Testimony Prepared for the Hearing: Perspectives on the Economy

United States House of Representatives
Committee on the Budget

July 1, 2010

By

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

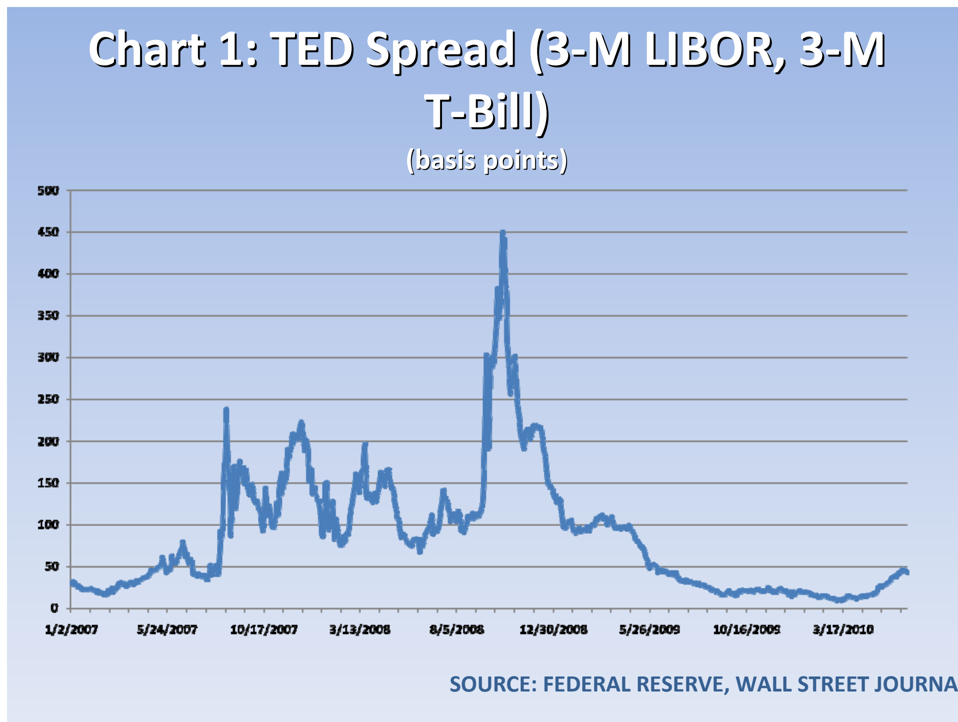
Key Points in this Testimony

- 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

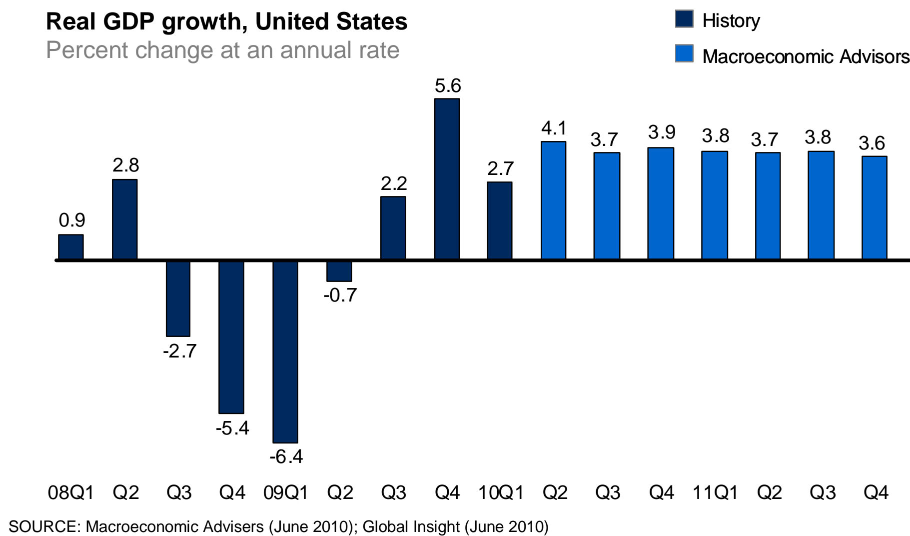
hit front and center in August of 2007 when wholesale lending markets seized up, making it difficult or impossible for some financial institutions to roll over their short term borrowing. Chart 1 shows the "Ted Spread" the difference between the LIBOR interest rate and the 3-month Treasury bill interest 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.

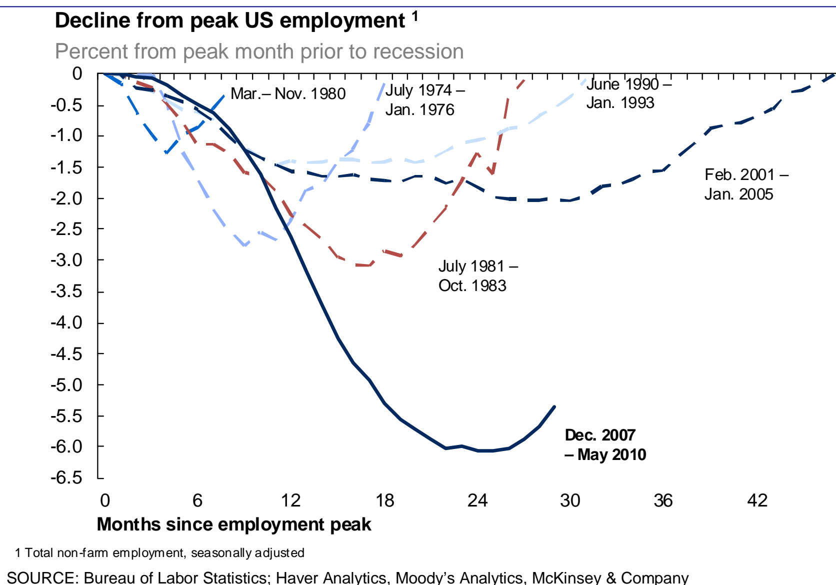
At first, it seemed as if the financial crisis would cause only modest collateral damage to the Main Street economy of jobs and production. Real GDP grew at 3.6 percent in the third quarter of 2007 and 2.1 percent in the fourth quarter. Even the first half of 2008 was not too bad with a small decline 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.

