THE STATE OF THE ECONOMY

HEARING

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

ONE HUNDRED ELEVENTH CONGRESS

FIRST SESSION

HEARING HELD IN WASHINGTON, DC, MAY 21, 2009

Serial No. 111–10

Printed for the use of the Committee on the Budget

Available on the Internet:
http://www.gpoaccess.gov/congress/house/budget/index.html

U.S. GOVERNMENT PRINTING OFFICE

49–969 PDF WASHINGTON : 2009

For sale by the Superintendent of Documents, U.S. Government Printing Office
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THE STATE OF THE ECONOMY

THURSDAY, MAY 21, 2009

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

The Committee met, pursuant to call, at 10:05 a.m., in room 210, Cannon House Office Building, Hon. John M. Spratt, Jr. [Chairman of the Committee] presiding.

Present: Representatives Spratt, Schwartz, Becerra, Doggett, Etheridge, McCollum, Yarmuth, Langevin, Schrader, Ryan, Hensarling, Garrett, Diaz-Balart, Campbell, Jordan, Lummis, Austria, and Latta.

Chairman SPRATT. We convene today to review the state of our economy, a dismal state, and its interaction with the budget. As Director Elmendorf, our witness this morning, told the Committee back last January, our economy is clicking on only four out of six cylinders at best, running at 7 percent below its full employment capacity.

To help put the economy back on its feet, Congress enacted the Troubled Assets Relief Program in October. This year, Congress has passed and the President has signed into law a $787 billion recovery package to spur demand and create 3 million new jobs while reinvesting in our physical and human infrastructure. The Treasury, the Federal Reserve, the FDIC have all taken unprecedented actions.

This morning, we want to explore what is the state of our economy, what is the course it has taken? Very importantly, what are the prospects of recovery? We have been told there are glimmers of hope. Are these glimmers real or they simply a mirage? What effect, in particular, are the extraordinary steps we have taken having upon the economy? The stimulus package, for example? The TARP package? The extraordinary intervention by the Fed and the Treasury? What impact is this having? What are the risks of deflation? And on the other hand, what are the risks of inflation given the extraordinary liquidity being pumped into the economy by the Fed, among others? What problems have we yet to face? I notice in the testimony, reading the testimony last night, that by CBO's estimate and others' estimates the banks of this country, the commercial banks, may face losses of nearly $1 trillion, of which only about a third have yet been recognized.

All in all, we would like to know, what is the state of the economy today? What can we expect for the immediate future? And what policy actions do we need to be taking? To that end, Dr. Elmendorf, the Director of CBO, has prepared extensive testimony, excellent testimony if you have read it. And we will make it part of the record so that you can summarize as you see fit, but you are the only witness this morning.

Now, you need to leave at 12:45. We want to give you wide berth to take as much time as you would like to discuss and to amplify your views of where the economy is going, what effect our policies have had to date, and what policies we should be considering for the future. Before turning to you for your testimony, let me turn to Mr. Ryan for his opening statement.

Mr. RYAN. Thank you, Chairman Spratt. Welcome back, Dr. Elmendorf. First, I just want to say you have lived up to your reputation in coming to CBO, in providing integrity, intelligence, impartiality, and you are doing a good job of upholding the tradition of CBO of being a fair, honest broker with the facts. And I appreciate that. And we encourage you to continue doing what you all are doing. And you guys have a hard job ahead of you. So it is nice to have you back here, and it is nice to see you doing well.

No question, all of us want to see this economy turn around. And all of us hope that the turnaround maybe in fact be on the horizon. And we see glimmers out there. But the economic and fiscal challenges we face are far too complex and too great to simply hope we get it right. We need to address the effectiveness of what we are doing to address today's challenges. And we need to consider where this path that we are speeding down will eventually lead us.

I have a great concern that the administration and Congress have exploited the current economic crisis, and the fear and diverted attention of the American people, to justify rushing through a sweeping and possibly irreversible expansion of the federal government. Let me list just a few things beginning this year. TARP, which was signed into law last year and provided $700 billion in emergency funding intended to thaw credit markets. We have seen this program's scope expand beyond stabilizing the financial sector to auto industry restructuring, auto supplier support, mortgage loan modifications, and insurance industry assistance. Worse, we have seen Washington use this program to pick economic winners and losers. I was part of those original conversations. The idea was to insure or buy toxic assets. Now it is equity injections and owning shares of private organizations.

On monetary policy, the Federal Reserve has pulled out all of the stops. They brought interest rates to all new lows. They have got massive assets on their balance sheets. They are actually monetizing debt. Our concern is that at some point the Fed is going to have to change direction. They are going to have to change course and take back this considerable monetary stimulus in order to prevent a nasty bout of inflation in the coming years. Getting the timing and magnitude of this adjustment right, while avoiding the political pressure to keep monetary policy loose will be critical. And quite frankly, I am skeptical that the Fed can pull it off.

We had the trillion dollar stimulus, which may get us a temporary boost but is certain to result in debt and tax burdens that will hinder sustained economic growth.

And then there is the President's budget, which this Congress has just adopted. We spent a lot of time here debating it, so I will be brief with a few concerns. The budget calls for record levels of spending, swelling this year's deficit to $1.8 trillion, more than triple its previous record; doubles the debt in five years and almost triples it in ten years. It puts us on a path of government controlled healthcare and paves the way for a cap and trade energy tax on nearly every American family, business, and individual, meaning everyone. It even adds almost $1.5 trillion to new entitlement spending, worsening our most severe fiscal problem. The budget calls for $1.5 trillion in new tax hikes in the midst of one of the worst recessions in generations.

Clearly, this is a challenging time and it demands solutions. But I honestly fear the path that we are speeding down, and that this path will only make the situation worse. We are now debating this summer about creating a brand new entitlement program, before we even solve the other three that are exploding just within the next decade.

At every juncture, we have offered alternatives that promote the kind of solid, sustained economic growth we need to keep America great for generations to come, and we have made proposals on how to rein in these entitlement programs so that they are sustainable. We certainly want to continue in this effort. I hope that we can shed some light on the details that are forthcoming in the economy with these programs. And I yield back the balance of my time, and I thank you, Chairman.

Chairman SPRATT. Thank you, Mr. Ryan. And before you proceed, Mr. Director, let me echo the remarks made by Mr. Ryan with respect to the tradition of excellence at CBO which you have continued. We are proud of the work you are doing and appreciate it very much.

And now, the floor is yours. I would encourage you to take your time as you work your way through your testimony.

STATEMENT OF DOUGLAS ELMENDORF, PH.D., DIRECTOR, THE CONGRESSIONAL BUDGET OFFICE

Mr. ELMENDORF. Thank you, Chairman Spratt and Ranking Member Ryan. I appreciate your very gracious introductions. And to all the Committee, I appreciate the invitation to testify to you today about the state of the U.S. economy.

In CBO's judgment the economy will stop contracting and start growing again during the second half of this year. But the hardships caused by the recession will persist for some time. The growth in output later this year and next year is likely to be sufficiently weak, so the unemployment will probably continue to rise into the second half of next year, and peak above 10 percent. Economic growth over time will ultimately bring the unemployment rate back down to the neighborhood of 5 percent seen before this downturn began, but that process is likely to take a number of years.

On a positive side, the fiscal stimulus, provided by the federal government, is now beginning to boost the economy, and financial markets show clear signs of improvement since the fall and winter. Moreover, the sharp reductions seen in manufacturing production will keep inventories to leaner levels than would have occurred otherwise so that upturns in sales, when they come, will lead to faster and larger increases in output.

However, many factors will temper the strength of the recovery: the loss of household wealth, the fragility of financial institutions, persistently weak growth in the rest of the world, a surplus of housing units, and low utilization of manufacturing capacity. How much those factors will dampen the recovery is uncertain. They may be overcome relatively quickly by the jumpstart provided by the stimulus, and improvements in consumer and business confidence. Or they may cause the economy to slump again next year as the effects of the stimulus begin to wane.

Recently released data are consistent with CBO's forecast, in March, that gross domestic product will bottom out this year. Indeed, a wide majority of economic forecasters share that view. However, CBO's assessment of developments in the financial system and the non-financial parts of our economy and other economies suggest that the initial stages of the economic recovery are likely to be more tepid than we had earlier projected. CBO's March forecast of roughly 3 percent growth in real GDP in 2010 is more optimistic than the current consensus, as is the Agency's March forecast for a peak unemployment rate of about 9.5 percent. We are now beginning the process of updating our previous forecast and will release a new forecast in August.

The uncertainty surrounding our forecast, and the forecasts of private analysts, deserves emphasis. If we could put up slide one, please?

The future course of the economy is always uncertain. This chart shows the confidence region around our March forecast of real GDP. The darker areas are the more likely outcomes and the progressively lighter areas are less likely outcomes. Uncertainty is especially great in economic forecasting, though, around turning points, and in unfamiliar conditions such as the current financial crisis. Moreover, even if the economy returns to positive growth this year, as we and almost all other forecasters expect, the loss in output and income during this downturn will be huge. As shown in the next slide depicting our March forecast, the difference between the economy's actual and potential output, what could be produced if all factors for production, labor and capital, were being fully utilized, will average 7 percent of GDP this year and next. That is about $1 trillion per year of lost output, and that gap in output will not close until 2013.

Based on current information, our next forecast is likely to show even larger shortfalls in output over the next few years. By this measure, the current recession and its aftermath will be the most severe economic downturn of the postwar period.

The persistence of high unemployment in our forecast does not stem from a failure of fiscal stimulus. We expect that the stimulus legislation will boost GDP a little more than dollar per dollar of reduced tax collections and increased outlays. However, as large as the stimulus package is, the contraction underlying private demand is far larger. So the stimulus will offset only part of the contraction.

Let me conclude with a few words about the budget outlook. Most experts believe that larger deficits are appropriate during recessions, because higher spending and lower taxes can bring the levels of resource use and output closer to the economy's potential.

From this perspective, the extremely large deficit this year, roughly $1.7 trillion, or nearly 12 percent of GDP in CBO's March projection, serves a purpose. However, most experts also believe that persistent large budget deficits reduce capital accumulation and thereby slow the growth of output and incomes in the medium and long run. Thus, the large deficits that we project for the years after the economy has returned to full employment, shown in the next slide, are more worrisome.

Moreover, the sharp increase in debt this year and in the next few years, the last slide please, raises the risk that investors might lose confidence in government debt as a safe haven. This risk heightens the importance of putting the budget on a sustainable path as the economy returns to full employment.

Thank you. I am happy to take your questions.

[The prepared statement of Douglas Elmendorf follows:]

STATEMENT OF DOUGLAS W. ELMENDORF, PH.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

In the Congressional Budget Office's (CBO's) judgment, the economy will stop contracting and resume growing during the second half of this year, but the hardships caused by the recession will persist for some time. The growth in output later this year and next year is likely to be sufficiently weak that the unemployment rate will probably continue to rise into the second half of next year and peak above 10 percent. Economic growth over time will ultimately bring the unemployment rate back down to the neighborhood of 5 percent seen before this downturn began, but that process is likely to take several years.

On the positive side, the fiscal stimulus provided by the federal government is now beginning to boost the economy, and financial markets show clear signs of improvement since the fall and winter. Moreover, the sharp reductions seen in manufacturing production will keep inventories to leaner levels than would have occurred otherwise, so that upturns in sales, when they come, will lead to faster and larger increases in output.

However, many factors will temper the strength of the recovery: the loss of household wealth; the fragility of financial institutions; persistently weak growth in the rest of the world; a surplus of housing units on the market; and low utilization of manufacturing capacity. How much those factors will dampen the recovery is uncertain: They may be overcome relatively quickly by the jump start provided by the stimulus and improvements in consumer and business confidence, or they may cause the economy to slump again next year, as the effects of the stimulus begin to wane.

Recently released data are consistent with CBO's forecast in March that gross domestic product (GDP) will bottom out this year.[1] Indeed, a wide majority of economic forecasters share that view. However, CBO's assessment of developments in the financial system and in the nonfinancial parts of the economy suggests that the initial stages of the economic recovery are likely to be more tepid than the agency had projected earlier. CBO's March forecast of 2.9 percent growth in real (inflation-adjusted) GDP in 2010 is more optimistic than the current consensus, as is the agency's forecast for a peak unemployment rate of about 9½ percent. CBO is now beginning the process of updating its previous forecast and will release a new forecast in August.

The uncertainty surrounding CBO's forecast—and the forecasts of private analysts—deserves emphasis. The future course of the economy is always uncertain, as can be seen in the confidence region around the agency's March forecast of real GDP (see Figure 1). Moreover, uncertainty is especially great around economic turning points and in conditions that have not been seen in the economy for some time, such as the current financial crisis.

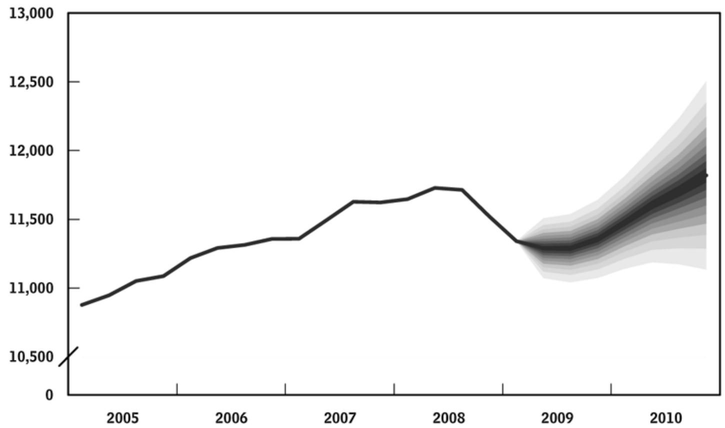
Even if the economy returns to positive growth this year, the loss in output, income, and employment during the recession and the next few years will be huge. Under CBO's forecast from March, the difference between the economy's actual and

1. Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* (March 2009).

Figure 1.

Uncertainty in Projections of Real GDP

(Billions of 2000 dollars)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: This figure, based on CBO's past errors in forecasting real (inflation-adjusted) growth, shows a range of possible outcomes for real gross domestic product (GDP). CBO's March projection falls in the middle of the darkest area of the figure. If the potential errors in the current forecast are similar to the errors in CBO's forecasts published between 1976 and 2006, the probability is 90 percent that real GDP will fall in the shaded area of the graph. In the current circumstances, larger errors are more likely to occur than usual.

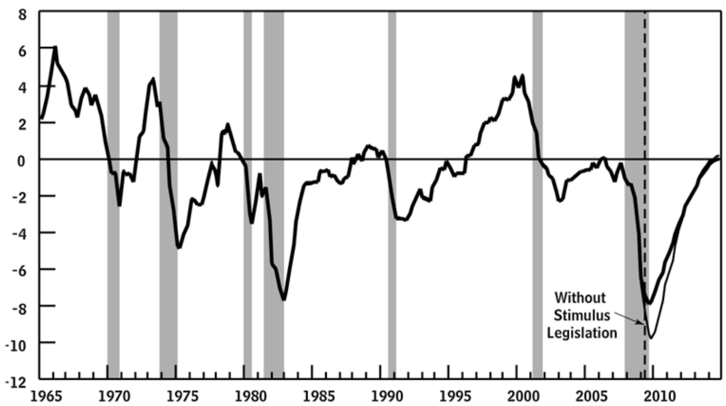
potential output will average 7 percent of GDP (which is equivalent to about a trillion dollars) this year and next, and that gap in output will not close until 2013 (see Figure 2). CBO's forecast in August is likely to show even larger shortfalls in output over the next few years. By this measure, the current recession and its aftermath will be the most severe economic downturn of the postwar period.

