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Main Points

1. The world economy is experiencing a modest recovery after near financial collapse this spring. The strength of the recovery varies sharply around the world:
   a. In Asia, real GDP growth is returning quickly to pre-crisis levels, and while there may be some permanent GDP loss, the real economy appears to be clearly back on track. For next year consensus forecasts have China growing at 9.1% and India growing at 8.0%; the latest data from China suggest that these forecasts may soon be revised upwards.
   b. Latin America is also recovering strongly. Brazil should grow by 4.5% in 2010, roughly matching its pre-crisis trend. We can expect other countries in Latin America to recover quickly also.
   c. The global laggards are Europe and the United States. The latest consensus forecasts are for Europe to grow by 1.1% and Japan by 1.0% in 2010, while the United Sates is expected to grow by 2.4% (and the latest revisions to forecasts continue to be in an upward direction). Unemployment in the US is expected to stay high, around 10%, into 2011.
2. The current IMF global growth forecast of around 3 percent is probably on the low side, with considerably more upside possible in emerging markets (accounting nearly half of world GDP). The consensus forecasts for the US are also probably somewhat on the low side.
3. As the world recovers, asset markets are also turning buoyant. Recently, residential real estate in elite neighborhoods of Hong Kong has sold at $8,000 US per square foot. A 2,500 square foot apartment now costs $20 million. Real estate markets are also showing signs of bubbly behavior in Singapore, China, Brazil, and India.
4. There is increasing discussion of a "carry trade" from cheap funding in the United States towards higher return risky assets in emerging markets. This financial dynamic is likely to underpin continued US dollar weakness.
5. One wild card is the Chinese exchange rate, which remains effectively pegged to the US dollar. As the dollar depreciates, China is becoming more competitive on the trade side and it is also attracting further capital inflows. Despite the fact that the Chinese current account surplus is

[1] This testimony draws on joint work with Peter Boone, particularly "The Next Financial Crisis: It's Coming and We Just Made It Worse" (*The New Republic*, September 8, 2009), and James Kwak. Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments for the global economy.

now down to around 6 percent, China seems likely to accumulate around $3 trillion in foreign exchange reserves by mid-2010.

6. Commodity markets have also done well. Crude oil prices are now twice their March lows (despite continued spare capacity, according to all estimates), copper is up 129%, and nickel is up 103%. There is no doubt that the return to global growth, at least outside North America and Europe, is already proving to have a profound impact on commodity markets.
7. Core inflation, as measured by the Federal Reserve, is unlikely to reach (or be near to) 2% in the near future. However, headline inflation may rise due to the increase in commodity prices and fall in the value of the dollar; this reduces consumers' purchasing power.
8. This nascent recovery is partly a bounce back from the near total financial collapse which we experienced in the Winter/Spring of 2008-09. The key components of this success are three policies.
   a. First, global coordinated monetary stimulus, in which the Federal Reserve has shown leadership by keeping interest rates near all time lows. Of central banks in industrialized countries, only Australia has begun to tighten.
   b. Second, global coordinated fiscal policy, including a budget deficit in the US that is projected to be 10% of GDP or above both this year and next year. In this context, the Recovery Act played an important role both in supported spending in the US economy and in encouraging other countries to loosen fiscal policy (as was affirmed at the G20 summit in London, on April 2nd, 2009).
   c. Third, after some U-turns, by early 2009 there was largely unconditional support for major financial institutions, particularly as demonstrated by the implementation and interpretation of the bank "stress tests" earlier this year.
9. However, the same policies that have helped the economy avoid a major depression also create serious risks – in the sense of generating even larger financial crises in the future.
10. A great deal has been made of the potential comparison with Japan in the early 1990s, with some people arguing that Japan's experience suggests we should pursue further fiscal stimulus at this time. This reasoning is flawed.
11. We should keep in mind that repeated fiscal stimulus and a decade of easy monetary policy did not lead Japan back to its previous growth rates. Japanese outcomes should caution against unlimited increases in our public debt.
12. Perhaps the best analysis regarding the impact of fiscal policy on recessions was done by the IMF. In their retrospective study of financial crises across countries, they found that nations with "aggressive fiscal stimulus" policies tended to get out of recessions 2 quarters earlier than those without aggressive policies. This is a striking conclusion – should we (or anyone) really increase our deficit further and build up more debt (domestic and foreign) in order to avoid 2 extra quarters of contraction?
13. A further large fiscal stimulus, with a view to generally boosting the economy, is therefore not currently appropriate. However, it makes sense to further extend support for unemployment insurance and for healthcare coverage for those who were laid off – people are unemployed not

