The Economic Outlook, Policies to Improve It, and Implications for the Budget Testimony of Richard Berner, Morgan Stanley Senate Budget Committee February 1, 2011

Chairman Conrad, Ranking Member Sessions, and other members of the Committee, my name is Richard Berner. I have until recently been Co-Head of Global Economics at Morgan Stanley in New York. Thank you for inviting me to this hearing to discuss the outlook for the US economy, to outline what policymakers can do to improve it, and briefly to discuss our budget challenges.

The Economy: Further Progress

In the six months since I last appeared before this Committee, the economy has improved. The financial crisis and the credit crunch that followed have receded further and most financial markets are functioning well. Aggressive and unconventional monetary policy and fiscal stimulus were instrumental.

Likewise, the deepest recession since the Great Depression is over, and while the recovery remains subpar, growth has improved. In the last quarter of 2010, the economy grew at a 3.2% annual rate. Gains in jobs and hours have been encouraging and appear poised to generate the household income and confidence needed to sustain recovery. Recent additional monetary and fiscal stimulus will promote faster growth this year.

But the legacy of the crisis endures and economic headwinds linger. One in four homeowners with a mortgage is still under water; lenders are still hesitant to lend to or refinance many borrowers. The process of cleaning up lenders' and household balance sheets is well advanced, but imbalances in housing mean home prices are still declining. State and local budgets are strained, limiting growth in their outlays.

The job deficit has left substantial slack in labor markets. Much faster job gains are needed to bring down the unemployment rate from 9.4% and to recover the remaining 7.3 million jobs lost in the recession. Other measures of slack, while narrowing, remain wide: Housing vacancy rates are high and industrial operating rates are still low. While the 'tail risk' of deflation is thus not zero, the Fed has greatly reduced it by boosting inflation expectations.

The Outlook: Still Moderate Growth

We expect the economy to grow by 4% excluding inflation over the four quarters of 2011 and 3.2% over 2012. Two policy-related factors assure at least moderate growth for now and raise the odds of a more bullish outcome this year and next: (a) the one-two punch from new fiscal stimulus and a Fed committed to achieve its dual mandate, and (b) a dramatic reduction in political uncertainty.

New stimulus impact. We estimate that the provisions of the Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010 will add about 1 percentage point to growth in 2011 relative to our earlier baseline, pushing it to 4% over the four quarters of this year. Three key temporary elements — a one-year payroll tax holiday for employees, a 13-month extension of emergency unemployment benefits, and full expensing of business investment outlays for 2011 — will boost growth in 2011 partly at the expense of 2012. We estimate that their expiration at the end of 2011 will net to an offsetting drag of about half a percentage point in 2012.¹

Exhibit 1 shows our estimates of the calendar year budget impact of all provisions based on JCT and CBO data.

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¹ See "Tax Deal Could Boost Growth to 4% Next Year," December 7, 2010.

Exhibit 1

Tax Relief, Unemployment Insurance Reauthorization and Job Creation Act of 2010

			Included in
			our Dec. 3
(effects on revenue, billions, calendar years)	2011	2012	baseline
Extend expiring tax cuts	-136	-178	
for those with incomes below \$250K	-95	-120	yes
for those with incomes above \$250K	-41	-58	no
Extend other expiring provisions	-187	-160	most
Extend unemployment benefits	-56	0	half
New initiatives	-184	-99	
2% payroll tax cut for employees	-114	0	no
Business expensing	-70	-99	50%
Total	-563	-437	

Note: Other expiring provisions include two-year extensions of the estate tax under the Kyl-Lincoln proposal (\$5 million exemption and 35% rate), marriage penalty relief, current law for capital gains and dividend taxes, an increase in the AMT exemption amount, the combined interaction from extending EGTRRA and AMT provisions, and other expiring credits and provisions.