Short-term and long-term goals for the federal budget are often in conflict during recessions. Whenever the threat of inflation is low and productive resources are not being fully used—that is, when the unemployment rate is high and many factories are idle—an important goal of fiscal policy is, most experts believe, to stimulate spending in the near term. By increasing the budget deficit through higher spending and lower taxes, the federal government can encourage growth and bring the levels of resource use and output closer to the economy's potential. But the long-run outlook for the federal budget is unsustainable and, if it is not resolved, will undermine economic growth. The sharp increase in debt this year and over the next few years heightens the

Figure 2.

The GDP Gap, 1965 to 2014

(Percent)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: The GDP gap is the difference between real (inflation-adjusted) gross domestic product and its estimated potential level (which corresponds to a high level of use of labor and capital resources).

Data are quarterly and are plotted through the fourth quarter of 2014.

importance of putting the budget on a sustainable path as the economy approaches full employment.

Is the Contraction Moderating?

Although huge uncertainties about the near-term path of the economy remain, a number of indicators have begun to show improvement of late. Manufacturing output may be stabilizing; consumer spending and confidence are showing some signs of life; initial claims for unemployment insurance may have peaked; a number of measures of financial markets have improved; and there are some signs that the decline in housing construction may be close to bottoming out.

Most forecasters now anticipate that the trough of the recession will occur sometime in the second half of this year. In a survey of about 50 private-sector forecasters released on May 10, the average forecast of GDP indicated a decline of 1.7 percent in the current quarter and weak positive growth during the second half of this year. The average of the 10 most optimistic forecasters indicated mildly positive growth in this quarter, and the average of the 10 most pessimistic indicated that the economy would begin to recover in the fourth quarter (see Table 1).

Table 1.

Private-Sector Forecasts for 2009 and 2010

	2009, by Quarter				Annual Average	
	1st	2nd	3rd	4th	2009	2010
Growth of Real GDP[a] (Percentage change)						
Top 10	-6.1	0.3	2.1	3.3	-2.3	2.8
Consensus	-6.1	-1.7	0.5	1.8	-2.8	1.9
Bottom 10	-6.1	-3.6	-1.3	0.4	-3.3	1.0
Unemployment Rate (Percent)						
Top 10	8.1	9.3	9.9	10.3	9.4	10.4
Consensus	8.1	9.0	9.4	9.7	9.1	9.7
Bottom 10	8.1	8.7	9.0	9.2	8.8	9.0

Source: Aspen Publishers, Inc., *Blue Chip Economic Indicators* (May 10, 2009).

Note: Growth rates are expressed as annual rates, and annual averages describe year-over-year growth.

a. Real GDP = inflation-adjusted gross domestic product.

Nevertheless, numerous factors pose the threat of continued weakness, highlighting the uncertainty of even those tentatively optimistic forecasts for the near term. Business fixed investment is likely to be extremely weak for some time, foreign economic activity slumped sharply in recent quarters, and many financial institutions face large further losses in coming years.

Manufacturing

Over the past few quarters, manufacturing output collapsed as firms reduced their output even more than their sales declined. However, the Institute for Supply Management's index of new orders, which tend to precede changes in manufacturing output, has rebounded over the past four months. That rebound does not yet indicate a corresponding rebound in manufacturing activity but does suggest a lessening in the rate of decline or, perhaps, a leveling out. Regional surveys of manufacturing (compiled for Chicago, New York, and Philadelphia) generally support that signal.

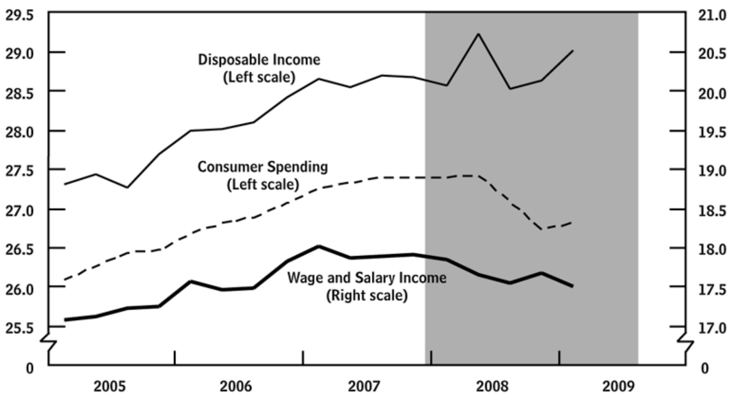
Consumer Spending

After falling at about a 4 percent annual rate during the second half of 2008, real personal consumption expenditures grew at a 2.2 percent rate in the first quarter. In recent months, measures of consumer confidence have either stopped falling or have ticked up slightly. Although the drop in employment has cut labor income, real disposable personal income actually rose in the first quarter, because of higher transfer payments (including a large cost-of-living adjustment for Social Security recipients), lower tax payments (or larger refunds), and lower energy prices. Real disposable income per capita has not fallen during this recession even though wage and salary income has (see Figure 3).

Figure 3.

Real Income and Consumer Spending per Capita, 2005 to 2009

(Thousands of 2000 dollars per person)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Note: Data are quarterly and are plotted through the first quarter of 2009.

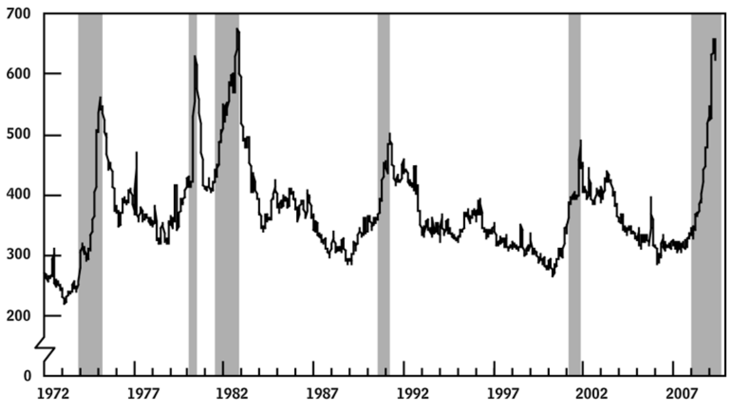
Two influences are supporting households' spending in the near term, but other factors may yet outweigh those effects. The American Recovery and Reinvestment Act of 2009 (ARRA, Public Law 111-5) is currently bolstering disposable income. Specifically, lower payroll tax withholding resulting from that legislation began in March and was fully phased in on April 1, and unemployment insurance benefits have been increased. Spending may also be receiving a boost from a new wave of mortgage refinancing, which in recent months has occurred at the highest rate since early 2003 and which may permit some households to reduce their monthly payments or withdraw equity. Although those effects may be small given recent changes in house prices, they contribute to households' spending.

But despite the effects of the stimulus package and mortgage refinancing, the sustainability of the recent gains in households' spending is unclear. Two factors—households' desire to increase saving in response to their loss of wealth over the past three years and further reductions in employment—may limit any near-term rebound in consumption. Declines in wealth will encourage households to try to raise their saving rate by slowing the growth of their spending. Households' loss of wealth in the past few years is likely to cause the saving rate to be at least 4 percentage points higher this year than it would have been otherwise. Some economists expect even larger increases in saving—perhaps back to the rates of 8 percent to 10 percent that prevailed before 1980. Although greater saving by households is beneficial in the long run—because it

Figure 4.

Initial Claims for Unemployment Insurance, 1972 to 2009

(Thousands)



Sources: Congressional Budget Office; Department of Labor, Employment and Training Administration, Unemployment Insurance Division.

Note: Data are four-week moving averages of weekly data and are plotted through May 8, 2009.

would help provide domestic financing for investment—in the short run, it may prolong the current recession.

Low employment and slow wage growth may also undermine consumer spending. For the recent resilience in households' spending to be sustained, declines in the number of hours worked and in the growth of wages must slow. There are some tentative signs that employment will not deteriorate as rapidly over the next few months as it has over the past eight months, but the growth of households' income from wages is likely to be depressed throughout this year.

The Labor Market

With the exception of initial claims for unemployment insurance, labor market indicators tend to lag changes in economic activity. The pattern of past recessions suggests that employment will not increase and the unemployment rate will not decline until 6 to 12 months after output begins to increase again. Hiring lags behind the initial stages of a recovery because firms tend to increase output by first increasing the number of hours employees work and their productivity and then later by adding employees. The unemployment rate also lags behind the turning point because the number of people seeking work tends to rebound faster than employment. According to the latest comprehensive information about employment from the Bureau of Labor

Statistics, the rate of deterioration in employment slowed only mildly in April, and the unemployment rate has continued to rise rapidly.

However, small signs of potential improvement in the labor market have emerged. The four-week moving average of initial claims for unemployment insurance has eased slightly, from 659,500 in the week ending April 3 to 630,050 in the week ending May 8 (see Figure 4). Initial claims for unemployment insurance may be useful as a leading indicator because, in the past five recessions, that number has typically started to decline at about the time the recession was ending. The number of claims responds more quickly than other employment indicators to changes in labor market conditions because the data pick up changes in flows into unemployment, rather than increases in employment. Although the data can be erratic, other information on the labor market (such as surveys of hiring plans, layoff announcements, and perceptions of the availability of jobs) also indicate some improvement in employment conditions.

Financial Markets

Some indicators suggest that conditions have improved in a number of financial markets, but those markets nevertheless remain strained. For example, a measure of the risk of default on interbank lending, which had jumped to 365 basis points in October 2008, eased back to 123 basis points by early this year; most recently, on May 8, it stood at 60 basis points, the narrowest spread since March 2008 (see Figure 5).[2] A narrower spread between the yields on corporate bonds and 10-year Treasury notes also indicates some improvement in financial conditions. For high-quality AA-rated corporate debt, the spread peaked at the same time that the spread for interbank lending did and then started to lessen. The improvement has accelerated over the past two weeks, with the yield spread narrowing by 70 basis points. The narrowing of spreads at the low end of the spectrum of investment-grade debt has been more gradual. The spread for BBB-rated debt remained elevated throughout the end of 2008 and the first quarter of 2009, reflecting the greater likelihood that lower-rated companies will have trouble paying their debt, particularly in an economic downturn, compared with higher-rated companies. Nevertheless, that spread has also narrowed by about 70 basis points over the past two weeks.

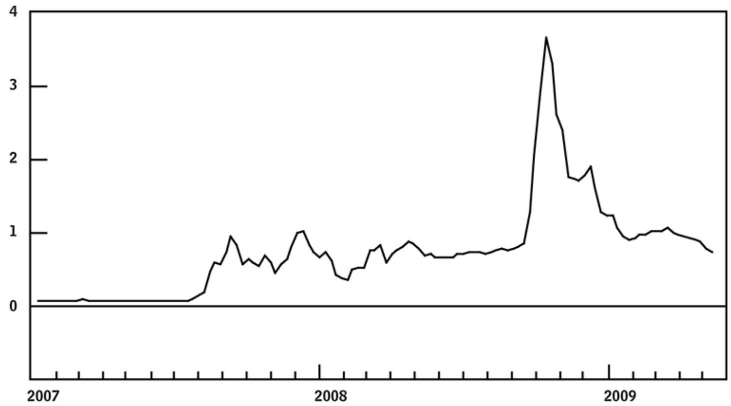
Another measure of risk, the equity premium—or the compensation that investors require for the risk of holding stock relative to the safety of Treasury notes— indicates less aversion to risk in equity markets. One measure of that premium, the spread between the earnings yield on equities and the interest rate on 10-year Treasury notes, has fallen by half since March—as the broad-based Standard & Poor's 500 index

2. The spread referred to is the difference between (1) the three-month Libor (London interbank offered rate, or the interest rate major banks offer to other banks for loans of that duration) and (2) market expectations of the federal funds rate (which can be measured from an overnight index swap contract). A basis point is one one-hundredth of a percentage point.

Figure 5.

The Risk Spread on Lending Between Banks, 2007 to 2009

(Percentage points)



Sources: Congressional Budget Office; Bloomberg.

Notes: A spread is the difference between two interest rates. One, the three-month Libor (London interbank offered rate), is the interest rate major banks offer to other banks for loans of that duration. The other is the average federal funds rate expected over a three-month period as measured by the overnight index swap contract.

Data are weekly and are plotted through May 8, 2009.

gained about 40 percent (correspondingly reducing the earnings yield on equities) and the yield on 10-year Treasury notes increased 60 basis points.[3]

Additionally, interest rates on residential mortgages remain under 5 percent, the lowest level in at least 38 years. The Federal Reserve's purchases of securities backed by residential mortgages have played some role in lowering mortgage rates.

In contrast, the Federal Reserve's survey of lending conditions shows only slight improvement over the past few months. A smaller percentage of banks are tightening their business-lending policies than were doing so earlier in the year, but all in all, banks are still tightening those policies.

Housing

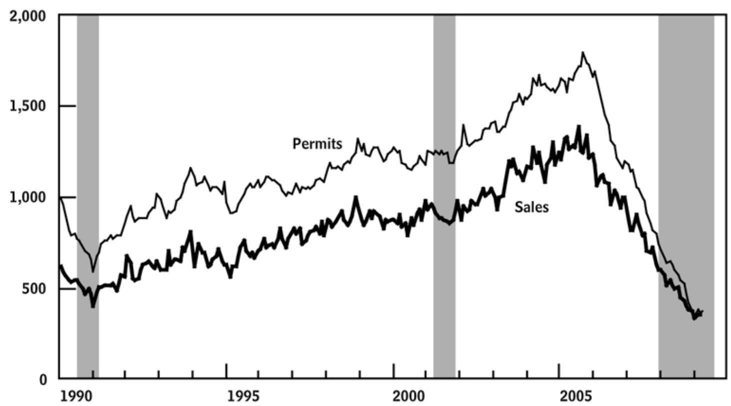
Sales of new homes and the number of single-family housing permits and starts have stopped falling in recent months, but a closely followed house price index, the

3. The earnings yield on equities is calculated by dividing the earnings per share over the preceding year by the current price of a stock.

Figure 6.

Single-Family Housing Permits and New Home Sales, 1990 to 2009

(Thousands)



Sources: Congressional Budget Office; Bureau of the Census and the Department of Housing and Urban Development; National Association of Realtors, Economics and Research Division.

Note: Data are monthly and are plotted through March 2009.

Case-Shiller index, is still declining (see Figures 6 and 7). Even though very low mortgage rates have improved the affordability of homes, concerns about further declines in prices, the difficulty in raising down payments during the recession, and the tightening of credit standards have so far kept sales from rebounding. Until sales pick up, the excess of new homes for sale will remain high, and new housing starts will probably remain moribund. Furthermore, the rate of foreclosures remains high, which may dampen expectations of stabilizing prices, further undercutting sales.

