PERSPECTIVES ON THE U.S. ECONOMY

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

SECOND SESSION

HEARING HELD IN WASHINGTON, DC, JULY 1, 2010

Serial No. 111–28

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

57–277 PDF WASHINGTON : 2010

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PERSPECTIVES ON THE U.S. ECONOMY

THURSDAY, JULY 1, 2010

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

The committee met, pursuant to call, at 1:17 p.m. in room 210, Cannon House Office Building, Hon. John Spratt [chairman of the committee] presiding.

Present: Representatives Spratt, Schwartz, Kaptur, Becerra, Doggett, Etheridge, Scott, Connolly, Schrader, Moore, Ryan, Hensarling, Campbell, Lummis, and Djou.

Chairman SPRATT. We meet today to discuss the economic recovery and the challenges that lie ahead of us. We are joined by three eminent economists to help us take stock of this situation.

When this Congress, the 111th, took office along with the Obama administration in January of 2009, the economy was shrinking at a 5.4 percent negative rate of growth. A year and a half later, the economy is in its third straight quarter of economic growth, growing at 5.6 percent in the fourth quarter of 2009 and 2.7 percent the first quarter of 2010.

A year and a half ago, the economy was losing jobs massively. In January of 2009, we lost 779,000 jobs in one month alone. Now, after a year and a half of concentrated fiscal initiatives, employers added nearly one million jobs between January and May of this year.

As Chairman Bernanke recently told us in his testimony before this committee, the Federal Reserve, quote, anticipates that real-growth domestic product will grow in the neighborhood of 3.5 percent over the course of 2010, at a somewhat faster pace, we hope, the next year.

Nevertheless, the economy seldom recovers in a straight linear fashion. In May, the economy added 431,000 jobs on the strength of new Census hires, but forecasters anticipate that tomorrow's job report will show that while we may have added as many as 100,000 new private-sector jobs in June, a solid accomplishment, total nonfarm payrolls may still have fallen due to the end of many of these temporary Census jobs.

The strength of our economy clearly lies in the private sector, but the action taken by this Congress and this administration we think have played a significant role. For example, it is the judgment of the Congressional Budget Office that the Recovery Act passed in February of 2009 has contributed significantly to the economic turnaround, raising GDP by 1.7 to 4.2 percentage points in the fourth quarter of 2010, increasing employment by 1.2 million and 2.8 million jobs overall.

Meanwhile, the Treasury Department, the Federal Reserve, and the FDIC have been engaged in unprecedented efforts to stabilize banks and the financial system by injecting liquidity, capital, and by securing people's savings and requiring banks to raise still more capital.

In response to my question last month at the hearing on whether the TARP and the Recovery Act had been necessary to rescue the financial system and the economy, Chairman Bernanke replied, quote, Certainly we have averted what I think would have been, absent those interventions, an extraordinarily severe downturn, perhaps as great as the Great Depression.

That from a person who is not known for exaggerated statements.

The recession and the necessary recovery efforts have taken a toll on the budget in the short run. We, as Democrats, have been focused on the economic recovery. We have also pursued and sought fiscal responsibility for the long term. We want to see the economy and the budget recover step by step, hand in hand.

Testifying before the President's Fiscal Commission yesterday, the Director of CBO, Doug Elmendorf, observed that, once again, there is no contradiction between providing additional fiscal stimulus today while the unemployment rate is high and many factories and offices unutilized, imposing fiscal restraint several years from now when output and employment will probably be close to the peak of potential.

Earlier this year, we passed statutory PAYGO, requiring that new mandatory spending or revenue reduction be paid for. In addition, the President established a bipartisan commission now at work to make recommendations to bring down the deficit to a sustainable level by 2015. And, finally, we may be close to an agreement on an enforcement level for 2011 appropriation bills. These fiscally responsible policies have been undertaken by this administration and this Congress to good effect.

At this time, however, our key concern is, over the short run, what is the economic outlook? What can we expect in the months ahead of us? And what is the appropriate fiscal response at this particular point in time?

We have with us today three eminent economists that will help us sort through the progress the economy has made and look to the future.

First is Dr. Martin Baily, Senior Fellow at the Brookings Institution and former Chairman of the CEA under President Clinton.

Second is Mark Zandi, co-founder of Moody's Analytics and former adviser to Senator McCain as well as a number of Democrats.

And, finally, we have Dr. John Taylor of Stanford University and the Hoover Institution, a former Under Secretary Treasurer for International Affairs under President Bush.

We look forward to your testimony. We appreciate your being here. But before giving the floor to you, I want to turn to the ranking member for any statement he may care to make. Mr. Ryan.

[The statement of Mr. Spratt follows:]

PREPARED STATEMENT OF HON. JOHN M. SPRATT, JR., CHAIRMAN, COMMITTEE ON THE BUDGET

We meet today to discuss the progress of the economic recovery and the challenges that still lie ahead of us and we are joined by three eminent economists who will help us take stock.

When the 111th Congress began and the current administration took office, the economy was shrinking at a 5.4 percent annualized rate. One year and a half later, the economy is experiencing its third straight quarter of economic growth, including 5.6 percent growth in the fourth quarter of 2009 and 2.7 percent growth in the first quarter of 2010.

A year and a half ago, the economy was hemorrhaging jobs. In January of 2009, we lost 779,000 jobs in one month alone. Now, after one and a half years of concentrated economic and fiscal initiatives, employers added nearly a million jobs between January and May of this year. And Chairman Ben Bernanke told us last month in his testimony that the Federal Reserve "anticipates that real gross domestic product will grow in the neighborhood of 3½ percent over the course of 2010 as a whole and at a somewhat faster pace next year."

As Americans and policymakers have come to know all too well, the economy seldom recovers in a straight, linear fashion, but instead tends to zigzag. In May, the economy added 431,000 jobs on the strength of new Census hires. However, forecasters anticipate that tomorrow's jobs report will show that while we may have added as many as 100,000 new, private sector jobs in June—which would be a solid accomplishment—total nonfarm payrolls may still have fallen due to the conclusion of many of these temporary Census jobs.

The ultimate strength of our economy clearly lies in the private sector, but the actions taken by this Congress and by the Administration have also played a significant role. For example, it is the judgment of the non-partisan CBO that the Recovery Act, which we passed in February of 2009, has contributed significantly to the economic turnaround, raising real GDP by 1.7 to 4.2 percentage points in the fourth quarter of 2010, and increasing employment by between 1.2 million and 2.8 million jobs overall. Meanwhile, the Treasury Department, the Federal Reserve, and the FDIC have engaged in unprecedented and coordinated efforts to stabilize banks and the financial system by injecting liquidity, capital, securing people's savings, and requiring banks to raise still more capital. In response to my question last month at our hearing on whether TARP and the Recovery Act had been necessary to rescue the financial system and the economy, Chairman Bernanke replied "Certainly we have averted what I think would have been, absent those interventions, an extraordinarily severe downturn, perhaps a great depression."

The recession and the necessary recovery efforts have taken an unavoidable toll on the budget in the short run. While we as Democrats have been focused on the economic recovery, we have also pursued fiscal responsibility. We want to see the economy and the budget recover step by step. Testifying before the President's Fiscal Commission yesterday, CBO Director Doug Elmendorf observed that "There is no intrinsic contradiction between providing additional fiscal stimulus today, while the unemployment rate is high and many factories and offices are underused, and imposing fiscal restraint several years from now, when output and employment will probably be close to their potential."

Earlier this year we passed statutory PAYGO, requiring that new mandatory spending on revenue reductions be paid for. In addition, the President has established a bipartisan commission now at work to make recommendations to bring the deficit down to a sustainable level by 2015. [[And, finally, we may be close to reaching agreement on a House budget plan.]] These fiscally responsible policies are in direct contrast to the actions of the previous administration, which inherited a $5.6 trillion surplus over 10 years and systematically turned it into large deficits, handing the current administration trillions of dollars of deficits for years to come.

We will continue to pursue steps towards fiscal responsibility so that over the medium and long term we put the Nation on a path that will provide a foundation for a strong economy in the future. At the same time, the key concern in the short term remains the economic outlook. We have with us today, three eminent economists, who will help us sort out the progress the economy has made. First off is Dr. Martin Baily, a senior fellow at the Brookings Institution and former Chairman of the Council of Economic Advisers under President Clinton. Speaking second will be Dr. Mark Zandi, Chief Economist and Co-Founder of Moody's Analytics and a former advisor to Senator McCain as well as Democrats. And finally, we have Dr. John Taylor of Stanford University and the Hoover Institution, a former Undersecretary of Treasury for International Affairs under President Bush. We look forward to hearing your testimony on economic developments and whether you agree with the Federal Reserve Chairman's take on the economy or whether you see things differently.

Before we hear from our witnesses, let me also turn to the ranking member, Mr. Ryan, for any statement he may care to make for an opening purpose.

Mr. RYAN. Thank you, Mr. Chairman; and thank you to our three distinguished witnesses for being here with us today. I know some of you had to travel a great distance, and we are really grateful for your attendance.

We convene this hearing under renewed concern about the health of our economy. Experts tell us that we are technically in the process of an economic recovery, but for too many Americans it feels more like an economic malaise. Private-sector job growth has been lackluster. The unemployment rate is hovering at a 25-year high; and fear and anxiety are, once again, gripping our financial markets.

Most policymakers here in Congress are asking the right questions, namely, how do we spark sustained growth and job creation? But too many are searching for answers in the discredited economic playbook of borrow-and-spend Keynesian policies. We have seen this movie before, and we know how it ends. Ask the Europeans. You can't take money from the private productive sector of our economy, funnel it through Washington, and expect to create wealth and sustained economic growth. Centralizing power in Washington, expanding government's reach into all sectors of our economy and more and more aspects of our lives does not create jobs.

Unfortunately, I believe our policy differences center more on ideology, not on economics. If a debate were purely about economics, the administration wouldn't be doubling down on the renewed debt-financed government spending spree. If it was about economics or even pragmatism, we wouldn't be planning to hit the economy, struggling to recover from a deep recession, with a slew of new tax hikes. We wouldn't be shackling our job-producing businesses with more regulations. But that is exactly what the administration and the majority in the Congress are doing.

Americans want their representatives to do what works. They want common sense pragmatism, not blind progressivism.

I reject the false premise that only forceful and sustained government intervention in the economy can secure this country's renewed prosperity. Adherence to this premise has given us a damaging policy mixture. It has sparked a government spending spree and borrowing binge with no end in sight. It has led to a centralization of power in health care, energy, financial services, the auto industry, and more, tightening Washington's grip on key sectors of our economy. It has fostered continued policy uncertainty about tomorrow, which stifles investment today. It has caused new barriers to growth that has rationalized the need for more tax hikes in the future.

This Congress has failed to even produce a budget, and it has refused to consider the tough choices that deal with our massive debt burden, a debt burden growing exponentially larger with each kick of the can further down the road.

Workers, taxpayers, and families across this country have been Guinea pigs in this neo-Keynesian experiment long enough. The results are in. Washington's economic experiment has failed.

Let's try something different. Let's try something that works. Instead of erecting new hurdles for entrepreneurs, let's reduce the government-imposed barriers to grow, produce, create, and innovate. Let's instill a sense of certainty and confidence for investment in job creation. Let's reform our anti-competitive Tax Code, restore the promise of our bankrupt entitlement programs, and work to lift our crippling debt burden.

We need to chart a new fiscal and economic course, reforming government and putting in place a plan for growth, a plan for prosperity.

I hope today's hearing can help inform policymakers as to why the economy remains sluggish, jobs remain elusive, and the forecast remains bleak. I believe we can, and must, do better than this. I appreciate your participation in today's hearing, and I look forward to your testimony.

Chairman SPRATT. Gentlemen, we have framed the issues for a lively hearing, and we look forward to your testimony.

Before turning to you, a couple of housekeeping details. I ask unanimous consent that all members be allowed to submit an opening statement for the record at this point.

Hearing no objection, so ordered.

We recognize you for such time as you need to take. Your statements previously filed have been made part of the record, so you can summarize as you see fit. Let's start with Dr. Baily.

STATEMENT OF MARTIN BAILY, PH.D., SENIOR FELLOW, BROOKINGS INSTITUTION; MARK ZANDI, PH.D., CHIEF ECONOMIST, MOODY'S ANALYTICS; AND JOHN TAYLOR, PH.D., SENIOR FELLOW, HOOVER INSTITUTION

STATEMENT OF MARTIN BAILY

Mr. BAILY. Thank you, Chairman Spratt, Ranking Member Ryan, and members of the committee. It is a great privilege to testify.

I am very pleased to be part of this very distinguished panel. I know Mark very well and John, and I am sure we will have some lively disagreements, but I have a lot of respect for their views.

I didn't come a long distance here, although, as I noted in my testimony, since the Recovery Act is digging up every street in Washington, it sometimes feels like a long distance just to get from Dupont Circle.

There were many contributors to this crisis. I think there are folks, and John may be one of them, that sort of focus on a particular cause in this crisis, that it was the Federal Reserve interest rate policy. My friend Peter Wallison believes it was Fannie and Freddie and the GSEs that caused the problem.

But, in my judgment, this really was, to use the cliche, a perfect storm. We had market failures on Wall Street, and even some of the Main Street banks did things that were very foolish in retrospect. I think there were policy failures, a lack of regulatory watchfulness, and also policy choices that were a mistake. So it is a variety of things that went wrong, and this really has been one of the nastiest recessions in history and certainly since the Great Depression.

I think it is important to stress this multiplicity of causes. Because when an economy goes into this kind of recession and we have this kind of financial crisis, we know it takes a long time to get out. That is the historical record. And Ken Rogoff and his coauthor have documented that very carefully. You cannot turn around an economy that quickly and easily.

I think that there should be a lot of credit given to the measures that were taken to overcome this crisis. It started, obviously, under Secretary Paulson and President Bush. Secretary Paulson asked for the TARP and was eventually given that, and that was a resource that was absolutely essential to turn around the financial sector. We really were on the verge of a huge meltdown.

I think there were some missteps taken on the way to getting the financial sector back, but eventually that was sorted out working with Secretary Geithner and Ben Bernanke. And the Wall Street banks are now, if not healthy, looking much stronger. I think the immediate crisis, the likelihood that those institutions are going to fail, has been alleviated.

We have also had a lot of, as I said, smaller banks, and the FDIC has played a really important role. That has been expensive, too. That cost is going to be borne by the banks themselves in terms of higher fees, but for the society it has been a very expensive business to restore the financial sector. It has taken a long time. We are still not all the way there. There are still a lot of banks on the watchlist, between 700 and 800 banks still on the FDIC watchlist.

So we have a ways to go on the financial sector, and that is restricting lending, and that is one of the factors that is slowing the recovery a little bit. But we could not have done this without the aggressive actions of the policymakers, including those of you here in Congress that somewhat reluctantly approved this. And the electorate doesn't like it, I know that, but I think it was to your credit that it was done.

I think the fiscal stimulus played an important role, too. I am actually not one of those who think we should use fiscal policy all the time to try to stabilize the economy. In normal times, I think the Fed does a good job of keeping the economy on track, and that is what we should do.

There are, of course, the automatic stabilizers are very important. I mean, they are very important. So that when we go into a downturn, tax revenues fall and things like unemployment insurance rise, and they help stabilize this economy. But given the situation we were in, which I liken in my testimony to being in a foxhole with the shells crashing around us, we really needed additional help; and the fiscal stimulus provided that.

Now, one can argue about this. I don't think it is rocket science that if an economy is suffering because aggregate demand is weak, consumers aren't spending, the housing market is collapsing, businesses aren't investing, you need to find some way to keep demand going, to keep jobs, to keep people employed. In a full employment economy, it is a different story. And I would point out that when I was chairman of the Council of Economic Advisers, we had a balanced budget in both of the years that I was chair.

So I am a believer in balanced budgets, and I am a believer in keeping Federal spending under control, but, in this situation, this was the medicine we needed, and I think it was delivered, and it does seem to have worked.

Let's look at a comparison of where we were in the spring of 2009.

It was just so dangerous. GDP was falling. We were losing 700,000 jobs a month. The financial sector was on the verge of collapse. Now, even by late 2009, the whole economic situation looks so much better. We have economic growth. We are beginning to get job growth. It is much too slow and much too hesitant, but it is beginning to happen. So it is just really a night-and-day comparison.

Again, not to say everything is great. Everything is not great. Not to say we won't have stumbles along the way. As Alan Greenspan I think said yesterday, in a normal recovery—and this is maybe not quite a normal recovery—you are going to get periods of slower growth. You are going to get hesitations. And when you get something like the aftershock in Europe, that is particularly true. So it is not a surprise that we are getting some weakness now.

You know, the month before, the numbers look good. The last month, the numbers have looked not so good. That is the way it is going to go during the course of a normal recovery.

I think Mark is going to talk—and he is one of the best modelers around—of what his model shows about the effect of stimulus. But I think one probably needs to go even beyond those models. When you get really a crisis situation, then the TARP and the stimulus spending become much more important.

Now, what about going forward, to which Chairman Spratt referred? What do we need to do going forward?

I guess my own view is sort of hold the course steady. I am still optimistic that we will get something like 3 percent to 4 percent growth this year. I don't think that is a certainty, but I am hopeful that we will get that.

What has happened in Europe has given us problems here. It is one of the main reasons the stock market has been weak just lately, and there is this sort of effect. It affects our trade, but it also affects confidence and business confidence. Quite large corporations are heavily involved in Europe, so some of their profits, some of their investment is derived from those markets. So, inevitably, that is having an effect on the U.S.

Now, in the G-20 meeting, the President, President Obama, said to the Europeans purportedly that they need to keep their stimulus going. And they said, no, they weren't going to do that. Was that right or not? I think they are sort of damned if they do and damned if they don't, if you excuse my language. It was a situation where their own economies really would call for more stimulus, that they need that, because they are not growing rapidly. Even Germany, let's say, which is in good budget position and their exports are growing, but even its overall economy is not growing. Certainly the others are not.

So from that point of view, it would be a good idea to keep the stimulus going. But given the crisis they have on their financing and with the Euro, I think they probably are making a wise decision to not try to put in additional stimulus.

Now, what I hope they don't do is try to contract or do fiscal consolidation too quickly. They do need to do fiscal consolidation, just as we do here in the United States, but I think they should do it slowly and not shoot themselves in the foot. If they push themselves back into another deep recession, it will affect not only us, but it will give them bigger deficits. Because, of course, declining tax revenues during a recession are a big reason why we have had deficits and why they have had deficits.

In terms of the U.S., we are in a somewhat similar situation. We really have to weigh off those two forces: Can we afford to borrow any more or can we afford not to, so to speak, in order to keep the economic stimulus going? And I think those things are quite evenly balanced at this point. Again, I would probably like to see some additional stimulus, except for the fact that we have this constraint.

As Larry Summers said back in the Clinton administration, one of the advantages of running a budget surplus is that you reload the fiscal canon. That means you can use fiscal policy without being concerned that you are borrowing too much or going to drive up interest rates or create a financial crisis. We are not in that situation now. Because we have had deficits for so many years, we are now somewhat vulnerable. I don't think we are Greece, because the U.S. is a much bigger and much stronger economy and our interest rates right now are very low, but we don't want to push the envelope there.

So I have supported the extension of unemployment insurance. I think that is a good thing to do. And I think some additional help to the States is called for, but I would not institute, in my judgment, another major fiscal stimulus because of the borrowing constraints. If we end up, towards the end of this year, going back into a second dip recession, then I would reevaluate that depending on where financial markets stood.

Thank you for the opportunity.

[The prepared statement of Martin Baily follows:]

PREPARED STATEMENT OF MARTIN NEIL BAILY, SENIOR FELLOW, BERNARD L. SCHWARTZ CHAIR, THE BROOKINGS INSTITUTION

Chairman Pratt, Ranking Member Ryan and members of the Committee, it is a privilege to testify to this committee on the economy.

KEY POINTS IN THIS TESTIMONY

There were early signs of financial crisis even in 2006 and early 2007, and then financial markets seized up in the summer of 2007. Initially, the decline in GDP and jobs was mild, but the economy fell like a stone in the last quarter of 2008 and the first quarter of 2009. The situation in the spring of 2009 was extremely dire with the risk of continuing deep declines and collapse of the financial sector.

There were many contributors to this crisis, market failures, regulatory failures and policy failures. Regardless, given the severity of the recession and the financial turmoil and the global reach of both elements, no policies could have restored full employment quickly or healed the problems in the financial sector rapidly. Financial crises and the ensuing recessions result in prolonged losses.

The Treasury and the Federal Reserve were slow to react to the financial crisis, but once its enormity became clear they moved aggressively to fight it. Secretary Geithner was part of the team at the Federal Reserve dealing with the crisis from the outset and he provided continuity as the Obama team took over. The TARP was essential to restoring the financial sector and the FDIC played a vital role in resolving small and medium-sized banks. The stress tests in the spring of 2009 were a turning point in financial recovery in large part because the Treasury was able to promise bank capital if the private sector could not provide it.

The fiscal stimulus had to be deployed quickly and the money had to reach households and businesses as soon as possible. The states were facing large budget deficits that would trigger sharp cutbacks unless federal funds could provide emergency relief. The stimulus package was messy, but it did what it was supposed to do as evidenced by the recovery of growth in the fall of 2009.

The fact that GDP growth was solid by the end of 2009 and that employment started to grow in 2010 is a miracle, given how bad the situation became.

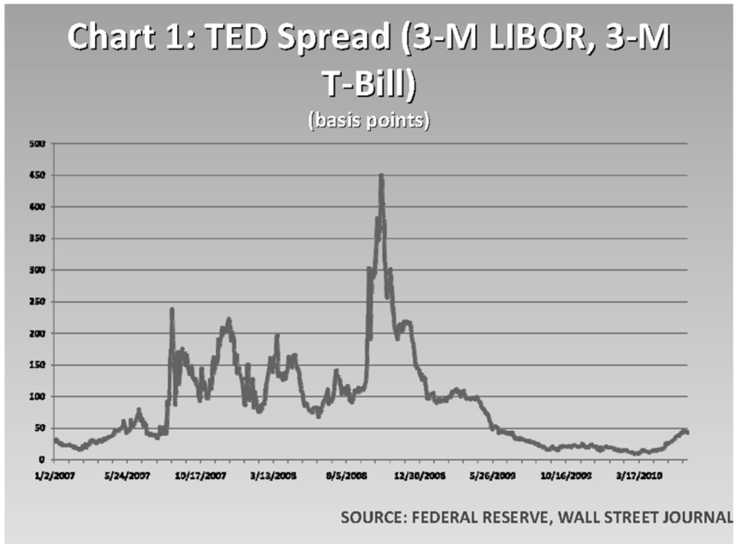
Despite the gains achieved, the jobs picture remains extremely bleak and the problems in Europe could result in a double dip recession here at home. Our ability to respond is weakened by the fact that there were federal budget deficits every year from 2002 on, and because the deficit ballooned in this crisis.

