Testimony to Senate Budget Committee, hearing on "The U.S. Economic Outlook," 10am Tuesday, February 1, 2011 (embargoed until the hearing starts).

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I. Short-Term Prospects

1) The latest IMF-led official consensus is that the world will follow a "three-speed" recovery in 2011, with the eurozone growing slowly (1.2 percent Q4-on-Q4), big emerging markets quickly (7 percent on the same basis), and the US roughly in between (3.2 percent). At the global level, using the IMF's standard PPP weights, this implies global growth will be 4.5 percent, comparing the 4th quarter of 2011 with the 4th quarter of 2010. This would be down slightly, on a comparable basis, from 2010 (4.7 percent) and just above what the IMF expects for 2012 (4.4 percent).

2) These figures are from the World Economic Outlook update, published on January 25, 2011. Compared with its most recent full biannual forecast in October, 2010, the IMF has marked up US growth significantly for 2011 (0.7 percentage points for Q4-on-Q4), while leaving the eurozone and emerging markets essentially unchanged.

3) The most prominent downside risks to this forecast are in the eurozone. There are three separate but related issues that suggest there is limited potential for upside in this view of Europe:

a) The weaker eurozone countries continue to face pressure from the financial markets, particularly as there are large amounts of government debt that need to be rolled over in the spring. Portugal, Spain, Italy and Belgium are all likely to face increases in interest rates and there is no clear policy framework within the eurozone for dealing with such developments.

b) The stronger eurozone countries, around a Germanic core, are growing quite fast – e.g., 1.2 percent for Germany itself this year, on its way to 2.7 percent for 2012 (according to the IMF); employment in Germany is already higher than it was before the financial crisis. When the European Central Bank begins to raise interest rates, this will put renewed pressure on Greece, Ireland, and other peripheral countries.

c) In principle, there is agreement that – in future – bondholders and other lenders to large banks and eurozone sovereigns can face losses. However, the precise rules and timing for these

[1] This testimony draws on joint work with James Kwak, including *13 Bankers: The Wall Street Takeover and The Next Financial Meltdown* (Pantheon, March 2010) and "The Quiet Coup" (*The Atlantic*, April, 2009), and Peter Boone, including "The Next Financial Crisis: It's Coming and We Just Made It Worse" (*The New Republic*, September 8, 2009) and "Will the Politics of Moral Hazard Sink Us Again" (Chapter 10, in The Future of Finance, July 2010). Underlined text indicates links to supplementary material; to see this, please access an electronic version of this document, e.g., at http://BaselineScenario.com, where we also provide daily updates and detailed policy assessments for the global economy. For important disclosures relative to affiliations, activities, and potential conflicts of interest, please see my bio on BaselineScenario.

arrangements are still not completely clear. There is room for further destabilizing markets in the short-term, particularly if there is severe pressure in some parts of the credit market.

4) The IMF and private sector forecasts all missed badly regarding 4th quarter GDP in the United Kingdom – the consensus was for 0.4 percent growth, but the outcome for seasonally adjusted quarterly change in GDP was minus 0.5 percent (see the latest Eurostat data). The contraction in December was due to bad weather, but October and November were also significantly worse than expected. The UK's path to fiscal austerity, for which it is still early days, may have more negative effects on the real economy than expected.

5) For the US over the next 12 months, the IMF forecast looks more balanced and agrees with the CBO forecast, which is 3.1 percent (Q4 on Q4). (The institutions have greater disagreement about what happened in 2010, with the CBO putting growth at 2.5 percent, while the IMF has this as 2.8 percent in its latest release).

6) Some private forecasts put US growth as likely closer to 4 percent and the latest news is encouraging, in terms of non-farm payrolls, private payrolls and the ISM data. Core inflation seems under control, both in the view of the Fed and according to many in the financial markets.

7) However, the employment picture remains bleak. In other post-war US downturns, employment fell 3-5 percent relative to its peak and return to the pre-recession peak within approximately 12-24 months. The previous exception was 2001, when it took nearly 4 years to get the jobs back; but the maximum fall in total employment was only 3 percent. In contrast, we lost 6 percent of employment in this cycle and after 3 years employment is still down 5 percent from its peak. This part of the economic picture looks more like a mini-depression of the pre-1900 variety rather than a standard post-war recession.

