

By the way, if you go back and you look at family incomes during the 1980s, I think you will also find that that wasn't as favorable a period as during the 1990s.

Mr. RYAN. Okay. I could go back and forth for a good hour with you on this. Let us not forget the 1997 budget agreement, which the Clinton administration used to control spending and cut taxes,

which I would argue gave us better economic growth, a better budget projection, which was more behind these projected surpluses. Remember, these surpluses materialized to the tune of, I think, about \$600 billion. You used that to buy back bonds. But after 9/11, the dot-com bubble and the recession, those projected surpluses never materialized.

We can go on and on and on about this, but the one fact remains: Unless Congress gets a handle on controlling spending, this whole point is moot. I would just yield on that point. I know, Dr. Sinai, you want to get a quick point in.

Dr. SINAI. I have to come down on the side of reductions in the growth of Federal spending in keeping tax rates low for those who will stimulate the economy most on the spending side given our current context. The rub is in the spending, and that is really up to Congress and how one wants to use Federal Government spending.

I happen to think there is room to use it now for some well-planned infrastructure projects over the long term. PAYGO gives you a way to offset tax cuts over a period of time with legislated-in-advance reductions in spending. Odds are Congress won't agree on the latter. And although you and I are in agreement philosophically, and I think actually Larry and I are very close philosophically in the wording of how he responded to the question, we are talking about practical problems on the spending side, and that, again, is a question of leadership to me, not from economists but from the people in Washington.

Mr. RYAN. We can come up with as many gimmicks as we want to. There is no substitute for the Congress actually having the discipline to control spending.

Thank you. I yield.

Ms. KAPTUR [presiding]. I thank the gentleman and would like to state for the record that if one looks back to the last decade, in 1998, that was the year in which the United States began to import over half of the petroleum that it used. That was when the scale began to really tip in the wrong direction. And this year, after this administration's two terms, we are importing an additional billion barrels of oil into this economy, and now we are over two-thirds to three-quarters coming from foreign sources.

And I am not one of the Members of Congress who believes there is a free market in the oil industry. It is amazing that companies can earn \$40 billion; one company, \$40 billion a year, the largest profits of any company in U.S. history, maybe in world history, just one of those oil companies.

So we have a market that is very, very unusual, and they literally have us captive. The situation we are facing now is how do we, as a country, delink ourselves from this hostage situation in which we are held? I would like to believe that what Congress does can help, but as I look back over several years of service, I think some of the most creative actions are being taken at the local level where communities are saying, we have to become energy independent in our own regions. And we are seeing a lot of activity in rural America. We are looking at rural cooperatives. We are looking at new biofuels. We are looking at even county governments beginning to look at solar fields and geothermal and green roofs and

cryogenic hydrogen, a whole host of—and wind farms going up across this country.

I think the American people are beginning to understand that Washington in many ways is paralyzed and perhaps captive of the very interests that are holding us hostage. I would like to believe that it is otherwise, but it seems whether it is the 1990s or the 2000s, the numbers just keep getting worse. I am very dismayed by that. I have done everything within my power to try to change it. But I am hoping that the republican nature of our government where we share power with States, with localities, with regions, will produce a different America, and that those of us at the national level who are trying to change this equation will—will aspire to the highest of our ideals, and that is that not all answers exist here in Washington, and that when Washington fails the country—and we are failing, we are failing this Nation by keeping us hostage—that the American people will find their way forward, and that there will just be enough incentives that we might be able to provide that will ripen these local efforts.

As far as I am concerned, Minnesota has been the “lone star” State in leading us forward. I think the new farm bill is a real—is a real plus, and I don’t think that history will record this generation as doing America any favors. I think that we could do a whole lot better. And I resent being held hostage by any group of interests that hold the American people by the carotid artery and by the aorta and don’t allow us to really be free. I consider our energy dependence our chief strategic vulnerability.

I wanted to ask unanimous consent that Members who did not have the opportunity to ask questions of the witnesses be given 7 days to submit questions for the record.

[Questions submitted by Mr. Barrett follow:\*

QUESTIONS SUBMITTED BY HON. J. GRESHAM BARRETT, A REPRESENTATIVE IN  
CONGRESS FROM THE STATE OF SOUTH CAROLINA

1. Considering the federal government’s new role in Fannie and Freddie, what incentives face Congress that would lead to policies that spur growth in the short term at a long term cost?