The European crisis has forced some countries to curtail their stimulus packages and move towards fiscal consolidation. With the backing of the IMF, they are making a virtue of necessity and arguing that fiscal discipline will encourage growth even in the short run. I agree they should start down a well-marked path to lower deficits, but they should avoid acting too quickly. An aborted economic recovery will result in even worse budget deficits.

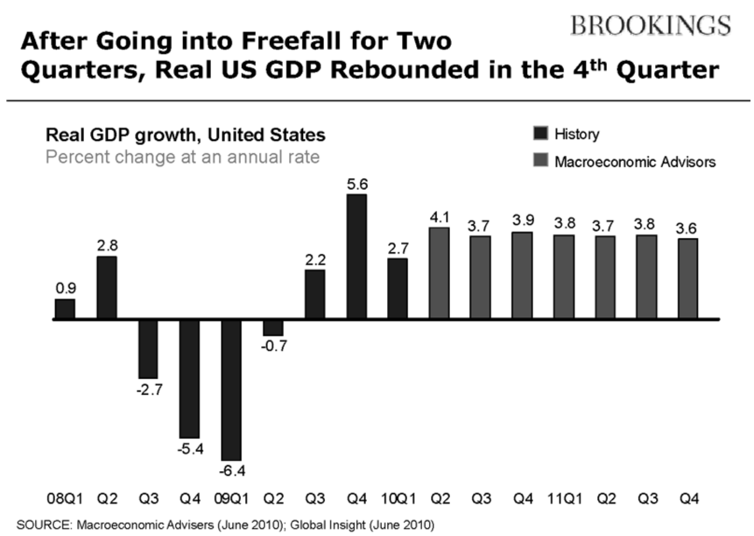
The US situation is somewhat similar in that we also need to weigh the need for stronger demand growth against the limits on Treasury borrowing. The US economy is less constrained and markets are not flashing warnings about Treasury borrowing, given that interest rates are at historic lows. That could change, however, and we do not want to get too close to the edge of the cliff. If the economic recovery peters out, I would support a further fiscal stimulus, but only if accompanied by a clear and credible path towards lower deficits in the out years.

Where We Were There were signs in 2006 and early 2007 that financial markets, particularly housing and mortgage-backed securities markets, were troubled. With the benefit of hindsight, we can see that the decline in median home prices that started in 2006, the collapse of 25 subprime lenders in early 2007 and the collapse of two Bear Stearns hedge funds in July 2007 were early-warning signs of much worse trouble to come. The financial crisis hit front and center in August of 2007 when wholesale lending markets seized up, making it difficult or impossible for some financial institutions to roll over their short term borrowing. Chart 1 shows the “Ted Spread” the difference between the LIBOR interest rate and the 3-month Treasury bill interest rate, an indication of the willingness of financial institutions to lend to each other. It spiked up in 2007 as the crisis hit and then went through the roof in 2008 in the turmoil following the collapse of Lehman.

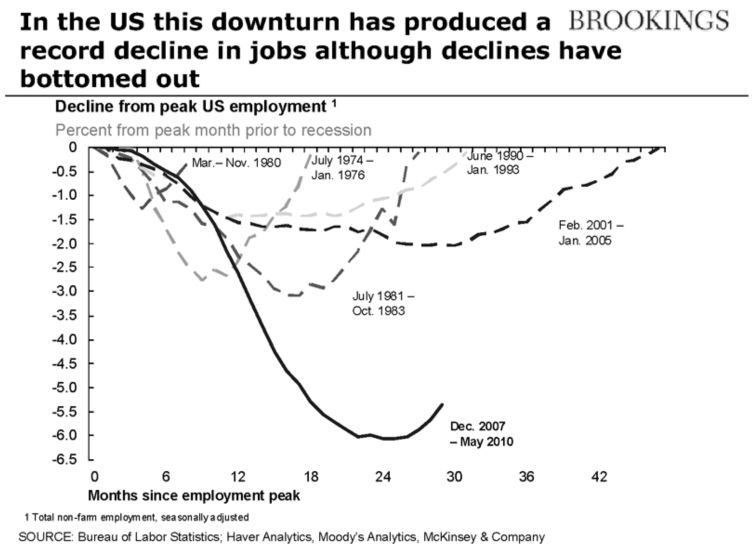
The financial crisis worsened through 2008 and into 2009 as both large and small banks failed or were propped up. Wall Street was reeling but so were a lot of regional and local institutions. Many FDIC insured banks have failed and the number of banks currently considered to be problem banks reached 775 by the end of the first quarter 2010. These banks collectively hold $431 billion of assets, so the difficulties facing the banking sector are not over yet.



At first, it seemed as if the financial crisis would cause only modest collateral damage to the Main Street economy of jobs and production. Real GDP grew at 3.6 percent in the third quarter of 2007 and 2.1 percent in the fourth quarter. Even the first half of 2008 was not too bad with a small decline in GDP in the first quarter and a modest increase in the second. By the second half of 2008, however, the economy went into freefall, particularly in the fourth quarter when GDP declined by 5.4 percent, followed by a 6.4 percent annual rate of decline in the first quarter of 2009. Chart 2 shows this pattern.



Employment in this recession has been horrendous. Payroll employment started to decline by the end of 2007 and the freefall of GDP that occurred in the second half of 2008 was matched and then some in the labor market with monthly employment declines of around 700,000. As Chart 3 shows, the loss of employment in this recession dwarfs anything in prior recessions in the postwar period. The business community became very scared by the speed and depth of the recession and moved very aggressively to cut costs in whatever ways they could find. Nonfarm payroll employment declined by 8.4 million jobs between December 2007 and December 2010.



The stock market directly affects households through their wealth holdings and affects the pension retirement accounts held by individuals and by companies. In addition, the stock market acts as a sign of confidence for everyone. If the stock market is plunging, families become reluctant to spend even if they do not have a significant stake in the market themselves. Chart 4 shows the movement of the S&P 500 index over the period 2001 to early 2010. After rising into the 1,500 to 1,600 range in 2007 it plunged over the next several months, dropping below 700 before recovering partially. Families that were counting on a comfortable retirement realized they lacked the necessary resources and would either have to keep working or adjust to a much reduced lifestyle.

WHERE WE ARE NOW

The good news is as follows:

- After its frightening freefall in late 2008 and early 2009, the economy slowed its rate of decline in the second quarter of 2009 and resumed growth in the third quarter, averaging a solid 3.6 percent through the first quarter of 2010. A mainstream forecaster suggests growth of 3-4 percent for the next year or two. This is a remarkable turnaround with the pattern also shown in Chart 2.
- The labor market has stabilized, with unemployment having peaked at 10.1 percent in October 2009 and now declining slowly to 9.7 percent in May. Payroll employment is rising, at a rate of about 200,000 a month for total payroll [1] and about 100,000 for private nonfarm employment for 2010 through May.
- The stock market has partially recovered from its swoon and is up substantially since March of 2009. Arguably, the high that it reached at its peak was above its sustainable level and it is now at an appropriate level in relation to earnings. I do not try to forecast stock price movements, but if the economy continues to recover, there is upside potential in the market.
- According to the S&P Case-Shiller home price index for April, the large drop in home prices has ameliorated with the index up modestly over the prior year.

The bad news is also evident:

- The unemployment rate is close to 10 percent while full employment is thought to be around 5 percent. This means that American output and incomes are about 10 percent below their potential.[2]
- If employment growth continues at the rate of 200,000 a month it will take around seven years to get back to full employment.[3]
- Household wealth, including financial assets and housing wealth, is $11.7 trillion below its peak as of the end of 2009 and this decline has erased all of the wealth gains accumulated since the early 1990s.[4]
- The federal budget deficit was over $1.4 trillion in 2009 and is forecast to be over a trillion dollars a year through 2019 unless there are major policy changes.
- Growth at 3-4 percent is below the usual level achieved in an economic recovery from a deep recession and there is a danger of a second dip recession.

Without in any way discounting the economic challenge that remains, I will make the case in this testimony that the big policy measures taken to turn the economy

[1] Total payroll employment received a temporary boost from Census hiring that will not persist.

[2] Based on a standard "Okun's Law" calculation that each percentage point decline in unemployment is associated with 2 percentage points of GDP relative to its trend or potential.

[3] Calculation made by Ezra Greenberg of McKinsey & Company.

[4] Calculations by the McKinsey Global Institute based on Federal Reserve Data.

around have worked extraordinarily well, indeed much better than could have been expected. Around the Ides of March of 2009 the economic situation was truly frightening. Workers had been laid off at a rate of 700,000 a month for several months, GDP was plummeting, the housing market was collapsing, and the stock market was hitting lows not seen for 15 years. At that time, I would have reacted with disbelief to anyone who had predicted that by the fall of 2009 there would be solid economic growth; that the stock market would have rebounded; and that employment would start growing by 2010. The natural resilience of the American economy has, of course, helped this ongoing recovery, but it would not have been possible without the massive policy interventions undertaken by Congress and two Administrations. There were plenty of mistakes made in the period leading up to the crisis, some of them very serious. And mistakes were made in dealing with the crisis, some of them also serious. But the simple fact is that in the end the treatment worked and the economy is recovering.

I read op-eds and hear commentary to the effect: Hey, it has been 18 months since Obama took office, so how come the economy has not recovered? He should quit blaming Bush for his problems. Such statements make no sense in terms of economic logic and represent political posturing. There were many causes of this crisis and plenty of blame to go around. Yes, the policies of the Bush Administration bear responsibility because they were based on the belief that financial markets did not need to be regulated. Federal housing policies pushed by both political parties, but especially by Democrats, contributed to the problem by encouraging over borrowing and too much home building. But, regardless of the causes of the crisis, this was a terrible global meltdown and recession and could not possibly have been reversed quickly. Former McCain advisor and Harvard economist Kenneth Rogoff has shown in his empirical studies with Carmen Reinhardt that economies always take a long time to recover from financial crises. Aftershocks of the global crisis, like the sovereign debt crisis in Europe, have slowed the pace of U.S. recovery and could threaten a double dip despite the progress to date. There are limits to the power of policymakers to affect economic outcomes. The policies that were followed have done what was expected of them; actually, they have worked much better than could have been expected—except for the fact that private employment gains are still very slow indeed.

POLICIES USED TO RESTORE THE FINANCIAL SECTOR

The financial crisis was threatening to pull the U.S. and global economies into recession or even depression when the Bush Administration and Secretary Paulson asked for a fund of $700 billion—the TARP—to stabilize the financial sector. The Emergency Economic Stabilization Act, signed in October 2008, authorized the Department of Treasury to spend up to this amount to purchase or insure troubled assets, but with broad discretionary authority. The Treasury's stated diagnosis of the financial crisis was that distressed mortgage-related assets had become impossible to trade and value because of the breakdown of normal market relationships. The TARP was to be used to facilitate the return of private valuation of these assets, including the use of reverse auctions. Treasury was willing to buy distressed mortgage-related assets on the open market in order to get this process started. As the crisis unfolded, it became clear that financial markets were too troubled and many of the assets were so bad that they simply had to be written down in the books of banks and other financial institutions. The proposed reverse auctions never got off the ground.

Consequently, the TARP's manner of intervention had to change. Under the Capital Purchase Program (CPP), one component of the TARP, money was used to stabilize and reinforce the core capital reserves of banks, primarily through the purchase of preferred shares. In October 2008, immediately after Congress created the program, the CPP bought $125 billion of preferred shares from nine of the nation's largest banks. Hundreds of other banks applied and were accepted into the program in the following weeks. Ultimately, the TARP would purchase $205 billion in preferred shares from 707 financial institutions. It is important to note that the TARP was not simply used as a transfer to failing institutions. Even healthy banks were forced to accept money in an attempt to mask government opinions about which banks were healthier than others.

Beyond the CPP, more extraordinary intervention was provided for critical and interconnected institutions. AIG received $40 billion from the purchase of preferred shares, money that was used, in part, to restructure two Federal Reserve credit lines that totaled $123 billion. The TARP also extended AIG a $30 billion preferred line of credit. Citigroup and Bank of America each received an additional $20 billion capital infusion on top of the $25 billion committed to each bank from the CPP.

Another problem is that "runs on banks" began to occur. Historically, a bank run occurred when retail depositors feared that their money in deposit accounts was not safe and they rushed to withdraw it before the bank went under. During the Great Depression, deposit insurance and the FDIC were created, and these policy changes have virtually eliminated the problem of retail bank runs in the United States. However, FDIC bank guarantees do not cover non-bank financial institutions, such as investment banks, which comprise the so-called shadow banking system. These institutions have grown increasingly important during the last decade, and in the lead up to the financial crisis they were engaged in a massive game of borrowing short and lending long. Given the lack of insurance as well as the generally opaque nature of their operations, brokers trading in derivatives and other securities were vulnerable to runs as their clients rushed to withdraw the funds they had deposited with them or avoided entering into new derivative or repo contracts. Bear Stearns went under as a result of this, followed by Lehman and then AIG.[5] It turned out that money market mutual funds were holding large amounts of repo contracts as part of their asset portfolios and as they feared losses on these contracts, they, too, pulled them out of troubled companies like Lehman and faced losses. One such fund threatened to impose losses on retail depositors that had accounts with them (break the buck) and this caused a run on money market mutual funds.

The Federal Reserve acted forcefully to contain the spreading damage, providing guarantees for depositors in money market funds (deposit insurance for these non-bank depositors) and guaranteeing interbank lending in order to stop the payments system worldwide from freezing up. Even with these measures there were disruptions as global trade plunged when importers and exporters were unable to obtain funding.

One of the biggest turning points of the financial crisis was the Supervisory Capital Assessment Program (SCAP), informally known as the "bank stress tests." This was a comprehensive, simultaneous assessment of the capital held by the banking groups of the 19 largest U.S. bank holding companies which collectively accounted for two-thirds of all deposits. Conducted by the Federal Reserve and bank supervisors, the effort was meant to determine if these groups had sufficient capital to withstand two macroeconomic scenarios, one with baseline conditions and the other a more pessimistic take on the economy in which the jobless rate would climb to 10.3 percent. The results were to be made public so the skeletons were going to be brought out of the closet.

Taken overall, the stress tests revealed that the banking industry was not as troubled as many had feared. Among the 19 surveyed, 9 were deemed to have sufficient capital already. The other 10 were told to raise a combined $75 billion in equity. The day after results were published, Wells Fargo and Morgan Stanley raised $7.5 billion and $8 billion, respectively. Goldman Sachs had raised $5 billion before the results were even released (though the report said they did not need any). Of the 19 banking groups that underwent stress tests, all but one were able to raise sufficient capital from issuing stock, selling business units, and strong earnings. GMAC, the troubled lending arm of General Motors, was said to need $11.5 billion, the most of any banking group as a percentage of assets—much of this money would come from the TARP in two subsequent rounds of funding. In the worst case scenario, the stress test report predicted losses by the 19 banks could total $600 billion. Nevertheless, the stock market reacted positively after the results were announced, with the S&P 500 climbing 2.4 percent that Friday. Soon afterwards, the strongest banks were able to begin repayment of their TARP funds.

The TARP and SCAP programs worked. The vast majority of banks receiving the TARP funding remained open,[6] and the large banks returned this funding more quickly than could have been expected from their problems, becoming much more stable and earning profits. As well as the capital injections, the low interest rate environment allowed them to make profits on the lending they made and their trading businesses were also profitable.

Various other programs, unrelated to toxic assets, were housed in the TARP, given its broad mandate and the difficulty of earning new allocations from Congress. Hence the TARP was involved with the auto industry, mortgage modification, and providing capital to institutions that serve underrepresented communities.[7] The

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[5] AIG, of course was an insurance company not a broker dealer but it had developed a huge book of Credit Default Swaps through its operations in London.

[6] Three banks that received TARP money have failed: Midwest Bank and Trust Company, Pacific Coast National Bank, and United Commercial Bank. A fourth, CIT Group Inc., filed for bankruptcy. The expected loss from these 4 institutions is $2.7 billion, $2.3 billion from CIT Group Inc. alone.

[7] Through the Community Development Capital Initiative.

automotive industry—including GM, Chrysler, and two of their financing arms[8]—has collectively received $64 billion, which is now held as a mixture of debt, equity, and preferred shares. The jury is still out on the sustainability of GM and Chrysler, but so far so good. They are both making a comeback and their survival prevented what would have been even more massive job losses.

Wall Street has taken the bulk of the criticism in this crisis, but actually the financial system more broadly contributed to the crisis and many smaller and regional banks remain troubled. Many of the bad mortgage loans were originated by state regulated non-bank institutions and many insured small banks have been troubled. The TARP funds were used to help smaller institutions as well as larger ones but nevertheless several hundred FDIC banks have been placed into receivership and, as noted earlier, 775 are currently problem banks. The chart below shows FDIC bank failures over time.

Chart 5: The Number of Bank Failures Shot Up And Is Still High

Bank Failures		
Year	**Number**	**Notes**
2010	83	(through June 24)
2009	140	
2008	25	
2007	3	
2006	0	
2005	0	

The FDIC has been faced with enormous challenges in this crisis and, under the leadership of Sheila Bair, has shown skill in resolving failing institutions. Not everything has gone right, and the FDIC programs have been pretty expensive (the costs will be borne by member banks in the form of higher deposit insurance premiums not directly by taxpayers). The FDIC programs to reduce foreclosures and keep people in houses have not been very successful—although no plan has proven good at that. Despite these issues, our economy is much, much better off today for having the FDIC on the watch and ready to deal with failing banks. It is hard to think how bad the situation would have become without the FDIC to step in and resolve failing banks.

Costs of the TARP: According to a March 2010 CBO report, the CPP part of the TARP should earn $2 billion in profit. Net income from investments in Citigroup and Bank of America will total $5 billion. That said, total returns will still be negative, largely because of anticipated losses from the automotive industry ($34 billion), AIG ($36 billion), and a home loan modification program ($22 billion). The total cost of the TARP program should be roughly $100 billion net, much smaller than February 2009 forecasts of more than $500 billion. At less than 1 percent of GDP, that cost is well below historical averages of 13 percent of GDP, according to IMF numbers. As Ben Bernanke, chairman of the Federal Reserve, said, "This is a pretty good return on investment."

In summary, the policies to restore the financial sector are working. The recovery of the sector is not complete but the period of extreme anxiety is over and banks are positioned to lend more as recovery takes hold. This was done with costs that are large but not disproportionate to the problems being faced.

FISCAL POLICY USED TO COMBAT THE RECESSION

At the end of the Clinton Administration, the federal budget was in substantial surplus and one of the many advantages of this was that we had "reloaded the fiscal cannon," in the words of then Treasury Secretary Lawrence Summers. This meant that in the event of a serious recession in the future, expansionary fiscal policy could be used to mitigate the unemployment and lost output that would result. The Bush Administration decided that the surpluses should be used to finance very large tax cuts and the result has been chronic federal budget deficits from 2001 through the present. I was not opposed to tax cuts as a way of returning families' incomes back to them and easing the tax burden, but the size of the cuts was excessive. It

[8] GMAC and Chrysler Financial.

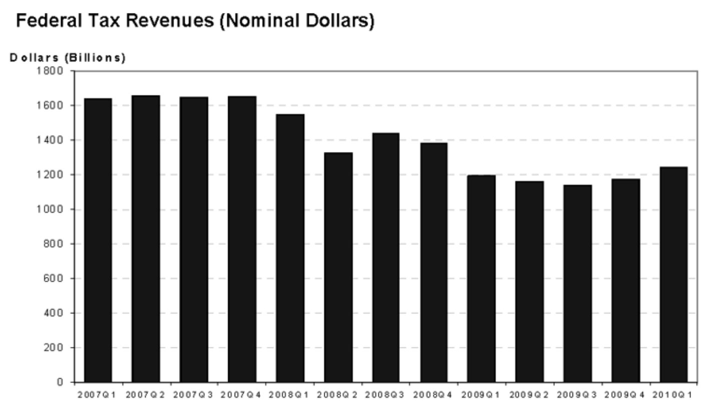
is irresponsible for the United States to run chronic deficits and become reliant on foreign capital inflows to finance our domestic investment. Moreover, it meant that we entered the crisis in 2007 in a vulnerable fiscal condition. The fiscal cannon was short on powder.

Recessions always cause deficits because tax revenues fall, and the severe recession of the past three years is no exception. Much of the deficit of $1.4 trillion in 2009 was the result of the loss of tax revenue that followed the economic decline. The chart below shows that federal revenues declined $515 billion or 31 percent from their peak to the trough.

Some expenditures rise automatically in recessions, notably unemployment insurance benefits, and these also add to deficits. It is important to note that these "automatic stabilizers" are vital to the maintenance of economic stability. Without any action by Congress, tax revenues fall and some types of spending rise, cushioning households and businesses from the downturn. Historically, these stabilizers have formed the frontline defense against more severe recessions and it is important that their effect not be offset by ill-timed actions to reduce the deficit—Herbert Hoover economics. As in other things in life, timing is everything. Chronic deficits are bad, in fact the budget should be balanced or even a little in surplus on average. But at times of recession deficits are a necessary evil.

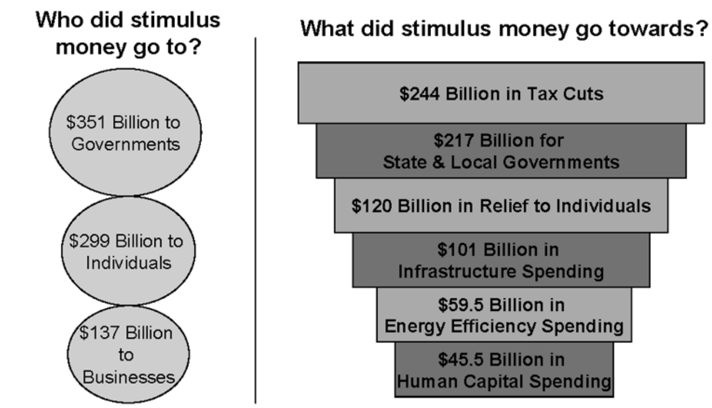
In an effort to hold off the recession, the Bush Administration had proposed and Congress had passed a stimulus package in 2007, mostly consisting of temporary tax cuts. I supported this policy, but it clearly did not solve a problem that was much bigger than we knew. During the transition, President Obama and his team proposed a much larger stimulus package of $787 billion, which was enacted in early 2009 and the chart below shows a breakdown of this spending by creditloan.com on the basis of who got the money and what was it used for.

