STATE OF THE U.S. ECONOMY AND IMPLICATIONS FOR THE FEDERAL BUDGET

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CONTENTS

STATE OF THE U.S. ECONOMY AND IMPLICATIONS FOR THE FEDERAL BUDGET

WEDNESDAY, DECEMBER 5, 2007

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

The committee met, pursuant to call, at 10:09 a.m., in room 210, Cannon House Office Building, Hon. John Spratt [chairman of the committee] presiding.

Present: Representatives Spratt, Edwards, Cooper, Schwartz, Becerra, Doggett, Berry, Tsongas, Scott, Etheridge, Baird, Bishop, Ryan, Bonner, Garrett, Diaz-Balart, Hensarling, Lungren, Conaway, Campbell, Tiberi and Alexander.

Chairman SPRATT. Before beginning the hearing, I would like to take this opportunity to welcome a new member of our staff, the staff director of the Republican staff, Austin Smythe. He is no stranger to many of us. He joins the Committee from the Office of Management and Budget, where he served as the associate director since 2001. He is also a veteran, having served on the Senate Budget Committee. But he will learn new things now that he is on the House Budget Committee, I am sure. We are glad to welcome him, glad to have a person of such clear credentials and capability on our staff. Regardless of whether he is a Democrat or a Republican, he is a net addition to our team.

Mr. Ryan, would you care to say something? Stand up and let everybody——

Mr. RYAN. I just want to introduce Austin Smythe. He is no stranger to the people in the budget world, the budgeteers. And we know he is going to bring great contributions to our side of the aisle. And he will be a great staff director when we are in the majority.

Chairman SPRATT. Austin, we look forward to working with you. Now I understand the Republican Conference is still going on. A few stalwarts broke out to come. We are glad to have you. And I guess your number will be increased as the hearing goes on.

I am pleased to welcome to our hearing today a panel of very distinguished economists, here to explore with us the state of our economy and its implications for our budget.

Dr. Orszag, Peter Orszag, needs no introduction. He is the director of the Congressional Budget Office and a highly respected economist. I suppose you could say his long suit is fiscal policy, but he has expertise that ranges across a wide spectrum of issues. CBO will soon be sending to us its economic outlook for 2008-2009, and we will be looking to CBO for guidance as we try to assemble a budget, the right budget for a shaky economy.

Dr. Martin Feldstein is the Baker Professor of Economics at Harvard, and also president of the National Bureau of Economic Research. NBER's Business Cycle Dating Committee is the official arbiter in deciding what constitutes a recession. This is just a small swath of his many interests in the realm of public sector economics that range from cost-benefit analysis to healthcare economics to Social Security reform.

Dr. Feldstein believes that the odds of recession are lengthening and that we should put in place now countercyclical policies that would be triggered by evidence or indications of an oncoming recession. Dr. Fred Bergsten has testified many times. He is the director of the Peterson Institute for International Economics and has been since its creation in 1981. His specialty is trade and international economics, which makes him a valuable addition to our panel, since we want to know the effects a declining dollar may have on our budget, given our dependence in particular on foreign capital to fund our perennial deficits.

We are faced with the grim impression of an economy caught in a confluence of adverse events, troubling events, unprecedented foreclosures, tightening credit, skyrocketing crude oil prices and a sharp decline in housing prices that does not seem to have bottomed out yet. I say, however, an impression, because it is not clear what exactly is happening.

Just a few weeks ago, the Fed indicated it had balanced the risk of inflation against the risk of recession, and another rate cut would probably be unlikely and unnecessary. But in the face of worsening events apparently unforeseen, the Fed seems to have reconsidered, and another rate cut, another cut in the overnight rate seems likely on December the 11th.

Business economists tend to be more pessimistic than the Fed. To cite one, David Rosenberg, who is the chief economist at Merrill Lynch, believes the economy faces a 60 percent chance of recession. Larry Summers is unable to join us today, but last week his column in the Financial Times said that the odds now favor a recession, which is a view he did not hold just a few months ago.

The Bush administration still stands by its projection of 2.7 percent growth in 2008, but they have to be careful, because we all know not to feed expectations of a recession for fear they will become self-fulfilling.

Growth in the third quarter of this calendar year has been revised recently to reflect a robust annual rate, 4.9 percent, which I believe is the fastest growth rate in 4 years, due partly of course to the dollar's devaluation and our strong net exports. But when you look at the data now gathering and accumulating, it is hard to believe that this rate of growth can be sustained.

Mortgage costs are rising dramatically for many Americans, and they will go up even more when rates are reset. Housing values are falling, on the other hand, sharply. Housing is one of the engines that drives our economy. In seasonally adjusted rates, home sales equaled 728,000 houses in September. That is the lowest level in 11 years. The median price for a home meanwhile dropped by 13 percent.

So the overarching questions we face today, first, are we at the tipping point, headed into a recession, or just leaning into a slump or a slowdown? Second, is the crisis in housing snowballing or leveling off; is the panic in the subprime credit markets spilling over into other credit markets? Third, if we are headed into a recession, or a long slump, what should we do to our budget to mitigate the effects, especially in housing, and to stimulate the economy?

Dr. Feldstein comes down on the side of a broadbased tax cut, triggered by conditions that signal or at least indicate a recession.

Dr. Summers seems to support a similar position. Last week he told the Financial Times, "as important as long-run deficit reduction is, fiscal policy needs to be on standby to provide immediate temporary relief through spending or tax benefits for low- and middle-income families if the situation worsens." Earlier this year, our committee, the Budget Committee heard from another panel of expert economists, which included Director Orszag. They stressed to us the paramount importance of boosting national savings, which is woefully deficient, of reducing deficits to ensure a stronger economy over the long run. Given our goals for the short- and longer-term economy, should the Federal Government be encouraging consumption via short-term stimulus, or should we instead be encouraging saving and long-term economic growth? Do we have to face that choice? And if we do face it, where do you come down?

To address these issues and many others, let me again thank our panel, Dr. Orszag, Martin Feldstein and Fred Bergsten, for coming. We look forward to your testimony. But before turning to you for your testimony, let me invite the ranking member to make any statements he would care to make. Mr. Ryan.

Mr. RYAN. I thank the Chairman for organizing this important and well-timed hearing. As you noted, Mr. Chairman, there are a host of legitimate concerns in the market today, many due to the bursting of the housing bubble. What I would like to do is put these recent developments in their proper context. First, we should not dismiss the clear economic successes of recent years and the still solid underlying fundamentals in the U.S. economy. Prudent and well-timed tax relief in 2001 made the recession that year one of the shortest in U.S. history. Further reductions in 2003, which accelerated those tax cuts, have led to economic benefits which we are still enjoying today and which, in fact, have made the economy more resilient than it otherwise would have been in the face of the current housing slump and the credit crunch.

Let's look at the facts. This economy has enjoyed more than 4 years of uninterrupted job gains of roughly 8.5 million new jobs created. Our unemployment rate stands at 4.7 percent, one of the lowest readings in the past 6 years. Due to this solid job market, the latest quarter showed American workers' real after-tax income grew by nearly 4 percent from a year earlier. The stock market is in a period of correction right now; that is clear. But even in the midst of the current volatility, equity indexes reached an all time high in October. And in terms of the Federal budget, the solid economic growth of the past few years has legally been the key factor in driving down the deficit, which this year fell to 1.2 percent of GDP, which is roughly half the level of the average of the last 40 years. So these are real gains that affect real people.

But now we have a set of conditions that Dr. Feldstein describes as a triple threat to our economy, a credit market crisis, a decline in the housing prices and home building, and a reduction in consumer spending. Add to those a clear upside risk of inflation; oil prices have risen to an all time high recently, and the price of gold, which is a traditional pro-cyclical indicator, recently hit a 27-year high.

Meanwhile, to stem the combined effects of the housing slump and the credit crunch, the Federal Reserve has cut interest rates in recent months and has signaled that more reductions may be on the way. That in turn has led to further declines in the dollar, which adds even more to inflationary pressures by raising import prices. In this climate, sound monetary policy will become even more crucial to getting through this rough patch. But Congress also needs to recognize its chief role in setting the path of fiscal policy in this country and the important ways that that affects the economy and the budget for the long run. Of all times, we have less room for error on fiscal policy than we do today. And an easing monetary policy stance, coupled with proposals for a high-tax policy could very well lead to the worst mixture, inflation and slower growth, or stagflation as it was known in the late 1970s when a similar policy blend prevailed.

So far the actions of this Congress are not reassuring in terms of setting fiscal policy for real growth. For one, Congress is creating a great deal of tax uncertainty. The end of the current tax year is less than a month away, and Congress has yet to pass a measure dealing with the alternative minimum tax or the AMT. And if Congress fails to act, more than 20 million taxpayers will be hit with a significant tax increase in their tax burden and one that the Federal Government never even intended to impose. Meanwhile, the majorityis considering a number of massive tax increases, which under the guise of the current PAYGO system they allege are needed to pay for their recent spending increases. So this mix of new spending, higher spending and higher taxes is exactly the wrong policy mix we need at this time.

There is also considerable doubt about the 2001 and 2003 tax laws, and whether Congress and the next President will let these laws lapse after 2010, leading to the single largest tax increase in our Nation's history. At a time when credit markets are freezing up and some businesses are having difficulty attracting financing in the marketplace, Congress is gumming up investment and expansion plans by creating a high degree of uncertainty about future tax rates on business profits and capital income. I would like to just point to one chart, which I think summarizes the crossroads we are at right now with our fiscal policy. The one thing the majority has been certain about is their claim on ever higher tax revenues in the future. As the chart shows, over the long run, the majority's proposed revenue path would push the tax burden on the American economy to a historically unprecedented level by the end of the next decade. The chart shows that revenues as a share of GDP would reach nearly 21 percent by the end of the next decade and nearly 24 percent by the end of the century, compared to the historical 40-year average of 18.3 percent. The driving force behind all of these tax plans is of course the future path of government spending.

This committee knows all too well that we will see unprecedented strains on the Federal budget in the coming decades as healthcare costs continue to rise rapidly and the baby boom generation starts to retire. Congress can choose to deal with these massive unfunded liabilities by chasing higher spending with even higher taxes which will sink the economy, harm our competitiveness in the international marketplace and guarantee an erosion of the value of the dollar; or we can work together to make the necessary choices today to reform our entitlement programs and curb this dangerous spending path.

Addressing our long-term entitlement problems, giving businesses and investors and American families tax certainty and a low-tax environment, keeping marginal tax rates low and promoting capital formation, innovation and productivity is the best recipe for real, long-term noninflationary growth.

And with that, Mr. Chairman, I thank you for your indulgence, and I look forward to this hearing.

Chairman SPRATT. Thank you, Mr. Ryan.

And one sentence to indicate our position. It is not to take the tax bite out of the economy to 24 percent. We have passed a bill in the House that would patch the AMT's impact on middle-income taxpayers for at least a year, maybe longer. And that is our proposed policy, not one would that would take taxes skyrocketing.

I want to ask unanimous consent before we begin that all members be allowed to submit an opening statement for the record. Without objection, so ordered.

And now we will proceed with our testimony.

STATEMENTS OF PETER ORSZAG, DIRECTOR, CONGRESSIONAL BUDGET OFFICE; MARTIN FELDSTEIN, GEORGE F. BAKER PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, AND PRESIDENT AND CEO, NATIONAL BUREAU OF ECONOMIC RESEARCH; AND C. FRED BERGSTEN, DIRECTOR, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

Chairman SPRATT. I think the best order of testimony is, Dr. Orszag, to begin with you, and then go to Dr. Feldstein, and then let Dr. Bergsten wrap it up.

We will then, after the testimony of all three of you, open the floor to questions. Once again, thank you for coming. We look forward to your testimony. You can summarize it. We are making your statements, without objection, part of the record. But take your time to walk through your subject matter, because this is extremely important.

STATEMENT OF PETER ORSZAG

Mr. ORSZAG. Mr. Chairman, Congressman Ryan, members of the committee, I appreciate the opportunity to testify this morning.

The economic outlook right now is particularly uncertain. Most backward-looking indicators suggest a relatively healthy economy. Despite the drop in housing construction and sales, economic activity has remained relatively strong, and core consumer price inflation remains contained. Net exports have risen rapidly, helping to support growth.

The economy, however, has been buffeted by several important and interlinked shocks, most importantly involving housing, financial markets and energy prices. As a result of these shocks, economic activity has probably already slowed significantly, and the risk of recession is elevated.

Most analysts believe that the economy will avoid a recession but will grow relatively slowly for several quarters. As table one shows, projections of economic growth for next year have been reduced noticeably since the summer, but they remain positive. That is, most analysts are projecting positive but sluggish economic growth.

Let me briefly explore several of these important factors affecting the economic outlook in a bit more detail.

First, the housing market has weakened significantly. By the end of 2005, the combination of increased mortgage rates and high prices for homes have reduced the affordability of buying a house. As a result, home sales and construction began to falter, and the appreciation in housing prices slowed substantially. By the third quarter of this year, housing construction was almost 25 percent below its rate in early 2006. The direct effect of that reduction in residential investment has reduced annualized real GDP growth in each of the past six quarters by about a percentage point. House prices have also weakened. The national average of home prices is now roughly 5 percent lower than it had been at its peak.

And as is now well known, particular concerns surround subprime mortgages, which are extended to borrowers who have low credit scores. In 2004, delinquencies on subprime adjustable rate mortgages, that is subprime mortgages whose rates are not fixed for their entire duration, started to rise rapidly. And as the next figure shows, by the second quarter of 2007, almost 17 percent of subprime ARMs, or adjustable rate mortgages, were delinquent, up from a recent low of 10 percent in the second quarter of 2005.

The problems in the subprime market are also manifesting themselves in the pricing of mortgage-backed securities, which are financial instruments whose payments of interest and principal are backed by the payments on an underlying pool of mortgages. In such mortgage-backed securities, different tranches are available depending upon the order in which investors are paid, and therefore the risks that the investors face. As the next chart shows, the price of the triple B tranche of subprime mortgage-backed securities, which is close to the riskiest investment grade, issued in the latter half of 2006, which is the bottom right chart, or bottom red line there, has experienced a dramatic further worsening since when CBO last reported on this topic in September and now is basically paying about $0.20 on the dollar. So that red line there is one indication of the very severe disruption and deterioration in the subprime market.

Concerns about the subprime market have translated into and been magnified by broader problems in financial and credit markets. The fundamental factors causing this broader disruption in financial and credit markets are a reduction in investors' tolerance for risk and an increased sense of ambiguity about exposures to assets with uncertain values. A reflection of this turmoil is that interest rates on riskier bonds, those with lower credit ratings, have increased significantly, as the next figure shows. Those high yield bonds are the bonds that are riskier and with lower credit ratings. And you can see the uptick that has occurred in recent months. It is worth noting, though, that much of the recent change comes after a period in which those interest rates were abnormally low. So part of what is going on is that the price of risk is returning to somewhat more normal levels after having been quite low during the past several years.

Another concern involves asset-backed commercial paper, which represents about half of the overall commercial paper market. Commercial paper provides a form of short-term financing for banks and firms. Since the beginning of August, the amount of asset-backed paper that is outstanding has fallen by about 30 percent, and interest rates have risen sharply.

The problems in the market for asset-backed commercial paper may force some firms to tap their lines of credit with banks as an alternative form of financing, which would then put unexpected pressure on the banks. Moreover, many large banks are committed, either explicitly or implicitly, to providing liquidity to entities known as structured investment vehicles, which are generally off of the banks' balance sheets, and allow the banks to earn extra income without correspondingly expanding their required capital.

Should these structured investment vehicles be unable to continue to fund their holdings on their own through the commercial paper market, the banks may need to provide the necessary liquidity. And if the structured investment vehicles losses worsen, the sponsoring banks may decide to bring the assets and losses back onto their balance sheets, thereby possibly impairing other lending activities. One European bank has already decided to do so.

Another factor causing concern involves oil prices. As the next chart shows, crude oil prices have risen by over 60 percent this year. Most of that increase reflects underlying fundamentals. There has been a significant increase in demand for oil, especially involving nations such as China, India and many nations in the Middle East. And there has been a slow growth of worldwide supply. The combination of rapid demand growth and slow supply growth has been upward pressure on prices. Although the economy is not as sensitive to oil price shocks as it was in the 1970s, this recent rise in oil prices could hamper economic activity.

On the brighter side, continued improvement in the Nation's current account deficit provides an important counterbalance to the weakness expected in domestic spending. After falling for many years—that is after the deficit expanded for many years—net exports have now risen by over a hundred billion dollars in real terms since the end of 2005, and have added one and a third percentage points to real GDP growth in the past two quarters. Further depreciation of the dollar and strong economic activity in the rest of the world are likely to contribute to continued improvement in net exports. Okay.

So that is all backward looking. Let us try to look ahead a little bit.

With regard to the housing market, it seems likely that house prices, and consequently housing wealth, will continue to decline next year. For example, although it is a very imperfect predictor of future prices over short periods of time, the ratio of housing prices to rents, to rental rates, seems very high relative to its history, as the next chart shows. And indeed, if you took a literal interpretation of that chart, you can imagine very steep declines in housing prices that would result.

Another measure which looks at an index of national prices and has a futures market associated with it, as the next chart shows, anticipates a decline in prices of about 7 percent over the coming year. Such housing price declines would reduce housing wealth and thereby constrain consumer spending and economic growth for several quarters. A significant amount of uncertainty surrounds the precise magnitude of that effect. CBO's analysis suggests that a reduction of housing wealth of a dollar will likely reduce consumer spending by somewhere between 2 and 7 cents.

So to calibrate the potential impact of a hypothetical and assumed 16 percent decline in nominal housing prices, the next chart shows you what the macroeconomic impact would be for that range of values of how much spending falls when housing wealth does. The effect would be somewhere between a half and 1.5 percentage points per year on average over the next 2 years. And if you added the impact of reduced residential investment, which is about a percentage point, the total impact would be somewhere between 1.5 and 2.5 percentage points per year. So the if the economy were otherwise growing at about 2.5 percent per year, it could mean that growth would be close to zero. I would note that it is unclear whether housing prices will decline as much as assumed in that scenario. And furthermore, in evaluating the probability of a recession, one needs to take into account not only this effect but also the credit market and financial market problems I mentioned, oil prices and, on the other hand, continued growth in net exports, and the fact that inflation remains contained and, therefore, the Federal Reserve has some room to adjust interest rates further.

The bottom line is that although the combined effect of these various forces is an elevated risk of recession, most analysts currently believe that the most likely scenario remains sluggish, albeit positive, economic growth.

Finally, in terms of the Federal budget, either an extended period of sluggish growth or a recession would cause a noticeable deterioration in budget outcomes. Since 1968, during recessions, the deficit has increased by about 1 to 3 percent of the economy, which translates to about $140 to $420 billion given the size of today's economy. Such increases in the deficit during periods of economic weakness in large part reflect the operation of the budget's so-called automatic stabilizers. That is, as the economy slows, tax receipts naturally decline, and some types of spending, for example on unemployment insurance and on food stamps, automatically increase. That combination temporarily boosts demand for goods and services, thereby helping to offset some of the macroeconomic weakness. Fiscal policy interventions that go beyond these automatic stabilizers in attempting to boost the economy during periods of economic weakness have had a mixed track record.

Although there have been examples of effective discretionary fiscal stimulus, in several other cases, attempts to stimulate demand through changes in fiscal policies have proved to be poorly timed or designed in a relatively ineffective way. Policymakers considering whether to adopt measures beyond the budget's existing automatic stabilizers would need to carefully weigh the current and projected macroeconomic environment but also the lessons from those past attempts at discretionary fiscal stimulus. Thank you very much.

[The prepared statement of Peter Orszag follows:]

PREPARED STATEMENT OF PETER ORSZAG, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, Congressman Ryan, and Members of the Committee, I appreciate the opportunity to testify this morning on the current economic situation.

The economic outlook right now is particularly uncertain. Most backward-looking indicators suggest a relatively healthy economy: Despite the drop in housing construction and sales, economic activity has remained strong and the rate of inflation in core consumer prices has fallen. But the economy has been buffeted this year by several interlinked shocks, most importantly the turbulence in the subprime mortgage market, decreased confidence within the financial markets, and substantially higher prices for oil. Economic activity has probably already slowed significantly, and the risk of a recession is now elevated. Most analysts currently believe the economy will avoid a recession but will grow relatively slowly for several quarters.

My testimony this morning covers five main topics:

- The Housing and Financial Markets. The turmoil that began in the subprime mortgage market and then spread to broader financial markets has posed substantial challenges for the economy. Housing activity remains quite weak, and house prices have declined in many areas, reducing household wealth and the outlook for consumer spending. Lenders' losses on mortgage-related assets and lower tolerance for risk have constrained the supply of credit, particularly for the riskiest borrowers. The problems in the housing and financial markets has reduced consumers' and businesses' confidence about future economic conditions, and presumably their willingness to spend and invest.
- Oil Markets. Crude oil prices have risen by over 60 percent this year. Most of that increase appears to reflect underlying fundamentals, including rapid growth of demand (especially in China, India, and other developing nations) and slow growth of supply. Geopolitical tensions and speculative and precautionary demand have also exerted some influence on prices. Although the economy is not as sensitive to oil price shocks as it was in the 1970s, the recent rise in oil prices could still dampen economic growth.
- The Current Account and the Dollar. Continued improvement in the nation's current account balance provides an important counterbalance to the weakness expected in domestic spending. After falling for many years, net exports have risen by over $100 billion (in constant dollars) since the end of 2005 and have added about 1⅓ percentage points to the growth of real (inflation-adjusted) gross domestic product (GDP) in the past two quarters. Further depreciation of the dollar and strong economic activity in the rest of the world are likely to contribute to continued improvement in net exports.
- Consumption and Consumer Confidence. The growth of consumer spending has been healthy this year but is likely to weaken over the coming year in response to slower income growth, lower housing wealth, stricter standards and terms for loans, and higher oil prices. Especially during times in which economic conditions are shifting rapidly, projecting consumer spending accurately is difficult; the effects of many influencing factors, including housing wealth and consumer confidence, have a significant range of uncertainty surrounding them. Because consumer spending currently accounts for 70 percent of GDP, the difficulties in projecting such spending pose challenges for projecting overall growth of GDP.
- The Potential for a Recession and Its Effects on the Federal Budget. The combined effect of those various forces is an elevated risk of a recession. The most likely scenario, though, remains slow economic growth. Few analysts currently expect an outright recession next year. For example, the average for the bottom 10 forecasts included in the Blue Chip survey (which covers about 50 private-sector forecasts) released in early November suggested 1.9 percent growth in real GDP in 2008, and not a single forecaster projected negative growth. However, the next Blue Chip survey is likely to show further downward revisions of the forecasts. Moreover, recessions have often proved very difficult to foresee, or even to recognize in their early

stages: Indeed, the apparently robust growth for the third quarter of this year may eventually be revised down.

