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THE ECONOMIC OUTLOOK

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BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

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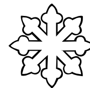

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THE ECONOMIC OUTLOOK

THURSDAY, APRIL 30, 2009

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC.

The committee met, pursuant to call, at 10:05 a.m., in Room 210, Cannon House Office Building, The Honorable Carolyn B. Maloney (Chair) presiding.

Representatives present: Maloney, Hinchey, Cummings, Snyder, Brady, and Campbell.

Senators present: Klobuchar and Brownback.

Staff present: Gail Cohen, Nan Gibson, Colleen Healy, Marc Jarsulic, Andrew Wilson, Lydia Mashburn, Jeff Schlagenhauf, Jeff Wrase, Chris Frenze, Bob Keleher, and Robert O'Quinn.

OPENING STATEMENT OF THE HONORABLE CAROLYN B. MALONEY, CHAIR, A REPRESENTATIVE FROM NEW YORK

Chair Maloney. The committee will come to order.

We are absolutely thrilled today to have Dr. Romer testifying, and I want to welcome Christina Romer, the President's Chair of the Council of Economic Advisers and thank her for her testimony today. The Council of Economic Advisers and the Joint Economic Committee were both created by the Employment Act of 1946 and share an important history of providing the White House and Congress with analysis of the economic conditions and effectiveness of economic policy.

This hearing today and our hearing next week with Fed Chairman Bernanke on the economic outlook are timely because there is a sense that the economy may be bottoming out. A few glimmers of hope have surfaced in the economy in recent weeks as consumer confidence jumped last month and credit markets have begun to thaw.

But yesterday's report that GDP fell at an annual rate of 6.1 percent in the first quarter and the huge job losses over the past 5 months are vivid reminders of a hangover from the Bush administration that we still have to shake.

The GDP and job loss numbers underscore the wisdom of the American Recovery and Reinvestment Act that Congress passed and President Obama signed into law in his first 60 days in office. The recovery measures are just starting to work their way into the economy, providing a much-needed boost. Americans are feeling more optimistic and are starting to spend more, which leaves me optimistic that we will begin to see the effects of the stimulus next quarter.

Taken together, the American Recovery and Reinvestment Act, the financial stabilization plan and housing reforms provide the framework for promoting economic progress. In addition, the House and the Senate passed our budget resolution this week. Our budget is fundamentally about priorities and I applaud the President for working with Congress to craft a blueprint that builds on our recovery efforts by making investments in health care, renewable energy and education, to put people back to work and strengthen our economy for the future.

Even before job losses began accelerating, many families were increasingly holding balances on their credit cards just to pay for basic household necessities. Because of this increased reliance on credit cards, especially by families of displaced workers, it is even more important that we pass legislation prohibiting unfair and deceptive practices that are hurting financially strapped households. The Credit Card Bill of Rights is on the House floor today, literally, and will, hopefully, pass today; and it will soon be taken up by the Senate.

So I hope you will understand the importance of getting this bill passed and will forgive me for having to leave this hearing early to go and help manage the bill on the floor. With the strong support of President Obama, I believe we can pass this bill and get working Americans some relief from mounting pocketbook pressures.

Nobel laureate Joseph Stiglitz testified before this committee last week and made a compelling case that we underestimate the impact of removing these kinds of predatory practices by only looking at potential reductions in the supply of credit when these practices are prohibited. Instead, we must also consider reductions in the demand for credit because of these practices. Reducing these fees and eliminating these practices will encourage creditworthy consumers to borrow and to buy goods and services which will help the economy recover from the current downturn.

I have some questions, Dr. Romer, that I would like to submit to your office; and I would appreciate your written responses to them. And again I want to thank you very much for your testimony and for being here today. We want to limit the opening statements today to just the ranking minority leader, Mr. Brownback, on the committee and myself in order to hear from Dr. Romer.

[The prepared statement of Representative Maloney appears in the Submissions for the Record on page 28.]

OPENING STATEMENT OF THE HONORABLE SAM BROWNBACK, RANKING MINORITY MEMBER, A SENATOR FROM KANSAS

Senator Brownback. Thank you very much, Chairwoman Maloney. I appreciate that.

Dr. Romer, welcome. I am delighted to have you here. I look forward to the testimony and comments you have.

I will put my full statement into the record, and just say at the outset, obviously the news yesterday was terrible on the contraction of the economy at such a rapid high rate. I was pleased to read this morning's paper, a number of people were saying, okay, I see

some silver linings in this. And I want to hear about those from you.

We are looking at—poised to have the longest recession, post-World War II period, and it doesn't look like, to me, we are out of the woods yet. I would certainly hope that we don't exacerbate it—the problem or lengthen the recession with increasing taxes, increasing taxes on small business. And I sure want to hear your thoughts about that as well.

Another thing that I would really appreciate, last week the chairwoman hosted what I thought was a very good hearing on what we need to do to get the banking system working again. And we had a panel, a Nobel laureate, a Federal Reserve chairman in the Midwest, testifying that too big to fail has failed; and we really need to work with some of these large institutions and just say, you know, it may be time that this goes through the normal process that you do when an institution doesn't work economically.

And I really want to hear what you have to say about that policy, whether or not you believe it is working or failing because it is a live issue, and I think it is a very important one for our credit markets to follow.

Also, it is just so obvious, you sit in the catbird seat on this one, about the amount of money we are putting into the economy, the Federal Government is, through monetary and fiscal policy. It may be at unprecedented amounts. It looks like, to me, we are virtually there; you on the fiscal side and then next week we will have Chairman Bernanke on the monetary side.

I am very concerned that we are going from a housing bubble to a government debt bubble on funding. Obviously, you could see those numbers, you can look back in hindsight and see that housing bubble build and build and build. And it was great going up and everybody enjoyed it. When it burst, it had a huge impact.

Well, if we build a big government debt bubble, how do you prevent that one from bursting, given the level of $3 plus trillion budgets, monetary policy producing large quantities of dollars being put out into the economy? And I really hope you give us some of your thinking and the advantage of your thoughts from where you sit on how you see us getting through this without having another big crash taking place once you—if you can slide on through this one, not creating another one on the other side of it. And I am certain you have thought a great deal about this, and I hope we can hear more.

Delighted to have you here. They are certainly challenging times. I have got a full statement to put into the record but I think the better thing would be to hear from you and let us have some questions with your time.

Thank you, Chairwoman.

Chair Maloney. Thank you very much.

[The prepared statement of Representative Brownback appears in the Submissions for the Record on page 28.]

Chair Maloney. And I would now like to introduce Dr. Romer. She is the Chair of the Council of Economic Advisers. Prior to joining the Obama administration, she was the Class of 1957 Garff B. Wilson Professor of Economics at the University of California,

Berkeley. Before teaching at Berkeley, she taught economics and public affairs at Princeton University from 1985 to 1988.

Until her nomination, she was codirector of the Program in Monetary Economics at the National Bureau of Economic Research and served as vice president of the American Economic Association where she was also a member of the executive committee. She is also a fellow of the American Academy of Arts and Sciences.

Dr. Romer is known for her research on the causes and recovery of the Great Depression and on the role that fiscal and monetary policy played in the country's economic recovery. She received her Ph.D. from the Massachusetts Institute of Technology in 1985.

Thank you so much for coming. I would love to invite you and Dr. Bernanke to come and talk about both of your research on the Great Depression and see what lessons you might have that we could use during this time.

We are fortunate to have you serving in government, given your expertise, your background on many of the issues we are confronting today. You are recognized for as much time as you would like. And thank you very, very much for your service and for being here today. Thank you.

STATEMENT OF CHRISTINA D. ROMER, CHAIR, COUNCIL OF ECONOMIC ADVISERS

Dr. Romer. Well, thank you very much. And certainly whenever Chairman Bernanke wants to come and discuss the Great Depression I would love to be here with him.

So Chair Maloney, Ranking Members Brady and Brownback and members of the committee, thank you so much for the invitation to join you today.

As Chair Maloney pointed out, the Joint Economic Committee and the President's Council of Economic Advisers do share a special relationship, and I am delighted to have my first opportunity to speak with you.

As I think we are all much too painfully aware, the United States is undergoing the most severe economic and financial crisis since the Great Depression. And so today I want to discuss the causes of the crisis, the policies that we are putting into place to address it and, as perhaps is most important, the outlook for the economy. So let me start just briefly with the causes of the crisis.

In thinking about how we got into the situation we are in, we need to begin with, as Mr. Brownback mentioned, the extreme fall in house and stock prices over the last 18 months. To just give you a number, housing prices, as measured by the Case Shiller index, have fallen some 27 percent since July of 2007. Stock prices today are roughly half of what they were at their peak back in October.

Now, why these two key asset prices have fallen so is a topic we could probably spend the whole morning discussing, but I think, regardless of their cause, the falls have had a direct impact on consumer behavior. By one measure, household wealth has fallen by some $13 trillion since its peak. The decline in wealth has inevitably led to a large decline in aggregate demand for goods and services.

The decline in asset prices has also been critical to what I think is surely the defining feature of this recession, which is the drying

up of credit. As housing prices declined, not only did the value of mortgage-backed securities fall, but uncertainty about their value rose dramatically. The volume of trades fell sharply and spreads between the interest rates on these assets and those on safe assets, such as government debt, rose tremendously, and this was disastrous for lending. When banks can't package their loans and sell them for cash, they become more cautious about making new loans.

On top of that, the collapse of asset prices put downward pressure on the asset side of bank balance sheets, and so banks sought to reduce their liabilities by letting loans run off and not making new loans. The decline in house prices also made potential borrowers less creditworthy and further reduced banks' desire to lend.

Finally, the dramatic failure or near failure of several major financial institutions in just about the first honest-to-goodness bank runs in over half a century no doubt increased banks' caution further.

Well, this restriction in credit had two devastating consequences. One is that it further lowered consumption and business investment and, hence, further lowered aggregate demand. The other, perhaps less well-known, effect of credit limitations or credit rationing is a reduction in efficiency. When credit is not available, consumption can't be smoothed over time in economic circumstances.

For example, students who rely on private lending may not be able to borrow to go to college so that they can earn even more in the future. Businesses can't replace outmoded equipment at the desirable time, and the overall productivity of the economy is reduced.

Now, last fall there was actually some debate about whether credit was actually all that important. The horrific falls, however, in employment and production over the last 5 months I think have largely ended that debate. Shuttered factories across the country simply screamed that Main Street and Wall Street really do intersect, and credit truly is the lifeblood of our modern economy.

The result of our credit disruption and the drop in spending has been, as I said, a very painful contraction in the economy. Total output of goods and services has now fallen for three consecutive quarters after barely rising over the previous three. The unemployment rate has risen from 4.7 percent in late 2007 to now—the most recent number was 8.5 percent; and as I am afraid we are all aware, payroll employment has now fallen by over 5 million. All right.

Well, in response to the economic crisis, the administration, working with Congress, has fashioned a broad, multifaceted plan that over time will cushion the downturn, bring about recovery and make the economy stronger and more secure in the long run. Although the plan has many parts, I think of it as having four critical elements.

The first is direct fiscal stimulus. The problems in housing and lending markets have led to a sharp decline in aggregate demand; thus, one crucial treatment is for the government to directly promote spending. This was the central purpose of the American Recovery and Reinvestment Act, which the President signed just 28 days after taking office.

The plan is quite simply the biggest and boldest counter-cyclical fiscal action in American history. The package amounts to roughly 2.5 percent of GDP over each of the next 2 years. And just to give you a useful comparison, the Federal Government's fiscal stimulus in Franklin Roosevelt's first full year in office was just 1.5 percent of GDP, and that was largely reversed the very next year.

Now, we expect the fiscal stimulus package to be incredibly helpful to the recovery. Because the spending is getting out the door quickly, we expect it to have a beneficial impact on output growth in employment well before the end of 2009. I have been told by the Office of Management and Budget that approximately $75 billion of spending under the Recovery Act has been obligated, and almost $14 billion in outlays have already occurred.

During the first 100 days in office, which the administration marked just yesterday, the Council of Economic Advisers estimates that the Recovery Act has already saved or created about 150,000 jobs. Of course, because only a small part of the spending and tax relief called for by the act has taken place and because much of the economy's response to stimulus occurs with a lag, most of the benefits of the act are yet to come. Our estimates remain that the American Recovery and Reinvestment Act spending will create or save 3.5 million jobs before the end of next year.