Chart 6: Federal Tax Receipts Drop by $515 billion between 2007 Q2 and 2009 Q3, a 31 Percent Decline.



SOURCE: BEA

Chart 7: Where Did the Stimulus Money Go?



SOURCE: creditloan.com

As you can see from the left side of the chart, the largest portion of the stimulus went to governments—federal agencies, state and local governments. As you know, states and localities are almost all in terrible trouble financially and are making cuts in spending. In the long run it is a good thing that our state and local governments are forced to operate with balanced budget constraints. But in a recession like the one we are going through, cuts in such spending contribute to the recession. In my judgment, it was a good choice to support states and localities. The spending on infrastructure and energy efficiency was a mixed bag and not part of a coherent national strategy to deal with energy or infrastructure problems. Understandably, perhaps, it was decided to act quickly and avoid political or implementation delays as far as possible. Judging by the District of Columbia, the infrastructure spending is being used to dig up every road on my commute home, but this does create jobs and hopefully is to good effect in the longer run.

Nearly $300 billion or 38 percent of the total went to individuals, and that may be a surprise to some. This money was received either in the form of lower taxes or in higher support payments but, either way, it was money in the pockets of American families that could be used to help them through the crisis and add to their consumption. About 17 percent of the total was used for businesses, not an especially large number.

Overall, the stimulus package was messy, and some of the spending was wasteful. But the context must be kept in mind. A sizeable stimulus had to be passed quickly to protect against an even deeper recession and there were 535 cooks stirring the pot. The stimulus package did add to aggregate demand and reduced the size of the recession.

Predictions about the Effectiveness of the Stimulus. President Obama asked his economic team—specifically Christina Romer, now CEA Chair, and Jared Bernstein, of the Vice President's staff—to prepare an estimate of the impact of his proposed stimulus package. They predicted that the package would generate 3.3 to 4.1 million additional jobs in 2010 and add 3.7 percent to GDP growth, compared to the counterfactual of no stimulus. Their forecasts have been criticized because employment was terrible in 2009 and GDP fell sharply in the first half of that year, but that is a misunderstanding of what they did. They looked at the incremental effect of the policy, relative to the no-policy alternative. I note also that their forecasts about the impact of the stimulus on GDP look reasonable in light of the second half of 2009 and early 2010.

A financial crisis and recession like the one we are in represents a discontinuity in our economic path. Econometricians are very skilled at sorting out the historical patterns of economic data and using them to say what is the most likely future given past experience. This crisis is not anything like any recent history and has produced very severe economic stresses. The employment declines in the United States in this recession have been much larger than would have been predicted given the path of GDP and much larger than in European countries with similar GDP declines. The stimulus package did not preserve as many jobs as Romer and

Bernstein had hoped, but that is because the old employment patterns broke down, which is not something they could have predicted. Productivity also soared in 2009, a very unusual occurrence in a deep recession.[9]

I do not support frequent use of active fiscal policy to respond to the business cycle ups and downs, but in 2008 and 2009 we were stuck in a foxhole with the shells landing all around and it was a good time to call for reinforcements. The stimulus package provided that much-needed help.

TODAY'S GROWTH AND DEFICIT CHALLENGE

In the recent G-20 meetings reportedly there was tension between the United States and Europe over continued fiscal stimulus. Understandably, President Obama is worried about the sluggish global recovery and wants to sustain fiscal stimulus. European countries argue that the fiscal crisis is too severe to allow continued stimulus and there must be a clear path to fiscal consolidation. The IMF officials at the meeting supported this view. The argument is that these countries do not have the freedom to pursue expansionary fiscal policies. The debt and deficit problems in Greece and the dangers in Spain, Portugal, Italy, Ireland and the UK are enough to reduce the range of policy choices.

Standard economic policy analysis indicates that increases in government spending or cuts in taxes will stimulate aggregate demand and hence economic growth in times of recession. I applied this logic to the U.S. stimulus package in claiming that it helped sustain demand during the downturn. Another example is China, which introduced a large stimulus package when the global downturn hit to offset the decline in their exports. This program has been judged successful and economic growth in China has been sustained. Does this economic logic break down when there is a threat of sovereign debt default and a fear of the financial turmoil that would result from this? Some policymakers in Europe even argue that fiscal consolidation will provide such great reassurance to markets and will so increase business and consumer confidence that the overall effect will be expansionary.

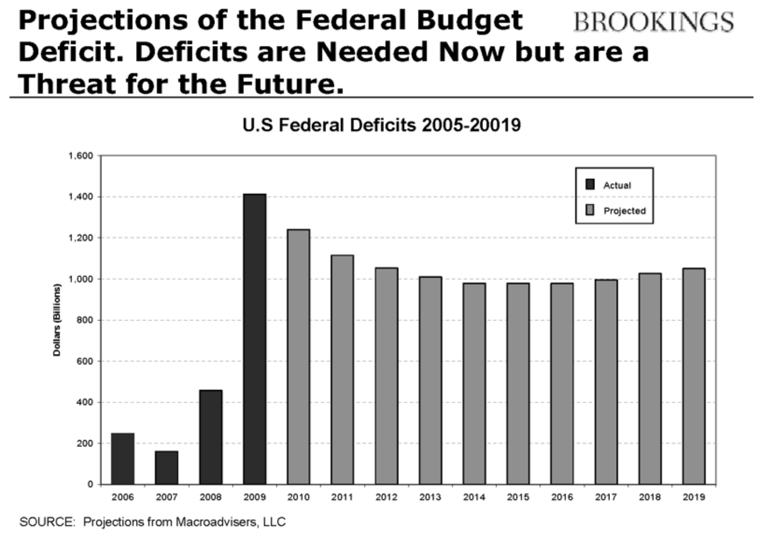
I am not willing to stand the usual economic logic completely on its head. Fiscal consolidation in Europe will have a direct effect in taking money out of people's pockets and cutting jobs and this will reduce demand and economic growth as a first-round effect. Nevertheless, I am sympathetic to a more moderate version of the European argument because the fears of renewed financial turmoil are real and potentially damaging to economic recovery and this must condition policy decisions. My advice to Europe would be to move as slowly as they can towards fiscal consolidation. If they act too quickly, they will shoot themselves in the foot and end up with a deeper recession and even bigger deficits. But they do have to be mindful of the limits they face on sovereign borrowing. They should take moderate but meaningful steps towards smaller budget deficits now and put in place policies that will continue progress towards budget balance as their economies recover from recession. Keep in mind also that European economies generally have much more extensive safety nets than does the United States. These social programs have created problems for them in terms of incentives, but they do have the advantage of providing strong automatic stabilizers to the economy because consumption is protected in downturns.

To what extent is the United States in the same position? The chart below shows a private forecast of likely federal deficits in the United States in the absence of any major policies to change the picture. This is a very scary picture. A trillion dollars a year is a lot of money to be borrowing. The U.S. Treasury does have some advantages, however, relative to Europe because of the size of our economy and the depth of the financial markets. And even though the projected deficits look large, the prospects for U.S. growth are pretty good and there are ways the deficit could be reduced if we only chose to follow them. Today, the yield on 10-year Treasuries is under three percent, so the market is saying that there is no problem so far in the ability of the Treasury to borrow, indeed these rates are among the lowest in history.

Treasury rates are low now because lending to the US government looks good relative to global alternatives but market views could change over the next few years and perhaps even sooner. If Treasury interest rates rise significantly, this will crowd out private investment or even trigger another crisis if the dollar were to drop precipitously. No one knows if or when the U.S. Treasury might have its Greece mo-

[9] GDP is measured with considerable uncertainty, especially data from recent quarters. There is an alternative way of getting at the same concept through total income, Gross Domestic Income or GDI. Based on the income side of the National Accounts, the recession has been much deeper than is implied by the GDP data. One explanation of the huge loss of jobs is that the fall in income and output have been understated by the available GDP statistics.

ment. Surely, this will not happen over the next year or two, but quite possibly it could happen over the next five years. And it would be foolish to push the envelope and let a disaster happen.



Given the reality of huge deficits, I do not support major fiscal expansion measures right now that would increase the deficit. I did support a continued extension of unemployment benefits and modest additional help to the states, measures that would not have significantly worsened the deficit. If the U.S. economy were to slip back into second dip recession later this year or next year, then my view would change and I would consider it necessary to provide another fiscal stimulus to the economy despite the risks to Treasury funding. Ideally, the Administration and Congress would agree soon on meaningful policies to reduce the budget deficit in out years (for example, a measure that put federal health care spending on a balanced-budget basis over a multiyear period). This would create confidence in global markets and would allow for further stimulus this year or next, if that were to prove necessary, but it would not take purchasing power out of the economy today.

CONCLUSIONS

You do not expect the bear to dance well; it is a miracle if it dances at all. The policies that restored the financial sector and helped turn around this very deep recession were not pretty but they were the right policies and they helped save the U.S. economy and indeed the global economy. The high unemployment, fluctuating stock market, struggling housing market and sluggish recovery that unfortunately are still with us are making the Administration and many other policymakers unpopular. It is too bad that the electorate does not give credit for the turnaround that has happened. It should.

Chairman SPRATT. Thank you.

Dr. ZANDI

STATEMENT OF MARK ZANDI

Mr. ZANDI. Thank you, Chairman Spratt, Congressman Ryan, and the rest of the committee, for the opportunity to be here today.

These are my own views and not those of the Moody's Corporation. I will make four points in my remarks.

Point number one. The recession, the great recession has given way to an economic recovery, and it is largely due to the policy response.

The recession ended almost precisely a year ago. GDP growth over the past year has been approximately 3 percent year over year, and we have begun to see job growth since the beginning of 2010. Subtracting from the Census hiring, the temporary Census hiring and the loss of the Census jobs that are coming, we have seen average monthly private-sector job growth of about 100,000 since the beginning of the year, and that is what I would expect to see for the month of June when we get that data point on Friday, which is an important point. The unemployment rate has stabilized as a result, obviously very high, close to 10 percent, but it has stabilized at that level since this time last year.

The recovery is broadening out. It began in manufacturing. It is now evident in distribution and transportation. We are seeing growth in various technology industries, some professional services, a bit in retailing. I would anticipate leisure, hospitality, financial services starting to hire more aggressively as we make our way through the year.

The recovery is also broadening out across the country. If you look at the Nation's almost 400 metropolitan areas, two-thirds of them, roughly speaking, are now in a recovery. Just for context, if you go back to the depth of the recession in late 2008, early 2009, only 10 percent of the Nation's metropolitan areas were expanding. So that is a significant improvement.

The policy response has been key to this turnaround. I think we all can take exception to any individual aspect of the response. Some folks don't like the bank bailout, others the auto bailout, the housing tax credit, cash for clunkers. There were many, numerous policy efforts. Each of us probably didn't like some aspect of the response.

But the totality of the response I think was unprecedented and aggressive and ultimately very successful. I don't think we would be experiencing a recovery at this point without those efforts; and that includes everything from what the Federal Reserve has done in providing liquidity to the financial system and shoring up the banking system, to what the FDIC has done with respect to insurance limits and guaranteeing bank debt temporarily, to what the Treasury has done with respect to the bank's stress testing process, to—as importantly or more importantly—what Congress has done with respect to all the elements of the TARP and fiscal stimulus.

In my view, the fiscal stimulus was absolutely vital to jump-starting this economy. It is no accident that this recovery began at precisely the same time that the stimulus was providing its maximum economic benefit to the economy. So, point number one, we are now in recovery, and it is because of the policy effort.

Point number two, the recovery is still fragile. The economic expansion is not in full swing. We are not off and running yet. There are a number of reasons for concern. Let me list a few.

First, going back to the job market. Most of the improvement in the job market is related to an end of businesses laying off workers. We are not seeing any appreciable pickup in hiring. Some modest pickup in the last couple 3 months, but it is very modest.

I think there are a couple impediments to hiring. One is a lack of credit, particularly to small businesses.

Here is a statistic that is important: Establishments that employ fewer than 100 employees—let's call it a small business—employ half of all the workers in our country, and they accounted for nearly two-thirds of the net job creation in the last economic expansion. If small business isn't hiring and if they are not hiring because of credit, we have got a problem. So that is an impediment.

The other issue is confidence. It was only a year ago that many businesses were suffering near-death experiences, and I think it is difficult to—as a businessperson and being a small business owner myself, I can attest to the fact that you don't forget something like that quickly.

I also think policy uncertainty is an issue. I do think we are having very significant policy debates that are very important. We need to have them. But it is important to recognize that when you are having them it does create angst among the business community. And that is everything from health care reform to financial regulatory reform to energy policy to immigration policy.

And I would have to say, just based on my experience just talking to business people in my work, they are very nervous about tax policy, that the tax rates are going up at the beginning of next year if there aren't changes, and that needs to be nailed down quickly, I think. That would make a big difference.

A second issue with respect to the recovery is what is going on in State and local government. That is a problem. State and local governments have very large budget holes. Those budget holes are smaller today than they were this time last year, but last year's budget hole was filled largely with the stimulus money. So that forestalled the most Draconian budget-cutting job loss and tax increase.

It didn't forestall those budget cuts. There were very significant cuts. In fact, State and local government employment is down 190,000 jobs from where it was 1 year ago. That is significant. But the job cutting was modest. It was not an overwhelming economic problem. If State and local governments do not get more help, they will have no choice but to significantly cut payrolls, cut other programs, which means a loss of private-sector jobs, and raise taxes at just the wrong time when the economic recovery is fragile. So reason number two for concern is what is going on at State and local governments.

Third, the foreclosure crisis is ongoing. It is not over. There are 4.3 million first-mortgage loans that are in default or headed in that direction, 90 days and over delinquent. For context, there are 49 million first-mortgage loans outstanding. That is a lot of loans. Those loans have been piling up in the foreclosure process because of the various loan mitigation efforts. Servicers, mortgage servicers are now figuring them out. They will begin to start pushing these loans that don't qualify for a modification through the foreclosure process to a sale, either short sale or foreclosure sale.

That will begin hitting the housing market this summer and fall. House prices are going to continue to decline. Nothing really works well in our economy if house prices are falling. It is still the largest asset in most people's balance sheet, and financial institutions aren't going to extend credit if house prices are falling.

Going back to small business. Small businesspeople put up their homes as collateral for loans. Banks aren't going to make a loan if they are unsure of the value of the home underlying that loan.

So point number two, broadly, is that the recovery is still very fragile. We are not off and running yet. We still have work to do.

This goes to point number three, and that is I think it would be premature for policymakers to exit out of their support for the economy too quickly. For the Federal Reserve, that means not raising interest rates. But the Federal Reserve shows no inclination to do that at any time in the near future. With unemployment where it is and unlikely to move lower any time soon, I don't anticipate that.

Unfortunately, the Federal Reserve can't do much more than what it is doing. It could restart credit-easing efforts to try to bring down long-term interest rates, but long-term interest rates are already at record lows and it is not having much of an impact on housing demand and other activities. So I don't think that that would be of measurable help.

So this puts more pressure on you, as fiscal policymakers. And I think it is important—in fact, I would say it is vital—that you continue to provide some additional temporary stimulus to the economy, and I would recommend three things.

First, I would extend emergency unemployment insurance benefits. Two to three hundred thousand folks are running off those rolls every week; 1.3 million are already off the rolls because those benefits have not been extended. This is going to hurt personal income and consumer spending very quickly, because these folks get the money and they spend it.

Moreover, it is very difficult to gauge how this is going to affect consumer confidence, which, as we can see, is incredibly fragile. So I think it is vital to extend UI.

Second, I would provide more help to State and local government. They have a budget hole, by my reckoning, that is close to $100 billion. I think it would be appropriate to fill about a third of that budget hole. That means they still have to go through very significant cutting and restructuring, but it would reduce the impact that would have on our job market in the next few months and on the broader economy in the next few months.

And, third, I would expand out the ability of the Small Business Administration to make more credit available to small business. That was shown to be a very effective part of the fiscal stimulus. That should be renewed and expanded. That is a good mechanism for getting cash out to small businesses quickly.

So, point number three, I think it is very important for policymakers, fiscal policymakers, for you to remain aggressive until the coast is, in fact, clear, until the unemployment rate is definitively moving lower.

Finally, point number four goes to our fiscal situation, which is indeed very serious. And, as such, I think it is entirely appropriate—in fact, it is desirable—that this additional stimulus that I have recommended is paid for not this year, not in 2011, but when the economy is off and running and the unemployment rate is moving south, let's say 2012, 2013, 2014. So I think it should be paid for.

Now, having said that, I don't think paying for it should be a precondition for this stimulus that I have recommended, that it is too important to the economy in the near term to get done. So I would suggest that it is okay, fine, to run a larger budget deficit than otherwise would be the case in the near term to make sure that we do jump-start this economy and we get going here.

Finally, let me say this. I do think once the economy is on a sound footing it is critically important that you do pivot as quickly as possible and address the long-term fiscal situation. I think without those efforts our long-term economic prospects will be significantly diminished.

Thank you.

[The prepared statement of Mark Zandi follows:]

Testimony of Mark Zandi
Chief Economist, Moody's Analytics

Before the House Budget Committee

"Perspectives on the Economy"

July 1, 2010

The economy has made enormous progress since early 2009. A year and half ago the global financial system was on the brink of collapse and the economy was engulfed in the Great Recession, the worst downturn since the Great Depression. Real GDP was plunging at an annual rate of more than 6%, and monthly job losses were averaging close to 750,000. Today, the financial system is operating much more normally, real GDP is advancing at a nearly 3% pace, and monthly job growth—excluding temporary hiring for the 2010 census—is nearly 125,000.

This dramatic turnaround is largely due to the aggressive and unprecedented response of monetary and fiscal policy. The Federal Reserve Board has implemented an effective zero interest rate policy and made a wide range of efforts to support the flow of credit throughout the financial system. The Treasury Department has required the nation's largest bank holding companies to conduct public stress tests. The FDIC has increased deposit insurance limits and guaranteed the issuance of bank debt. Congress and the Bush administration passed the Troubled Asset Relief Program, creating a fund that was ultimately used to support the banking system, the auto industry, and the housing market. And under both the Bush and Obama administrations, Congress passed a series of fiscal stimulus efforts ranging from expanded benefits for unemployed workers to aid for state and local governments to tax cuts for businesses and households. While the effectiveness of any individual aspect of the policy response can be debated, there is no question that the overall policy response has been very successful.

Despite the enormous economic progress, the economy is not yet out of the woods. Unemployment is stuck near double digits, and the current rate of job growth is barely sufficient to forestall further increases in unemployment as population and the labor force grow. Though stock prices have rallied and house prices are more stable, household nest eggs have been significantly diminished. Confidence also remains fragile: Consumers and small businesses feel better than they did a year ago but no better than in the depths of past recessions. The recovery thus remains vulnerable if anything further goes wrong, and there is plenty to be nervous about, including skittish businesses that are reluctant to hire and cannot get credit, the ongoing foreclosure crisis, budget problems plaguing state and local governments, and most recently, the pernicious European debt crisis.

With the recovery so fragile, policymakers must not end support for the economy too quickly. While odds are that the recovery will remain intact and steadily gain traction, if the economy were to backtrack into recession, there would be no effective policy response. The Federal Reserve could restart its credit easing efforts, but it is not clear that any resulting decline in long-term interest rates would provide a meaningful boost to the economy. Fixed mortgage rates are already near record lows, and the housing market is still struggling. A renewed recession would also cause the yawning federal budget deficit to balloon, making it difficult for policymakers to add a further fiscal stimulus without triggering much higher interest rates.

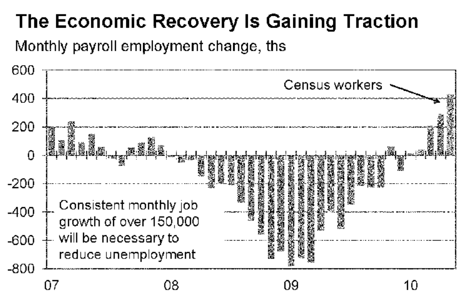
Fortunately, the Federal Reserve is signaling it is likely to hold to its zero interest rate policy at least through the remainder of this year. With nearly double-digit unemployment, low and still-weakening inflation, and low and stable inflation expectations, there is no impetus for raising interest rates any time soon. However, fiscal policymakers appear increasingly unlikely to provide an additional stimulus. Legislation to extend emergency unemployment insurance benefits through the end of this year and provide further financial aid to hard-pressed state and local governments in fiscal 2011 has failed in Congress.

Many lawmakers worry that an additional stimulus will add to the nation's serious fiscal problems. This is a reasonable concern that must be addressed before too long or global investors will balk at buying our debt, as they are now doing with countries in Europe. It would be ideal if Congress funded an additional stimulus through spending offsets or additional taxes—not this year or even next, but when the economy is in full swing. A larger near-term federal deficit is not an economic problem, given the current deleveraging by the private sector and exceptionally low interest rates, particularly if we make up for it with greater fiscal discipline in coming years.

Paying for it, however, should not be a precondition for Congress to provide more financial help to unemployed workers, strapped states and municipalities, and small businesses looking to expand. This stimulus will help ensure the recovery gains traction as expected, a precondition for addressing our long-term fiscal challenges. Odds are that the economy will not fall back into recession even if Congress fails to help further, but the odds of a double dip are still much too high to gamble. Until the economy is expanding solidly, federal policymakers should not risk reducing their support.

Economic recovery

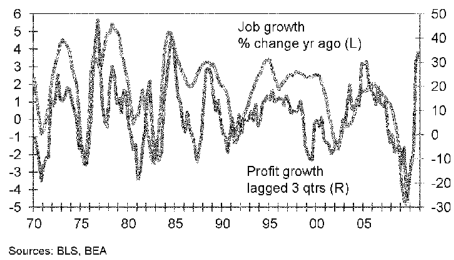
The economic recovery is one year old.[i] Coming after the Great Recession—the deepest and longest downturn since the Great Depression—the recovery has in some respects been surprisingly strong. Real GDP is estimated to have grown more than 3% during this period, and some 500,000 jobs have been added in the private sector since the beginning of this year (see Chart 1). Unemployment, which surged during the recession, has been essentially unchanged since the recovery began.



The sources of economic growth have become more diverse over the past year. Consumer spending has been solid, business investment in equipment and software is sturdy, and export growth could even be characterized as strong. The downdraft in housing construction that led the economy into recession is largely over, and even commercial construction appears to be approaching a bottom.

Corporate profits have made a stunning rebound over the past year, rising more than 30% as businesses significantly raised productivity while reducing cost structures.[ii] The revival in demand for goods and services has fallen straight to their bottom lines. Historically, rising corporate profits have led to increased investment and hiring within six to 12 months as businesses responded to better earnings by seeking growth opportunities (see Chart 2).