Either an extended period of sluggish growth or a recession would cause a noticeable deterioration in the budget deficit. Since 1968, during recessions, the deficit has increased by about 1 percent to 3 percent of GDP, which translates to about $140 billion to $420 billion in today's economy (after the estimated effects of policy changes are removed). Such increases in the deficit during periods of economic weakness in large part reflect the operation of the budget's "automatic stabilizers." When the economy weakens, tax burdens and revenues tend to decline, and some types of spending (on unemployment insurance, for instance) tend to rise, helping to boost the demand for goods and services and thereby stabilize the economy.

The Congressional Budget Office (CBO) will release an updated economic and budget outlook in January. This testimony, therefore, does not provide specific economic or budget projections.

THE HOUSING AND FINANCIAL MARKETS

The housing market has weakened significantly this year. Sales of new and existing homes have declined, and many forecasters expect further declines in coming months. The construction of new single-family homes has diminished sharply. The inventory of unsold new homes has climbed to high levels, about 8-½ times the rate of sales in October, which is about twice the ratio that existed on average earlier in this decade. Home prices have begun to fall in many areas: According to the Standard & Poor's (S&P)/Case-Shiller national house price index, the average price has fallen by 5 percent from its peak. Many forecasters now believe that the national average price of a home will decline significantly more before the housing market stabilizes.

The current contraction of the housing market comes after several years of extraordinary growth. By 2005, home sales had climbed to record levels. The residential construction industry boomed, and home prices soared in many areas of the country. Many people who had previously been renters became homeowners. As a result, the rate of home ownership, which had varied within a narrow range from the 1960s to the mid-1990s, increased from about 65 percent in 1995 to about 69 percent in 2006 (see Figure 1). That rise meant that approximately 4-½ million more families who otherwise would have been renters owned their homes. Investors and second-home buyers also purchased a large number of properties.

BACKGROUND ON THE HOUSING MARKET

The housing boom stemmed from three main factors.

- Low Interest Rates on Mortgages. Over the past several years, nominal long-term rates were exceptionally low, driven by a benign outlook for inflation, high tolerance of risk by investors, and strong investment in the United States by foreigners. In addition, the Federal Reserve kept the federal funds rate at very low levels through mid-2004.[1] Rates for 30-year conventional mortgages, which had averaged 7.6 percent from 1995 through 2000, dropped to 5.8 percent in 2003 and generally remained below 6 percent until the fourth quarter of 2005. The low rates ultimately helped feed the increase in house prices.
- Homebuyers' Expectations of Rapid Appreciation in House Prices. As the housing market began to heat up and house prices rose, people began to believe that prices would continue to rise. That expectation made housing an attractive investment opportunity, spurring demand and putting upward pressure on prices. Thus, for a time, the expectation of higher prices became a self-fulfilling prophecy that bore little relation to the underlying determinants of demand, such as demographic forces, construction costs, and the growth of household income.
- A Plentiful Supply of Mortgage Credit, Including the Expansion of Subprime Mortgage Lending. The share of subprime mortgages, which are extended to borrowers who have low credit scores, rose rapidly after 2002, constituting 21 percent of all home mortgage originations (in dollar terms) in 2005 and 2006. By the end of 2006, the outstanding value of subprime mortgages totaled more than $1 trillion and accounted for about 13 percent of all home mortgages.

The growth of the subprime mortgage industry was facilitated by changes in regulations and innovations in financial markets. Legislative and regulatory changes made in the 1980s lifted constraints on the types of institutions that could offer mortgages and the rates that could be charged. The development of new credit-scoring technology in the 1990s made it easier for lenders to evaluate and price the risks of subprime borrowers. The securitization of subprime mortgages expanded, encouraging such lending by allowing the market to spread the associated risks.[2] Global investors poured large amounts of money into subprime investments that they judged to offer attractive risk-adjusted returns. Indeed, the price that investors charged for taking on risk in the subprime mortgage market, as well as other financial markets, fell to abnormally low levels. Finally, the rating agencies appear to have miscalculated the risks of some securities backed by subprime loans, and they may have unduly emphasized the unusual period of appreciating prices.

Many of the subprime mortgages turned out to be riskier than many investors expected. The problems in the market began to appear after 2004, when delinquencies on subprime adjustable-rate mortgages (ARMs) started to rise unexpectedly rapidly. By the second quarter of 2007, almost 17 percent of subprime ARMs were delinquent, up from a recent low of 10 percent in the second quarter of 2005 (see Figure 2). In addition, the share of subprime ARMs entering foreclosure increased from an average of 1.5 percent in 2004 and 2005 to 3.8 percent in the second quarter of 2007. Although delinquencies have also risen for fixed-rate subprime loans, the level for those loans has been lower, and the increase has been slower.

Those problems have undermined investors' confidence in the securities backed by subprime mortgages. Liquidity in both the primary and secondary markets for subprime mortgage-backed securities (MBSs) has declined, as some of the country's largest originators of such loans have experienced severe difficulties (see Box 1). In the market for assets collateralized by subprime mortgages, price changes have been dramatic. The price of the BBB tranche of subprime MBSs (close to the riskiest investment grade) issued in the second half of 2006 was 20 cents on the dollar as of November 30, and the price of even the safest (AAA) tranche was 77 cents on the dollar—in both cases, a dramatic worsening from the amounts when CBO last testified on this issue in September (see Figure 3). Prices of tranches based on MBSs issued earlier, in the last half of 2005, ranged from 33 cents for the BBB tranche to 95 cents for the AAA tranche.

BOX 1.—WHAT ARE MORTGAGE-BACKED SECURITIES?

Financial institutions issue mortgage-backed securities (MBSs) to investors with the payments of interest and principal backed by the payments on a package of mortgages. MBSs are structured by their sponsors to create multiple classes of claims, or tranches, of different seniority, based on the cash flows from the underlying mortgages. Investors holding securities in the safest, or most senior, tranche (AAA) stand first in line to receive payments from borrowers and require the lowest contractual interest rate of all the tranches. Investors holding the least senior securities (the equity tranche) stand last in line to receive payments, after all more senior claims have been paid. Hence, they are first in line to absorb losses on the underlying mortgages. In return for assuming that risk, holders of the equity tranche require the highest contractual interest rate of all the tranches.

Several factors seem to have contributed to the growing delinquencies of subprime mortgages. After mortgage rates began to move up in late 2005, many ARM borrowers appear to have defaulted after the initial period of low rates expired and their monthly payments were reset at significantly higher levels. Faced with prepayment penalties (which protected lenders from the potential churning of mortgages with very low initial rates), such borrowers often found it expensive to refinance their mortgages to avoid the increasing payments. In addition, some borrowers who had purchased their home with little money down may have seen their equity vanish as house prices began to decline in some areas. In the industrial Midwest, especially in Michigan, those problems were aggravated by the slowdown of the regional economy as the automotive industry retrenched.

The underwriting standards of some originators in the subprime mortgage market had slipped in recent years, perhaps because they as well as investors were lulled by unusually low default rates while house prices were rising rapidly. Some made loans to borrowers who put little money down—and who had little to lose if they defaulted—and to borrowers with particularly weak credit histories. Some subprime lenders also required little or no documentation of borrowers' income and assets and established borrowers' qualification for mortgages on the basis of initially low teaser rates. That approach created opportunities for both borrowers and originators to exaggerate borrowers' ability to repay the loans.

BOX 2.—ISSUES IN THE CREDIT MARKETS, IN BRIEF

The disruption in the credit markets reflects the fundamental fact that in the wake of the turbulence in the subprime market, investors' tolerance for risk, which was unusually high in the past few years, has fallen sharply. That change has had two effects: The value of risky assets has declined; and the availability of credit to risky borrowers is constricted. In addition, some domestic and foreign investors who in recent years have invested in U.S. markets are now investing more in other countries.

Although the adjustment in asset prices has been going on since August, it is not clear whether the adjustment has finished, and the prices of some securities remain exceptionally volatile. The prolonged period of price adjustment reflects in part uncertainty about when and how the problems in the subprime mortgage market will be resolved and to what extent they will spill over into the broader economy.

Decreased tolerance of risk has led to higher interest rates and less availability of credit, particularly for high-risk borrowers. In recent years, financial markets developed an alphabet soup of new channels that allowed credit to flow to risky borrowers and allowed investors to get high returns while diversifying their risk. The growth of the subprime mortgage market and of highly leveraged investment pools are examples of those developments (see Box 3). Many of those new channels for funding investments are currently largely closed. As a result, the credit now being extended is flowing to a larger extent through more traditional channels, such as banks.

BOX 3.—STRUCTURED INVESTMENT VEHICLES

Structured-investment vehicles (SIVs) are entities that issue commercial paper and medium-term notes and then invest the funds in higher-yield, longer-maturity assets, such as asset-backed securities, including mortgage-backed securities and collateralized debt obligations (CDOs) backed by subprime mortgages. (CDOs are securities that are collateralized with a range of asset-backed securities.) Fitch Ratings estimates that there are $320 billion of SIVs.[1] SIVs are usually not carried on the balance sheets of the institutions creating them (because the institutions do not have a legal obligation to cover the SIVs' losses). As long as they remain off the balance sheets, they have little or no effect on the institutions' capital requirements.

Because of the mismatch in maturity between the assets and liabilities of SIVs, they periodically need to roll over their debt. That "refunding" requires that lenders are willing to take on the risks associated with a SIV's underlying portfolio. However, when markets are disrupted and ascertaining the value of such portfolios is difficult, refunding may be difficult or impossible. In that case, the SIV will have to liquidate its portfolio.

Although some financial analysts initially believed that bank-sponsored SIVs were well positioned to avoid forced liquidations because their portfolios were diversified and they had commitments of liquidity from their sponsoring banks, that view has changed. SIVs are often required to start selling their assets once their losses exceed threshold percentages of their capital or if they violate liquidity provisions. Those involuntary sales could then push down asset prices, which could cause losses at other SIVs to exceed their capital thresholds. The losses could also trigger defaults on commercial paper already issued by the SIVs and further impede their ability to borrow money.

A consortium of financial institutions, prodded by the Treasury, has agreed to create a new entity, the Master Liquidity Enhancement Conduit (MLEC), to purchase the best of the assets from SIVs as necessary. Although the MLEC may mitigate refunding difficulties and help the market to distinguish between good and bad assets, critics of the proposal fear that the MLEC might simply postpone the recognition of losses, which could delay the recovery of the credit markets by reducing transparency.

SIVs and CDOs also remain vulnerable to the failure or downgrading of bond guarantors. Most of the rated securities held by the CDOs carry credit enhancements in the form of insurance guarantees, because the underlying securities are, on average, rated BBB. Thus, those guarantees are critical to the AAA ratings for the senior tranches of CDOs. Perhaps more significantly, bond guarantees are also critical to a smoothly functioning municipal bond market. The rating agencies have placed several of the leading bond insurers (which are likely to suffer significant losses and have seen their market values fall between 50 percent and 75 percent from their peaks) on their watch lists of institutions whose credit rating they might

[1] Fitch Ratings, SIVs—Assessing Potential Exposure of Sponsor Banks, Special Report, November 14, 2007.

> downgrade, which suggests that those insurers might have to raise more capital.
>
> The result is that some relatively risky activities, including some housing investment, are not being funded. That reduces total spending in the economy. Whether there will be any further real effects on the economy depends on whether the banks (and other financial institutions) experience capital problems and have to curtail lending because of their own exposure to losses on subprime mortgages and other affected securities. Further reductions in asset prices could impair the capital positions of some institutions and curtail their ability to lend, at least until they are able to raise additional new capital. The Federal Reserve and the bank regulators are closely monitoring those developments.

Those problems seemed to have stemmed from a high tolerance for risk on the part of investors, exacerbated by a failure to provide the right incentives to and oversight of originating brokers. In the traditional form of mortgage financing, the originator of the loan also holds the loan in its portfolio and therefore has a strong incentive to learn about the borrower's ability to make the loan payments. By contrast, in the securitized form of mortgage financing, the originator sells the mortgage to a third party and earns a fee for origination but receives little immediate reward for discovering relevant information about the borrower. As a result, originators may not have had adequate incentives to exercise care and discretion in their underwriting.

The rise in defaults of subprime mortgages may also reflect the fact that some borrowers lacked a complete understanding of the complex terms of their mortgages and assumed mortgages that they would have trouble repaying.[3] Defaults in areas where speculation drove home sales and prices may also reflect investors' inability to sell their properties as prices fell.

Difficulties in the subprime mortgage market have spread to other mortgage markets. One is the market for jumbo mortgages, which are those that exceed the maximum size of a mortgage that Fannie Mae and Freddie Mac are eligible to purchase. That amount, which is also known as the conforming limit, was $417,000 in 2007. As problems in the market for financing subprime mortgages became more apparent, investors began to demand much higher premiums on jumbo mortgages. In addition, the terms of those jumbo loans tightened, as many lenders began to require larger down payments and higher credit scores. The market for conventional loans also has been affected. Although mortgage rates on conventional loans have actually declined in recent months, as they have benefited from a "flight to quality," the Federal Reserve reports that commercial banks have tightened lending standards for all mortgage borrowers.

Mortgage delinquencies and foreclosures will be a problem for a number of years as interest rates on subprime ARMs that were originated in recent years are reset to higher market rates. Rates have already been reset for some of those ARMs, but an additional 1.8 million subprime mortgages will have their rates reset during 2008.[4] Those resets, plus additional ones in later years (most of which will occur before the end of 2010), could eventually add about $40 billion to borrowers' annual payments.[5] Although that amount is not large relative to total household after-tax income of $10 trillion, many households will be hard pressed to make the higher payments, and some will become delinquent on their mortgages.

RISKS TO THE ECONOMY FROM THE HOUSING MARKET

The turbulence in the housing market reflects the correction of an unsustainable growth of house prices. Although a significant adjustment has already occurred, the current correction in the housing market could continue to affect the broader economy through several main channels:

- Reduced investment in residential housing;
- Less spending by consumers because of their reduced housing wealth; and
- Contagion in mortgage and financial markets.

Those various channels through which the problems in mortgage markets could spread to the broader economy make the current situation particularly uncertain; the potential effects involving contagion, along with the effects of a decline in consumers' and businesses' confidence (to be discussed later), are especially difficult to evaluate because they depend in part on how financial market participants, consumers, and business executives perceive the situation.

Residential Housing Investment. Investment in residential housing bolstered the economy every quarter from 2002 to the end of 2005, at times contributing up to 1 percentage point to the growth of real GDP. By the end of 2005, though, the combination of increased mortgage rates and high prices for houses had reduced the affordability of buying a house. Home sales and construction began to falter, and the appreciation in housing prices subsequently slowed. By the third quarter of 2007, housing construction activity was almost 25 percent lower than it had been in early 2006, and according to the S&P/Case-Shiller national house price index, the national average of house prices was 5 percent lower than it had been at its peak. The direct effect of the fall in residential investment reduced annualized real growth of GDP in each of the past six quarters by about a percentage point.

The severity of the problems in mortgage markets will exacerbate the decline in residential investment. A few months ago, before the extent of the troubles in the subprime market was recognized, housing analysts generally anticipated a rebound in housing construction during 2008. Now, however, they assume that increased difficulty in arranging financing will cause housing sales and construction to fall much further, perhaps delaying the recovery in the housing market until 2009.

Housing Wealth. The major factors influencing consumer spending are household income and wealth. Greater income and wealth provide consumers with more buying power. The amounts that consumers spend out of their income and wealth vary over their lifetime and vary with the actual and expected pace of economic activity, with interest rates, and with opportunities to borrow, among other things. In recent years, homeowners have been able to easily make use of their housing wealth by using home equity loans and lines of credit and by taking cash out when refinancing their mortgages, for example. But lower house prices constrain the opportunity for such cash withdrawals. The withdrawal of housing equity (net of mortgage fees, points, and taxes) amounted to $644 billion in 2005, $662 billion in 2006, and $567 billion in the first half of 2007.[6]

The outlook for home prices is highly uncertain, but it seems likely that house prices and, consequently, housing wealth will continue to fall next year. The inventory of unsold homes stands at high levels, which will place continued downward pressure on house prices in many regions of the country. Moreover, the ratio of housing prices to rents still seems very high relative to its history (Figure 4). To be sure, homebuyers' expectations of home prices may deviate from long-term fundamentals for extended periods of time, and the price-rental ratio may therefore not provide a reliable guide to potential changes in prices over relatively short periods of time.[7]

Futures markets expect significant further declines in house prices. One measure, which looks at a constant-quality index of home prices in 10 metropolitan areas, anticipates a decline in nominal prices of about 7 percent over the coming year (see Figure 5).[8] However, the index may not indicate what is happening to prices nationwide. Another measure, from Radar Logic, Incorporated, a New York-based real estate and data analytics firm, with coverage of 25 metropolitan areas but with a less sophisticated adjustment for changes in the quality of the homes sold, projects a decline of 11 percent over one year and 24 percent over the next three years. Those expectations may also not be a reliable guide, however, because those contracts do not trade frequently or in large numbers and therefore may not represent a broad consensus of investors.

Private forecasters differ widely in their projections of the decline in house prices, although all agree that there is a substantial decline still to come. Macroeconomic Advisers projects a 6 percent decline over two years, while Global Insight projects a similar decline over the next year. Goldman Sachs projects a 15 percent total decline before an upturn occurs—perhaps as much as a 30 percent decline if a recession occurs.

A significant amount of uncertainty exists about the extent to which spending changes when wealth changes (known as the marginal propensity to consume out of wealth). Estimates of that parameter range from 2 cents to 7 cents out of a dollar of wealth.[9] So if the value of a home drops by $10,000, the owner might eventually reduce his or her annual spending by between $200 and $700, if nothing else changes. Some studies find that people adjust their spending more in response to changes in housing wealth than to changes in other forms of wealth, while other studies do not reach that conclusion.

The combined effects of lower housing wealth and the reduction in home construction could together be enough to push the economy toward a recession. In order to evaluate the size of just the wealth effect, CBO examined two cases (at the low end and the high end of assumptions about the marginal propensity to consume out of housing wealth) of the potential effects of a substantial decline of 16 percent in nominal house prices over two years. At the low end, by the third year, real output would be about 1 percent lower, implying that growth would fall by about one-half of a percentage point per year. At the high end, those effects would more than double; that is, growth could drop by about 1½ percentage points per year, on average, just from the wealth effect (see Figure 6).[10] If the economy would otherwise be growing at something like 2½ percent per year, a response by consumers at the high end combined with the drop in construction spending could be enough to reduce growth to close to zero.

CONTAGION FROM MORTGAGE MARKETS TO OTHER FINANCIAL MARKETS

Concerns about future economic activity have been magnified by the possibility that the problems in the subprime mortgage market could continue to create further problems for banks and other institutions in the credit markets. The possibility of such contagion upset financial markets earlier this year, as the market's expectation of the potential magnitude of problems in the subprime market worsened. Markets were further roiled in July and August following the failure of several hedge funds that had invested heavily in subprime securities, the knowledge that some European banks were exposed to large losses from similar types of hedge funds, and the arrival of other news on the depth of the problems in mortgage markets. The third round of turmoil, in November, was triggered when quarterly financial reports of banks and other financial institutions revealed larger-than-expected losses derived from the subprime mortgage market that could threaten the supply of credit to businesses and households. Those developments have led to a repricing of risk in general, which has affected valuations of and interest rates on a wide variety of investments: Prices of risky assets fell, whereas prices of Treasury securities rose, widening the unusually narrow risk spreads that had existed.

Interest rates have risen on various types of business borrowing. One indication of the lower tolerance for risk is the change in spreads between interest rates on corporate bonds and the rate on 10-year Treasury notes. To date, interest rates on riskier bonds (those with lower credit ratings) have increased substantially, while rates on less risky bonds have fallen (see Figure 7). Much of the recent change, though, simply brings the spreads on risky assets back to more normal levels. That is, investors appear to have been underpricing risk for some time, and the jump in spreads on the riskiest bonds in recent months brings their rates up to levels that are still fairly low relative to those in more serious episodes when investors' aversion to risk was heightened, such as during the fall of 1998, when the Long-Term Capital Management hedge fund failed, and in late 2000, after the last peak in the stock market.

Serious problems have persisted in the asset-backed segment of the commercial paper market.[11] Asset-backed paper (which totaled $981 billion in August) accounts for about half of the commercial paper market. Since the beginning of August, though, the amount of asset-backed paper that is outstanding has fallen by about 30 percent (see Figure 8). Interest rates on asset-backed paper rose sharply during the turmoil in financial markets in August, when holders of those investments became concerned about the extent of their exposure to subprime mortgages (see Figure 9). The underlying collateral was difficult to value, in part because the market for trading subprime loans was never liquid to begin with.[12] Although the spreads over Treasury rates have since declined, they remain substantial.