8) Large firms are doing well, with profits having recovered faster than in earlier recessions (Section III below provides more detail). But there are limited signs that these firms want to hire in the United States. Emerging markets offer the market expansion opportunities and increasingly global firms want to hire people in India, China, and similar countries.

9) Interest rates remain low for households and firms that are deemed creditworthy. But lending standards have tightened (appropriately in some cases) and smaller firms presumably are having a harder time borrowing. At the same time, there are increasing concerns about the fact that concentration in the financial system has increased; big banks may feel less competitive pressure to lend – despite the fact that they are highly profitable.

10) Overall, the US continues to have very loose monetary and fiscal policy. As we move towards normalizing policy, which must happen in the next 12-18 months, this will presumably slow down the economy.

11) The most important wildcard in all forecasts is the rate of new household formation, which is down substantially – it was 1.1 million per annum on average in the decade before the crisis, but has averaged 600,000 per annum in the last three years. No one knows when or how this will recover and it is hard to see the housing market return to health quickly with the household formation rate around today's level.

12) There is an increasingly dissonance between the exuberance within parts of the financial sector and its push for more immediate fiscal austerity. If people begin to feel that their future social security and Medicare benefits are under serious threat, they will presumably begin to save

more. As I discussed in my August testimony to the Senate Budget Committee, it is impossible to put the longer-term federal budget onto a sustainable basis without controlling the future increases in costs for Medicare and health care more generally.

13) Growth in emerging markets remains high and, with a few exceptions, they weathered the financial crisis well. But now inflation begins to increase, partly as a result of tighter commodity markets. Higher interest rates attract more capital and tend to cause their currencies to appreciate. Most likely these economies will find the need to tighten fiscal policy before too long.

14) A great deal of success across the entire emerging and developing world is related to the rise of China and India, particularly the fact that growth is relatively commodity intensive at their levels of income. The next global cycle will likely focus on these economies, fuelled by capital being funneled through large money center "too big to fail" banks – much as the so-called recycling of petrodollars flowed through institutions such as Citibank in the 1970s. If this boom is based primarily on debt, as currently seems likely, it will end badly.

15) Not that this boom-bust cycle would be consistent with current account surpluses in emerging markets and a current account deficit in the United States. But such "global imbalances" are neither necessary nor sufficient for destabilizing capital flows – the mechanisms at work are based on gross capital flows much more than net flows.

16) Overall, the US tradeable goods sector (exports and products that compete with imports) has struggled for past decade. These problems were masked by the growth of the nontradeables sector, particularly around housing. It is very unlikely that we can go back to the same pattern of growth as before 2008. Most likely real wages will fall for Americans with less education, as unemployment for this group declines. This will further exacerbate the long-standing widening of income inequality in the United States (more on this in Section IV below).

17) In addition, the rescue of big banks at the United States comes at a considerable price that we will pay as the next economic cycle develops. Our largest banks are well on their way to becoming "too big to save". We should respond by greatly increasing their capital requirements, a point being made forcefully by Anat Admati (Stanford University) and a large group of top academic finance experts, as well as by Mervyn King, Andrew Haldane, and David Miles from the Bank of England; the actions of the Swiss National Bank are also very much pushing in this direction. Unfortunately, the bank lobbyists prevailed in the Basel III forum and the equity-financing of systemically important financial institutions is likely to remain too low in the United States.

18) The latest report from the Financial Stability Oversight Council (FSOC) is also most discouraging. Instead to moving to limit the size and complexity of our largest financial institutions, with an eye to making them small enough to fail and therefore subject to market discipline, the FSOC seems content with the dangerous status quo in which private banks have become the new implicit government sponsored enterprises. Section II below elaborates on why this is such a serious mistake with first order macroeconomic consequences.

II. The Economic Implications Of Too Big To Save Banks

In August 2010, in written testimony submitted the Senate Budget Committee, I provided an analysis of the contingent fiscal liabilities that are in inherent in having a large, concentrated, and undercapitalized financial sector.