All right, the second key element of our comprehensive approach, as the chairwoman mentioned, is financial stabilization and rescue. We have initiated a number of programs designed to strengthen our financial institutions and restart the flow of credit. One piece that I would guess the Chairman of the Federal Reserve will talk about next week is our joint program on the consumer and business lending initiative; and this is the program designed to restart the securitized lending market, which accounts for some 40 percent of lending.

Another recently announced component of the financial stabilization plan was the program to facilitate sales of legacy or toxic assets. Banks and other financial institutions have a large number of mortgage loans and mortgage-backed securities on their books. And the value of these loans is hard to determine because the market has virtually disappeared. So the Treasury is partnering with the FDIC, the Federal Reserve and private investors to try to restart this market through the Public-Private Investment Program.

A final component of the financial rescue plan is a careful evaluation of the health of the 19 largest banks in the country. The so-called "stress test" asks regulators to evaluate whether banks have enough capital to weather a more severe downturn than is currently anticipated, a process that, as you know, is almost reaching its end. At the end of the evaluation regulators will decide—if regulators decide that banks need more capital to be safe and maintain confidence, they will encourage banks to raise private capital, but the Treasury is going to be prepared to provide public capital, if needed, through the Capital Assistance Program.

Though the financial stabilization plan is still just in its very early stages, we are optimistic that it will play a critical role in the economy's recovery. By restarting lending, it should have beneficial effects on aggregate demand. Credit-constrained households and businesses should be able to spend and invest again.

All told, the spending that could be unleashed is surely very large. In fact, Secretary of the Treasury Tim Geithner is fond of saying there is more stimulus in financial rescue than there is in the stimulus.

The third element of our comprehensive recovery plan is direct help to the housing market through our Homeowner Affordability and Stability Plan. The crisis began in the housing market, as I mentioned, and defaults, foreclosures and falling house prices are contributing to the downward spiral of the economy.

Now, our housing plan has several pieces. One is to work with the Federal Reserve to bring down mortgage rates. And these actions have helped to bring rates to historic lows. The lower mortgage rates have set off a wave of refinancing. Indeed, recent numbers say that refinancing applications have jumped nearly 80 percent since the program was announced in mid-February. This is important because the refinancing activity has the potential for macroeconomic benefit.

If you think about a family that manages to refinance their mortgage at a lower rate, their payments go down; it is almost as if they have gotten a tax cut. And, indeed, Mark Zandi, a noted forecaster, has said that our housing plan has about the same stimulus as if we had done a $30 billion tax cut.

Another key piece, of course, of the housing plan aims to reduce foreclosures. And the Treasury has announced a program that encourages banks and loan servicers to modify mortgages so that payments are more manageable and homeowners are able to remain in their homes. By preventing millions of homes from being dumped on the market, not only do we have the very desirable effect of preventing the tragedy of foreclosure, but we also prevent having a lot of homes there on the market that tend to bring down housing prices. As we know, foreclosure sales tend to lead to very low prices, so we think that this is something that has the potential to help stabilize house prices.

All right. Well, the fourth and final element of our comprehensive plan involves starting to address our long-run economic problems. Even in the midst of an economic crisis, we are trying to take actions that will make the economy stronger in the long run.

The focus on the long run, of course, was evident in the American Recovery and Reinvestment Act, as the very name suggests. Though any spending would be helpful for creating jobs, we, working with the Congress, focused on spending that increases productivity in the future, such as investments in health information technology, infrastructure and a smarter power grid.

As you are well aware, the budget resolution that just passed provides for continuing investments in education and energy. In addition, we are committed to fundamentally reforming health care in the United States. Health care reform is central to our long-run fiscal prospects because the rising costs of health care are the single major determinant of future budget deficits. More fundamentally, our broken health care system is depressing American standards of living and leaving tens of millions of us without health insurance.

Finally, we have begun to work on fixing our financial regulatory system. The specifics of how to best regulate financial institutions

are a difficult and complex issue, and the detailed proposals will require careful study and hard work, but it is clear that the system that allowed our current crisis to occur cannot be permitted to continue.

All right. Well, where does all of this leave us? I have talked about the causes. I have talked about our response. What is the economic outlook? I am sorry to have to start with a sad fact, but in the short run we are surely in for more bad news. The economy we inherited was so weak and deteriorating so rapidly that even the aggressive actions we have taken can't turn it around immediately. I often like to compare the economy to a supertanker. Its momentum is so great that it responds to the forces pushing on it only slowly and gradually.

As was mentioned just yesterday, the advanced first quarter GDP numbers were released. They showed that overall output continued to decline rapidly in the first 3 months of this year. The rate of decline was 6.1 percent as an annual rate; and we, like most private forecasters, expect another decline in the second quarter, and we expect to see continued declines in employment and rises in unemployment for the next several months.

But there is every reason to think that the policies we have put into place over the last 3 months, together with the natural strength and resiliency of our workers and businesses, will spur recovery. Already as the President likes to say, we have begun to see glimmers of hope that our economy is stabilizing. Here, I would mention a couple.

The housing sector has shown some tentative signs of finding a bottom, housing starts increased slightly from January to March, and builder confidence in April rose substantially. The fall in housing prices appears that it may be abating.

As of Tuesday, the S&P 500 had risen some 26 percent from its low point, showing at least one financial market indicator doing better.

And perhaps most importantly, consumer confidence has increased, indicating that the American people are increasingly optimistic about our recovery. And indeed this is one feature of yesterday's GDP report, that consumer spending rose some 2.2 percent in the first quarter, suggesting that the rise in confidence is actually being reflected in spending behavior.

This development, together with the fact that nearly half of the fall in GDP in the first quarter reflected negative inventory investment, could suggest that firms will need to start producing again to meet demand. We currently expect the pace of the overall decline in the economy to moderate sharply in the next several months.

This is consistent, for example, with the Blue Chip consensus forecast, which shows a rate of decline in GDP of 2.1 percent in the second quarter. We expect the economy to level out in the second half of the year and then begin to recover.

Whether the recovery begins in earnest later this year, as most private forecasters predict, or takes a bit longer is hard to know because labor market indicators tend to lag changes in output. Most likely we will see positive GDP growth before we see increases in employment and declines in the unemployment rate.

The President's economic team is keeping a watchful eye on all aspects of the economic situation, and we will certainly not rest until we are assured of long-term and lasting recovery with robust employment growth. Because the downturn has been so long and so severe, the recovery will almost surely take a long time. But as I have stressed, our intent and our expectation is for the economy not just to recover but to emerge even stronger and more resilient than before.

Thank you. And I would be delighted to take any questions you might have.

[The prepared statement of Christina D. Romer appears in the Submissions for the Record on page 30.]

Representative Hinchey [presiding]. Thank you very much, Dr. Romer. And I think we all very much appreciate that statement that you just gave. It is very insightful and I think it clearly understands the set of circumstances that we are dealing with and the need to continue to address the set of circumstances.

That is somewhat controversial, the need to continue to readdress them. And I think, in the opinion of some of us, that needs to continue; and I think, largely the main evidence of that is the impact that this economic circumstance is having on working people, the middle-income people.

With continued decline in employment, we are continuing to lose about half a million jobs a month. And as you indicated in your testimony, household wealth has gone down by $13 trillion.

The mortgage situation is improving to some extent, and that mortgage situation was based to a large extent on the subprime mortgage issue, which was created back several years ago. It seems, though, also, that some of these houses that are being bought by wealthy people and then put out for rent, not that they are being bought by middle-income people, the people who have lost their houses and are now trying to come back to them. I think that is something that really needs to be addressed, and I think—that seems to be the case, and I think it needs to be understood and then more effectively dealt with.

One of the problems that the working people of this country are experiencing on a daily basis is the increase in debt. There is a very, very substantial increase in debt, particularly of working people. That increase in debt stretches across the economic pattern, but a large part of it is credit card debt.

I wonder if you could tell us something about that and what you think about that situation and how it should be dealt with.

Dr. Romer. You raise many important points. One of the things that we—you are absolutely right about the rise in consumer indebtedness. The other thing, as you mention also, that kind of goes together with the tremendous decline in wealth that we have seen because people's housing wealth has gone down; if they were fortunate enough to have some stock market wealth, that has certainly gone down.

I think what that means going forward, certainly for our macroeconomists like myself, looking at where the economy is going to be, I do definitely predict that we are going to see higher savings rates going forward. And this actually comes back to some of the things that Mr. Brownback talked about. Because, you know, one

of the things—the President often talks about a post-bubble economy, how do we not go back to going from a high-tech bubble to a housing bubble? And I think one of the parts of that is people saving more, sort of more moderate kind of growth in the various parts of the economy.

So I do think that is going to be an important feature going forward. I do think it is going to be something that will be a bit of a challenge going forward, because if consumers are not going to be where the growth is coming from, if they are not going to come roaring back to their old very high—you know, high-debt, high-spending ways, then we need to find some other mechanism.

And I think, again going forward, what would be best for the economy is to move to a place where we have more private investment, taking up the slack in aggregate demand, something that will put us on a trajectory for faster growth in the whole economy, faster rising wages for workers if we have productivity increase.

I think all of that would be important.

I wanted to say one word about what you were saying about the move from purchasing to rental housing. That is actually an issue I have heard the President talk about in the sense that it is certainly better to have those units up for rent rather than just sitting vacant, which is happening in so many places. So though it is very sad not to have—you know, the home ownership not play the same role, but at least having those units be used and helping the rental market, I think, would probably be a positive development.

Representative Hinchey. Well, I agree with that. But at the same time we need to be doing something that is going to allow people to continue to purchase their homes rather than just rent them, because that puts them in a not very good economic circumstance.

Yesterday, the President in his press event at 8:00 yesterday evening talked about the situation of indebtedness and interest rates; and there are some efforts here being done to look at the high rate of interest rates on credit cards and things like that and dealing with that situation in some positive way. Is there anything that you would have in terms of a suggestion for us to deal with that set of circumstances? Because that is a problem that is deeply affecting a growing number of people in this economy.

Dr. Romer. Absolutely. And as I am sure Chairwoman Maloney knows, the President is a very strong supporter of the credit card bills that are on the floor today and the one in the Senate, because we definitely have a sense that there have been problems, abuses in this market. And doing things that are going to help, that are going to help consumers make better choices, protect them from abusive practices, I think absolutely those are very important things that we need going forward.

And then on the issue of, you know—and part of that feeds into things like—you know, things like when people make a payment over their minimum payment, applying it to the higher interest rate balance, not the lower interest rate balance. I think all of those are so important for consumers, as you put out, to help them get out of any debt overhang that they have, but also to be in a better position going forward.

Representative Hinchey. Thank you very much, Dr. Romer.

Mr. Brownback.

Senator Brownback. Thank you very much, Mr. Chairman.

Dr. Romer, thanks very much for being here.

It really looks like, to me, we are creating a government bubble. We have done a housing bubble, well documented, and you talked about it; and I am very concerned about this. I am very concerned about it from a monetary and fiscal policy, and we will talk about it on Monetary Policy next week.

But how do you back out of this? I mean, you are saying, and most private forecasters are saying, we start to flatten out, maybe a slow growth at the end of this year. It looks like we might be on track to do that. Unemployment always lags, so that is going to lag afterwards.

But, my word, the level of this debt is huge. And I know you have got to be concerned about that. So how do you back out of that without it bursting on us?

Dr. Romer. All right. I will admit that I am as worried about the deficit and the debt as you are, and I would say the President is as well. I mean, that is something that he is very, very much aware of. So there are a couple of things I would say.

The first is, I think we need to distinguish what we are doing right now from policies going forward, because in the middle of a severe economic crisis, I feel very strongly the actions that we are taking, even an $800 billion fiscal stimulus, a $700 billion financial rescue, that is money well spent simply because if an economy goes into free fall, there is nothing as bad for government revenues and for the——

Senator Brownback. I think a lot of economists would agree with that point.

But you were talking about 2.5 percent of GDP over the next 2 years and an unprecedented amount of spending, which it is—an unprecedented amount of spending. But if you are coming out of it, why wouldn't you then back out of that spending—like, say, if we are coming out of it at the end of this year, it would seem to me prudent on your pulling back out to say, well, okay, then we are going to pull back out of the government spending bubble because—not at a rapid pace or not at any sort of cataclysmic pace that you synch things back in, but it wouldn't seem wise to continue that level of spending for another year if you are pulling out of this.

