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Senate Budget Committee
Hearing on the Global Economy: Outlook, Risks and Implications
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Overview of current conditions

The economic and financial crisis that has engulfed the United States over the past year is now cascading throughout the global economy, producing a painful, sudden, synchronized global contraction. The IMF has once again revised downward its estimate for global growth in 2009 to the lowest in over 25 years and to just a fraction of the 5% pace seen in 2007. Many noted private forecasts are even more pessimistic, expecting negative global growth this year, possibly shattering all post-war records for a global slowdown. The World Bank estimates that global trade will decline this year for the first time in a quarter-century. The likely global wealth loss from this crisis could exceed $50 trillion, which is more than global GDP.

The G7 economies, which compose roughly half of global GDP, are experiencing the first synchronized recession in the post-war era. The U.S. economy likely shrank about 5% in the last quarter and will likely continue to contract during the current year, even with a sizable stimulus in place. Germany, the world's fourth largest economy and top global exporter, will likely suffer its worst economic performance in its modern history. The UK economy is forecasted to shrink the most since 1946, with the Pound Sterling already plummeting to a 23-year low. Japan is in the midst of a severe and protracted contraction, with exports plummeting and crude-steel output sinking in December by the largest amount in 60 years. In short, the economies of the developed world have ground to a halt.

The emerging market economies are mirroring the downturn in the developed world. China, now the world's third largest economy and along with the U.S. one of the key drivers of growth during the recent expansion, is experiencing economic challenges not seen since the Asia Financial crisis a decade ago. China's growth has slowed from a blistering 13% pace in 2007 to a relatively languid 7% this year (with downside risk), a level that is regarded as insufficient to generate enough jobs to meet demand. But China is not alone. Asia broadly is suffering, proving wrong the oft-repeated quip of the past few years that the region had "decoupled" from the U.S., insulating it from possible weaknesses and shocks from outside the region. For example, Korea's fourth quarter 2008 GDP growth collapsed a staggering -21 percent (annualized quarter over quarter), and Singapore an equally stunning -17 percent, the biggest drop on record. Finally, India will likely suffer a growth rate this year that's at best just half the pace of last year.

The world's principal commodities producers, who just nine months ago were in an enviable position of benefiting from stratospheric price levels, have been whipsawed by a freefall in prices. With oil prices plummeting by roughly $100 a barrel, from a record $147 in July of 2008, the oil producers are under enormous financial and fiscal stress. Russia has experienced and is experiencing a substantial outflow of capital, a collapsing Ruble, a sizable loss of official reserves (i.e., roughly $130 billion or 30% of holdings) and a large swing in its external position from positive to negative. The GCC economies are facing the toughest conditions in decades with many of the economies suffering budget deficits and slumping activity. Dubai, one of the seven emirates composing the United Arab Emirates, and a symbol of globalization and leverage-generated wealth of this past expansion, is witnessing a cooling of its renowned economic boom. One noted multinational heavy equipment manufacturing firm commented

just last week that construction activity and crane demand in the region had simply "evaporated." The non-oil commodities producers, such as copper exporters Chile and Zambia and iron ore producers Brazil and Australia are also experiencing falling demand and plummeting exports.

Needless to say, these are sobering statistics, reflecting an unprecedented period in modern economic history where no part of the global economy -- from Norway to Nigeria to New Zealand -- is immune from this crisis and the painful contraction in economic activity.

Key Challenges Ahead

The world's policymakers have responded with imagination and alacrity, implementing polices well outside the conventional textbook suggested options and instruments. Central banks have slashed rates to historic levels, with the Federal Reserve pushing its Fed Funds rate to near zero and the Bank of England cutting rates to the lowest level in over 300 years. Central banks have also moved to employ their balance sheets in ways and magnitudes unimaginable just a year ago in an effort to re-liquefy financial markets, unfreeze credit channels and address concerns of financial counter-party risk. The world's principal central bankers should be applauded for these efforts and for their willingness to undertake extraordinary action to combat this crisis. That said, many central banks around the world have plenty of room to reduce rates further and ease monetary conditions employing a variety of tools. They should do so quickly. For example, the European Central Bank (ECB) has cut rates an aggressive 225 bp over the past four months to a record low 2%. But, given that the European Commission is forecasting that the 16-nation Euro area will contract by 1.9% this year, inflation has plunged to 1.6% in December from 4% last July and the banking system remains highly fragile, the ECB can and should push rates lower as soon as possible.