Profits Surge; Jobs Should Follow



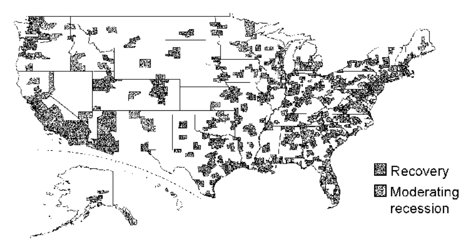
Sources: BLS, BEA

Indeed, the recovery has steadily broadened across industries and regions in recent months. The demographically sensitive healthcare and educational services industries added to payrolls throughout the recession, supported by demographic trends and government spending. Manufacturing began to revive at the end of last year, led by a pickup in technology and auto production, and more recently, distribution and transportation have expanded. Retailers and leisure and hospitality companies are also growing, and professional services and some financial services businesses also appear set to add to their payrolls.

Across the country, approximately two-thirds of the nation's nearly 400 metropolitan area economies are now recovering (see Chart 3).[iii] For context, at the depths of the recession, all but a handful of metro areas were in decline. The strongest recoveries to date have been in the Midwest and South, driven by the revival in manufacturing and distribution, and in technology centers. Those regions still in recession are mainly those where the housing bust and foreclosure crisis are most severe, including parts of Florida and the Mountain West and the Central Valley of California.

Economic Recovery Broadens

Business cycle status of the nation's metropolitan areas



Source: Moody's Analytics

The recession's severity and the recovery's strength are well summarized by the performance of the stock market. From the market's peak in 2007 to early 2009, stocks dropped more than 50% in price, approaching levels last seen before the internet revolution in the mid-1990s. Since the bottom, stock prices have recovered half their losses, the recent selloff notwithstanding.

Unprecedented policy response

That the Great Recession gave way to recovery as quickly as it did is largely due to the unprecedented monetary and fiscal policy response. The range of efforts by the Federal Reserve, the Bush and Obama administrations, and Congress is stunning (see Table 1). The effectiveness of any individual aspect of the policy response is debatable, but there is no debate that, in total, the response was very effective. If policymakers had not responded as aggressively and quickly, the financial system would arguably still be unsettled, the economy still in a downturn, and the costs to taxpayers would be measurably greater.

Federal Government Response to the Financial Crisis

Billions $

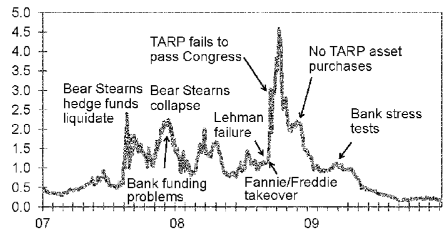
	Committed	Provided	Ultimate Cost
Total	**12,342***	**3,495**	**1,354**
Federal Reserve			
Term auction credit	900	0	0
Other loans	Unlimited	68	3
Primary credit	Unlimited	0	0
Secondary credit	Unlimited	0	0
Seasonal credit	Unlimited	0	0
Primary Dealer Credit Facility (expired 2/1/2010)	Unlimited	0	0
Asset-Backed Commercial Paper Money Market Mutual Fund	Unlimited	0	0
AIG	26	25	2
AIG (for SPVs)	9	0	0
AIG (for ALICO, AIA)	26	0	1
Rescue of Bear Stearns (Maiden Lane)**	27	28	4
AIG-RMBS purchase program (Maiden Lane II)**	23	16	1
AIG-CDO purchase program (Maiden Lane III)**	30	23	4
Term Securities Lending Facility (expired 2/1/2010)	200	0	0
Commercial Paper Funding Facility** (expired 2/1/2010)	1,800	0	0
TALF	1,000	43	0
Money Market Investor Funding Facility (expired 10/30/2009)	540	0	0
Currency swap lines (expired 2/1/2010)	Unlimited	0	0
Purchase of GSE debt and MBS (3/31/2010)	1,425	1,295	0
Guarantee of Citigroup assets (terminated 12/23/2009)	286	0	0
Guarantee of Bank of America assets (terminated)	108	0	0
Purchase of long-term Treasuries	300	300	0
Treasury			
TARP *(see detail in Table 2)*	700	297	116
Fed supplementary financing account	560	200	0
Fannie Mae and Freddie Mac	400	145	153
FDIC			
Guarantee of U.S. banks' debt*	1,400	305	4
Guarantee of Citigroup debt	10		0
Guarantee of Bank of America debt	3		0
Transaction deposit accounts	500	0	0
Public-Private Investment Fund Guarantee	1,000	0	0
Bank Resolutions	Unlimited	23	71
Federal Housing Administration			
Refinancing of mortgages, Hope for Homeowners	100	0	0
Expanded Mortgage Lending	Unlimited	150	26
Congress			
Economic Stimulus Act of 2008	170	170	170
American Recovery and Reinvestment Act of 2009***	784	391	784
Cash for Clunkers	3	3	3
Tier 3 and 4 Emergency UI benefits	13	13	13
HIRE Act (Job Tax Credit)	17	4	17

Notes:
*Includes foreign denominated debt
**Net portfolio holdings
*** Excludes AMT patch

Broadly, the policy response involved first stabilizing the global financial system and then jump-starting economic growth. The financial crises that took hold beginning in the spring of 2007 with the failure of broker-dealer Bear Stearns had spiraled into a financial panic by the fall of 2008 with the federal government's takeover of Fannie Mae and Freddie Mac and the Lehman Brothers bankruptcy. The turmoil created in the financial system is evident in the difference between Libor—the interest rate banks charge for borrowing and lending to each other—and Treasury yields (see Chart 4).[iv] At the height of the panic, the three-month Libor-Treasury spread was an astounding 450 basis points; the globe's largest banks were afraid to lend to each other.

Policymakers Stabilize the Financial System

Difference between 3-mo Libor and Treasury bill yields



Sources: Federal Reserve Board, Moody's Analytics

The Federal Reserve took a number of extraordinary steps to quell the financial panic. In late 2007, the Fed established the first of what would be a half dozen credit facilities to provide liquidity to a range of financial institutions and financial markets.[v] The Fed also aggressively lowered interest rates throughout 2008, adopting a zero interest rate policy by year's end, and engaged in credit easing throughout much of 2009 and in early 2010, purchasing Treasury bonds and Fannie Mae and Freddie Mac mortgage securities in an effort to bring down mortgage and other long-term interest rates.

Despite the Fed's efforts, the financial system remained in turmoil. The FDIC increased deposit insurance limits to stem potential bank runs and provided guarantees to ensure that banks could continue to borrow in capital markets. Congress and the Treasury also established the Troubled Asset Relief Program in the fall of 2008 to shore up the financial system (see Table 2).[vi] TARP was used in part to fund the Capital Purchase Program, which provided much-needed capital to a large part of the nation's banking system. While the bank bailout has been very unpopular, it was essential and has proven very successful. More than half the banks that received TARP funds have already repaid them, and it is likely taxpayers will ultimately see a profit on their investment.

TARP Funds
Billions $

	Provided	Completed	Ultimate Cost
Total	**554**	**580**	**116**
CPP (Financial institutions)	208	205	-16
Less: Tarp Repayments		136	
Homeowner Affordability and Stability Plan	50	40	50
AIG	70	70	45
Citi (TIP)	20	Repaid	
Bank of America (TIP)	20	Repaid	
Citi debt guarantee	5	Repaid	
Federal Reserve (TALF)	55	20	0
GMAC	13	13	4
GM	50	48	20
GM (for GMAC)	1	1	
Chrysler	13	13	8
Chrysler Financial (loan 1/16)	Repaid		
Public-Private Investment Fund	30	30	1
SBA loan purchase	15	>1	0
Auto suppliers	5	3.5	3.5

Sources: Federal Reserve, Treasury, FDIC, FHA, Moody's Economy.com

Perhaps the key to ending the financial panic was the bank stress testing that took place in the spring of 2009. The Treasury and Federal Reserve required the nation's 19 largest bank holding companies to stress their balance sheets to determine their losses if the economy suffered a downturn on par with the Great Depression, and then show they had sufficient capital to withstand such a setback, raising more if necessary. The results of the stress tests were made public and, combined with the capital raising that went on, fully restored confidence in the banking system. The Libor-Treasury spread narrowed back to where it had been prior to the crisis.

The fiscal stimulus

The effort to end the recession and jump-start recovery has been built around a series of fiscal stimulus measures.[vii] Tax rebate checks were mailed to lower- and middle-income households in the spring of 2008, the American Restoration and Recovery Act was passed in early 2009, and several small stimulus measures became law in late 2009 and early 2010.[viii] In all, close to $1 trillion will eventually be distributed through temporary tax cuts and increased government spending. The stimulus has done what it was supposed to do: end the recession and spur recovery. It is no coincidence the Great Recession ended last summer, when the ARRA was providing its maximum economic benefit.

The fiscal stimulus encompassed a wide array of tax cuts and government spending. Providing additional unemployment insurance benefits for workers who use up their regular 26 weeks of benefits produces the most economic activity per federal dollar spent (see Table 3). Without this extra help, laid-off workers and their families have little choice but to slash spending. The impact on consumer confidence cannot be underestimated. Financial aid to strapped state and local governments also provides a significant multiplier, forestalling government and private sector job cuts and tax increases that would be necessary in most states to meet constitutional balanced-budget requirements.

Fiscal Stimulus Bang for the Buck

Source: Moody's Analytics

	Bang for the Buck
Tax Cuts	
Nonrefundable Lump-Sum Tax Rebate	1.01
Refundable Lump-Sum Tax Rebate	1.22
Temporary Tax Cuts	
Payroll Tax Holiday	1.24
Job Tax Credit	1.30
Across the Board Tax Cut	1.02
Accelerated Depreciation	0.25
Loss Carryback	0.22
Housing Tax Credit	0.90
Permanent Tax Cuts	
Extend Alternative Minimum Tax Patch	0.51
Make Bush Income Tax Cuts Permanent	0.32
Make Dividend and Capital Gains Tax Cuts Permanent	0.37
Cut in Corporate Tax Rate	0.32
Spending Increases	
Extending Unemployment Insurance Benefits	1.61
Temporary Federal Financing of Work-Share Programs	1.69
Temporary Increase in Food Stamps	1.74
General Aid to State Governments	1.41
Increased Infrastructure Spending	1.57
Low Income Home Energy Assistance Program (LIHEAP)	1.13

Note: The bang for the buck is estimated by the one-year dollar change in GDP for a given dollar reduction in federal tax revenue or increase in spending.

The stimulus program has been criticized on a number of grounds. Charges that the government took too long to distribute its stimulus funds are largely misplaced (see Table 4). What matters for economic growth is the pace of stimulus spending, which surged from nothing at the start of 2009 to over $90 billion in the second quarter. That is a big change in a short period and is why the economy began to grow again by the third quarter. Infrastructure spending funded by the stimulus was slow to get started, partly because of safeguards against funding unproductive or politically driven projects. Infrastructure projects are now gearing up and will be particularly helpful in supporting growth during the second half of this year, when the economy can still benefit from it.

American Recovery and Reinvestment Act Spendout

$ bil

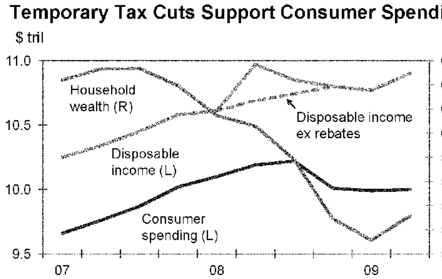
Historical data through June 2010

	Available	Paid-out	2009 Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	2010 Jan	Feb	Mar	Apr	May	Jun	2009q1	2009q2	2009q3	2009q4	2010q1	2010q2
Infrastructure and other spending	**147.2**	**56.0**	**0.0**	**0.0**	**0.0**	**0.0**	**1.5**	**3.7**	**1.7**	**3.2**	**4.3**	**3.8**	**3.9**	**4.7**	**2.8**	**5.5**	**5.8**	**6.1**	**4.1**	**4.9**	**0.0**	**5.2**	**9.2**	**12.4**	**14.1**	**15.1**
Traditional Infrastructure	37.8	14.0	0.0	0.0	0.0	0.0	0.2	0.2	0.8	1.2	0.7	1.8	1.5	1.4	0.6	1.2	1.1	1.3	1.1	1.0	0.0	0.4	2.6	4.6	2.9	3.4
Transfers to state and local governments	**174.3**	**119.3**	**0.0**	**3.4**	**6.6**	**5.8**	**9.4**	**8.4**	**8.2**	**8.0**	**8.4**	**8.2**	**8.0**	**7.7**	**2.8**	**7.3**	**7.0**	**7.1**	**5.6**	**7.4**	**10.0**	**23.5**	**24.6**	**23.9**	**17.2**	**20.2**
Medicaid	87.3	68.7	0.0	3.4	6.6	5.4	4.8	4.7	4.5	4.3	4.3	4.1	4.3	4.1	2.5	3.9	2.6	2.7	2.1	4.4	10.0	14.9	13.1	12.6	9.0	9.3
Education	87.0	50.6	0.0	0.0	0.0	0.3	4.6	3.7	3.7	3.7	4.1	4.1	3.7	3.6	0.3	3.4	4.4	4.4	3.5	3.0	0.0	8.7	11.5	11.4	8.2	10.9
Transfers to persons	**112.4**	**104.4**	**0.0**	**0.0**	**0.8**	**6.1**	**17.5**	**7.6**	**6.1**	**6.4**	**6.4**	**6.4**	**6.7**	**6.7**	**6.6**	**6.5**	**6.2**	**6.1**	**6.3**	**1.8**	**0.8**	**31.2**	**18.9**	**19.8**	**19.4**	**14.3**
Social Security	13.1	13.1	0.0	0.0	0.0	0.0	11.6	1.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	13.1	0.0	0.0	0.0	0.0
Unemployment assistance	65.7	61.4	0.0	0.0	0.0	4.1	4.1	4.1	4.1	4.5	4.5	4.5	4.8	4.8	4.7	4.6	4.3	4.2	4.4	-0.1	0.0	12.2	13.1	14.1	13.6	8.5
Food stamps	9.6	9.6	0.0	0.0	0.0	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.0	1.9	1.9	1.9	1.9	1.9
Cobra Payments	24.0	20.4	0.0	0.0	0.8	1.4	1.3	1.4	1.4	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	1.3	0.8	4.1	3.9	3.8	3.9	3.9
Tax cuts	**112.0**	**111.4**	**0.0**	**0.0**	**2.3**	**4.1**	**3.9**	**22.7**	**4.2**	**3.9**	**25.8**	**3.3**	**3.5**	**5.3**	**5.7**	**5.7**	**5.7**	**5.2**	**5.1**	**5.0**	**2.3**	**30.7**	**33.9**	**12.1**	**17.1**	**15.3**
Businesses & other tax incentives	40.0	40.0	0.0	0.0	0.0	0.0	0.0	18.0	0.0	0.0	22.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	18.0	22.0	0.0	0.0	0.0
Individuals excluding increase in AMT exemption	72.0	71.4	0.0	0.0	2.3	4.1	3.9	4.7	4.2	3.9	3.8	3.3	3.5	5.3	5.7	5.7	5.7	5.2	5.1	5.0	2.3	12.7	11.9	12.1	17.1	15.3
Total	**545.9**	**391.1**	**0.0**	**3.4**	**9.7**	**16.0**	**32.3**	**42.4**	**20.2**	**21.5**	**44.9**	**21.7**	**22.1**	**24.5**	**18.0**	**25.0**	**24.8**	**24.6**	**21.1**	**19.1**	**13.1**	**90.7**	**86.5**	**68.3**	**67.8**	**64.8**

Sources: Treasury, Joint Committee on Taxation, Recovery.gov, Moody's Analytics

Arguments that the temporary tax cuts included in various stimulus measures have not supported consumer spending are incorrect. This is best seen in the 2008 tax rebates. While these rebates significantly lifted after-tax income in the period, consumer spending did not follow, at least not immediately. The reason lay in the income caps on the rebates, which meant higher-income households did not receive them. Because of rapidly falling stock and house prices, these same households were saving significantly more and spending less (see Chart 5). The saving rate for households in the top quintile of the income distribution surged from close to nothing in early 2007 to well into the double digits by early 2008. Lower- and middle-income households did spend a significant part of the rebates they received, but the sharp pullback by higher-income households significantly diluted the impact of the tax cut on overall spending.

Temporary Tax Cuts Support Consumer Spending



Sources: BEA, FRB, Moody's Analytics

Critics who argue that the ARRA failed since it did not keep unemployment below 8%, as the Obama administration projected it would when lobbying to get the legislation through Congress, are wrong. Unemployment was already above 8% in February 2009, when the legislation was passed; administration economists did not know that at the time, because of lags in the data and the rapid rise in unemployment that was occurring. They, like most private forecasters, including Moody's Analytics, misjudged how serious the downturn had already become. If anything, this suggests the stimulus provided in the ARRA was not large enough.

How much the fiscal stimulus has helped the economy cannot be determined through an accounting exercise. Washington's statisticians cannot canvas the country and pick out which jobs have been created or saved by the stimulus and which have not. The best tools available involve statistical analysis that is subject to a range of uncertainties. But although the exact number of jobs that would have been lost without the fiscal stimulus will never be known, it is clear that this number is significant. Research by Moody's Analytics and others, such as the Congressional Budget Office, suggests that without ARRA, at least 2 million fewer jobs would exist today and the unemployment rate would be closer to 11% (see Table 5).[ix]

Forecast Comparison: Baseline vs. No ARRA stimulus scenario

Sources: BEA, BLS, Moody's Analytics

		2009Q1	2009Q2	2009Q3	2009Q4	2010Q1	2010Q2	2010Q3	2010Q4	2011Q1	2011Q2	2011Q3	2011Q4	2009	2010	2011
Real GDP (05$ bil, SAAR)	*Scenario (no ARRA stimulus)*	12,912.6	12,795.7	12,763.6	12,868.6	12,923.6	13,001.7	13,080.8	13,180.4	13,335.8	13,542.3	13,736.2	13,922.6	12,835.1	13,046.6	13,634.2
annualized % change		-6.8	-3.6	-1.0	3.3	1.7	2.4	2.5	3.1	4.8	6.3	5.9	5.5	-3.6	1.6	4.5
Real GDP (05$ bil, SAAR)	*Baseline (with ARRA stimulus)*	12,925.4	12,901.5	12,973.0	13,149.5	13,248.2	13,346.7	13,430.3	13,522.0	13,654.8	13,826.4	13,999.2	14,180.5	12,987.4	13,386.8	13,915.2
annualized % change		-6.4	-0.7	2.2	5.6	3.0	3.0	2.5	2.8	4.0	5.1	5.1	5.3	-2.4	3.1	3.9
Payroll Employment (mil, SA)	*Scenario (no ARRA stimulus)*	132.8	130.6	129.1	128.2	127.8	128.1	128.0	128.3	128.8	129.7	130.8	132.0	130.2	128.0	130.3
annualized % change		-6.5	-6.3	-4.6	-2.8	-1.1	0.9	-0.3	1.0	1.4	3.0	3.5	3.6	-4.8	-1.6	1.8
Payroll Employment (mil, SA)	*Baseline (with ARRA stimulus)*	132.8	131.1	130.1	129.6	129.7	130.3	130.5	130.8	131.2	131.8	132.6	133.5	130.9	130.3	132.3
annualized % change		-6.4	-5.0	-3.1	-1.3	0.2	2.0	0.6	0.9	1.3	1.8	2.3	2.7	-4.3	-0.4	1.5
Unemployment Rate (%)	*Scenario (no ARRA stimulus)*	8.2	9.5	10.0	10.7	10.6	11.0	11.5	11.6	11.5	11.3	10.6	9.8	9.6	11.2	10.8
Unemployment Rate (%)	*Baseline (with ARRA stimulus)*	8.2	9.3	9.6	10.0	9.7	9.8	10.0	10.1	10.1	9.8	9.3	8.8	9.3	9.9	9.5
CPI (Index, 1982-84=100, SA)	*Scenario (no ARRA stimulus)*	213.2	214.1	214.9	215.2	215.5	215.7	215.8	216.2	216.8	218.1	219.9	221.9	214.3	215.8	219.1
annualized % change		-2.3	1.8	1.5	0.6	0.4	0.5	0.2	0.8	1.0	2.4	3.4	3.7	-0.4	0.7	1.6
CPI (Index, 1982-84=100, SA)	*Baseline (with ARRA stimulus)*	212.5	213.5	215.4	216.8	217.6	218.1	218.7	219.5	220.7	222.1	223.8	225.5	214.5	218.5	223.0
annualized % change		-2.2	1.9	3.7	2.6	1.5	0.8	1.2	1.6	2.1	2.6	3.2	3.1	-0.3	1.8	2.1

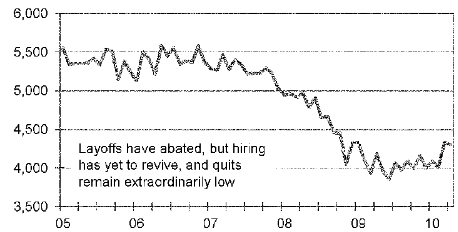
These estimates are not an idle academic exercise. Whether the ARRA and other fiscal stimulus measures are deemed successful will influence how policymakers respond if the recovery does not take root, or worse, if the economy slides back into recession. Although a double-dip downturn remains less than likely, the recovery remains fragile and vulnerable to a number of threats.

No help wanted

Especially worrisome is the reluctance of businesses to increase hiring. Layoffs have abated, which has allowed job growth to resume, but hiring remains moribund. Prior to the recession, well over 5 million workers were being hired throughout the economy each month (see Chart 6). Hiring slid during the downturn, since hitting bottom in early 2009; since then, it has remained near 4 million per month. Until hiring revives substantially, job growth will not be sufficient to meaningfully reduce unemployment, which at close to 10%, poses a significant risk to the recovery.[x]

Recovery Remains Fragile as Hiring Is Dormant

Number of monthly hires, ths, SA

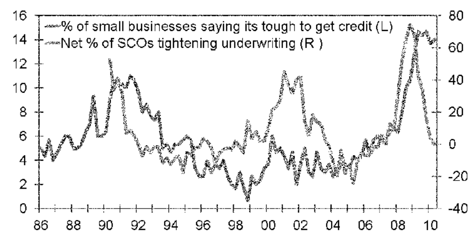


Source: Bureau of Labor Statistics

Hiring remains soft across most industries and firms of all sizes, but particularly among very small businesses (those with up to four employees) and very big ones (those with more than 1,000 employees).[xi] Given the large number of workers in small businesses, about half the decline in job creation has been among firms with fewer than 100 employees. About a fourth occurred among firms with between 100 and 1,000 employees, and the remaining fourth happened at firms with more than 1,000 employees.