The problems in the market for asset-backed commercial paper may force some firms to tap their lines of credit with banks, leaving less bank credit available for other borrowers. Moreover, some large banks are committed either explicitly or implicitly to providing varying levels of liquidity to entities known as structured investment vehicles (SIVs), which have invested in a variety of asset-backed securities such as subprime MBSs (see Box 3). Such entities, which are off the banks' balance sheets, allow the banks to earn extra income without correspondingly expanding their capital. Should SIVs be unable to continue to fund their holdings through the commercial paper market, the banks may need to provide the necessary liquidity. If SIVs' losses worsen, the sponsoring banks may decide to bring the assets—and losses—back onto their balance sheets, possibly impairing other lending activities. One European bank, HSBC, has already decided to do so: Its SIV-sponsored assets were marked down 30 percent. The losses will reduce its capital, which in turn will slow the growth of its lending to households and businesses.

Although some banks may be distressed, most are well capitalized and should be able to absorb the losses. According to the most recent data available, as of September 30, 2007, the book value of equity capital for banks whose deposits were insured by the Federal Deposit Insurance Corporation (FDIC) totaled more than $1.3 trillion. In addition, the FDIC has indicated that of the 8,560 institutions covered, the vast majority (8,481) are well capitalized. Those well-capitalized banks, furthermore, hold 99.8 percent of the industry's assets. Only nine institutions, holding a trivial percentage of the industry's assets, are undercapitalized. Another 70 institutions, holding 0.2 percent of assets, are considered adequately capitalized.

Still, the large size of potential losses suggests that some banks, abroad as well as here, will absorb losses that could impair their lending.[13] On the basis of current discounts on subprime MBSs, expected depreciation in home prices, and past experience with defaults, some private-sector analysts estimate that mortgage losses over several years could be $300 billion to $400 billion. Because those losses will also be shared globally by investors, including hedge funds, pension funds, and other investment funds, it is unlikely that the banking system as a whole will be imperiled.

Credit losses have also affected the potential lending capacity of Fannie Mae and Freddie Mac. Their concentration in the prime mortgage market serves as an insulating factor, but they hold about $230 billion in subprime and Alt-A mortgages.[14] Their credit losses have lowered their capital cushions to just about $3 billion, on top of the $73 billion in capital currently required to safeguard $1.6 trillion of balance-sheet assets and $3.3 trillion of off-balance-sheet guarantees of mortgage-backed securities. That modest cushion leaves little capacity to absorb further losses. Consequently, Freddie Mac has announced that it will raise $6 billion in new capital and cut its dividend in half. However, even if the enterprises chose not to raise more capital, they could continue guaranteeing MBSs as long as they reduced their portfolios of mortgages, because the capital requirements for the mortgages held on their balance sheets are about five times higher than the requirements for their guarantees. Because the enterprises' guarantees with their implicit federal backing are the source of lower borrowing costs in the conforming mortgage market, any problems that they encounter are unlikely to affect that market but could affect their ability to buy more subprime and Alt-A mortgages.

THE RESPONSE OF MONETARY POLICY

As the extent of the turmoil in financial markets became clear in August, central banks in both the United States and elsewhere took action to maintain liquidity. Starting on August 10, the Federal Reserve injected $24 billion in temporary reserves into the U.S. banking system, a larger-than-usual amount, by accepting greater-than-normal amounts of mortgage-backed securities as collateral (see Figure 10). That action included a tacit temporary suspension of targeting the federal funds rate, as it was permitted to trade below the 5.25 percent target set on August 7. That approach continued until the Federal Reserve reduced the target to 4.75 percent on September 18. On August 17, the Federal Reserve also reduced the discount rate from 6.25 percent to 5.75 percent, and it extended the length of loans to 30 days and allowed borrowers to renew them.[15] On October 31, the Federal Reserve again cut the target federal funds rate by another 25 basis points, to 4.5 percent (see Figure 11).

The trouble in the U.S. subprime mortgage market also directly affected banks in other countries that had invested heavily in U.S. securities backed by subprime mortgages or were relying on short-term interbank financing (which became disrupted by the troubles in the mortgage markets) for longer-term loans. The European Central Bank (ECB), the Bank of Japan, the Bank of Canada, and the Bank of England all have injected substantial amounts of liquidity into their countries' financial markets to contain the credit crisis. For example, on August 9, the ECB provided an unprecedented amount equivalent to $129 billion, which the Bank of Japan followed the next day with $9 billion. On September 6, the ECB injected $59 billion into temporary reserves. Even the Bank of England, which was reluctant to intervene earlier, announced on September 19 that it would inject $20 billion into money markets, in a bid to bring down short-term interest rates, which had risen after the Northern Rock bank experienced difficulties in refinancing. So far, those foreign central banks have not yet cut their interest rates, but they have held off planned increases.

The resurgence of market jitters in November has prompted the central banks to take or announce new steps intended to calm the markets. For example, that month, the Bank of Canada provided to money markets funds totaling more than $3 billion to bring the overnight rate down to its target (4.5 percent). On November 26, the Federal Reserve announced that it would extend the length of loans to bond dealers to ease funding pressure on banks through the end of the year. On November 29, the Bank of England announced that it would inject about $20 billion to alleviate concerns about overly tight credit conditions. Earlier this month, the ECB also announced that it would inject $85 billion in three-month loans on November 23, to be followed by another $85 billion on December 12.

OIL MARKETS

Developments in oil markets could also affect the macroeconomic outlook, although their impact to date has been modest. In 2007, the price of crude oil increased by over 60 percent, reaching almost $100 a barrel in recent weeks, an inflation-adjusted level not seen since the 1980s (see Figure 12). Supply and demand fundamentals account for much of the recent increase in crude oil prices, but geopolitical tensions and related increases in speculative and precautionary demand for oil have also exerted upward pressure on prices. The increase in crude oil prices has pushed higher the prices of petroleum products such as gasoline and heating oil.

The Energy Information Administration (EIA) of the Department of Energy projects that world consumption of crude oil will have increased in 2007 by about 1.1 million barrels per day, to 85.8 million barrels per day.[16] China, India, and nations in the Middle East together account for over 75 percent of the projected increase. Although the United States accounts for about 25 percent of global oil consumption, it accounts for much less of the recent increase: Only about 10 percent of the increase in 2007 is attributable to the United States.

That increase in global demand comes against the backdrop of slow growth in world oil production. According to EIA's forecasts, total production will be about 200,000 barrels per day higher in 2007 than in 2006. Total production by nations outside of the Organization of Petroleum Exporting Countries (OPEC) will increase, but that increase will have been almost completely offset by the organization's cuts in production in November 2006 and February 2007.[17] Crude oil prices have declined in recent days to below $90 a barrel, on the basis of expectations of a near-term increase in OPEC's production, though the organization has yet to confirm such an increase. With such limited growth of supply, the increase in crude oil consumption is being drawn from privately held inventories. While tight markets result in elevated prices, lower inventories reduce the buffer against uncertainties about the supply and increase the potential for price volatility.

Over the longer term, there is some concern that future supply may not be able to keep pace with increased demand and that prices could rise further. World consumption is expected to continue to grow, reflecting large growth in demand in China, India, the Middle East, and elsewhere. The International Energy Agency forecasts growth of world petroleum consumption of about 2 percent per annum in the years ahead.[18] However, the supply may become increasingly limited as crude oil from existing reserves becomes harder and more expensive to access. In some areas, for example, the North Sea, Mexico, and Venezuela, production has been unresponsive to rising prices. But analysts differ on whether the market as a whole is constrained by a limited accessible supply or whether specific factors, such as political unrest in Nigeria or slow development of new central Asian oil fields, account for relatively flat production despite rising prices. Regardless of the underlying cause of a sluggish supply response, prices will increase if future increases in demand are not matched by a growing supply.

Some analysts argue that the rise in the price of oil also reflects increases in speculative and precautionary demand for oil. For example, Middle East tensions could disrupt the supply and drive prices higher, and some of that risk is currently reflected in the market price. Similarly, some investors may conclude that holding crude oil is a better investment than other assets.

Looking to the future, both EIA's price forecasts and futures prices available at the New York Mercantile Exchange (NYMEX) suggest that crude oil prices will decline from current levels next year, though prices are still projected to remain high relative to historical experience. In its most recent forecast, EIA estimates that the prices for West Texas Intermediate crude oil will be about 11 percent lower at the end of 2008 than at the beginning of that year.[19] That projection is somewhat greater than current NYMEX futures prices; the current price for December 2008 is about $85 per barrel, or about 4 percent below the January 2008 prices.[20]

GASOLINE

The price of gasoline has broadly reflected the rise in crude prices since the beginning of the year. As of late November 2007, the weekly average retail price for all grades of gasoline in the United States was about $3.15, or about 32 percent higher than it was at the beginning of January. (See Figure 13). However, short-term movements in gasoline prices did not necessarily reflect movements in crude oil prices throughout the year. As is typical, average gasoline prices peaked during the late spring in anticipation of increased summer driving. By late August, average prices for retail gasoline in the United States declined by nearly 15 percent from the spring peak even as crude oil prices had risen by about 10 percent.[21] Since August, both crude oil prices and average retail prices for gasoline have increased.

HEATING OIL AND NATURAL GAS

According to current data from EIA, average real prices for heating oil are about $3.30 a gallon, about 38 percent higher than they were a year earlier.[22] In contrast, winter 2006-2007 heating oil prices were approximately unchanged from those of the previous winter. By EIA's projections, heating oil prices will decline in 2008 by about 8 percent, approximately the same amount that the agency predicts for crude oil prices. However, the severity of the winter will be a key determinant of whether heating oil prices continue to increase over the next several months.

Natural gas prices have fluctuated throughout the past year and currently stand at about $8 per million British thermal units, a level approximately consistent with prices a year earlier. EIA estimates that natural gas prices will grow by about 3 percent in 2008,[23] while NYMEX futures indicate greater growth of about 11 percent.[24]

MACROECONOMIC EFFECTS

The historically high crude oil and related energy prices have had a limited impact on the U.S. economy to date. At the consumer level, individuals tend to be inflexible in their use of gasoline, at least in the short term. Estimates of the short-run elasticity of demand for gasoline suggest that a 10 percent increase in the price of gasoline will cause the consumption of gasoline to decline by 0.5 percent or less. According to CBO's research, higher gasoline prices have induced only a small change in driving patterns. Individuals are buying somewhat more fuel-efficient vehicles than in the past, and the share of sport utility vehicles has declined as the share of passenger cars has increased. But even if high prices persist, the full effect of that higher efficiency on gasoline demand will not be completely realized for many years because fully replacing the automobile fleet takes about 15 years.

The relatively modest effects on the economy from higher oil and related prices may seem puzzling to those who remember the substantial impact from the oil price shocks of the 1970s. At that time, however, monetary policymakers had been unable to control inflation in the years before energy prices rose, and many other aspects of the structure of the U.S. economy made it less able to respond to energy price shocks than it is today.[25]

THE CURRENT ACCOUNT AND THE DOLLAR

The current-account balance has stabilized in recent years and real net exports have increased sharply since early last year, providing an important offset to the weakness of housing spending. But after increasing for many years, the nation's current-account deficit has become unsustainably large. Between 2000 and 2005, it grew from about $400 billion to about $800 billion. Since then, it has remained roughly constant, even though the cost of oil imports has risen sharply. Indeed, with oil excluded, the deficit has begun to decrease since 2005. The stabilization of the current account reflects a slight increase in the real growth of exports and a sharper decrease in the real growth of imports. Thus far, the adjustment in the current account has occurred in an orderly way without major disruptions of exchange markets.

Both strong growth abroad and depreciation of the dollar have played roles in stabilizing the current account. The economic growth of major U.S. trading partners has been stronger than expected so far this year, mainly because of the strength of emerging economies. The problems in the U.S. subprime mortgage market, though they have caused a credit squeeze in advanced economies, appear to have channeled capital to some emerging economies, especially those of Brazil and India, supporting their domestic growth and imports and adding to the growth of their asset prices and exchange rates. Economic growth in other countries, however, appears to have slowed since the summer, as industrial economies grapple with the problems in financial markets, the sharp rise in oil prices, and the appreciation of their currencies against the dollar.

The dollar, which has been on a downtrend since early 2002, has dropped by more than 5 percent against the currencies of the country's major trading partners since midsummer. The recent more rapid decline probably largely reflects the consequences of the financial strains in the United States, through the following channels:

- The Federal Reserve cut interest rates more aggressively than most other central banks have, lowering the rate of return on U.S. short-term securities;
- Investors remained concerned about the dollar's status as the main reserve currency for central banks, and some countries are rebalancing their official portfolios and reducing the share of dollar assets; and

• Fear of a U.S. recession and uncertainty about the true scale of U.S. corporations' exposure to the fallout from the financial turmoil may also have reduced foreign demand for U.S. stocks and bonds.

Eventually, such a large movement of exchange rates would be expected to have some impact on consumer prices, but little impact has been seen yet. Several studies have observed that the "pass-through" from exchange rates to U.S. prices has recently been smaller than it used to be, perhaps because foreign exporters have so far been able to absorb a large part of the dollar's depreciation without changing U.S. prices much.[26] However, there is a limit to how much compression of profits those exporters can absorb, and eventually more of the decline in exchange rates is likely to be passed through to prices. That limit—whose position is unknown—is likely to be reached more quickly when exchange rates depreciate more rapidly.

CONSUMPTION AND CONSUMER CONFIDENCE

Because consumption accounts for such a large share of overall economic activity, the economic outlook will be substantially affected by what happens to consumer spending. The turmoil in credit markets could affect consumption because consumer and mortgage loans may be more difficult to obtain, because the decline in house prices reduces consumer wealth, and because consumer confidence about future economic activity may be diminished. Moreover, continued weakness in stock markets also would work to reduce consumption spending somewhat.

So far, there is little direct evidence of any significant slowing in consumption. Through the third quarter of this year, real personal consumption expenditures had not moved to a significantly lower trend growth path (see Figure 14). The first look at overall consumer spending in October, which came out last Friday, indicates weaker growth, but some of that weakness may reflect unseasonably warm temperatures that reduced heating needs and purchases of seasonal clothing and shoes. Despite the problem of delinquencies of subprime mortgage loans, delinquency rates on consumer loans at commercial banks have moved up only slightly in the past year and are not signaling major problems.

The apparent resilience of consumption is somewhat less reassuring in light of some other factors. First, consumers' energy bills have risen significantly this year, by roughly $80 billion (at an annual rate) in the first half of the year, which may force consumers to cut back on other spending. Although energy costs fell by about $18 billion between June and September—just as the financial turmoil emerged—oil and gasoline prices have risen again since September. Second, the effect of weaker house prices and the lower stock market may not have yet filtered through to consumer spending. As house prices continue to decline, they may affect consumer spending because houses are the main source of collateral for loans (mortgages and home equity lines) to consumers. But such effects are likely to take some time to occur. Third, the Federal Reserve reports that commercial banks have tightened their lending standards and terms on consumer loans other than credit cards and on residential mortgage loans, including prime mortgages.

Moreover, consumers' attitudes have deteriorated this year and suggest that a broader slowing of economic activity from its pace during the middle of this year may be in the offing. The consumer sentiment index, created by the University of Michigan, fell to 76.1 in November, its lowest level since the aftermath of the 2005 hurricanes (see Figure 15). Higher energy prices and continued weakness in the housing market continue to depress consumers' assessments of current conditions. The Conference Board's index of consumer confidence also has fallen sharply since the summer. Both of those entities' indexes of consumers' expectations also have fallen this year and are at levels that, if maintained, appear to be consistent with weak growth in consumer spending.

THE POSSIBILITY OF A RECESSION AND EFFECTS ON THE BUDGET

Recessions are notoriously hard to forecast, so it is not surprising that very few forecasters have a recession in their base forecast for the near future, though most have revised down their forecasts of growth since last summer (see Table 1). From the point of view of the budget, however, the effects of being in a mild recession may not differ very much from those of being in a period of slow growth.

TABLE 1.—COMPARISON OF FORECASTS OF REAL GDP FOR 2008

[Percentage change, fourth quarter to fourth quarter]

	Current	As of Mid-2007
Administration	2.7	3.1

TABLE 1.—COMPARISON OF FORECASTS OF REAL GDP FOR 2008—Continued

[Percentage change, fourth quarter to fourth quarter]

	Current	As of Mid-2007
Blue Chip	2.4	2.9
Federal Reserve	1.8 to 2.5	2.5 to 2.75
Global Insight	1.9	2.9
Macroeconomic Advisers	2.8	2.9
NABE	2.6	3.1

Sources: Council of Economic Advisers, Department of the Treasury, and Office of Management and Budget, ''Administration Economic Forecast'' (joint press release, November 29, 2007, and June 6, 2007); Aspen Publishers, Inc., Blue Chip Economic Indicators (November 10, 2007, and July 10, 2007); Federal Reserve Board of Governors, Minutes of the Federal Open Market Committee (October 30-31, 2007), and Monetary Policy Report to the Congress (July 18, 2007); Global Insight, Inc., U.S. Economic Outlook (November 2007 and July 2007); Macroeconomic Advisers, LLC, Economic Outlook (November 21, 2007, and July 10, 2007); National Association for Business Economics (NABE), NABE Outlook (November 2007 and May 2007).

Notes: GDP = gross domestic product.

The Blue Chip consensus is the average of about 50 forecasts by private-sector economists. The forecast from the Federal Reserve is termed the central tendency, which reflects the most common views of the Federal Open Market Committee. The NABE Outlook is a survey of about 50 professional forecasters.

Forecasters currently face considerable uncertainty about what has already happened—not an unusual occurrence.[27] In the third quarter of 2007, the most recent for which data are available, real growth of GDP was reported to have been 4.9 percent at an annual rate. However, a measure of total income in the economy—which apart from measurement errors should be the same as GDP—suggests much slower growth of slightly below 2 percent.

In evaluating the possibility of a recession, forecasters must balance the negative aspects of the economy described above—the collapse of housing, the risk of contagion, and the likely weakness of consumption—against the better news from the rest of the economy. Among that better news is the improvement of the current-account balance and inflation that is still contained despite the increases in oil prices and the weakness of the dollar. Such news gives the Federal Reserve room to adjust interest rates.

One way of thinking about the probability of a recession is to look at indicators that in the past have been correlated with recessions. The best single such indicator is an inverted yield curve—which occurs when a short-term interest rate (such as the rate for one-year Treasury bills) is above a long-term interest rate (such as the rate on 10-year notes). Such an inversion has preceded every recession in the past 50 years and has given only one false signal (see Figure 16). The yield curve was inverted for much of last year and the first five months of this year It is not inverted now, but such an inversion has frequently ended before a recession starts.

Another approach is to see what people are willing to put money on. Trading on the Intrade Web site, which allows investors to trade a derivative based on a recession in 2008, in September put the probability of a recession close to 60 percent. Since then, the probability dropped to 30 percent and is now a little below 50 percent, according to that market. That indicator is a very thinly traded contract, though, and therefore may not accurately reflect the broader views of investors.

A third approach is to survey forecasters. The November Blue Chip survey asked participants about the probability of recession in 2008. While the consensus of the 10 most pessimistic forecasters thought that the probability was over 43 percent, the consensus of all responders put that probability at about 1 in 3 (up from 1 in 4 in August). No forecaster in the survey thought that a recession was the most likely outcome. Forecasters do agree, however, that the next year will see GDP growing considerably below its potential trend, and the next survey will probably reveal forecasts of lower projected growth.

In January, CBO will release its comprehensive analysis of the current economic situation and the implications for the federal budget. Pending that full analysis, a look back at what past recessions have meant for the budget provides a rough guide to what might happen in the event of a recession in the coming year. Since 1968, recessions have worsened the annual budget balance—by CBO's rough estimate, by between about 1 percent and 3 percent of GDP from just before the cyclical peak to the second fiscal year following. In the current economy, a recession similar to those experienced over the past four decades might therefore increase the deficit by between $140 billion and $420 billion (see Table 2).

TABLE 2.—BUDGET EFFECTS OF THE PAST SIX RECESSIONS

[Percentage of gross domestic product]

Period Before (Peak to Trough)	Change in Actual Deficit	Change in Adjusted Deficit
1969 to 1971	−2.5	−2.5
1973 to 1975	−2.3	−2.0
1979 to 1981	−1.0	−0.8
1981 to 1983	−3.5	−2.0
1990 to 1992	−0.8	−1.5
2000 to 2002	−4.0	−2.9
Average	−2.3	−2.0

Source: Congressional Budget Office.

Notes: In this table, the period before the peak is the fiscal year preceding the onset of a recession, and the trough is either the fiscal year containing the last quarter in which the economy was in recession or the fiscal year following that last quarter.

The deterioration in the budget deficit during periods of economic weakness provides a form of automatic stimulus to the economy. As the economy slows, the decline in income, payrolls, profits, and production causes tax receipts to fall relative to spending—and causes outlays, for unemployment compensation and food stamps, for instance, to rise. The combination temporarily boosts demand for goods and services, thereby helping to offset some of the macroeconomic weakness.[28]

Fiscal policy interventions that go beyond those automatic stabilizers in attempting to boost the economy during periods of economic weakness have had a mixed track record. Although there have been examples of effective discretionary fiscal stimulus, in several other cases, attempts to stimulate demand through changes in fiscal policies have proved to be poorly timed or relatively ineffective. Part of the reason has to do with the time lag typically involved in enacting such legislative changes. Another involves the specific stimulus policies enacted in the past, as different types of changes in spending and tax policies can have substantially different effects on short-term macroeconomic demand.[29] Policymakers considering whether to adopt measures beyond the budget's existing automatic stabilizers would need to carefully weigh not only the macroeconomic environment but also the lessons from past attempts at such economic stimulus.