2. What are the international macroeconomic effects of this takeover in terms of our trade balance, flows of capital from international firms, and strength of the dollar?

3. What type of effect does the addition of Fannie and Freddie’s debt have on the federal balance sheet?

a. How will this additional debt affect expected economic growth given the already growing national debt?

4. How important is energy independence to the long-term health of the economy?

Ms. KAPTUR. And I also wanted to ask a question of any of the witnesses. In Dr. Summers’ testimony, Dr. Summers, you say that losses in output relative to potential are likely to cost the economy \$300 billion a year, or more than \$4,000 for the average family of four. So you talk about the real cost to the average family of what is happening in the economy. Could I ask any of you or Dr. Summers to comment, with a trillion-dollar trade deficit now bearing down on this country, with more imports coming in here than exports going out, what share of lost output can we attribute to the displacement of U.S. productivity here at home, U.S. production

\*As of March 13, 2009, responses to the questions submitted have not been received by the committee.

here at home, in manufacturing and agriculture and related wealth-producing activities that used to occur here?

Dr. SINAI.

Dr. SUMMERS. Congresswoman, if you will excuse me, I have another commitment, so I will have to leave.

Ms. KAPTUR. You don't wish to comment on that, Dr. Summers?

Dr. SUMMERS. I will make a very brief comment. There is no question that over the long term we are going to have to reduce our trade deficit and our consequent dependence on foreign capital. As we do that, there are likely to be significant benefits in employment, and those significant benefits of employment, of course, will be focused on parts of the country that have lagged, parts of the country that have lagged behind to our very significant benefits. Certainly the trade deficit at its roots, which go to many different aspects of our economic performance, is, as you have often highlighted in the past, a crucial issue.

Ms. KAPTUR. Thank you. Thank you very much.

Dr. SINAI, we are almost finished here.

Dr. SINAI. Thank you.

I was going to say we are moving in the right direction at the moment on our trade balance and on current account deficits, so it isn't quite as dire as it was. And I think a trillion dollars is a little high on that deficit. So you want—

Ms. KAPTUR. Well, three-quarters of a trillion to \$1 trillion.

Dr. SINAI. So 25 percent margin of error. I am an economist, not a statistician. I will accept that.

Ms. KAPTUR. Seven hundred billion dollars is pretty significant.

Dr. SINAI. If whatever we do in our concern about the deficit, international account and our dependence on foreign capital leads us down a protectionist path, that would be very counterproductive. That is the only comment I have on that. It is definitely a huge problem. We are a big debtor almost everywhere, particularly on the government side. That is going to get much, much worse.

I think on trade in the current account deficit and our indebtedness there, that actually is probably going to keep on improving. And we are losing fewer jobs at the moment overseas. Nevertheless it is a big problem. But if the answer turns out to be any kind of protectionism, fair trade, which is sometimes hand-to-hand combat with our trading partners who are not playing the game in a free-trade way, and where we are, I go back to Mickey Cantor and the tough approach. Fair trade is more for me than free trade, depending on who you are dealing with. But protectionism is definitely the wrong way to go.

Ms. KAPTUR. We need to have all markets open.

Dr. SINAI. And fear. And fear. So the playing rules are the same for the participants.

Ms. KAPTUR. Thank you, Doctor, very much.

Dr. KREUTZER, do you have any final words?

Dr. KREUTZER. No, thank you.

Ms. KAPTUR. I want to thank you, thank all the witnesses for your attendance today, all of the membership. The committee is now adjourned.

[New York Times article submitted by Ms. Schwartz follows:]

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### OPEC Takes Steps to Cut Oil Production

By JAD MOUAWAD  
Published September 9, 2008

VIENNA — In an unexpected decision made after a six-hour meeting that lasted well into the night, the OPEC oil cartel said it would reduce its oil production by about half a million barrels a day in a bid to stem a rapid decline in oil prices in recent weeks.

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RONALD ZAKI/ASSOCIATED PRESS

In the short term, the strategy appeared to be working. Oil rose more than \$1 a barrel in New York trading on Wednesday, rising above \$104.30 a barrel. Still, oil prices remain near a five-month low. The outcome of the meeting, which ended around 3 a.m. this morning, represented a significant loss for moderate OPEC producers like Saudi Arabia, which had argued for the group to keep producing at full tilt.