because they don't want to work, but because there are far more job applicants than vacancies. Compared with other industrial countries, our social safety net is weak and not well suited to deal with the consequences of a major recession.

14. The first-time home buyer tax credit should be phased out.
15. GMAC should not receive a further infusion of government money. It should be turned down for any kind of additional bailout; as with CIT Group earlier in the summer, this would force a negotiation with creditors and some losses for bondholders (most likely through a pre-packaged bankruptcy process). This would not cause a general financial panic; probably it would actually strengthen the overall process of economic recovery, as it would move incentives in the right direction.
16. The lack of skills among people who did not complete high school or who did not attend college is a critical longer term problem in the United States. The impact of the recession will exacerbate the problems in this regard. We should respond by further strengthening community colleges, allowing them to offer more vocational skills classes and to provide a viable way for more people to work their way into four-year colleges.
17. America is well-placed to maintain its global political and economic leadership, despite the rise of Asia. But this will only be possible if our policy stance towards the financial sector is substantially revised: the largest banks need to be broken up, "excess risk taking" that is large relative to the system should be taxed explicitly, and measures implemented to reduce the degree of nontransparent interconnectedness between financial institutions of all kinds.

The remainder of this testimony reviews current U.S. macroeconomic issues in broad terms, assesses the lessons of Japan's experience in the 1990s, and make proposals for further essential reform (both fiscal and financial).

Current U.S. Issues

To be a strong global leader in the future, America needs to generate an environment where entrepreneurship, technological innovation, and immigration ensure that the nonfinancial private sector can continue to propel the US economy.

It is premature to argue that the US economy has stumbled into a "new normal" paradigm that involves slower growth. The factors that drove our growth over the last 150 years, particularly entrepreneurial startups and the commercialization of invention, remain despite the crisis. Indeed, these drivers of growth may become even stronger in the future, if we can reduce the wasteful financial sector activities that grew since the 1980s (and really flourished over the past decade) and allocate resources to more productive activities in the future.

America needs a new framework to harness that growth. That framework needs to address the following problems with our current economic structure.

Problem 1: With the recent financial sector bailouts, we have sent a simple message to Americans: The safest place to put your savings is in a bank, even if that bank is so poorly managed, and has such large balance sheet risks, that just six months ago it almost went bankrupt.

Despite being near to bankruptcy six months ago, Bank of America credit default swaps now cost only 103 basis points per year to protect against default, and the equivalent rate for Goldman Sachs is a mere 89 basis points. Goldman Sachs is able to borrow for five years at just 170 basis points above treasuries. This is not a sign of health; rather it indicates the sizable misallocation of capital promoted by current policies. American's leading nonfinancial innovators would never be able to build the leverage (debt-asset ratio) on their balance sheet that Goldman Sachs has, and then borrow at less than 2% above US treasuries. The implicit government guarantee is seriously distorting incentives.

Problem 2: We have not changed the incentive structures for managers and traders within our largest banks. Arguably these incentives are more distorted than they were before the crisis. So the problems of excessive risk taking and a new financial collapse will eventually return. Financial system incentives are a first-order macroeconomic issue, as we have learned over the past 12 months.

Today bank management is strongly incentivized to take large risks in order to raise profits, increase bank capital, and pay large bonuses to "compete for talent". Since they have access to a pool of funds effectively guaranteed by the state through being "too big to fail", there is the potential to make large profits by employing funds in risky trades with high upside. Such activities do not need to be socially valuable, i.e. it could be that the expected return on the investments is negative, but as the downside has limited liability, the banks can go ahead.