Dr. Romer [continuing]. I would have to say I disagree. Because if you think about the—well, first of all, 2.5 percent real growth, which is what, say—I think the Blue Chip is even a little lower than that for 2010, that that is really—you need to grow more than 2.5 percent to bring down the unemployment rate.

If real GDP is only going up 1 or 1.5 percent, you will actually see the unemployment rate continue to rise. So we not only need growth in 2010, we actually need pretty rapid growth to bring the unemployment rate down. If you think about just how far we have fallen, a typical pattern is, then you need a period of very rapid growth to get back to the old path.

So I would absolutely—I mean, if you think about where we are likely to be in 2010, I don't think anyone is thinking of the economy being robustly healthy. And so you actually—and those fore-

casts are predicated on the amount of spending that has already been approved with the Recovery Act. So I think if you were to ask those Blue Chip forecasters, suppose we took out $300 or $400 billion of fiscal stimulus, what would be your forecast for 2010, it would be much less than the 2.2 or 2.5.

Senator Brownback. I hope you really watch this, and I am certain you will because these numbers are gargantuan and you know they are gargantuan. These are unprecedented levels; and it sure seems like to me, if you start pulling out of this, you would sure want to ease up on your government bubble that you are doing in this.

I don't get much time here. So one other thing I wanted to ask you about was the too-big-to-fail policy. We had a hearing on it last week, a Nobel Prize-winning laureate and a former regulator who were both saying, you really should put these—the big institutions, your 19 biggest or, particularly, the four largest, through the normal process you do all other banks if they get too highly levered and they can't function; and you need to take them through what we did with Continental Illinois or what the Swedish system did at their banks.

What do you think about that?

Dr. Romer. Again, I think there are two issues. There is the immediate issue of, if you have got big banks that are in trouble, what do you do with them.

And I think one of the things—you know, what we described—we all are giant fans of the FDIC. And one of the things I think doesn't get enough play is, we have a number of banks that have gotten into trouble, small banks.

The FDIC comes in. They deal with them. They shut them on a Friday; they are back open on a Monday. It is a process that works very well for small banks.

I think what we have come up against is, when you have very big banks that are very complicated, bank holding companies and all of this, it is a much more complicated process to do something that sounds like exactly what you want to do, a quick and easy, you know, clean 'em up/put 'em out.

So that is really the issue that we are facing: How do you deal with these in a way that doesn't set off a bank run, doesn't create uncertainty about the other banks in the system, all of that?

So the reason—so anyway—so that is mainly a way of saying what we have proposed—I know what Secretary Geithner has been talking about very much—is the need for a new financial regulatory system that includes someone keeping track of these banks, making sure they don't get to be too big to fail and to set up a mechanism, a resolution authority for, if you have got a big, complicated bank that needs to be dealt with, you have got the tools to do it. Because, right now, we just simply don't. We don't have the equivalent of the FDIC for these big complicated banks.

Senator Brownback. The group we had in last week said we do have the tools to deal with this now. I recognize that you want additional ones. But they believe that the tools do exist to be able to use that.

Thank you very much for your expertise and thoughts.

Representative Hinchey. Thank you, Dr. Romer.

Mr. Cummings.

Representative Cummings. Thank you very much, Dr. Romer. Welcome. I was very pleased to hear your testimony.

Dr. Romer, a lot of people are looking at these banks, and consumers in my district are feeling very frustrated. And, in some instances, people feel that we have a phenomenal transfer of wealth here—I know you may not look at it that way—they see their tax dollars being spent, as Senator Brownback just talked about. I mean, they see money going out, but then they see the banks seeming to not be that anxious to lend.

But I am just looking at this Public-Private Investment Program, for example. Will the effort to relieve banks of toxic assets be successful if banks aren't willing to participate?

Dr. Romer. I mean, you raise so many good points. Let me start with——

Representative Cummings. You understand the frustration of the public?

Dr. Romer [continuing]. I do. I do. As a consumer and a citizen, I share it. Right. So I certainly understand.

I think what all of us, who have been watching this and working on the recovery plans, I think one of our jobs is to point out that as frustrating and as much as we wouldn't want to do this, it is what is, in fact, best even for ordinary Americans.

This has never been—dealing with the banks has never been because anyone wanted to be nice to the banks. It was fundamentally because we want them—we know they play a crucial role in the economy; and if lending collapses, we now have concrete proof of just how devastating that is for the ordinary Americans that lose their jobs. So that is the big picture here.

And the difficult thing, of course, is, we see us putting money into the banks, trying to deal with things, and you know, there is some—you know, we have seen lending kind of hold even, but we haven't seen it shoot up the way that we would like to see.

And so what is so hard is knowing what would have happened in the absence of the government intervention. And so it is never a fun case to have to make. But to say it would have been so much worse had we not done this is, unfortunately, probably what is true. But I agree, it is not very satisfying.

The Public-Private Investment Partnership, that is going to be something—again, we are going to have to see. There are those who have said, gee, it is too generous, everybody you know will want to do it; and others will say, no bank will want to participate. So this is definitely sort of the design feature, the design challenge, and have to see who shows up and if it works and if we have to tweak it if we aren't getting the results we want.

But we do think it will be helpful to have a mechanism. Because some of these assets, not only is there a real question about their value, but there is also just a lot of uncertainty. And there is the thought that having them on the balance sheet just prevents private capital from coming in and makes the banks nervous and not willing to lend. So we actually think it could be a very useful mechanism.

It also may just—coming back to some of the questions that have been raised, it may also provide a good way—if the regulator comes

in and says, you know what, I would feel a lot better if your balance sheet looked better. It is a framework where they could say, there is this lovely facility, go use it. And I think that that could be a way that it could be very useful to use.

Representative Cummings. Let me ask you this: Does the continuing financial crisis reduce the potential effectiveness of the economic stimulus, do you think?

Dr. Romer. That is an interesting question. My own view is that these two things sort of reinforce one another. So I think—the way I would say it is, the fiscal stimulus package is probably helping the financial rescue, because to the degree we can get the economy going again, to the degree we can get stock prices and housing prices going up again, that is going to be great and make it easier for the financial system to recover.

I think the point you are saying is, the more the financial system recovers, the more effective that fiscal stimulus is going to be because we give people a tax cut. If they can also get credit, they are more likely to go out and buy a car, they are more likely to go out and buy a house. So it will be reinforcing.

I think it is part of our strategy, and I would guess that the Chairman of the Federal Reserve will tell you a similar thing is getting—you know, attacking recovery along many dimensions make all the pieces more successful.

Representative Cummings. Thank you very much. I see my time is up.

Dr. Romer. Thank you.

Representative Hinchey. Mr. Brady.

Representative Brady. Thank you, Mr. Chairman. For the sake of time, I appreciate the opportunity to provide my statement and will submit it for the record.

Representative Hinchey. Without objection.

[The prepared statement of Representative Brady appears in the Submissions for the Record on page 37.]

Representative Brady. For the record, it is fascinating, compelling reading; and if I were you, I would not go to sleep tonight until you have memorized it.

Dr. Romer. Yes, sir.

Representative Brady. That is just me. That is just my view.

Dr. Romer. Here I thought you were holding up my statement, and I was getting a compliment.

Representative Brady. I may do that too, Chairwoman.

Dr. Romer. We will both stay up all night reading.

Representative Brady. Great.

Well, thanks for being here today. I have three concerns, that the rosy economic assumptions included in the President's budget mask much higher deficits that the budget that Congress rushed through this week, yesterday, ignores the true financial—the cost of the financial rescue plan.

And then I have got a serious question about Treasury and the special investigator's—inspector general's report from last week and about how Treasury is not responding to it.

The first concern, rosy economic assumptions, the President's budget projects real GDP will decline by only 1.2 percent this year. Blue Chip forecast, dramatically different than that; this first quar-

ter, dramatically different than that. The end result is that we will end up with much higher deficits.

So given the data that is now available today, would you agree the administration's forecast for the year appears to be too optimistic?

Dr. Romer. Well, I will say, we certainly did our forecast back in early January, and we absolutely—the economy did deteriorate after we did it, and most private forecasters also sort of downgraded their forecasts. So I think it was right in the middle of the pack, at the time it was done, by the time the budget came out. I think it was more optimistic than most.

I have to say, I think we may ultimately be vindicated, quite honestly. I think what we are seeing in a lot of the forecasts, as they are coming out, is a real change; I mean, there is the sense that those glimmers of hope are starting to cause people to rethink some of their assumptions. We know, for example, the CBO forecast that came out in March was more like ours, at least in 2010, than it had been originally.

And so, anyway—so I actually—I think it is certainly possible that it will turn out to be completely correct.

That said, we are going to—we always do a mid-session review, and we will be doing another forecast in the next couple of months. So we will make honest budget estimates based on our best estimates of where we think the economy is at that time.

Representative Brady. I did get a chance to question Secretary Geithner about these forecasts. At the time, it appeared to be nowhere near the middle of the pack and very worrisome.

I do agree with you that adjusting to the economy is important. And as the administration produces any new quarterly estimates, could you provide them to the committee? Because I think this—really that budget assumption underlies and affects a whole lot of our problems within the budget.

Second question: This morning, the *Financial Times* reported that International Monetary Fund estimates the U.S. taxpayer cost of the financial cleanup could be up to $1.9 trillion over the next 5 years. None of that is included in either the President's Budget—well, $250 billion was included in his—and zero in the budget that we approved yesterday.

So I think, how can Congress, how can the White House make informed decisions on budget priorities while ignoring a nearly $2 trillion cost over the next few years?

Dr. Romer. The important thing to say is, there is incredible uncertainty about what it will take to heal the financial system and how much taxpayer money will be needed. So I think the—I would go—again, it comes to, there is indeed a lot of uncertainty about what the economy is going to do. If the economy does grow more quickly, I think there is every reason to believe that the kind of actions we are taking will be enough to heal the financial system. It is just very hard to know.

The International Monetary Fund, I would say, doesn't have—you know, they are a very fine organization, but whether they have really good estimates of exactly what the cost is going to be, I think is highly questionable.

I think the real thing is, there is just a tremendous amount of uncertainty. And that was why the President put—the placeholder in the budget was to say, we think we have enough now. We have a plan for using what we have now. But we wanted to signal in case we needed more to have the honest budgeting.

Representative Brady. I would agree there is a great deal of uncertainty around all these unprecedented actions. But even if the IMF was off by 50 percent, we are at a $1 trillion hole there.

And maybe you do know. Are there any estimates, credible estimates, that say there will be zero cost to taxpayers over the next 5 years?

Dr. Romer. We what we certainly know, we have already—the original TARP funds. We have had the $700 billion, and the question is going to be what fraction of those turn out to be losses and what fraction does the government get paid back? So we certainly have to think about those.

I think there are absolutely credible estimates that have to do with how, you know, how fast the economy grows, all of those. I think something like the IMF, there is so much reliance on historical estimates; what these studies are typically based on is, other countries that have had these problems, this is what it has cost in terms of GDP. But one of the things that fails to take into account, obviously, is differences in the size across these episodes, but also differences in the policy response.

I mentioned in my testimony, we have never had counter-cyclical fiscal action this bold before, right; and I think it is very likely that it may be an important part of turning around the economy and making, as I said in response to one of my earlier questions, making the financial rescue less costly, easier to do.

Representative Brady. One thing I appreciate about the IMF report was, they didn't look just at the bailout. They looked at all the bank—the direct support, the bank funding guarantees and the nonstandard central bank loans, all of which are, as you said, very uncertain; much of it is unprecedented.

And I just think this is a credible organization. They raise an issue that is worrying a lot of people, a lot of lawmakers these days. And I think we would be better to err on the side of caution in putting those dollars in the budget, rather than ignoring it completely.

The final question deals with the TARP and the public-private investment funds that are really key to the administration's efforts to deal with the toxic loans that are on the books today.

Last week, this committee had the Special Inspector General Neil Barofsky, and he told us a couple of things that were very troubling. One is that he believes that many aspects of the Public-Private Investment Program could make it inherently vulnerable to fraud, waste and abuse; and he has made recommendations to the Treasury how to stop these vulnerabilities before they become a problem.

And then he also in his report recommends that all TARP recipients account for the use of their funds, set up internal controls to comply with such accounting and certify a compliance. And he told this committee that the administration, to date, has not accepted

either the recommendations on accountability for TARP or the recommendations to accept just basic safeguards.