The principal impediment to hiring at smaller businesses appears to be a lack of credit. Bank lenders remain cautious in their underwriting: According to the Federal Reserve's senior loan officer survey, banks are no longer tightening small-business lending standards, but those standards remain exceptionally tight (see Chart 7).[xii] This is evident in the credit data, as commercial and industrial loans outstanding continue to fall rapidly and the number of bank credit cards has plummeted by nearly 100 million, or 25%, since peaking in mid-2008.[xiii] Most of these loans are to large businesses, and the credit cards are to consumers, but small businesses rely heavily on loans and credit cards to finance their activities.

Small Businesses Struggle to Get Credit



Sources: NFIB, Federal Reserve Board

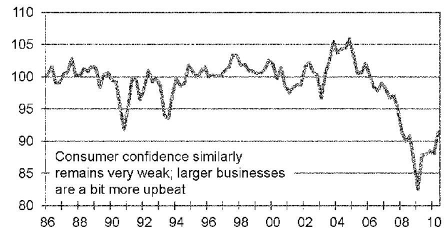
It is unlikely that credit conditions for small businesses will improve soon. Hundreds of the small banks so important to small business lending, particularly in smaller communities, have failed or will fail in the next couple of years. More than 700 banks are now on the FDIC's troubled list; in many cases, defaulting commercial mortgage loans are overwhelming banks' capital. Credit card lenders also continue to adjust to new legislation and regulation. Small business borrowers are also being hampered by weak housing and commercial real estate prices. Real estate is often used by small business owners as collateral for borrowing. With the value of that collateral less certain, lenders are less willing to make loans.

Credit is not the chief impediment to job creation at large businesses—the corporate bond and commercial paper markets are functioning well. The larger problem there is uncertainty about government policy. Washington is arguably changing the legal and regulatory landscape more than at any time since the Great Depression, enacting reforms to healthcare, energy, financial regulation and tax policy. All of these policy changes are important and should be carefully considered, but until businesses figure out what each means for them, they are likely to hold back decisions on hiring and expansion.[xiv]

Uncertainty and indecision among business executives cannot be discounted as a reason for the poor job market. Business surveys broadly show sentiment has improved since early in the year but remains extraordinarily fragile (see Chart 8).[xv] Many businesses suffered near-death experiences in the past year, and those memories remain fresh. Managers must also wonder whether recent pickups in demand will prove temporary. The massive monetary and fiscal stimulus and an inventory swing have clearly contributed to the turnaround, but these are not long-lasting sources of demand growth. Executives are plagued by the thought of what happens if they build it and no one comes. Until that question fades, many will neither build nor hire.

Businesses Remain Very Anxious

Small business confidence index, 1986=100



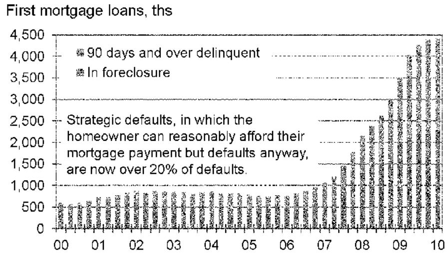
Source: NFIB

Foreclosure crisis

The foreclosure crisis and chance of further house price declines remain threats to the recovery. At the end of May, there were 2.8 million mortgage loans at some stage of the foreclosure process and an additional 1.6 million loans 90 days or more past due and thus headed toward foreclosure (see Chart 9).[xvi] Fully 9% of the 49 million first-mortgage loans outstanding are in deep trouble.

Foreclosure Crisis Continues

First mortgage loans, ths



Sources: Equifax, Moody's Analytics

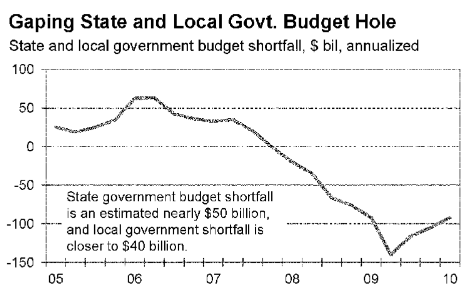
The glut of loans in the foreclosure pipeline is due in large part to delays in the process created by the Obama administration's loan modification plan. The Home Affordable Mortgage Plan is a complicated arrangement that has only recently been fully implemented. Mortgage servicers have delayed pushing loans through foreclosure until they know which homeowners qualify for the plan. A drop in foreclosure sales, along with stronger nondistressed home sales due to the first-time homebuyer tax credit and lower fixed mortgage rates resulting from the Federal Reserve's credit easing efforts, have resulted in more stable house prices over the past year.

This is about to change. Foreclosures and short sales are expected to increase as mortgage servicers push loans that cannot be modified through the process to a sale. The number of loans receiving permanent modifications to date through HAMP—close to 350,000—has been disappointing, while the number of homeowners going into new trial modifications slowed sharply this spring.[xvii] Changes to the HAMP announced earlier this year to provide greater incentives for modifications that include principal reductions should make the program more effective, but the changes come too late to forestall greater foreclosure and short sales in coming months. With nondistressed home sales already weakened by the recent end of the tax credit, house prices will likely decline further during the second half of this year and early next. Nationwide, house prices have already fallen nearly 30% from their peak four years ago, according the national Case-Shiller house price index.

Nothing works well in the economy when house prices are falling; as household wealth erodes, consumers lose the ability and willingness to spend, and the financial system loses the ability and willingness to extend credit. The recovery will not gain traction until the foreclosure crisis ends and house prices fully stabilize.

State and municipal budget shortfalls

The recovery is also threatened by massive shortfalls in most state and municipal budgets. This is forcing increasingly large job cuts, budget reductions, and tax increases. There is no dispute that state and local governments are struggling with epic budget shortfalls. The aggregate deficit likely for fiscal 2011, which begins in July in most states, is over $90 billion (see Chart 10). Fiscal difficulties in California, Illinois and New York are receiving the most attention, but similar problems plague most states and municipalities from coast to coast.



Source: Moody's Analytics

Last year's budget woes were even worse, but states were saved by the federal government's fiscal stimulus program. With help from the ARRA, states avoided the worst. They made cuts—nearly 200,000 state and local government jobs were lost over the past year—and increased revenue, mostly through higher sin and property taxes. But these steps were accomplished without significant economic damage.

That will not be the case in the coming year if federal aid is not forthcoming soon. States' rainy-day funds are dry, and their borrowing capacity is depleted. Based on what they were hearing from Washington when drawing up their 2011 budgets, more than half the states assumed Congress would come through with more help. Without it, the budget cuts will be draconian and the tax increases debilitating. There is also a greater chance of municipal bond defaults, which historically have been rare. While a major default is a remote possibility, equally unlikely things have occurred recently.

Many jobs will be lost, at the very least. Another half million teachers, policemen, and other government workers will be laid off, and since much of what state and local governments spend is on goods and services from private businesses, many private sector jobs will be lost as well.

The drag on the economy in coming months will be substantial. Historically, state and local governments have been a small but steady source of economic growth, adding a quarter of a percent on average to annual real GDP growth since World War II. If state and local governments instead become a drag on economic growth, it will impede the broader recovery's prospects significantly.

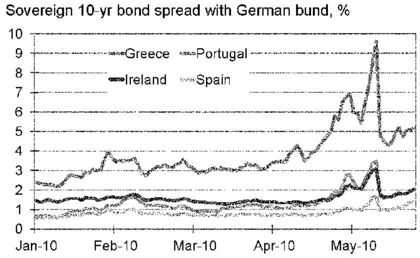
European debt crisis

Europe's debt crisis is another reason for concern about the staying power of the recovery. Though the European Union and International Monetary Fund have cobbled together $1 trillion to bail out struggling euro zone economies, and the European Central Bank has already purchased close to $50 billion in sovereign debt (mostly from Greece and Portugal), global investors remain unconvinced.

Perhaps most discouraging is that investors seem to be losing faith in the ability of major European governments such as Spain and Italy to navigate their fiscal problems. Interest rates on Spanish and Italian sovereign debt are as high as they have been since the crisis began relative to benchmark German securities (see Chart 11). All this puts enormous financial pressure on the European banks and other financial institutions that are these countries' largest debt holders.

European Debt Crisis Remains a Threat

Sovereign 10-yr bond spread with German bund, %



Source: Bloomberg

Even if the financial turmoil ends soon, it is difficult to see how Europe will avoid sliding back into recession. The European economy was barely growing before recent events, and that was mostly because of the temporary policy stimulus and an end to massive inventory liquidation by manufacturers. As Europe's strained financial system tightens credit further and governments impose fiscal restraint, the economy will suffer.

European policymakers thus need to do more to settle financial markets and limit the economic damage. Most importantly, nations need to offer credible plans to restore fiscal stability—and then show they are following through. So far so good; the Greeks, Portuguese and Spaniards appear to be doing just this. The British also recently put forth a budget that credibly addresses that nation's fiscal problems, at least on paper.

The ECB and Bank of England will not be able to begin normalizing interest rates soon; thus, both the euro and the British pound will continue their recent slides. It would not be surprising to see the euro approach one-for-one parity with the U.S. dollar by year's end and for the pound to reach quarter-century lows. There are also meaningful odds that the ECB will have to increase its sovereign debt purchases and not sterilize those purchases as it has been doing, thus allowing interest rates to fall even closer to zero. Further credit easing by the Bank of England is also a possibility.

Assuming Europe's policy response is sufficient to soon calm financial markets, the fallout on the U.S. economy should be manageable. A weak European economy and a stronger dollar will have a negative effect on U.S. exports. This impact should be small, however, as Europe accounts for about a fifth of total U.S. exports, and exports in turn make up less than a tenth of U.S. GDP. The debt crisis also brings some economic positives for the U.S., including lower prices for oil and other commodities and, in particular, lower interest rates. Long-term rates have fallen significantly, given global investors' flight to quality into U.S. Treasury bonds and Fannie and Freddie mortgage securities; fixed mortgage rates are now near record lows.

However, just how badly the U.S. economy is damaged by the European debt crisis will depend largely on the stock market. Stock prices are off 10% to 15% since the crisis began; not much more than a garden-variety correction, particularly following a year of strong gains. The drop thus far does not make anyone feel good, but it will not change consumers' spending behavior or businesses' hiring decisions too much.

Yet the market's recent turmoil shows why the European debt crisis is such a serious threat: Further stock price declines could do significant damage to the U.S. psyche and economy. Spending by high-income households is particularly sensitive to the markets' ups and downs. The saving rate for households in the top fifth of the income distribution—a group that accounts for about 60% of consumer spending—surged during the recession, as higher-income households saw their nest eggs erode. The stock market's rally over the past year came as a huge relief, pushing these households' saving rates back to prerecession levels. The market's current travails have surely put this group on edge again.

Continued policy support

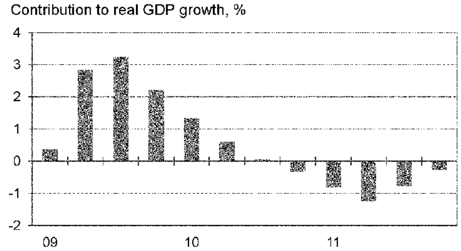
Given the sizable threats to the fragile recovery and the difficulty of dealing with another slide into recession, it is important for policymakers to continue to provide substantial support to the economy. The Federal Reserve is signaling it will not begin to raise rates soon.[xviii] The Fed will likely continue to pursue its zero interest rate policy until unemployment moves definitively lower, which is not expected until next spring at the earliest.

If the recovery were to falter, the Fed could resume its credit easing efforts, but the economic benefit of this would be limited. Long-term interest rates are already extraordinarily low, and even if they fall further, it is unclear how much this would help to revive home sales, consumer purchases of cars and other durable goods, and business investment. Moreover, banks would presumably tighten underwriting standards in such a scenario, restricting the availability of credit at any interest rate.

The limits of monetary policy to further support the recovery put added pressure on fiscal policymakers, particularly since the effect of the fiscal stimulus in place is beginning to fade (see Chart 12). By late this year, the stimulus will begin to decline in earnest, becoming a meaningful drag on growth by early 2011.

The Boost From ARRA Will Soon Fade

Contribution to real GDP growth, %



Source: Moody's Analytics

With this context, it would seem prudent for fiscal policymakers to provide some additional stimulus. I would recommend a total of $80 billion, including $45 in additional funding for emergency UI benefits through the end of 2010, $30 billion to states to meet their Medicaid obligations through fiscal 2011—this would allow them to redirect their resources and forestall the worst of the coming budget cuts and tax increases—and $5 billion to finance additional small business lending.

If policymakers provide additional funds this summer similar to my recommendation, the odds of a double-dip recession in the next year will remain no more than one in four.[xix] If policymakers provide no further stimulus, the odds will rise to one in three. Thus, even if policymakers fail to provide an additional fiscal stimulus, the recovery should remain intact and eventually evolve into a self-sustaining expansion, but the odds are uncomfortably high that it will not.

Given this, fiscal policymakers should also consider scaling back and phasing in the tax increases due to start in 2011 under current law. Personal marginal tax rates and capital gains and dividend income tax rates are set to rise back to where they were a decade ago.[xx] Any tax increases would be counterproductive until the economy is consistently expanding at a strong enough rate to significantly lower unemployment.

Federal deficit concerns

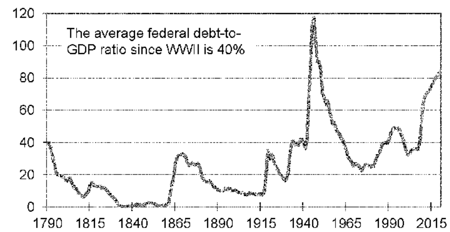
Fiscal policymakers are rightfully worried about providing an additional stimulus, given the nation's large budget deficits and daunting fiscal outlook. The federal budget deficit ballooned to $1.4 trillion in fiscal 2009, equal to a record 10% of GDP, and this year's deficit is expected to be a similar $1.4 trillion. Even President Obama's budget, presented earlier this year, does not result in a fiscally sustainable deficit at any point during its 10-year outlook.[xxi]

This very poor fiscal situation reflects the ultimate expected price tag of the financial crisis and recession of more than $2.15 trillion.[xxii] This includes $1.35 trillion in direct costs— approximately $1 trillion in federal fiscal stimulus spending and $350 billion to support various institutions and markets, less what the government will recoup in future asset sales. The loss of tax revenues and the growth of unemployment and other income support programs will cost the Treasury another $800 billion.

Even after the costs associated with the financial crisis abate, without significant changes to tax and government spending policy the budget outlook is bleak. This is largely due to the rising expected costs of the entitlement programs, despite the passage of healthcare reform. The nation's federal debt-to-GDP ratio is projected to increase to almost 85% a decade from now, double the approximately 40% that prevailed prior to the current financial crisis and the highest ratio since World War II (see Chart 13).

Policymakers Must Change This Outlook

Federal debt-to-GDP ratio



Sources: Treasury, Moody's Analytics

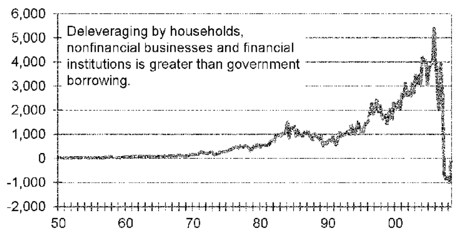
The need to make fundamental changes to government spending and tax policy is thus much more intense in the wake of the financial crisis and recession. Unless policymakers credibly address these issues soon, a future fiscal crisis will likely result in higher interest rates, lower stock prices, a weaker U.S. dollar, and ultimately lower living standards.

As such, it would be desirable for fiscal policymakers to pay for any additional stimulus with spending offsets and tax increases. Doing so this year or next would dilute or neutralize any economic benefit from the stimulus, but it should be placed high on the legislative agenda as soon as the economy is in full swing, most likely beginning in 2012. Making such a commitment now would send a strong signal to global investors that policymakers are serious about addressing the nation's fiscal problems. This would make it easier for policymakers to run a larger deficit in the coming year to fund the stimulus without causing long-term interest rates to rise and crowding out private investment.

That said, fully paying for the recommended additional stimulus should not be a necessary condition for providing it. Policymakers have some latitude to run a larger deficit in the coming year, given the ongoing global flight to quality into U.S. government debt and, more importantly, given deleveraging by the private sector. Households, businesses and financial institutions are reducing their debt outstanding so rapidly that total credit demand is still declining despite enormous borrowing by federal, state and municipal governments (see Chart 14). With still-moribund private credit demand, there is little prospect that providing a deficit-financed stimulus in the coming year will result in higher interest rates.

No Credit Growth

Total domestic credit growth, $ bil



Sources: Federal Reserve Board, Moody's Analytics

Conclusions

The economy has come a long way since the end of the Great Recession. Job growth has resumed in earnest, stock prices are up strongly, and house prices have largely stabilized. That the recovery is a year old is testimonial to the unprecedented and ultimately successful monetary and fiscal policy response. If policymakers had not acted as aggressively, the economy would still very likely be in recession.

However, there still is no free lunch. The government response was extraordinarily costly and effectively pulled the nation's fiscal problems forward by a full decade. Policymakers have little choice but to soon deal with the nation's byzantine tax structure and ballooning entitlement programs. It is thus understandable that many policymakers are reticent to heed calls to provide even more fiscal stimulus, lest they make these fiscal problems even more severe.

Indeed, if policymakers ignore these calls, the recovery will in all likelihood not devolve into recession. The next six to 12 months will be uncomfortable as the recovery struggles to gain traction, but a full-fledged expansion should take hold by this time next year. Policymakers would be taking a significant gamble, however. Given the still-fragile recovery and the clear threats remaining, it is not difficult to construct scenarios in which the economy backtracks into recession. Once back in recession, moreover, it is not clear how the economy would get out, at least not for a long time or before millions more lose their livelihoods. The nation's fiscal problems would then be completely intractable.

Prudent economic risk management strongly argues that policymakers should err on the side of providing too much near-term fiscal stimulus rather than too little.

[i] The National Bureau of Economic Research, the official arbiter of the U.S. business cycle, has yet to determine when the recession ended. The widespread consensus among economists is that the recovery began sometime during the summer of 2009.
[ii] Nonfarm business productivity rose 6.1% in the year ending in the first quarter of 2010. Only in two other periods since World War II has productivity growth been stronger. It is not unusual for productivity to surge early in recoveries, but the recent gains are noteworthy.
[iii] Moody's Analytics determines where each state and metropolitan area is in its business cycle based on a methodology similar to that used by the NBER in determining the national business cycle.
[iv] The difference between Libor and Treasury yields is only known as the TED spread.
[v] The new credit facilities include the Term Auction Facility, the Term Securities Loan Facility, the Term Asset-Backed Securities Loan Facility, the Commercial Paper Funding Facility, the Money Market Investor Funding Facility, and currency swap lines.
[vi] The success and failures of the TARP fund are discussed in "Taking Stock: Independent Views on TARP's Effectiveness," Mark Zandi, testimony before the TARP Commission, November 19, 2009.
[vii] Other key policy measures include the auto industry bailout early in 2009 and the ongoing effort to encourage foreclosure mitigation, both of which have been funded by TARP monies.
[viii] This includes, among other things, the cash for clunkers tax incentive in the fall of 2009, the extension and expansion of the housing tax credit through mid-2010, the passage of a job tax credit through year-end 2010, and extensions of emergency UI benefits through June 2010.
[ix] The CBO's estimates of the economic impact of ARRA can be found at http://www.cbo.gov/ftpdocs/115xx/doc11525/05-25-ARRA.pdf .
[x] The underemployment rate, which also includes those working part-time for economic reasons and discouraged workers, is closer to 17%. This is the highest underemployment rate on record dating back to World War II as constructed by Moody's Analytics.
[xi] This analysis is based on data from the BLS business employment dynamics survey.
[xii] The Fed asks respondents whether they have tightened their underwriting or increased their loan spreads in the last quarter. Recent responses indicate that fewer lenders are tightening further, but there is no indication they have eased after the extreme tightening that occurred this time last year.
[xiii] It is difficult to disentangle the impact of credit standards and weaker demand on credit outstanding, but suffice it to say, standards have arguably never been as stringent.
[xiv] The potential of policy to affect job creation is amplified by the ability of large firms to shift activities overseas. Despite big productivity gains and lower labor costs in the U.S., costs and market opportunities in emerging economies are growing in attractiveness.
[xv] The National Federation of Independent Business survey of small businesses, the Conference Board survey and Business Roundtable surveys of large businesses, and the Moody's Economy.com weekly global business survey all roughly show this.
[xvi] This is based on a 5% random sample of all the credit files in the country maintained by the credit bureau Equifax.
[xvii] In the HAMP program, homeowners are initially put into trial modifications, during which they must remain current on their modified loans. After three months of timely payments, the modification is made permanent. It is important to note that private mortgage servicers are also implementing modification plans that are as significant as HAMP in terms of the number of loans being modified.
[xviii] This is evident in the statement from the late June meeting of the FOMC in which policymakers stated their intent to keep interest rates "exceptionally low for an extended period." The consensus interpretation of this within the financial system is that the Fed is committing to not raising rates for at least six months.
[xix] These are subjective odds to provide the reader with a general sense of my assessment of the risks of a double-dip recession.
[xx] The tax cuts were implemented as part of the Economic Growth and Tax Relief and Reconciliation Act of 2001.
[xxi] A fiscally sustainable deficit-to-GDP ratio—consistent with a stable debt-to-GDP—is no more than 3%.
[xxii] This is equal to nearly 15% of GDP. For historical context, the savings and loan crisis in the early 1990s cost taxpayers some $350 billion in today's dollars—$275 billion in direct costs and $75 billion due to the associated recession. That was equal to almost 6% of GDP at that time.

Chairman SPRATT. Thank you, Dr. Zandi.
Dr. TAYLOR

STATEMENT OF JOHN TAYLOR

Mr. TAYLOR. Thank you, Mr. Chairman, Ranking Member Ryan for inviting me to testify. I appreciate the opportunity.

I think the economic recovery has slowed significantly, if you look at the numbers carefully. Just, for example, in the fourth quarter of last year we had growth at 5.6 percent. That has slowed by more than half, to 2.7 in the first quarter of this year and probably around 3 percent the rest of the year. So it is what economists think of as a U-shaped recovery, not the V-shaped, and some are even worrying about a double dipper or W-shaped recovery.

In my view, the problem here is largely a great deal of uncertainty about what is happening with economic policy. I think there is also uncertainty about how some obvious inconsistencies in policy are going to be resolved. There is uncertainty about tax increases, there is uncertainty about regulatory reform, there is uncertainty about how the Fed will unwind its operations, and perhaps the biggest uncertainty now is what is going to happen with the rapidly growing debt.

