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Statement of Roger C. Altman
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Before the Senate Banking Subcommittee on Economic Policy
United States Congress

Mr. Chairman and Members of the Subcommittee, thank you for inviting me to testify before you today on American fiscal policy.

You are holding this hearing at a time of serious economic and financial fragility for the United States. More than two years after the trough of the Great Recession (June, 2009), our recovery has stalled and there is a serious threat of slipping back into negative growth. The sovereign debt crisis in Europe continues to rage, and that is undermining consumer, business and investor confidence. As a result of these two factors, severe and alarming strains have re-emerged in our own financial system and in the global system.

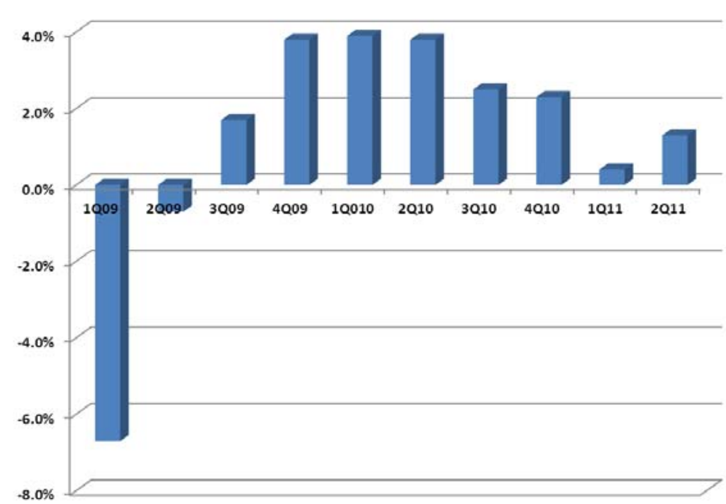
In other words, this is a dangerous moment from an economic and financial perspective. And, the decisions which the President and Congress make on fiscal policy over the short and medium term will play an important role in diminishing, or in worsening, those financial strains and our economic stability itself.

Economic and Financial Conditions Today

I want to spend a moment walking through this point on fragility.

First, the U.S. economy is threatened with renewed recession. It decelerated to an 0.8% growth rate during the first half of this year. That was down from 3.9% for the first half of 2010, as you can see in Table 1. Just a few negative developments, in financial markets, employment trends, or in overall confidence levels, could push this low growth rate into negative territory.

Table 1: GDP Growth



Source: Bureau of Economic Analysis

In addition, the present growth rate trend is far too slow to improve our struggling labor markets, given population growth. This is why net monthly job growth for the past three months has averaged only 35,000 new jobs, with zero jobs added in August.

The medium term outlook is also not encouraging. The latest IMF forecast for the U.S. economy over the second half of this year is a similarly meager 1.5%. And, the well regarded Goldman Sachs economic forecast is just slightly above that.

As for next year, Goldman Sachs' 2012 growth number is now down to 0.5%. And, in the face of such weakness, the U.S. unemployment rate will likely rise. That same forecast envisions an average 2012 unemployment rate of 9.4%. That is discouraging.

Further, the unemployment rate, while high, probably understates the real weakness in labor market conditions. The so-called underemployment rate (U-6) reflects those who have given up looking for work and those who work part time but would like a full time job. It presently stands at 16.2%, the highest since 1994. Moreover, the labor participation rate, which just measures the percentage of working age adults with a job, is 64% currently. That is a 27 year low.

The latest Census Department data on poverty is also important, and it received too little attention. 15.3% of the American population, or 45 million people, now lives below the poverty line. The latter is defined as income of $22,000 or less for a family of four, excluding in-kind benefits like food stamps. This is the highest percentage of Americans in poverty in 28 years.

My point is that this is a poor overall economic picture. There are two main explanations. The aftermath of the credit market collapse of 2008, the second worst financial crisis in 100 years, is still restraining consumers. And likely will do so for another few years. Household balance sheets, which were severely overleveraged when the bottom fell out (debt at 140% of household income) have only returned halfway to historically average levels of debt.

More household deleveraging will occur, driven by the continuing weakness in home prices, weak incomes and overall economic insecurity. This is why the personal savings rate, at 4.5%, is so far above the negligible level of three years ago. Which, in turn, explains why consumer spending, which constitutes approximately 70% of U.S. GDP, is relatively stagnant.

The other major factor contributing to economic weakness is credit availability and lending volume. Total bank loans to commercial and industrial businesses are well below 2008 highs. Present outstandings are $1.29 trillion, as compared to the $1.61 trillion high. This reflects the bad combination of tighter lending standards and weak loan demand. The problem is that such low levels of borrowing are not consistent with a durable economic recovery.