Do you know why Treasury would not accept those independent recommendations? Or is there a timetable that you could give us when we will have assurances? Because building on rosy economic assumptions, ignoring the costs of the financial rescue plan, then adding on top of that more taxpayer risks within the bailout, all three become a pattern. And I think it would build confidence in the program and confidence on Capitol Hill if Treasury were to begin accepting some of those basic safeguards.

Dr. Romer. All right. So on your specific question, I am going to have to get back to you because I don't know what the timetable is.

But what I can tell you is, you know, from the President right on down, the emphasis on accountability and transparency in the recovery actions, in the financial rescue, have been unprecedented. I know that is a top priority for the President.

So I will certainly—I will certainly mention it to the Secretary of the Treasury and try to get you more information because, you know, I know—and certainly in our design of the Public-Private Investment Program, we obviously don't want to have any chance of fraud. Nothing would be worse for the program, worse for the Treasury. And so figuring out what we can do to prevent that will be a top priority.

Representative Brady. If you would do that, I think it is important.

This is a bipartisan issue. We were not pleased with the accountability in the Bush administration on the TARP funds; not pleased or satisfied with the accountability so far in the new administration and with the public-private investment vehicle.

Why not stop those abuses before they occur? Please deliver that message to the Treasury Secretary.

Dr. Romer. I will. Right after I memorize your report, I will do that one.

Representative Brady. Don't do that. But thank you, Madam Chairman, for being here today. Thank you, Mr. Chairman.

Representative Hinchey. Thank you.

Mr. Snyder.

Representative Snyder. Thank you, Mr. Chairman.

Dr. Romer, it is great to have you here today on this, the 101st day of the Obama presidency, the key benchmark by which we judge all history—like Dalmatians, I guess, 101 Dalmatians.

I wanted to ask—first of all, by the way, not all of us think it is a clear-cut wrong decision that Secretary Geithner doesn't agree with everything the inspector general does with regard—I think I share your concerns about the fungibility of money. And I think, as investors in some of these institutions, we want all their projects to do well, not just the ones that they say, this is where the TARP money went. I think there is a broader issue there than just what happens to the TARP loan moneys.

Dr. Romer, would you tell us how we should view the added uncertainty in the economy both here and abroad that may be created by the threat of a major health flu pandemic around the world? How should we view that?

Dr. Romer. Well, of course, it is a major concern, primarily, of course, from the public health issue, and so that certainly within the administration we are taking the attitude that public health is job number one and the thing, of course, that the President is focusing on unbelievably.

But, of course, one does—I mean, my job is economics. So one of our jobs is to think about what would be the possible economic consequences of this. And I think your uncertainty—so there are two things to think about.

The fundamental determiner, of course, is going to be how severe it is, and that is something that we are just now trying to get the information. Are we looking at a more typical flu and a flu with a sort of a typical kind of mortality rate, or is it something much more severe? And that is going to fundamentally determine the public health consequences and the economic consequences.

So I think, you know, at this point you are right that uncertainty is probably the biggest effect right now, whether it will make consumers nervous, whether it will make, you know, people—governments will have to take actions that unfortunately will have economic consequences; that is certainly what we are facing.

But certainly the administration's job number one is do whatever it takes to make sure that lives are saved.

Representative Snyder. Just my own editorial comment. And I appreciate what you are saying about number one is public health. But as you know—and I think it has probably been your life's work—poverty also is a killer. And if this delays the economic recovery for 3 months, 6 months, 1 year, 2 years—I don't think it will, but if it has that kind of potential—that also leads to devastating consequences for those families who are in destitute poverty all around the world for that length of time. And that is literally a physical killer also.

So I think that is very appropriate, what your comments were.

I wanted to ask one very specific question. You are the Chairman on the Council of Economic Advisers. I would think you would make a lot of people happy if you go back and advise the President from your council that, you know, you really do need to move this trade with Cuba along. I mean, there are some things they could do tonight before 5:00 that would dramatically increase our ability to sell agricultural exports to Cuba that would turn into hundreds of billions of dollars in the next few months in additional revenues coming into this country.

It makes no sense to many of us why we are not doing that. And you can put on just your economic hat and not your Florida political advisor hat, or whatever hats there are, in being more aggressive about this. But if we want to do something to help certain segments of the country, that is a very, very simple thing that would translate into real money and real jobs for people.

Dr. Romer. I mean, you are certainly raising an important issue. And as you allude to, while I do economics, I am quite aware that there are many other factors, political and diplomatic and whatever, that are affecting this.

Representative Snyder. The thing about the agricultural products though is, it is already our policy to sell agricultural products there. It is just we have got some intricacy in the financing that

was brought about by the Bush administration. I don't think this is a huge new river to cross. It could be done very, very rapidly, and it would mean a lot to our agricultural exports.

Dr. Romer. I will certainly take the message back and see what I can find out.

Representative Snyder. I wanted to ask in the short time I have left, we have heard over the years people refer to the fundamentals of the economy.

What is the list? What are the fundamentals of an economy? And how are they doing?

Dr. Romer. That is an excellent question, because for an economist, especially an macroeconomist, when I teach my students, we often talk about the short run, sort of where are we in the business cycle over a 1-year, 2-year horizon; and what is the level, say, of GDP growth or unemployment that we come back to? Because if you look at a picture, say, of GDP, it wiggles around. But the thing that hits you is, it is on an upward trajectory.

So when people talk about the economic fundamentals, they talk really about the determinants of that long-run trend and are we growing at 2.5 or 3 percent on an average basis year after year? Or is it something anemic like one to 1.5 percent, right?

That maybe doesn't make a big difference in 1 year, but if you look over a decade or a generation, that has an incredible effect on standards of living, right? So if you can just get the growth rate up a little bit, because it happens year after year, that normal, long-run growth rate, that has a huge effect on standards of living, so the things that we think determine that long-run growth rate, right, what is happening to your labor, your capital, and your productivity.

And so that is why—if you say, what has the President been looking at? He has been so interested in getting us out of this short-run fluctuation, but he has also been interested in when we come out, what does that long-run trend look like. That is why he has put an emphasis on education, improving our energy delivery system, putting an emphasis on getting more efficiency in health care because that is the giant piece of the economy that is supposed to explode over time; getting productivity improvements there are just absolutely crucial.

So when I think about the long-run fundamentals, I do think they are sound. I do think that we have a fundamentally good educational system, well-trained workers. We have got a capital stock that is the envy of the world. We have had some of the fastest productivity growth, technological change. I think the real thing is going to be maintaining those things, doing what we need to make sure—like stimulating, you know, his work on science and investment in R&D; that is a crucial determinant. You know, over the long term are we doing—you know, are we coming up with new technologies? That has been the fundamental determinant of economic growth over generations, over centuries. Do we keep that up? Anything you can do to get more technological progress, more of these innovations, that is going to put you on a trajectory for higher growth.

So that really, I think, explains the President's emphasis. And the reason I am optimistic is, I think we are doing really good

things, not just to get us through this crisis, but to make sure on the other side we are growing faster.

Representative Snyder. So it also explains why you share Mr. Brady's concern about budget deficits because of the capital markets long-term interest rates effect.

Dr. Romer. Absolutely. I just actually wanted to come back because Mr. Brownback had mentioned this. I had started by saying that the budget deficit—I wasn't worried about it this year or next year because we are in the middle of an economic crisis.

But absolutely I, all of the economics team, the President—very much, long-run budget deficits are a whole other issue, and getting that down is crucial because it pushes up real interest rates in the long run; it lowers investment, and that is bad for our long-run growth. And that is why the President has wanted to cut it in half, and that is why I think we would all love to work with Congress to cut it much more than that.

Representative Snyder. Thank you.

Representative Hinchey. Mr. Campbell.

Representative Campbell. Thank you, Mr. Chairman. Thank you, Dr. Romer.

Do you believe that last September/October that we were on the verge of or close to a financial collapse or a collapse in the banking sector? And if you do, do you believe that the risk of that has largely passed or still exists or what?

Dr. Romer. I do think we were on the verge of a financial collapse. And the chairwoman mentioned my speciality was the Great Depression. And if anyone had ever told me that that knowledge would become handy in the modern economy, I would never have believed it.

But I think, last September/October, the notion that we were on the edge of a cliff, I think, is absolutely correct. I think that we could have seen just an incredible meltdown of the financial situation.

Since Chairman Bernanke is coming in next week, let me just say, I think he and the Federal Reserve have been unbelievably creative in taking, as we all know, unprecedented actions that I do think walked us back from that cliff. Where we are now, I think we are in a much more stable place. It is not great, but it is certainly—we have edged back further from that cliff. And so I think there is real hope that we will come through.

Representative Campbell. But then, to Senator Brownback's point earlier, if a major institution was on the verge of failure, why couldn't we let it fail if it didn't—if the system itself is now reasonably stable—you know, not great, I agree, but stable?

Dr. Romer. Ah, but that is, in fact—the key thing is, I think the reason that we are stable is precisely—because we have taken all these actions, I think made it clear that we are not going to have another Lehman Brothers. We are not going to let another systemically important institution just go down. I think that is precisely why we are in this place of being somewhat more stable.

So I think—though another way to say it is, you know, back last August, I would have said we were nowhere near a cliff, right? We were unbelievably healthy. And we saw how quickly we come to that edge.

Representative Campbell. Okay, switching gears to a couple of things.

There are a couple areas where it seems to me that administration policies are kind of at cross purposes with one another. If we look at the TARP program, the original purpose of that, to a large degree, was to inject capital into these institutions so they would have a capital base on which to make greater lending. Now because of many of the restrictions and, you could argue, punitive things being attached to the TARP funds, many of these institutions want to pay them back. And I am personally aware of institutions that have basically stopped lending money because they are trying to contract their asset base so that they can have—so they can reduce their capital and meet all their requirements with reduced capital.

I mean, aren't we sending a conflicting message—we want to you to lend, here is this capital, but if you do, we are going to put these restrictions on you and all this stuff we know you don't like—so we are actually getting the reverse of what we want out there?

Dr. Romer. We certainly are—I mean, the basic idea of getting capital into these institutions, I think, is absolutely sound. That is what they need, to feel more confidence and to be willing to lend.

You are pointing out an important fact, which is right now they are not acting like our capital is the capital that they want; and that is certainly a problem. Unfortunately, there are two sides to this because we just simply can't give them our capital and then let them fly in big jets, so—do things that offend and waste the American taxpayers' money.

I think what we are going to have going forward—and maybe this is a desirable thing coming out of the stress test—is to say, all right, we have to look at how you are doing. If we think you need more capital, one of the things we will say is, for heaven's sakes, go raise private capital. If that would be more, you know, you would like it better, you know, we are here as your backstop.

But I think everyone would agree, if they would go out and get more capital from the private sector, that would probably be the best of all worlds.

Representative Campbell. And on a similar sort of thing, on the PPIC program the public-private partnership that was discussed earlier, it seems the same sort of thing: We want this private capital.

Now I happen to think it is highly leveraged, overleveraged in my view. I don't know if you share that or not. But again, as you said, many institutions are like, if we make a lot of money here, you put 100 percent tax on us; if we don't make money, you will call us into a hearing for losing the taxpayers' money. Why should we participate in this because of all the ancillary things that may occur?

And I guess if that doesn't go anywhere—I am not seeing that there is a lot of movement on that right now; and if I am wrong, let me know. Is there a backup plan for the toxic assets after the PPIC program?

Dr. Romer. So I think the—as you described, and we can talk first about, is it overleveraged? I mean part of the—I mean, the design challenge that I mentioned earlier is to make it favorable enough that people want to participate, but not so favorable that

it wastes taxpayers' money, that it does any more than we need to do to get this market functioning again.

One of the things, though—and again coming into this question of what are the restrictions that come with it or what do we worry about, the President has tried to be very clear: This is a program where private investors coming in with us, right, would be helping, would be doing the system, you know, not a favor, but we are trying to lure them in, and so the idea that perhaps they should be treated differently than someone that only exists because the government is there holding them together.

Representative Campbell. Have any deals been made yet?

Dr. Romer. The program is still very much—as you would guess, the nuts and bolts, or the final pieces, are very difficult on this. So, no, it is not—it is not up and actually making deals yet.

Representative Campbell. Thank you.