The adjusted deficit is calculated by removing from the actual deficit (1) all discretionary spending; (2) the effects of legislation on taxes and mandatory spending; and (3) all interest payments. In addition, the adjusted deficit has the impact of inflation attributable to progressivity (bracket creep) removed from individual income tax receipts (except for the last two recessions, because personal income tax brackets have been indexed for inflation since 1985). Finally, it includes the effect that the increase in the deficit has on debt service.

ENDNOTES

1. The federal funds rate is the rate at which banks make overnight loans to one another.
2. Securitization is a process whereby mortgages are pooled and then their cash flows sold as securities (tranches) with different risk characteristics. Some of the risk tranches are designed to be relatively safe, and others can be quite risky; investors can choose according to their preferences and objectives.
3. Certain ARMs may have been among the more difficult mortgages for first-time borrowers to understand. Many of those mortgages made in recent years included teaser rates, which may have confused some borrowers about the eventual size of their mortgage payments when their mortgage rates were reset. Most of those mortgages also included prepayment penalties.
4. Statement of Ben S. Bernanke, The Economic Outlook, before the Joint Economic Committee (November 8, 2007).
5. See Christopher L. Cagan, Mortgage Payment Reset: The Issue and the Impact (Santa Ana, Calif.: First American CoreLogic, March 19, 2007).
6. Defaults on mortgages might even have helped to support consumer spending at first. Such defaults mean a loss for investors (who tend to be relatively wealthy and may not have needed to adjust their consumption) but can be a gain for the people who default because they no longer need to make unaffordable mortgage payments and may be able to spend the money on other things.
7. See Jonathan McCarthy and Richard W. Peach, "Are Home Prices the Next 'Bubble'?" Federal Reserve Bank of New York Economic Policy Review, vol. 10, no. 3 (December 2004), pp. 1-17.
8. The S&P/Case-Shiller 10-City Composite Home Price Index tracks changes in the value of residential real estate in 10 metropolitan regions. Futures based on that index trade on the Chicago Mercantile Exchange.
9. See Congressional Budget Office, Housing Wealth and Consumer Spending (January 2007).

10. The Federal Reserve conducted similar experiments using its model and found smaller effects. See Frederic S. Mishkin, Housing and the Monetary Transmission Mechanism, Finance and Economics Discussion Series No. 2007-40 (Washington, D.C.: Federal Reserve Board, August 2007). Both CBO's and the Federal Reserve's analyses assume that the Federal Reserve adjusts its target for the federal funds rate to offset some of the negative effects of the decline in house prices. In the Federal Reserve's simulation, the federal funds interest rate is more than 1½ percentage points lower by the end of the third year; in CBO's simulation, the rate is between one-half of a percentage point and 2 percentage points lower at the beginning of the third year.

11. Asset-backed commercial paper is collateralized by receivables including MBSs, credit card loans, and student loans.

12. Some of the financial contracts underlying that paper contain clauses that delay price discovery if the market for an underlying asset is too illiquid. Designed to prevent a "fire sale" of an individual asset, in the aggregate such mechanisms have partially contributed to the slow emergence of the losses sustained as a result of the turmoil in the subprime mortgage market. Generally, if an asset becomes subject to some triggering event, an agent solicits bids for the asset to discover the asset's current value. If the agent receives too few bids, the agent solicits bids at a later date. Although the subsequent valuation dates and the requisite number of bids are privately negotiated, such mechanisms may delay price discovery by 30 days or more. That delay effect is compounded if the new-found values then cause triggering events for another set of contracts.

13. Citigroup has been identified as having the largest exposure to losses arising from SIVs. In its third-quarter financial filings, Citigroup's total risk-based capital was 10.6 percent of assets, barely above the 10 percent level needed to be considered well capitalized under current law.

14. Alt-A mortgages are higher rated than subprime mortgages but lower rated than prime mortgages.

15. The discount rate is the rate at which banks can borrow from the Federal Reserve.

16. Energy Information Administration, Short-Term Energy Outlook (November 2007), available at *www.eia.doe.gov/emeu/steo/pub/contents.html.*

17. OPEC nations are Algeria, Angola, Indonesia, Iran, Iraq, Kuwait, Libya, Nigeria, Qatar, Saudi Arabia, the United Arab Emirates, and Venezuela.

18. International Energy Agency, Medium-Term Oil Market Report (July 2006), p. 6, available at *http://omrpublic.iea.org/currentissues/MED—OMR06.pdf.*

19. Energy Information Agency, Short-Term Energy Outlook (November 2007).

20. New York Mercantile Exchange, Light Sweet Crude Oil, accessed December 3, 2007, available at *www.nymex.com/lsco—fut—csf.aspx.*

21. Energy Information Agency, Weekly Heating Oil and Propane Prices, accessed December 3, 2007, available at *http://tonto.eia.doe.gov/dnav/pet/pet—pri—wfr—a—EPD2F—prs—cpgal—w.htm.*

22. Ibid.

23. Energy Information Administration, Short-Term Energy Outlook (November 2007).

24. New York Mercantile Exchange, Natural Gas, accessed December 3, 2007, available at *www.nymex.com/ng—fut—csf.aspx.*

25. See Congressional Budget Office, The Economic Effects of Recent Increases in Energy Prices (July 2006).

26. See Mario Marazzi and others, Exchange Rate Pass-Through to U.S. Import Prices: Some New Evidence, International Finance Discussion Paper No. 833 (Washington, D.C.: Federal Reserve Board of Governors, April 2005), available at *www.federalreserve.gov/pubs/ifdp/2005/833/ifdp833.pdf.* See also Mario Marazzi and Nathan Sheets, "Declining Exchange Rate Pass-Through to U.S. Import Prices: The Potential Role of Global Factors," Journal of International Money and Finance, vol. 26, no. 6 (October 2007), pp. 924-947.

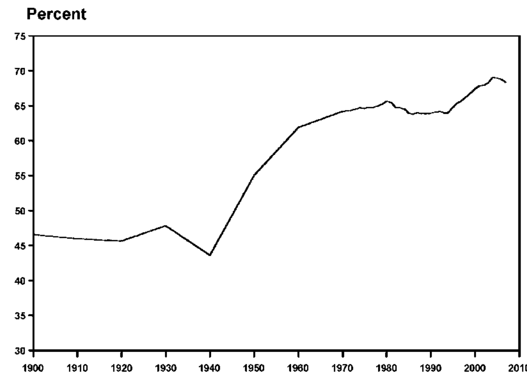
27. See Dennis J. Fixler and Jeremy J. Nalewaik, News, Noise, and Estimates of the "True" Unobserved State of the Economy, Finance and Economics Discussion Series No. 2007-34 (Washington, D.C.: Federal Reserve Board of Governors, September 18, 2007).

28. Economists have long noted that the tax system serves as an automatic stabilizer that offsets at least part of demand shocks to the economy. A decline in aggregate before-tax income of one dollar generates a decline in aggregate after-tax income of less than one dollar. As a result, the tax system helps to stabilize demand for goods and services, which in turn helps to reduce fluctuations in the overall economy. See Alan J. Auerbach and Daniel Feenberg, "The Significance of Federal Taxes as Automatic Stabilizers," Journal of Economic Perspectives, vol. 14, no. 3 (Summer 2000), pp. 37-56; and Thomas J. Kniesner and James P. Ziliak, "Tax Reform and Automatic Stabilization," American Economic Review, vol. 92, no. 3 (June 2002), pp. 590-612.

29. See Congressional Budget Office, Economic Stimulus: Evaluating Proposed Changes in Tax Policy (January 2002).

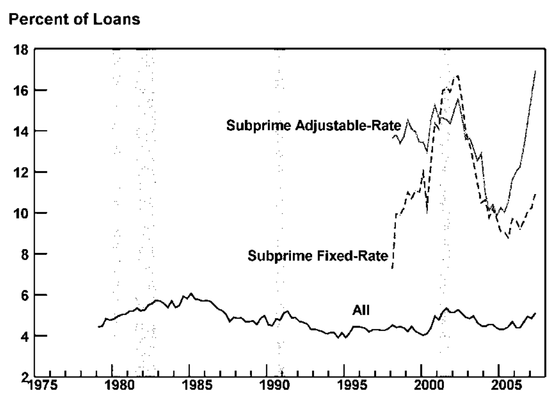
ADDENDUM.—CBO CHARTS PRESENTED IN THE HEARING

Figure 1. U.S. Home Ownership Rate



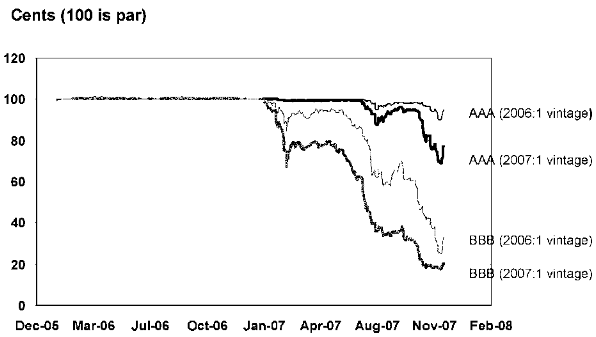
Sources: Congressional Budget Office; Bureau of the Census.
Notes: Data are for census years from 1900 to 1960 and annual from 1970 to 2007. The value for 2007 is an average for the first three quarters.

Figure 2. Mortgage Delinquencies



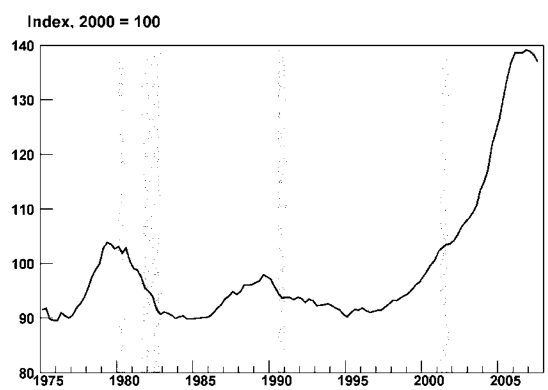
Sources: Congressional Budget Office; Mortgage Bankers Association.
Note: Data are quarterly and are plotted through the second quarter of 2007.

Figure 3. Prices of Subprime Mortgage Tranches



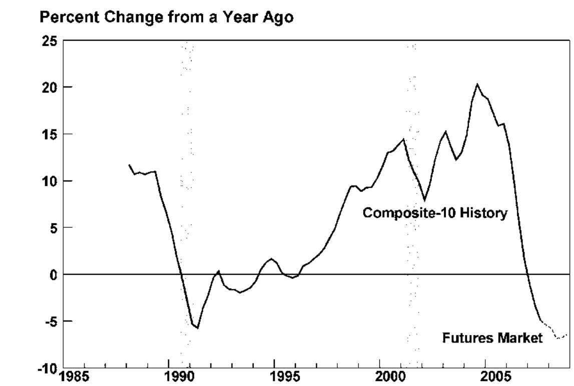
Source: Congressional Budget Office based on data from Markit.
Notes: Markit ABX.HE index published by Markit for the BBB (close to the lowest investment grade) and the safest (AAA) tranches of mortgage-backed securities. The 2006:1 vintage reflects mortgages available for securitization from July 19, 2005, to January 5, 2006. The 2007:1 vintage reflects mortgages available for securitization from July 19, 2006, to January 5, 2007. Data are daily and are plotted through November 30, 2007.

Figure 4. House Price-to-Rent Ratio



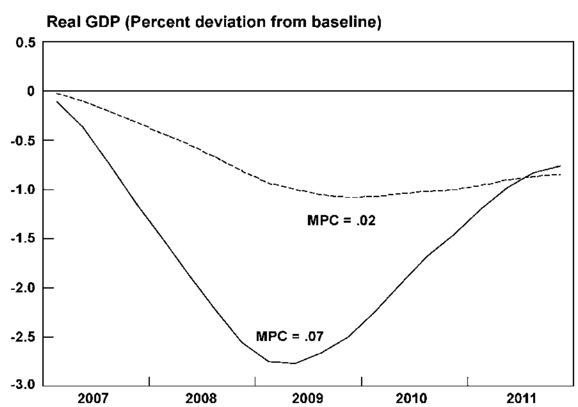
Sources: Congressional Budget Office; Office of Federal Housing Enterprise Oversight; Department of Commerce, Bureau of Economic Analysis.
Note: Data are quarterly and are plotted through the third quarter of 2007.

Figure 5. S&P/Case-Shiller Home Price Index and Futures Market



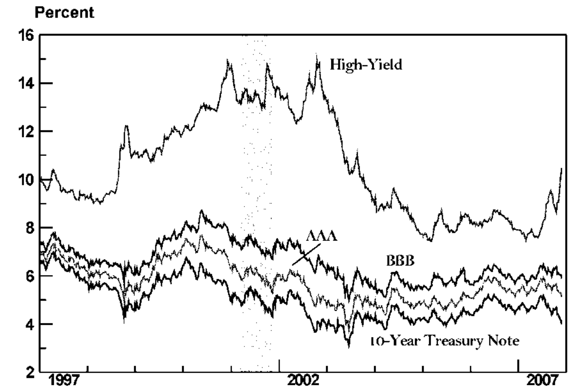
Sources: Congressional Budget Office; Bloomberg.
Notes: The S&P/Case-Shiller Home Price Index tracks price changes from the previous time a house was sold.
Data are quarterly and are plotted through the third quarter of 2007.
Includes futures contracts from the fourth quarter of 2007 to the fourth quarter of 2008.

Figure 6. Simulations of a 16 Percent Decline in House Prices



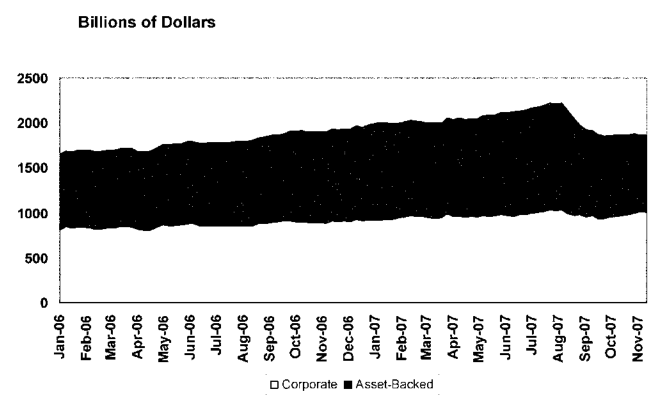
Note: MPC = Marginal propensity to consume out of wealth.

Figure 7. Interest Rates for Corporate Bonds



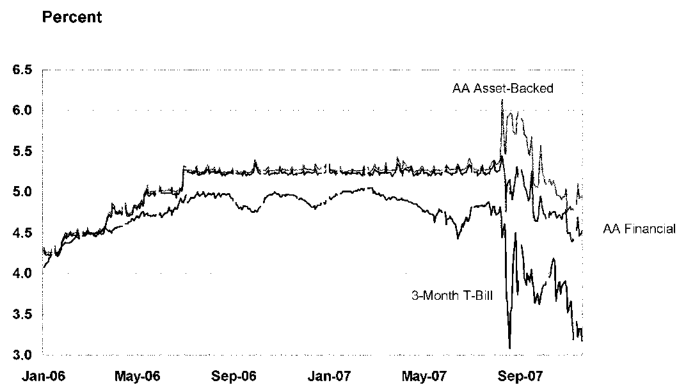
Sources: Congressional Budget Office; Bloomberg.
Note: Data are weekly and are plotted through November 23, 2007.

Figure 8. Commercial Paper Outstanding



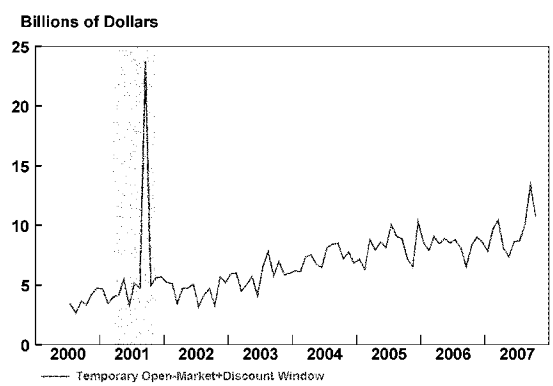
Source: Congressional Budget Office based on data from the Federal Reserve.
Note: Data are weekly and are plotted through November 14, 2007.

Figure 9. Overnight Commercial Paper Rates



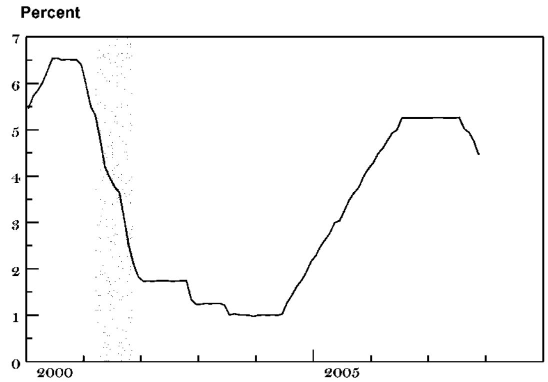
Source: Congressional Budget Office based on data from the Federal Reserve.
Note: Data are daily and are plotted through November 20, 2007.

Figure 10. Injections of Reserves by the Federal Reserve



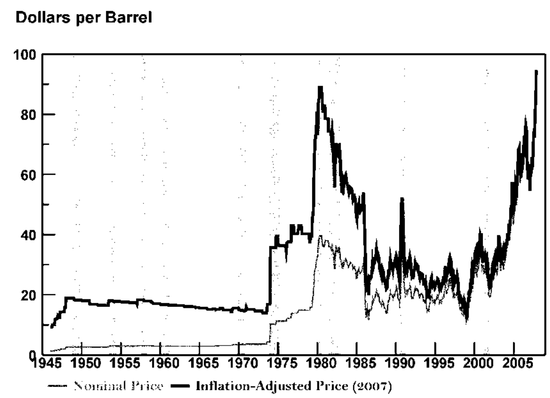
Sources: Congressional Budget Office; Federal Reserve Board.
Notes: Includes both reserve injections through open-market operations and the discount window. Data are monthly and are plotted through October 2007.

Figure 11. Effective Federal Funds Rate



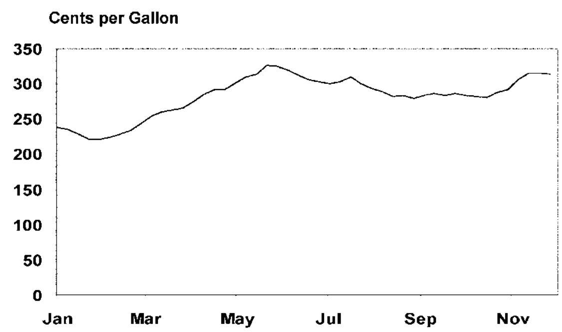
Sources: Congressional Budget Office; Federal Reserve Board.
Notes: Data are monthly and are plotted through November 2007.
The value for November is an average for the first three weeks.

Figure 12. Price of West Texas Intermediate Crude



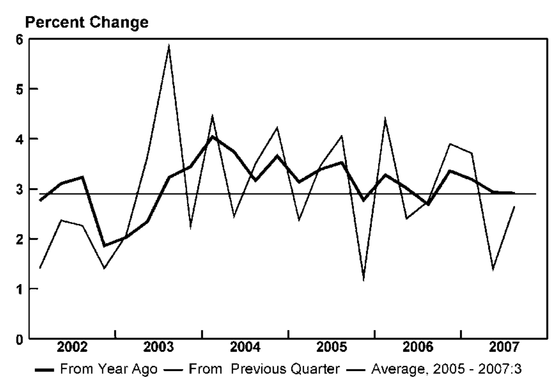
Sources: Congressional Budget Office; Foundation for International Business and Economic Research.
Notes: The inflation-adjusted price is computed using the price index for personal consumption.
Data are monthly and are plotted through November 2007.

Figure 13. 2007 Average Retail Gasoline Price (all grades)



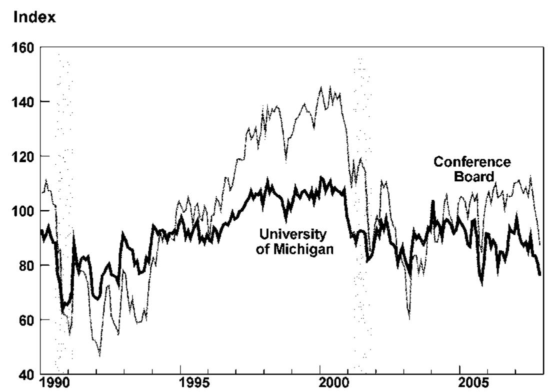
Sources: Congressional Budget Office; Department of Energy, Energy Information Administration.
Note: Data are weekly and are plotted through November 26, 2007.

Figure 14. Real Personal Consumption Expenditures



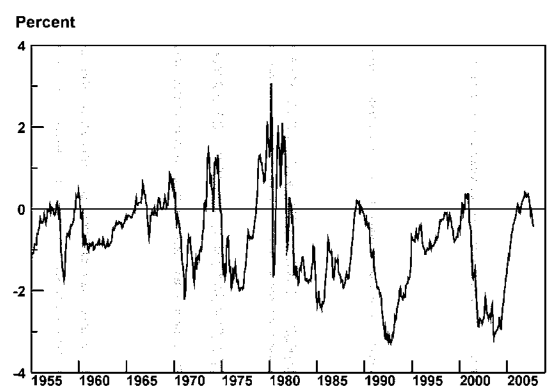
Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.
Note: Data are quarterly and are plotted through third quarter 2007.

Figure 15. Consumer Confidence



Sources: Congressional Budget Office; University of Michigan; Conference Board.
Note: Data are monthly and are plotted through October 2007.

Figure 16. Difference in Yield Between 1-Year and 10-Year Treasury Notes



Sources: Congressional Budget Office; Federal Reserve Board.
Note: Data are monthly and are plotted through October, 2007.