These factors explain why, according to CBO, the country is "only halfway through the cumulative shortfall in output relative to its potential level" which will have resulted from the Great Recession. The total of that cumulative shortfall is estimated at $5 trillion.

Let me also comment on financial market conditions, starting with credit markets. Again, two main points. One is that the level of yields on U.S. Treasury securities is so low as to be nearly incomprehensible. Or the Treasury ten year, for example, the yield is hovering around 1.80%. That is the lowest recorded level since the Federal Reserve System began publishing market data in 1953. And, it is a profoundly negative development. For, it signals negligible demand for capital and negligible inflation. These are hallmarks of recession.

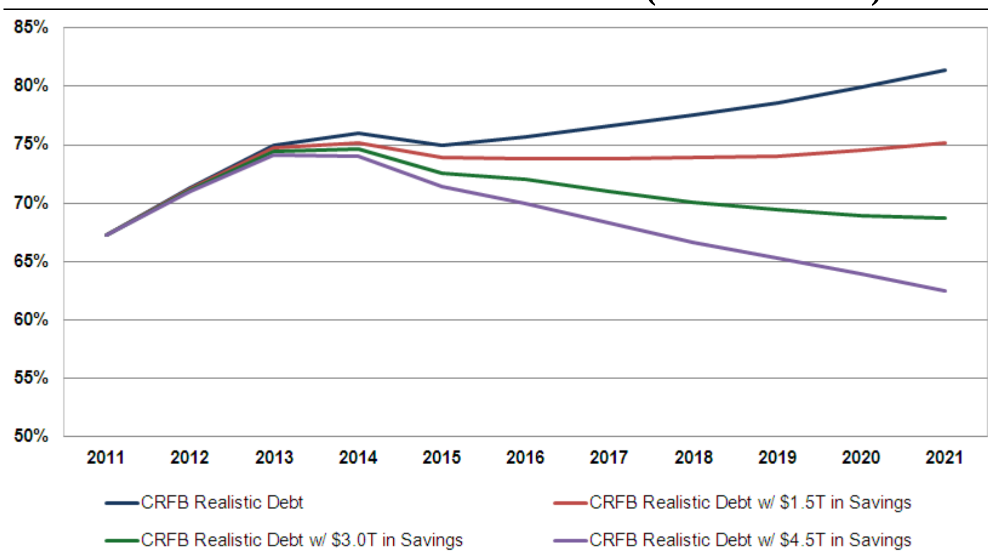
Second, the sovereign debt crisis in Europe, and the concomitant risk of a banking crisis there, has infected financial markets all around the world. Borrowing in public credit markets has recently become much more difficult. Stock prices have fallen nearly 20% since April, and equity financing levels have dropped accordingly. The window for initial public offerings, for example, has nearly closed. The fear factor which we saw so vividly in late 2008 and early 2009, has crept back into these markets. They are on a razor's edge.

<u>Role of the Federal Deficit</u>

The members of this Committee, and all of your Congressional colleagues, should recognize that they will be making crucial decisions on deficit reduction in the midst of this economic and financial fragility. The right decisions can help to alleviate it. But, poor ones can worsen it, even to the point of serious crisis.

We all know that the U.S. is on the wrong track when it comes to deficits and debt. CBO recently projected that the amount of federal debt held by the public will equate to 67% of U.S. GDP. That will be the highest ratio since 1951. Worse, CBO forecasts that, based on current policies, this proportion will be 82% by 2020. That would be the highest level incurred since record keeping began in 1792, excepting the period during and immediately after WWII. All of this is depicted in Table 2.

Table 2: Debt Paths Under Various Scenarios (Percent of GDP)



Source: The Committee for a Responsible Federal Budget,
September 7, 2011 report, *What We Hope to See from the Super Committee*

The federal debt grows, of course, in proportion to the size of the budget deficit. And, you well know that, in absolute terms, deficits hit all-time record highs in 2009 and 2010 and were still stratospheric at $1.3 trillion for the federal fiscal year which ended a few days ago.

These deficits reflect a historically wide gap between spending and revenue levels. Federal spending has been hovering around 23% of GDP and revenue around a modern historic low of 16%. This seven point difference appears to be the largest in our modern history.

It is obvious that this mismatch, and the scary rate at which it is increasing our debt/GDP relationship, is not sustainable. Everyone agrees that, unchecked, it will reduce productivity, incomes and our standards of living. There is also reasonable agreement on the magnitude of deficit reduction which America needs to cure this disparity. The Bowles/Simpson Commission set a goal of stabilizing the debt/GDP ratio by 2015 and beginning to turn it downwards from there. The amount of 10 year deficit reduction necessary to achieve this approximates ($5 trillion).