Representative Hinchey. Thank you very much, Mr. Campbell.

Dr. Romer, I would like to try to clarify something that was mentioned a little bit earlier, and the question is this: Does the Federal Government have now the resolution authority that it needs to deal with banks, the banks that are so-called "too big to fail"?

Our understanding is that the Treasury has now requested additional authority to deal with that set of circumstances. Can you inform us what has been requested by the Treasury and what is likely to take place in the context of this circumstance?

Dr. Romer. I will certainly do what I can.

Obviously, the Secretary of the Treasury is very much involved in the design of this and certainly working with the regulators and Congress to come up with a whole sort of comprehensive regulatory reform. It is the view of the administration that we do not have all of the tools that we need now to do the safe resolution of complicated financial institutions that get into insolvency or distress. The model that works so beautifully for small banks through the FDIC process really is not there for the very large banks. And so, you know, the way it certainly is described is—you know, just as, right, a bankruptcy judge would have the ability to come into a firm and say, all right, this is how we handle creditors, this is how we handle—quickly sell off assets, all of that.

We don't have that same kind of thing for a big, complicated institution like AIG, right, something that has a bit of a hedge fund, a big insurance, all of these things; and certainly then for very big, big banks. So we absolutely feel that we need more.

As for particular details, I think that is still very much being worked out. And I am sure there will be many hearings in the Congress talking about the specifics of this.

Representative Hinchey. Well, I thank you very much for clarifying that to some extent.

The circumstances that we are dealing with, as you mentioned, and now, as being generally recognized, the economic conditions we are dealing with are the most severe that we have had to encounter—that this country has had to encounter since the Great Depression, since the collapse of 1929. And when we look back on the circumstances that brought about this collapse, we see the similarities between that and what brought about the collapse of 1929,

too—the manipulation of funding, et cetera, internally here and in other places around the world.

Back then and now I think one of the most effective actions that were taken was the need to invest internally in our own country. And that proved very significant back then, although there was a lot of opposition to it, and there was a lot of difficulty that tried to block it from taking place.

Now we are experiencing some similar circumstances. But the fact of the matter is that while some people are saying that the so-called "stimulus package," the investment bill that was passed and signed by the President, initiated by him, is causing an increase in debt, what we know, based on experience, is that investment internally, whether it is in infrastructure, transportation, things of that nature, health care, education, new technology, all of that is going to bring back more than what was invested. So it is not an increase in debt; it is a reduction in debt as it stimulates the economy.

Dr. Romer. I mean, so I couldn't agree more in the sense that, you know, when we were working with the Congress to design this bill, I think one of the most wonderful features of it is its focus on these useful investments, rather—you know, the quintessential economic argument, well, for an economy just digging ditches and filling them in will at least create jobs. But what we all know is, that is very wasteful. Why not, if you are going to be doing spending, let's do it for something good; and that is exactly what Congress did working with the President.

And so those investments—you are absolutely right, we expect them to pay off tremendously in terms of—you know, think of infrastructure, right; it makes you more productive to have better roads and bridges that aren't falling down. You can have better internal trade, building up our levees to make sure we don't have another Hurricane Katrina-like incident.

Just think of what that does to the potential for growth in the economy and then the health IT, the investments in education; all of those put us on a path to be more productive going forward. And that, as you pointed out, is exactly what we saw in the 1930s.

I had the most wonderful meeting with a group representing people sort of looking at the legacy of the New Deal and making a map of all of the things that were built in the 1930s under the WPA and the CCC, to just get, you know, a sense of, we are participating in this exact same kind of process today. And we are actually developing maps to show where those recovery funds are building roads, improving things, weatherizing buildings, improving schools, I think is an amazing achievement.

Representative Hinchey. I think you are absolutely right. And it is part of the responsibility of this government to make the circumstances that we have to deal with and that the people of this country have to deal with to make them more solid, more secure and more productive and more creative. Those are the things that we should be doing, and that is what this so-called "stimulus package" is doing.

I don't expect you to answer this question now, but maybe you could provide us with this at some point in the future, and that is, how much money of the investment legislation has already been spent, including that which is being spent through the Federal

Government, but also that which is being sent by the Federal Government into State governments and local governments around the country? How much of that is already in play?

I think it is only a tiny fraction, and there is an awful lot more to go. And in the context of that, I can't help but think that there are some of us here in this Congress who thought that something in the nature of 5 percent of the GDP would be much more sound and solid and produce a lot more growth than something a little over 2 percent of that GDP. And I am hoping that we don't get anybody to lock the door for additional stimulus spending, because we know, based upon a whole host of things, including your response to the question, that this is a positive issue.

It is a positive issue for two reasons. It gives us the kind of country that we need, one that is not old and foundering and falling apart; one that is vibrant and creative and generating new kinds of growth, new technology, new ideas, new strength.

All of that is included in this so-called "stimulus bill," and I am hoping that if we have the ability, we can continue to do that, because largely—one of the reasons is because there has been so much negativity, so much neglected of the internal needs of the country over the last several decades.

Dr. Romer. No. I couldn't agree more. That is something I want to come back to.

I have often said the shocks that the economy faced—and so in some of the discussion we had earlier, the financial shocks, the macroeconomic, you know, trouble that we faced was enormous. And the fact that, you know, as bad as this recession is, it is not the Great Depression, right?

We have had GDP fall, and yet it fell almost 25 percent back in the 1930s. If we make it through this, it will be because of actions like the American Recovery and Reinvestment Act, actions like what the Federal Reserve did last fall, work that we have done on the financial rescue. All of that, I think, we have learned from the 1930s; and by taking these actions, I think it will have incredible effects.

On what you said about how much has actually been spent, I mean, the number that I have, I know that $14 billion in actual outlays and some $75 billion have been obligated. But what fraction of that is sort of the direct Federal Government, and a lot of that—one of the things we could do the most quickly is get some of that State fiscal relief so that State governments weren't laying off first responders and nurses and things like that.

So I think you are absolutely right. We are just at the very beginning of the really useful spending that is included in the bill. And, you know, it is one of the things we are monitoring very closely, so—the Vice President's office is doing just an amazing job of keeping track and keeping us all on our toes to make sure that that money is going out as it is supposed to.

Representative Hinchey. Well, Dr. Romer, on behalf of the other members of this Joint Economic Committee and the other Members of the Congress, I want to just express my appreciation to you for the insightful statement that you provided us and also the insightful answers that you provided to questions.

Thank you very much for being here. And thank you for the economic leadership that you are providing. We appreciate it very much.

Dr. Romer. Thank you. It was an honor to be here.

[Whereupon, at 11:22 a.m., the joint committee was adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF CAROLYN MALONEY, CHAIR, JOINT ECONOMIC COMMITTEE

I want to welcome Dr. Christina Romer, the President's Chair of the Council of Economic Advisers, and thank her for her testimony here today. The Council of Economic Advisers and the Joint Economic Committee were both created by the Employment Act of 1946 and share an important history of providing the White House and Congress with analysis of economic conditions and the effectiveness of economic policy.

This hearing today and our hearing next week with Fed Chairman Bernanke on the economic outlook are timely because there is a sense that the economy may be "bottoming out." A few glimmers of hope have surfaced in the economy in recent weeks as consumer confidence jumped last month and credit markets have begun to thaw. But yesterday's report that GDP fell at an annual rate of 6.1 percent in the first quarter and the huge job losses over the past five months are vivid reminders of the hangover from the Bush administration that we still have to shake.

The growth and job loss number underscore the wisdom of the American Recovery and Reinvestment Act (ARRA) that Congress passed and President Obama signed into law in his first 60 days in office. The recovery measures are just starting to work their way into the economy, providing a much needed boost. Americans are feeling more optimistic and are starting to spend more, which leaves me optimistic that we will begin to see the effects of the stimulus next quarter.

Taken together, the American Recovery and Reinvestment Act, the financial stabilization plan, and housing reforms provide the framework for promoting economic progress. In addition, the House and the Senate passed our budget resolution this week. A budget is fundamentally about priorities and I applaud the President for working with Congress to craft a blueprint that builds on our recovery efforts by making investments in health care, renewable energy, and education to put people back to work and strengthen our economy for the future.

Even before job losses began accelerating, many families were increasingly holding balances on their credit cards just to pay for basic household necessities. Because of this increased reliance on credit cards—especially by families of displaced workers—it is even more important that we pass legislation prohibiting unfair practices that are hurting financially strapped cardholders.

The Credit Cardholders' Bill of Rights is on the House floor today and will soon be taken up by the Senate. With the strong support of the White House I believe we can pass this bill and get working Americans some relief from mounting pocketbook pressures.

Nobel laureate Joseph Stiglitz testified before this committee last week and made a compelling case that we underestimate the impact of removing these kinds of predatory practices by only looking at potential reductions in the supply of credit when these practices are prohibited. Instead, we must also consider reductions in the demand for credit because of these practices. Reducing those fees and eliminating those practices will encourage creditworthy consumers to borrow and to buy goods and services, which will help the economy recover from the current downturn.

I have questions that I will submit to your office and I would appreciate your written responses for the hearing record.

Dr. Romer, we thank you for your testimony and I look forward to working with you as the committee continues our focus on fixing the economy, putting people back to work, and helping struggling families.

PREPARED STATEMENT OF SENATOR SAM BROWNBACK, RANKING REPUBLICAN

Thank you Chairwoman Maloney for arranging today's hearing and thank you Dr. Romer for testifying today about the economic outlook.

Our economy is in the midst of a serious recession and many Americans are suffering from job losses, home losses, and uncertainty about their retirement savings, their jobs, and their children's future. Unfortunately, in addition, our financial system remains a problem.

Just yesterday, we learned that the economy contracted at a 6.1% annualized rate in the first quarter, on the heels of a 6.3% rate of decline in the fourth quarter of last year. We are poised for the longest recession in the post-World War II period, and we are by no means out of the woods yet.

Given the severity of the economic downturn that we face, and efforts already under way to try to offset the downturn, it is absolutely clear to me that the last things we want to do is raise taxes and add uncertainty to the economic and financial environments. Unfortunately, that is precisely what is happening.

Taxes on anyone earning over $250,000, including someone running a small business, will go up. Taxes on capital income will go up. Many Americans, including re-

tirees living partly on dividend income, will see their taxes go up and values of their portfolios hurt. Under a cap-and-trade scheme to generate higher prices on anything produced using carbon, taxes will go up for everyone. Every time you turn on the light switch, you will pay a tax. With the Administration's budget outline, we are adding trillions of deficit-financed Federal government spending, which adds trillions to our Nation's debt. Eventually, of course, the debt has to be paid off, meaning higher taxes for our children and grandchildren.

In addition to the prospect of higher taxes, as the Administration reaches to expand the size of government, we have been adding to uncertainties facing American families and businesses. Judging from comments from my constituents, many businesses are in a precautionary mode, fearful of expanding their operations once the economy recovers and fearful of adding jobs to their payrolls. And some of that fear comes because they are uncertain about what will be the cost of carbon under a cap and trade scheme and what will be the cost of providing health care benefits given the Administration's intentions to move toward greater government control of the health-care system

On the financial front, it seems that the Treasury Department continues to try to experiment with devices like the Public-Private Investment Programs which amount to speculative experiments in which taxpayers face risks and losses while large financial investors face the prospect of subsidized gains. Rather than remove uncertainty by facing up to losses in the financial system and breaking up and reorganizing financial institutions, as Kansas City Federal Reserve Bank President Hoenig has advocated recently before this very committee, Treasury seems to want to take another risk at trying to solve the problem with even more leveraged speculative maneuvers. It seems clear to me that President Hoenig and the majority of experts I talk with have it right: we have the tools to resolve and break up large, overleveraged, insolvent banks and we should get to work using them.

I am concerned about the economic outlook. These days in Washington, throwing hundreds of billions of dollars of increased, deficit-financed spending at our problems is becoming all too common. Even the word trillion is becoming all too comfortable. Over $1 trillion, when interest is included, was devoted to an economic "stimulus" package earlier this year. I believe there was as much planned expansion of long-term government spending and place markers for ever-expanding government programs in the package as there was government actions to actually try to stimulate spending, production, and job formation in this country. Add to that $1 trillion plus in stimulus the President's unprecedented $3.5 trillion budget outline for 2010, which adds $1.2 trillion in deficits, and we see trillions of dollars of additional debt that we are leaving to our children.