In this respect, I think that CBO's release yesterday of their annual long-term budget outlook is quite of concern. I had some charts in my testimony which try to illustrate this.

If you have a chance to look on page 1, there is a chart which I put together from the data reported in the CBO long-term outlook. It reports debt as a share of GDP in the United States. We used to think that the gigantic increase in World War II was about as much as we would ever have. If you look at this chart, it looks like a small blip compared to where we are going, according to CBO, if we don't do something about it. 947 percent of GDP. It is just astronomical. Obviously, the United States of America will not be the United States of America if we let this happen. So resolving this inconsistency I think is one of the biggest drags on the economy at this point.

On the other hand, if we address it, address it in a sensible way, I believe we can start to restore confidence, start to grow more robustly again, and ultimately get that unemployment rate declining back.

So what is holding us back? What is holding us back from just moving ahead right away? I think the main factor is people are worried about removing stimulus, so to speak. And my distinguished colleagues on this panel have already referred to that. In my view, there shouldn't be much worry from either ending or even removing some of the so-called fiscal stimulus, and my written testimony tries to describe why.

I basically, respectfully, but also strongly, disagree with the view that the stimulus has been a big factor in the recovery. And there are various ways to think about this. I think one is to try to realize that those who argue—those economists who argue that it was a big factor are using models about which there is not a large degree of agreement. I try to illustrate this on some charts on page 3 of my testimony, if you would look at those.

I took some charts which were originally published in the New York Times which purport to show that the stimulus was effective, and they look at three different models. Actually, one of the models is from Mark Zandi's group. And you can see, if you just glance at the black line, that is sort of what has happened or what is forecast to happen, and the gray line is what the models say what would have happened without the stimulus, and the three models in the left which were in the New York Times show a big effect.

The problem is, those aren't the only models around. To illustrate this, I took another model, actually, one that me and my colleagues at Stanford have looked at quite a bit. It is a model developed by the European Central Bank. It is also a quite common kind of model that academics use in their own research, and you can see there is very little effect. In fact, to make the point completely, if you take the view of the modeling of Professor Robert Barro at Harvard, there is actually no effect of the stimulus, using exactly the same reasoning that people who use models of this kind.

So the bottom line here is I view the right model as something where there is very little impact of the stimulus. But at least you have to recognize there is a tremendous amount of disagreement.

I think in terms of understanding what has happened, it is important to go beyond models, quite frankly. Models have their problems, I can speak to that as an economic modeler, and look at actually what happened. So the other charts in my testimony try to look at what actually happened, and page 4 is one example.

We have actually had a couple stimulus packages in this downturn. One was back in 2008 and the other in 2009. And if you look at my chart, you can see that part of those packages were to send checks to people, rebate checks or advance tax cuts. And, in both cases, in 2008 and 2009, you can see from the red line personal income rose substantially. But if you look at the lower line and see what people spent, look at their consumption—remember, these were supposed to jump-start consumption—you see very little impact whatsoever. So I think if you look at the data, look what actually happened, stop simulating models and look at what actually happened, you see very little impact of this part of the stimulus packages.

But, of course, the stimulus packages have more than just sending cash to people. They actually have to do with changing government purchases. As Martin indicated, you can see some of this when you drive around Washington. But let's look at really what happened in terms of government purchases. So if you look at page 5 of my testimony, I think it is a pretty simple illustration of this great recession, the recovery, the weakening of the recovery, and what are the factors.

So the chart at the very top is a picture of real GDP growth. And you can see the blue line, it comes down, goes about down to pass minus 6, and you have this recovery up to 5.6, and then the slowdown, as I mentioned in my introduction. You can find out how much of that growth is due to different parts of GDP, investment, consumption, government purchases, net exports. So I did that.

And you can see, if you look at the contribution of investment, private investment, the private economy, it almost tells the whole story: a huge decline in investment in the panic, a huge increase in investment after the panic, a slowdown in investment now. So it is the private sector that is driving this.

And to actually illustrate this further, look at the chart at the bottom of page 5, and you can see that, through these ups and downs in the economy, changes in government purchases have played almost no role whatsoever. Now, this doesn't prove anything, but it certainly convinces me that one should be wary about claims that this fiscal stimulus did very much. In fact, my view is that it has done remarkably little.

So where does this lead me? It seems to me the conclusion is that we should focus on this problem of the debt and the deficit, address the consolidation issues now. Don't delay. Because concerns about either ending or not continuing with stimulus packages, get started now, orderly way. It doesn't have to be Draconian. But I think that as soon as people realize that this is what you are trying to do confidence will be restored and you can see the recovery picking up again.

Thank you very much.

[The prepared statement of John Taylor follows:]

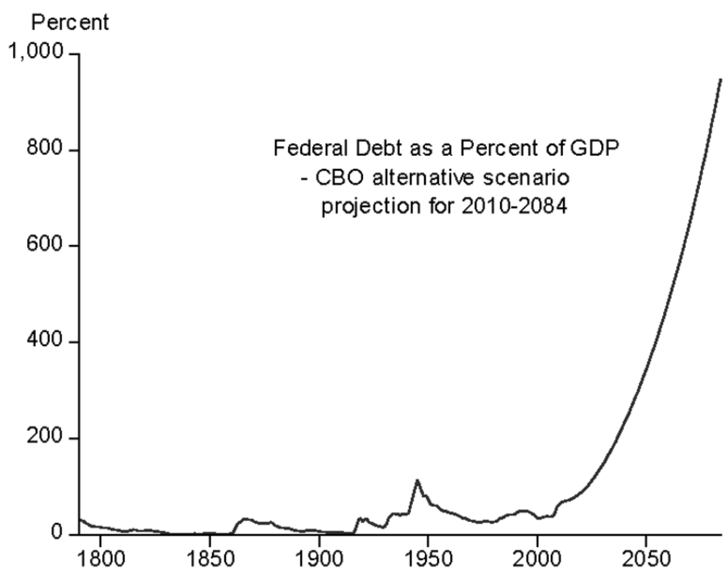
PREPARED STATEMENT OF JOHN B. TAYLOR, MARY AND ROBERT RAYMOND PROFESSOR OF ECONOMICS; GEORGE P. SHULTZ SENIOR FELLOW IN ECONOMICS, HOOVER INSTITUTION, STANFORD UNIVERSITY

Thank you, Chairman Spratt, Ranking Member Ryan, and other members of the House Committee on the Budget for inviting me to testify on "Perspectives on the U.S. Economy."

The recovery of the U.S. economy has slowed significantly since the start of this year. After rebounding to 5.6 percent in the fourth quarter of last year, real GDP growth slipped to 2.7 percent in the first quarter and is expected to remain in the 3 percent range for the rest of the year. In the lingo of economics it is a U-shaped recovery rather than a V-shaped recovery and some economists are now predicting a double dip, or a W-shaped recovery. As a result of the slower economic growth unemployment remains high and is expected to decline slowly.

UNCERTAINTY AND FISCAL POLICY INCONSISTENCIES

In my view the weakness in the recovery is mainly due to uncertainty about economic policy and concerns about how large policy inconsistencies will be resolved in the future. The long term budget outlook released yesterday by the Congressional Budget Office (CBO) is a timely reminder of these inconsistencies as this alarming chart of past and future federal debt illustrates.



The chart shows the federal debt as a share of GDP going back to the beginning of the United States and continuing into the future assuming that fiscal policy is not changed as defined by the CBO's alternative scenario. You can see the increase in the debt ratio during World War II, which fortunately was reversed in the years after the war. The CBO's projection through the next decade shows a similar increase in federal debt as a share of GDP as in World War II. The projections for future decades then explode. According to the CBO, the debt reaches an unbelievable 947 percent of GDP by 2084 which dwarfs the peak debt incurred during World War II. So something has to give, and people are beginning to wonder what.

The near term increase in the debt is due to the recession, the stimulus packages, and other recent expansions in government spending growth. The longer term increase is due to the inability to rein in spending on entitlement programs. Thus it is not only the fiscal response to the crisis that has caused debt problems for the United States. But the response to the crisis has distracted us from efforts to address the problems. Adding to the uncertainty is that many tax provisions are scheduled to expire in just 6 months, and without legislative action, there will be substantial tax increases on all Americans. There is also a looming change in financial market regulations which add uncertainty to a financial system still recovering from the crisis.

A clear and credible path of fiscal consolidation is clearly needed and would do much to remove uncertainty about future policy and thereby build confidence. The reason why such a plan is not being articulated and carried out now is an apparent concern that such a consolidation would remove needed stimulus from the economy. In my view, the fiscal stimulus packages did not stimulate very much if at all and ending them would not have such negative consequences. But the debate is a serious one and for this reason I want to devote the rest of my testimony to explaining why I disagree with those that claim the stimulus has worked.

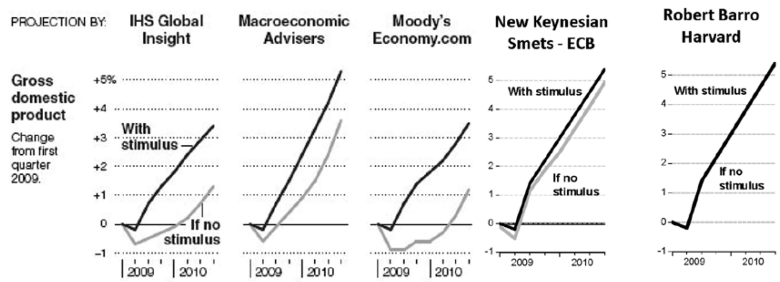
EVIDENCE FROM THE MODELS: NO CONSENSUS THAT THE STIMULUS HAD A SIGNIFICANT IMPACT

Unfortunately most attempts to answer the question "What was the impact of the fiscal stimulus?" are still based on economic models in which the answer is built-in, and was built-in well before the stimulus package was enacted. Frequently the same economic models that said, a year and half ago, that the impact would be large are now used to show that the impact is in fact large. In other words these assessments are not based on the actual experience with the stimulus. I think this has confused public discourse.

An example is an article in the New York Times (11/21/2009) with the headline "New Consensus Sees Stimulus Package as a Worthy Step," which states that "accumulation of hard data and real-life experience has allowed more dispassionate analysts to reach a consensus that the stimulus package, messy as it is, is working. The legislation, a variety of economists say, is helping an economy in free fall a year ago to grow again and shed fewer jobs than it otherwise would."

As evidence the article includes simulation results from three models, which are reproduced in the three charts on the left below. Each of the three graphs on the left corresponds to a model maintained by the group shown above the graph. All three graphs show that without the stimulus the recovery would be considerably weaker. The difference between the black line and the gray line is their estimated impact of the stimulus. But this difference was built-in to these models before the stimulus, and in this sense there are no new hard data or experiences here.

In fact other economic models predicted that the stimulus would not be very effective, and, using the same approach those now say that it has not been very effective. To illustrate this I show two other graphs on the right-hand side of the chart which did not appear in the New York Times article. The first one is based a model estimated by Frank Smets, Director of Research at the European Central Bank, and his colleague Raf Wouters. The difference between the black and the gray lines is what is predicted by that model. Note that the impact is very small. The second additional graph on the right is based on the research of Professor Robert Barro of Harvard University who reported in an article in the Wall Street Journal "when I attempted to estimate directly the multiplier associated with peacetime government purchases, I got a number insignificantly different from zero." So according to that research, the difference between the black and the gray line should be about zero, which is what that graph shows. So there is no consensus among models or theories that the stimulus had a significant impact.



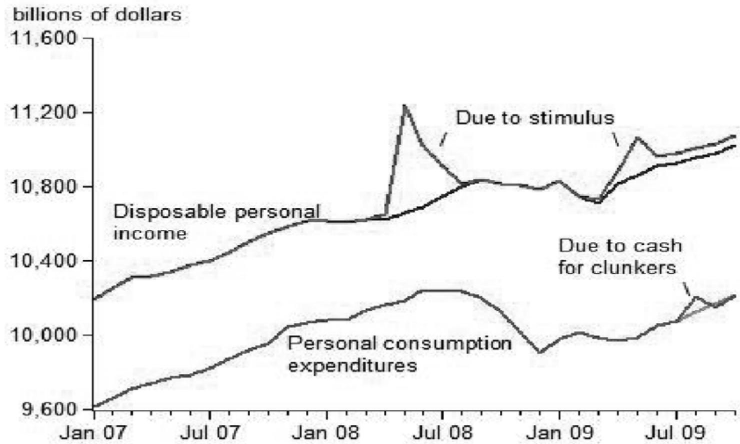
Other evidence from models comes from an International Monetary Fund study which reports estimates of government spending impacts which are much smaller than those previously reported by the Administration. The IMF uses a very large complex model called the Global Integrated Monetary and Fiscal (GIMF) Model. It shows that a one percent increase in government purchases (as a share of GDP) increases GDP by a maximum of 0.7 percent and then fades out rapidly. This means that government spending crowds out other components of GDP (investment, consumption, net exports) immediately and by a large amount. The IMF estimate is much less than the impact reported in a paper released last year by Christina Romer of the Council of Economic Advisers and Jared Bernstein of the Vice President's Office.

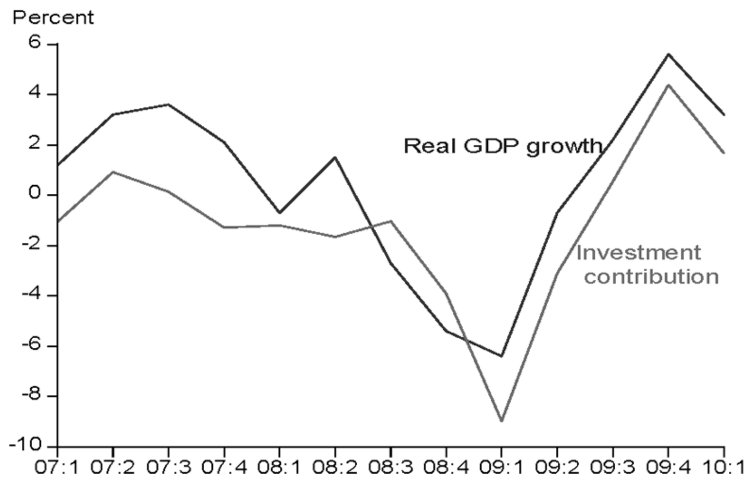
John Cogan, Volker Wieland, Tobias Cwik and I raised questions about the Romer-Bernstein estimates soon after they were released in January 2009 because the estimates seemed to be much different from comparable estimates based on more modern models. In fact, we found the economic impacts to be much smaller. Since then many technical papers have been written on this subject and in my view the consensus is that the impacts are much smaller than originally reported by Romer and Bernstein.

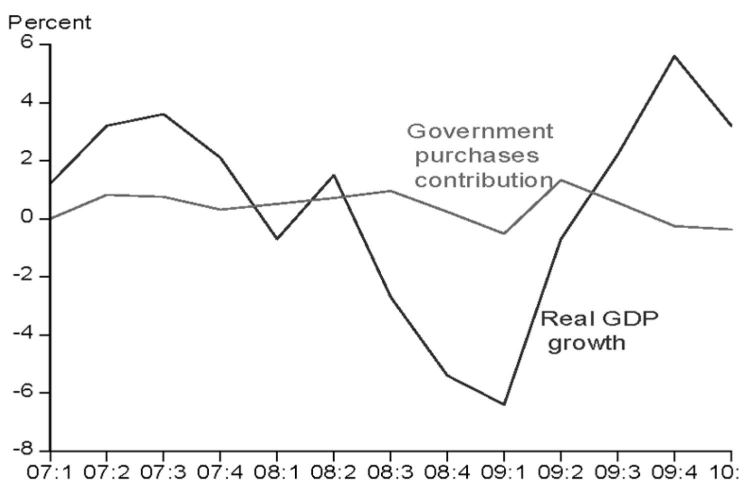
EVIDENCE FROM THE FACTS: THE STIMULUS DID NOT HAVE A SIGNIFICANT IMPACT

Now let me go beyond the models and look at the direct impacts using data. Consider first the 2008 discretionary countercyclical fiscal stimulus—the Economic Stimulus Act of 2008—in which checks were sent to people on a one-time basis and aggregate disposable personal income jumped dramatically though temporarily. The objective of the stimulus was to jump-start consumption demand and thereby jump-start the economy. However, aggregate personal consumption expenditures did not increase by much at all around the time of the stimulus payments. For the discretionary fiscal stimulus which was passed in February 2009—the American Recovery and Reinvestment Act of 2009—checks were also sent; they were smaller and more drawn out than the 2008 stimulus, but the impact was about the same: no noticeable effect on consumption. Both cases are illustrated in the chart below. This is what basic economics—in particular the permanent income theory and the life cycle theory of consumption—would predict from such temporary lump-sum payments.

In addition, my analysis of the government spending part of the stimulus suggests that it had little to do with the turnaround in economic activity. Indeed the swings in economic growth from positive to negative during the recession and again to positive during the recovery (including the slowdown to 2.7 percent growth rate of real GDP in the first quarter) provides evidence that changes in government spending had at best a very small contribution to the recovery. Most of the recovery has been due to investment—including inventory investment, which was positive in the first quarter after declining for all of last year—and has little to do with discretionary stimulus packages. The two charts show the percentage contribution of investment and government purchases to real GDP.


billions of dollars
11,600
11,200
10,800
10,400
10,000
9,600
Due to stimulus
Disposable personal income
Due to cash for clunkers
Personal consumption expenditures
Jan 07
Jul 07
Jan 08
Jul 08
Jan 09
Jul 09


Percent
6
4
2
0
-2
-4
-6
-8
-10
Real GDP growth
Investment contribution
07:1 07:2 07:3 07:4 08:1 08:2 08:3 08:4 09:1 09:2 09:3 09:4 10:1


Percent
6
4
2
0
-2
-4
-6
-8
Government purchases contribution
Real GDP growth
07:1 07:2 07:3 07:4 08:1 08:2 08:3 08:4 09:1 09:2 09:3 09:4 10:1

The charts clearly indicate that the changes in real GDP growth have been mostly due to changes in investment and little to changes in government purchases. In fact, government purchases were a drag (a negative contribution to real GDP growth) in the fourth quarter of 2009 and the first quarter of 2010.

One could argue that government spending might have declined by a larger amount without the stimulus because the stimulus package prevented state and local government from cutting spending. More research is needed to determine what would have happened in the counterfactual of "no discretionary stimulus," but in the meantime these data at the least suggest that the recovery and the slowdown have been due to changes in investment not government purchases.

CONCLUSION

The combination of the unsustainable debt projections illustrated in my first chart and the little if any impact of the stimulus packages illustrated in my other charts has clear policy implications: Fiscal policy should avoid further debt-increasing stimulus packages which do little to stimulate employment or GDP. Fiscal policy should focus on reducing the deficit and the growth of the debt-to-GDP ratio. Reforming existing entitlement programs to hold their growth down and limiting the creation of additional entitlement programs are essential.

Chairman SPRATT. Thank you, sir.

Let me read you what Dr. Bernanke had to say, each one of you, and ask you do you think it is a fair statement.

"Certainly we have averted what I think would have been, absent those interventions, an extraordinarily severe downturn and perhaps a Great Depression."

Is this overstating it for dramatic effect? Is this exaggerating the risk? And do you accept his judgment that, absent those interventions, we would have had severe consequences? Dr. Baily?

Mr. BAILY. I would generally agree with what Ben Bernanke said. And, by the way, I think he is one of the heroes of this. He made mistakes before the crisis, but when he got hold of things he did a lot of the right things, working with Congress and the administration.

Would we have gone into a Great Depression? I think our economy is a little bit more stable, the institutions and so on are more stable than they were in the Great Depression. And we do have deposit insurance. We do have unemployment insurance. So I am not sure we would have gone 25 percent unemployment, but basically he is right. We already did go into a very nasty recession, and it would have been much worse without those things.

Chairman SPRATT. Dr. Zandi?

Mr. ZANDI. Yes, I would have agreed with that view, that without the policy response the recession would have devolved into another depression; and, in all likelihood, we would still be struggling with that.

And one other quick point. I think if we go back into recession, which I would put the odds at still being low but uncomfortably high and rising—if we go back into recession, we cannot rule out that we would go back into a depression.

Chairman SPRATT. Dr. Taylor.

Mr. TAYLOR. Yes. I disagree with that interpretation. Of course, it is a generalization. But I have looked carefully at many of the programs and new facilities that the Federal Reserve has implemented, and I have tried to divide it into things done before the panic and the fall of 2008, those during the panic of 2008, and those since the panic of 2008.

By and large, the ones done before the panic I think were quite harmful; and, in fact, I think you can argue they led to the panic. The ones—some during the panic I think were constructive. They indicated there were some markets that were actually shut down and were helpful. The ones after the panic, I would go back and say it seems to me they have not been very effective.

So I believe that if you just look back through all the interventions and if we had actually followed policies that were followed much of the 1980s and 1990s, we wouldn't have not only the—we wouldn't have had even the recession we had. And so, in my view, the way to think about the policy is a better policy could have avoided the whole mess, and I have seen no evidence that the policy that was taken avoided another Great Depression.

Chairman SPRATT. Dr. Taylor, you have shown some graphs which you think cast some doubt on whether or not there was a causal connection between the Recovery Act and the performance of the economy. To all three of you, how do we establish a causal connection between economic policies taken and the apparent turnaround of the economy in a rather dramatic fashion over a period of 12 months? What is the correct way to establish causality?

Mr. TAYLOR. I think timing is probably the best way to do it, Mr. Chairman. If you look at monthly data, for example, on orders, investment orders definitely bottomed in December of 2008, January, 2009, forward-looking order statistics. It seems to me that represented a fact that people realized the panic was over and it wasn't going to be as bad as they thought. That is pretty simultaneous with the second group of measures I mentioned that were taking place during the panic, and so that is why I say some of those I think were helpful.

But this fiscal stimulus package, the originally $878 billion, that came after that. So I think the timing is important.

Plus you have to really look at the data, look at the numbers. And, as I showed you, my numbers seem to say that the private investment, including inventory investment, by the way, both accentuated that downturn and was part of the reason for the rapid boom.

So I believe you can learn a lot from looking at the numbers themselves. It is not foolproof. You need to have sort of a model or a theory to think through what would have happened otherwise, try to do that. But you have to look at the numbers and look at the timing. That is what I have tried to do.

Chairman SPRATT. Dr. Zandi, Dr. Baily, how do you determine this causality between policies taken and results achieved?

Mr. ZANDI. Well, I also think timing is important, and I think the timing is very consistent with the view that the stimulus, the fiscal stimulus—and I am speaking of the ARRA—jump-started the recovery.