Fortunately, the tide of public opinion has moved, and moved sharply on deficits and debt. It would seem that the basic wisdom of the American people has asserted itself. For, polls indicate that the public is deeply unhappy over continued, record deficits and the explosion in federal debt, realizes the inherent dangers, and wants this path altered.

While this past summer's dispute over extending the federal debt limit was difficult, it did provide a modest breakthrough. A 10-year package of specific deficit reduction actions totaling $917 billion was agreed then. And, the twelve member so-called Congressional Super Committee was established. It is charged, as we all know, with devising an additional $1.5 trillion program of deficit reduction actions and submitting them to the full Congress by November 23. If the Super Committee cannot agree on a package, or the Congress votes down its recommendations, then $1.2 trillion of reductions in domestic discretionary spending over 10 years will be automatically triggered. Essentially, these would take effect in 2013 and cuts would be divided equally between the defense and non-defense portions of the budget.

All of this means that a minimum of $2 trillion in 10-year deficit reduction actions will be set motion by the end of this year. That is a good start but not enough. Further, difficult decisions by the Super Committee, the full Congress and the President would be necessary to properly adjust U.S. fiscal policy.

A Growth and Jobs Initiative

The economic slowdown and recession risk which I initially discussed represents a huge short term risk. Slipping back into negative growth, and seeing the unemployment rate rise again, would deliver a psychological blow to consumers, businesses and financial markets. They could retrench further and a downward economic and financial spiral could result. And, that could occur when the fiscal and monetary authorities are largely out of ammunition.

Therefore, it makes sense to undertake a short term, entirely temporary growth and jobs agenda. This would represent a form of insurance policy.

President Obama has proposed a $447 billion program of tax cuts, infrastructure spending and extended unemployment insurance benefits. The core element is a deeper one year extension of the 2010 payroll tax cut for employees and a similar one year payroll tax cut for small businesses.

In my view, the President's proposal is a sound one. And, it is clear to me that such actions, like the 2009/2010 stimulus program, would have a beneficial economic impact. But, there also are numerous, possible variations on the President's package. The point is that a short term growth and jobs package of this approximately magnitude should be undertaken now. Economic conditions demand it, and financial markets would welcome it.

<u>Long Term Deficit Reduction</u>

At this very moment, financial markets are pre-occupied with the European Sovereign debt crisis and the risks of renewed recession in the U.S. and Europe. That is why yields on U.S. Treasury securities, and German and British government bonds, are at all-time lows. Concerns over the long term deficit outlook, poor as it is, are secondary.

But, such views can change in an instant. It is just a matter of time before financial markets again are preoccupied with the threatening U.S. fiscal outlook.

At that point, the trajectory of interest rates will reverse itself. After all, the 10 year average yield on 10 year U.S. Treasuries is nearly three times the present yield. Then, if our deficits actually follow the CBO path, exceeding 80% of GDP, family incomes would be lower, productivity would be lower and our standards of living would be lower. That is not an acceptable outcome, which is why a major, long term deficit reduction package is necessary.

There are three possible outcomes for the Super Committee process. The first is, unfortunately, the most widely expected result. Namely, that the Committee cannot find a majority to support the necessary $1.5 trillion package of reductions and does not submit a recommendation to the full Congress. On that basis, the so-called trigger would be pulled, and $1.2 trillion of discretionary spending reductions would be initiated.

This outcome would be disappointing across the board. It would vividly underscore an inability to address such a fundamental and important problem. And, if financial markets were as unstable then as they are now, this outcome also could further destabilize them. I would urge the members of the Committee to work with other Senators to avoid this disappointment.

The second outcome would involve the Super Committee finding a majority on a credible $1.5 trillion deficit reduction package, submitting the related recommendations to the full Congress and having those pass and become law. This would send a reassuring signal to the public, and to the business and financial communities. At a time of such economic and financial weakness, this would be particularly helpful.

The third outcome, albeit unlikely, would be the optimal one. This is the “Go Big” scenario under which the Super Committee reaches agreement, on a much larger, and balanced package of deficit reduction actions. In effect, it solves the debt/GDP problem in one fell swoop with a $3-4 trillion 10-year agreement along the lines of Bowles/Simpson. And, one which wins the support of President Obama and a majority of the full Congress.

Provided that this did not take effect too quickly in such a weak economic environment, this is just the type of solution which could shore up consumer and business confidence, reassure financial markets and begin to restore public faith in government itself.