Source: Joint Committee on Taxation, Congressional Budget Office, Morgan Stanley Research

This plan should have more bang for the buck than ARRA. The fiscal stimulus enacted in the American Recovery and Reinvestment Act (ARRA) of February 2009 (Pub.L. 111-5) did not seem to add much oomph to the economy relative to its size; why should this smaller one produce more results? In our view, there are two reasons. First, the nature of the stimulus matters: Most of the new stimulus (about 0.7 percentage point) results from the new payroll tax holiday for employees. Such cuts accrue mostly to lower-income, budget-constrained taxpayers and show up quickly in spendable income, so they are more likely to be spent. In contrast, the Making Work Pay tax credit that was a key part of ARRA was disbursed slowly, and some empirical work suggests that taxpayers spent only about 13% of the increment to income from that credit. In contrast, consumers spent about 1/3 of the one-time tax rebates incorporated in the 2008 stimulus package.² In addition, the MWP credit at \$60 billion was smaller than the payroll tax holiday. Likewise, while grants to states and healthcare insurance premium (COBRA) assistance provided a helpful buffer for governments and individuals, they tended to be saved rather than spent. Finally, outlays for infrastructure projects featured in ARRA took as much as a year to show up in spending.³

A second reason that the current stimulus is likely to be more potent is that the deleveraging process for households and lenders is far more advanced today than in 2009.⁴ Back then, liquidity-strapped consumers,

The total shown here over CY2011-12 exceeds the JCT/CBO estimates of the 10-year, \$858 billion cost because it excludes the recapture of business expensing in the outyears.

² In a recent paper, Sahm et al. noted that, "based on responses from a representative sample of households in the Thomson Reuters/University of Michigan Surveys of Consumers, the paper finds that the reduction in withholding led to a substantially lower rate of spending than the one-time payments. Specifically, 25 percent of households reported that the one-time economic stimulus payment in 2008 led them to mostly increase their spending while only 13 percent reported that the extra pay from the lower withholding in 2009 led them to mostly increase their spending." See Claudia R. Sahm, Matthew D. Shapiro and Joel B. Slemrod, "Check In The Mail Or More In The Paycheck: Does The Effectiveness Of Fiscal Stimulus Depend On How It Is Delivered?" NBER Working Paper No. 16246, July 2010. For an analysis of the 2008 rebates' impact on spending, see Matthew D. Shapiro and Joel B. Slemrod, "Did the 2008 Tax Rebates Stimulate Spending?" <u>American Economic Review</u>, May 2009, 99(2): 374–79.

³ Indeed, CBO's analysis suggests that refundable tax credits, grants to states, and infrastructure outlays likely would have a "substantial proportion of their impact" appear with a one-year lag; see Congressional Budget Office, "Policies for Increasing Economic Growth and Employment in 2010 and 2011," January 2010.

⁴ See, for example, "Deleveraging the American Consumer: Faster than Expected," August 20, 2010.

suddenly denied access to borrowing in the credit crunch, were then more likely to save their tax credits and other forms of stimulus or use them to pay down debt.⁵

Four other factors already are promoting sustainable growth. First, balance-sheet healing is more advanced and, courtesy in part of the Fed's new asset-purchase program, financial conditions are gradually becoming easier. Debt-to-income and debt-service-to-income ratios continued to decline in Q3. The Fed's Senior Loan office Survey indicated that banks' willingness to lend to consumers continued to improve and that they eased lending standards for consumer loans. The glaring exception, of course, is that mortgage credit is still tight.

Second, the cyclical dynamics of recovery are finally promoting the handoff from rising output to increased hours, employment and income. While December's employment report was disappointingly weak, inclement weather likely depressed the job tally. A broader perspective shows that rising hours have supported moderate gains in wage and salary income, and the improvement in a variety of labor market indicators — declines in jobless claims, rising job openings, surveys of hiring plans, and incoming data on withheld taxes — point to renewed job gains. Third, stronger global growth finally seems to be boosting US output. Finally, pent-up demand for capital spending is healthy.

A Two-Tier Economy. These developments have created a "two-tier" economy: Strong leadership from exports and capital spending are the bright spots. The drag from weak housing activity/home prices and from cuts in state and local government budgets are headwinds that may take one percentage point or more from growth this year.

The upper tier is strong... Reflecting the strength of global growth, net exports seem likely to provide a major boost as the import surge reverses and import growth is subdued. In addition, pent-up demand for capital spending is healthy; in the recession, capex slipped well below depreciation expense. Together with the acceleration we expect in economic activity and the business expensing provisions of the new tax deal, that pent-up demand should spur hearty gains in capex in the coming year. And we think improving fundamentals will boost capex outlays in 2012 despite the inevitable "payback" in outlays after the tax expensing provision expires.