I am speaking from memory, but Q-1 '09 the economy contracted, as measured by real GDP, at just over a 5 percent annualized rate. In Q-2, it contracted approximately 2 percent; and by Q-3 we had positive growth. This is precisely when the stimulus kicked in. We had no stimulus in Q-1 '09; we had 60, 70 billion in Q-2; and about 80, 90 billion in Q-3. And that is precisely when we went from a very severe recession with rapidly rising unemployment to economic growth and stable unemployment.

So I think timing is very, very important. And the timing, from my perspective, is very strong evidence that the stimulus has worked well. And even using the graphs that John has presented, I think we can explain exactly what is going on in those charts if we look at the data a little bit more carefully. So it is a matter of I think extensive debate, but I think the timing is clear evidence of the stimulus' benefit.

Chairman SPRATT. Dr. Baily.

Mr. BAILY. John looks at model results, and obviously models do differ. But I think a set of reasonably mainstream models, including Mark's Moody model, Global Insights, Macro Advisers, the main forecasting models that have been successful in forecasting the economy, they didn't necessarily forecast the depth of this recession but have proven their worth over the years. They generally show that the stimulus had a significant impact.

John mentions Robert Barro's model. Well, Bob Barro is a wonderful economist, but he very firmly believes, starting from the beginning, that fiscal policy won't do anything to stabilize the economy. That has been one of his viewpoints for years and years. And he believes that if you cut taxes now, for example, people won't change their spending because they will anticipate taxes are going to rise later. I think that is a little bit fanciful.

So I think some of these models are more plausible than others, and I think the more sensible models show the effect.

In terms of government purchases, well, I would agree with John in the following sense: Government purchases were not by any means the biggest driver of this recovery. I think the fact that they continued to go forward even though we were going into this downturn was helpful. So the fact that they did not fall dramatically, and particularly the State and local spending didn't fall dramatically, was a positive item. But quite a bit of the stimulus was not directed toward government spending. It was directed towards tax cuts or benefit increases of some kind and went into people's pockets. And, again, it is just the underlying logic.

I am sympathetic to the view, in a full-employment economy, if the government increases its spending, probably someone else in the private sector is going to cut back their spending if you are going to maintain overall balance. But during a recession when you have got a huge shortage of demand, when employment is falling, when GDP is falling, you don't get that offset. It is just a net addition to jobs and income.

Chairman SPRATT. Thank you.

And let me turn now to Mr. Ryan for any questions, because it looks like we have a vote coming up.

Mr. RYAN. I will try to keep mine briefer than normal.

We have John Taylor here. You are from California. You are not here that often. So I want to go into monetary policy just for a minute, if I could, since we don't have the opportunity to have this kind of conversation; and, these days, that monetary policy matters a great deal.

You wrote a great book sort of indicting the Fed funds rate, the loose money in 2003 to 2005, getting us off the Taylor rule, off the great moderation. Give us a sense of where you see monetary policy now, how this unwinds, and what is your read of your rule?

Some people say we ought to have a negative fed funds rate. What is your take on where rates ought to be now? And what is the unwinding going to look like, in your opinion, and when will the timing of it occur? And interest on reserves. I am very concerned about that tool, on how, when it is deployed to fight an eventual inflation problem—obviously, not one right now—will that basically precipitate another credit crunch?

Mr. TAYLOR. Thank you very much.

I think there is no question in my view—and I think more and more people are looking at this—that the very low rates in 2003, 2004, 2005 did accentuate the housing boom and ultimately the bust. There are different ways to look at it. If you look at other countries, that seems to be a major factor as well. Of course, there is still debate about it.

When you look at the current level of the Federal funds rate, of course, we are in a much different situation now. We are just coming out of a deep recession. The inflation rate is lower. There is not inflationary pressure. So the low interest rate that is there now seems to me about right.

I don't think that if you use a Taylor rule, at least as I originally defined it, you see negative rates. I think that some people change the rule and they do other things. So I think it is about right, right now. And what that suggests is that if we are unfortunate and inflation starts to pick up sooner than we think, or even if we are fortunate and the economy starts to move faster than as markets indicated, then the Federal Reserve will have to raise rates if they are going to prevent a future inflation or actually prevent another downturn later in typical boom-bust style.

With respect to the unwinding of the huge balance sheet, over $1 trillion of reserve balances which largely is due to the purchases of mortgage-backed securities, I am concerned that that could occur too rapidly or too slowly. It is one of the uncertainties that is out there about how this is going to be unwound. I would prefer that the Federal Reserve reduces that balance sheet rather than try to pay interest on reserves or try to actually go out and do some actions itself with respect to its own securities. I think that would be a much quicker way to get back to what was working.

Because, after all, it seems to me, if you follow my logic, what we were doing before monetary policy got off track worked very well. We had this long great moderation, expansion in the 1980s, expansion in the 1990s, two minor recessions during that period. So as soon as we can get back to that policy, I think the better off we will be. And we don't do that by trying to do new things like interest on reserves, using that as a way to manage the Federal funds rate, but rather use just money, the supply and demand for money, to get to the funds rate that we need.

Mr. RYAN. Multiplier effects.

I have read Bernstein/Romer, read some of Mark's work. You did a piece with two German economists. I can't recall their names. I read it a while ago. Bob Barro, we have heard his stuff. Why are the multiplier rates lower, in your view, than what, say, Bernstein/Romer claims?

Mr. TAYLOR. Well, the models used by Bernstein/Romer, which by the way they didn't indicate which models they were, unfortunately. But as far as we can tell, there was one type of model used at the Federal Reserve and one private-sector model. As far as I know, those models don't have expectations built in very well. They don't model the financial market's expectations of the impact of future interest rates or inflation. And, in fact, there are many models that have been developed in the last 20, 30 years, the kind of models that we teach our graduate students. Almost all the universities do take account of expectations. So people will see, for example, that if there is a stimulus package, that means their taxes are going to increase to some extent in the future.

Mr. RYAN. It is a Neo-Keynesian model——

Mr. TAYLOR. It is called new Keynesian. It has the word Keynesian in it. Absolutely. It has very many of the rigidities and things like that that are typical Keynesian models. They are good models, but they do have this crowding out that can come pretty quickly even when the economy is at reduced levels of operation.

Mr. RYAN. I will cut my thing short.

Dr. Baily, you had a really interesting op-ed today in the Journal on multinationals. When it comes to tax policy, obviously, they are very elastic and sensitive to it. Is repealing deferral, trimming back on the tax, the foreign tax credit, is that helpful? Is that a good idea for fiscal policy with respect to multinationals going forward?

Mr. BAILY. I don't want to give you a direct answer to that question. What I would——

Mr. RYAN. Most economists don't.

Mr. BAILY. Well, give me a break here. I think it is appropriate to take a good, hard look at how we tax corporations. We don't collect a lot of revenue from corporations and so——

Mr. RYAN. Relative to?

Mr. BAILY. Relative to the tax rate. We have a high marginal tax rate of 40 percent, but we don't collect a lot of revenue. So I don't think the corporate tax is very efficient. I think we do need to make sure—and maybe this goes in your direction—that the way we treat our corporations is in line with the way other countries do so that we don't give them a competitive disadvantage. So I agree with you there.

I would mention, by the way, if we are talking about taxes, one of the things we do is give a very strong preference for borrowing in our society, both at the personal level and at the corporate level.

Mr. RYAN. That is the negative in your view.

Mr. BAILY. So maybe we could do a deal with the corporations. We will cut their corporate tax rate but maybe they pay a little more tax on interest and level that playing field a little bit.

Mr. RYAN. Should we go to a territorial system? Most of the rest of the world is. Do you think worldwide, hamstring us, we ought to go territorial?

Mr. BAILY. I think it is certainly worth looking at. I am not a tax expert at that level, I am afraid, but I think it is something that can be considered, yes.

Mr. RYAN. Do the rest of you agree that our bias in favor of debt is a distortion that ought to be remedied? What is—you can just give a quick answer.

Mr. ZANDI. Yes.
Mr. BAILY. Yes.
Mr. TAYLOR. I do.
Mr. RYAN. Thank you.
I want to give other people time. Thank you very much.
Chairman SPRATT. At this particular point in time I recognize Mr. Becerra.
Mr. BECERRA. Thank you, Mr. Chairman; and thank you, gentlemen, for your testimony. And recognizing our time is short, let me go to Dr. Zandi and ask a quick question.
Dr. Zandi, when you were an economic adviser for then-Presidential candidate John McCain, Senator McCain, in his Presidential campaign, you and others who were advising him economically, did you foresee at that point back in 2007, 2008, the depths and the grip of this economic—great recession, I guess you would call it at this stage, that we are now trying to escape?
Mr. ZANDI. No, I can't say that I did, no.
Mr. BECERRA. And could you have foreseen the economic consequences that we now find ourselves in as we try to escape the grips of this great recession?
Mr. ZANDI. I am less surprised at how difficult it is for the recovery to get going, because this was a very, very severe shock with enormous implications. So it is not surprising to me that this is a weak recovery.
Mr. BECERRA. And there are always the Scrooges and the folks who say America has got the glass half empty these days, the pessimists that won't accept some good news. And while we are still in the midst of this great recession, the fact is over the last 5 to 6 months we have created about 1 million new jobs in this country. Compare that to the last month that George Bush was in office, where in that 1 month of January, 2009, we lost close to 800,000 jobs, big turnaround.
Obviously, we have a long way to go. And you mentioned, as the chairman in his remarks mentioned, that Chairman Bernanke has mentioned, that we need to continue to make sure we can climb out of this dark hole and that if we act too quickly to squeeze ourselves out of this fiscal deficit that we face this year and this national debt that we are facing that we might actually squeeze out the economic recovery.
And yesterday, in testimony before the President's fiscal commission, I believe Mr. Elmendorf, Doug Elmendorf of the Congressional Budget Office, said something about the same as what you just said. He essentially said—again, speaking your economic language—"There is no intrinsic contradiction between providing additional fiscal stimulus today while the unemployment rate is high and many factories and offices are underused and imposing fiscal restraint several years from now when output and employment will probably be close to their potential."
Is what Mr. Elmendorf said consistent with what you were saying?
Mr. ZANDI. Exactly. I wish I could say it as nicely as he just said it.
Mr. BECERRA. I think I prefer the way you said it. It is more like plain English.

Mr. ZANDI. I think that is entirely correct, yes.

Mr. BECERRA. Dr. Baily, quick question for you as well.

You mentioned in your testimony that we had to be very careful how we go about trying to get ourselves out of this black hole, but my sense was that you also believe that fiscal stimulus, where we try to help that recovery accelerate, is essential, although we have to be careful that it is modest enough to give us a chance to make sure that we can do the fiscally responsible thing with our budgets into the future.

Mr. BAILY. I think it would be helpful. I think, as Mark said, a lot of people are living off unemployment insurance, and I think it would be helpful to give them some consumption—some income so they can keep consuming.

And on the States and localities that are in just terrible budget situation—now, you know, obviously, we want our States and localities to be disciplined over the long run, but I think right now none of them foresaw this any more than the rest of us did, and it is a good thing to help them.

Mr. BECERRA. Don't cut off the swimmer's ability to swim out of the pond before it is too late and drown.

Mr. BAILY. Exactly. Now, you do have to send, I think, the right signal that you really are thinking substantively, and I applaud the commission and I hope that it is effective and I hope its recommendations result in changes in policy, but we do need to signal both ourselves and the rest of the world that we are going to do something about these huge deficits.

Mr. BECERRA. Thank you.

And, Dr. Taylor, before I run out of time, first, can you convey back to Stanford our best wishes, tell them that we gave you some Stanford weather here in Washington, D.C., today. It is nice to know we have got someone from our alma mater here with us.

I would love if you—and, unfortunately, my time is getting ready to expire, Mr. Chairman, but perhaps I can ask the doctor that he might give me his comments about the situation in Ireland, which my sense is tried to apply the brakes on any kind of stimulus and, in fact, went the other way, more along the lines that I think you talked about and that is to try to be fiscally responsible with our budget, and my understanding is things are pretty bad.

I am going to real quickly just mention that Ireland's downturn has been sharper than if the government had spent more to keep people working. Lacking stimulus money, the Irish economy shrank 7.1 percent last year and remains in recession. Joblessness in the country is above 13 percent. The ranks of their long-term unemployed have more than doubled, and the budget went from surpluses just a few years ago in 2006 and 2007 to a staggering deficit of 14.3 percent of gross domestic product last year, and it continues to deteriorate.

I would be interested to hear your comments. I don't have time, but if you can go ahead and give me some comments on how you see the situation in Ireland I would very much appreciate that.

Mr. TAYLOR. Just very quickly now?

Mr. BECERRA. Well, I know I am out of time, but go right ahead.

Mr. TAYLOR. I think when you look at Ireland you have to recognize where they were coming into this. It is like Portugal. It is like

Greece. High debt levels mainly because of an over-stimulus and so they are partly reacting to something that was so excessive.

If you want to look at examples that are I think more helpful to the current situation, look at Poland. Poland is the only country in the entire European Union that didn't even have a recession. They didn't have a recession because they followed I think a sensible policy.

Mr. BECERRA. But we did have a recession here, and while Poland may be a good example, Poland didn't have a recession. We are in the depths of a great recession.

Mr. TAYLOR. They didn't have a recession because they followed these good policies. We had a recession I think in part——

Mr. BECERRA. But our problem is we probably didn't follow those good policies because President Obama inherited an economy that was in the depths of a great recession. So while it may not be exactly like Ireland and it may not be exactly like Poland, I am interested in understanding, because my sense is for those who say we shouldn't do economic stimulus are speaking much the way the Irish were speaking about how they would get out of their great recession, and as far as I can tell, they are still in theirs, and they are trying to fiscally constrain it.

Mr. TAYLOR. What I am suggesting is that we don't have more stimulus at this point. The idea you can trade off in stimulus now, catch up later, I think that is a fine-tuning approach that has failed many times in the past.

What I think is most important if we get on with the business now of consolidation, it doesn't have to be Draconian. The point has to be laid out clearly in an orderly way. I think that could bolster confidence, indicate that the United States Government is moving ahead on the thing that the American people are concerned about, and I think that would help the economy much more than another stimulus.

Mr. BECERRA. Appreciate that. And if you have any comments on Ireland, I would love to hear them.

Mr. ZANDI. Can I make one quick point on that?

If you look at every European country that is going through fiscal austerity right now, their bond spreads have actually widened out. One interpretation of that, and I think it is a reasonable one, is that investors are nervous that the austerity is undermining their economy and therefore their ability to execute on these austerity plans. So I think that is increasingly good evidence that if you don't get out of a weak economy you are never going to be able to address your long-term fiscal problems.

Mr. BECERRA. To that point, I think the article I was reading from pointed out that the spread between Ireland's bond—what it pays for bonds and Germany pays for bonds is about 3 percent.

Mr. ZANDI. Right, it has widened out.

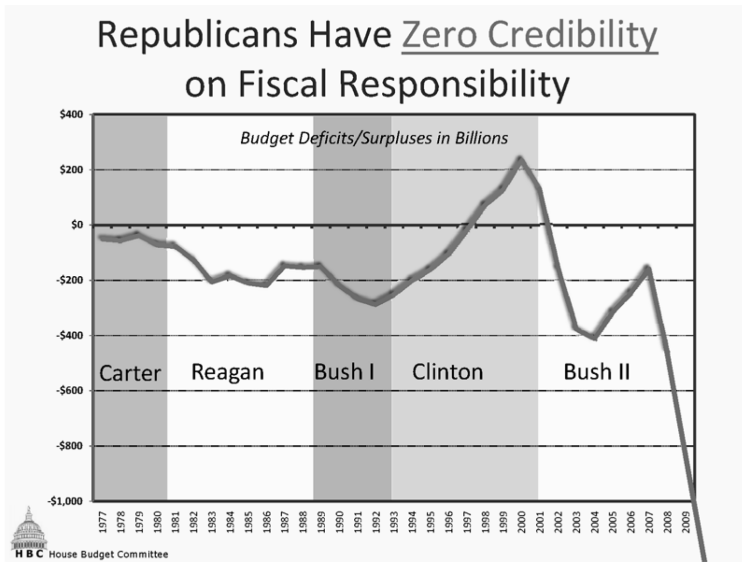
Mr. BECERRA. It is tough for them to get any money unless they pay a whole bunch for it.

I appreciate that very much, gentlemen. Thank you for your testimony.

Chairman SPRATT. Mr. Scott.

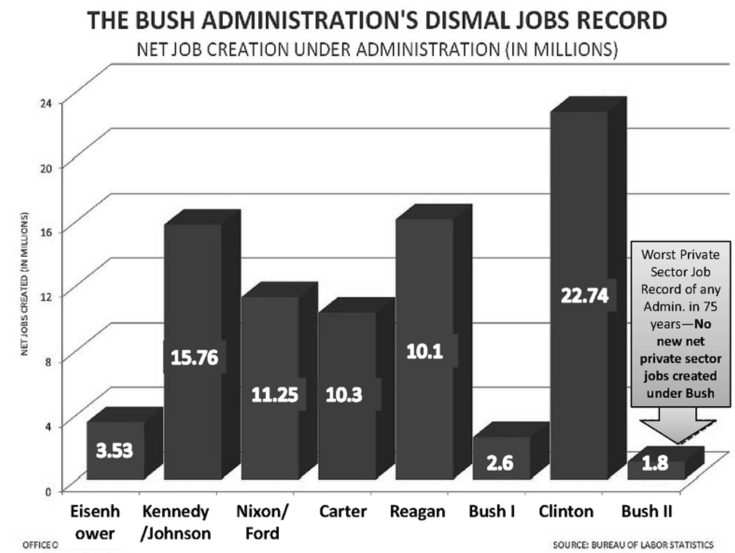
Mr. SCOTT. Thank you, Mr. Chairman.

We have been lectured by the other side about fiscal responsibility, and I think if can we just get that first chart up, this chart, the red is Republican administrations, blue is Democratic administrations. And you can see that we dug ourselves out of a ditch in 1993 and put us into a surplus situation, such a surplus that it was not allowed to continue. We were headed toward paying off the national debt held by the public by 2008.



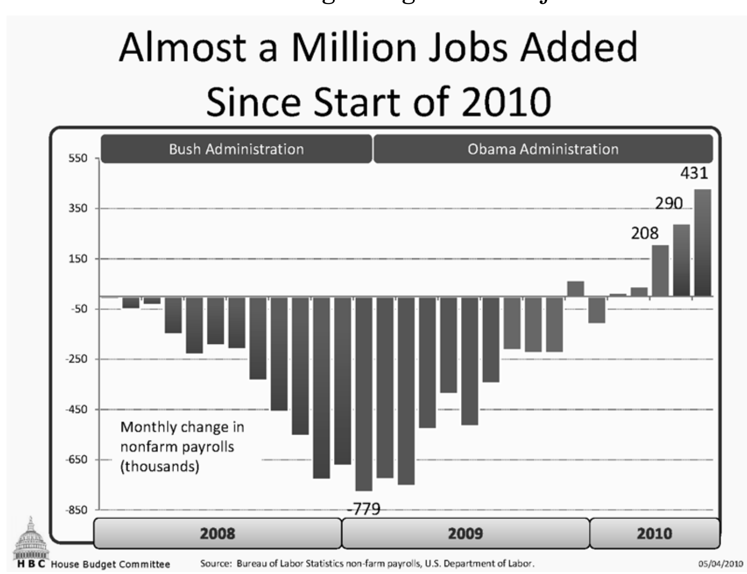
Chairman Greenspan, when he testified in 2001, was talking about, in answer to questions, what would happen to the bond market when there are no government bonds, what would happen with interest rates. President Clinton had to veto Republican budgets all through that to make sure that that blue line wasn't changed. If you wanted to know what would happen if he had not vetoed those bills, you can see President Bush signed those budgets and you see where we ended up in the ditch.

The next chart, we see that the incredible thing is, notwithstanding the fact that during the Bush administration they overspent the budget about $1 trillion a year, they produced the worst job growth since the—goes back to the Great Depression.



Now, the attack on the Democrats is we have a big deficit, but we also know that we have—we need to make sure that the complaint is precise. The complaint is that we have a big deficit that is there because of the policies put into effect by the Bush administration and the Democratic administration has not dismantled the Bush policies quickly enough. That is the chart. Now, the fact is we made a deliberate choice not to build the deficit until we got the job situation fixed.

And the other chart, we see where we were when—the red is the end of the Bush administration. We can see the blue, digging ourselves out of the ditch and beginning to create jobs.



Dr. Zandi, if we had had serious deficit reduction during the first year and a half of the Obama administration, what effect would that have had on jobs? And serious deficit reduction would mean, of course, increased taxes or reduced spending.

Mr. ZANDI. Of course, that would be very counterproductive and be consistent with no policy response and the idea that we would still be in a downturn.

Mr. SCOTT. In addition to the counterproductive effect of cutting spending and increasing taxes in the middle of a recession, what drag effect has there been because of cuts at the State level? How much have States cut their spending, thereby reducing jobs, that we have had to try to offset?

Mr. ZANDI. If you look at it in the context of State and local government spending as a contribution to GDP growth, in an average year since World War II, State and local governments add about a quarter percentage point to GDP growth every year. Over the past year, they have subtracted from GDP growth by approximately 20-basis points, 2 percentage points. And if they don't get any additional aid from the Federal Government, then over the coming year—of course, I have to do a number of assumptions—but that will be a negative contribution of somewhere around 35, 40 basis points, .4 percentage points. So that is a swing from normal times of at least half a percentage point.

Mr. SCOTT. Now, in terms of budget cuts, have the States not cut their budgets about $500 billion already?

Mr. ZANDI. I don't know the exact number, but they have clearly gone through some very significant budget cuts.

Mr. SCOTT. On the order of magnitude about $500 billion?

Mr. ZANDI. I think if you total it all the way back, in the hundreds of billions sounds about right to me.

Mr. SCOTT. And localities have been doing the same thing?

Mr. ZANDI. Yes, and I am including both State and local governments in those hundreds of billion of dollars, yes.

Mr. SCOTT. Say again?

Mr. ZANDI. The several hundred billion dollars would be both State and local together.

Mr. SCOTT. Okay. And so the first several hundred billion dollars of stimulus, all that did was to catch the people that had been laid off by the localities?

Mr. ZANDI. Exactly. If you take a look over the past year, the budget hole was about $150 billion for State and local together, and that is almost precisely what State and local governments got as part of the stimulus package.

Mr. SCOTT. Dr. Baily, did you want to comment on the drag that States have caused and the necessity of the Federal Government to actually increase spending which has a detrimental effect on the budget? As soon as we get the jobs back, we will do the responsible thing and get the budget under control. Because that first chart showed we know how to do it, and we will do it, but we just can't do it in the middle of a recession. Did you want to make a comment?