Foreign Economic Developments

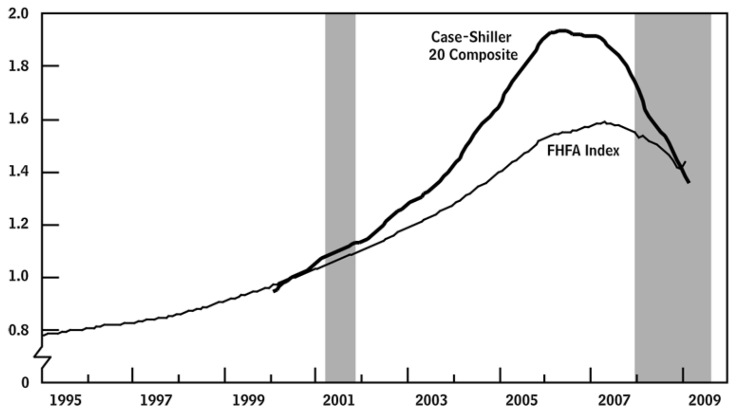
Despite a few uncertain signs of improvement, many countries in the rest of the world are still in a severe recession. Equity markets have improved in most countries; business and consumer confidence has rebounded somewhat; the contraction in manufacturing activity has moderated in some countries; and in China, South Korea, and India, manufacturing activity has expanded in recent months. Furthermore, credit spreads have narrowed overseas, as they have in the United States.

However, the current declines in economic activity in most of the advanced economies—the major trading partners of the United States—now appear to be much worse than anticipated a few months ago. In the first quarter of this year, output in the 16-country Eurozone fell by 10.4 percent at an annual rate, the biggest drop since

Figure 7.

House Price Indexes, 1995 to 2009

(Index: 2000 = 1)



Sources: Congressional Budget Office; Federal Housing Finance Agency; Standard & Poor's; Fiserv; and MacroMarkets LLC.

Notes: The FHFA index is the Federal Housing Finance Agency's monthly measure of house purchases for the nation. The S&P/Case-Shiller index is the monthly measure for 20 metropolitan areas. Both measures track repeat sales of existing single-family houses to avoid distortions resulting from changes in quality attributable to the mix of houses. The FHFA index is generally a broader measure, but it includes only transactions involving conforming conventional mortgages purchased or securitized by Fannie Mae or Freddie Mac, whereas the S&P/Case-Shiller index does not exclude any type of mortgage.

Monthly S&P/Case-Shiller house price indexes are calculated using three-month moving averages and published with a two-month lag.

Data are monthly and are plotted through February 2009.

the data were first collected in 1995. In the United Kingdom, real GDP in that quarter fell by 7.4 percent at an annual rate. Similarly, Japan's economy contracted at an annual rate of 15.2 percent in the first quarter of this year. Canada's economy is stronger, though still in recession; that country's output fell at an annual rate of 3.4 percent in the fourth quarter of last year.

The only major countries with prospects for positive growth this year are China and India. China's economy grew at a rate of 6.1 percent in the first quarter of this year. According to one index, manufacturing activity in China first expanded in March and grew further in April, as the decline in export orders moderated and as investment increased, prompted in part by the government's $586 billion stimulus package. India has weathered the international downturn somewhat better than other economies because its export sector is a small share of the economy.

Spending by Businesses

Businesses' spending on fixed investment, especially structures such as offices, oil wells, and retail space, does not appear likely to recover soon. A leading indicator of business investment in structures, the billings index of the American Institute of Architects, implies severe declines in nonresidential construction during the rest of the year. Other investment spending by businesses—that for equipment and software—is also weak, though it may recover if the rest of the economy picks up. Spending on equipment tends to lag in recoveries, as businesses usually wait until demand for their products begins to press their existing capacity before they commit to additional capital spending. Because the utilization rate of manufacturing capacity, at 65.7 percent, is the lowest it has been in the postwar period, business investment spending may be slow to recover. The continued contraction in investment spending threatens to undercut any increase in demand from other sectors of the economy. If households' spending continues to post moderate gains, but businesses' spending on equipment and software fails to respond to the pickup in demand, the recovery could be very weak.

Major Determinants of the Outlook Through 2010

The outlook for the next year and a half is influenced by a number of factors: the effectiveness of the American Recovery and Reinvestment Act; the degree to which excess stocks of housing, business structures, and inventories may dampen the recovery; and, of course, the state of financial markets and the effect that they, along with consumers' need to reduce their debt, will have on the economy.

Although CBO expects that ARRA will provide a significant boost to economic activity the rest of this year and next, uncertainty about the legislation's effects is greater than normal for fiscal stimulus because the stimulus was enacted during a period of unprecedented financial turmoil and was significantly larger than such efforts in the past.

Similarly, there is uncertainty about the degree to which the excessive accumulation of physical stocks (for example, housing units or automobile inventories) and financial imbalances will affect growth for the next year and a half. Stocks of housing and goods have fallen relative to sales, but it is not clear how much further they must fall to encourage a rebound in production.

Last, gauging the effects of the financial turmoil on the near-term outlook is problematic. The improvement in various financial market indicators in the past several months does not prove that the financial system is strong enough to provide sufficient lending to support a robust economic recovery. Indeed, economic recovery may be necessary for the full recovery of the financial system, rather than the other way around.

Table 2.

Estimated Macroeconomic Impacts of the American Recovery and Reinvestment Act of 2009, Fourth Quarters of Selected Calendar Years 2009 Through 2019

	Fourth Quarters of Calendar Years			
	2009	2010	2011 ...	2019
Real GDP[a] (Percentage change from baseline)				
Low estimate of effect	1.4	1.1	0.4	-0.2
High estimate of effect	3.8	3.4	1.2	0
Unemployment Rate (Percentage-point change from baseline)				
Low estimate of effect	0.5	0.6	0.3	0
High estimate of effect	1.3	1.9	1.0	0
Employment (Millions of jobs change from baseline)				
Low estimate of effect	0.9	1.2	0.6	0
High estimate of effect	2.3	3.6	1.8	0

Source: Congressional Budget Office.

a. Real GDP = inflation-adjusted gross domestic product.

The Effects of the American Recovery and Reinvestment Act

Only a small part of the spending authorized by ARRA has occurred so far. It appears that about 5 percent, or about $19 billion, of the approximately $380 billion in budget authority for 2009 granted under the law was spent through the end of April. (Reported expenditures of $29 billion include $11 billion in federal transfers into the unemployment insurance fund, most of which has not yet been distributed to recipients.) In contrast, reductions in payroll taxes were fully in place by April 1.

That rate of spending is broadly consistent with the assumptions that CBO used to estimate the macroeconomic effects of the legislation. Under those assumptions, ARRA will boost the level of GDP by the end of this year by between 1.4 percent and 3.8 percent, but the positive effects of the law on the level of GDP will taper off during 2010 and subsequent years (see Table 2). Therefore, the recovery will falter in 2010 if private-sector demand for goods and services does not accelerate to offset the diminishing federal stimulus.

Imbalances in Inventories of Goods and Structures

In spite of the massive slowing in the creation of new housing units, CBO estimates that the excess of unsold homes is still between 2½ and 3 million units. At current rates of construction and sales, that surplus would take about two years to work through. However, it seems likely that housing starts will gradually pick up in 2010, and the elimination of the surplus in housing will occur over many years.

During 2007, just before the onset of the recession, inventories of goods rose relative to sales. The slowdown in sales during 2008 kept the inventory-to-sales ratio high even as manufacturers slowed production. Ultimately, manufacturers slashed production by the end of last year, which finally reduced the overall "overhang" in inventories. Of course, some sectors still have significant surpluses, the motor vehicle sector in particular, but the overhang is not likely to dampen growth now as much as it did during the past 12 months.

The situation for business structures may be the worst. The stock of retail space, warehouses, factories, and the like appears to be far in excess of current needs, and businesses' investment in structures is likely to fall steadily throughout this year. It could fall further during 2010, even if there is a mild recovery for the rest of the economy.

Gauging the Effects of the Financial Turmoil

Although a number of financial market indicators are encouraging, huge questions remain about the ability of the system to adequately finance an economic recovery. Because of massive losses, banks have been tightening the availability of credit, and now it is primarily the higher-quality borrowers who have ready access to financing from banks. Major sources of uncertainty are the magnitude of additional losses that financial institutions may experience, the effectiveness of the various financial rescue actions, and the extent to which households' spending will be held back by losses in wealth. In addition, tracking the effect of the financial sector on the real economy is subject to uncertainties of its own.

Estimates of Losses of U.S. Financial Institutions. Banks and other financial institutions are in the process of absorbing losses on their bad loans and reducing their leverage—the amount of assets in relation to their capital. However, losses absorb capital and hence slow the deleveraging process. While that deleveraging occurs, financial institutions will be less willing to make risky loans, hurting the ability of businesses and consumers to spend and invest. If losses on loans remain high—as most analysts believe—the deleveraging process and the recovery of the financial sector will take some time to complete.

Recent estimates suggest that U.S. financial institutions will need to absorb a significant amount of losses over the next few years. According to *The Supervisory Capital Assessment Program: Overview of Results*, released by the Federal Reserve Board, losses at the 19 largest U.S. banks will total approximately $950 billion through 2010 under pessimistic economic conditions. Of that $950 billion, approximately $350 billion has already been recognized, leaving nearly $600 billion in anticipated losses in 2009 and 2010. The International Monetary Fund, in its April 2009 *Global Financial Stability Report*, predicts that the entire banking sector in the United States and Europe combined will have to write down and charge off more than $1.6 trillion in losses this year and next.

Financial Rescue Actions. The losses on financial instruments have created enormous uncertainty about the health of financial institutions, which has led to problems in other financial markets. The financial rescue actions by the Treasury, the Federal Reserve, and the Federal Deposit Insurance Corporation have played a significant role in stabilizing financial markets and maintaining a flow of credit. Indeed, some lending programs created by the Federal Reserve since the crisis began are already shrinking in size, suggesting that some markets are beginning to return to normal. For example, the size of the Commercial Paper Funding Facility (CPFF) has declined from a high of approximately $350 billion in January to $167 billion in the week ending May 13. Dollar funding provided to foreign central banks via liquidity swaps has also fallen from a peak of $580 billion in December to $250 billion. With Libor (London interbank offered rate) funding becoming more readily available, banks outside the United States have less need to obtain dollars from their central banks.

Financial Adjustments by Consumers. Consumers' attempts to reduce spending to better cope with the recession are also prolonging the recession and will probably weaken the recovery. Household wealth increased rapidly between 2001 and 2006, spurred primarily by the appreciation in house prices but also by gains in financial assets. Households borrowed against some of those gains to finance a boost in personal consumption expenditures—in effect, they were able to increase their spending faster than their income was increasing. As a result, the standard measure of the household saving rate declined rapidly during that time. Since the onset of the recession, however, households have reduced their appetite for debt and raised their saving rate. They may want to cut back more on spending, however, to try to further reduce debt and build up savings.

Assessing the Effects of Financial Markets. Assessing the role of the financial problems in the current recession is complicated by the presence of other significant recessionary factors and the difficulty of determining how much of the reduction in the growth of credit stems from supply constraints versus the usual drop in demand for credit during recessions. If a significant part of the sharp decline in economic activity over the past six months stemmed from factors other than the financial problems, then the near-term outlook may not depend as heavily as most forecasters believe on assumptions about the state of financial markets and institutions.

A number of factors other than the financial turmoil probably played a large role in the decline in economic activity during 2008 and early 2009:

- Most of the debilitating effect of the persistent decline in housing construction and housing-related employment occurred long before the severe phase of the financial crisis in September 2008;

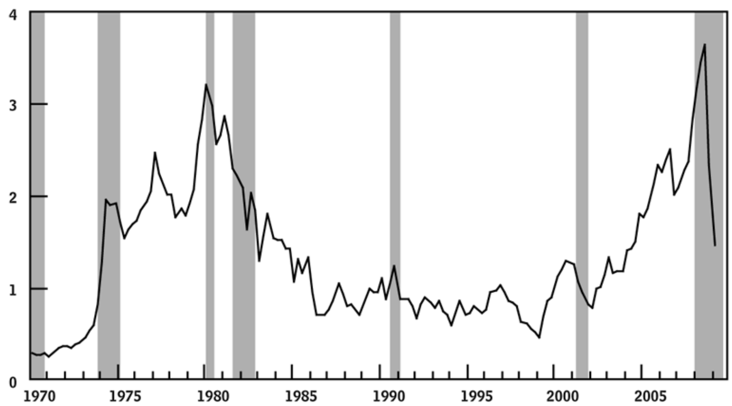
- The decline in housing wealth contributed to the recession by reducing households' spending on goods and services, and much of that decline also predated the financial market turmoil; and

- The sharp rise in oil prices between early 2007 and the third quarter of 2008 had a large negative effect on the economy.

Figure 8.

Petroleum Imports as a Share of Nominal GDP, 1970 to 2009

(Percent)



Sources: Congressional Budget Office; Department of Commerce, Bureau of Economic Analysis.

Notes: GDP = gross domestic product.

Data are quarterly and are plotted through the first quarter of 2009.

The rise in oil prices may have been the most significant factor. The value of petroleum imports rose from 1.3 percent of GDP at the end of 2003 to 3.7 percent in the third quarter of 2008 (see Figure 8). The increase was particularly sharp during the last four quarters of that period, and such increases in the past were followed by recessions. The short-run effect of the increase in oil imports on GDP is similar to that of a sharp tax hike, so the rise in oil prices certainly weakened growth in the United States and may have been sufficient to cause at least a mild recession by itself. Since then, however, the implicit tax imposed by oil imports has dropped back down to 1.4 percent of GDP in the first quarter of this year, greatly lessening the drag on the economy.

Another difficulty in assessing the relationship between financial problems and the real economy is determining how much of the credit tightness stems from supply factors. Growth in lending has certainly been weak, but a large part of the contraction probably is due to the effect of the recession on the demand for credit, not to the problems experienced by financial institutions.

The Threats of Deflation or Higher Inflation

The outlook for 2010 is also clouded by uncertainties about prices. The recession has raised two apparently contradictory concerns. In the near term, the weakness of the economy, combined with falling price indexes both here and abroad, seems to pose the threat of deflation. However, in the longer term, the Federal Reserve's actions to try to fight the recession raise concerns that excess liquidity after the economy has recovered could pose the threat of high inflation. Both of those concerns have to do with the constraints on the ability of the Federal Reserve to achieve its goals.

Deflation is the bigger threat, at least for 2010. Deflation is the decline in a broad array of prices of goods and services for a protracted period. It is a concern because deflation and expectations of future deflation discourage investment and spending. Because nominal interest rates cannot go below zero, a decline in prices implies an increase in real interest rates, reducing the desire of both firms and households to borrow for investment or consumption spending. A deflationary spiral—lower prices, growing real debt burdens, lower spending, and subsequently even lower prices and lower spending—contributed to the depth of the Great Depression, and some analysts argue that even the mild deflation experienced by Japan during the 1990s made it more difficult for the country to escape a period of economic stagnation.

Measures of prices have fallen in the United States and in many other countries, but that phenomenon is not by itself an indication of deflation. Price indexes have fallen primarily because of the sharp drop in the prices for oil and many other commodities since July 2008, but prices have not yet fallen for a wide variety of goods and services. However, the huge amount of excess capacity, indicated by the size of the GDP gap, could drive down the prices of more goods and services.

In contrast, the massive amount of monetary stimulus during 2008 and 2009 has raised concerns about rapid inflation in 2010 or subsequent years. The Federal Reserve has engineered a huge increase in liquidity in the financial system to mitigate the contractionary effects of the credit crunch. Because reducing the federal funds rate—its most commonly used policy tool—was clearly insufficient to alleviate the problems in financial markets, the Federal Reserve took actions to ease conditions in credit markets more directly. It reduced the terms for lending to depository institutions; cooperated with foreign central banks through currency swaps; and, for the first time since the 1930s, extended credit and other support to nondepository institutions. That increase in liquidity will need to be drawn down as the economy recovers, in order to avoid the possibility that demand will run ahead of supply and create inflation.