...While the lower tier is still fraught. In contrast, housing imbalances remain the most significant single downside risk; we expect a 6-11% decline in home prices this year, which will limit the supply of mortgage credit, restrain consumer net worth, and thus cap growth in consumer spending. In turn, limits on the supply of mortgage credit are a key hurdle for housing demand and any significant recovery in activity. Second, state and local government finances remain weak; faced with additional shortfalls, officials are likely to cut spending and employment somewhat further, especially as federal grants fade. In particular, some \$26 billion in assistance for Medicaid will disappear in July. The good news is that revenues are starting to improve, which should somewhat mitigate that risk.

Inflation inflection point. Low inflation has promoted an ultra-accommodative monetary policy and low, long-term yields, which in turn has helped to hold down Federal interest costs. We believe that is about to change. In our view, inflation is bottoming and will gradually move higher. We don't think inflation will rise back to the Fed's "mandate-consistent" rate of 2% or just below until 2012. But a rise in core inflation back above 1% in the next several months is highly likely, and that inflection point will kick off the inflation debate in earnest. A tug of war is under way: Significant slack in markets for goods and services, housing and labor will depress inflation. But stable-to-higher inflation expectations will push it higher. While operating rates are low and the jobless rate is high, changes in those gaps — so-called "speed effects" — are promoting an inflation inflection point. That is especially the case for rents, which are a major inflation component and which are already moving higher.

In addition, several global factors seem likely to contribute to US inflation over the next few months. Strong global demand and limits on supply are boosting energy and food quotes. Recent developments in

⁵ See, for example, "Policy Traction: The Key to Recovery," February 17, 2009.

⁶ See "Trade Tailwinds: Coming Strongly in Q4," November 5, 2010.

the Middle East point to the potential for energy supply disruptions, which could boost inflation and depress growth. Finally, many prices for imported goods are beginning to turn up again, despite the recent stability in the dollar. We believe that sellers typically pass some of these price hikes through to core prices with roughly a 2-4 month lag, and these price hikes may also contribute to US inflation by reviving inflation expectations.

Six risks to the outlook. Risks still lurk for the economy, and we've tried to capture six in our baseline outlook.

As I mentioned, two of these risks are domestic: More intense declines in home prices or larger state and local government spending cuts could pose a more significant threat to the outlook than we expect.

Four of the risks represent intensification of global challenges that are also in our baseline global view: more spillover from Europe's sovereign crisis; more intense Chinese monetary tightening; a surge in crude quotes to \$120 or more; and politics interfering with appropriate policy responses.

That last risk has a new, important domestic dimension: The looming battle over budget priorities here seems likely to crystallize in a showdown over increasing the Federal debt ceiling, which could prove disruptive to financial markets.⁷

Policies to Improve the Outlook

While the outlook is gradually improving, the risks to the economy mean it is hardly time for complacency. Congress might consider other policies to improve the outlook for housing and employment, and thus the overall economy. Two years ago I testified before this Committee⁸ and argued that:

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). 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.

Both are still true. So while the recent fiscal stimulus package will boost growth in the short run, it won't put our economy on a strong, sustainable path. Absent policies that go directly to the cause of our problems, over time such stimulus will likely boost deficits and debt, netting to a negative for the economy.

Policies to Improve Housing

First, we must address the legacy of the financial crisis for housing lenders and mortgage borrowers. Housing and mortgage markets remain dysfunctional, making any recovery in housing a remote prospect. While the proportion of delinquent loans declined from 10.6% early this year to 9.4% in December, our housing research team estimates that loans in foreclosure continue to rise well past 5%, bringing non-current loans to a new record high of more than 15%.

⁷ See David Greenlaw, "The Looming Debt-Ceiling Showdown," January 6, 2011. On January 27, Treasury announced that it will begin paying down T-bills issued under the Supplementary Financing Program. The \$200 billion in outstanding SFP bills on the Fed's balance sheet count against the debt ceiling. The additional borrowing room provided by the \$195 billion SFP bill paydown will postpone the constraint from March until mid-May. Accounting moves involving nonmarketable debt in government trust funds could allow another \$250 billion in borrowing, extending the debt ceiling constraint until mid-July.

⁸ "The Debt Outlook and Its Implications for Policy," January 15, 2009.

⁹ Fourteen months ago we expected only a modest recovery in housing; we were too optimistic. See "Assessing Housing Risks," November 30, 2009.