Mr. BAILY. I think I agree with pretty much everything you said, and certainly I think it goes to the earlier discussion. When you see the stimulus and say, well, it didn't prevent the recession from happening, that is in part because States and localities were cutting so much employment that you were really just filling in the hole they were creating. So I think I agree with you very much on that.

Going forward, I think dealing with the deficit is going to be tougher than it was during the Clinton years. It was plenty tough then, but we did get very strong economic growth, and we had not yet reached the sort of some of the pressures that come from the baby boom generation retiring. So I think it is going to be a tougher challenge down the road as we deal with the deficit. But on the points you made and that Mark made I agree with you completely.

Mr. SCOTT. Well, people suggested that the Clinton administration was lucky because of the economic growth, but it is kind of paraphrasing that sports analogy, the more fiscally responsible we were, the luckier we got.

Mr. BAILY. I think we were lucky, but I also think that the administration did the right things, and, you know, it was Congress as well as the administration. But I think Clinton—the general Clinton-Rubin policy was to try to allow markets to work but to get the budget back on track and to regulate responsibly, and I think those policies worked extraordinarily well.

Mr. SCOTT. So we made our luck because we were fiscally responsible and we had that loaded cannon every time something——

Mr. BAILY. Exactly.

Mr. SCOTT. We had a surplus that was sufficient to pay off the national debt. If this recession had occurred back in the Clinton years, we could have had the stimulus out of the surplus without having to borrow the money.

Mr. BAILY. Exactly.

Chairman SPRATT. Thank you, Mr. Scott.

Mr. ETHERIDGE.

Mr. ETHERIDGE. Thank you, Mr. Chairman.

Let me thank these gentlemen this afternoon for being here.

Early on, I was a small businessman long before I got into this business and understand something about balancing your books and keeping your books right. But, at the same time, there are times when you are required to make an investment, and I think you have to be prudent in how you make that investment if you want to grow. And if you are a businessperson and you continue to cut, you can't get there, but you have got to have prudent investments.

Dr. Zandi, let me ask you a question, because the economic recovery, many are saying, is still fragile. I think you have said that. All three of you have indicated that one way or another.

Do you agree with the Federal Reserve Chairman Bernanke, as the chairman said earlier, when he testified at our last hearing that the danger of scaling back too soon may be far greater than some of the other things we could do if we want to keep this economy from really sliding into some more problems?

Mr. ZANDI. Yes, I would agree with that. I think the odds are that if fiscal policymakers did nothing else that the economy would still probably get through this period without going back into recession.

But, having said that, I think the odds are uncomfortably high that I am wrong and that we would go back. And more importantly than that, if we do go back into recession, there is no good policy response. The Federal Reserve cannot respond effectively, and you won't be able to effectively respond because at that point the deficit will be ballooning out.

So, given that, I think it is prudent risk management to err on the side of doing too much rather than too little over the next 6 to 12 months.

Mr. ETHERIDGE. Let me ask one additional question along that line. Because we have been struggling here, as you well know, for several months on Federal medical assistance percentages going to the States. We have talked with our Governor, and I think something like 34 Governors have included it in their budgets, and in North Carolina that is about half a billion dollars. It is a substantial amount. If it doesn't flow, then they will be cutting education and a host of other things.

And many States are really suffering from unemployment. My home State is higher than the national averages——

Can you speak for just a moment about the importance of this kind of aid, how this blends with the other—you touched on it some—and if it continues to decline, what effect it will have on the overall deficit in the short term as well as in the long term as we are trying to dig out of this hole?

Mr. ZANDI. Well, I think that the need for helping—the Federal Government to help State and local governments through this mess next fiscal year is very important for the reasons we have discussed. The most efficient way I think to do that is to help them with the Medicaid program, the costs related to FMAP; and if the Federal Government is able to provide help for FMAP say for the second half of fiscal year 2011, that would free up resources that will allow them to forestall more serious job cuts, program cuts, and tax increases. They will have to do it anyway, because their budget hole is that large and there is no way the Federal Government is going to help them to the degree to forestall it. It will be significant but at least it will forestall the most Draconian cutting.

Mr. ETHERIDGE. Let me ask one additional question or maybe two if we can get them in in time.

Congress passed—I introduced a piece of legislation and the administration worked on it, we got it through—called the HIRE Act to create credit for people hiring people who are unemployed. Is it too early to know if this is really working?

I have talked with some people in the last few days. One company has already hired 50 people. Now, whether or not they would have hired them or not, I don't know, but they are going to get the tax credit. So that is an advantage. I would be interested in your thought on that.

Mr. ZANDI. I think it is too early to evaluate that program based on macroeconomic data. I think right now it is mostly anecdotal.

I do think as you approach the deadline, which I believe is November, December, I think you will start to see—in the next few months, we should see a little bit more take-up. But, you know, so far, the macroeconomic data is not sufficient to be able to evaluate it.

Mr. ETHERIDGE. Dr. Taylor, let me ask you one question. Because you didn't talk about the recession or how deep it was. What you talked about was panic. I would be interested in your definition of panic.

Mr. TAYLOR. I was referring to the period mainly in the fall of 2008 when the financial markets froze up, equity prices fell by 30 percent in 2 or 3 weeks, and that really went around the world, actually, equity prices. It was a major hit to the world economy in that particular period. So that is what I mean by the panic. The crisis is sort of a longer period beginning——

Mr. ETHERIDGE. Right. During that panic period, as it was descending, we lost about $17 trillion in value of retirement income, housing, et cetera, 8 million jobs, and all these things were a part of that panic piece——

Mr. TAYLOR. Part of the panic. And I think without that panic we obviously were going into a recession anyway, but that is really what made this the great recession. That panic was really a terrible shock. And I think, in my looking at the numbers, people realized were stabilizing by December of 2008, and if you look at the monthly data, you see investment beginning to recover by January. So that panic was very important, and so in my analysis of this whole great recession, that is why I focused on it.

Mr. ETHERIDGE. I am not an economist. I just have enough training in 101 to know that the markets are doing some of the same things all over again, I have noticed over the last several days, and people are getting nervous all over again.

Thank you, Mr. Chairman. I yield back.

Chairman SPRATT. Thank you, Mr. Etheridge.

Mr. RYAn has further questions, and Mr. Hensarling I believe is on his way. Mr. Ryan.

Mr. RYAN. I am just curious. I would like to ask each of you. Sovereign debt is now becoming a new kind of toxic asset, I suppose. Give us your take on the risk of contagion washing up on our shores with respect to Europe. Do you think the European bailout program, whatever you want to call that, is going to work and what is the risk of default among the PIGS, Greece? And if a default does occur, what do you think happens to our bond market?

Dr. Baily and going over, why don't we just do that?

Mr. BAILY. It is very hard to see Greece getting out of its mess without some of kind of restructuring, which means to say a partial default on those bonds. If you look at—I think John mentioned in his testimony there are some fundamental structural problems in the euro, that some of the countries are just not competitive. Germany got its costs under control and became competitive, and Greece and some of the other countries did not. And so that puts you in a bind. Because if you are going to repay that debt, basically you have got to transfer money to the other countries in Europe. The only way to transfer the money is to make the money by exporting, and if you are not competitive exporting, you are really locked up.

So I think they are going to have to restructure. I think there is a threat that the euro could unravel, although I think it is very unlikely. I don't think Greece and Spain and Portugal would leave the euro, because they would see their own interest rates rise so much that they don't want to.

A country that in a sense might be thinking about it is Germany, because they are, in a sense, carrying the weight of the other countries. But then again I don't think Germany will because Europe is a big export market, and so I think it will hold together, but it is proving to be fairly costly.

Your question was, will this wash up on our shores? Well, it has washed up on our shores. Every time there was sort of a new story about problems in Europe our stock market lost a couple hundred points and that foments some of the concerns and panics here, and it is amazing how these financial crises do spread around the world. I mean, some of it is also interdependent in trade but also a lot of the same companies operate, a lot of the banks operate across borders.

You would sort of think, well, Greece is such a tiny country and it is only a fraction of California, never mind the United States, but it does seem to create an unsettled feeling in the markets that could affect us.

I think the blessing in disguise for Greece is that it maybe has given all of us a lesson in that we can't just borrow and borrow and borrow forever, that at some point we are going to have to deal with deficits. As I say, not necessarily today but down the road we have to do that.

Mr. ZANDI. My sense is that the European policymakers will contain the crisis, that what they have done so far is really quite impressive and they still have room to maneuver. The trillion dollar package from the EU IMF is equal to all of the sovereign debt of Greece, Portugal, Spain, Ireland that will mature over the next 5 years. So I don't think there is any real possibility of a default anytime in that period of time.

And the ECB, European Central Bank, is engaged in purchases of sovereign debt. Mostly, it appears they are buying Greek and Portuguese debt. They can expand that out.

Mr. RYAN. How do they sterilize? They claim to be sterilizing. They are not easing. How do they do that?

Mr. ZANDI. They are issuing securities into the marketplace to drain the liquidity. So they are buying the bonds that is providing liquidity and they are issuing other securities.

Mr. RYAN. And the market is working for that?

Mr. ZANDI. So far, so good. The ECB target rate is still 1 percent, and they have been able to target that pretty well, but they could decide if things start to weaken to not sterilize, right? They have room to maneuver there, too, and the European economy is roughly the same size as the U.S. economy, the Federal Reserve about $300 billion worth of Treasury bonds, when they were credit easing, put it in the same kind of ballpark, they could buy up $300 billion.

Now, so far, the impact on our economy has been meaningful, but it is modest. There is positive and there is negative. The negative, obviously, is the equity market.

The bond market has been a positive, right? Long-term interest rates have come in. The 10-year Treasury yield is below 3 percent. There is a flight to quality. People still believe, and rightfully so, that we are the AAA credit on the planet. We have the strongest economy. We have a large economy. We have managed our affairs extraordinarily well over centuries. So I think they trust us and I think with good reason. So I think we are the beneficiaries and we have latitude in the near term to continue to borrow to help finance and support our economy.

Mr. TAYLOR. I do think Greece will have to restructure their debt. I think it can be done in a pretty orderly way, so I wouldn't call it default or something that would shock the markets. Their foreign bonds are all denominated in euros. That is a fairly straightforward operation. Some of the debt is issued under Greek law, some under English law. So it is pretty simple to do.

I think it would have been much better if they did it earlier because then we wouldn't have had to have this huge bailout package which creates its own worries down the road because other countries may get into the same situation.

I think the ECB's intervention is quite worrisome from the perspective of monetary policy. They are actually buying distressed debt. Central banks are supposed to be insuring the money supply and interest rates, keeping things stable. So this is taking them into a really new phase. They didn't want to do it. I think they want to get out of it as fast as they can.

I think I agree with Mark, and I put it this way. Contagion can be through markets but it can also be through policy. So often bad policy is contagious. It spreads across countries. It seems to me that what we might be finding here is the reaction in Europe to Greece is spreading. At that G-20 meeting where the United States was told a few things, I think is beneficial for us as well because that feels like a contagion of some better policies.

Mr. RYAN. Thank you.

I see we have got somebody back.

Chairman SPRATT. I recognize Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman. I am glad that you have reconvened us. I wish it would be to take up a budget, but we haven't lost hope yet. Maybe that day will occur sometime this year.

I see that at least two of the three of our panelists have been published in the Wall Street Journal today. I am not sure what to accord this honor to. And, Dr. Zandi, I haven't read one of your opeds recently, but I did read your book, and it was helpful.

Mr. ZANDI. Thank you.

Mr. HENSARLING. It was helpful. I appreciate that.

Mr. ZANDI. I am going to start working harder.

Mr. HENSARLING. Apparently, you need to work a little harder here.

Dr. Taylor, before I ask you about your editorial, I am actually going to ask you if you had read one by Dr. Meltzer that appeared in the Wall Street Journal yesterday on why Obamanomics has failed. He seems to take up a theme that you have about a kind of seed of uncertainty that had been sowed due to major policy initiatives. He states in his editorial piece, "Second, the administration and Congress have through their deeds and work heightened uncertainty about the economic future. High uncertainty is the enemy of investment and growth."

I assume that you agree with that; and, if so, could you go into greater detail in what you base your thesis on that uncertainty is part of what is keeping back our economic growth?

Mr. TAYLOR. Sure, and I do agree with Allan Meltzer in that piece. The uncertainty is due to several factors. It is just the depth that I mentioned is coming in a way we have never seen it before. Look, in our history this is well beyond, many times, what we have seen before. So that, if you like, new situation creates uncertainty. People don't know how it is going to get resolved.

There is an inconsistency. You can't have all that debt created and have the inflation forecast the things that people are predicting. So there is an inconsistency that has to be resolved, and people don't know how it is going to be resolved. That is an inherent uncertainty.

I think also you referred to my piece in the Journal today. That highlights another form of uncertainty, a massive change in how our financial institutions will be regulated, their relationship with government, a very complicated set of changes which people don't know exactly how it is going to work. It is a very complex bill.

Mr. HENSARLING. Including one of the authors of the legislation, Senator Dodd. You may have read his quote in the newspaper.

Mr. TAYLOR. I missed that.

But I think if you just go down the line you see this great uncertainty, plus globally you see situations like the sovereign debt that Congressman Ryan was referring to. We haven't seen that for a long time. I think that is affecting our markets. I say there is a lot of evidence for this. It is hard to measure. I don't want to say we have great models and theories of it, but I have never seen it like this before. It is very concerning to me.

Mr. HENSARLING. The chairman, the ranking member, and myself all serve on the President's Fiscal Responsibility Commission. We had a session yesterday and heard from Dr. Elmendorf. There still appears to be a continuing debate within the Commission on whether or not it is possible to both lay out a plan of fiscal sustainability for the long term while we debate government stimulus in the short term. I myself have strong opinions that the stimulus has failed, and I think it is a bad policy.

But, setting that aside—and I know that Chairman Bernanke's name has been invoked here. I believe he has said something along the lines of how important it would be to job growth today to lay out a plan of fiscal sustainability. And so do you have an opinion whether these are competing goals, complementary goals? Can Congress or this Commission, in specific, walk and chew gum at the same time?

Mr. TAYLOR. I guess I would say it would be tremendously valuable for confidence if a plan could be laid out, a credible plan, to keep the debt from exploding, which is where it is going right now, to keep it at a low level, to try to get it down.

There is not really an inconsistency. I think I would prefer if that path began right now with the budget you are starting to deliberate with, but even if that is up a little bit, then you can lay out the plan. So there is no—there is so much advantage—I used to do simulations of models that showed that you can get fiscal stimulus from having a good plan laid out for consolidation in the future. It builds confidence. It affects interest rates in a healthy way. So I think it would be beneficial to the economy, plus it would have the added advantage of showing that government is really doing something that is hard to do.

Mr. HENSARLING. In the absence of other members, if the chairman might indulge me one more question—I didn't hear the word "no"—in your piece, Dr. Taylor, you mentioned that I believe by far the most significant error of omission in this bill—referring to the financial regulatory markets bill—is the failure to reform Fannie Mae and Freddie Mac, the government-sponsored enterprises. Can you elaborate on just how significant an omission this is? And by lack of reform, to what extent does that contribute to the uncertainty that in turn contributes to our high unemployment rate?

Mr. TAYLOR. Well, it is an omission because if you would like the reform bill to address the financial crisis and, therefore, deal with it, that was one of the big factors in the financial crisis, the encouragement by Fannie and Freddie to buy risky mortgages, which accentuated the housing boom. So in terms of addressing the financial crisis, it was essential to have that in there.

Also, by not having it in there, if the bill actually goes through without that, it will be very hard to get it later. Because, as you know, comprehensive reform has the advantage of balancing off different interests, and so that balancing is now going to be much harder to do if Fannie and Freddie want to build a future.

With respect to the uncertainty, yes, the housing market isn't moving along as much as you think. I think Mark Zandi's referred to that. I think there is uncertainty about what the Fed has done, what Fannie and Freddie are going to do in the future. So some clarification of that would be I think very valuable for the same reasons I mentioned.

Mr. HENSARLING. Thank you.

Thank you, Mr. Chairman.

Chairman SPRATT. Gentlemen, thank you very much for your testimony today. We have got several votes coming up on the floor. We could continue this fruitful conversation for the rest of the afternoon, but thank you for coming. Thanks for your clarity and forbearance and your answers. We very much appreciate it, and we will be calling upon you in the future, I am sure. Thank you again.

The hearing stands adjourned.

[Questions submitted by Mr. Aderholt and their responses follow:]

QUESTIONS SUBMITTED TO WITNESSES BY HON. ROBERT B. ADERHOLT, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF ALABAMA

DR. BAILY

1. In your testimony, you state that the financial crisis was caused by a "perfect storm" of problems, one of which was regulator errors. Today, I hear from many community bankers in my district that overzealous regulators are hurting their ability to loan money to their customers. Do you believe such knee-jerk reactions as over-regulating may hurt the recovery more than it will help?

As discussed in my testimony, poor decisions by regulators did contribute to the financial crisis. Regulators and credit rating agencies were caught up in the same spirit of excessive risk taking that was endemic amongst financial institutions and ordinary market participants alike. In addition, government regulators failed to adequately oversee Fannie Mae and Freddie Mac, whose behavior did contribute to the development of a housing bubble, an important—but not singular—cause of the crisis.

However, the mistakes made by regulators were often a result of a systematic decline in the premium placed on risk following 25 years of strong performance in the financial sector and the belief that the business cycle had effectively vanished. All sorts of investors and financial institutions learned that financial risks were profitable and became less risk averse. Regulators remained more risk averse than the financial system writ large, but in times of excessive risk taking, regulators that are more conservative than the average investor are unlikely to provide adequate oversight. As a result, bubbles were allowed to pervade the financial system, in housing and other sectors.

The number of bank failures continues to remain high, with 118 in 2010 alone (through August 20), most of which are small banks. In addition, 775 banks continue to be classified as problem banks by the FDIC. These banks continue to have bad assets on their balance sheets and regulators can and should play an important role in ensuring that community banks are brought back to health responsibly, without returning to excessively risky lending standards that characterized the period immediately preceding the crisis.

During the boom years regulators erred in the direction of not being strict enough and in not requiring more stringent lending standards. However, the pendulum may have swung back too far in the other direction as banks are discouraged from making loans even when the prospects for repayment are good, if rather risky. It is important that we find the right balance of protecting depositors and taxpayers while encouraging economic growth.

2. In the question and answers with Congressman Becerra, you noted that "the right signal does have to be sent" to the world that the United States is serious in its commitment to put our fiscal house in order. Is the House of Representatives failing to pass a budget for the first time in 35 years the signal we want to send to the world regarding our fiscal stability? Do you see any negative consequences resulting from the failure of passing a budget for fiscal year 2011?

The failure to pass a budget is a problem and does not send the right signal to the world that the United States government can manage its fiscal affairs. I will not comment on who is to blame for the lack of agreement on the budget. In order to balance the federal budget over the next ten years it will be necessary to both increase revenues and curb spending. I hope that Republicans and Democrats will recognize this and work together to restore our fiscal integrity.

3. The Constitution does not give spending authority to a Presidentially-appointed Commission; it gives it to elected officials who comprise the House of Representatives and who must face the voters every two years to be re-elected. Isn't the refusal to pass a budget a direct refusal to do the job House Members are elected to do?

It is my understanding that the Commission will make recommendations and then Congress will act on those suggestions, while of course retaining its constitutional powers. Unfortunately the budget process has become mired in politics, a politics that is not grounded in reality. Any political leader that suggests raising taxes is vilified. Any political leader who suggests serious efforts to curb federal health spending or proposes measures to balance the long term Social Security budget is also subject to attack. Until Congress overcomes this poisonous atmosphere it will be difficult to achieve budget agreements. The Presidential Commission is a brave effort to cut through the politics and I hope that its recommendations can form the basis for a more constructive bipartisan dialog aimed at solving the terrible fiscal crisis we face.

DR. TAYLOR

1. As you know, the House of Representatives recently passed the conference committee version of the Financial Reform Bill. Unfortunately, this bill does little to reform government sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac. Does failing to address GSE reform in the financial reform bill leave the economy and financial sector exposed to another possible meltdown?

Failing to reform Fannie Mae and Freddie Mac leaves the economy and the financial sector in a more risky situation. Fannie Mae and Freddie Mac now sit with an estimated several hundred dollar cost to taxpayers and no path to resolution. Effectively their obligations add to the federal debt which is already starting to reach unsustainable levels.

These agencies were encouraged to expand and buy securities many of which were backed by mortgages that were very risky. Five years ago legislation, such as the Federal Housing Enterprise Regulatory Reform Act of 2005, was proposed to control these excesses, but it was not passed into law. These actions of these agencies should be added to the list of government interventions that were part of the problem leading to the financial crisis. Without reform the same series of events could occur again.

Unfortunately, neither the conference committee report nor the final Dodd-Frank financial legislation dealt with Fannie Mae and Freddie Mac, so reform is still needed. Doing so outside of that broader reform effort will be very difficult, but it is essential to get started.

DR. ZANDI

1. You noted that Congress must pivot to the "long-term fiscal situation once the recovery is complete". What policies would create a "long-term fiscal situation" that is conducive to economic growth and leaves future generations of Americans with a fiscally secure country? Do you prefer cutting spending or tax increases?

To ensure the nation's long-term fiscal sustainability, policymakers should work to reduce the nation's cyclically adjusted federal budget deficit to GDP ratio to no more than 3% by fiscal year 2021. The current cyclical adjusted deficit to GDP ratio is almost 6%.

To accomplish this objective will require both federal government spending cuts and tax increases. I would prefer that the majority of the required deficit reduction be done through spending cuts; something close to ⅔ spending cuts and ⅓ tax increases would be a reasonable goal. Based on an assessment of previous fiscal austerity efforts here in the U.S. and overseas suggests that government spending cuts rather than tax increases results in better longer-term economic performance.

With regard to spending restraint, a good first step would be address the current short-falls in the nation's Social Security system. This is a well-defined problem that if addressed could result in significant deficit reduction. With regard to tax increases, a good first step would be to cap the amount of tax deductions to some percent of taxpayers' total tax liability. This too would contribute significantly to deficit reduction. Taken together and fully implemented by FY 2014, these actions would go a long way to obtaining the goal of a 3% cyclically adjusted deficit to GDP ratio by 2021.

It is likely that policymakers will eventually need to do even more to address our longer-term fiscal problems as the large baby-boomer generation retires and uses the entitlement programs more intensively. To do this, growth in the costs of the Medicare and Medicaid programs will likely have to addressed. Comprehensive tax reform will also be necessary given that the nation's current tax system is complex, opaque, unfair, and is an impediment to strong long-term economic growth.

Returning the nation to fiscal sustainability will not be easy, but it is very doable, and of course we have no choice but to do it.

[Whereupon, at 2:48 p.m., the committee was adjourned.]

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