The Federal Reserve can take actions to try to avoid both deflation and high and persistent inflation. The actions that it has already taken, intervening directly in credit markets and buying Treasury securities, could be vastly expanded if deflation started to affect the economy. Conversely, the Federal Reserve has designed some of its programs (such as the CPFF) to be self-liquidating: They charge interest rates that the private market will not be willing to pay in normal times. Any additional excess liquidity would have to be pulled back quickly by reversing direct intervention programs, reducing reserves, and raising interest rates.

The risks of deflation and high inflation remain, however, because it is by no means easy to determine when further monetary easing or tightening is appropriate. The Federal Reserve must base its policy decisions largely on uncertain measures of the current economic situation and forecasts of the near term. Policy, therefore, may not be able to forestall deflation or high inflation, and if either extreme came to pass, the recovery could be adversely affected. A threat of high inflation might cause the Federal Reserve to raise interest rates and slow growth before the recovery took hold; and deflation would cause buyers to pull back, similarly slowing growth.

The Conflict Between Near-Term and Long-Term Fiscal Objectives

During a recession there is an inherent tension between fiscal policy goals for the near term and for the long term. Efforts to combat the recession, such as ARRA, may have significant short-term benefits, but they also increase the budget deficit for at least the short run. CBO's March baseline implied that deficits would peak at about 12 percent of GDP in fiscal year 2009 and remain at about 2 percent of GDP throughout the 2013–2019 period and that debt held by the public would peak at 62 percent in 2011—even if the economy recovered to its potential level of output and current laws, under which tax rates revert to higher levels, remained in place (see Figures 9 and 10). Beyond the 10-year budget window, pressures arising from spending on health care portend higher deficits.

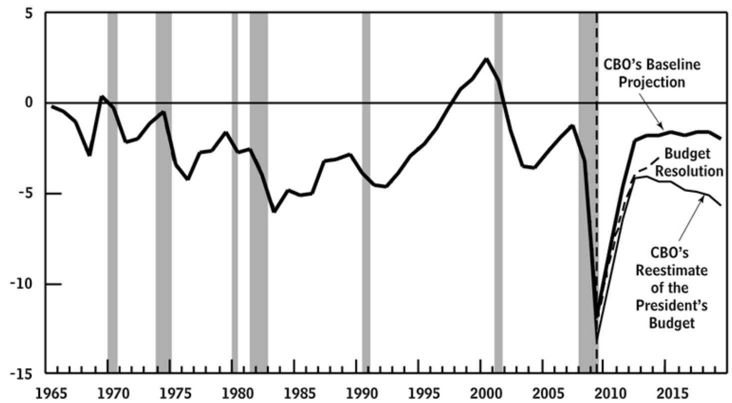
Budget deficits tend to slow economic growth in the long term if they are allowed to persist, because they tend to reduce capital accumulation and the upward trend in the economy's capacity to produce. Given the significant projected shortfall of federal revenues relative to outlays in the medium term, and the larger projected shortfalls in the long term, any policy designed to provide short-term fiscal stimulus will have to contend with long-term consequences. Increases in spending and decreases in taxes that are intended to be temporary may be difficult to reverse later. Moreover, even if taxes and noninterest spending return to their baseline levels, the additional debt service from the period of larger deficits will—unless offset by greater fiscal discipline later—crowd out some amount of future economic growth.

In addition to their negative long-term effects, policies that substantially worsen the fiscal outlook can have negative short-term effects as well. The nation currently benefits greatly from the fact that investors worldwide consider U.S. Treasury securities a safe haven in times of trouble. That tendency provides an important advantage for the United States in times of crisis, helping to increase liquidity and decrease interest rates. If investors lost confidence in the government's debt as a safe haven because of deterioration in the long-term fiscal outlook, the U.S. economy would lose that advantage, perhaps permanently.

Figure 9.

Total Deficit or Surplus, 1965 to 2019

(Percentage of GDP)



Source: Congressional Budget Office.

Notes: GDP = gross domestic product.

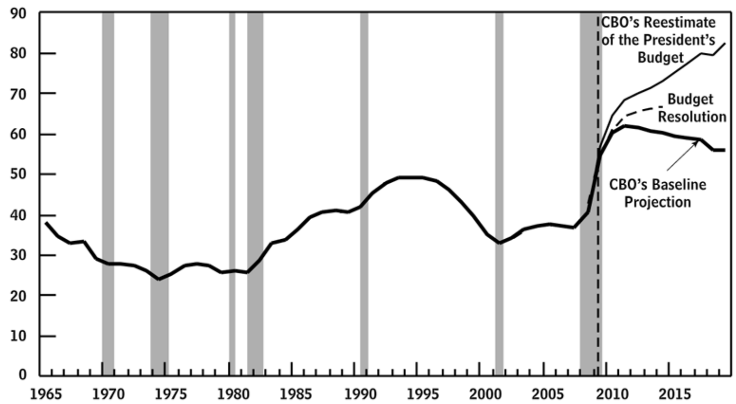
For information on CBO's baseline projection and reestimate of the President's budget, see Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* (March 2009). The data on the budget resolution are from the conference report *Concurrent Resolution on the Budget for Fiscal Year 2010* (April 27, 2009).

Data are by fiscal year and are plotted through 2019.

Figure 10.

Debt Held by the Public, 1965 to 2019

(Percentage of GDP)



Source: Congressional Budget Office.

Notes: GDP = gross domestic product.

For information on CBO's baseline projection and reestimate of the President's budget, see Congressional Budget Office, *A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook* (March 2009). The data on the budget resolution are from the conference report *Concurrent Resolution on the Budget for Fiscal Year 2010* (April 27, 2009).

Data are by fiscal year and are plotted through 2019.

Chairman SPRATT. Dr. Elmendorf, one of the things you point out in your testimony is that the current economy, current recovery effort, may peter out as the effect of what we have done thus far be-comes attenuated into 2010, or maybe 2011. Could you expound upon that? Just how big a risk is it that the effects will cease to have effect, and there might be a second slump?

Mr. ELMENDORF. Yes, Mr. Chairman. If we could put up the second table? I am not sure where that stands in the number of slides. I think that will help the, slide nine, please. In our estimate, Mr. Chairman, the stimulus package provides the largest boost to the level of GDP this year, near the end of this year, in 2009. And the range of those effects, as shown in the upper left set of numbers in this table, as you know we offered a range of estimates given the great uncertainty, so we estimate that the effect of the stimulus package is to raise the level of real GDP between 1.5 percent and 3.75 percent at the end of this year. And that reflects the initial burst of tax reductions and spending increases.

But the effect wanes over time as the stimulus package wanes over time. In other words, the stimulus package principally cut taxes and raised spending in the near term, and as those effects wane then the direct effects on GDP wane as well. So we think the stimulus package will still be holding GDP next year but less so at the end of next year then this year, and even less still than that at the end of 2011. That is really a design feature of the stimulus package, to provide the biggest boost up front. But the effect of that, then, is that as the effect wanes the economy will slow again unless private demand picks up. And of course, the expectation in designing the stimulus package was that private demand would pick up.

We are not forecasting as our basic outlook a renewed slump in the economy. But, as I said in the testimony, that continued growth depends on private demand coming up as the stimulus package wanes. And that is, I think, a reasonable forecast. I think it is the best forecast now. But it is a forecast. It is not by any means a fact that that will happen on a timetable that we project.

Chairman SPRATT. The deficit for this year is likely to be $1.8 trillion, something of that order, and for next year——

Mr. ELMENDORF. Yes.

Chairman SPRATT [continuing]. Your forecast is somewhere in the range of $1.1 trillion to $1.2 trillion. Does that $600 billion decline in the deficit actually pose a threat to undermine the recovering growth of the economy?

Mr. ELMENDORF. Well, it is—yes. But I would say it not as the deficit, per se. It is, the decline in the deficit from this year to next in our forecast reflects partly the strengthening of the economy, and also, as I said, some waning of the effects of the stimulus. So the withdrawal of the tax boost, the withdrawal of the spending boost, all else equal will slow economic growth. And again, as I said, the presumption as this package was designed was that private demand would build up over time. That is what we have seen in past recoveries. But the timing of that increase in private demand is very uncertain. And that raises the question, I think, about whether the withdrawal of the stimulus, as this initial package wanes, whether the withdrawal of that stimulus will come too quickly and leave the economy still very weak or not.

I think I would emphasize in our forecast, even with the private demand coming up and overall growth not faltering, it still takes a long time to catch up for the weak growth last year and this year. And it is that catching up process, bringing the level of output back up to the potential level of output, that corresponds to bringing the unemployment rate down from its current level around 9 percent, and we think ultimately higher, bringing that back down toward the 5 percent which is more standard outside of recessions. And that is the process we think will take a number of years.

Chairman SPRATT. Over the last year and a half some truly extraordinary steps have been taken, including the so-called TARP program, the Recovery Act program, and the Fed's own actions to make an extraordinary amount of collateralized loans to its member banks. Would you comment on each of these? In retrospect, does it appear that these actions were well taken? And are they working as intended, or at least having an impact on the economy that is positive?

Mr. ELMENDORF. Mr. Chairman, I think it is a widely held view that all of those actions have had positive effects on the economy. There is plenty of dispute about whether they were the best possible actions. And as is often the case in unusual circumstances when decisions are made in real time, hindsight offers lessons or information that would have been helpful if it had been known at the time. But the recovery package, as I said we, and the vast majority of private forecasters, think is making, and will make over the course of this year and next year a very important difference in the level of economic activity and the level of unemployment.

Chairman SPRATT. You quantify that as between 1.4 percent and 3.8 percent?

Mr. ELMENDORF. As of the fourth quarter of this year, and then tapering off to some extent next year and even more in 2011. The effects of the TARP and the actions of the Federal Reserve are harder to quantify. I mean, one can count the dollars that have moved but the effects on GDP are harder to quantify. But again, I think a very widely held view that the aggressive actions in the fall and winter helped the financial system to step back from the edge of the abyss. And those actions have brought down household borrowing rates, particularly mortgage rates, they have brought down corporate borrowing rates. And that enhanced supply of credit has helped the economy in very important ways.

The uncertainty going forward that I highlighted in our forecast is whether that help is enough to make the economy strong again. As one of my colleagues said to me, those actions have stabilized the health of the financial system at a low level. So, stable is a lot better than where it looked like it might be going a few months ago. But the fact that it stabilized at a low level of health raises concerns that there may not be enough loans provided to help the economy get on a robust growth path again.

Chairman SPRATT. Had we not taken those actions do you think we would be faced with a much bleaker situation now than otherwise?

Mr. ELMENDORF. Yes, absolutely.

Chairman SPRATT. Now, the Recovery Act itself has been slow to get out of the starting blocks. Only a few billion dollars out of a huge amount, $787 billion, has actually found its way into the real economy. Can you account for that? Apparently, CBO did expect it, and can we expect it to pick up at a more rapid rate in the near future?

Mr. ELMENDORF. Yes, Mr. Chairman. We warned at the time the recovery bill was being discussed that it was difficult to increase government outlays in the categories or the ways that were being proposed overnight. Some of the tax changes are having a larger initial effect. The spending changes take a little longer. And you are seeing that, now, in the numbers. It is very early to judge whether our assumptions were precisely right. We did not forecast outlays on a monthly basis, and we are really only a few months into the package. But we are not surprised at the slow start.

As I said at the time, the package had a number of elements. And one of the virtues of having a combination of elements is that they affect the economy in different ways with different speed. So the details matter a lot about the sorts of tax cuts or the sorts of spending increases, but a broad generalization would be that the tax cuts worked more quickly but tend to have somewhat dollar for dollar effects on GDP in our judgment and most economists' judgment. And the spending increases work more slowly but have a little more bang for the buck when they get there. So the estimates that I am showing here reflect our going through the details of the bill on a fairly granular level and trying to judge, as best we can, the size and timing of the effects. So these estimates incorporate our view that some of the spending increases will be slow and will have their biggest effects next year, whereas other pieces, like some of the tax provisions, are having big effects right away.

Chairman SPRATT. In your testimony you point to some weak spots in the economy which have not been fully exploited yet such as, well you do not indicate, but bank losses $950 billion of which only about $300 billion thus far has been recognized and declared a loss. Are there some weak spots like that? Some sand pits that we still are faced with? Commercial real estate loans, credit card loans, things of this nature that could trip up the recovery?

Mr. ELMENDORF. Yes, Mr. Chairman. I am not a golfer but I think the number of sand pits that we see ahead would scare a good golfer. There are——

Chairman SPRATT. I was concerned by quicksand more than the sand pits.

Mr. ELMENDORF. So as you know, the largest U.S. banks have recently undergone a stress test, and the stress test was examining what might happen to their balance sheets if the economy turns out worse than most people expect. Not a lot worse, it is not the worst possible scenario, but it is a worse outcome for the economy than is the consensus view. And in those tests, most banks either had sufficient capital to weather that possible storm or were close to having enough capital and are now making plans to raise capital.

But I should emphasize the uncertainty there. These banks have trillions of dollars of assets and even a small misjudgment in the value of those assets under a given economic scenario can make a world of difference in the amount of capital they need to raise.

Having said that, I think the consensus view is as you said. There are a lot more losses to be realized, but that the losses that are coming will come progressively over time. That banks hold some combination of loans and securities, and again this is a generalization, but the securities tend to, the banks have to record losses in their value very quickly. Whereas for loans the losses can be realized over time. So a lot of the immediate losses have been realized, and the consensus view is that the losses they are going to suffer can be offset to a large extent by earnings they will have over the next several years, and thus that they will weather the storm. Again, I say the question of the overall economy is whether they are healthy enough to do enough new lending.

Commercial real estate is I think another very important risk factor. There is a lot more commercial real estate in the world now, and in our country now certainly, than there is demand for. And there is a lot of concern about the effects of that. It matters directly for construction, but also on the financial side, and it is not just a matter of whether people can meet their current interest payments but whether they would be able to obtain new financing to roll over loans as they come due, say, given that there has been a tightening of credit standards since many of these loans were initially issued. Because of the financial problems and because of the recession they may have difficulty rolling over those loans. And that poses a very serious threat, particularly to some of the medium and small banks that have received less attention over the last year and a half than some of the biggest banks.

Chairman SPRATT. I have a number of other questions, but let me let others ask questions. We will come around for a second round. Mr. Ryan?

Mr. RYAN. Thank you. Let me just pick up off on the commercial real estate. That is something I wanted to get into. That is what a lot of analysts are saying is going to be the next shoe to drop, is the commercial real estate market. And we had the stress test on the big banks, but we know that there is a lot of exposure in commercial real estate in the small and medium-sized banks. Have you seen or done any analysis on the kind of exposure to that segment of the banking system? And just give me kind of an assessment of your risk to the small and medium-sized banking system should that shoe drop, so to speak.

Mr. ELMENDORF. So we are monitoring the situation. You know, it is a big financial system and we have a reasonably compact staff of people following it. Let me report some of the analyses that others have done that seem to us to be a correct and relevant situation. The fundamentals in the market are quite weak. People are looking for price declines of 35 percent, 45 percent, exceeding those in the early 1990's. Rent declines, the vacancy rates may approach those of the early 1990's. And it really is a demand side shock. In the nineties there was more of an issue of overbuilding, and in this case it really is just a pull back, and we see this in employment as well, in the financial sector, and the retail sector, the businesses are contracting, not growing. So the delinquency rate is rising. And is expected to peak at the level of the early 1990's, say around 6 percent.

So the Wall Street Journal, in fact, did an analysis of the exposure of banks to this, to this sector. And using the same scenario that the Fed used in the stress test the Wall Street Journal concluded the total losses of these banks could surpass $200 billion.