Of course, debt eventually has to be paid off, and that means higher taxes for our children and our grandchildren. It also represents plans of the Administration to reach out and increase the size of Federal government as a share of our economy. That means more and more of any gains from hard work by American families will be taken by the Federal government and, if history is any guide, used far less efficiently than would be the case if those families could have used the resources themselves.

In terms of the outlook, I am concerned about overreach by the Administration on expanding the size of government and setting up costly and most likely inefficient programs that will stay with us forever and be paid for by hard-working Americans. I am concerned about years and years of trillion dollar deficits and a piling up of our debt, pushing us to a tipping point where our international creditors lose confidence in investing in the United States. I am concerned that we are moving from a housing bubble to a government-debt bubble. And, I am concerned that we do not have a concrete plan for addressing losses in the financial system and confronting and resolving the problem of "too big to fail."

The Administration has promised a review of the federal budget "page by page, line by line" to eliminate inefficiencies and promote savings. I understand that such an effort cannot be completed in a short time, if it can be completed at all. The President recently called upon cabinet members to take 90 days and identify a combined $100 million in budget savings. I understand the importance of symbolism, but at that rate it would take us close to 250 years to generate $100 billion in budget savings, and it seems as though we are spending hundreds of billions of dollars around Washington by the day. And, I fear, rather than scouring the budget line by line and page by page, most of what has been done over the past 100 days has been additions of more lines and more pages and more spending in the budget. I am very concerned that we are taxing too much, spending too much, borrowing too much, and creating too much uncertainty.

PREPARED STATEMENT OF CHRISTINA D. ROMER, CHAIR, COUNCIL OF ECONOMIC ADVISERS

THE ECONOMIC CRISIS: CAUSES, POLICIES, AND OUTLOOK

Chair Maloney, Vice Chairman Schumer, Ranking Members Brady and Brownback, and members of the Committee, thank you for inviting me to join you today. The Joint Economic Committee and the President's Council of Economic Advisers share a special relationship and I am delighted to have my first opportunity to speak with you.

As we are all much too painfully aware, the United States is undergoing its most severe economic and financial crisis since the Great Depression. Today, I want to discuss the causes of the crisis, the policies we are putting in place to address it, and the outlook for the economy.

Causes of the Crisis

Understanding the sources of the crisis is critical to crafting the right policy responses for recovery. In thinking about the causes, one needs to begin with the extreme fall in house and stock prices over the last eighteen months. Housing prices, as measured by the Case-Shiller index, have fallen by 27% since July 2007.[1] Stock prices have fallen roughly in half since their peak in October 2007.[2]

Why these two key asset prices have fallen so much is a topic that we could spend hours discussing. Was there a bubble? If so, what caused it, and what caused it to burst? But, regardless of their cause, the falls in asset prices have had a direct impact on consumer behavior. Consumers have substantially less wealth than before. By one measure, household wealth has fallen by $13 trillion, or 20%, since its peak.[3] Consumer spending depends on many things, including income, taxes, confidence, and wealth. Studies suggest that when consumer wealth declines by a dollar, annual spending falls by about four cents.[4] So, a decline in wealth as large as the one we have experienced has led to a large decline in the aggregate demand for goods and services.

Another factor to consider is the uncertainty created by the gyrations in asset prices. In a paper I wrote many years ago, I argued that the main effect of the crash of the stock market in 1929 on spending operated not through the direct loss of wealth, but through the enormous uncertainty it created.[5] The initial crash in October was followed by wild fluctuations of stock prices. This volatility led consumers and firms to be highly uncertain about what lay ahead. I found narrative and statistical evidence that this uncertainty led to large drops in consumption and investment spending. This makes sense: when you don't know what is likely to happen, the best thing to do may be to simply do nothing as you wait for more information.

The same factor may be at work today. While house prices have been steadily down, stock prices have been on a wild ride. Volatility, according to some measures, has been over five times as high over the past six months as it was in the first half of 2007.[6] The resulting uncertainty has almost surely contributed to a decline in spending, especially in the last few months.

The decline in asset prices and the rise in uncertainty have also been critical to the defining feature of this recession: the drying up of credit. As housing prices declined, not only did the value of mortgage-backed securities fall, but uncertainty about their value rose dramatically. It is almost as if investors suddenly woke up

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[1] House price data are from the S&P/Case-Shiller Composite 20 Home Price Index, *http://www2.standardandpoors.com/spf/pdf/index/SA__CSHomePrice__History__042841.xls* [Haver: CASC20XA@USECON].

[2] Stock prices are from the S&P 500 Index; historical data can be found on Bloomberg or at: *http://finance.yahoo.com/q/hp?s=%5EGSPC&a=00&b=1&c=2007&d=03&e=28&f=2009&g=d*.

[3] Household and nonprofit net worth data are from the Federal Reserve Flow of Funds Data, Household and Nonprofit Net Worth, Table B.100, change from 2007:Q2 to 2008:Q4, *http://www.federalreserve.gov/datadownload/Choose.aspx?rel=Z.1* (choose table B. 100). [Haver: PA15CDA5@FFUNDS].

[4] See, for example, the literature surveyed in Ricardo M. Sousa, "Financial Wealth, Housing Wealth, and Consumption," *International Research Journal of Finance and Economics*, Issue 19 (2008): 167-191, see page 171. Estimates of the MPC out of housing wealth are often higher than the estimates for the MPC out of financial (or total) wealth; see, for example, John D. Benjamin, Peter Chinloy, and G. Donald Jud, "Real Estate Versus Financial Wealth in Consumption," *Journal of Real Estate Finance and Economics*, 29:3 (2004): 341–354, which estimates that for every $1 increase in housing wealth, consumption increases 8 cents.

[5] Christina D. Romer, "The Great Crash and the Onset of the Great Depression," *Quarterly Journal of Economics* 105(August 1990): 597–624.

[6] S&P 500 daily volatility, as measured by the daily return standard deviation for the previous 30 days, averaged 3.3% from October 27, 2008 to April 27, 2009. It averaged 0.6% from January 1, 2007 to June 30, 2007.

to the realization that bundling securities together and slicing them up does not change overall risks, only rearranges them. And, when there are nationwide movements in house prices, the values of many mortgages, and thus the values of many securities backed by mortgages, move together. Add to this the general uncertainty about the path of house prices, and it is not surprising that people stopped trading mortgage-backed securities. Volumes fell sharply and spreads between the interest rates on these assets and those on safe assets, such as government debt, spiked upward.[7]

All of this was disastrous for lending. When banks can't package their loans and sell them for cash, they become more cautious about making new loans. On top of this, the collapse of asset prices put direct downward pressure on the asset side of bank balance sheets. Mortgages and mortgage-backed securities became less valuable, and so banks sought to reduce their liabilities by letting loans run off and not making new ones. The decline of house prices also made potential borrowers less creditworthy, and so further reduced banks' desire to lend. Finally, the dramatic failure or near-failure of several major financial institutions, and just about the first honest-to-goodness bank runs in over half a century, no doubt increased banks' caution further.

Fear, uncertainty, and a desire to contract lending spread to other markets. Overall, the Federal Reserve estimates that net lending to nonfinancial businesses has fallen to a seventh of its peak level.[8] More dramatically, in the fourth quarter of 2008 lenders reduced the amount of consumer loans on their books for the first time since 1992.[9]

Some of the decline in lending surely reflected lower demand for credit. As businesses and consumers became more nervous and wanted to spend less, they sought fewer loans. But much of the decline reflects the supply-side factors I have described. Creditworthy borrowers found banks unwilling to lend at posted interest rates. Credit standards were raised, and other methods of rationing credit were employed.[10]

The restriction of credit had two devastating consequences. One was a further lowering of consumption and business investment.[11] Households that can't get credit have trouble purchasing cars, furniture, and other big-ticket items. Businesses that can't get credit find it difficult not just to invest, but often to buy the raw materials or finance the payrolls that go into production. The result is that reduced credit availability lowers aggregate demand further.

The other consequence of credit rationing is a reduction in efficiency. When credit is not available, consumption cannot be smoothed over time and economic circumstances. Students who rely on private lending may not be able to borrow to go to college so that they can earn more in the future. Businesses cannot replace outmoded equipment at the desirable time. The overall productivity of the economy is reduced.

Last fall, there was some debate about whether credit was actually all that important. Some pundits suggested that we should just let the financial system fend for itself because it really didn't matter. The horrific falls in employment and production over the last five months have largely ended that debate. Shuttered factories

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[7] Data on volumes of MBS are from the Federal Reserve Flow of Funds data, Table F.126 *http://www.federalreserve.gov/releases/z1/Current/accessible/f126.htm*. Mortgages held as assets by Asset-Backed Security Issuers to back the issuance of mortgage backed securities (MBS) have been falling since 2007:Q3; in 2008:Q4 they fell 15% at an annual rate [Haver: FA67MOR5@FFUNDS]. This decline in mortgages held implies fewer issuances of private MBS, which suggests less demand for MBS. Data on spreads between rates on MBS and Treasuries come from proprietary Lehman Brothers data through LehmanLive. The spread is specifically between option adjusted Fannie Mae 30 year current coupon and comparable Treasuries. The spread trended up from January 2007 through September 2008, and has narrowed since then.

[8] Data on lending to nonfinancial business data are from the Federal Reserve Flow of Funds Data, Table F.2, Nonfinancial Business Liabilities: Credit Market Instruments, *http://www.federalreserve.gov/releases/z1/Current/z1r-3.pdf* [Haver: FL14TCR5@FFUNDS].

[9] Data on consumer loans are from Federal Reserve Board Flow of Funds, Table L.2, Consumer Credit Outstanding, end-of-period on quarterly basis, *http://www.federalreserve.gov/releases/z1/Current/z1r-4.pdf* [Haver: AL15CNC0@FFUNDS].

[10] Federal Reserve Board, Senior Loan Officer Survey. In 2007:Q4, over 80% of lenders said they were keeping lending standards constant; in 2008:Q4, over 80% said they were tightening credit standards. *http://www.federalreserve.gov/boarddocs/snloansurvey/*.

[11] Real personal consumption expenditures data are from the Bureau of Economic Analysis, *http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=66&FirstYear=2006&LastYear=2008&Freq=Qtr&3Place=Y*. Real private fixed investment data are also from the BEA, *http://www.bea.gov/national/nipaweb/TableView.asp?SelectedTable=129&FirstYear=2006&LastYear=2008&Freq=Qtr&3Place=Y*.

across the country simply scream that Main Street and Wall Street do indeed intersect.[12] Credit truly is the lifeblood of our modern economy.

The result of our current credit disruptions and the drop in spending has been a very painful contraction in the economy. Total output of goods and services has now fallen for three consecutive quarters, after barely rising at all over the previous three.[13] The unemployment rate has risen from 4.7% in late 2007 to 8.5%, and payroll employment has fallen by 5.1 million.[14]

Rising unemployment and falling home values have intersected to greatly increase home foreclosures. Hard-working families find themselves underwater and with falling incomes. Defaults have risen steadily over the last year.[15] Foreclosed homes destroy neighborhoods. And, foreclosure sales further reduce housing prices, putting in motion another wave of troubles.

Finally, falling income in the United States means we are buying less from abroad. Our imports fell 32% in the last six months.[16] This fall in our spending on foreign goods, coupled with the fact that other countries have experienced swings of their own in stock prices and housing prices, has had a devastating impact on our trading partners. To give just a few examples, Singapore saw its GDP fall at a 16% annual rate in the fourth quarter of 2008, and Japan by 12%.[17]

Policies for Recovery

This long discussion of what has gone wrong in our economy is important. Only by describing what the problem is can I explain how the actions we are taking will make things better. As I have described, the sources of our current economic problems are complicated and strong. As a result, the solution can be neither simple nor quick. Instead, we have fashioned a broad, multi-faceted plan that, over time, will cushion the downturn, bring about recovery, and make the economy stronger and more secure in the long run. Although the plan has many parts, I think of it as having four critical elements.

