The Debt Outlook and Its Implications for Policy
Testimony of Richard Berner, Morgan Stanley
Senate Budget Committee
January 15, 2009

Chairman Conrad, Ranking Member Gregg, and other members of the Committee, my name is Richard Berner. I am Co-Head of Global Economics at Morgan Stanley in New York. Thank you for inviting me to this hearing to discuss the debt outlook and its implications for policy.

We are at a crossroads for America's economic challenges, both immediate and long term.

Our short-term challenge is to end the recession and promote recovery. All tools at our disposal will be needed. Among them:

- The traditional tools of fiscal stimulus and monetary policy to cushion the blow.
- More important, unconventional tools to clean up lenders' and household balance sheets and to help restore the functioning of financial markets.

Both of these are needed to end the credit crunch that is the root cause of this global downturn.

Our long-term challenges are to promote a sustainable fiscal policy and to reform our entitlement and other programs that represent long-term claims on our future resources.

There is clearly a tension between these short- and long-term challenges, and that conflict will play out in financial markets. Fiscal stimulus and other measures likely will require the Treasury to issue $4 trillion or more additional Federal debt. For now, investors are buying. The yields on nominal 10-year notes and 30-year bonds are at or close to record lows. Treasuries are safe, inflation is falling, private credit demand is weak, the Fed will keep short-term rates low and may buy longer-term Treasury debt until they are sure the economy is on firmer ground. Debt held by the public starts at a low level in relation to GDP — only 40.3% of GDP at the end of FY2008.

But this is changing quickly. The debt-GDP ratio will rise towards 60% by FY2013. Barring action to fix our entitlement programs, that ratio will jump over 100% by FY2022. History shows that such a jump in debt may boost debt service at the expense of other needs and with not much to show for it. Indeed the Japanese experience shows the danger of assuming that fiscal stimulus alone can solve a financial crisis. Until the Japanese authorities took the aggressive steps required to fix their crisis, their economy was mired in a lost decade. At the same time, one measure of our creditworthiness already shows some deterioration — US sovereign credit default swap (CDS) spreads have widened to about 60 bps (0.6%) from 10 bp last summer. So the message is that you ignore global investors at your peril.

Yet, I believe that using the right policies to end the crisis and addressing our long-term needs will be mutually supportive. Specifically, putting our economy back on track will give us the resources to provide for future needs. At the same time, crafting an exit strategy from short-term stimulus and a credible and specific roadmap for longer-term reform will yield near-term benefits. It will reassure investors that we're on the right track and free up private resources for long-term investment.

We all agree that to promote recovery, we must ensure we get the most bang for every buck we spend. I'll have some recommendations on how to do that.

And we all agree that a responsible fiscal policy requires fixing our entitlement programs. It also requires much more. I'll talk about key elements needed.

Putting the economy back on track

It's critical to diagnose how we got into recession. Losses at "leveraged lenders" — banks, nonbanks and other investors — have eroded their capital and promoted the deepest credit crunch in our lifetimes. Think of the S&L crisis — a crisis of solvency — ten times over. My colleague Betsy Graseck, Morgan Stanley's

large-cap bank analyst, estimates that "baseline" losses for the US financial system will eventually total $1.5 trillion and could easily run to $1.9 trillion. This loss of capital to support good and bad loans has forced lenders to shrink their balance sheets. The credit crunch has spread to the broader US economy and beyond our borders. The upshot will likely be the deepest recession in the postwar period.

History suggests that financial crises take time to fix, because they result in deep and prolonged declines in asset values, and thus deep recessions (see Carmen M Reinhart and Kenneth Rogoff, "The Aftermath of Financial Crises," January 3, 2009). Fed Chairman Bernanke this week said, "History demonstrates conclusively that a modern economy cannot grow if its financial system is not operating effectively." And as I read it, history also suggests that policies that go directly to the cause of the crisis are most effective.

As you debate the size and composition of a fiscal stimulus package, therefore, keep in mind that tax cuts and stepped-up infrastructure outlays, whatever their merits, don't get to the causes of this downturn. They mainly tackle its symptoms and can only cushion the blow.

In my view, two critical ingredients are still missing from the policy menu: Cleaning up lenders' balance sheets and mitigating mortgage foreclosures. Lenders will start lending again when they feel secure about their balance sheets. Balance sheet repair is necessary to attract private capital and end the credit crunch. Of course, we want a return of responsible, not reckless lending. Likewise, rising foreclosures worsen the imbalance between housing supply and demand. Mitigating foreclosures is necessary to stem the slide in home prices, slow credit losses, and reduce the pressure on household wealth.

The Fed, the FDIC and the Treasury have taken important first steps to attack the credit crunch but they are not enough. FDIC guarantees of lenders' debt stopped the run on the financial system that emerged with the shock from Lehman's bankruptcy. The Fed has also massively and "quantitatively," eased monetary policy, has deployed an array of financing facilities, and will soon implement another with great promise, the Term Asset-Backed Securities Loan Facility (TALF). Those steps have restored functionality to money markets that are critical for financing business and finance, though some are still on life support. The Fed's purchases of mortgages are lowering borrowing rates to historical lows, boosting housing affordability and enabling borrowers to refinance their mortgages. The next step must be an aggressive effort to fix balance sheets.

Good Bank/Bad Bank to clean up balance sheets

In my view, a "good bank/bad bank" solution is the most effective solution. The "bad bank" is an entity or fund set up to liquidate segregated bad assets; implementation requires a way to value the assets, capital (or a mechanism to absorb and share the losses), and funding. Investors will see in the "good bank" a new, cleaner balance sheet, which has two key benefits. Most important, clarity on asset quality is needed to attract private capital. A clear split between the good and bad assets will also enable the managers of the good and bad banks to focus exclusively on their respective businesses.