That is a good deal of money. It is spread among a large number of banks, but nonetheless these are not the Citigroups and the Bank of Americas. So it is a, losses at that level would likely exceed the revenue that those banks would otherwise take in. That would mean a reduction in their capital over time. And I think a significant number of those banks might find themselves with capital low enough that regulators would become very concerned. We have not tried to calculate the expected effect on that on particular parts of the——

Mr. RYAN. That is what I am——

Mr. ELMENDORF [continuing]. FDIC, and so on.

Mr. RYAN. That is what I am trying to get a sense for. If the shoe drops, you know, what kind of percentage of the small and medium-sized banking system are we going to see shrink and be liquidated? Any——

Mr. ELMENDORF. So that, that I am sorry, we do not have estimates of. There are actions underway to try to help this market. The Federal Reserve has announced that it will, in parallel to a number of its credit facilities, help investors finance their purchases of top rated commercial mortgage-backed securities, CMBS, issued before the crisis. And there has been, you know, a rally in the market for those securities. So it is possible that they are already, as we know, the Federal Reserve has a lot of levers that it is using and that may help to stabilize the market without other action.

Mr. RYAN. And they are going to prop up the secondary market in commercial paper? Commercial mortgage-backed paper?

Mr. ELMENDORF. Commercial mortgage-backed securities. I mean, prop up would not be their language. They are providing liquidity to help blah, blah.

Mr. RYAN. Okay. Let me go to the bond markets. The bond markets are beginning to recover. Investors seem to be getting some risk appetite back, which means that many may start to move out of our Treasuries, that safe haven, you know, sort of dissipating it seems. Meanwhile, many other countries along with the U.S. are tapping global debt markets to raise money for economic recovery and to finance our deficits. The Treasury, our own Treasury is going to issue about $2 trillion in fresh debt this year alone. How might these factors, a higher risk tolerance and the flood of new sovereign bond issues, influence our government's borrowing costs going forward? How significant might there be upward pressure on medium and long term interest rates in your view, given this new climate we are kind of going into now?

Mr. ELMENDORF. I think certainly over the next several years there is likely to be very significant upward pressure on Treasury interest rates. Whether it is now or later is much less clear.

Mr. RYAN. Yeah.

Mr. ELMENDORF. Although there are, as I have said, signs of improvement in the financial system and signs of improvement around the world in the financial markets, and some equity prices, and some improvements in confidence.

Mr. RYAN. But that means——

Mr. ELMENDORF. We are still in a—excuse me?

Mr. RYAN. That means our rates will then go up——

Mr. ELMENDORF. Yes.

Mr. RYAN [continuing]. Because people will leave Treasuries, yeah?

Mr. ELMENDORF. Yes. But at the moment, despite some glimmers of hope and green shoots in the economy and other phrases like that, in our view our economy and the world economy still have a long way to go before they really come out of this slump. And I think the judgment of most economists is that these increases in interest rates are likely to be delayed until we come out of this slump. But the factors, the forces you describe, I think, are the pressures, which are that people will, the greater risk tolerance, there will be more demand for funds by the private sector as the economy improves, and that will tend to divert investors' interest from Treasuries.

Mr. RYAN. I wonder if we are not a few years behind Great Britain with respect to the state of our finances? And what I mean when I say that is, they had a bond auction fail a month or two ago. Standard and Poor said yesterday that they are about to downgrade their credit, which I think has put a severe slump in their stock market today. They are basically saying if Britain does not get its finances their credit is going to go down.

The question is, are we coming close to that moment here? A bond sale may not work, our credit is going to get downgraded. And the reason I ask you that is, in the context of your score of the President's budget which has passed and now is being implemented, our deficits never go below a 3 percent of GDP. We have a deficit this year of $1.8 trillion, $1.2 trillion you are saying next year. Our publicly held debt is going to triple, nearly, in about ten years. And now we are talking about creating a new entitlement program for everyone with a new healthcare option. And so the question is two-fold. Are we risking our credit? Are we going to have a problem selling our bonds? And if we create this new entitlement without fixing the other entitlements that are exploding? And we come up with a "pay for" for this new entitlement that really does not track what the growth of this new entitlement?

And that is one of my number of concerns. And I would like your comments on this. If we come up with a pay for for this new entitlement with a grab bag of revenue raisers, you know a MedPAC recommendation on Medicare payment reductions here, a loophole closer there, you know, a small tax change here, and they all culminate to get the $1.2 trillion that everybody says is needed to make this healthcare plan work, a lot of this stuff goes away but the entitlements grow. BBA 97, a perfect example, we had a lot of Medicare savings which led to the surplus, but Congress gave all that stuff back after, you know, people pounded on Congress to, you know, spend more.

And so it looks to me like we are beginning to create a new entitlement without really actually paying for it, creating now a fourth unfunded entitlement liability. Given the state of that, given the state of your analysis says our deficits are never going below 3 percent of GDP, we are prone to create a new entitlement that probably will not be really, actually paid for. Britain could not sell their bonds, their credit is getting downgraded. Are we about to go down that path, in your judgment?

Mr. ELMENDORF. Well, could we put up slide twelve, which I think is good to look at as we have this conversation. Let me first tackle the forecast——

Mr. RYAN. Yeah, I gave you four questions, there.

Mr. ELMENDORF [continuing]. As we have it, and then I will come to the new entitlement question. As slide twelve shows, this shows debt held by the public as a share of GDP over the last four decades and then looking ahead roughly a decade. The baseline projection is the solid line that is under current law. Even under that projection, as you have noted Congressman, the debt rises very sharply as a share of GDP. It rises to a level not seen since the 1950's when we were working down the debts accumulated in the Depression and the Second World War. U.S. debt peaked at a little over 100 percent of GDP at the end of the Second World War and then declined. But we are launching, with two successive years between them deficits of 20 percent of GDP, the debt is rising by roughly 20 percentage points in GDP.

Under current law the debt recedes again. But it is worth remembering that current law assumes that the 2001 and 2003 tax cuts expire. It assumes that the AMT remains as it is in current law. It assumes that other expiring tax provisions expire. It assumes the Medicare physician payments fall by 21 percent next year and more in subsequent years. So it is the current law and our job is to follow that. But that list of factors embedded in current law I think suggests very clearly that that is not a path that will feel to most Americans like a continuation of what is happening now. It is a path that would feel like a tightening. That is what it requires to get to that dark line, which as you see leaves the debt as a share of GDP above what it has been at any point in my lifetime.

The top line is our estimate of the President's budget released in March. That shows debt relative to GDP rising essentially because the annual deficits exceed the growth rate of the economy, and thus the debt rises. The budget resolution is the dashed line in the middle. There is no doubt, I think, that this is a worrisome picture. This is a grim outlook for the federal budget. And it poses the risk that you raise, Congressman, that at some point people may decide that the U.S. is not the safest haven.

Now, I do not think that we are that close to that point right now. At the moment, the U.S. government can borrow money at incredibly low interest rates. Now there are special factors and those factors will wane, as we discussed. It is very difficult to assess how quickly they will wane. And there can be a range of views about that. I think in general—Rudi Dornbusch, who had been a leading international economist and passed away a few years ago, had a line to the effect of, when something is unsustainable it can go on longer than you would think possible and then swing more sharply and quickly than you thought possible. I think this may be a situation like that. It is hard to know when sentiment will turn, but it could turn quickly and that is a risk.

Now on your question about the new entitlement, naturally given that picture policy changes that make the medium and long run budget deficit worse increase that risk that we have just discussed. Whether a particular piece of legislation does that is one that CBO will try to judge when the legislation is constructed. I do not think in principle it is a matter of whether you are paying for something in little pieces or big pieces. It is more a question, as I think you suggested, about the permanence of the various pieces.

Mr. RYAN. Yes, the sustainability.

Mr. ELMENDORF. And that is a difficult thing to judge. We do not produce budget estimates that go out beyond ten years normally. I think that since that is the question you are getting at, if something can be paid for within ten years and not beyond that, and we do not normally produce formal estimates of that, I think it is appropriate for you and the other members to judge for yourselves what you think the political dynamic may be around certain changes that are being made.

But I do want to say one quick positive word on behalf of changes in Medicare reimbursements. MedPAC, a congressionally established agency, studies very closely with a great deal of rigor the reimbursements in Medicare and the costs that providers receive. And we do not duplicate that work, but we have tremendous respect for what they do. I think in the cases where they think that there are overpayments in Medicare I would commend those to your attention because I think that it is important, although we talk now about trillions of dollars, obviously it is important not to lose sight of the billions of dollars that can legitimately be saved in terms of delivering health insurance in the most efficient possible way.

Mr. RYAN. Thank you. I agree, basically, with your MedPAC point. From being on Ways and Means for a number of year now, what ends up happening is we might pass a MedPAC recommendation or two and what we find out is Congress then takes that away because of political pressures and time. And if we use those kinds of things to finance the creation of a new entitlement the funding stream is specious, in my opinion. Thank you, Chairman.

Chairman SPRATT. Ms. Schwartz?

Ms. SCHWARTZ. Thank you, Mr. Chairman. And thank you, Dr. Elmendorf. And I appreciate some of your both clear caution about where things are in the economy and on economic growth, but the positive feeling about the tax provisions, the tax cuts for 95 percent of Americans having an effect, and the fact that some of the dollars have already gone out fairly slowly, truthfully it has only been a couple of months.

Mr. ELMENDORF. Right.

Ms. SCHWARTZ. That is not in our timeframe really that slow. And for many of our states, we are seeing those dollars being not only announced but contracted, and so we will start to see them in a number of months.

I wanted to follow a bit about something you touched on in the response to Mr. Ryan, and ask about it in a slightly different way, if I may. The President has made it very clear that in the economic recovery package we needed to make some real investments if we were going to both be more economically competitive, enable the private sector to really grow, and particularly I am talking about healthcare but energy is obviously an issue as well, and that both the effect on the economy and the effect on the federal budget requires us to tackle the growth in cost in healthcare in particular.

And so what I wanted to ask you about is really to look at it a different way. If we do nothing, we are going to see quite substantial growth in healthcare costs. So the choice is to do nothing, either to help the private sector or businesses that are saying to us, "We really need some action here to contain the growth of costs in healthcare, so that we can continue to provide those benefits and have some stability so that we can invest those dollars in other ways and produce those jobs." And secondly, for the federal government it is really not only a question about how do we address the issue that so many Americans spend dollars on healthcare, or we spend dollars on healthcare in very inefficient ways.

The choice we are faced with is, do we do nothing? Or do we actually tackle this issue? And do we do it because of the concerns about the economy as well as the moral imperative around healthcare, and our own federal budget? So could you speak to two things? One, the consequences of doing nothing, and the growth that we might see, maybe you have a chart on this, if we do nothing in terms of the federal budget and our lack of economic competitiveness? And secondly, a maybe more insider discussion, but many of us believe, and I think you do as well, that certain investments in healthcare, particularly in redirecting dollars to primary care, to early intervention, to improving healthcare status of Americans and health outcomes, will in fact have a savings. It is difficult to score, as we say. It is difficult to calculate what those savings might be. But, again, to not do those things we are going to continue to see this unsustainable growth in cost. So if you could speak to both those aspects? Of doing nothing, and then also some of the investments we are making that in fact could have a really enormously positive effect on the rate of growth in cost, both for the private sector and for the federal budget?

Mr. ELMENDORF. Congresswoman, it is a widely held view among budget experts and experts about our health system that changes in that system are urgently needed. In contrast to, say, financial markets where things can change overnight, healthcare does not, and in that sense can appear to be less urgent. Next year will be much like this year. But in fact, the inertia in the way that system works is viewed by most analysts as an argument for urgent action. That the sorts of thoroughgoing changes that are desirable in the healthcare system in the views of most experts will not happen overnight, and one needs to therefore get started, most analysts will tell you.

The reason these thoroughgoing changes are needed in the views of most analysts is not just that healthcare costs are rising, but that a lot of the money that is being spent on healthcare is viewed by experts as not contributing that much to people's health. And one of the most dramatic examples of this is that the amount of money that Medicare spends in different regions of the country, per patient, after controlling for differences in their ages and other aspects of their physical conditions, and after controlling for differences in underlying costs of living, Medicare will still spend much more, twice as much, in some areas of the country as in others. But the people do not seem to be any healthier in the areas where more money is being spent.

So there is a widespread view that a lot of money going into the healthcare system is not being used very effectively in terms of producing good health as the outcome. And that fact combined with the rapidly growing share of the economy devoted to healthcare, leads many people to believe that urgent action is needed both on behalf of, from the private sector and for the government budget. And——

Ms. SCHWARTZ. But in the budget that we passed we actually have set out a course to tackle some of these issues. And that, in terms of greater efficiencies, the right kind of investments, both containing costs and expanding coverage—and my time is almost up. But if you could just, if you could say that that course of action, that we are going to take action and we are going to tackle these issues, would you say simply that that is an important path for us to be moving forward on so that we in fact are reducing costs, both for the government and for the private sector?

Mr. ELMENDORF. I think tackling, again a widespread view among experts that tackling those issues is very important and desirable. The precise nature of the tackling, however, is very important. And some aspects of the proposals being discussed would expand healthcare entitlement in this country. Other aspects of the proposals being discussed would generate efficiencies in how public money is used, and save public money. And the budgetary effects of this piece of the proposal can cut in different directions, and there are obviously many important considerations apart from the budget. So it depends how this shakes out.

Ms. SCHWARTZ. Maybe that is a topic for another hearing, but that is what we are working on, of course, to get that right both for our budget for the taxpayers and for the private sector. That is what our job is, and that is what we are working on. Thank you.

Mr. ELMENDORF. Thank you.

Chairman SPRATT. Mr. Hensarling?

Mr. HENSARLING. Thank you, Mr. Chairman. Thank you, Dr. Elmendorf. Following up on my colleague's questioning, I think everybody on the panel agrees that you will never control federal spending until you find a way to control healthcare costs. But my question is, if the administration's plan is supposed to save us money with various efficiencies, why did the budget include an approximately $600 billion line item for healthcare, and we were told that was merely a down payment?

Mr. ELMENDORF. Well, I cannot speak to the construction of the President's budget, of course. But nobody disputes——

Mr. HENSARLING. It sounds like a funny way to save money.

Mr. ELMENDORF. Nobody who has studied the problem disputes the fact that expanding health insurance coverage to a significant number of additional Americans could be done without spending federal money. I think nobody disputes the fact that there could be changes made in the way we run our current federal health programs, Medicare in particular, in a way that would save money. And as I suggested, there is a balancing of those actions that is up to Congress to decide. And as you note, the administration has clearly set aside in its budget a significant amount of money, a net to fund this program.

Mr. HENSARLING. Speaking of balancing, in your testimony you have, I guess on page seventeen, entitled a section, A Conflict Between Near Term and Long Term Fiscal Objectives, and you touched upon this subject earlier. I believe, Dr. Elmendorf, correct me if I am wrong, in your testimony you have stated that it is your opinion that the stimulus plan, that I guess borrowing the President's phrase, has helped create the little green shoots that you may see in the economy. Is that a fair assessment of your testimony today?

Mr. ELMENDORF. Well, we think on balance that the stimulus package will improve GDP. I do not want to link it to any particular piece of news.

Mr. HENSARLING. And if, as I understand it, though, you believe it can have a beneficial impact on the economy in the short term——

Mr. ELMENDORF. Yes.

Mr. HENSARLING [continuing]. But a detrimental impact in the long term, which I believe was contained in an analysis of a letter that you sent to Senator Grassley in March. Is that correct?