Chairman SPRATT. Thank you, Dr. Orszag.
And now Dr. Feldstein.

STATEMENT OF MARTIN FELDSTEIN

Mr. FELDSTEIN. Thank you very much, Mr. Chairman.

I am very pleased to appear before this committee at this important time.

Although I think we need to remember that the U.S. economy has great long-term strength, I am also worried about the near-term outlook. In my testimony today and in an op-ed piece in today's Wall Street Journal, I suggest what the Congress can do to reduce the risk of a serious recession. I think the U.S. economy is now getting substantially weaker. There is likely to be virtually no increase in real GDP in the current fourth quarter. Virtually every economic indicator, including credit conditions, housing markets and consumer sentiment, has deteriorated significantly during the past month.

I believe that the probability of a recession in 2008 has now reached 50 percent. If it occurs, it could be deeper and longer than the recessions of the recent past. As Peter Orszag has just noted, most analysts are forecasting that by the time we get to the middle of 2008, the U.S. economy will not be in recession but will be growing at a slow pace. And yet those same economists, when surveyed, say that they believe that the probability of a recession is, at least the last time I saw such a survey, somewhere in the 30 to 40 percent range. I find it hard to square these two sets of comments by professional forecasters; on the one hand, pretty high probability that we will have negative GDP growth and, at the same time, a belief that in some sense the most likely, or the average—they never make it clear what they mean by their forecast—growth will be around 2 percent.

I think the probability of recession that is embodied in the views of these economists needs to be given more weight. I think the Federal Reserve should, and I believe it will, reduce the Fed funds rate next week at its meeting. And I think it should then continue cutting the Federal funds rate toward 3 percent in 2008 unless there is a clear sign of an economic improvement. Today's 4.5 percent Federal funds rate is essentially neutral. It is not low enough to stimulate growth. And that is why it needs to be reduced and, if the economy weakens, needs to be reduced substantially. But I think because of the current credit market conditions that Peter Orszag has summarized, there is a risk that interest rate cuts will not be as effective in stimulating the economy as they were in the past. Nevertheless, rate cuts can still help by lowering the monthly payments on adjustable rate mortgages and thus freeing up spendable cash for households that have adjustable rate mortgages—that is about a third of all mortgages—by decreasing the cost of borrowed funds to households and businesses, and by making the dollar more competitive. So the Federal Reserve really does need to keep reducing interest rates.

But let me turn now to the role that I think the Congress should play to reduce the risk of recession or to reduce its seriousness if a recession occurs. I believe that the lower interest rates should be supplemented by enacting a tax cut, enacting it now, but triggering it in 2008 if the economy deteriorates substantially. There are many possible forms of a tax cut stimulus. It could be a flat rebate per taxpayer, or it could be a percentage reduction in each taxpayer's liability. In some sense, that matters less than just the magnitude of the increased spending that can be generated in that way, household spending that can be generated in that way. And there are also a variety of possible triggering events.

My judgment now is that the most suitable of these would be a 3-month decline in payroll employment. If the payroll employment number falls for 3 months, the tax cut would automatically occur. So this fiscal stimulus would be, in effect, like an automatic stabilizer. In order to be effective, the PAYGO rule would have to be set aside for this specific tax cut. It makes no sense to have a PAYGO rule that blocks short-term fiscal stimulus, even though a PAYGO rule can be a useful thing for longer-term fiscal discipline.

Enacting such a conditional stimulus would have two desirable effects. First, it would immediately boost confidence of households and businesses since they would know that a significant slowdown would be met immediately by a substantial fiscal stimulus. And second, if there is a decline of employment, and therefore of output and incomes, a fiscal stimulus would begin without the usual delays of the legislative process. In effect, as I said a moment ago, such a preenacted conditional fiscal stimulus would act as an automatic stabilizer in much the same way that the pay out of unemployment benefits does now. So a key advantage of a preenacted conditional tax cut is that it would eliminate the legislative lag that has made economists critical, correctly critical, of countercyclical fiscal policy in the past. It would also mean that the countercyclical fiscal action would respond to actual economic weakness rather than to potentially unreliable economic forecasts.

Let me conclude with two further brief points. First, the case that I have just made for using fiscal as well as monetary policy when the economy weakens shouldn't be limited to just the current situation. I think we have learned something about the use of very low and sustained interest rates. Excessive asset price increases caused by past monetary expansions, especially the rise in real estate prices, provide a further reason to use fiscal as well as monetary policy. In other words, a fiscal stimulus can provide a more balanced expansion, not just pumping up house prices and construction. And my second and final point is a comment about the dollar. The falling dollar, that is a more competitive dollar, is a necessary part of reducing the massive U.S. trade deficit. I think we can look ahead and expect to see the dollar continuing to fall for quite a while in the future. Moreover, it is going to be an important source of demand and of growth in 2008 and 2009.

As Peter Orszag has already commented, the fall in the dollar that has occurred over the last 2 years has already shown itself to be an important source of economic demand. So a more competitive dollar should not be seen as a problem for the United States. Thank you, Mr. Chairman.

[The prepared statement of Martin Feldstein follows:]

PREPARED STATEMENT OF MARTIN FELDSTEIN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

(1). The U. S. economy is now very weak and could get substantially weaker.

There is likely to be virtually no increase in real GDP in the current quarter. Virtually every economic indicator—including credit conditions, housing, and consumer sentiment—has deteriorated significantly during the past month.

I believe that the probability of a recession in 2008 has now reached 50 percent. If it occurs, it could be deeper and longer than the recessions of the recent past.

(2) The Federal Reserve should reduce the fed funds rate at its December meeting and should continue cutting that rate toward three percent in 2008 unless there is a clear sign of an economic improvement.

The current 4.5 percent federal funds rate is essentially neutral—not low enough to stimulate growth.

Because of current credit market conditions, there is a risk that interest rate cuts will not be as effective in stimulating the economy as they were in the past.

But rate cuts can still help—lowering monthly payments on adjustable rate mortgages, decreasing the cost of borrowed funds, and making the dollar more competitive.

(3) The lower interest rate should be supplemented by enacting a tax cut now that is triggered to take effect if the economy deteriorates substantially in 2008.

There are many possible forms of stimulus, including a flat rebate per taxpayer or a percentage reduction in each taxpayer's liability.

There are also a variety of possible triggering events. The most suitable of these would be a three month cumulative decline in payroll employment. The fiscal stimulus would automatically end when employment began to rise or when it reached its pre-downturn level.

(4) Enacting such a conditional stimulus would have two desirable effects.

First, it would immediately boost the confidence of households and businesses since they would know that a significant slowdown would be met immediately by a substantial fiscal stimulus.

Second, if there is a decline of employment (and therefore of output and incomes), a fiscal stimulus would begin without the usual delays of the legislative process. In effect, such a pre-enacted conditional fiscal stimulus would be an automatic stabilizer in the same way that the payout of unemployment benefits is now.

(5) The advantage of the pre-enacted conditional tax cut is that it would eliminate the legislative lag that has made economists critical of countercyclical fiscal policy.

It would also make the countercyclical fiscal action respond to actual economic weakness rather than potentially unreliable economic forecasts.

(6) The case for using fiscal as well as monetary policy when the economy weakens is not limited to the current situation.

The excessive asset price increases caused by some past monetary expansions—especially the induced rise in the prices of real estate—provide a further reason to use fiscal as well as monetary policy.

(7) The falling dollar is not only a necessary part of reducing the massive U.S. trade deficit but will be a source of demand and growth in 2008 and 2009.

A more competitive dollar should not be seen as a problem for the United States.

Chairman SPRATT. Thank you very much, Dr. Feldstein.

And now Dr. Bergsten.

STATEMENT OF C. FRED BERGSTEN

Mr. BERGSTEN. Thank you very much, Mr. Chairman.

It is a great pleasure to appear again before the committee. And as you have suggested, what I will do is add a couple of important global dimensions to this discussion of the U.S. outlook and what policy steps might be taken to improve the outlook. I want to give you a piece of good news and a piece of bad news just to verify my standing as a well-trained and good economist. The good news, and it is very good news, is that the world economy continues to expand robustly and provides an important buffer against significant reductions in U.S. growth. Global expansion this year in 2007 is running at about 5 percent for the fourth consecutive year. And despite all the risks and uncertainties, and even if we in the U.S. slow sharply, world growth is likely to approximate at least 4 percent next year for the sixth consecutive year. This is in fact the most robust growth performance in the world economy in the entire post-World War II period; little bit beyond the previous record, which was in the late '60s and early '70s. So it is critical to keep in mind that our U.S. slowdown is occurring in the context of a world economy that continues to boom or very close to it.

In essence, I am suggesting that the global economy has now in essence decoupled from the United States to a substantial extent. There has always been a kind of mantra that says, if the U.S. catches cold, the rest of the world will get pneumonia. Well, it is no longer true, as indicated by the continued buoyancy of the world economy even when we began to slow in 2006 and the early part of this year. In fact, I am going to suggest we may now be witnessing reverse coupling, where the U.S. is going to be held up, to some important extent, by the world instead of the world being dragged down by the United States.

Now, a major reason for this critical structural change in the economic environment is the dramatic rise in the global economic role of emerging market nations, notably China and India, but lots of others. When you calculate exchange rates in the right way for this purpose, the emerging markets now account for fully half the world economy. And they are growing at rates of 6, 7, 8 percent, depending on which of the last several years you want to look at. So even if the U.S. and other industrial countries, Europe and Japan, drop to 2 percent or even less, that continued rapid growth in the rest of the world, which will slow a little but has enormous domestic momentum, will keep the world economy quite strong and help pull us up.

Now, as Dr. Orszag, Dr. Feldstein have both already indicated, that robust global growth boosts the U.S. economy directly—and Mr. Chairman, you noted it in the numbers for the third quarter—by expanding demand for our exports. Exports in real terms, that means volume terms, have been growing at more than 8 percent for the last 4 years and at annual rates of 10 to 20 percent over the last year, more than five times the pace of import increases. That is why our trade deficit in real terms has fallen substantially and added more than 1.25 percentage points to overall economic growth during three of the last four quarters.

What is really important to keep in mind, however, is the swing. Over the 10 years from the mid '90s until 2 years ago, the increase in our trade deficit was subtracting between half a percentage point and a full percentage point from U.S. growth every year. Now the reduction in the deficit is adding a like number, between half and a full percentage point a year, maybe more, to our growth rate. So we have gone from minus one to plus one, more or less. This is a swing of 2 percentage points per year in the U.S. growth picture emanating from our international position based on strong world growth and the more competitive dollar. Note that that swing of 2 percentage points in a positive direction offsets the downturn in the housing market. Now there are all sorts of statistical comparisons one can make in components of GDP, but if you want to think of it in those terms, you can think of the world boom and our improved competitive position as compensating for the turndown in the economy generated by the housing slump. And that is no mean element to keep in mind as you look at that picture.

Now, as Peter and Marty have both indicated, the export boom is also being fueled by the sharp rise in our competitiveness stemming from a fall in the exchange rate of the dollar. The dollar has declined by a trade-weighted average of 20 to 25 percent over the last 5 years in quite a gradual and orderly way and with the usual lags, that is, in textbook fashion. And despite the nay sayers who said it wouldn't work in terms of improving the trade performance, the real trade deficit peaked 3 years ago. It has been coming down since.

What we are experiencing, Mr. Chairman, and it is important for everybody to keep that in mind, is a reversal of the U.S. growth composition of the prior 10 years. From the mid '90s to about 2 years ago, we were experiencing very rapid growth in domestic demand, consumption, investment, including housing investment, which exceeded our ability to meet our own resources and to pay for it with domestic savings. So we ran a huge trade deficit and borrowed massive amounts from the world. Now that process, as I testified to this committee many times would inevitably have to happen, has gone in reverse. Domestic demand will now be growing more slowly than domestic potential, but we will get an output boost from the improvement in our trade position so that output growth will not suffer nearly as much as it would in the absence of that swing. This is a change in the composition of U.S. growth, which is likely to stay in place for a number of years. As I say, the external side will provide help. The bottom line from this point is that the strength of the world economy will cushion the intensity of the coming downturn here at home. A world recession is inconceivable given the sharp momentum of the past 5 years and the robust outlook in most of the emerging markets. And trade improvement is in fact the strongest likely counterweight to the slowdown in domestic economic demand that is looming over this coming period. That is the good news.

The bad news, but it is only a risk, is that the continuing decline of the dollar, which as Marty indicated and I fully agree is a necessary and desirable part of this adjustment, however, like other things it could become too much of a good thing. It could accelerate into a free fall, which would add very significant complications to our prospects and to our proper policy responses. I won't take the time to outline—I do in my statement—why the dollar is likely to keep falling. Some of it is short term. Some of it is structural, having to do with the advent of the euro, which for the first time in a century provides a competitor to the dollar. For a century the dollar was the world's dominant currency for a simple reason: There was no competition. There was no other currency based on an economy anywhere near the size of the United States, based on financial markets anywhere near the size or resilience of those in the United States. Now there is. There is another game in town. There is a place where you can alternatively invest your money. There is a global structural portfolio diversification going on from dollars into euro as the euro moves up and inevitably alongside the U.S. as a key global currency. And that adds to the short-term interest rate differentials, current account imbalances in pushing the dollar exchange rate down. So far it has been gradual and orderly.

The risk is that, with the Fed lowering interest rates more, with the downturn in U.S. growth, with the continued large trade deficit and this structural advent of the euro, the dollar could fall out of bed and create a free fall and a hard landing, which would be extremely adverse for our efforts to come out of the problem. Markets frequently overreact. And a sharp fall of the dollar could trigger sharp and sudden increases in U.S. inflation and interest rates, particularly if energy prices were going up further at the same time and the two would interact.

In short, and we heard reference to that before from Mr. Ryan from a different standpoint, that combination would to some extent replicate what we experienced actually in the 1970s, push the economy in the direction of stagflation and make it much more difficult to come out. At a minimum, such a scenario would limit the ability of the Fed to reduce interest rates to counter the slowdown. I agree with Dr. Feldstein, the Fed should reduce rates, 3 percent would be a good target, but it will be extremely difficult for them to do so if the dollar was to fall sharply, push up inflation pressure and interest rate pressures. Indeed, at some point, the Fed might even feel it had to raise interest rates to resist that scenario. And that then would foul things up. To me, that is the greatest risk to the modest slowdown prospect that I agree with the majority of economists is the most likely course, but a risk to be kept in mind.

I would note that that scenario would add to the case for Dr. Feldstein's proposal for a conditional temporary tax cut. Because if there is increased inflation pressure that limits the flexibility of the Federal Reserve to reduce interest rates to respond through monetary policy, it adds to the case for doing so through fiscal policy. But the basic point, and it is not to say I told you so, but the basic point is the U.S. might have to pay dearly now in the teeth of a financial crisis and possible recession in an election year for living so far beyond its means for so long and thus becoming dependent for large in-flows of capital from the rest of the world to finance our internal economy. There are steps the U.S. can take to minimize those risks, the most important for this committee and the Congress as a whole being to assure continued reductions in the structural budget deficit, with the goal of restoring the modest surpluses of the early part of this decade whenever economic growth gets back to trend levels.

I would note that the pending AMT fix actually already goes in the opposite direction by reducing the revenue base on a lasting basis. I think that is a good change to make, but it has to be noted it moves against strengthening the budget position over time.

So, in sum, I would actually modify Dr. Feldstein's proposal and make it symmetrical in light of the long-term fiscal problem. If he wants to return to fine-tuning fiscal policy, with which I have no quarrel in this case, and wants to put in place a temporary conditional tax cut if the economy weakens, I would say, fine, balance it with a predetermined conditional temporary tax increase when the economy returns to strong growth. And we need to strengthen the fiscal base by bringing the budget position into the kind of long-term, modest surplus that we need to make up for low private saving, avoid getting again into the thrall of foreign debt and running the risks that we face in coming out of this very difficult situation today. Thank you very much.

[The prepared statement of C. Fred Bergsten follows:]

PREPARED STATEMENT OF C. FRED BERGSTEN, DIRECTOR, PETERSON INSTITUTE FOR INTERNATIONAL ECONOMICS

The US economy faces significant risks over the coming period. Developments in the financial and housing markets raise the specter of a sharp turndown or even a recession. High energy prices and the falling dollar, in the context of nearly full employment, trigger concerns about inflation as well. The current course for US policy, including fiscal policy per the mandate of this Committee, is thus much more complicated than usual.

My focus today will be on several aspects of the world economy, and the international economic position of the United States, that have an important bearing on these considerations. There is both good news and bad news on that front.

GLOBAL ECONOMIC GROWTH

The good news is that the world economy continues to expand robustly and thus provides an important buffer against significant cutbacks in US growth. Global expansion is running at about 5 per cent for the fourth consecutive year in 2007. Despite all the risks and uncertainties, and even if the US slows sharply, world growth is likely to approximate at least 4 per cent in 2008 for the sixth consecutive year.

The global economy has now in essence decoupled from the United States. As late as the 1990s, it could be argued that the world depended on the United States—that "the world caught pneumonia when the United States caught a cold." That is no longer true, however, as revealed by continued buoyant global expansion in 2006 despite the beginning of the US slowdown. In fact, my colleague Michael Mussa has correctly suggested that we are now witnessing "reverse coupling" in which the United States has become heavily dependant on developments in the rest of the world.

A major reason for this phenomenon is the dramatic increase in the global economic role of emerging market nations, especially China and India but many others as well. With exchange rates calculated at purchasing power parity, which is appropriate for these purposes, the emerging markets now account for fully one half of the world economy. They are expanding at 6-7 per cent annually and will thus sustain worldwide activity at a brisk pace even if the United States and the other industrial countries fall to 2 per cent or less.

This robust global growth boosts the US economy directly by expanding demand for our exports. Exports in real (volume) terms have in fact been growing at more than 8 per cent for the past four years and at annual rates of 10-20 per cent for the past year, more than five times the pace of import increases. Hence our trade deficit, in real terms, has fallen substantially and added more than 1¼ percentage points to overall economic growth during three of the last four quarters. (In value terms, the external deficit has fallen by less because of the sharp rise in oil prices and in some other import prices due to the decline in the dollar.)

This compares with the subtraction of 0.5 per cent annually from US growth over the past decade due to the steady climb in the trade imbalance. This swing, of 1-2 percentage points annually, is a major positive component of the US growth picture that is likely to prevail for some time.

The US export boom is also being fueled by the sharp rise in US competitiveness stemming from the fall in the exchange rate of the dollar. The dollar has now declined by a trade-weighted average of 20-25 per cent since its peak in early 2002, correcting an important part (thought not yet all) of the overvaluation generated by its rise of about 40 per cent from 1995 until that time. Currency changes translate into recorded trade flows with a lag of two to three years and, in textbook fashion, the real trade deficit peaked in 2004 and has been coming down since.

I have testified to this Committee many times over the years that the large US external imbalances of recent years, and the overvalued dollar that helped produce them, were unsustainable and would have to come down. They would do so through a combination of a lower exchange rate and a slowdown in the growth of domestic demand (e.g., consumption and housing investment) coupled with improvement in our trade position. That is precisely the change in the composition of US growth that we are now experiencing and can expect to continue for at least a couple of years.

The good news from all this for the short run is that the strength of the world economy is likely to cushion the intensity of the coming downturn here at home. A world recession is inconceivable given the sharp momentum of the past five years and the robust outlook in most of the emerging markets. A US recession is not impossible but would probably be quite shallow, as in 2001, rather than sharp and steep as in the more typical past US experience. Trade improvement is in fact the strongest likely counterweight to the slowdown in domestic economic activity that is looming over the coming quarters.

THE EXTERNAL RISKS

The bad news, however, is that the continuing decline of the dollar could accelerate and add significant complications to our economic prospects and proper policy responses to them. There are at least four reasons to expect the dollar to keep falling, perhaps by another 10-20 per cent on a trade-weighted average, even without taking account of any broad collapse of market confidence in the US economy due to the subprime crisis and related developments:

- the current account deficit, though reduced, is still unsustainably high at more than 5 per cent of GDP;
- the US growth slowdown, relative to the rest of the world, reduces the appeal of investment in the United States;
- the associated reductions in short-term US interest rates also reduces the incentives for capital to move into dollar assets; and
- the creation and maturation of the euro provides, for the first time in almost a century, a real competitor to the dollar that is already triggering a structural portfolio adjustment into the world's second key currency.

A further decline of the dollar, if gradual and orderly as has been the case since 2002, is a desirable and indeed necessary component of completing the adjustment of the unsustainable US and international imbalances. However, markets frequently overreact and a free fall of the dollar could trigger sharp and sudden increases in US inflation and thus interest rates (especially if energy prices were to rise further at the same time). This would push the economy in the direction of the stagflation of the 1970s (albeit presumably with less intensity on either the "stag" or "flation" sides of the equation that occurred at that time).

Such a scenario could, at a minimum, limit the ability of the Federal Reserve to reduce interest rates to counter the economic slowdown (and provide additional liquidity to the financial markets). It might even force the Fed to raise rates to halt the currency depreciation. I believe this is in fact the greatest risk to the "modest slowdown" prospect posited above as the most likely course for the US economy over the next year or so.

Hence the United States might have to pay dearly now, in the teeth of a financial crisis and possible recession (in an election year), for living so far beyond its means for so long and thus becoming dependent on large continuing inflows of capital from the rest of the world. There are of course steps that the United States can take to minimize these risks. For this Committee and the Congress as a whole, the most important is by assuring continued reductions in the structural budget deficit with the goal of restoring the modest surpluses of 1998-2001 when economic growth returns to trend levels of 2½-3 per cent. This is the only way to assure that the United States will continue to benefit from global economic developments as it seeks to cope with the domestic difficulties that loom so importantly now and will inevitably arise from time to time in the future as well.