Officials worldwide have also turned to fiscal policy, with most of the major economies having enacted or currently enacting sizable spending and tax cut programs. For example, the U.K has approved a package equal to roughly 1% of GDP, mostly through changes in the VAT, Japan a package of about 1.1% of GDP, the Euro area about 2% of GDP, China 15% (over two years) and Korea 3.7% of GDP. Despite this effort, the deepening nature of this crisis will likely require even more fiscal stimulus. The estimate of the size of needed additional stimulus varies based on expectations of global growth and country specific demand shortfalls, but may be as much as $2 trillion globally. Additional fiscal stimulus would be most welcome and should occur in those countries with large or growing savings rates and moderate to low debt to GDP levels (i.e., those with the capacity to enlarge their deficits). Both Germany and China fit this description and, given their economic size, could have a significant impact on global growth.

Despite aggressive monetary and fiscal policy measures, the next year (or two) will still prove challenging. The global financial deleveraging process will continue. Banks will continue to rebuild their balance sheets and remain reluctant to extend new credit. Private capital will likely avoid the banking sector, paralyzed by the uncertainty over asset quality and expected sweeping changes to the U.S. and likely European regulatory regimes. The demand for credit will also remain weak. Many U.S. consumers face negative equity on their homes, auto loans that exceed the residual value of their vehicles, depleted savings and 401K accounts, stagnated wages and one of the worst labor markets in twenty-five years. For many of the country's 77 million baby boomers, retirement now seems unrealistic in the near-term and most will have to set aside a greater portion of income to compensate for the roughly $11 trillion (or 20%) wealth loss that's occurred through the end of 2008. Corporations will also prove

unwilling to borrow for expansion, facing weak demand for goods and services, little or no pricing power, excess capacity and pension fund shortfalls that may exceed a half a trillion dollars. In short, neither the supply nor demand conditions for credit are likely to improve much in 2009.

The credit crunch is also slamming the already highly weakened emerging market economies (EMs). During the 2002 to 2008 expansion, emerging markets boomed, experiencing a solid average annual growth rate of 7%. During this time, many implemented sound polices, such as reducing deficits, reducing foreign exchange denominated debt, accumulating reserves and moving to flexible exchange rates. Such policies and good economic performance created a fertile environment to attract capital, and many of the EMs did attract capital, especially the corporate sector. JP Morgan notes that emerging market corporates borrowed (direct and syndicated lending) over $1.3 trillion for the three year period of 2006 -2008. These corporate borrowers will need to rollover roughly $200 billion of debt during this current calendar year, which will prove incredibly difficult to accomplish. Fortunately, U.S. banks have little direct exposure, in fact just only 11% of the $4.7 trillion in total outstanding bank lending to the emerging markets. Unfortunately, European banks are highly vulnerable, having about 74% or $3.4 trillion in exposure, and are likely to face losses over the coming year.

In addition to portfolio flows, Emerging Markets are also suffering from a drop off in foreign direct investment. The World Bank, in its latest Global Development Finance Report, predicts that FDI into the developing economies will slump by whopping $180 billion or 31% in 2009, following on a 10% decline last year. Given that FDI accounts for 40% of total flows to the developing world, such a substantial decline will further depress growth and weigh on the value of EM currencies.

With the collapse in commodity prices, the loss of capital flows (and in some instances capital flight), swooning currency values, increasing austerity measures and faltering growth, political pressures in many countries are heating to a boil. Press reports just this week note riots and social unrest throughout Eastern and Central Europe, Russia, Iceland and Ukraine. Thousands of other disturbances are occurring in Asia, Africa and the Middle East but don't make the pages of the daily U.S. papers. China too is not immune to the pressures of faltering growth, with unemployment now likely above 10%. There are mass layoffs in the coastal, export-oriented provinces, where over 7 million of the country's 130 million migrant work force have left to return home. U.S. foreign and development assistance policy will need to be attuned to these trends and to the plight of those most vulnerable to swings in commodity prices and the sharp edge of a faltering business cycle. In fact, The World Bank estimates that this crisis has pushed 100 million people back into poverty, a trend that will continue placing enormous strain on development organizations and budgets.

One of the great challenges over the next year is determining, and managing where possible, a new growth model to replace the one that has powered global demand for the past decade. That model is best described as where countries with excess savings, namely but not exclusively in Asia, cycled those savings primarily into the U.S. where cheap and abundant credit inflated asset values, pumped up residential investment, increased financial leverage and supported consumption well in excess of incomes. This so called Bretton Woods II system appeared at the time to offer benefits to both the capital importers and the goods exporters. In fact, between 2002 and 2007, the U.S. and China alone accounted for close to half of global economic growth. However, many government officials, including myself, were concerned that these imbalances were not sustainable and likely distorting capital in a sub-optimal fashion. Starting in 2005, we (the Bush Administration) worked with the G7, the G20, the IMF and other institutions and forum to address these imbalances. Obviously, we did not know at the time

the extent of the miss-allocation of capital or the speed with which they might unwind, but we did appreciate the unsustainable nature of this system.