Mr. ELMENDORF. Yes, that is right.

Mr. HENSARLING. And I think you also testified——

Mr. ELMENDORF. Put up slide nine, and then you can see the point to which you are referring, Congressman.

Mr. HENSARLING. Please. Also, did I understand in your testimony—well, forgive me. When did you expect to see GDP growth turn positive?

Mr. ELMENDORF. We think it will turn positive later this year.

Mr. HENSARLING. Okay.

Mr. ELMENDORF. And that is the view we expressed in March as well.

Mr. HENSARLING. Okay, so you are projecting positive GDP for the latter part of this year. And when did you say, under your projections, that unemployment would peak?

Mr. ELMENDORF. Later next year.

Mr. HENSARLING. Later next year.

Mr. ELMENDORF. Traditionally in business cycle recoveries, the unemployment rate peaks maybe six to twelve months after output growth turns up again. In this particular case, we expect weak growth of output and thus a delayed turn in the unemployment rate.

Mr. HENSARLING. Well, here is my question, then, Dr. Elmendorf. Under your projections, we have positive GDP growth at the latter part of this year. We have unemployment peaking next year. You say the long term impact of the stimulus program could prove to be detrimental to the economy. Clearly, I believe you have said in your written testimony that any policy designed to provide short term fiscal stimulus will have to contend with the long term consequences. My question is this. The administration presented a ten-year, ten-year spending plan that spending dips to a low point of 22.7 percent of GDP in 2012, after 2014 spending exceeds 23 percent of GDP through 2019. We have not seen spending like this since World War II. I think under one of your slides the federal deficit decreases to about 2013, rises again, averages 5 percent of GDP over the ten-year budget horizon. By 2018 deficits exceed $1 trillion again.

I mean the question is this, if you are predicting essentially that the economy is going to turn around in the next eighteen months, what economic rationale for the explosion of spending, debt, and deficits over a ten-year window?

Mr. ELMENDORF. Congressman, as I said in my remarks the widespread view among experts that deficits serve a useful purpose in recessions, equally widespread view among experts that persistent large deficits outside of recessions are damaging to a country's long run economic prospects. And I do not think anybody has actually defended those deficits over the ten years as a virtue. There is, obviously, an active debate about what changes in policy might be more or less desirable to put us on a different course.

Mr. HENSARLING. Well, they may not see the virtue but Congress just voted to approve it. I see I am out of time. Thank you, Mr. Chairman.

Chairman SPRATT. Mr. Becerra?

Mr. BECERRA. Thank you, Mr. Chairman. Dr. Elmendorf, good to see you. Thank you for your testimony. Actually, if you could put that chart back up that was just on, that would be helpful. Let me make sure I am settled on what I have heard you say in your testimony in response to some of these questions. The economic recovery package, which was deficit spending but at a time when we were seeing credit markets freeze up, when the economy was on a downward slide, jobs were being lost, deficit spending, so long as it is responsibly done, can help avoid a further fall and perhaps help us see the trough come sooner so we begin to see a pick up in the economy, with a pick up in economic activity, which means a pick up in jobs in the near term?

Mr. ELMENDORF. Yes, exactly.

Mr. BECERRA. And your chart begins to reflect that in showing that the drop that we are seeing in the economic activity concludes sooner as a result of the economic recovery package?

Mr. ELMENDORF. Yes.

Mr. BECERRA. And so, so long as that spending in the economic recovery package is smartly done, focused, and economists would agree that it is focused, we can have some reasonable projections by economists that we will begin to see an upturn in the economy? And there are some, in fact, signs right now that we may be seeing the end of the worst. Not that we are going to see sunshine over night, and blossoming of the economic flowers tomorrow. But we are beginning to see some signs that maybe there is the beginning of the end of this recession?

Mr. ELMENDORF. The rate of decline has lessened. So we are going downhill, but there are signs that we are reaching a leveling out. Now of course, people who know hills know sometimes it levels out and then worse things happen. Sometimes you turn up the other side of the valley very steeply and that is the uncertainty. But we are declining at a slower rate than we had been.

Mr. BECERRA. And so there are those who would have said, "Do not do this recovery package, do not do this." Who would have said, "Let us just close our eyes. Let us not do anything. And let us just hope that this roller coaster that we are on that is going down actually ends and that we can survive the steep drop of this roller coaster. And if we just raise our hands and yell it will come to some conclusion on its own." That is a course we could have taken. And we at some point probably would have seen the economy recover on its own naturally. But we might have seen millions more Americans lose their jobs, thousands of other American businesses go under, and may have seen the suffering extended quite some time. So, so long as we have some smart spending it could help us out of this economic recession.

Now on this chart I notice that that roller coaster drop did not begin on January 22, 2009 when President Barack Obama was sworn in. It actually began, I think the chart shows sometime around 2007. And so we were already on this roller coaster ride down not knowing how it was going to end, very steeply so, in fact steeper than any roller coaster ride we have been on in many decades, well before President Obama suggested we do this economic recovery package. I think President Obama was saying, "For all of those who do not like the thrill ride of losing jobs and losing American businesses, let us try to get ourselves out of this sooner."

Now healthcare, you mentioned, could make things worse or make things better. There are some who, once again, will say, "Let us close our eyes. Let us not try to deal with this headache and heartburn that is now healthcare because too many Americans are not able to pay for their insurance, or get the coverage they want." Some Americans do not even have any of that whatsoever. And the President said, "Let us move boldly." Now some folks say, "We are not prepared to move boldly. We would rather have status quo." But the President said, "We need to corral costs. There are ways to corral costs. You can still give people their choice of doctors but you can try to bring the price down of what they have to pay for." And there are a whole bunch of folks who cannot afford health insurance, and if we can get them to have health insurance they will make wiser spending decisions on their healthcare which could help us reduce the cost of overall healthcare.

If we could do a smart program on healthcare, and I am not going to ask you to give us the elements of what smart healthcare reform would be, and I am not going to tell you what they would be. I am just going to ask, if we could be smart, the way I think we were smart in this economic recovery package to help with the recession, would corralling the cost of healthcare help us get out of this economic recession and also help us avoid the massive budget deficits we have been experiencing?

Mr. ELMENDORF. Reducing the path of federal spending on health costs is absolutely essential to bringing down budget deficits in the long run. If you look at the path of the deficit under, that we estimate for the President's budget, tax revenue is about the same share of GDP there that it has been on average historically in this country. All spending apart from social security, Medicare, and Medicaid is a smaller share of GDP than it has been for most of my lifetime. What is different about that, about the next ten years relative to the history, what gives the line that slope that it does, is basically rising health costs. So reducing the path of federal health spending is absolutely essential to the long run deficit, to addressing or solving the long run deficit problem.

Mr. BECERRA. Doing nothing keeps that line going down?

Mr. ELMENDORF. Yes. But one has to, as I have said, do the right sorts of things. So as you said, smart reform, and without either of us defining what that means in this context, the reform has to be one that reduces federal health spending over time.

Mr. BECERRA. Thank you. I appreciate it. Thank you, Mr. Chairman. I yield back.

Chairman SPRATT. Mr. Garrett?

Mr. GARRETT. Thank you, Mr. Chairman. I will have a couple of other charts if they can bring them up right now. Thank you, doctor. Earlier in January the chief economist to the President released a study entitled, "The Job Impact of the Stimulus." And wow, the final bill was at that time still a month away from passage. The broad outline of the so-called stimulus package was already basically in that document, and they called for $775 billion. You know the final passage was $787 billion.

Now in the study Drs. Romer and Bernstein said, "A key goal enunciated by the President concerning the stimulus is that it should save or create at least 3 million jobs by 2010." Now, disregarding for the moment the difficulty in measuring the number of jobs that have been saved, I do not know how anybody could explain that yet, by a particular action by the federal government, this was a key metric by which the incoming administration wished to measure the results of stimulus. Later in the report the authors provided a useful chart, there it is, from which we could visualize potential outcomes our economy would experience if we had stimulus and without it.

[Chart]

Mr. GARRETT. If you look up on the chart there, with the recovery you see the bold line on the bottom. And without the stimulus plan you see things not going as well.

Now on February 17th the stimulus became law. Later, after Congress had considered the legislation you folks at CBO issued a report on March 2nd outlining the bill's expected fiscal impact. And in that report you noted that CBO estimates that the stimulus will increase employment by .9 million to 2.3 million by the fourth quarter of 2009.

But now we have had a little over three months to evaluate the impact of this legislation and so far the results have not been all that promising. So let us look at chart two.

[Chart]

There we go. And as you can see, chart two shows where we really are. The actual unemployment rate jumped to 8.5 percent in March and then 8.9 percent in April. So this rate of job loss is considerably worse than what the President's top economic advisor predicted would happen without the stimulus. So just doing it on the back of an envelope here, unemployment would now need to drop a full percentage point in the next three months simply to catch up with the projections outlined in their initial document.

So my first question, would you think that job creation of this magnitude, in other words dropping of unemployment by 1 percent in three months, would that be totally unprecedented?

Mr. ELMENDORF. Well, as you understand, Congressman, everything about this sort of picture is uncertain. We do not know what would have happened without the legislation.

Mr. GARRETT. Right. But we know where we are now.

Mr. ELMENDORF. Yes.

Mr. GARRETT. And that is where we are now.

Mr. ELMENDORF. Yes.

Mr. GARRETT. We know what they said we were going to be, and that is what is up there as well. Now, my question to you is would dropping by one percentage point in order to get us down to where they say we should be in the next three months, is that something that has ever happened before? Is that unprecedented or is that what we should anticipate?

Mr. ELMENDORF. I am not sure if it has ever happened before but it would certainly be very unusual. And given the trajectory of the unemployment rate that you show the kind of reversal that would be required would be completely shocking.

Mr. GARRETT. Right. Okay. So, because the question on the other side was, "Oh, it is between doing something and doing nothing." I have not heard anybody say do nothing. But now we can see what doing something did. Doing something put us at a, well——

Mr. ELMENDORF. But, I mean, doing something in combination with everything that was going on in the economy apart from the stimulus package. And my point I am trying to emphasize about the uncertainty of the economic forecast is that one could have drawn around that line that they graphed with or without a very large confidence region of the sort that I showed you around our forecast that would encompass a whole range of possibilities.

Mr. GARRETT. But, so they were wrong. And the projections of where we would be even with it, they were wrong. And the projections of where they would be without it, they were wrong. And where we are right now having done it, and spent almost $800 billion, we are in essence worse than where they project we would be even without doing anything. Just going by their projection.

Mr. ELMENDORF. Yes. We are, yes, the outcome has been worse than they projected at the time. As you know, our own March forecast was more negative than the forecast the administration formed earlier in the year.

Mr. GARRETT. The takeaway from your opening comments with regard to the stimulus is that the stimulus, I think you said, started out slow and then sort of petered out altogether by next year?

Mr. ELMENDORF. No, no——

Mr. GARRETT. Well, because you said that by next year you indicated that the stimulus would be winding down, was your words, and that——

Mr. ELMENDORF. Waning.

Mr. GARRETT. Waning.

Mr. ELMENDORF. So the peak effect of the stimulus on the level of GDP would be the end of this year.

Mr. GARRETT. And why is that?

Mr. ELMENDORF. And then——

Mr. GARRETT. Why do you say that? Because previously CBO testified that most of the money will not be actually out the door and onto the projects until 2010. So why is it that the peak positive effect is going to be this year if CBO testified that most, as a matter of fact I heard one person say that we will be celebrating the Fourth of July 2010 before most of the money will get out the door and actually in the ground doing projects?

Mr. ELMENDORF. So the stimulus legislation included both revenue and spending provisions. So in the estimate that we formed last winter, and I have in front of me the letter to Senator Grassley in March, we estimate that about three-quarters of the total amount of money, tax cuts and spending increases, would have flowed out by the end of fiscal year 2010, which is next September.

Mr. GARRETT. Right.

Mr. ELMENDORF. So three-quarters out by then. So the spending part, as I said earlier, lags the tax revenue effects. And that is why the spending is more lagged than the overall economic impact of the plan.

I also want to be careful about stressing the fourth quarter of this year. The chart I showed looks just at the fourth quarters. So on a fourth quarter basis the biggest effect is this year and then it wanes next year. If we actually looked at this on a quarterly frequency, and I gave you a chart with more columns, we find a little more effect in the first half of next year, and then waning after that. So, but the effect on the level of GDP, it sort of goes up this year and then starts to come down later next year, and then wanes after that.

Mr. GARRETT. You know, Chairman Bernanke has come here before and he is a great historian on the Great Depression. And he educated us on the fact that during the Great Depression you had basically sort of two depressions. You had the original Depression most people know about, and then during the Roosevelt administration you have sort of a second Depression. And I am not saying that we are in a depression by any means. But hearing your testimony it almost sounds like we had the one recession and now we are going to have the next recession, potentially going forward.

Mr. ELMENDORF. So I think that is a risk. As I said, that is not our forecast, and it is not the consensus forecast. If you look at the, I think I have another chart which actually shows this. If you look at slide three you can see the forecast. These are private sector forecasts, something called the Blue Chip which surveys private forecasters. As you can see that for 2009, so I am looking now at the, let us look at the annual averages on the upper right corner. For 2009 all the forecasters, obviously expect a decline in GDP. For 2010 the most optimistic ten of this group of about fifty expect growth pushing 3 percent. The average is about 2 percent. And the bottom ten expect growth of 1 percent. So it is, I would not say that nobody predicts another dip in the recession next year but that is very far away from the consensus. The issue at hand, I think, is how quickly private demand rebounds. Whether it rebounds quickly enough to offset the waning of the effect of the stimulus package. And again our forecast, and almost everybody else's forecast, is that it does. But it is, as I have said, there are risks. And there is a risk of faster growth than people expect, of course. We have had faster growth than this in a number of previous recoveries. But there is also a risk of slower growth.

Mr. GARRETT. Right. Because that was your projection before, showing it going down. Thank you.

Chairman SPRATT. Mr. Doggett?

Mr. DOGGETT. Thank you very much. When Dr. Peter Orszag appeared here in March I asked him to explain why President Obama believes that American families will be better served by auctioning 100 percent of pollution allowances instead of giving polluters "pollute free" cards. He responded that an approach which relies on giveaways instead of relying upon auctions would, "represent the largest corporate welfare program that has ever been enacted in the history of the United States." Do you agree with him?

Mr. ELMENDORF. Yes, I do.

Mr. DOGGETT. And on May 7th in your blog you discussed this and why simply giving away pollute-for-free allowances to certain industries does not work. That this would not hold down the price of the goods and services produced by these energy intensive manufacturers, and would only result in windfall profits for them which in turn would benefit the wealthy the most. Can you explain why the pollute-for-free approach would have such a regressive effect, and explain why the price of products to American families even after these pollute-for-free allowances are given out will not be held down?

Mr. ELMENDORF. Certainly. As I explain in testimony to the House Ways and Means Committee and also the Senate Finance Committee, the crucial aspect of the cap and trade program, or of a carbon tax, is to raise the price of carbon emissions. And that increase in price is created by the cap, the limit that is imposed. And that will raise the price of products that embody a lot of carbon emissions. And it is by raising the price of those products that businesses and households will change their behavior, develop new technologies in ways that economize on carbon emissions. That is the point of that sort of plan.

When the government sets this cap, and then has a set of allowances to distribute, it is holding something of great value—because the ability to emit emissions will be valuable when the cap is set. And the distribution of those allowances matters critically for the distributional effects of the cap and trade plan.