Since that time, Ireland encountered a serious economic crisis – and received a bailout from the International Monetary Fund and the eurozone – largely because of the mistakes made by its largest three banks.

The executives running those banks and the people – mostly other European bankers – who lent to them believed that they were "too big to fail" in the Irish context, i.e., that they were implicitly backed by the full faith and credit of the Irish government. This turned out to be correct but, unfortunately, it is also the case that the financial needs of these distressed banks are so large that they overwhelmed the fiscal capacity of the Irish state.

The latest quarterly report from the Neil Barofsky, the Special Inspector General for the Troubled Asset Relief Program (TARP), is the best official articulation yet of why Too Big To Fail is here to stay in the United States – and we are likely on the path to these institutions becoming Too Big To Save.

In its executive summary, the document, which appeared on last week, discusses "perhaps TARP's most significant legacy, the moral hazard and potentially disastrous consequences associated with the continued existence of financial institutions that are 'too big to fail'."

This reasoning builds on evidence presented in Mr. Barofsky's recent report on the "Extraordinary Financial Assistance Provided to Citigroup, Inc," but it goes a great deal further with regard to the general policy issues we now face.

Mr. Barofsky credits Mr. Paulson and Mr. Geithner with making it clear that TARP funds would be used to prevent any of the country's largest banks from failing during the recent financial crisis and thus "reassuring troubled markets" (p.6). But the very effectiveness of Treasury actions and statements in late 2008 and early 2009 had undeniable side effects, "by effectively guaranteeing these institutions [the largest banks] against failure, they encouraged future high-risk behavior by insulating the risk-takers who had profited so greatly in the run-up to the crisis from the consequences of failure."

And this encouragement is not abstract or hard to quantify. It gives "an unwarranted competitive advantage, in the form of enhanced credit ratings and access to cheaper capital and credit, to institutions perceived by the market as having an implicit Government guarantee."

Of course, the Dodd-Frank financial reform legislation was supposed to end too big to fail in some meaningful sense. But Mr. Barofsky is skeptical and with good reason. Our largest banks are now bigger, in dollar terms, relative to the financial system, and relative to the economy, than they were before 2008 – so how does that make it easier to let them fail?

At the end of the third quarter of 2010, by my calculation, the assets of our largest six bank holding companies were valued at around 64 percent of GDP – up from around 56 percent before the crisis and up from merely 15 percent in 1995 (this is an update of estimates James Kwak and I provided in our book, *13 Bankers*; we explain the methodology and sources there). Barofsky quotes Thomas Hoenig, president of the Kansas City Fed, who uses very similar numbers and draws the same conclusion: the big banks have undoubtedly become bigger.

Today's increasingly complex mega-banks are global – their potential collapse cannot be handled within national resolution or bankruptcy frameworks and there is no chance we'll get an international agreement on how to handle these issues any time soon. At least in private (and including at the World Economic Forum in Davos, late January 2011), I find relevant economic officials from a wide range of countries increasingly agree with the arguments made in this respect by Senator Kaufman and some of his colleagues (including Senator Sherrod Brown of Ohio) during the financial reform debate in the first half of 2010.

According to the Barofsky report, the FDIC under Sheila Bair is apparently willing to take this assessment to its logical conclusion – potentially being willing to force megabanks to simplify their operations and divest themselves of activities, if this is what it takes to make "orderly liquidation" a feasible option. Unfortunately, there is no sign that the Treasury Department is inclined to move in that direction – the quotes from Mr. Geithner here are all about preserving his freedom of action in future crises, including the ability to determine that any financial institution of any kind is "systemic" and therefore needs to be protected.

And the Federal Reserve remains completely on the fence. On the one hand, Ben Bernanke is capable of clearly defining the problem. Firms perceived as likely to be saved by the government, according to Bernanke, "face limited market discipline, allowing them to obtain funding on better terms than the quality or riskiness of their business would merit and giving them incentives to take on excessive risks." On the other hand – although it is not in the report – all indications suggest that the Fed is not taking a tough line with big banks.