1. The first element is direct fiscal stimulus. The problems in housing and lending markets have led to sharp declines in aggregate demand: consumers are spending less, firms are investing less, and our trading partners are buying less. Thus, one critical treatment is for the government to directly promote spending. This was the crucial purpose of the American Recovery and Reinvestment Act (ARRA), which the President signed just 28 days after taking office. The plan is, quite simply, the biggest and boldest countercyclical fiscal action in American history. The package amounts to roughly 2.5% of GDP over each of the next two years.[18] For comparison, the Federal government's fiscal stimulus in Franklin Roosevelt's first full year in office was only 1.5% of GDP, and that was largely reversed the following year.[19]

The ARRA promotes spending in many ways. First, it cuts taxes for 95% of American households. The Making Work Pay tax credit reduces taxes on middle class

[12] Data on employment are from the Bureau of Labor Statistics, Establishment Survey, total nonfarm payrolls, *http://www.bls.gov/news.release/empsit.t14.htm*. Data on production are from the Federal Reserve Board, Industrial Production Index, *http://www.federalreserve.gov/releases/g17/Current/default.htm*.

[13] Bureau of Economic Analysis, National Accounts Data, real GDP; includes 2009 Q1.

[14] Data are from the Bureau of Labor Statistics, Establishment Survey, total nonfarm payrolls and unemployment rate, downloaded through CES and CPS databases "one-screen data search," *http://www.bls.gov/ces/#tables*.

[15] Data on defaults are from the Federal Reserve Board, Loan Delinquency Rate, Real Estate Loans, Residential, *http://www.federalreserve.gov/releases/chargeoff/delallsa.htm*.

[16] Imports data are from the Census Bureau, Foreign Trade Statistics, Historical Series, Nominal Imports of Goods and Services, *http://www.census.gov/foreign-trade/statistics/historical/gandsimp.xls*.

[17] Data on Singapore's GDP come from the Singapore Department of Statistics, *http://www.singstat.gov.sg/stats/latestdata.html* [Haver: S576NGPC@EMERGEPR]. Data on Japanese GDP come from the Cabinet Office of Japan, *http://www.esri.cao.go.jp/jp/sna/qe084-2/nritu-jk0842.csv*.

[18] The deficit impact of the American Recovery and Reinvestment Act is from the Congressional Budget Office, Letter to Senator Charles E. Grassley, March 2, 2009, Table 2, *http://www.cbo.gov/ftpdocs/100xx/doc10008/03-02-Macro*__Effects__of__ARRA.pdf. The data are for fiscal years. Because most of the spending ends early in 2011, I assume that the bulk of the spending in fiscal 2009, 2010, and 2011 will occur the 24 months between April 2009 and March 2011. This number is then divided by nominal GDP in 2008 to express it as a percent of GDP.

[19] The deficit figures are from *Historical Statistics of the United States: Colonial Times to 1970*, Part 2, p. 1194, series Y337. Nominal GDP data are from the Bureau of Economic Analysis, *http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=Y, Table 1.1.5*. I average calendar year figures to estimate fiscal year nominal GDP figures. The 1½% is for the rise in the deficit-to-GDP ratio from fiscal year 1933 (July 1932–June 1933) to fiscal 1934 (July 1933–June 1934).

families by $800 per year.[20] This tax cut started showing up in paychecks during the month of April. We think that households are likely to spend a substantial fraction of their higher take-home pay on the things they haven't been buying for the past year and a half. This will help spur the production of consumer goods and put people back to work.

The Act also raises spending by helping states and people directly hurt by the recession. State and local governments have seen tax revenues decline as the economy has declined, and are constrained by balanced-budget requirements. As a result, many states were in the process of cutting employment of teachers, nurses, and first responders, and raising taxes. The ARRA gave $150 billion in aid to state governments to try to stop this process.[21] At the same time, the money we are spending on extended unemployment insurance and nutritional assistance both helps the unemployed maintain the essentials of life and dignity, and provides spending that keeps local businesses producing.

Finally, and most importantly, the ARRA includes more than $250 billion in direct government investment. When the private sector isn't spending, it is appropriate for the government to step in and use unemployed resources to do work that desperately needs to be done. The Recovery Act has money for rebuilding roads and bridges, fixing up 10,000 schools, strengthening dams and levees, and weatherizing Federal buildings.[22] It also includes spending on crucial 21st century investments—building a newer, smarter power grid and funding innovations in health information technology.[23] This funding will not only create jobs over the next two years, it will leave us with an economy that is safer, more energy efficient, and more productive.

We expect the stimulus package to be incredibly helpful to the economic recovery. Because the spending is getting out the door quickly, we expect it to have a beneficial impact on output growth and employment before the end of 2009. I have been told by the Office of Management and Budget that approximately $75 billion in spending under the ARRA has been obligated and almost $14 billion in outlays have already occurred. During the first 100 days in office, which the Administration marked yesterday, we estimate that the ARRA has already saved or created 150,000 jobs.

Of course, because only a very small part of the spending and tax relief called for in the Act has taken place, and because much of the economy's response to stimulus occurs with a lag, most of the benefits of the act are yet to come. Our estimates suggest that ARRA spending will save or create 3.5 million jobs by the end of next year.[24]

It is important to realize while the ARRA was a crucial first step, it is just a piece of our overall battle plan to deal with the economic crisis. A crucial lesson of economics is that it is often much more effective to apply a whole range of measures, rather than to focus exclusively on one cure. Trying to repair the economy by direct stimulus alone would inevitably require that we resort to low-value spending, necessitate enormous increases in the deficit, and leave us with an unbalanced economy. This is a central reason for the Administration's multi-faceted approach.

2. The second key element of our comprehensive approach is financial stabilization and rescue. As I described, our current economic distress derives principally from problems in the financial sector. For this reason, we have initiated a number of programs designed to strengthen financial institutions and restart the flow of credit.

One piece is the Consumer and Business Lending Initiative. This is a program designed to restart the securitized lending market, which accounts for about 40% of lending.[25] The Treasury has partnered with the Federal Reserve to create the Term Asset-Backed Securities Loan Facility (or TALF). This program provides financing to private investors to help unfreeze markets for various types of credit, including auto, student, small business, and credit card loans. Just last month, this facility started operations and $9 billion of this securitized lending happened the

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[20] Details of the Recovery Act and Making Work Pay can be found at: *http://www.recovery.gov/?q=content/making-work-pay*.

[21] Details of the Recovery Act can be found at Recovery.gov, *http://www.recovery.gov/?q=content/act#TB_inline?height=240&width=400&inlineId=tb_external*.

[22] The American Reinvestment and Recovery Plan—By the numbers, *http://www.whitehouse.gov/assets/documents/recovery_plan_metrics_report_508.pdf*.

[23] Recovery Act Information, National Institute of Standards and Technology, *http://www.nist.gov/recovery/bill.html*.

[24] Recovery Act, Recovery.gov, *http://www.recovery.gov/?q=content/act*. For more details on the methodology for estimating job creation, see Christina Romer and Jared Bernstein, "The Job Impact of the American Recovery and Reinvestment Plan," January 9, 2009, *http://otrans.3cdn.net/ee40602f9a7d8172b8_ozm6bt5oi.pdf*.

[25] Secretary Tim Geithner Opening Statement—Delivery Senate Banking Committee Hearing, February 10, 2009, *http://www.treas.gov/press/releases/tg02102009.htm*.

first week, more than had happened in the previous four months. We are optimistic that this program will restart this crucial market. By doing so, it will make financial institutions able to increase their loans to consumers and businesses.

One important type of loan that will eventually be facilitated by the TALF are Small Business Administration (SBA) Loans. This is another market where secondary lending has virtually evaporated. Because conditions were so severe and because small businesses are so crucial to job creation, the Treasury announced a program to immediately buy up both current and future securitized SBA loans. This program is designed to get SBA loans flowing again quickly. Also, the ARRA provided for a temporary reduction in fees and a temporary increase in guarantees for SBA loans.

Another recently announced component of the financial stabilization plan was the program to facilitate sales of legacy or toxic assets. Banks and other financial institutions have a large number of mortgage loans and mortgage-backed securities on their books. The value of these loans is hard to determine because the resale market has virtually disappeared. Furthermore, even if we knew the current value, the value of these assets is simply very uncertain. As a result, the presence of these assents on bank balance sheets makes banks hesitant to lend and makes private investors unwilling to put more capital into banks. Finally, because of the seizing up of markets for these assets, there is some evidence that their current prices may reflect temporary “fire sale” levels, not reasonable estimates of the assets’ fundamental value.

The Treasury is partnering with the FDIC, the Federal Reserve, and private investors to restart this market through the Public-Private Investment Program. In the case of the toxic real estate loans, the Treasury will form 50-50 partnerships with private investors and then receive loan guarantees from the FDIC for up to 85% of the purchase price. The loan guarantees will allow the partnership to receive favorable financing, and so should provide a moderate subsidy. This is exactly what is needed to counteract the market failure and get this market functioning again. The result should be slightly higher prices for the toxic assets, which will encourage banks to sell. Also, by creating a market, the government is providing a convenient mechanism by which regulators can encourage banks to clean up their balance sheets.

A final component of the financial rescue plan is a careful evaluation of the health of the 19 largest banks in the country. The so-called “stress test” asks regulators to evaluate whether banks have enough capital to weather a more severe downturn than is currently anticipated—a process that is currently underway.[26] If at the end of the evaluation, regulators decide banks need more capital to be safe and maintain confidence, they will encourage banks to raise private capital. The Treasury will be prepared to provide public capital if needed, through the Capital Assistance Program.

Both the Public-Private Investment Program and the Capital Assistance Program are aimed at the same goal—returning American banks to full health. Japan’s experience in the 1990s shows the costs of skimping on bank rescue. Until banks are cleansed of highly uncertain assets and robustly capitalized they will be hesitant to lend, and lending is what we need them to do.

Though the financial stabilization plan is still in its early stages, we are optimistic that it will play a critical role in the economy’s recovery. By restarting lending, it should have beneficial effects on aggregate demand. Credit constrained borrowers should be able to spend again. This includes families that want to purchase their first home; consumers who need a new car or major appliance; and students who need to borrow to attend college. It also includes businesses that have had to curtail investment and production because they couldn’t borrow to buy machinery or raw materials. All told, the spending that could be unleashed is surely very large. As Treasury Secretary Geithner is fond of saying, there is probably more stimulus in financial rescue than there is in stimulus.

As with direct stimulus, it would be foolish to try to combat the recession solely by trying to fix the financial system. The shocks that have hit the system are so large that no matter what we do, financial recovery will take time. Thus, financial rescue is no substitute for immediate stimulus. Moreover, bringing about recovery solely through financial rescue would probably require that the government intervene in every nook and cranny of the financial system, which would be unwise, inefficient, and almost surely unhealthy in the long run.

3. The third element of our comprehensive recovery plan is direct help to the housing market through our Homeowner Affordability and Stability Plan. The crisis

[26] Details of the “stress test” can be found at *http://www.treasury.gov/press/releases/reports/tg40__capwhitepaper.pdf*.

began in the housing market, and defaults, foreclosures, and falling housing prices are contributing to the downward spiral of the economy. Thus, although the crisis has spread so far beyond the housing market that it cannot be solved by actions in that market alone, addressing housing has to be part of any solution.

Our housing plan has several pieces. One is to work with the Federal Reserve to bring down mortgage rates. The government-sponsored enterprises (GSEs), Fannie Mae and Freddie Mac, currently finance about 50% of all outstanding home mortgage loans.[27] Even following the announcement of Federal government conservatorship of these entities in the summer, their borrowing costs remained well above Treasury bond rates.[28] The Federal Reserve has instituted a program to purchase GSE debt as a way to bid down its interest rate. The Treasury has also announced a total funding commitment of $400 billion for the Preferred Stock Purchase Agreements, which serve as a backstop for Fannie Mae and Freddie Mac to ensure these GSEs are financially secure. These two actions helped to bring mortgage rates to historic lows.[29]

The lower mortgage rates have set off a wave of refinancing. Indeed, mortgage refinancing applications have jumped almost 80% since the housing program was announced in mid-February.[30] Furthermore, the GSEs, in consultation with their regulator, the Federal Housing Financing Agency, and the Treasury, have modified their downpayment requirements so that even many homeowners who have seen the equity in their home fall because of home price declines, can still qualify for refinancing. This refinancing activity has the potential for important macroeconomic benefits. When a homeowner qualifies for a lower interest rate, their monthly payments fall. It is as if they just got a tax cut. They have more money to spend on other goods (and to help recover their savings). Mark Zandi, a noted forecaster, estimates that the Administration's housing plan is equivalent to at least a $30 billion tax cut.[31]

Another key piece of our housing plan aims to reduce foreclosures. Because of the fall in house prices and increasing weakness in the labor market, as many as six million homeowners are in danger of losing their homes.[32] The Treasury has announced a program that encourages banks and loan servicers to modify mortgages so that payments are more manageable and homeowners are able to remain in their homes. This program is a win for both the banks and the troubled homeowners. By covering some of the costs of the lower payments and by providing a standard modification framework, the Government is encouraging modifications that prevent both the economic and social losses inherent in foreclosure. And, by preventing millions of homes from being dumped on the market and sold at huge discounts, as foreclosure sales inevitably induce, the program should help to stabilize house prices. Since declining housing prices were at the center of the crisis, this would surely be a very desirable development.