If you give an allowance to a business then it can use that allowance itself, or it can sell that allowance. In either case because the allowance has a price, that raises the cost of the business' activities. And it will pass that price along, in general, to its customers.

Giving it an allowance with no strings attached does not prevent it from raising the price. It does not ensure that it continues to hire the workers it is hiring to do the production it is producing. It is just handing over a no strings attached gift. And that is the sense in which my more colorful predecessor used the term largest corporate giveaway.

One can give allowances to companies with strings attached, and this is something I talked about in my testimony to the Senate Finance Committee. For example, linked to continuing employment or continuing a production in ways that would, that could in fact diminish the disruptive effects of the cap and trade system. But without any strings attached it just amounts to giving them money.

Mr. DOGGETT. And do not giveaways to local utilities or local distribution companies just hoping they will pass along some of the benefit to the consumer, do they not have some similar problems?

Mr. ELMENDORF. Yes, similar. But because many electric utilities are regulated the ultimate effects depend on the specifics of regulation as they vary across the country.

Mr. DOGGETT. On the other hand, if we fail to address this problem of global warming and climate change, has not CBO measured the effect on the economy and what we have real long term reduction in growth and economic reduction because of the effect of climate change on agriculture, fisheries, and a number of other industries?

Mr. ELMENDORF. As you know, Congressman, it is a very uncertain, there is a growing conviction and consensus that climate change aided by people's emissions of carbon dioxide is occurring, and it is occurring at a pace that will be very damaging to the natural world. The further link to economic conditions is a difficult one and one that is, I think, in its infancy of analysis. I think the consensus view is that climate change will have some costs for overall U.S. economic activity. In fact, the aggregate costs are much smaller than the costs for particular regions or sectors. Some parts of the country would be able to grow a wider range of crops, for example, and the people who own that land might become richer over time. Other parts of the country that, particularly say in the Southwest, would become drier, making growing much more difficult. So there is tremendous geographic differences, and sectoral differences depending on what part of the economy one is part of that are probably more important, in fact, than the aggregate economic impacts. And that is why, I think, most experts think it is appropriate for Congress to think about how to ameliorate some of those effects. It turns out that just giving over allowances without strings attached does not seem to be a particularly good one.

Mr. DOGGETT. Mr. Chairman, just one quick healthcare question? Last week, as you are aware, a number of major lobby groups met President Obama, the health insurance lobby, the pharmaceutical lobby. And they said, "We will do our part to achieve your goal to decreasing by 1.5 percent healthcare spending growth rates. And we will save you at least $2 trillion." And then shortly thereafter at least one of those lobbies said, "Our savings are not subject to the rigid scoring rules used by the Congressional Budget Office." Are not alleged savings that do not meet PAYGO fiscal responsibility rules truly illusory? And has not the Congressional Budget Office in the Budget Options document that you provided this Committee earlier in the year outline real ways to produce savings that could amount to $2 trillion, such as your $110 billion in savings by requiring manufacturers to pay a minimum rebate on drugs covered under Medicare Part D?

Mr. ELMENDORF. Yes.

Mr. DOGGETT. Thank you. You want to add to that?

Mr. ELMENDORF. I would just say that we, one of the points to which I have testified several times about healthcare is that there is a widespread consensus, I think, around the types of changes that our health system should make to ensure that we are getting better value for our money. But much less agreement about exactly who should do what differently to which patients. And I think the question, I think this discussion among these representatives of the health sector with the President revealed both sides of that, essentially. That they came together with a widespread view that something different should be done, and I think some sense about the general direction. But much less specificity and willingness to be subject to——

Mr. DOGGETT. Exactly.

Mr. ELMENDORF [continuing]. Particularly changes affecting particular providers over any sort of predetermined time period. And I think that is the fundamental challenge in healthcare reform, is to develop the specific approaches that one could have confidence will lead to great efficiency and save money.

Mr. DOGGETT. Thank you. Thank you, Mr. Chairman.

Chairman SPRATT. Thank you, Mr. Doggett. I give you credit for being a better trial lawyer. You got your answer, and you still wanted elaboration. Mr. Diaz-Balart?

Mr. DIAZ-BALART. Thank you, Mr. Chairman. Good to see you, sir.

Mr. ELMENDORF. Thank you.

Mr. DIAZ-BALART. Your predecessor and current OMB Director, Mr. Orszag, testified on September 18th, and I am going to quote him. He said speaking about energy, "Decreasing emissions would also impose a cost on the economy." He went on to say that much of those costs would be passed along to consumers in the form of higher prices for energy and energy intensive goods. On March 17th, Energy Secretary Chu testified before the Science Committee and he said, "The cap and trade bill will likely increase the cost of electricity," to the point where he advocated adjusting for trade duties, etcetera. The Secretary also testified, "If other countries do not impose a curb on carbon then we will be at a disadvantage." Do you disagree with any of those statements by Secretary Chu or by your predecessor Mr. Orszag?

Mr. ELMENDORF. I think I agree with all of them. CBO has been very clear that a cap and trade system or a carbon tax would raise the cost of carbon emissions, and the cost would ultimately be borne by households. It is also widely understood that if we raise the price of carbon emissions and our trading partners do not, that creates an additional challenge for our carbon emitting industries. A number of foreign countries, of course, are imposing caps on their emissions or taxes or establishing cap and trade systems, or in other ways moving down this path. But I think again it is not controversial that other countries would need to be brought into such a system, or that some sort of adjustments would need to be made at the border as affecting trade, or that some other thing would be done for domestic producers to try to redress the imbalance that would create.

Mr. DIAZ-BALART. Right. Because otherwise, you agree that otherwise it would put us at a disadvantage. So if China and India, as they have stated, do not do it and we do, that would put us at a disadvantage?

Mr. ELMENDORF. If we just put the price on carbon emissions and do not either get other countries on board or do some adjustments at our border to address that differential or do anything else to help those manufacturers, then they would be at a disadvantage. But I am trying to suggest here there are several courses of action that could be taken.

Mr. DIAZ-BALART. Sure, absolutely. Now, have you had a chance to, you know, the President has mentioned Spain as one of the countries that the United States needs to look at and follow. As you know, they are number one in green jobs. They went, however, from being a country a few years ago that created more jobs than Germany, France, and Italy combined, to now be the country that has lost more jobs than Germany, Italy, and France combined. There are a number of factors, obviously. It is not just their energy policies. But clearly, I think there is a consensus that their energy policy has been a major factor in losing jobs. Have you had an opportunity to study the Spain example? By the way, they are also now having blackouts, which is, I grew up in Spain. It is hard to believe that an industrialized country like that would now have to impose, you know, shut off electricity at certain times of the day to industry. But have you had an opportunity to look at that?

Mr. ELMENDORF. So Congressman, I do not know much at all. I now learned a fair bit about the Spanish situation. But I want to emphasize, read a line from testimony I gave on cap and trade a few weeks ago. "CBO expects total employment to be only modestly affected by a cap and trade program to reduce greenhouse gas emissions." And we go on to explain that, except during recessions of course, most Americans who are interested in working can find a job. And that is a very desirable feature of our labor market and economic system. The biggest effects of cap and trade are felt regionally and in particular sectors. And the transition from current patterns of employment toward the patterns of employment that would prevail if we had a price on carbon that then changed our output and so on, it is the transition that can be costly, particularly to the workers who are most affected. And I think most economists would say that it is not that green jobs are necessarily better or more numerous, but it is the case that the whole nature of trying to limit carbon emissions is trying to change the production structure of the economy, and so that some jobs are lost and some jobs are created. And it is the process of helping workers or communities move from one world to the other that is disruptive and that warrants the attention of policy makers.

Mr. DIAZ-BALART. I just wanted to, it is important to look at Spain as an example. The President himself has mentioned Spain as an example, and Spain now has 18 percent unemployment, forecasted to go to 20 percent. So I think we just need to make sure that we look at that, and I hope you have an opportunity to do so. And Mr. Chairman, I know my time has expired. Thank you, sir.

Mr. YARMUTH. Thank you, Mr. Chairman. Welcome back, Dr. Elmendorf.

Mr. ELMENDORF. Thank you.

Mr. YARMUTH. Referring to Mr. Garrett's questioning about the effects of the Recovery Act, he made the statement, "having spent $800 billion." That is not an accurate statement, is it? I mean, we have not spent $800 billion.

Mr. ELMENDORF. No.

Mr. YARMUTH. Approximately how much of the total appropriation have we spent?

Mr. ELMENDORF. To date the amount spent is quite small. I think I have that number with me. I do not have it at hand. Only a very small fraction of the spending has gone out the door. I think that has sometimes raised questions, but as I said it is not surprising to us.

Mr. YARMUTH. So while that, the chart he showed about employment may indicate that the projections so far have not been what they were projected to be before the stimulus package, it is a little bit premature, would you not say, to project what the ultimate outcome in terms of employment for the country will be?

Mr. ELMENDORF. Yes. Absolutely. As I tried to suggest before, the crucial question is what would have happened otherwise? And that cannot be directly observed, and you cannot, as I said in my opening remarks, in our forecast the persistence of high unemployment is not because the stimulus did not work. It is because there were larger offsetting forces.

Mr. YARMUTH. Right. I want to go to the question of, a related question about employment. I have a brother who is in the barbecue business. And he has done very well over the years in the barbecue business, and he has always been very concerned about his tax rate. And last year, I talked to him last fall and he said he had had an epiphany of sorts. And he said he realized that unless people could afford barbecue it did not really matter what his tax rate was. And in a sense, we are in that same position that he is in as the government. Unless people make money, and create income and so forth, we are not going to have any revenues to do anything. So my question is, looking at the forecast in terms of spending, you spent a lot of time on consumer spending but very little on wage and income in terms of projections. Do you have projections about when per capita income in this country will increase, and what the long term projection for that is? Because we know over the last seven or eight years that there has been a real decline in average income.

Mr. ELMENDORF. Let me put up slide four, which does not quite answer your question, but it starts in that direction and I will try to add to that. Slide four shows overall income from wages and salaries and overall disposable income. So wage and salary income is the bottom line. As you can see that has been declining for the last couple of years. That is just a reflection of the weak labor market. Disposable income at the top has done better. The little tent that you see in 2008 owes importantly to the rebates passed last year. And the turn up at the end owes, this predates, the data point here predates the effect of the stimulus so it really is the, but it owes importantly to the larger social security cost of living adjustments at the beginning of the year and so on.

This chart does not show projections, and I do not have them offhand. One very important risk in the economic forecast is how long labor market weakness persists, and how that affects income, and how that affects the ability of households to spend. And although the spending data, since our March forecasts have been pretty closely aligned with what we had expected, the labor market has looked weaker. And the employment loss last month was very large. Initial claims for unemployment insurance remain quite high, including this morning's data. And the longer that persists and the more that drains income from households, the worse the economic prospects are.

You also raise, I think, a different, important issue. Which is that these are aggregate numbers, the economy as a whole. The distribution of income, of course, has become much wider over the last several decades. And that means that the income of the typical person has not necessarily tracked the overall income. And that is probably being reversed to some extent during this economic downturn, particularly with problems in the financial sector which was a source of some of those very high incomes. But I do not think anybody expects that it is being completely reversed. And that is, I think that is an important issue for policy makers to consider. It is not one that is very readily addressed through macroeconomic policy, the actions of the Federal Reserve, or the amount of federal spending and taxes, although there are more specific changes in spending and taxes that one may make to address that.

Mr. YARMUTH. Good. Thank you very much.

Chairman SPRATT. Mr. Langevin?

Mr. LANGEVIN. Thank you, Mr. Chairman.

Chairman SPRATT. I want to remind you we have got about nine minutes to make it to the floor for three votes. And I will stay here for along enough so that both you and Mr. Etheridge can pose questions, but we are going to have to hustle to the floor. Mr. Langevin?

Mr. LANGEVIN. Thank you, Mr. Chairman. And Dr. Elmendorf, thank you, welcome back here. I would like to turn I think it is to slide twelve. This is debt held by the public 1965 to 2019. So I think it is the last slide in the pile.

Mr. ELMENDORF. Yes.

Mr. LANGEVIN. Can you just give us a little bit more perspective in terms of what went into coming up with these percentages? And what will the practical effects be on each of these levels? On the economy, interest rates, and such, or the fall out if, you know, each of these were to, at each level were to come to pass?

Mr. ELMENDORF. So the baseline projection follows current law.

Mr. LANGEVIN. And if you could also talk about maybe some, you know, maybe some historical or practical effects of the countries that have had publicly held debt that high at levels of GDP?

Mr. ELMENDORF. So the baseline projection follows current law. Obviously, debt jumps quite sharply in these couple of years with very large deficits because of the recession and because of the policy actions that have been taken. It jumps to a level above what we have seen for some time. Not a level that is out of the ordinary of other countries, I would say. And we have some advantages over other countries, in that our financial markets are viewed, despite their problems, as a relatively safe place to put money. And our Treasury securities are viewed as a particularly safe to put money. That vantage could be squandered. I do not think most experts would say we are at that point yet.

The highest line, our projection of what would happen to debt under the President's budget, does push our debt up to levels that are, have been seen by other countries but are not common. And the slope of that line, of course, as one that beyond this picture comes into greater population aging and continued rising health costs I think is a very grim picture. And under that, we are in the process right now of producing a formal analysis of the economic effects of the President's budget which we plan to release next month. But qualitatively, that path certainly would lead to higher interest rates, less capital accumulation, less long term growth than the lower path.

Mr. LANGEVIN. Okay. Thank you. Let me just talk about the, obviously, the economic downturn and some of the responses that Congress and the administration have enacted, TARP, and the American Recovery and Reinvestment Act. In your estimation, which of the federal responses to the financial and economic turmoil have shown the most success in containing and alleviating the crisis? And thinking more broadly, what additional government measures really need to be taken to address both the housing and the financial crisis?

Mr. ELMENDORF. I think most experts would say that the collection of policy measures taken was important. And that the different policy measures address different aspects of the problem. That an overall weakness in private demand, and household and business spending, is being offset to some extent by the greater government spending and lower taxes. And that most experts would have said was the role of fiscal policy. At the same time, this particular recess we have a very serious financial system problem. And the actions of the Federal Reserve and the Congress through the TARP and the Fannie Mae and Freddie Mac, and so on were focused on those problems. And I think, again, most experts would say that one needed the combination of actions to address the different aspects of the underlying problem.

I think further actions at this point, you know, the administration is trying to implement a plan to reduce mortgage foreclosures. Analysts have wrestled now for two years with what one might do, or a year and a half at least, one might do on the housing, on the foreclosure front, and it is a very difficult problem to solve. And it is difficult for various reasons, including particularly that underwriting standards, the standards for getting into housing became so lax that there are unfortunately a significant number of people who are in houses that they cannot reasonably afford. And they were counting on appreciation or other good things to happen that are not happening. So not everybody who is in a house can plausibly stay in it.

Moreover, among those who with some amount of help might be able to stay in a house in a way that might be viewed as socially beneficial, helping them also changes the incentives of all the other people who are currently struggling but meeting their mortgage payments. And that one can actually, the cost to the government in even the number of foreclosures might rise sharply if one designed a plan to help some people that ended up providing incentive for others to engage in behavior that is less desirable. So it is a real, it has been I think a very problematic area for analysts who have tried to develop better solutions and have been unable to.

Mr. LANGEVIN. I will have some other questions for the record but I see my time has expired, so I yield back. Thank you.

Mr. ELMENDORF. Thank you, Congressman.