Chairman SPRATT. Thank you very much. And Dr. Feldstein, we just started a bidding process here. Can you buy the other half of the solution?

Mr. FELDSTEIN. I think it is a lot harder to buy. I think the idea that we are having a surge of economic activity and therefore want to raise taxes temporarily would be a dangerous thing. That really would be a kind of fine-tuning. After a recession, economies generally bounce back at a pretty fast clip. And it would be a mistake I think to try to offset that bounce back. So what I proposed is that the temporary fiscal stimulus be turned off once we get back to the predownturn level of employment, but not that we try to stop the strong recovery that usually comes after a recession.

Chairman SPRATT. Well, we have a problem around here that some say, when you don't renew an expiring tax cut, that is tantamount to increasing taxes. So we would be subject to the same charge that by not providing for the continuation of whatever tax relief we——

Mr. FELDSTEIN. But I think this should really be seen as a countercyclical tax change. It is not part of a broad structural incentive program for the long term.

Chairman SPRATT. Let me pursue that with you. If a problem, at least at its core, is structurally the fallout in the residential credit markets, if it started there and its ramifications run from there, if the problem is structural, shouldn't the solution be structural, targeted to the very problem itself, since we can identify the problem, as opposed to having a countercyclical response that is scattered over a whole——

Mr. FELDSTEIN. Well, I don't the think we can go back and undo all the mistakes that were made that created the subprime losses or that caused the financial institutions to take on their books assets whose values they can't now calculate and therefore are afraid to transact in. So I think that what we can do, what the Congress can do, what the Fed can do is to avoid the adverse consequences for the economy as a whole. And that is why the Fed lowers interest rates, and that is why I think a fiscal stimulus coming from the Congress would be a good thing.

Chairman SPRATT. Secretary Paulson is proposing now an industry-wide agreement to freeze rates at the introductory level for those who are at least not already in default at that level. And what he is trying to do is a heck of a balancing act, because he does not propose to spend any money to bail out the borrowers or to bail out the lenders, just get them to agree to somehow absorb the impact of freezing things in place. If that doesn't work, wouldn't it be wise, if we are going to have some stimulus to get the economy going at a faster pace that addresses that problem by maybe using some money to get—to spare us from a raft of foreclosures?

Mr. FELDSTEIN. It is really very hard to undo the mortgage problems because these mortgages are no longer held by the originators. So a mortgage starts with a mortgage company, but that mortgage then gets sliced up in various ways, put into collateralized debt obligations, held around the world. As Peter Orszag's chart showed, you talk about the triple B tranche of those, that is not a bunch of mortgages; that is conditional claims on mortgages. So it is very hard to see how you compensate people for this idea of stopping the contractual changes in interest rates. It is hard to see through what that does to the individual pieces of that. Legally, no doubt, it would be possible to order that to happen. But I think it would have very bad long-run effects on the willingness of investors around the world to buy assets created in the United States if the Treasury could come along and say, no, we are going to stop the interest rate payments on those loans, or we are going to roll them back, or we are going to not let them go up. If I were an investor in a pool of mortgages, I would like to believe that whatever the contract said was going to be fulfilled.

Chairman SPRATT. But if that is the risk that there will be an adverse reaction to the effect of we asking them to forego contracted interest rate increases, shouldn't we be addressing that particular problem with a structural solution to that particular problem as opposed to a possible countercyclical solution, particularly since that might be the precipitant that says to the international market, hey, what if the United States does this with other dollar denominated assets at some other point in the economy?

Mr. FELDSTEIN. I don't see how you do it. That is to say, I don't think that the proposal that started with the FDIC and that the Treasury seems to be supporting this roll back or freeze as a viable option because of its adverse effects on long-term acceptability of U.S. borrowing. I don't mean government borrowing; I mean private borrowing. So I don't see how one—you could provide relief to the individuals who would otherwise have their mortgages foreclosed. Congress could spend money doing that. But people are pretty clever, and they would quickly find ways to stop paying their mortgage payments in order to line up and get a check from the U.S. Government. So I think the incentive effects of that are all wrong.

Chairman SPRATT. Dr. Orszag, do you have a response to this? Particularly in light of the fact that we would have to lower some of the budget disciplines that we have put in place that have worked pretty well for us, like PAYGO, in order to allow this trigger to be a net impact on the economy? Does that give you a problem, or do you have other problems with his proposed solution? We have got a $13 trillion economy. How large does the stimulus have to be to get the economy chugging back at a more normal rate of growth?

Mr. ORSZAG. Let me answer the question in the following way. I already mentioned that the budget does have a set of automatic stabilizers. And those automatic stabilizers mean that when the economy weakens by a dollar, roughly 33 cents of additional deficit results from that. So there is some sort of offsetting impact that is already automatically baked in. The history of moving beyond that is, as I mentioned, mixed in large part because of timing lags and then also the specific interventions that were adopted.

Professor Feldstein's proposal would address the timing lag issue but at the cost of having a specific trigger. And that then makes the proposal very sensitive to the details of that specific trigger. And in addition, it is worth noting, given the specific trigger that he chose, employment is not a leading indicator of a recession; it is at best a contemporaneous or maybe even a lagging indicator. So if you think of—if you are expecting that the fire truck will already be on the scene when the fire starts, that is not going to be the case. Maybe, at best, it will be sort of on its way as opposed to arriving after the rebuilding has already started, which has unfortunately been the case in some past episodes.

So it is important to sort of calibrate expectations, and then, obviously, also the form of the intervention also matters. All of that having been said, I want to return to one of the questions that you posed in your opening remarks. During a period of economic weakness, there is attention between what is good in the short run and what is good in the long run. In a period of economic weakness, the key thing that is constraining economic activity is the demand for goods and services that firms could produce with existing capacity. And in order to boost that demand, you need additional spending power, basically, and tax cuts, or increased spending help to provide that. Over the long term, however, the key constraint on economic activity is that underlying capacity of firms to produce goods and services. And there you need higher national saving in order to be increasing the capacity at a higher rate. So during periods of economic weakness, what is good in the short run is exactly the opposite of what is good in the long run. And that creates a very difficult policy—set of policy trade-offs for all of you.

Chairman SPRATT. Dr. Bergsten, one last question. Do you think that policy like this would have an impact on the dollar and particularly on whether or not there might be a run on the dollar?

Mr. BERGSTEN. I think it is hard to tell, Mr. Chairman. There would be crosscutting currents. On the one hand, when the U.S. has had sizable fiscal stimuli in the past, I am thinking back, particularly to the Reagan tax cuts in the 1980s and with some lag the Bush tax cuts more recently, the flip side was higher, and considerably higher, interest rates, which drew in a lot of foreign capital and actually strengthened the dollar. Now, that was a short run phenomenon. And as Dr. Orszag just said, it undermined our long-term position. But in the short term, it actually shored up the dollar.

On the other hand, if at the current time we were both cutting interest rates, as the Fed obviously would like to do, and now came along with fiscal stimulus at the same time, I think there would be a risk of triggering international concerns and domestic concerns that inflation would again rear its ugly head. And that would be the kiss of death for the dollar. Keep in mind in all this discussion going forward about the weakening of the economy, correct as it is, remember that in his backward look at the start, Dr. Orszag pointed out, we are an economy that is still very close to full employment. There is not a lot of slack in the economy. So whatever stimulus one puts in, you better be correct that there is going to be an autonomous easing of demand pressures from autonomous sources or else you are going to pump up the economy much too sharply. And that could be, as I say, the kiss of death internationally. That could trigger a free fall in the dollar.

Chairman SPRATT. Thank you. Mr. Ryan.

Mr. RYAN. Thank you, Chairman.

There are just three areas I want to get into, the fiscal policy prescriptions you gentlemen have made, the subprime and then some monetary questions. I will try to do this quickly. Both Dr. Bergsten and Dr. Feldstein are suggesting a precondition, some kind of precondition tax cut to send signals to the market, it seems, that help is on its way and that we are going to prevent this sluggish downturn or a recession. I would suggest that we have something right in front of us, which is an enormous tax increase scheduled to occur in law already. And add insult to that, from an economic perspective, we have a proposal by the chairman of our Ways and Means Committee to replace the AMT with an even higher tax rate on small businesses, which is where, you know, 75 percent of our jobs come from, which would raise the top rate on small businesses to 44.2 percent. So not only do we have tax uncertainty on the horizon, cap gains goes up, dividends goes up, marginal rates go up across the board, child tax credit, marriage penalty all coming in in 2011, providing this uncertainty, hampering this investment, we have a new proposal that says, let us go even farther than that with even higher tax rates on sub S corporations, small businesses and the like.

So let me start with you, Dr. Feldstein. Wouldn't it be a good fiscal policy to, even before we get to talking about a tax cut, prevent the largest tax increase in history from occurring in the first place and giving investors and the markets and families certainty that their tax burden is not going to dramatically escalate?

Mr. FELDSTEIN. I would like to think that that will happen. I think that those——

Mr. RYAN. This could happen, and then what would be the result?

Mr. FELDSTEIN. The result of those sharp increases in taxes, as they begin to be more concrete in the minds of individuals and businesses would be adverse both in the short-term sense that Peter Orszag spoke of—that is, it would cause them to cut back on expansion plans for their businesses, investment decisions, hiring decisions because they would see themselves facing much higher tax rates. The individuals would see that their net incomes going forward would fall and so they would cut back on spending plans. So all of that would be a serious damper on the economy. I think it has not yet gotten salient enough in the thinking of the—those taxpayers for it to have had that effect. But as we get closer to that date, I think that would have a very serious effect.

Mr. RYAN. Do you think it is becoming salient in the capital markets?

Mr. FELDSTEIN. I don't really know. I mean, it—the reduction in capital gains tax rates, I think—and the reduction in the tax on dividends I think both helped the capital markets, both lowered the cost of equity capital. I don't see that reversing at this stage. I think if they knew for sure that we were going to go back to the kinds of tax rates we had on capital gains and on dividends, that would be a serious blow to equity markets. I don't think that has happened yet. I think that the decline in the equity market that we have seen makes it very hard to know how to unravel any of these things. I think the decline we have seen in the equity market has been more a reaction to—short-term economic conditions than to the overhang of this potential very large tax increase on equity income.

Mr. RYAN. Peter, I don't know if you want to get into that or not. I understand if you don't feel comfortable answering that. Let me ask you a more CBO side to that question. If we are heading into the sluggish growth and the lowering of GDP does expose our deficit, increases our deficit, would it not be a good idea to add $23 billion in higher discretionary spending this year, which when you put it into the baseline translates into $204 billion over the next 5 years? Would it not be a prudent fiscal path seeing sluggish growth at best coming which will increase the deficit not to build more spending into the baseline which will actually increase the deficit? That is really the one thing we know we can control. We can't control GDP, but we can control discretionary spending on a year-by-year basis. So If our goal is to lower or keep low the deficit, wouldn't it be wise not to add $23 billion on top of the 954 that we are doing right now which translates into $204 billion in spending over the 5 years?

Mr. ORSZAG. I think the real question is what the goal is. If the goal is to offset short-term economic weakness as Professor Feldstein and others have noted, that could be accomplished both through tax relief and through additional spending. Additional spending does boost demand for goods and services.

Mr. RYAN. Do you believe spending increases are just as effective an economic tool to boost growth as tax cuts are?

Mr. ORSZAG. I think we need to separate the short term and the long term. Again, coming back to the period of economic weakness in the short term, certain types of spending that especially involve transfer payments—so, for example, food stamps are an example, do boost demand for goods and services pretty quickly and pretty effectively in the short run. There is a different question about the long run. And there as CBO has said in the past, higher levels of government spending, especially if they are not financed—in other words, if they are deficit financed do constrain economic activity. We are in one of these periods where the short run and the long run can be a lot different in terms of sort of what works.

Mr. RYAN. Dr. Bergsten, if you don't care to comment, I understand. Let me ask you about the subprime.

Peter, you brought a number of charts and Marty—I am sorry—Dr. Feldstein, we know each other, so I get too casual sometimes. Your op-ed in the Washington Journal today, you talked about the various ideas that are out there. Isn't it true that the worst vintage of loans have yet to come? Isn't it true that the worst vintage are kind of coming into the cycle in 2008? So we are going to see the worst paper coming through the system; the ARMs are snapping more in 2008 than they did in 2007. So there is going to be tremendous pressure put upon Congress to do something about it. But as we look at doing that, you say don't raise the Fannie-Freddie limit, you say don't freeze—take the FDIC suggestion and lock in mortgage rates. We know your position. And if you care to comment more, I would appreciate it.

But I want to ask Dr. Bergsten and Dr. Orszag, Peter, if you could just take your CBO hat off and put on your economic hat, doesn't the phrase moral hazard scream out with these kind of proposals? Aren't we inviting future disaster in our bond markets, in our mortgage markets, in the confidence of our paper? And shouldn't investors who took risks bear the down side of those risks? And if we do try to incorporate some kind of a federally financed taxpayer-paid-for bailout package, aren't we inevitably going to end up bailing out people who don't deserve it, who made bad decisions and use the taxpayer dollars from people who made good decisions to do that? And isn't this one of those cases where you—it is a clear short-run trade-off for long-term losses?

Mr. ORSZAG. Maybe I could talk about, just for a second, about the broad outlines of the Treasury proposal, which does not involve Federal money.

Mr. RYAN. I realize that.

Mr. ORSZAG. And it is important to realize that all the details of that proposal have not yet been specified. But in addition to the risks that Professor Feldstein has already identified in terms of whether going down that path will impede the reestablishment of normal credit conditions in particular, there is also a question about the details of how homeowners are—the borrowers, the mortgage borrowers, will be sorted into different categories, and those can be quite complicated. On the other hand, it is—I had to do that. On the other hand, it is the case that individual level negotiations between borrowers and other entities can be administratively complicated, and having some sort of structural system can help from an administrative perspective. Another thing is that some investors belief there is a collective action problem; that is, that it is difficult for them to renegotiate the terms of these mortgages on a sufficient scale to address a broadbased problem and that they would all be better off if the problem were addressed on a broad scale.

Mr. RYAN. Let me ask it more clearly. Facilitating communications between the market is a fine thing, and I don't think there is a moral hazard involved in getting people at a table to talk to one another. But raising Fannie and Freddie loan limit and freezing rates, is that not a problem?

Mr. ORSZAG. There is a moral hazard problem when you step in and renegotiate contracts that have already been adopted, and that hazard or that risk has to be weighed against the potential benefits.

Mr. RYAN. If you were advising us to raise the Freddie and Fannie loan limit, what would you say, whether to do it or not?

Mr. ORSZAG. I am not allowed to make policy recommendations.

Mr. RYAN. I tried.

Dr. Bergsten, if you have any interest in answering.

Mr. BERGSTEN. I think raising the loan limits on Fannie and Freddie would be okay. I wouldn't put that in the moral hazard category.

I do think the freezing of loan rates is a big problem. I happen to think the subprime lending market was a good innovation. I would like to see it continue in the future. It gets housing to a lot of people who otherwise wouldn't have gotten it.

Mr. RYAN. So better underlining guidelines.

Mr. BERGSTEN. Well, it obviously overshot. It went too far. It needs to be better regulated. But I want to see that market continue. I'm afraid that if you now ask lenders or more extremely force the lenders to freeze those rates, they won't make those loans again in the future, and it does raise the broader problem that the chairman raised of whether or not the same reaction might be sought from lenders in other categories, and that would have very broad implications for our financial markets.

Mr. RYAN. Yes, Dr. Feldstein.

Mr. FELDSTEIN. As you said, as this thing gets worse, there will be pressure to, quote, do something. There was a recent study that the new President of the Federal Reserve bank of Boston spoke about. I haven't read the study. I just received it. But I think if it is worth careful examination because what he claims is that a very large fraction, about half of the people with subprime loans, are in a position to shift away from subprime loans back into loans with lower rates. So there may be a lot of self-help that is possible out there, and it may be that there is a role to guide people in that as opposed to forcing the lenders to undo their contractual rights.

Mr. RYAN. One last—both you and Dr. Bergsten suggested moving the Fed funds rate to 3 would be a good idea. That means we would have to see anywhere from three to six more rate cuts from the Fed given the way they typically do rate cuts in 25 and 50 basis point cuts. Dr. Feldstein, if I recall, you were the chairman of the CEA in the Reagan administration when we were fighting back inflation. Don't you think we are in this position where the trade-off of sluggish growth in the short run versus inflation in the long run, which would be very difficult to deal with, is at that tipping point where we are going to get to that point where inflation is the bigger cost, the bigger problem, versus this possible sluggish growth we are going to have? Don't you think we are getting close to that? If we do six cuts, you don't think——

Mr. FELDSTEIN. What I said about the 3 percent was I think they should be moving in that direction unless the economy improves. So I am not saying that they should put themselves on automatic pilot to go down to 3 percent. But if the economy is continuing to weaken over the next 12 months, I think that is a reasonable thing to do.

And, of course, the inflation situation now is dramatically different from what it was when President Reagan came to office. At that time, we were looking at double digit inflation. People had no confidence in the Fed. They had no confidence in the government with respect to inflation. There was a fear that inflation would spiral out of control as it was in Latin America and even in some of our European allies.

Now there is a very different attitude and of course much, much lower actual inflation rates. So I think that the seriousness of the risk of the damage associated with a recession is greater than the risk associated with increasing inflation. But having said that, I think one of the advantages of using a fiscal policy is you don't bump up the money supply. You don't build in that longer-term inflation price level risk.

Mr. BERGSTEN. Just two comments on that. I am somewhat surprised that we are all assuming without yet any hard evidence of a really sharp turn down in the economy and maybe even a recession. We are coming off very strong growth. The economy is still very close to full employment. Yes, there are all these worrisome signs that we talked about, but we haven't yet seen the turn down. We have been surprised on the upside for several years. I pointed to the strength of the world economy as helping to hold us up. So I would be a little less certain that there is going to be this huge falling off a cliff that we have to offset on a contingency basis.

On the other side, I agree with Marty's analysis of the differences of today from the early 1980s in terms of inflation. But there are the two big risks that I mentioned. We are one or two untoward supply side events away from an oil price at $120 or $150. We could easily see the dollar falling very sharply with a rapid pass through to inflationary price increases in this country. Those were the factors, in fact, which created the stagflation of the 1970s. That was the story, an interaction between subsequent sharp rises in world oil prices and periodic declines of the dollar. There were three or four episodes of each. They reenforced each other. I could trace that analytically if you want. But the worst thing would be to subject ourselves to that cycle for the reason you indicated. So I would put a little less certitude on the sharp fall off the cliff of the real economy; a little more weight as you were doing, Mr. Ryan, on the risks to the inflation side as I came to my policy judgment in trading off short run, long run.

Mr. FELDSTEIN. The advantage of a conditional tax cut, enacting it but triggered only if the economy does turn down is that you don't have to make the judgment today about whether the economy is, as Fred said, going to fall off a cliff. You can wait and see where we are when the economy moves into 2008. But having said that, we don't want to be fooled by the fact that we had 5 percent growth in the third quarter. The fourth quarter is likely to come out at essentially zero, and that will feel to a lot of people like falling off a cliff.

Mr. BERGSTEN. If I could put a quick question to my friend and fellow panelist here, Marty. In your conditional criterion for implementing the tax cut, you have no inflation variable. So your method, if endorsed by the Congress as you propose it, would go into effect even if inflation was shooting up. Surely that is not what you intended.

Mr. FELDSTEIN. I think the chance of inflation shooting up at a time when the economy is slipping into recession is very low.

Mr. ORSZAG. Very quickly. I just want to again put a caveat that a trigger might look very attractive, but the details of the trigger matter a lot, and the specific proposal that Mr. Feldstein has put forward involving 3 months of consecutive declines in employment can send false signals. For example, in 2003, there was a 7-month decline in employment during a period in which the economy was not technically in recession. So one needs to trade-off the fact that it is not exactly always geared to one's definition of what a recession is. The counter argument to that might be, well, if employment is falling that much even if we are not in recession, you might be concerned anyway.

Chairman SPRATT. Mr. Edwards.

Mr. EDWARDS. Thank you, Mr. Chairman. I think there is a clear difference of opinion between Democrats and Republicans today. Democrats believe tax cuts should be paid for. My Republican colleagues in general seem to think they should not be. My concern about my Republican colleagues' approach in some cases is that it is a feel-good philosophy. In good times, they support tax cuts because it is your money; you deserve it back. So we get rid of the surpluses that are supposed to be a cushioning of the fall when we have recessions.

Then when we get on the verge of recessions, they say, well, we have got to cut taxes to help us get out of the recession. The problem with that fuzzy math is it is not fuzzy. It is very clear what the result has been, and that is the creation of the largest national debt and deficits in our history.

Dr. Orszag, I just want to get on the record some answers to questions without getting you in the middle of a philosophical debate. And there is an honest difference, and I respect that, between Republicans and Democrats. I just want to get some facts on the table in light of the discussion we have had here. Did the United

States Federal government hit a $9 trillion national debt in the last 2 or 3 weeks for the first time in our Nation's history?

Mr. ORSZAG. If you measure by gross Federal debt.

Mr. EDWARDS. So the answer is, yes, if you count the gross debt. What is the interest to taxpayers on that each year?

Mr. ORSZAG. On the publicly held debt, net interest is somewhere in the range of $250 billion a year.

Mr. EDWARDS. So the interest on the debt is one of the largest spending programs in the Federal Government; is that correct?

Mr. ORSZAG. It is a significant component of the Federal budget.

Mr. EDWARDS. How much has the gross debt gone up, Dr. Orszag, since President Bush was sworn into office in 2001?

Mr. ORSZAG. In general, I prefer using the publicly held debt number. So I don't have the gross Federal debt numbers in my head.

Mr. EDWARDS. The publicly held debt number then.

Mr. ORSZAG. It has gone up by several—I will have to get you the exact number. I don't have it——

Mr. EDWARDS. Over $2 trillion?