Housing imbalances and tight credit are locked in a vicious circle with housing activity and home prices, despite a record plunge in housing activity and thus supply, record declines in home prices, and plunging mortgage rates. Two metrics of imbalances throw the circle into sharp relief: the 8 million unit shadow inventory of yet-to-be-liquidated homes and the one-in-four borrowers in negative equity. ¹⁰ Absent forceful policy action, the supply-demand imbalance won't correct itself for years. Consequently, home prices, which have started to decline again, are likely to fall as much as 11% before bottoming in 2012. ¹¹

The best options for relief are simple, act quickly, and spread the pain broadly among borrowers, lenders, and taxpayers. ¹² Several Federal programs are in place ¹³, but this suite of options has failed to prevent a further deterioration in mortgage and housing markets, as the November HAMP servicer report on loan modifications makes clear: For example, of the ~1.4 million borrowers who have entered trial modifications, over 54% have redefaulted. ¹⁴ In our view, lacking aggressive policy intervention to stop the downward spiral, that deterioration will continue.

Two groups of remedies. Remedies fall into two groups: (1) mortgage modifications or refinancings that reduce monthly payments and (2) writedowns or forgiveness of principal. The latter are far more likely to succeed; only when some cushion of owner's equity returns and there is less risk of declining home prices will lenders be willing to offer credit more broadly, allowing housing and housing finance to begin real recovery.

Option #1: Modifications and Refis. Loan modification or refinancing programs like HAMP can be helpful, but have not put housing finance on track for sustainable improvement. Unfortunately, they do not address the fundamental supply-demand imbalances in housing, and they are not widely available. Beyond the factors restricting the supply of credit noted above, second liens complicate modification programs because borrowers must meet certain criteria to be eligible for modification.

Option #2: Write down principal. Writedowns or forgiveness of principal are the real solution to housing woes. Policy options to reduce principal take two forms: those encouraging principal writedowns to avoid default, including so-called strategic defaults, and those encouraging short sales, which allow underwater borrowers to sell their house at market value without writing a check to the current lender. Such programs exist, and some lenders have offered them to borrowers in lieu of foreclosure, but restricted eligibility has limited their success.

Adding incentives for both borrower and lender could make such programs much more attractive. The best approach gives incentives to both. For example, in March 2010, Treasury proposed the idea of "earned principal forgiveness," where FHA refinancing would be available to underwater but performing borrowers if the lender agrees initially to forbear principal and thus modify payments, and to forgive a portion of the forborne principal at the end of each year the borrower is current on the modified payments. Such a plan gives the borrower both payment relief and an incentive to stay current, with an option on future home equity, and it gives the lender a performing asset — one with a lower coupon but also with a lower

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¹⁰ It's worth noting that the shadow inventory includes homes that are vacant or rented; at the time of foreclosure, J.P. Morgan notes that in their experience, about 35-40% of homes were vacant and roughly 45% were non-owner occupied. See presentation at the Bancanalysts Association of Boston Conference, November 4, 2010. See also Oliver Chang, Vishwanath Tirupattur, and James Egan, "Housing Market Insights: In the Shadows," January 28, 2011.

¹¹ See Oliver Chang, Vishwanath Tirupattur, and James Egan, "Housing Market Insights: Now What?" September 30, 2010.

¹² See "Fixing Housing: Policy Options," November 19, 2010.

¹³ The Home Affordable Modification Program (HAMP) provides eligible homeowners the opportunity to modify their mortgages; the Home Affordable Refinance Program (HARP) gives borrowers with GSE-guaranteed loans an opportunity to refinance; the Second Lien Modification Program (2MP) offers homeowners a way to modify their second mortgages when their first mortgage is modified under HAMP; and the Home Affordable Foreclosure Alternatives Program (HAFA) provides alternatives to foreclosure: a short sale or deed-in-lieu of foreclosure. See http://makinghomeaffordable.gov/

¹⁴ Making Home Affordable Program, *Servicer Performance Report Through November 2010*, US Department of the Treasury, December 22, 2010.

probability of default. Unlike the FHA program, HAMP 2.0 has focused on principal forgiveness for already-delinquent borrowers. ¹⁵