But fears that the market was currently oversupplied while demand for oil was slowing led the group to say it would "strictly comply" with production quotas set in September 2007. Since then, the group has been producing above those levels to drive prices down.

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global oil market outlook."

Given OPEC members' history of frequently pumping more than their quotas, it is not certain that they will abide by the new agreement.

Ali Al-Naimi, the oil minister of Saudi Arabia, which has been pumping more than its quota in recent months, left the meeting without any comment. With crude oil heading down toward \$100 a barrel, Saudi Arabia and other producers meeting here on Tuesday had suggested that OPEC would keep pumping at full tilt, even as some members of the cartel expressed concerns about rapidly declining prices.

Members of the Organization of the Petroleum Exporting Countries account for 40 percent of the world's oil exports. They had scheduled the late-night session to consider how to

respond to a 30 percent drop in oil prices since July. Crude oil fell more than \$3 a barrel on Tuesday.

Ahead of the meeting, the cartel's members appeared deeply split, with one camp, led by Iran and Venezuela, advocating reductions in output to stem further price declines, and another, led by Saudi Arabia, wishing to allow prices to fall further.

As the group's representatives arrived in Vienna, Mr. Khelil, who is also Algeria's oil minister, said the cartel would probably keep production unchanged. At a news conference held after the meeting, Mr. Khelil said the group was merely responding to oversupply in the market.

"My hunch is that prices will be going down despite the decision," Mr. Khelil said. "There is an oversupply, everybody agrees about this."

The decision represents a rare case of OPEC's going against the position of its biggest member, Saudi Arabia. The Saudi oil minister had said when he arrived in Vienna early Tuesday that the market was "fairly well balanced."

"We have worked very hard since June to bring prices to where they are now," Mr. Naimi told reporters Tuesday morning. "We have been very successful."

Mr. Naimi was referring to a pledge Saudi Arabia made in June at a meeting of producers and consumers in Jeddah to keep pumping at full throttle to bring prices down. The kingdom is producing about 9.5 million barrels a day, 600,000 barrels a day more than its official OPEC quota.

Oil prices peaked at \$145.29 a barrel on July 3 but have been falling lately because of slowing global demand. On Tuesday, prices fell \$3.08 to \$103.26 a barrel in New York, their lowest level since April.

The drop partly reflected the feeling that Hurricane Ike, which killed at least four people in Cuba and forced more than a million to evacuate, will miss the oil-production platforms in the Gulf of Mexico. About 80 percent of the gulf's offshore oil production remains shut in after the passage of an earlier storm, [Hurricane Gustav](#).

Slowing economies and falling oil demand in major developing countries have led to a slowdown in the growth of oil consumption. As a result, many analysts agree there is more than enough oil on the market. Also, refiners typically need less oil in the third quarter, when they shut down for maintenance.

Behind their sometimes opaque language, OPEC's leaders are forced to perform a delicate balancing act. Leaving production unchanged at a time when demand growth is slowing could precipitate a price collapse, as happened in the late 1990s when prices fell below \$10 a barrel. But cutting production at today's high levels could incur the wrath of consumers, who are already unhappy with the elevated prices. Oil has been above \$100 a barrel since March.

In the days leading to the meeting, some countries, like Iran, Libya and Venezuela, had signaled that they wanted the cartel to cut production. OPEC's own analysis suggested that the group was producing far more oil than is needed. According to [Lehman Brothers](#), OPEC is pumping 2.18 million barrels a day more than it did last year.

Saudi Arabia is in a particularly sensitive position. The kingdom is the only country with any significant spare capacity and is in a position to impose its will on other OPEC countries. The Saudis recently brought a new field online, called Khursaniyah, which has a production capacity of 500,000 barrels a day.

But the Saudis are also keenly aware of the state of the market. Oil consumption in the United States, the world's biggest market, is about a million barrels a day lower than last year and consuming nations have pleaded for producers not to reduce their production.

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Some OPEC members are also worried about a potential slowdown in demand in Europe and Asia

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*Michael Grynbaum contributed reporting from New York.*

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[Whereupon, at 5:05 p.m., the committee was adjourned.]