Mr. ORSZAG. We will get it for you in a second.

Mr. EDWARDS. Okay. Probably in the $2 trillion range or more. In your opinion, without getting in a long discussion, because I would like to go on to another question or two, did the tax cuts of 2001 and 2003, because they were not paid for by corresponding spending cuts, contribute to the unprecedented increase in national debt in recent years?

Mr. ORSZAG. The tax cuts have been deficit financed, and they have expanded the fiscal deficit, yes.

Mr. EDWARDS. Next question. Without lengthy elaboration, could you just list for me quickly and in maybe 30, 45 seconds, the potential negative consequences, long-term negative consequences of tax cuts paid for by borrowing?

Mr. ORSZAG. Yes. And for deficit financed tax cuts over the long-term, there is a trade-off. You can have benefits from lower marginal tax rates which can spur economic activity. On the other hand, to the extent they are deficit financed, they increase the budget deficit and reduce national saving, and that imposes harm on the long-term economy. Most studies suggest that those two factors roughly offset each other and you wind up with very little and perhaps even a small negative long-term impact.

Mr. EDWARDS. Okay. I think your previous report at CBO has indicated that. Finally, with a little less than the 2 minutes I have left, I would like to get to the Consumer Price Index. I keep hearing that the CPI is 2 percent, 3 percent. I think Social Security seniors are going to get a 2 percent—little over 2 percent increase based on inflation. But yet when I am back home, anecdotally, and I talk to average working families, their health insurance rates have risen dramatically higher than the CPI; their food costs in the last year have gone up significantly. Gasoline prices are now on average over $3 a gallon for the average family out there. And I think you said crude oil has gone up by 60 percent this year. When I talk to families about the cost of educating their children in college, those have gone up dramatically. Utility bills are up. Now many people are facing huge increases in variable mortgage costs because they didn't have locked-in mortgage rates, and now those who lost their homes moving into apartments are seeing significant increases in apartment rates. In your opinion, Dr. Orszag, does the CPI reflect the real expenditures of an average, typical working family in America?

Mr. ORSZAG. CBO actually put out an issue brief on precisely that topic, whether perceptions of inflation matched the mechanics of the Consumer Price Index. I guess I would say the Consumer Price Index is designed with a particular objective in mind. It has some imperfections that economists have long noted. And I just would be happy to provide that issue brief to you which explores these issues in more detail.

Mr. EDWARDS. I would welcome that. Thank you very much.

Thank you, Mr. Chairman.

Chairman SPRATT. I beg your pardon, Mr. Lungren, I had already indicated you were up anyway.

Mr. LUNGREN. I have great respect for my chairman. I wait until you give me the word, sir.

Dr. Feldstein, I recall being here in Congress when you came here with President Reagan. And I recall the economic circumstances we faced at that time. I am not a Pollyanna, but one of the things that bothers me a bit is when we seem to have a lack of confidence in the underlying economic strength of our society. If I am not mistaken, during those first 2 years I was here in Congress prior to when Ronald Reagan comes, we had this perfect storm of inflation rate that was double digit, exceedingly double digit. We had unemployment rates that were close to that it seems to me, if I am not mistaken. I mean, they were very high compared to what we have seen over the last 6 to 8 years. Interest rates were exceedingly high. As I recall, at one point in time, they hit 22 percent if I am not mistaken. That to me, if we saw that today, would be such a perfect storm that people would be talking about the underlying weaknesses of the American economy. We haven't seen anything like that in the last 20-plus years, 25-plus years.

And while I don't want to be a Pollyanna about it, I wonder, number one, whether you could tell us what the significant differences are in the structural strength of the U.S. economy now versus then; secondly, why you think there might be this fear or uncertainty about the underlying strength of the economy. Is that real? Is that imagined? And I say that knowing your opening statement with respect to your concern about the possibility of a recession coming upon us.

Mr. FELDSTEIN. Well, I began, not in my written statement but in what I actually said, by emphasizing the fact that the U.S. economy has great long-term strength, and I can continue to believe that that is the dominant condition. When I talk to my friends from Europe, I marvel and they marvel as how much stronger our fundamentals are, how much better our labor markets, our capital markets, our education system operate than in other industrial countries. And that has given us the stronger productivity growth over the last decade.

I think the changes in the tax rules that were put in place back in the 1980s represent a major reason why incentives are stronger and economic performance is better in this country. It is easy to forget that when Mr. Reagan came to Washington, the top tax rate was 70 percent on investment income; on capital gains, could easily reach over 40 percent; on dividends, it was 70 percent. Nobody would think about going back to those bad old days at the present time.

Mr. LUNGREN. I hope not.

Mr. FELDSTEIN. I hope not, too. So those changes in personal tax rates and in the structure of taxes between taxes on savings versus taxes on other forms of income have made a big difference I think in terms of the underlying strength and the productivity growth of the U.S. economy.

But people are worried now because the economy is softening, and they are seeing increases in prices. And they are seeing, whether it is immigration or it is off-shoring, there are all kinds of things that make people nervous. But I think that is sort of a continuing state that the public is in, that they are nervous that things are going to get worse for them and get worse for their children, and yet we see that decade after decade things do get better.

Mr. LUNGREN. Very quickly. To me, the remarkable difference between then and now is our accepted unemployment rate versus then. Can you give us any indication as to what structurally has changed such that——

Mr. FELDSTEIN. The amazing thing is, in this country, our unemployment rate is around 5 percent, and it was 5 percent when I first started studying these numbers back in the 1960s. And to me, the amazing thing is that our friends in Europe then were a source of envy for us. We would look at Germany, and we would say, they have 2½ percent unemployment, and we have 5. Now they have 10. So the big change in unemployment has happened there as their economies have failed to adjust and failed to get their incentives right. And we have had cyclical ups and downs when they had that very, very high double-digit inflation. The economy was forced to go through the ringer in order to bring inflation down, but now that we have inflation down, we hope to avoid the kind of counter inflationary spikes that Paul Volcker was forced to visit on the economy back in those days.

Chairman SPRATT. Mr. Cooper of Tennessee.

Mr. FELDSTEIN. Could I just maybe add one sentence to the last question? Because you raised the distinction between what is really happening in the economy and people's anxieties about it. And I share virtually everything Dr. Feldstein said about the strength of the economy as measured by macro economic indicators, but I think most of the anxiety comes from the way that the pie has been distributed. And the anxieties that the growth, the low unemployment, the low inflation rates have not been widely shared in terms of real incomes, and therefore the macro payoffs that we expected to happen have not passed through to the populous as widely as should have been the case.

Chairman SPRATT. Thank you, Dr. Bergsten.

Mr. Cooper.

Mr. COOPER. Thank you, Mr. Chairman.

And I thank the distinguished panel. I worry that we are being presumptuous even talking about efforts to fine tune the economy in the short term when we have done such a terrible job of getting the long-term picture right. I am particularly worried that Dr. Feldstein's proposal to have a conditional temporary tax cut could be as dangerous for this Congress as offering an alcoholic another drink. We always err on the side of stimulus, and we seldom are on the side of fiscal discipline. Regarding the subprime market, these instruments have become so complex that they are almost impossible to unwind. You know, years ago, we had this doctrine of too big to fail for some banks. Now some of these instruments are so complex that you have to have almost a macro solution to an individual mortgage origination problem.

The testimony of Dr. Orszag, I think, was particularly interesting, and this may be down in the weeds too much, but you mentioned just offhandedly that banks have the option of putting a structured investment vehicle on balance sheet or off balance sheet. And apparently it can go back and forth at will. Could you elaborate on that?

Mr. ORSZAG. Sure. Most structured investment vehicles are not on the balance sheets of banks. Some are. The motivation I should say for keeping them off balance sheet is that they can generate income for the bank without adding to the bank's required capital, which is part of our banking regulatory system. Structured investment vehicles fund themselves largely through short-term commercial paper and then invest in longer-term assets like commercial-backed—I am sorry—mortgage-backed securities. And the difficulty is that, as the short-term financing market has dried up, they have a refunding problem that in addition the value of their assets has been impaired. That is causing severe pressure on these structured investment vehicles. And many banks, whether out of a requirement or out of concern about the reputation, are either providing additional liquidity to the structured investment vehicles or, as I mentioned, one European bank actually taking the step of moving it back onto the balance sheet.

Mr. COOPER. So this creates a situation in which it is optional for the bank whether to have these SIVs on or off balance sheet?

Mr. ORSZAG. There is some choice involved, yes.

Mr. COOPER. And their decision is based on the advantage of the individual bank. So you get a remarkably different financial picture judging on the bank's preference.

Mr. ORSZAG. I think one of the concerns that is going on in financial markets is a lack of transparency about exactly where all the problems are arising. And part of that has to do with off balance sheet entities like structured investment vehicles.

Mr. COOPER. Time is short. If I could switch now to Dr. Bergsten. I thought an important but little noted part of his testimony was the strength of the rest of the world. And in this day and age in which protectionism is very much en vogue and, according to the front page of the Wall Street Journal, even two-thirds of the Republicans now think of themselves as protectionists, your comment basically pointing out that it is the strength of world trade that is essentially offering us recession protection today here in the United States. Because as you pointed out in your testimony, we used to think, when we got a cold, they got pneumonia. Now the coupling may have been reserved, and we may depend on world trade to keep our economy strong. And that is a fundamental insight I think that perhaps has escaped most of Congress.

Mr. BERGSTEN. I hope you and others will inject it further into congressional debate. We have also done studies that show that the U.S. economy today is $1 trillion per year richer as a result of our trade globalization of the last 50 years. That is 10 percent of the whole economy; it is $10,000 per household. It has been a big winner. Now, on top of that, comes this improvement in the trade balance which, yes, could keep us from at least the worst of the turn down that is being feared.

Mr. COOPER. I have seen your study on the $1 trillion benefit from world trade to the U.S. Economy. But that study admits that there is a $50 billion annual dislocation. But our remedial programs of trade adjustment assistance and things like that only ameliorate $2 billion of the $50 billion. So there is a clear lack of remedy there for that painful dislocation cost. But I see my time has expired.

Mr. BERGSTEN. You get an A-plus for your studious attention to our work.

Chairman SPRATT. We have a vote on the floor with about 12 minutes and 29 seconds. What I propose to do is, I am willing to miss this vote for anybody who wants to ask questions, but we have three 5-minute votes thereafter. So we will go through this complete vote. Anybody who wants to ask questions, and if you are just about on deck and ready to come up, fine. We will stay here, and then we'll vote three votes, three 5-minute votes, and get back as quickly as possible. We appreciate our witnesses' indulgence.

Mr. Hensarling.

Mr. HENSARLING. Thank you, Mr. Chairman.

I am not sure what survey the gentleman from Tennessee was alluding to where two-thirds of the GOP considers themselves anti-trade. If it is two-thirds of the GOP, it must be about 95 percent of the Democrats. And I certainly lament any falling off of support for international trade.

The question I would first pose is to you, Dr. Feldstein. You mentioned earlier that you feel the pressure will mount for some type of subprime response by Congress. You are probably aware that the House has already passed subprime legislation. I am not sure how closely you observe that legislation. I think my own observation, if you looked at it closely, the legislation de facto outlawed certain mortgage products by creating certain so-called safe harbor provisions. But if you look even closer, the safe harbor provisions are not particularly safe. There are all types of liability exposure issues, including assignee liability in the secondary market, causing many of us to conclude that, unfortunately, at a time when more liquidity is needed in the secondary mortgage market, that this legislation would actually dry up due to the questionable increased liability exposure saying that as people try to refinance their adjustable rate mortgages, that there will be fewer products available for them to do that. So my fear is that we have taken a bad situation and perhaps made it worse. My question to you is, have you looked at the House passed legislation, and if so, have you made any conclusions of what impact it might have on the subprime challenge?

Mr. FELDSTEIN. I am afraid I have not.

Mr. HENSARLING. Okay. That will be a quick and honest answer. You spoke about—the term moral hazard came up earlier. And we know there have been proposals floated by various Members that would somehow modify these particular terms. Could you in some greater detail tell us that if Congress would unilaterally step in to either freeze rates or modify rates, modify terms, what will that do to the secondary mortgage market? What will it do to liquidity? What impact will it have on our economy?

Dr. Feldstein.

Mr. FELDSTEIN. The moral hazard problem is that it will encourage people to take just the kind of risks that have gotten us into this trouble; that they will go for mortgages with high loan-to-value ratios, mortgages with low teaser rates that will go up later in the future because they will expect that if there is a problem, the government will come along and bail them out by the kind of legislation that is being proposed. But I think that is the real danger in this. And to the extent that there are more bad loans being created, there will be greater nervousness in the secondary markets about taking on those loans. So I think it would exacerbate the problems that we have seen and cause a continuation of the incentives rather than rolling back those incentives.

Mr. HENSARLING. Another proposal that is on the table, as you are aware, is increasing the loan limits of Fannie and Freddie which are essentially, as you well know, a government sanctioned duopoly in the secondary mortgage market. If most of the challenge is in the subprime market, which tends to be at the lower end of the mortgage market, why not lower Fannie and Freddie loan limits as opposed to increase them so that they can take their taxpayer subsidies and focus it where the challenge resides?

Mr. FELDSTEIN. Well, I certainly think raising it from the current limit to a million dollars doesn't make sense in terms of the problems that we face. The average home being sold is around 200 and something thousand dollars, $250,000. So why we would want to use taxpayer funds to guarantee, to subsidize the million dollar mortgages just doesn't make sense to me as public policy.

Mr. HENSARLING. Dr. Bergsten, in the 18 seconds I have left, I think you advocated for increasing Fannie and Freddie loan limits. Why not move in the opposite direction.

Mr. BERGSTEN. What I meant was raising the total ceiling on their portfolio, not the per-loan limits.

Mr. HENSARLING. Sorry. My misunderstanding. And I yield back.

Chairman SPRATT. Thank you, Mr. Hensarling.

Ms. Schwartz.

Ms. SCHWARTZ. Thank you, Mr. Chairman.

Well, thank you. It was an interesting discussion, and I appreciate your comments. But I wanted to follow up on some of the other questions that have been raised and sort of maybe take it a little bit further. About the long-term issues we are facing, it seems if we do just focus on the short term, we are really missing making sure that we grow this economy and that Americans are better off in the long term. And if we keep just looking short term, we are not really going to be helping to deal with what are really very significant problems for us both in the Federal Government and for the economy. And it seems that you can almost phrase the questions—the issue in the same way for the Federal Government as you do for American families, which is that we don't have enough money to meet our expenses. We are borrowing money at pretty extraordinary rates, and we don't even have the money to borrow from Americans. We are borrowing from foreign governments. And the Americans are doing the same thing. They are borrowing on credit card. We are encouraging them to spend money they don't have, so actually behaving similarly. So we need to both rein in what the Federal Government is doing both in terms of spending but also in terms of being able to commit to paying for what we spend, which of course as Democrats we are trying to do, the whole pay-for, PAYGO is a major issue for us. But for Americans as well, the President keeps encouraging them to spend, that that is going to get us out of any potential recession we are facing. When in fact we know seriously that many Americans are in serious credit card debt. Many have borrowed against their homes. Now that is at risk as well. So I would ask you to speak to not just the fiscal stimulus, but really what is a long-term economic stimulus and how we can encourage more economic growth, which I would interpret as not just more money in the system but more jobs and better paying jobs, because that is obviously an issue as well. If we have more jobs that are low paying, that doesn't exactly help our families to be able to do what we are asking them to do. So I just wanted you to comment if you would—this is what we are facing tomorrow as a matter of fact.

We have put forward a serious and fundamentally different policy on energy, which seems to me to answer some of these questions. We are saying, we want to stimulate job growth in energy. We want new jobs and alternative renewable fuels. We want to use innovation. We want to be able to see the job growth in both small and large businesses, and we want to reduce the cost of energy for Americans and be more self-reliant so we don't have to borrow so much or rely on foreign governments. That, seems to me, is a perfect place to go, and we ought to be doing that in other areas as well. So could you speak to how important it is for us to look long term and, again, not just from a fiscal stimulus but really an economic stimulus package, which we are trying to do through energy tomorrow? We may well see that vetoed by the President. Where does that put us as a country if we aren't in fact making those long-term growth decisions right now? I think we have just about 2 minutes for each of you——

Mr. ORSZAG. I can take a quick crack at that. In fact, I will be back here next week, I gather, to talk about the long-term budget outlook. The Nation faces many important long-term challenges that are not just fiscal but include fiscal challenges, and I would include the long-term fiscal problems in that. Climate change is another one. With regard to some of the comments about national saving, basically, not just the Federal Government but private also. Over the long term, it is not in the Nation's best interest to be saving only 1 or 2 percent of our national income, which is what we have been doing. And there are many steps that can be taken in addition to improving the Federal budget's saving basically to boost private saving. And I would highlight one in particular. Research has shown that making saving easier so that it is more automatic is a very effective tool to boosting saving. You already took steps to boost automatic saving in 401(k) plans. There are opportunities for the other half of the workforce which are not offered a 401(k) at work to boost their automatic savings opportunities also. And I understand that on a bipartisan basis, there is legislation that has already been crafted to create something called an automatic IRA which would do that kind of thing. So there are opportunities to boost national saving over the long term even beyond getting the Federal Government's own books in order.

Ms. SCHWARTZ. Thank you. I appreciate that. I will say, though, it is very hard on American families. I am very committed to saving. I think what we do with the 401(k)s is really important, and we should do more. We do know, for American families whose wages have not gone up as fast as inflation, who are seeing increasing expenses for healthcare and energy and mortgage and everything else, that it is really hard to then say, by the way, you have to save. I do think we ought to say that, but I think it is the reality for very many Americans who are making more money than they ever imagined; it is still hard for them to do that.

Mr. BERGSTEN. I would just add one sentence. The time is up. I heartily endorse every objective you cited. I would simply suggest that when you look at proposals for policy changes, you test them against one critical criteria, will they increase U.S. productivity growth? The underlying answer to your question is to maximize U.S. productivity growth. The reason the U.S. economy has done well from the mid 1990s until the last couple of years is because productivity growth, depending on how you measure it, doubled or tripled from what it had been in the 1970s, the 1980s, the early 1990s. That provided a quantum jump in professional growth in the U.S. which we realized over this last decade period. So whether it is a tax issue or spending issue, an energy policy issue, you always want to test it against whether it will increase productivity growth because that is the only ultimate way that you get real incomes and wages up.

Chairman SPRATT. Mr. Campbell of California. Let me say that, after you have your questions, we will recess to go vote. I may disappear before you finish your question, but you have the floor for the full 5 minutes.

Mr. CAMPBELL. Thank you, Mr. Chairman.

I will make these quick so that we don't—we all have to get to votes.

For Dr. Feldstein and Dr. Bergsten, talking about the potential temporary stimulating tax cut next year, how do you do that? And then, under current law, as has been discussed in 2010 and 2011, all the tax reductions of 2003 and 2001 expire. If you did a temporary stimulative tax cut and it was followed by an elimination of that temporary tax cut and then followed a year or something later by all of these things—all of these tax increases, wouldn't that be a whipsaw on the economy which would cause a lot of distortions in investment decisions and so forth because of a significant difference in as short of a 3-year period in tax rates?

Mr. FELDSTEIN. I see this temporary tax stimulus not as something that drives incentives; it is basically a transfer of cash that people will spend. It will be—if it comes to pass, if we actually have the downturn, it will be turned off long before we get to 2011. Just the enactment of it will help reduce the risk of recession because it will give people more confidence that there is that fiscal back stop should the economy soften. So I think it is quite separate from these other long-term incentive effects of pushing tax rates up and particularly pushing tax rates up on investment income, both capital gains and dividend income.

Mr. CAMPBELL. Do you agree with that.

Mr. BERGSTEN. I agree with that. This is Marty's proposal. I mainly suggested making it symmetrical. I also must admit that I make an implicit assumption that you are going to work out that problem of the termination of the current tax cuts. And so my baseline is probably a little different than you were suggesting.

Mr. CAMPBELL. Another question, would elimination of the AMT, just elimination of the AMT tax without any replacing, supplanting tax, is that a good idea for the wealth—for the transfer back economic stimulus, or is it geographically and income distributionally not ideal.

Mr. FELDSTEIN. It seems to me, before you get there, it is a tremendous fiscal problem if you simply repeal the AMT and you don't put anything in its place. You are looking at a very large increase in the fiscal deficit. That is one of the things that would both worsen our trade situation with the rest of the world and also the size of the ongoing national debt.

Mr. CAMPBELL. Any tax reduction will do that without—I mean, I am just saying, taking your suggestion of a stimulating tax reduction.

Mr. FELDSTEIN. Well, you could say if the—I don't think you want to solve the AMT problem by linking it to what happens to unemployment in—it is a kind of cyclicly adjusted patch. Using it as a way—is that what you are proposing?

Mr. CAMPBELL. I was just throwing it out there and saying——

Mr. FELDSTEIN. I haven't thought about doing that before. It seems to me turning it off for a year and then turning it back on again just adds to the complexity of the AMT.

Mr. CAMPBELL. Fair enough.

Mr. ORSZAG. I would just add, if you were for a similar sized—and again, I don't—I am not—I want to emphasize again, it is not clear that fiscal stimulus is or should be warranted. But if it were that for the same size tax relief, say $50 billion, AMT versus an alternative, the AMT's relief unpaid for would likely be somewhat less effective at boosting demand in part because of the distributional effect that you noted. It would largely go to sort of upper-middle-class or lower upper-income taxpayers. And the evidence does suggest that if you want to get the biggest bang for your buck from tax relief in a period of economic weakness, tilting towards moderate-income households would be a benefit.

Mr. CAMPBELL. Last question for you, Dr. Orszag. What was CBO's forecast for economic growth during the time that we were projecting out what future deficits would be? And if economic growth dropped for each—is there any kind of calculus that if economic growth is 1 percent down and if we have declining interest rates, then our interest on that national debt will be offsetting some of the other factors of that. But is there any kind of rough economic calculus for if GNP growth drops a percent, then the deficit increases by $100 billion or whatever.