Senator Kaufman and his colleagues were right to worry about the big banks, his ideas have gained lasting traction, and the debate among officials shows some promise.

But the situation is still dire. The incentives facing large private banks are now as distorted as the incentives that previously faced Fannie Mae and Freddie Mac – those institutions had too little capital and took on too much risk when they had an implicit government guarantee (although efforts to pin the crisis of 2008 primarily on those institutions are misplaced.) As the Barofsky report puts it, "TARP has thus helped mix the same toxic cocktail of implicit guarantees and distorted incentives."

III. Employment and Profits Over The Cycle

Relative to any post-war recession, the rebound in profits during the Obama administration has been dramatic. To be sure, the end of 2008 was shocking to many entrepreneurs and executives – as credit was disrupted in much more dramatic fashion than they thought imaginable. Large and immediate cuts in employment followed.

But then the government saved the failing financial sector. The means were controversial but the end was essential – without private credit, the US economy would have fallen far and for a long time.

And profits rebounded almost at once. The financial sector recovered quickly on the back of implicit guarantees provided to our largest banks – really the only bad quarter was at the end of 2008 (hence the angst about bankers' bonuses in 2009). But the nonfinancial sector has done even better. Profits for those private businesses fell by no more than 20 percent from top-to-bottom in the cycle and in 2010 through the third quarter (the latest available data in the BEA

series) profits were back at the level of 2006. After the deep recessions of the early 1980s, for example, it took at least three times as long for profits to come back to the same extent. (I went through this comparison in more detail recently for the NYT's Room for Debate).

And investment in plant and equipment has also recovered fast – this was the one bright part of the domestic economy in the past two years (with the other good relatively source of news being exports). Look around at the places you work and where you do business (or shop). Is there any indication they have cut back on information technology spending recently?

Overall, the policies of late 2008 and early 2009, including the much-debated fiscal stimulus, protected corporate sector profits to an impressive degree -- despite the fact that this was the steepest recession of the past 70 years, profits fell only briefly and seem likely to be just as strong going forward as they were pre-crisis. Large global American-based companies, in particular, are well positioned to take advantage of growth in emerging markets such as India, China, and Brazil.

But the link between corporate performance -- measured in terms of profit or executive pay for U.S. companies -- and domestic employment has fundamentally changed in recent decades. At the very least, employment responds slower now than in previous cycles when output and sales recover. We are still waiting for employment to turn back up decisively; compared with previous recessions, the delay is simply stunning (see the employment charts available on the Calculated Risk blog).

Ideally, in a situation like this, we'd provide more stimulus to the economy in some form. But our monetary policy is already close to exerting its maximum efforts, and the scope for using fiscal policy was undermined by high deficits during the "boom" years of the 2000s – so there is no safe fiscal space for action (even if the politicians could agree on what to do.)

We are reduced to waiting for the private sector to recover enough to want to take on new employees. No one has a good answer for why this is so slow – perhaps because it is so easy and so cheap to hire workers in those very emerging markets that are now booming, or perhaps because the skill mix available at prevailing wages in some parts of the US is not exactly what employers want.

Or perhaps there are artificial barriers to entry at work, meaning that companies can effectively keep out new entrants – thus keeping profits artificially high and, at the sectoral level, limiting employment. The constraints on entrepreneurship in our post-credit crisis economy need careful scrutiny. Hopefully, the administration's charm offensive will not prevent it from enforcing our anti-trust laws, which were more than slightly neglected in the Bush years.

Listening attentively to the nonfinancial sector makes sense in this situation; in return, corporate leaders need to focus on creating jobs in the United States.

But bending over backwards to accommodate the wishes of the financial sector is exactly what got us into this mess to start with. Allowing our largest banks to become even bigger and more dangerous would be a very bad mistake.

IV. What Caused The Crisis?

In December, a minority on the Financial Crisis Inquiry Commission (FCIC), weighed in with a preemptive dissenting narrative. According to this group, misguided government policies, aimed at increasing homeownership among relatively poor people, pushed too many people into taking out subprime mortgages that they could not afford.