Problem 3: We have not changed the financial regulatory framework in a substantive way so as to limit excessive risk taking. The proposals currently proceeding through Congress are unlikely to make a significant difference.

Problem 4: The policy response to this crisis, with very low interest rates and a large fiscal stimulus, is merely a larger version of the response to previous similar crises. While this was essential to stop a near financial collapse, it reinforces the message that the system is here to stay.

Problem 5: The public costs of this bailout are much larger than we are accounting for, and people who did not cause this crisis are ultimately paying for it. Taxpayers and savers are the big losers each time we have these crises. We are failing to defend the public purse.

Our financial leaders have emphasized that our banks are well capitalized, and no new public funds are likely to be needed to support them. This is misleading. The current monetary stance is designed to ensure that deposit rates are low, and the spread between deposit rates and loan rates is high. This is a massive transfer of public funds to the private sector, and no one accounts for that properly.

It is striking that the Chairman of the Federal Reserve himself, in a recent speech, stated that no more public funds were needed to bail out banks. His institution continues to provide massive transfers to the banking system through loose credit and low interest rate policy. That credit could instead go to others; the Federal Reserve has chosen to transfer those funds to banks. This policy was used in the past to recapitalize banks (e.g., after 1982), but we have now a very different financial sector – with much more capacity to take high risks and a greater tendency to divert profits into large cash bonuses.

Today, depositors in banks earn little more than the Federal Funds rate and are effectively financing our financial system. We are giving them very low returns on their savings because the losses in the financial system were so large in the past. This is essentially public money – it is the pensioners, elderly people with savings, and other people who have no involvement in the financial system, that are being required to suffer low returns to support the banks.

We Are Not Japan

After the bursting of its real estate bubble, at the end of the 1980s, Japan faced a serious problem in its financial sector. This fact has inspired many people to look for parallels with the current US situation, and – in some cases – to draw the implication that we should pursue further large-scale fiscal stimulus today.

There is a cautionary tale to be learned from the Japanese experience – on the need to promote, rather than to prevent, appropriate macroeconomic adjustment. But this does not encourage a further expansion in the budget deficit at this time.

The property bubble and general credit bubble in Japan were actually much larger than what we recently experienced in the U.S. The implied price of the land in the Emperor's Palace, in central Tokyo, was worth more than all of California (or Canada) at its peak. Land prices collapses and never recovered. US house and land prices never got so far out of line with the earning capacity of homeowners.

The Japanese stock market rose to price-earnings ratio of around 80 (depending on the exact measure), also as a direct result of the credit bubble. The US did not experience anything similar in the last few years.

Japan was – and largely remains – a bank-based finance system. And their nonfinancial corporate sector was generally much more indebted (often using borrowed money to buy land, but also over-expanding their manufacturing capacity) than was the case in the US. Total Japanese corporate debt was 200 percent of GDP in 1992 – more than double its value in 1984. The implication was a long period of disinvestment and saving by the corporate sector – in fact, this change from the 1980s to 1990s explains most of Japan's increased current account surplus after the crisis. Since Japanese corporates had accumulated too much capital, they exhibited low returns in the post-crisis period. The US has strong bond and equity markets, and our corporate sector is not heavily indebted – so the cash flow of the nonfinancial sector should bounce back strongly.

In contrast to Japan, the US consumer has much more debt and saves less – in fact, on average over the past decade, the our household sector has saved roughly nothing (partly due to the effects of rising wealth, from higher house prices). This sector will be weak in the US. In contrast, in Japan during the 1990s there was no significant increase in household saving (and thus no contribution from this sector to their current account surplus.)

The obvious solution for any country in the situation faced by the US is to let the economy adjust, which implies and requires that the real exchange rate depreciates – so our exports go up, our imports (and consumption) go down. This is a level adjustment downward in our GDP and standard of living, but then growth will resume on this new basis.