Streamlining short-sale programs would also help the writedown process for those borrowers who would otherwise go through foreclosure. Specifically, an expansion of the Home Affordable Foreclosure Alternatives Program (HAFA) beyond its current limitations could help clear the market of such liquidations with minimal damage. ¹⁶

First repair, then reform. Fixing housing and housing finance requires a new regulatory architecture that will balance efficient intermediation between borrowers and lenders and a stable financial system. Key questions involve the appropriate role of government in housing finance, and how to reform the GSEs. In addition, significant attention must be devoted to appropriate rules under the just-passed financial reform legislation. For example, to improve future underwriting, the Dodd-Frank Act requires that securitizers in the future retain 5% of the credit risk in assets they originate and transfer through issuance of an asset-backed security, with exceptions for certain "qualified residential mortgages" and CMBS. Exactly what qualifies has yet to be determined.

The problem with this debate, while needed, is that it overlooks the pressing need to fix past problems. In fact, I think these debates create uncertainty for lenders and investors who are still struggling with the legacy of past loans gone bad. This underscores how critical is the sequencing of policy options: The first priority should be to focus on repair, to reduce housing imbalances and restore market functioning. Only then can policymakers implement reform of mortgage finance — including rules governing underwriting, securitization, loss taking, and the housing GSEs — critical to assure longer-term financial and economic stability.

When I appeared here two years ago, I noted that

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.

That is still true today.

Policies to Improve Employment

America still has a daunting job deficit, and diagnosing the causes is critical before recommending remedies. Clearly, much of that weakness is cyclical, reflecting the sub-par economic rebound, but four structural culprits are also at work: labor immobility resulting from negative equity in housing; mismatches between skills needed and those available; rising benefit costs; and uncertainty around policies in Washington. Compared with last summer, I am more optimistic about future job growth, partly because of new stimulus and partly because the Administration has moved more broadly and decisively to address the economy, thus reducing policy uncertainty.

¹⁵ The jury is still out on both the FHA program and HAMP 2.0; each has been operational for only about three months. But two hurdles currently stymie broader participation in the FHA program —dealing with second liens and adding servicer incentives. Currently, there are no servicer incentives for the FHA program, and short refinancing will deprive servicers of fee income on performing loans. Without servicer incentives (\$2,000-3,000 per loan would probably suffice), this program won't likely take off.

¹⁶ To be eligible for HAFA, borrowers must have a verifiable financial hardship and either fail to qualify for a modification or else redefault. Servicers must consider every HAMP-eligible borrower for HAFA before the homeowner's loan is referred to foreclosure. But the requirement that borrowers must be HAMP-eligible to qualify for HAFA excludes many of the borrowers the program is designed to help. And the process is slow; some triage of the borrower pool could expedite the process for those cases with little chance of successful modification.

However, more is needed. If we can fix our housing mess, labor mobility will improve. Homeowners trapped in their houses can't move to take another job — until they sell or walk away. Owners suffering from negative equity are one-third less mobile according to one study. The wave of "strategic defaults" and foreclosures is undermining the economic and social fabric of communities and reducing job opportunities.

Worker skills have greatly lagged technical change and tectonic shifts in the structure of our economy, so some jobs go begging. Jobless spells degrade worker skills just when workers need re-training. One short-term remedy would pair training in basic skills that are needed for work with income support. A Job Training Corps, like Teach for America, could build a pool of training advocates who then go on to work in other occupations with the perspective and conviction that come from helping others to acquire needed skills. ¹⁸

The Economy and the Budget

The economic outlook has clear cyclical implications for the budget. Conversely, the policy choices we make to address our structural budget problems will have a profound effect on our long-term prospects for growth and prosperity. I'd like to conclude with some remarks on both the cyclical and structural outlooks for the economy and the budget.

Cyclical outlook. A healthier economy would improve the *cyclical* budget outlook in several ways. Stronger growth would directly boost receipts and rein in outlays for automatic stabilizers such as UI benefits and Medicaid outlays as well as discretionary transfers such as FMAP assistance to state governments. More indirectly, high "bang for the buck" policies to fix our cyclical problems in housing and employment could provide a sustainable boost to the economy and thus narrow the budget gap. Moreover, curing those problems would allow us to unwind the traditional, discretionary fiscal stimulus now in place, further reducing deficits and the growth in debt.