4. The fourth and final element of our comprehensive recovery plan involves starting to address our long-run economic problems. Even in the midst of an economic crisis, we are trying to take actions that will make the economy stronger in the long run. This focus on the long run was evident in the American Recovery and Reinvestment Act—as its very name suggests. Though any spending would be helpful in creating jobs, as I described earlier, we focused on spending that increases productivity in the future.

As you are well aware, the budget provides for continuing investments in education and energy. For example, it includes more funding for the Pell grant program, so that low-income students can achieve a college education. It funds crucial investments in alternative energy and research and development, as well as a proposal for a cap and trade system to encourage energy independence and limit green-

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[27] GSE financing data are from the Federal Reserve Board Flow of Funds, Table L.218. Home Mortgages, *http://www.federalreserve.gov/releases/z1/Current/z1r-4.pdf* [(GSE + Agency and GSE mortgage pools)/total assets].

[28] Data on borrowing costs come from Bloomberg and are the spreads between Fannie Mae and Freddie Mac 2 and 10 year debts and appropriate Treasuries.

[29] Data on rates are from the Freddie Mac Weekly Primary Mortgage Market Survey, *http://www.freddiemac.com/dlink/html/PMMS/display/PMMSOutputYr.jsp*.

[30] Refinancing application data come from the Mortgage Bankers Association Weekly Applications Survey, *http://www.mbaa.org/ResearchandForecasts/ProductsandSurveys/WeeklyApplicationSurvey* (subscription only). [For internal use, data is on Haver: MBAMR@SURVEYW.]

[31] Mark M. Zandi, "Assessing Obama's Housing Plan," *Moody's economy.com*, March 10, 2009, *https://www.economy.com/home/login/ds__proLogin__4.asp?script__name=/dismal/pro/article.asp&cid=113267* (subscription only).

[32] The number of families facing foreclosure is noted in the Homeowner Affordability and Stability Plan Fact Sheet, *http://www.treasury.gov/initiatives/eesa/homeowner-affordability-plan/FactSheet.pdf*.

house gas emissions. By educating our workforce and encouraging the development of cleaner, more efficient energy, we hope to raise long-run growth and living standards.

In addition, we are committed to fundamentally reforming health care in the United States. Health care reform is central to our long-run fiscal prospects, because the rising costs of health care are the single major determinant of future budget deficits. More fundamentally, our broken health care system is depressing Americans' standards of living and leaving tens of millions of us without health insurance.[33] The Administration is committed to moving ahead with health care reform—and is taking concrete steps to do so.

The budget also calls for making significant improvements in our long-run fiscal situation. We inherited a budget deficit that was huge and expected to grow substantially over time. This trajectory is unsustainable and could have devastating consequences for financial stability and standards of living. We have already moved to adopt honest budgeting that acknowledges our long-run problems; held a fiscal summit and a health care summit; and proposed a budget that identifies important savings. The budget resolution working its way through Congress reduces the deficit we inherited in half over the next four years. And, we are committed to working with Congress to reduce the deficit event further.

Finally, we have also begun to work on fixing our financial regulatory system. The specifics of how best to regulate financial institutions are a difficult and complex issue, and detailed proposals will require careful study and hard work. But, it is clear that the system that allowed our current crisis to occur cannot be permitted to continue. It is also clear, as the President said long before the downturn had become a full-fledged financial crisis, that any institution whose actions have the potential to affect the stability of the financial system as a whole, and that is likely to receive government support in a crisis, must be subject to oversight and regulation. We also know that we need a resolution mechanism other than traditional bankruptcy when a large financial institution becomes insolvent, so that we are no longer caught between the impossible choice of a disruptive bankruptcy, as occurred with Lehman Brothers, and the propping up of a failing institution without adequate power over it, as has occurred with AIG. And, the system where institutions get to choose who they are regulated by, or even choose not to be regulated at all through something as simple as renaming a default insurance contract a credit default swap, must end.

Before I finish my discussion of policies, I want to say a little about interaction effects. A key feature of our multi-faceted program to restore our economic health is that the different elements reinforce one another, with the result that the whole is greater than the sum of the parts. Let me give you just a few examples. One key interaction is that stimulus promotes recovery in financial and housing markets. When people are employed and buying things, loan defaults fall and asset prices are likely to rise. A second is that restoring the health of the financial system will ease the burden on stimulus. Repairing our financial system will allow the natural forces of consumer- and business-led recovery to kick in, and so allow the economy to continue growing as the direct stimulus winds down. A third is that the fiscal stimulus will help the economy not only in the short run, but also in the long run. There would be nothing worse for our long-run fiscal health than an extended period of economic weakness and stagnation. And, by starting critical investments in areas like infrastructure, green energy, and medical information technology, the government investments in the package will make the economy more productive in the long run.

A final key interaction is that starting to tackle our long-run problems now will make the short-run stimulus more effective. Households and firms, understandably, have lost confidence in financial markets, and in some cases, in the economy. If they saw a large fiscal package unaccompanied by any commitment to addressing our fiscal challenges, their confidence might be further shaken, and the benefits of the package muted as a result. If they saw a financial rescue unaccompanied by a commitment to long-term financial reform, they would remain reluctant to participate in financial markets. This is one reason we are addressing our short-run and long-run problems together.

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[33] Data on health insurance coverage are from the National Coalition on Health Care, "Health Insurance Coverage," *http://www.nchc.org/facts/coverage.shtml*—nearly 46 million Americans were without health insurance in 2007.

THE ECONOMIC OUTLOOK

Where does all of this leave us? I am sorry to say that in the short run, we are still in for more bad news. The economy we inherited was so weak, and deteriorating so rapidly, that even the aggressive actions we have taken could not turn it around immediately. People often compare the economy to a supertanker. Its momentum is so great that it responds to the forces pushing on it only slowly and gradually.

Just yesterday, the advance first quarter GDP numbers were released. They showed that overall output continued to decline rapidly in the first three months of this year. We, like most private forecasters, expect another decline in the second quarter. And we expect to see continued declines in employment and rises in unemployment for the next several months. But, there is every reason to think that the policies we have put into place over the last three months, together with the natural strength and resiliency of our workers and businesses, will spur recovery. Already, we are beginning to see "glimmers of hope" that the economy is stabilizing. The housing sector has shown some tentative signs of finding a bottom. Housing starts increased slightly from January to March and builder confidence in April rose five points from March.[34] The fall in housing prices is abating.[35] As of Tuesday, the S&P 500 had risen 26% from its low point on March 9th. And, perhaps most importantly, consumer confidence has increased, indicating that the American people are increasingly optimistic about our recovery. Both the Conference Board index and the University of Michigan index have risen for the past two months, with the Conference Board measure showing a particularly large rise in April.[36]

We currently expect the pace of the overall decline in the economy to moderate sharply over the next several months. This is consistent with the Blue Chip consensus forecast, which shows a rate of decline of GDP of 2.1% in the second quarter.[37] We expect the economy to level out in the second half of the year and then begin to recover. Whether the recovery begins later this year, as most private forecasters predict, or takes a bit longer is hard to know. Because labor market indicators tend to lag changes in output, most likely we will see positive GDP growth before we see increases in employment and declines in the unemployment rate.

The President's economic team is keeping a watchful eye on all aspects of the economic situation, and we will not rest until we are assured of a long-term and lasting recovery with robust employment growth. Because the downturn has been so long and so severe, the recovery will almost surely take a long time. But, as I have stressed, our intent, and our expectation, is for the economy not just to recover, but to emerge even stronger and more resilient than before.

Thank you. I would be happy to take any questions you might have.

PREPARED STATEMENT OF KEVIN BRADY, SENIOR HOUSE REPUBLICAN

It is a pleasure to join in welcoming Chairwoman Romer before the Joint Economic Committee this morning.

The bursting of the housing and credit bubbles has wrecked much of the financial sector, devastated the savings and investments of many American families, and left the economy mired in a deep recession with rising unemployment. While there is plenty of blame to go around, government policy played a key role in the crisis by promoting weaker lending standards, excessive mortgage borrowing, and keeping interest rates artificially low for too long.

The Administration's confidence in its policy solutions to the crisis are reflected in the economic assumptions that form a key component of the President's budget submission. The Administration projects that real GDP will decline 1.2 percent in 2009, compared to the 2.6 percent decline forecast by the Blue Chip Consensus. The Administration assumes that the unemployment rate will be 8.1 percent in 2009, lower than the 8.5 percent rate already reached last month. The Administration's

[34] The housing start data are from the Bureau of the Census, *http://www.census.gov/const/newresconst.pdf*. The builder confidence measure is the National Association of Home Builders/Wells Fargo Index of Builder Confidence, *http://www.nahb.org/news_details.aspx?sectionID=134&newsID=9045*.

[35] See, for example, the behavior of the Federal Housing Finance Agency monthly House Price Index, *http://www.fhfa.gov/webfiles/2119/1Q09m02F.pdf*.

[36] The Conference Board Index is available at *http://www.conference-board.org/economics/ConsumerConfidence.cfm*. The Reuters/University of Michigan Index of Consumer Sentiment is available at *https://customers.reuters.com/community/university/default.aspx*.

[37] The Blue Chip Consensus Forecast is based on a number of private forecasts. It is a proprietary forecast and is published in the document *Blue Chip Economic Indicators*. The numbers reported are from the April 10, 2009 issue.

economic assumptions are unrealistic, and have reduced the projected deficits and debt in its budget submission.

The Economist called the assumptions in the Administration's budget "deeply flawed" in an article entitled, "Wishful, and dangerous, thinking." Their effect is to understate the true cost of the Administration's expansive new spending proposals. The Congress passed the President's budget yesterday, but resorted to accounting gimmicks instead of the Administration's economic assumptions to keep the costs down. As the *Washington Post* observed of this approach, "Congress deals a blow to 'honest budgeting.'" The end result is the same dangerous level of excessive deficit spending and debt as the Administration proposed.

One of the accounting tricks in the budget resolution is to ignore the true costs of the financial crisis. According to the IMF, U.S. losses on toxic assets are now estimated at $2.7 trillion. There is a broad consensus among economists that an effective bank clean-up plan is necessary for a sustained economic recovery. The Treasury has proposed a financial rescue plan, but it has serious weaknesses.

The public-private investment funds proposed to purchase toxic loans would be structured so that private investors contributing about 7 percent of the total investment would receive half of the profits, but 93 percent of the losses would fall on the taxpayers. Nobel Laureate Joseph Stiglitz has called the proposal, "robbery of the taxpayers."

Even more disturbing was the testimony last week of Special Inspector General Neil Barofsky before us on the problems with the Treasury's proposal. According to his quarterly report, "Many aspects of PPIP could make it inherently vulnerable to fraud, waste, and abuse." The vulnerabilities identified in his report include the huge size of the program along with conflicts of interest, collusion, and money laundering.

Also troubling was Mr. Barofsky's revelation that the Treasury Department has indicated that it would not adopt his report's recommendations that "all TARP recipients account for the use of TARP funds; set up internal controls to comply with such accounting;" and certify compliance. Why won't the Administration accept basic safeguards for the trillions of dollars of taxpayer money?

Mr. Barofsky's report estimated that up to $3 trillion of taxpayer money is now at risk in 12 different TARP programs. These programs include wide-ranging government involvement in banking, insurance, automotive, housing and other industries. There are many dangerous aspects of this level of government intervention, but the least we can do is protect the taxpayers from fraud. Furthermore, at the earliest feasible time, the firms owned or controlled by the government should be privatized.

In conclusion, the Administration should immediately adopt the safeguards recommended by Mr. Barofsky. The Administration should also develop a plan to sharply reduce the government's involvement in the economy to normal levels once the economy recovers.

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