In contrast, Japan did not grow largely due to their over-investment cycle (in real estate, but also plant and equipment). This created a much more difficult adjustment process, which worked for manufacturing primarily through depreciation of installed capacity and a gradual movement of production off-shore (e.g., to China and other Asian countries).

In addition, another major cause of Japan's poor performance was its demographics, and the relatively lackluster growth of its trading partners in Asia due to the Asian crisis. With its working population peaking in 1995, Japan lost a major driver of growth. The country still has strong enterprises and decent productivity growth in the manufacturing sector, which allows them to grow. But the pace is naturally slower than when they were "catching up" through the 1980s. During the last ten years Japan's has grown around the same pace as some of the continental European nations with better but also poor demographics, such as Italy and Germany (the comparison is from Q1 1998 to Q1 2008).

The Japanese policy reaction was to run budget deficits and maintain very loose monetary policy for over a decade, in an attempt to stimulate the economy and obviate the need for painful adjustment (including job losses, recognizing losses at major banks, and properly recapitalizing those banks). Today Japanese gross debt to GDP is at 217%, and it is still rising (net debt, even on the most favorable definition, is over 110% of GDP). The working population of Japan is now declining quickly, and so those people that are required to pay back the debt face ever rising burdens. There is a real risk that Japan could end up in a major default, or need a large inflation, to erode the burden of this debt since their current path is clearly unsustainable.

Japan's policy approach from the 1990s – repeated fiscal stimulus and very easy money – is not an appealing model for the U.S. today. All dynamic economies have a natural adjustment process – this involves allowing failing industries to decline, and letting new businesses develop where there are new opportunities.

In fact, while Japan hesitated for over a decade to let this process work (particularly protecting the insiders at their major banks), it has finally moved in this direction. Unit labor costs in Japan have declined sharply over the last ten years, helping making the country a more competitive exporter. The forced recapitalization of some major banks, at the end of the 1990s, was also a move in the right direction.

The process of deflation – spoken of with terror by some leading central banks around the world today – actually makes industry more competitive, and while there are negative aspects to it (particularly if the household sector is heavily indebted, as in the US), the modest price declines seen in Japan are not a disaster. In fact, real GDP per worker in Japan – annualized over the past 20 years – has increased by 1.3 percent per annum; while the comparable number in the US is 1.6 percent. Over the past 10 years, real GDP per worker (annualized) increased by 1.3 percent in both Japan and the US – and now it turns out that much of the GDP gains in the US financial sector may have been illusory.

The Japan-US comparison is not generally compelling, particularly as Japan ran a current account surplus even during its destabilizing capital inflows of the 1980s. The current US experience more closely matches the experience in some emerging markets, which have in the past run current account deficits, financed by capital inflows – with the illusion that this was sustainable indefinitely.

The long and hard experience of the International Monetary Fund (IMF) with such countries that have "lived beyond their means" – or over-expanded in any fashion – is that it is a mistake to try to prevent this process of competitive adjustment, i.e., bringing spending back into line with income, which implies a smaller current account deficit or even a surplus. The adjustment can be cushioned by fiscal policy – and here the IMF has changed its line over the past few years, now offering sensible support for this approach. But attempting to postpone adjustment with repeated fiscal stimulus is almost always a mistake.

Japan did not want to force its corporate sector to adjust (i.e., in the sense of going bankrupt and renegotiate its debts), so it offered repeated stimulus. As a result, it has become stuck with a "permanent" fiscal deficit program which is now threatening their survival as a global economic power, and will – regardless of the exact outcome – burden future generations for decades.

Some analysts further claim that Japan's early withdrawal of stimulus is a major factor explaining why they have not returned to robust growth rates. It is true that Japan introduced a new VAT tax in April 1997 not long before the Asian Financial Crisis began, and the Bank of Japan raised interest rates by 25 basis points in August 2000. Subsequent to these changes the economy slowed down.

However, each of these measures were relatively small. The Bank of Japan reversed course on interest rates quickly, and a negative turn in the economy was surely already in the cards – this occurred at the same time as the global economy slowed down, and a great stretch to argue that a 25 basis point move could explain the poor performance of Japan's economy for years or decades subsequent.