Mr. ORSZAG. Yes. We will have updated rules of thumb in our January outlook. And I will be delighted to talk to about them when we come out with that.

Chairman SPRATT. The committee stands in recess subject to the call of the chair. With the indulgence of our witnesses, we will be back in about 15 minutes. We have got three 5-minute votes. Make yourself at home. And I will be back as quick as possible.

[Recess.]

Mr. COOPER [presiding]. The hearing will return to order. And our first questioner will be Mr. Doggett from Texas.

Mr. DOGGETT. Thank you very much. And thanks for all the testimony you have all been presenting. I certainly agree with our ranking member, Mr. Ryan, that the goal here is not to pursue policies that would sink the economy. But I think he has framed the question in a somewhat backward way. We have pursued policies for at least the last 7 years of cutting regulations, cutting taxes, cutting at the expense of significant increases in debt, combined more recently with a foreign policy that has contributed to international instability and the soaring price of oil. And the real question we have now is whether these policies that we followed for 7-plus years are sinking the economy or merely contributing to sluggish growth. And the Republican—our Republican colleagues, like this administration, pursue every economic condition, as Mr. Edwards noted, with an economic medicine chest that only has one brand of medicine, and that is tax cut elixir with a stack of IOUs, because really their approach to a credit crunch is to ask for more credit for more tax cuts.

Let me begin with a question to you, Dr. Bergsten. Do you believe that, given our current economic situation, we should have another unpaid tax cut with or without a trigger?

Mr. BERGSTEN. Well, I am a big supporter of moving to a budget surplus, as I said in my remarks. That is the structural budget deficit which I look at as the main indicator, so I am willing to see fluctuations around that depending on the state of the cycle. So I don't rule out a short-term tax cut aimed at a cyclical downturn in the economy of the type Dr. Feldstein was trying to advocate. But as I said in my own remarks, I would be very nervous about any kind of further additions to the budget and therefore the external deficits. I think any kind of tax cut of the type he proposed ought to be symmetrical and you ought to have a conditional tax increase on the other side that would take advantage of a strengthening position of the cycle in order to strengthen the underlying position and avoid a net weakening and addition to the debt at the time.

Mr. DOGGETT. Do you recommend a tax cut at this time?

Mr. BERGSTEN. No, not at this time. If you were going to do it, you should only do it with a trigger because it should be conditional and——

Mr. DOGGETT. But you don't recommend doing it either way.

Mr. BERGSTEN. No, I would not recommend doing it either way.

Mr. DOGGETT. Dr. Orszag, recognizing your position is a little different on policy matters, let me ask the question this way. Do the economic conditions that have been relied on in the past to justify a stimulus package exist today?

Mr. ORSZAG. Not currently. And most of the discussion we have had about it today is about the risk of about whether it will in the future and, in particular, next year.

Mr. DOGGETT. You mentioned that the history of congressional action with stimulus is not altogether a happy picture, that the stimulus is often late and often misdirected.

Mr. ORSZAG. That is correct.

Mr. DOGGETT. You have written, prior to coming to your current position, I believe when you were at Brookings, that there were times that certain kinds of fiscal stimulus is preferable to a tax cut.

Mr. ORSZAG. Sure. I mean, as I mentioned earlier and as CBO also has said before, if you were to do fiscal stimulus, it does not need to be done on the tax side. It can be very effectively done also through particular kinds of transfer payments. For example, research has shown that the unemployment insurance system, for example, is among the most effective dollar-for-dollar automatic stabilizers that we have in terms of counterbalancing periods of economic weakness.

Mr. DOGGETT. As far as continued commitment to our PAYGO rule, which you have advocated and I certainly have supported, is it possible to have short-term stimulus that is paid for in the out years still comply with the PAYGO rule but have a stimulative effect over the short term?

Mr. ORSZAG. Absolutely it is.

Mr. DOGGETT. If it becomes necessary to have a stimulus package because of the policies of the past that haven't worked as well as the boundless economic growth we were promised from one tax cut for the rich after another and we do need some short-term stimulus, it doesn't mean we have to abandon the PAYGO approach?

Mr. ORSZAG. No, in fact, as you noted, you can have some deficits in the first couple of years that are offset by additional fiscal discipline thereafter.

Mr. DOGGETT. Thank you very much.

Dr. Feldstein if time——

Mr. FELDSTEIN. When I made my comment about waiving PAYGO, and I thought about it in concurrent terms, but I would subscribe to the idea that—and that would also deal with what Fred Bergsten said—as the economy recovers, you want to have more revenue being collected. So I don't see this as a net permanent tax cut but rather something counter cyclical. And let me point out that, as the Chairman said in his opening remarks, in a Financial Times article the other day, Larry Summers, Democrat, Secretary of the Treasury in the Clinton administration, also argued for a fiscal stimulus next year of the economy. So it is not just——

Mr. DOGGETT. I heard his comments last night as well. And just to clarify on that point, because I think it is significant. You can tell from the drift of my comments, I don't share enthusiasm for your proposal, but you are saying that if we do a short-term stimulus using the tax approach that you have recommended, that it is not essential that we abandon PAYGO. We could have it paid for in the out years and be true to our concern for a pay-as-you-go approach and still stimulate?

Mr. FELDSTEIN. Yes, that is correct.

Mr. DOGGETT. Thank you so much.

Mr. FELDSTEIN. And it could be done on the spending side through transfer payments. But the danger to tying it to something like unemployment insurance is that it may increase the length of time that individuals with a tendency to become unemployed because of the incentive effects that go with it. So that would have to be traded off. On the other hand, that is a population where they are more likely to spend the money dollar for dollar than just giving it across the board to all taxpayers.

Mr. DOGGETT. Dr. Orszag.

Mr. ORSZAG. If I could add one comment. Obviously, as policymakers, you are going to have a difficult set of decisions to make if the economy does weaken. And I want to underscore two features just for emphasis about the proposals that are being discussed. The first is that they are conditional, and the second is that, as Professor Feldstein just said, they are offset. So in discussions about potential stimulus, those important features—and I am not saying that even with them it is desirable to do. But without them I think there would be much less support among many economists for that kind of step.

Mr. DOGGETT. Thank you very much. Thank all three of you.

Mr. COOPER [presiding]. The gentleman's time has expired. The gentleman from North Carolina is recognized.

Mr. ETHERIDGE. Thank you, Mr. Chairman.

Dr. Bergsten, let me ask you a question because I think, given your looking at the world view, there was a time if you go back, you know, 12, 15, even 20 years ago now, if you looked at the world economy versus ours and you looked at the world stock markets versus the U.S., there is a lot of stuff moving to different markets around the world.

I would be interested in your comments, as you shared earlier, about how we can look to the world economies, depending upon how they are doing versus ours, but also at those markets. Even though they may move from market to market, we are far more integrated today than we have ever been in the history of this world, probably, in terms of the markets.

I would be interested in your comments as relates to those markets and their movement, because I think they tend to be more barometers than anything else—or thermometers, more than a barometer, up and down—but how that interplays with the economies as they move around the world and how much stronger some of those tend to be in terms of trading volume versus what they were 10 or 15 years ago, how that impacts the economy of the world and the United States.

Mr. BERGSTEN. You can observe the same trend in financial markets that I mentioned in terms of economic output and GDP. The U.S. share, while still by far the biggest of any single country, has declined relatively to that of other parts of the world. I mentioned briefly that the euro has now become a second global currency, moving up alongside the dollar. It is interesting, some indicators of financial markets, the euro actually already exceeds the dollar.

There are more flotations of private bond issues, for example, now in euros than in dollars. There is more euro currency held around the world than dollar currency. So those are indicators of that set of financial markets.

The dramatic expansion in recent years, again as with the GDP growth, has been in emerging markets, where their financial markets also have developed rapidly. They are still much smaller than ours or the European or even the Japanese, but they have been growing very rapidly. They have been attracting very large amounts of capital relative to what they had in the past, relative to the global supply.

So the diversification of the world economy is happening very much on the financial side, as well as the output side. That is, on balance, good news because it provides these buffers and offsets and greater options for achieving world growth that I mentioned at the outset. But it is also a risk because it means that people have lots of places to go other than the dollar or the U.S. markets if they don't like our performance.

Mr. ETHERIDGE. Let me ask each of you, because I want you to just comment quickly—because I only have a little time left—certainly as we are looking in hindsight at the tremendous debt that has now been created, it is going to have a significant impact on our ability to invest in the long run in core infrastructure needs in this country long beyond water, sewer, schools, education. You know, if we are looking down the road, that is what got us here and that is what will get us down the road in our ability to invest in the future of our young people.

My question is as you look at the outyears, we have been talking about the drag with all the other stuff, no one has touched on this issue of investment in education and the other pieces. I would be interested in comments from each of you very briefly how you see that switch coming that could greatly impede our ability to be a major competitor in the world economy 20, 25 years from now if we don't start investing more today in tomorrow's workforce.

Mr. FELDSTEIN. Let me distinguish between investment in the traditional sense, as you say, everything from infrastructure to business plant and equipment——

Mr. ETHERIDGE. Well, let me tell you what I am talking about in investment. I believe education is an investment.

Mr. FELDSTEIN. Okay.

Mr. ETHERIDGE. Some people call it an expenditure. You expend today, you invest in the future.

Mr. FELDSTEIN. No question about that. I accept that. I was just going to say that that expenditure is mostly publicly financed, both local and State, and national. And so that has a different—that requires a commitment on the part of governments at these levels to spend money on education and to change the nature of the education so we get more for the dollars that we spend. No quarrel about that.

On the other kinds of investment, the traditional bricks and mortar and infrastructure, that requires an increase in our saving rate. If we continue to have a low saving rate, then we become dependent on the rest of the world to finance that kind of investment. There is a limited ability to do that. As our trade deficit shrinks, the inflow of funds from the rest of the world will shrink. And therefore our ability to invest will shrink. So if we want to invest, we have to save more.

Mr. ORSZAG. I guess what I would say, just briefly, is just as different forms of taxation have different effects on economic growth over the long term, different forms of government expenditures also do. The evidence, for example, on high quality pre-K education suggests potential for significant returns there. And that is different than other kinds of spending. So the same kind of more nuanced approach that is required with regard to forms of taxation is also required in terms of evaluating different kinds of Federal spending and other government spending, I should say.

Mr. BERGSTEN. I had mentioned earlier the emphasis on productivity growth, which gets to your question. And a critical element of that is investment, "capital deepening" as we call it. So yes, that is absolutely essential. And I think, again, you ought to test all of your policy proposals against the criteria of whether they will enhance productive investment.

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

Mr. COOPER. The gentleman's time has expired. The gentleman from California is recognized.

Mr. BECERRA. Thank you, Mr. Chairman. And thank you to the panelists for their testimony today and all their responses.

I would like to, if I may, begin with Mr. Bergsten and find out from you, if you could elaborate a little bit more on a comment you made earlier in response to some questions that we have been living so far beyond our means that what we are seeing now is a reaction to the consequences of that. And we now are going to hear any number of proposals that will come our way to try to get us back into a prosperous economy.

And I am wondering if you could tell me, as we move forward. Is it more important in your mind, given that we are not yet certain if we are going to go into a recession, to talk about the short-term fix or deal with the long-term instability that we have in our fiscal house?

Mr. BERGSTEN. What I meant by living beyond our means was the fact that the country as a whole has been for 15 years spending more than we produce at home. That difference was met through net imports of product from the rest of the world. And then we had to borrow from the rest of the world to finance that imbalance and built up sizable foreign debt. The number that is often cited is that our net foreign debt is now something like $3 trillion. But in a way, the relevant number is $20 trillion. That is the amount of dollar holdings by foreigners all around the world, and in different forms, which provides the base from which sell-offs could occur if there was a sharp decline in confidence in the U.S. and in the dollar. And that is why this risk of a shortfall in the dollar or a hard landing is not fanciful.

The way we got to that position, spending more than we produced at home, was just as the terms imply. The domestic demand growth in our economy, private consumption, private investment, government spending, all that added up to more than we were able to produce at home. So domestic demand growth exceeded our output growth, and the difference was the trade deficit, the buildup of foreign debt.

Mr. BECERRA. Let me stop you there and ask a question. So, as we continue to see our spending exceed our production, and we saw the size of the budget deficits for the Federal Government explode, would you say that that had a consequence? Do deficits matter, I guess, is the question.

Mr. BERGSTEN. Sure. The budget deficit and the increases in the budget deficit clearly were a component of that excess of domestic demand over domestic output. That was clear in the eighties. It was not so clear in the late nineties, when actually the budget was headed toward surplus and the external deficit went up. So there were other factors in there. It is not twin deficits in any kind of Siamese sense.

Mr. BECERRA. Well, and in 2000 we were told we were heading towards massive surpluses, but that quickly reversed itself. By the middle of this decade we saw that we were not going to have surpluses, yet we continued to run some fairly substantial deficits. And today now we see the consequences of not having the freedom to try to act more agilely in responding to the debt crisis and so forth.

So as we look forward to how we make sure that we move the economy in a good direction and make sure people have stable jobs and the rest, I guess the question will confront us: Do we deal with this through a short-term fix or do we try to do something more to stabilize us down the road? While as most people say 5 percent unemployment ain't that bad, I am one of those who always says it is 5 percent more than I would like to see. But it is certainly lower than you see in other places around the world. And we still haven't seen the type of real dislocation that you have seen in other recessions.

So while things aren't that bad, isn't it time for us to try to make sure that we put our fiscal house in order so that we can deal with any of these hiccups again, so they don't become more than a hiccup, rather than try to figure out some quick fix, which may actually, as I think some of you have said, may actually go in the wrong direction if we do it the wrong way?

Mr. BERGSTEN. Well, I would certainly put my emphasis on that, as I did in the last paragraph of my statement; that the best thing we can do to avoid risks of a dollar collapse or some other calamities would be credible, steady movement toward modest budget surpluses over the long run to boost our national saving rate, as Dr. Orszag said.

What I wanted to add was that as this buildup of our foreign debt now inevitably—and I underline inevitably—reverses, it means that the growth in our domestic spending has to be a bit less than the growth of our economic output, so that the difference is freed up to improve our trade balance, which is happening now. So we always kind of knew there would be that period of adjustment.

Mr. BECERRA. I like to pull this out. This is actually a government credit card. This is what we have been using to do any number of things, whether it is pay for the war in Iraq, pay for the Bush tax cuts, pay for any number of things. And we still, after using this, are finding that we don't have enough money at the end of the year to cover the costs.

Most Americans, if they were to spend the way we have spent on Iraq, tax cuts or the rest, would find themselves quickly in bankruptcy. We, fortunately, can print up money, I guess, to cover some of that, some of the debts we have to our creditors.

My final question, because my time has expired, is to say this. If we do what you just finished saying, which is don't spend quite as much as we produce, we won't have to worry about using this. But until that time that we are spending less than we are producing, what we are really doing is just using the people's credit card and putting the debt on our children's backs, because we are not paying it today.

As Dr. Orszag mentioned, we have got about a quarter of a trillion dollars in interest payments on that debt. And so as long as we don't get ahold of ourselves and be fiscally responsible and continue to just use the credit card, we are actually telling our kids you will pay later.

Mr. BERGSTEN. And compounding that, a lot of that debt is owed to citizens, countries outside our own boundaries, where we have less control and there is less offsetting within our own national economy.

Mr. BECERRA. Which, in a world where the U.S. is no longer the only king, means that we are not the only ones in control of our destiny.

Mr. BERGSTEN. And that is what I think we are beginning to see and could see with a vengeance. That is the risk I foresaw.

Mr. BECERRA. I thank you very much, all of you, for your testimony. Mr. Chairman, I thank you very much.

Mr. COOPER. The gentleman's time has expired. The gentleman from Virginia is recognized.

Mr. SCOTT. Thank you, Mr. Chairman. I had another committee meeting I had to go to. I am sorry I am running a little late.

I would like to ask Dr. Feldstein, the Ranking Member mentioned how well the stock market was going. If the stock market had gone up in the last 7 years like it had gone up during the Clinton administration, what would the Dow be at, approximately, right now?

Mr. FELDSTEIN. I just don't know.

Mr. SCOTT. It almost quadrupled under the Clinton administration. It would be around 30- to 40,000.

He mentioned the unemployment rate, which suggested that we are doing well in jobs. Could you give us an idea of how this administration compares to other administrations in creation of jobs?

Mr. FELDSTEIN. We have effectively full employment now. So any change, any differences over time, would have to be in the growth of the labor force.

Mr. SCOTT. Is it worst creation in jobs or tied for worst since Herbert Hoover——

Mr. FELDSTEIN. Let us say if we could double the number of jobs that were created over the last 8 years, we would have negative unemployment now. Is that the goal we should be aiming for?

Mr. SCOTT. Well, you have a lot of people that are discouraged and stopped looking.

Mr. FELDSTEIN. I think even if you counted "discouraged," if you added them in we would have negative unemployment.

Mr. SCOTT. So the average of 200-some thousand a month under Clinton was not sustainable?

Mr. FELDSTEIN. Well, if you tell me—I don't have the numbers in front of me. So what I am saying is we now have effectively full employment. And if you had much more job creation, I am not sure who would take those jobs. But you would be driving the unemployment rate down to numbers which historically have created big increases in inflation. That was one of the problems that we ran into toward the end of the Clinton administration. The Fed was keeping monetary conditions too easy, and so in the end Mr. Greenspan pushed up interest rates and pushed us into a recession in the beginning of this decade.

Mr. SCOTT. In terms of improving the economy, everybody talks about tax cuts like they are all equal in their stimulus effect. Isn't it true that some tax cuts are more stimulative to the economy than others?

Mr. FELDSTEIN. Absolutely.

Mr. SCOTT. And which of those tend to have more of a stimulus effect?

Mr. FELDSTEIN. Well, tax cuts that are focused on business investment of the sort that Congress passed in—whenever, 2003.

Mr. SCOTT. The accelerated depreciation?

Mr. FELDSTEIN. Accelerated depreciation can have a very——

Mr. SCOTT. Which is an interesting one because long term if you ignore the present cost of money doesn't really cost anything.

Mr. FELDSTEIN. Well, that is right. There is the minor factor of ignoring cost of money. But, yes.

Mr. SCOTT. So that is a very—it stimulates the economy and doesn't cost much. That is very cost-effective.

Mr. FELDSTEIN. Yeah.

Mr. SCOTT. Earned income tax credit?

Mr. FELDSTEIN. I wouldn't have said that that was—I would say that there are a lot of negative things associated with the phase-out range for the earned income tax credit, so it has quite negative impacts.

Mr. SCOTT. The $300-a-person cash rebate?

Mr. FELDSTEIN. You know, I am close to saying something like that is what I think ought to be in the conditional tax cut that I am talking about. It is easy to implement. It doesn't have incentive effects of a long-term sort. It neither encourages more work effort nor more saving. But it stimulates some spending at a time when you need it. And that is why Congress passed it then, and that is why I think it ought to be put up where it would be easy to do and fast to do if the economy warrants it in 2008.

Mr. SCOTT. Did you want to make a comment, Dr. Orszag?

Mr. ORSZAG. I guess I would just say I think some humility is needed in terms of our ability to pick out the best possible tools for this purpose. For example, I agree with Professor Feldstein that economic theory and sort of the conventional wisdom in economics suggests that accelerated depreciation provisions are a relatively cost-effective tool for stimulating the economy. In fact, CBO has said that. But the evidence from our experiment with that provision was not overwhelmingly supportive of that conclusion.

Mr. SCOTT. Well, reducing the rate for dividends and capital gains, is that stimulative? Of the numbers I have seen, that is about the worst thing or least effective in terms of stimulating the economy.

Mr. FELDSTEIN. You don't do it for short-run stimulation purposes. You do it for long-term incentives in terms of how we invest, whether we have excessive debt versus equity and so on.

Mr. SCOTT. I had one other question I would like to get in real quickly, if I could. And that is that I thought I heard from the panel the idea that a collapse in the value of the dollar is a necessary element of digging ourselves out of the debt we have gotten ourselves into in the last 7 years. Is that right?

Mr. BERGSTEN. No. What I said——

Mr. SCOTT. How else are we going to pay our way out of it?

Mr. BERGSTEN. I think we all agree that the decline in the dollar is an essential part of this adjustment process. The dollar rose by 40 percent in value from 1995 to 2002. It overpriced us in world markets. That was a big factor in going to the large trade deficit. Now you have to work that back down. People differ in amounts. I think it has come down 20 to 25 percent. Probably got another 10 percent or so to go.

The issue is whether that happens in a continued gradual, orderly way that does not disrupt markets and the economy—which it has so far—or whether it accelerates and maybe overshoots and then causes a rapid run-up in inflation and interest rates. And I was worried about the latter. I have always felt that we needed a big decline in the dollar—and that is in the process of happening—but needed to do everything we could to avoid a collapse of the dollar in terms of the pace at which that decline occurs.

Mr. SCOTT. And what does the deficit have to do with that?

Mr. BERGSTEN. The budget deficit?

Mr. SCOTT. Right.

Mr. BERGSTEN. Budget deficit, as we said a minute ago, is a contributor to the trade and current account deficits, which in turn are a reason why the dollar exchange rate has to come down to improve our competitive position.

Mr. SCOTT. Thank you, Mr. Chairman.

Mr. COOPER. The time of the gentleman from Virginia has expired. Let me ask unanimous consent that members who did not have the opportunity to ask questions of the witnesses be given 7 days to submit questions for the record.

Without objection, so ordered.

I would like to thank our unusually distinguished panel for their patience and their expertise. Without objection, the committee meeting is adjourned.

[Whereupon, at 12:54 p.m., the committee was adjourned.]

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