This narrative has the potential to gain a great deal of support, particularly in the run-up to the 2012 presidential election. But, while the FCIC minority writes eloquently, do they have any evidence to back up their assertions? Are poor people in the US responsible for causing the most severe global crisis in more than a generation?

Not according to Daron Acemoglu of MIT (and a co-author of mine on other topics), who presented his findings at the American Finance Association's annual meeting in early January. (The slides are on his MIT website.)

Acemoglu breaks down the narrative into three distinct questions. First, is there evidence that US politicians respond to lower-income voters' preferences or desires?

The evidence on this point is not as definitive as one might like, but what we have – for example, from the work of Princeton University's Larry Bartels – suggests that over the past 50 years virtually the entire US political elite has stopped sharing the preferences of lower- or middle-income voters. The views of office holders have moved much closer to those commonly found atop the income distribution.

There are various theories regarding why this shift occurred. In our book *13 Bankers*, James Kwak and I emphasized a combination of the rising role of campaign contributions, the revolving door between Wall Street and Washington, and, most of all, an ideological shift towards the view that finance is good, more finance is better, and unfettered finance is best. There is a clear corollary: the voices and interests of relatively poor people count for little in American politics.

Acemoglu's assessment of recent research on lobbying is that parts of the private sector wanted financial rules to be relaxed – and worked hard and spent heavily to get this outcome. The impetus for a big subprime market came from within the private sector: "innovation" by giant mortgage lenders like Countrywide, Ameriquest, and many others, backed by the big investment banks. And, to be blunt, it was some of Wall Street's biggest players, not overleveraged homeowners, who received generous government bailouts in the aftermath of the crisis.

Acemoglu next asks whether there is evidence that the income distribution in the US worsened in the late 1990's, leading politicians to respond by loosening the reins on lending to people who were "falling behind"? Income in the US has, in fact, become much more unequal over the past 40 years, but the timing doesn't fit this story at all.

For example, from work that Acemoglu has done with David Autor (also at MIT), incomes for the top 10% moved up sharply during the 1980's. Weekly earnings grew slowly for the bottom 50% and the bottom 10% at the time, but the lower end of the income distribution actually did

relatively well in the second half of the 1990's. So no one was struggling more than they had been in the run-up to the subprime madness, which came in the early 2000's.

Acemoglu also points out that the dynamics of the wage distribution for the top 1% of US income earners look different, using data from Thomas Piketty and Emmanuel Saez. As Thomas Philippon and Ariel Reshef have suggested, this group's sharp increase in earning power appears more related to deregulation of finance (and perhaps other sectors). In other words, the big winners from "financial innovation" of all kinds over the past three decades have not been the poor (or even the middle class), but the rich –people already highly paid.

Finally, Acemoglu examines the role of federal government support for housing. To be sure, the US has long provided subsidies to owner-occupied housing – mostly through the tax deduction for mortgage interest. But nothing about this subsidy explains the timing of the boom in housing and crazy mortgages.

The FCIC minority points the finger firmly at Fannie Mae, Freddie Mac, and other government-sponsored enterprises that support housing loans by providing guarantees of various kinds. They are right that Fannie and Freddie were "too big to fail," which enabled them to borrow more cheaply and take on more risk – with too little equity funding to back up their exposure.

But, while Fannie and Freddie jumped into dubious mortgages (particularly those known as Alt-A) and did some work with subprime lenders, this was relatively small stuff and late in the cycle (e.g., 2004-2005). The main impetus for the boom came from the entire machinery of "private label" securitization, which was just that: private. In fact, as Acemoglu points out, the powerful private-sector players consistently tried to marginalize Fannie and Freddie and exclude them from rapidly expanding market segments.

The FCIC dissenters are right to place the government at the center of what went wrong. But this was not a case of over-regulating and over-reaching. On the contrary, 30 years of deregulation in finance, made possible by capturing the hearts and minds of regulators and of politicians on both sides of the aisle, gave a narrow private-sector elite – mostly on Wall Street – almost all the upside of the housing boom.

The downside was shoved onto the rest of society, particularly the relatively uneducated and underpaid, who now have lost their houses, their jobs, their hopes for their children, or all of the above. These people did not cause the crisis. But they are paying for it.