The TARP embraced those goals but foundered on how to value and purchase opaque assets. Pay too much and put taxpayers at risk; pay too little and lenders won't participate. That dilemma should not bar action. But such a plan may take time to implement, especially with fiscal stimulus plans demanding your immediate attention. In that context, a halfway house that could help clarify the nature of the policy commitment and of the assets themselves might be a step forward. It would involve financing or warehousing the troubled assets in a special purpose vehicle (SPV). This would go part of the way towards cleaning up balance sheets for both surviving and failing lenders.

Foreclosure Mitigation

Foreclosures are costly and disruptive, threaten home prices and market functioning, and thus weaken housing and the economy. But there are obstacles to improvement: Not all foreclosures can or should be prevented. Offering help to the 3 million borrowers who are in serious trouble will create moral hazard by attracting the 52 million who aren't. It is hard to segregate responsible borrowers and lenders from those who weren't. Poor underwriting has resulted in redefault rates of 50% or more for modified loans.

The best options for relief are simple, act quickly, and spread the pain broadly among borrowers, lenders, and taxpayers. Christopher Mayer and his collaborators at Columbia University propose a modern Homeowners' Loan Corporation that would share the cost of writedowns between lenders and taxpayers and give the latter a warrant on future home price appreciation; Mayer also proposes changes in securitization law and an industry fund to reimburse servicers for expenses. Fed Chairman Bernanke urges realistic principal writedowns with loss-sharing arrangements. The FDIC's foreclosure mitigation process seems a reasonable standard: Write down principal to achieve 38% debt-to-income; use TARP funds to guarantee refinanced loans; and use the IndyMac protocol to streamline the process.

This mix does not address all the obstacles, and will not assure success. But the alternatives are worse. The economic cost of further declines in home values would likely exceed the cost of mitigation. More ominously, letting foreclosures fester may erode the sanctity of the mortgage contract for an increasing number of borrowers, who will decide that making payments is optional. If many borrowers walk away from their houses and their obligations, losses to lenders will rise dramatically and the availability of credit will dry up.

Getting the Most Bang for the Buck

How should we think about getting the most bang for the buck from stimulus? First, policies that directly address the cause of the financial crisis are likely to be most effective in fixing it. Second, I favor providing insurance backstops and financing facilities, because they restore market functioning and enable policymakers to "leverage" the taxpayer monies they put at risk. Finally, for traditional tools such as tax cuts or increased spending, I favor policies that will offer the most direct stimulus.

No single policy will fix the crisis; I've described the necessary combination. It's worth emphasizing that balance sheet cleanup would vastly increase the potency of capital injections as a stimulant.

Regarding financing facilities and insurance backstops, note that some approaches are more potent than others. I favor the Fed's TALF structure; dollar for dollar, I believe that Treasury contributions to capital in such a structure are far more potent than asset purchases because every dollar from the taxpayer goes to support $10 of assets. In addition to the asset-backed securities (ABS) market, two other markets might be helped by such facilities — those for municipal bonds and commercial mortgage-backed securities.

Restoring two insurance backstops that have long facilitated the functioning of financial markets would be especially helpful today. Like lenders, mortgage insurers have good and bad books of business. Cleaning up the bad book and recapitalizing the insurers to get back to providing mortgage insurance would be a potent tonic for mortgage securitization. Likewise, cleaning up the insurers of municipal bonds — many of them the same entities that insure mortgages — would pay big dividends for that market, whose troubles have further impaired the ability of strapped state and local governments to obtain financing.

Last, traditional fiscal policy tools will be far more potent in the midst of a financial crisis if steps are taken to address the crisis itself. I favor two options: A payroll tax holiday or a sizeable cut in payroll taxes, and grants to state and local governments. For example, a six-month suspension of the payroll tax would inject $425 billion into the economy. It would provide a boost to discretionary spending for lower-income workers who have the highest propensity to spend. In addition, cutting payroll taxes would reduce the cost of labor for employers, which, in turn, should help to stem the pace of job loss and shore up profitability. Some view such cuts as a raid on Social Security, and others argue that their potency is small because half the cuts would accrue to businesses. On both counts, I disagree. Grants to state and local governments would forestall cuts in needed services, especially if they were aimed at boosting temporarily the share of Medicaid borne by the Federal government. There are obstacles: Such grants run the risk of rewarding less responsible governments at the expense of the prudent. And it is hard to assure that the monies freed up in state/local budgets would be spent effectively.

Principles for fiscal responsibility

Beyond embracing steps to reform health care and other long-term programs, I endorse fully several steps that will help us get back on the road to fiscal responsibility. By embracing them now, the inevitable sacrifices and tradeoffs among policies can be spread more broadly.

First, tell voters that we have a serious fiscal problem, and a limited time in which to fix it. Mr. Chairman, your recommendation with Senator Gregg for a bipartisan fiscal task force could be the platform for that process. Second, elevate the issue and make it tangible. Making sure we have resources for our children is concrete. Third, commit to realistic goals and a rough outline of the gameplan needed. Good policymaking involves setting priorities, evaluating options and making choices. Fourth, begin to reform the broken budget process. Work with the new Administration to break down compartmentalized decisionmaking that holds no one accountable. Fifth, be honest about the numbers. Sixth, reinstate the discipline of PAYGO. Seventh, be willing to put all options on the table. Finally, don't spend revenue windfalls or savings from budgeted programs.

Mr. Chairman and members of the Committee, we proved in the 1990s that these principles can turn the budget around. We can do it again. Otherwise, as in the 1980s and early 1990s, financial markets may again impose discipline on the political process and force you to make much harder choices than the ones you face today.