Statement of
David Malpass before the
Joint Economic Committee
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Vice-Chairman Klobuchar, Chairman Brady, members of the Committee, thank you for the invitation to testify on the debt limit. It's a vital economic and legislative issue.

The national debt already exceeds the nation's annual output, and the Administration is now requesting that Congress increase the debt limit above $17 trillion. As part of providing this increase, I think there should be an honest national debate on federal spending priorities and an agreement with the President on constructive spending restraint. There's huge economic upside for jobs, investment, the stock market and the dollar if you could lower the federal spending path or rewrite the debt limit to make it more effective.

The federal government is spending nearly $3.6 trillion per year and is planning to increase spending rapidly in coming years even with the sequester and the underfunding of national defense. Some of the spending is successful and adds to the nation's well-being, but another portion of the spending, several hundred billion dollars, is not successful enough to justify the taxes and debt used to pay for it.

This has created a spending and debt crisis that harms the economy and undermines investment and jobs. The crisis is particularly acute because several categories of federal spending will need to increase over the next two decades as the baby boom ages and requires more government services. Government health-care spending will more than double over the next decade to $1.8 trillion annually in 2023, while annual debt-service costs are expected to quadruple as interest rates normalize.

Given this demographic and interest rate cycle, spending and debt should be at lower-than-normal levels now in order to prepare for the coming increases. In addition, the maturity of the national debt held by the private sector should be longer than normal. Instead, the Fed's bond purchases have materially shortened the effective maturity of the national debt, and both spending and debt are at record levels even though the demographic bulge is just beginning to hit the federal budget. This leaves fiscal policies completely out-of-synch with long-term growth.

The debt limit provides a good opportunity to address this crisis. In negotiating the next increase, Congress and the Administration should take steps to downsize current spending and slow future spending growth. It's also vital to improve the allocation of spending -- less successful government programs should be reduced in order to make room for new programs and for more spending on successful programs. In my August 30 Wall Street Journal column, I advocated a menu approach in which the various parties suggest numerous methods to reduce spending and then negotiate a compromise.

Looking longer term, Congress should work to repeal and replace the current debt limit with a more effective limit. The current debt limit law is fatally flawed because Congress and the President are able to make unlimited spending commitments without first choosing how to pay for them. The debt limit law was initially created in 1917 to facilitate debt rather than limit it. The goal was to relieve Congressmen from having to vote for individual bond issues to fund their spending plans. This has left members unaccountable to voters – they get to create new spending programs and then let the Treasury Department and President demand more debt in order to pay for spending that has already occurred. The debt limit needs to be rewritten so that debt is approved prior to spending commitments rather than after-the-fact.

In my Forbes and Wall Street Journal columns, I've advocated replacing the debt limit with legislation to establish continuous spending restraint that strengthens when the debt-to-GDP ratio rises above a ceiling. I was privileged to work for Senator Bill Roth on this Committee in 1990 when he wanted to create a 50% debt-to-GDP limit. Unfortunately, the debt ratio is now more than double that, and it will take many years of continuous spending restraint to restore a more pro-growth debt level. In the ideal, there should be a downward glidepath for the debt ratio. It would set gradually lower debt-to-GDP limits which, if exceeded, would require Congress and the Administration to reduce their spending commitments or face escalating procedural restraints on spending.

I emphasis the huge economic and market upside from lowering the spending path and rewriting the debt limit to make it effective. Around the world and in the competition among U.S. states, investors reward spending limitations -- private sector investment and employment increase and median income rises. The second term of the Clinton Administration provides an example.

Movement toward spending restraint would also cause U.S. assets to appreciate materially. This lowers the cost of capital and creates more jobs. We've already seen a demonstration of that with the big market gains when the sequester was implemented. The sequester was a blunt instrument -- well-thought-out spending restraint would be even better received by financial markets.

There's been a great deal of discussion about whether an extended negotiation over the debt limit might unsettle financial markets or slow the economy. I think the benefits of a negotiation far outweigh the costs. Bond markets have examined the U.S. debt limit process and are very comfortable holding U.S. Treasury debt during debt limit negotiations – in fact, bond yields fell sharply during the 2011 negotiations, with the 10-year Treasury yield falling from 3.2% to 2% in July and August 2011.

In contrast with August 2011, it's unlikely that a major credit rating agency would downgrade the U.S. credit rating. I think financial markets would greet a partial shutdown of government spending during the debt limit negotiations with a yawn or quiet applause. The Administration would like to use financial markets to scare Congress into a clean debt limit, but I think the reality is that voter reaction will be the stronger referee on the debt limit negotiation. If voters think the negotiations are reasonable and constructive, they'll tolerate a partial shutdown, as will financial markets. There's no indication that financial markets are worried about a default or technical default on U.S. debt.

In making budget decisions, one of the confusing issues is whether austerity is bad for growth. Austerity or "fiscal consolidation" encompasses two separate economic policies: government downsizing on the one hand, which causes more growth; and private sector downsizing on the other hand, which causes recessions. Many of the reform programs undertaken in Europe were harmful because they were built on private sector austerity, not government downsizing. The austerity often took the form of higher value-added taxes, wealth taxes and increases in government fees.

As the U.S. examines options, it should aim to reduce ineffective government spending. It drains the private sector because it requires new taxes or debt. An open Washington discussion of spending restraint, even a contentious one using a menu of options -- would receive a very positive market reaction.

In addition to spending restraint, I think the debt limit increase should include three steps to make the debt limit more honest. In recent years, the Federal Reserve has incurred extra debt by buying higher coupon Treasury bonds at a premium. The cumulative premiums that the Fed has paid and includes in its liabilities is already $200 billion and climbing fast. It is true national debt and should be included in the statutory debt limit.

Second, the Treasury is planning to issue a new class of debt, floating-rate notes. This would understate the nation's fiscal burden because interest payments on this type of debt will go up faster than on fixed-rate debt when interest rates rise.

Third, the debt limit should also consider the burden the Fed is creating for future taxpayers by buying longer-term Treasurys with trillions of dollars in short-term Federal Reserve debt. This will escalate the deficit and the national debt when interest rates rise.

One of the reasons for a debt limit is to protect future generations. This is being undermined by the government borrowing short-term. One concept would be to require Treasury to maintain a five-year minimum on the effective duration of the national debt held by the private sector. The Fed's bond purchases and any floating-rate notes issued by Treasury would reduce the effective duration, causing Treasury to lengthen the maturities of its fixed-rate debt issuance.

In conclusion, the U.S. is stuck in a "new normal" of very slow economic growth, high unemployment and falling median incomes. Federal spending and debt trends are weighing on growth and investment. The debt limit provides an opportunity to break out. The Administration and Congress should create a menu of constructive restraints and agree on a package. Movement in this direction would create a very positive economic and market reaction. Changes made now, even if they take effect in several years, would bring immediate benefits by improving the debt outlook.