Structural challenges. We all agree that addressing *structural* budget challenges by reducing entitlement outlays will trim long-term deficits and debt, and will thus free up resources and capital for productive investment. Three entitlement programs — Medicare, Medicaid and Social Security — will account for half of Federal outlays by 2020. In the long run, the structural budget deficit is almost entirely about Federal healthcare spending — directly through Medicare and Medicaid, and indirectly through the tax treatment of employer-provided healthcare benefits.

In addition, addressing our healthcare challenges — especially the cost side of the equation — would have important implications for employment and for state and local budgets, as well as for the Federal budget.

High and rising healthcare benefits provided through the workplace drive up labor costs, reduce employment and hurt growth. Importantly, the cost of employee health benefits is "fixed" because benefit costs don't vary with hours worked; they are paid on a per-worker basis. In my view, the high and fixed cost of those benefits helps explain why American employers cut payrolls relative to GDP more aggressively in the recession than did their counterparts elsewhere.¹⁹

What's more, the plunge in employment pressured state budgets, as many workers who lost their healthcare benefits when they were laid off became eligible for Medicaid. FMAP assistance as part of ARRA filled in the states' budget holes but added significantly to Federal red ink. The upshot: High fixed costs of

¹⁷ See Fernando Ferreira, Joseph Gyourko, and Joseph Tracy "Housing Busts and Household Mobility," forthcoming in the *Journal of Urban Economics*.

¹⁸ http://www.teachforamerica.org/mission/mission_and_approach.htm

¹⁹ See Sarah Reber and Laura Tyson, "Rising Health Insurance Costs Slow Job Growth and Reduce Wages and Job Quality," Working paper, University of California at Los Angeles, August 2004; Katherine Baicker and Amitabh Chandra, "The Labor-Market Effects of Rising Health Insurance Premiums," NBER Working Paper 11160, February 2005; and Richard B. Freeman and William M. Rodgers III, "The Weak Jobs Recovery: Whatever Happened To The Great American Jobs Machine?" November 2004, Revised January 2005.

healthcare benefits have enlarged both our employment deficit and our budget deficits at all levels of government.

Taking steps to reduce healthcare costs is the next logical step in healthcare reform. The Affordable Care Act includes a series of reforms aimed at cost savings for Medicare, but more work is needed to reduce the soaring costs of healthcare for employers and employees alike. In my view, changing the tax treatment of healthcare benefits would be a good place to start.

The cost of uncertainty. The debates around how to solve America's long-term challenges have only begun. In the heat of those debates, it's important to remember that uncertainty around the costs of coming policy changes, and the uncertain magnitude of prospective tax hikes that will be required to address our fiscal problems, may be weighing on business and consumer decisions to hire, to expand, to buy homes and to spend.²⁰ In effect, uncertainty raises the threshold that must be cleared to make a business choice worthwhile, and as uncertainty declines, the threshold falls with it.

There is an important lesson here for today's policy debates. Long-term solutions involve bipartisan leadership to tackle these complex challenges in steps that are fair and call for shared sacrifice and benefits. That means setting priorities, making hard choices, communicating the game plan, and getting buy-in for it in advance. Proposals to freeze or to cut nondefense discretionary outlays do not address our long-term budget challenges. In contrast, the Bowles-Simpson Commission's report offers sound principles and a balanced menu for action.²¹ I know you agree that crafting a long-term credible plan to restore fiscal sustainability will ease concerns and uncertainty about future tax hikes and the potential loss of our safety nets.

Mr. Chairman and members of the Committee, we have many challenges ahead. Our short-term challenge is to enhance the odds for a more vigorous, sustainable recovery. 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. I thank you for your kind attention today and for the opportunity to offer advice. I would be happy to answer any questions you may have.

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Recent work confirms this intuition, underlining how uncertainty produces negative growth shocks. Nicholas Bloom shows how a rise in uncertainty makes it optimal for firms and consumers to hesitate, which results in a decline in spending, hiring and activity. In effect, the rise in uncertainty increases the option value of waiting as volatility rises. See "Policy Uncertainty Redux," June 25, 2010 and Nicholas Bloom," The Impact of Uncertainty Shocks,"

Econometrica, vol. 77(3), pages 623-685, 05, May 2009

²¹ The Moment of Truth: Report of the National Commission on Fiscal Responsibility and Reform, December 1, 2010.