Now, this U.S consumer-led dollar recycling phenomenon has likely run its course, or at least has dissipated in potency, as US households will save more -- possibly dramatically more -- and consume less to help rebuild tattered balance sheets and respond to reduced wealth holdings and possible loss of income. Thus, the imbalances are correcting somewhat automatically. If this indeed continues, the global economy will need a source of growth beyond the U.S. consumer to help lead us into a new expansionary phase.

Implications for U.S. Policy

These challenges will require additional actions from policymakers. Some suggestions are as follows:

1.) **Additional, meaningful fiscal stimulus**. Without question, the U.S. economy needs a large and immediate fiscal stimulus package to address insufficient demand and rising unemployment, now 7.2% and heading higher. The $850 billion top line estimate for the proposed package currently winding its way through the Congressional process is likely would be sufficient to achieve the stated objective. However, it is critically important that the composition of the package be such that the funds are spent as quickly as possible, ideally within the current calendar year, and pass some level of cost-benefit analysis. According to preliminary analysis from the Congressional Budget Office and the Joint Tax Committee, the current package offers only a modest level of current year stimulus -- just $170 billion of the $850 billion package. I would strongly urge this Committee to set aside those components where the majority of the effect is outside the current calendar year window, or certainly outside the next 18 months, and evaluate those items through the normal appropriations and budget process. This is not to say that these items are unworthy of support, many of them will prove beneficial over the long term, but they are not what are commonly accepted as “stimulus.” For example, the proposed wireless and broadband deployment grants program will see only $10 million of the overall $2.8 billion budget spent in 2009 with the bulk (i.e., $2 billion) not occurring until 2012 and beyond, when the economy will certainly be in recovery. We also need to see additional fiscal stimulus from other key economies, especially in Europe and Asia, with a heavy emphasis on supporting near-term domestic consumption.

2.) **Stabilize and restore confidence in the banking sector**. Despite having experienced more than $1 trillion in write downs and credit losses over the past year and receiving hundreds of billions in government assistance, the banking sector still suffers from uncertainty over the sufficiency of its capital base and quality of assets on the balance sheet. Until this uncertainty is resolved, banks will remain unwilling to extend new credit, which is critical to spurring economic growth and recovery. The new Administration should use a portion of the $350 billion of the second tranche of the TARP funding to stabilize the housing market, which underlies many of the assets on banks’ balance sheets, and use the remaining portion of the TARP to either remove troubled assets from the banks or at least ring-fence them in a way to insure against the downside risk of further deterioration. Given that the extent of the troubled assets is probably at least $1 trillion and quite possibly as high $3 trillion, the Administration will likely need to seek additional resources from the Congress. Another possible policy path would be for the Federal Reserve to purchase assets by expanding its balance sheet. The TARP funding could then be applied to just the expected present value of the calculated credit risk or loss, allowing the Fed to leverage the $250 billion or $300 billion to as much as $2.5 trillion to $3 trillion in actual asset purchases.

Stabilizing the banking sector is a necessary but not sufficient condition to ensuring a healthy and well functioning financial system. The Administration and Congress need to fix the numerous problems and failures that led to this crisis. Currently, there is enormous uncertainty as to how and when officials will begin crafting a new regulatory regime. This uncertainty is keeping tens of billions of dollars in private capital on the sidelines and out of the capital structure of the industry. To reduce this uncertainty, officials need to begin signaling the contours and composition of a comprehensive regulatory reform proposal. I strongly urge the Congress to consider the just-issued Group of 30 (G30) report entitled Financial Reform: A Framework for Financial Stability. The Report offers a thoughtful, broad-sweeping response.

3.) **Strengthen the International Monetary Fund and support development assistance**. Given the breadth and depth of this fast-moving global financial crisis, the International Monetary Fund has been thrust back into a central role of promoting macroeconomic stability among its member states. Over the past several months, the Fund has extended tens of billions in financing to such countries as Pakistan ($7.6b), Hungary ($15.7b), Ukraine ($16.4b), Iceland ($2.1b) and Lativa ($2.34b) to stabilize their fragile economies. The Fund is in discussion with several other key economies and has also set up a large liquidity facility for good performing economies that are innocently suffering collateral damage from global events. As this crisis spreads, it's highly likely that the Fund will need to tap a large share of it resources and could potentially exhaust available lending balances. In the spring of 2008 the IMF shareholders agreed to submit to members a comprehensive reform package. The Bush Administration submitted this package to the Congress in November of last year. The package includes such changes as a quota increase, re-balancing of voting rights , flexibility in how the Fund manages its investment portfolio and proposes a sale of a small percentage (about 12.5%) of it gold holding. While I would like to have seen a more robust reform proposal, especially regarding issues of governance and resources, I would urge the Congress to approve this package as soon as possible to ensure that the IMF has the legitimacy, stature and resources to serve its critical role in global macro-economic stability.