Chart 2: After Going into Freefall for Two Quarters, Real US GDP Rebounded in the 4th Quarter



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.

Chart 3: In the US this downturn has produced a record decline in jobs although declines have bottomed out



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:

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

- 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 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

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[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.

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

[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.

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 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	

[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.

[8] GMAC and Chrysler Financial.

2004	4
2003	3
2002	11
2001	4

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."

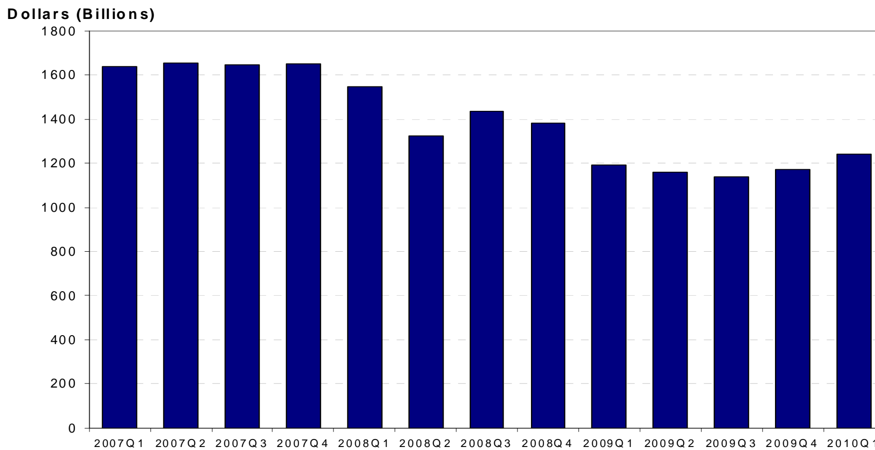
In summary, the policies to restore the financial sector are working. The recovery of the sector is not complete but the period of extreme anxiety is over and banks are positioned to lend more as recovery takes hold. This was done with costs that are large but not disproportionate to the problems being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

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

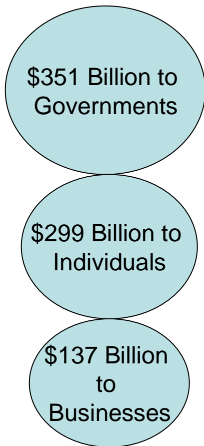


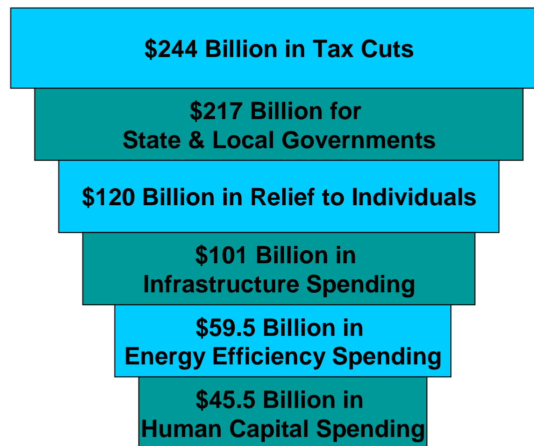
SOURCE: BEA

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 front-line 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 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.

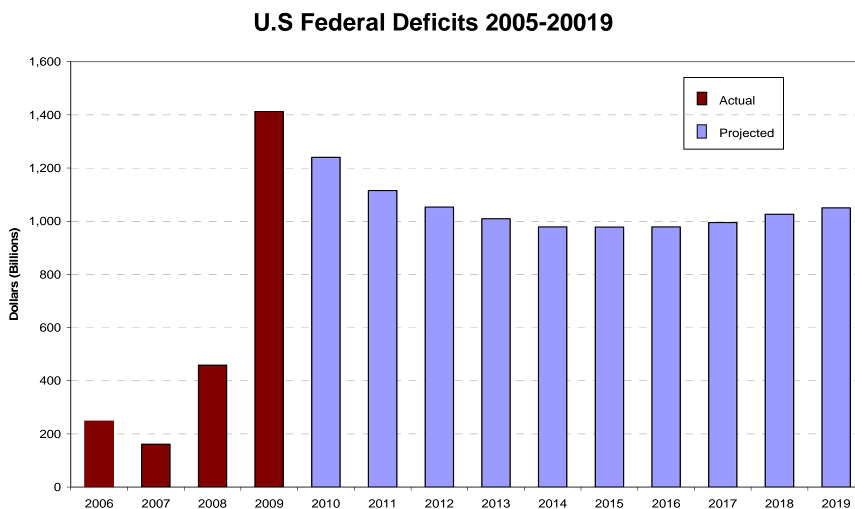
I am not willing to stand the usual economic logic completely on its head. Fiscal consolidation in Europe will have a direct effect in taking money out of people's pockets and cutting jobs and this will reduce demand and economic growth as a first-round effect. Nevertheless, I am sympathetic to a more 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.

[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.

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 moment. 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.

Chart 8: Projections of the Federal Budget Deficit. Deficits are Needed Now but are a Threat for the Future.



SOURCE: Projections from Macroadvisers, LLC

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.