Chairman SPRATT. Mr. Etheridge?

Mr. ETHERIDGE. Thank you, Mr. Chairman. I just have one question. I mean, you may have covered it indirectly, because being in a state where unemployment has doubled in the last twelve months. We are the fourth highest in the nation, now, North Carolina. And, you know, all these things we talk about in the future, folks at home are not really concerned about that. They are worried about where they are right now. They are in a depression, those who have lost their jobs. In your professional opinion, given all the factors, because we have probably one of the worst economies in North Carolina in the country, from manufacturing automotive parts, to housing, etcetera, what are your best guesses as to when we are going to start seeing unemployment change and go down rather than go up? Because that is a critical issue that I hear every weekend. And I am sure next week I am going to get it everyday.

Mr. ELMENDORF. So I wish I had better news for you, Congressman. In our March forecast we thought that unemployment would peak in the first half of next year at around 9.5 percent. If we were writing down a new forecast today we would put off that peak and we would raise it. So that we would now, currently we expect the unemployment rate might peak around 10.5 percent in the second half of next year.

Now a lot can, we will learn a lot more before we actually write down the forecast in August. And the worsening in the last few months in our outlook, you know, just reveals the uncertainties that surround this. But we think it will be a slow, a painfully slow recovery because there is still a substantial overhang of housing. Because the financial system, although it has crawled back from the edge of the abyss is still in a weakened state. Because households have lost a lot of wealth through house prices and stock prices, and thus will be pulling back on their spending. Because economies around the world and thus the demand for our products remain weak. And all those factors we think will lead to a tepid recovery, and somewhat more tepid than we thought when we assessed conditions a few months ago.

Mr. ETHERIDGE. Thank you, Mr. Chairman. I would like to go further but I know we are running out of time. But thank you.

Chairman SPRATT. Thank you, Mr. Etheridge. And Mr. Elmendorf, thank you very much for your excellent testimony and for your very responsive and complete answers. We will be working with you further on these issues, and we will probably want to do this again in the next quarter.

Mr. ELMENDORF. Thank you, Mr. Chairman.

Chairman SPRATT. Thank you very much indeed.

[Questions for the record submitted by Ms. Kaptur follow:]

QUESTIONS FOR THE RECORD FROM HON. MARCY KAPTUR, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF OHIO

Question 1: What is the projected effect on the economy of sending both Chrysler and GM into bankruptcy in the short and long term?

It is impossible to distinguish the direct effects of bankruptcy from the underlying near-term difficulties faced by the auto industry in general, and by Chrysler and GM in particular. Assessing the longer-term impact is even more difficult.

The recession has sharply reduced vehicle sales, forcing the industry to shrink in order to regain profitability. However, the best estimate based on analysis conducted by others—most notably Goldman-Sachs—suggests that the effects on the overall economy of chapter 11 bankruptcy filings by the two firms are likely to be relatively small. Some vehicle sales may have shifted away from GM and Chrysler and toward Ford and one of the transplant manufacturers (such as Toyota). Since the vehicles produced by the transplant manufacturers have somewhat smaller domestic content than those produced by the Detroit 3, this would slightly reduce U.S. output of motor vehicles and parts. In addition, the uncertainty surrounding the fates of the two manufacturers may have temporarily depressed total vehicle sales while prospective vehicle buyers decide whether to go ahead with their planned purchases of GM and Chrysler products, wait until the future of the manufacturers is clearer, or buy a vehicle from Ford or one of the transplant manufacturers. Assuming that Ford and the transplants would split those sales in proportion to their current shares of the rest of the market each reduction of 10 percentage points in Chrysler and GM's combined market share due to the bankruptcy filings might reduce U.S. output of motor vehicles and parts by less than 1 percent.

The impact on jobs is potentially somewhat larger, though again difficult to distinguish from underlying trends in the industry. Through April, employment in the motor vehicles and parts industry was already down by nearly 400,000 (37 percent) from its average level in 2006, and employment at auto dealers was down by about 190,000 (15 percent) over the same period. Following the bankruptcy filing by Chrysler, employment in May fell by an additional 30,000 in the auto industry and 7,000 among auto dealers (although it is not clear how many of these additional losses are directly attributable to Chrysler's filing and the subsequent idling of assembly plants). Chrysler has since emerged from bankruptcy, and a number of the idled plants have re-opened or are expected to in the near future.

Plans submitted by GM and Chrysler will result in direct headcount reductions of nearly 40,000 by 2011, and the elimination of dealerships could, according to the analysis by Goldman Sachs, cost about another 160,000 jobs. That analysis suggests that the total number of job losses could rise to as much as 400,000 after taking into account effects throughout the supply chain and, possibly, local multiplier effects. Further direct cutbacks at GM and Chrysler cannot be ruled out. But in light of the industry's difficulties, it's likely that many if not most of these jobs would have been lost even without a bankruptcy filing. As the economy recovers, however, the increased sales projected for Ford and the transplants should eventually result in some job creation, offsetting at least some of the lost jobs at GM, Chrysler, and their dealers and suppliers.

Even under strong assumptions about changes in market share and possible job losses, the near-term impact on real gross domestic product should be small. Moreover, the bankruptcy process allows GM and Chrysler to control costs, permitting the viable parts of the companies to continue operating while freeing up resources that had been put to unproductive uses.

Question 2: What is the projected effect of the continuing rise in the cost of a barrel of oil on the US economy?

The price of oil has risen sharply in the past few months, driven in part by expectations that the global recession may be easing and the rate of inflation may be higher. The price of West Texas Intermediate crude oil has risen by about 50 percent this year to about $72, about half of its peak value of $145 of last year and close to its level in early November. The futures market expects the price to rise to about $75 by year-end and about $80 by the end of next year. The increase in the price to date has very likely raised the share of national income that is spent on oil imports, which acts like a tax on U.S. consumers, and slightly reduced the pace of economic activity.

Question 3: The dollar's value has dropped during this financial crisis. Could the dollar continue to drop and what effect will that have on the economy and our deficit?

Between February of 2002 and April 2008, the dollar's exchange value was falling in response to the continuing large deficit in the nation's current account balance. The dollar's exchange value reversed course and began to rise sharply thereafter, due to international investors' demand for safe-haven assets during the financial crisis as well as to U.S. companies' sales of foreign assets in their attempt to deleverage. Since March of this year, however, the dollar has declined slightly as the financial crisis has abated somewhat.

If the financial crisis and the global economy continue to stabilize and recover, the short-term support for the dollar is likely to give way to the downward pressure exerted by long-term factors—namely, the large current account deficit and U.S. net international liabilities. A gradual depreciation of the dollar, if sustained, will help to boost U.S. net exports and economic activity and narrow the current account deficit in an orderly fashion. An abrupt fall of the dollar will also help to boost U.S. net exports, but it will also subject the economy to risks of suddenly higher inflation and/or interest rates.

Question 4: Has CBO done any analysis of the potential outcome if U.S. Treasury securities are not considered a safe haven in times of trouble, and if so, what was the result?

CBO has not formally analyzed a scenario in which Treasury securities would no longer play a safe haven role. In CBO's view, the extent to which U.S. Treasury securities are considered a safe haven is closely tied to the U.S. dollar's role as the major reserve currency—the dominant currency used for international transactions and held in reserves by major financial institutions around the world. For example, the U.S. dollar was involved in almost 90 percent of all foreign exchange transactions in 2007, and about two-thirds of the currency reserves of global central banks remain in dollars.[1] Because of the size of the U.S. economy and financial markets relative to other economies, the dollar is expected to remain the reserve currency for years to come. Even though the euro may potentially rival the dollar as the global reserve currency at some point, at the present euro-area capital markets still lack the depth of U.S. markets.

Nevertheless, the sustainability of the dollar's reserve-currency status cannot be taken for granted. If the U.S. indebtedness to foreigners were to keep rising relative to GDP, it is likely to erode the dollar's role as the main international reserve currency. If the dollar's reserve-currency status is sufficiently eroded, some of the advantages that accrue to the United States from that special role of the dollar—such as less costly financing of US spending and a more stable dollar exchange rate than otherwise—will also be notably diminished.

Question 5: What actions can the Federal Reserve take to effectively return its balance sheet to about $1 trillion without negatively affecting the economy?

The Federal Reserve's balance sheet is currently over $2 trillion, more than twice as large as it was before the crisis began in August 2007. About $750 billion is allocated to relatively shorter-term lending such as central bank liquidity swaps, term auction credit and commercial paper. As the economy and credit markets return to health, the amount of shorter-term lending should decline in an orderly manner as existing loans mature and market participants find they can again obtain credit from markets at lower cost. Indeed, that process appears to be happening now.

However, the composition of the balance sheet is shifting to a higher share of longer-term assets as the Federal Reserve continues to purchase Treasury, agency and mortgage-backed securities. Currently, about $1.25 trillion of the balance sheet is composed of those securities, along with small amounts of other long-term assets. For the Federal Reserve to reduce its balance sheet using its current operating procedures, it would likely have to sell some of those longer term securities. Many analysts expect that such selling will have to be done at a fairly deliberate pace so as not to flood markets with an excess supply. The risk is that the size of the balance sheet may constrain the Fed from tightening as rapidly as it otherwise would choose. Under this constraint, monetary policy might initially be too loose once economic recovery starts.

As an alternative to shrinking the balance sheet, policymakers within the Federal Reserve System have suggested that the Fed itself issue longer-term debt. With funding locked in through longer-term debt, the Fed could increase its policy rate without concern about funding its balance sheet. A change in current law is necessary before the Fed would be allowed to issue longer-term debt.

Question 6: Does the CBO analysis of the budget include any institutions repaying any of the TARP funds, and why or why not?

The analysis of the TARP that CBO presented in its March 2009 baseline did not assume any early repayments of TARP funds. At the time of that analysis, the Treasury had indicated that it was not favorably disposed to accepting repayments before the initial three-year holding period (as specified in the Treasury's term sheets) had passed. We had also assumed that most institutions would be unable to meet the Treasury's requirement for early redemption—selling equity to private investors.

[1] See Triennial Central Bank Survey 2007, Bank of International Settlements, December 2007, for the figure on foreign exchange transactions, and *http://www.imf.org/external/np/sta/cofer/eng/cofer.pdf* for the most recent figures by the IMF on foreign currency reserves.

As of May 27, more than 20 small community banks had repaid TARP funds in the amount of approximately $1.7 billion. Since then, the Treasury has confirmed that ten of the largest banks to have received TARP funding have been cleared to begin repayments. Should all of those banks do so, the total level of repaid TARP funds would rise to about $70 billion. We are in the process of modifying our current analysis to appropriately account for repayments.

Question 7: Has CBO examined the effect of the TARP dollars on the economy overall? Is there any way to quantify TARP's effect on the recovery, be it good or bad?

CBO has not explicitly examined the effect of the TARP on the overall economy. Spending by the TARP has primarily been used to assist the financial and automotive sectors with additional money set aside for housing initiatives. While we can estimate the positive effects of the economic stimulus bill, trying to quantify the effects of the TARP on financial markets is difficult because so many other factors are affecting those markets. For example, actions by the Federal Reserve (some of which were fostered by the TARP), are undoubtedly playing a big role in the recent improvement in financial markets, as is the FDIC's guarantee program for bank debt.

Nevertheless, few would disagree with the view that the provision of capital by the TARP helped to strengthen the banks and restore confidence in the banking system. At the height of the financial crisis last year, when accessing private capital markets was very difficult, some of the recipient banks would have had to cut back lending to meet their capital requirements in the absence of TARP money. The amount of loans and leases at large banks has fallen since October 2008, but that should not be taken to mean that the TARP was necessarily a failure. Without the TARP, banks probably would have reduced their lending by much greater amounts and our economy would be even weaker. Moreover, demand for credit declines in a recession, so looking at the changes in the actual amount of credit provided is a misleading indicator of TARP's effects on the financial system.

Now that conditions in financial markets are improving and there is some clarity to banks' capital needs, some banks are again raising private capital. Bloomberg reports that financial institutions raised nearly $80 billion in the first quarter of 2009. Some of that money will be used to repay the TARP money to the government, but the amount of capital in the banking industry should increase, which will give the industry greater ability to support an economic recovery.

The economic impact of the assistance to Chrysler and General Motors (GM) is difficult to estimate because it is impossible to know how the situation would have otherwise played out. Federal assistance gave Chrysler and GM some time to arrange for an orderly resolution of its difficulties, which very likely preserved some jobs at least temporarily. The firms' creditors might have responded differently in the absence of their expectations of federal assistance. Perhaps they would have been more agreeable to debt for equity conversions.

The longer-run effects of the TARP depend on how productive that spending was relative to the cost of financing the additional debt and on other behavioral effects. For example, rescues of financial institutions and assistance auto manufacturers may reduce market discipline by undermining creditors' monitoring incentives and encouraging large "too big to fail" institutions to take on more risk. If those behaviors impair the market's ability to reward efficient companies and penalize inefficient companies, capital may be misallocated and future living standards lowered. Many analysts believe that the longer the government remains an owner, the greater the risk that politically determined allocations of capital rather than market-based decisions will guide the firms. This concern is especially pertinent to the auto manufacturers, whose competitiveness has been declining for many years.

Question 8: Has the CBO assessed the health of the Federal Reserve? If so, what was the result?

In the process of putting together the estimate of the baseline federal budget, CBO must project the Federal Reserve's remittances to the Treasury. Those remittances depend on not only the income that the Federal Reserve receives on its assets, but also its payments on liabilities. (Since October 2008, the Federal Reserve has paid interest to banks on the reserves they hold with the Federal Reserve.) In our last baseline projection, CBO projected that the Federal Reserve would not experience net losses on its portfolio of assets, even though the Federal Reserve has experienced some losses on a few types of assets.[2] The Federal Reserve is holding a

[2] Congressional Budget Office, A Preliminary Analysis of the President's Budget and an Update of CBO's Budget and Economic Outlook (March 2009).

riskier portfolio of assets than it did before the financial crisis, but it has taken precautions to limit its exposure to losses.

Question 9: In your testimony, you state "Indeed, economic recovery may be necessary for the full recovery of the financial system, rather than the other way around." When do you expect a full recovery, or when do you expect enough recovery to instigate a full financial recovery?

When CBO published its last economic outlook in March, we expected the current recession to end in the fall of this year. (The consensus forecast of private economists currently points to an end of the current recession in the third quarter of this year.) We expected the recovery of the economy to proceed slowly and extend into late 2010, in part because of the weakened state of the financial sector.[3] Because it generally takes several quarters of solid growth for financial institutions to see sustained improvements in their profits and capital positions, CBO also expected the recovery of financial markets to proceed slowly.

What, if any, policies can be enacted to further encourage full economic recovery? At this point, it is not clear whether policymakers will need to consider enacting more economic stimulus. The full impact of the American Recovery and Reinvestment Act of 2008 has yet to be felt because only a portion of the $787 billion has been spent. Any need for additional stimulus would be more evident when the effects of the ARRA begin to wane next year.

Should we wait on financial institutional reform for a full recovery?

Policymakers do not need to wait for a full recovery of the financial sector in order to strengthen the regulatory oversight of the industry. There is rarely a bad time to put in place safeguards against excessively risky lending practices.

Question 10: Has CBO analyzed, assessed, or examined the potential creation of a systemic risk regulator and the resulting effects on the financial industry and economy?

No. The Administration released its proposal on June 17th and others may follow.

[Whereupon, at 11:38 a.m., the Committee was adjourned.]

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[3] The recovery period is the length of time it takes for real output to return to its peak before the recession.