We should also ensure that world's poor and most vulnerable do not suffer greatly in this crisis. Mounting budget deficits and overwhelming domestic priorities will likely strain the developed world's capacity to meet, let alone exceed, development assistance pledges. This is no time to short-change our commitments and I urge the Congress to ensure that our bilateral and multilateral assistance obligations are fully funded.

4.) **Address global imbalances**. As a result of the expected large increase in the U.S. household saving rate and dramatic fall in consumption and investment, we will likely witness some dissipation in the large imbalances that have characterized the global economy over the past decade. However, policymakers should endeavor to undertake additional policies to further reduce these imbalances but do so in a way consistent with restoring global growth as quickly as possible and maximizing global growth over time. More specifically, the larger surplus countries (e.g., China, Germany, Japan, etc) should significantly increase domestic consumption and reduce domestic savings. Indeed, China has announced a large stimulus plans (15% of GDP over two years) and the EU has cobbled together a meaningful plan as well. More needs to be done, but the composition is critical. We also need to see greater currency flexibility in those places that it does not now occur, but we should proceed cautiously in the short-term to avoid unnecessary and potentially destabilizing currency volatility and actions that might trigger protectionist responses or "beggar thy neighbor" actions. The fragility of the global economy and financial system cannot now withstand a trade skirmish or confrontation. Further,

addressing issues of the appropriateness of exchange rate regimes and levels is best done via the multilateral channels of the IMF, which has such responsibilities as its central mandate. Addressing exchange rate issues just bilaterally will be regarded by many as lacking international legitimacy and driven by domestic political demands and agendas, and thus unlikely to achieve its objective.

5.) **Stabilize the long run fiscal outlook**. The historically large deficits that we will run over the next couple of years (a post- WWII high of 8.3% of GDP this year alone) may be a necessary cost of returning the U.S. and global economies to a positive and sustainable rate of growth. However, the medium- to long-run fiscal outlook is not sustainable and, ultimately, deficits do matter as there are limits to the willingness and ability of investors to absorb such large sums of debt. Federal spending as a percentage of GDP will surge to around 25% this year, up from 20% in 2007. But longer term, outlays will rise as mandatory programs, now 8.5% of GDP and steadily increasing to 14.1% by 2030, take a larger share of our economic output. Revenues are expected to fall from 2007's 18.8% of GDP to around 16.5% this year and then normalize over time, but this normalization assumes that all the Bush Administration tax cuts are allowed to expire in 2010 and that the Alternative Minimum Tax (AMT) is no longer "patched" and thus sweeping in millions of taxpayers. The CBO's most recent analysis projects an additional $3.1 trillion in deficits over the next ten years. This projection contains many optimistic assumptions, such as the expiring tax cuts and the end of AMT relief, and thus likely understates what will actually occur. The Concord Coalition has done its own analysis based on the CBO's projects, forecasting an eye-popping $10.3 trillion increase in deficits over that period of time. This is on top of an already mountain of debt (i.e., $10 plus trillion) and enormous unfunded liabilities, which the Peterson Foundation estimates at $56 trillion. Moreover, reforming mandatory programs now, with most of the changes occurring in the out-years, would not negatively impact the near-term stimulus objective but would help bend the trend lines back towards a more sustainable pathway. Once Congress has finished its most pressing task of passing a stimulus package, it is imperative that we act swiftly and comprehensively to put our nation's financial future on a sound and sustainable basis or lest we may face other, more damaging crises in the future.

Conclusion

In sum, the global economy faces its greatest challenge in over a quarter-century, and possibly in the post-war World War II era. Policymakers need to move quickly and intelligently on a broad range of fronts. We need a substantial fiscal stimulus package to return growth to a positive and sustainable trajectory but we should spend wisely, remembering that once past this crisis we will need to significantly adjust our fiscal trends to a more sustainable basis. We need to stabilize the capital structure of the banking system by removing or ring-fencing bad assets and quickly outlining the contours and composition of a new regulatory structure. We need to support our multilateral institutions, especially the International Monetary Fund, in its efforts to promote macro-economic stability and assist those most vulnerable to an economic downturn. We need to find a new growth model that is not reliant on U.S. consumer-led, debt-financed consumption. Finally, we need to invest in the productive capacity of our country, especially in human capital, so that we can raise living standards and retain our position as an economic leader.