As long as there are not major adverse shocks from the rest of the world, the US will experience higher savings, a fall in consumption, a recovery in investment, and an improvement in the its net exports (so the current account deficit will become smaller, or stay at its current level even as the economy recovers). Growth will resume, driven by demographics, technical progress, and entrepreneurship. The high level of unemployment also implies that rapid growth will be fuelled by willing workers, subject to the right skills being available.

Proposals For Change

The main threats to the recovery scenario come from the financial system, which has developed serious and macro-level pathologies over the past two decades.

We have weak bank regulation and supervision. Politically we can't let banks fail: they bend or lobby to change the rules in order to grow big, and then we bail them out.

New theories of deflation and zero interest rate floors attempt to explain why we need unprecedented large bailouts – with the experience of Japan and the Great Depression of the 1930s offered as partial justification. More likely, we are on an unsustainable fiscal path with the potential for new financial bubbles.

The following changes should be priorities.

1. Reduce the impact of financial sector lobbying on bank regulation and supervision. Today the US Treasury is filled with former finance sector workers in key positions responsible for

financial sector reform and bailouts. This is too large a conflict of interest. We need to close the revolving door between government and the financial sector.

2. Put far greater regulation and closer supervision on the large remaining banks that are clearly too big to fail. These should be broken up into much smaller pieces, so we have a more competitive system.
   - When major financial institutions request additional help from the government, such as GMAC, they should be turned down. This would force their bondholders to take a loss and lead to better incentives for the future. It is highly unlikely that it would cause a major financial panic. The financial system is experiencing a sharp bounce back more broadly and GMAC can likely arrange a pre-packaged bankruptcy that would actually allow its debt to rise in value.
   - Banks can syndicate if they need to do large transactions. This is actually what they do for most capital raising transactions.
   - Banks should draw up “living wills” and raise additional capital as they become larger relative to the system.
3. We should also toughen our monetary policy to send a clear message that we will not maintain a pro-cyclical monetary policy which bails out banks at the end of each crisis. The cross-liabilities on banks’ balance sheets should be reduced as far as possible to lower the risks involved with letting one fail. By doing this, we would free the hands of those running our monetary policy to take tougher actions to stop the next bubble.
4. We need to address the inequality driven by our bailouts as a gesture to show that we will defend the public purse beyond the simple accounting in the budget.

- Increasingly, there is discussion of taxing “excess risk taking” (reflected in high profits and bonuses) in the financial sector, particularly if that is large relative to the system. The terms in this debate have not yet been clearly defined and this initiative could go in the wrong direction. But we should recognize that mismanagement at major banks has created huge negative externalities both for the financial system and for the economy as a whole. Taxing activities that generate such externalities is entirely appropriate in other sectors, and the same reasoning is likely to be applied for banking also.
- In addition, we should also require that Goldman Sachs, GMAC, and other non-banks (i.e., those operating without deposit insurance) with access to the Federal Reserve’s window pay a substantial long term annual fee to compensate taxpayers for that access. This is a valuable insurance policy which they have – at this point – been given for free.

5. We should withdraw the fiscal stimulus over 5 years and aim for fiscal consolidation, including Medicare costs, at that time. We should use extra spending to target specific issues that will help people improve their skills, but wind down the temporary public works programs that build jobs in the public sector.
6. All industrialized countries need to make a substantial fiscal adjustment over the medium-run, in order to stabilize public debt levels. The size of this adjustment depends on assumptions (and policies) regarding longer-run medical costs as the population ages and medical technology

becomes more expensive. The US and almost all other members of the OECD most likely require a fiscal adjustment in the range of 4-8 percentage points of GDP. In that context, further unfunded or nontransparent contingent public liabilities vis-à-vis the financial sector are untenable; the Japanese experience should be taken as a warning sign in this regard.

7. For the longer-run, we should focus on measures that improve skills for people with fewer years of formal education. Supporting the expansion of community colleges and other practical skills training is the best way forward, although this will take some time to scale up.