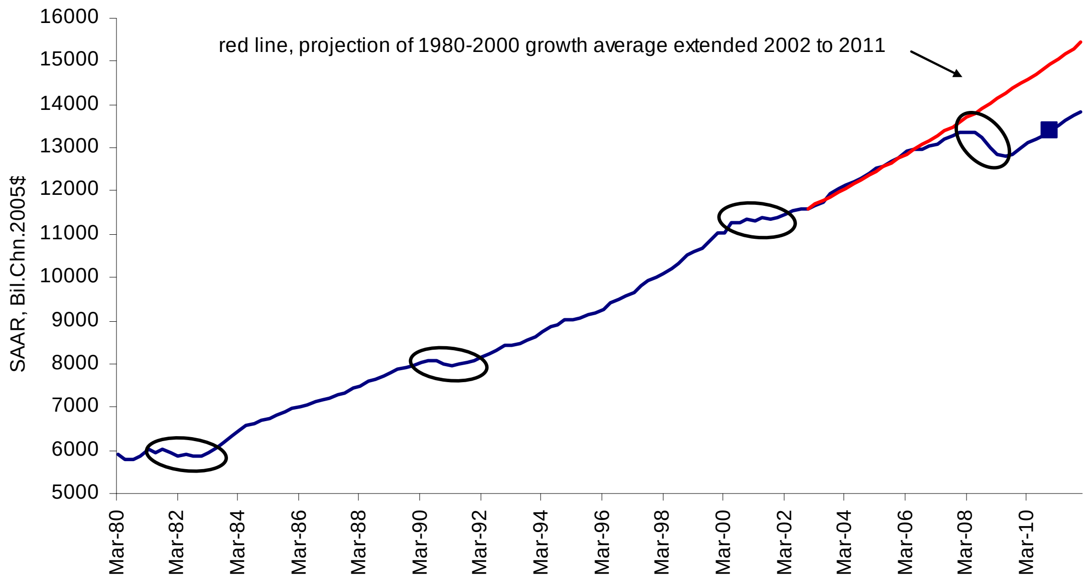
Statement of
David R. Malpass before the
Senate Budget Committee
February 1, 2011

Chairman Conrad, Senator Sessions, members of the Committee, thank you for the invitation to testify on the economic and fiscal outlook. We have a full-blown fiscal crisis underway which requires an upheaval in our federal spending and budgeting culture. My testimony is in four sections covering the economic outlook, the fiscal outlook, the risk of hitting a tipping point where debt gets so large that investors step away, and some policy suggestions.

Before turning to the economy, I'd like to give a little of my background. I'm President of Encima Global, an economic research firm, and was Chief Economist at Bear, Stearns, where I worked 15 years. I served at Treasury and State in the Reagan and Bush-41 Administrations and was previously the tax analyst on this Committee during the 1986 tax rate cut. I'm also Chairman of GrowPac.com, an organization which supports smaller government. I ran in the New York Republican primary for U.S. Senate in 2010 and can attest to the loud demand for federal spending restraint coming from many voters. I live in New York with my wife Adele who was also on the staff of this Committee.

Real GDP Growing From a Low Base (last obs. Q4 2010, proj to Q4 '11)



Source: Bureau of Economic Analysis; Encima Global

In summary:

- The economic outlook is for moderate U.S. growth after the deep 2008 collapse, weighed down by the increasing reliance on the government for the allocation of capital and credit as its debt expands.

- The current fiscal trend is for continued mega-deficits and a marketable debt-to-GDP ratio reaching 100%, well above sustainable levels. The statutory debt limit, now $14.3 trillion, is headed toward a staggering $31 trillion in the latest CBO outlook.

- My testimony addresses the risk of a catastrophic tipping point due to our enormous federal debt and the growth in spending. Adding to the risk, the maturity of the national debt is dangerously short, made worse by the Federal Reserve's buyback of long-maturity debt.

At the end of the testimony, I give some policy views.

- The expiration of the continuing resolution on March 4 should be used as an opportunity to make numerous spending cuts now -- to put Washington on a diet where it shrinks day by day. Waiting for a deficit reduction package ducks responsibility and is a recipe for continued out-of-control deficit spending.

- The debt limit increase should be used to install a lasting limitation on the U.S. marketable debt-to-GDP ratio, enforced by escalating penalties on Washington. There should also be a minimum maturity for the debt to stop the government from artificially lowering near-term interest costs.

- By buying long-term assets, the Federal Reserve is conducting fiscal policy. QE2 should be wound down. It is shortening the effective maturity of the national debt and is causing substantial market distortions.

- Tax reform is a high priority. I favor including permanent extensions of current tax rates in the baseline to facilitate growth-oriented tax reform and modifying scoring rules to stop the practice of temporary tax rates.

- I believe these policy approaches would give new confidence to American businesses and financial markets, causing an inflow of capital and jobs to the U.S. private sector.

Economic Outlook

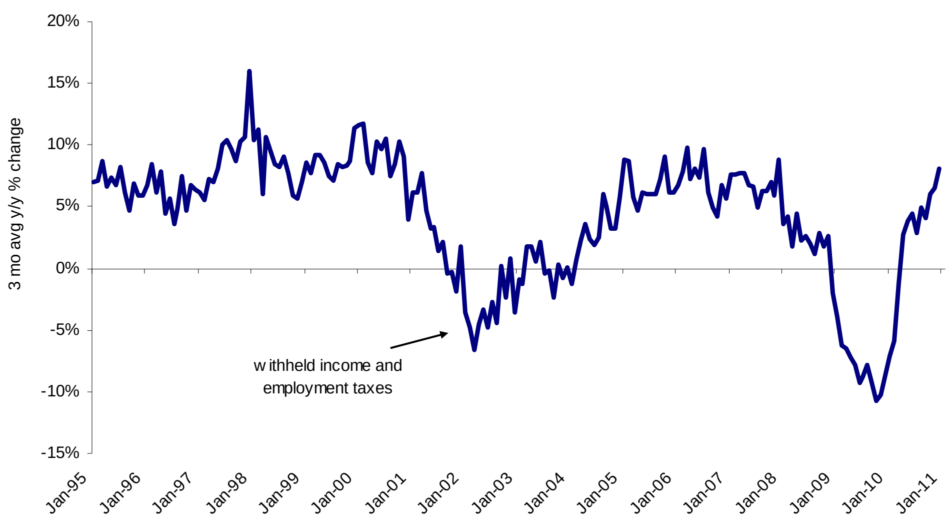
I expect moderate U.S. growth in 2011, perhaps 3.5% in real terms, up from 2.8% in 2010. The improvement is welcome, but it is still a weak expansion by historical standards. Growth is being held back by structural problems like the tax code, labor barriers and sweeping regulatory expansion; the growth of federal spending and debt, which cancels private sector investment; and the many debt and credit problems left over from the 2008-2009 recession.

- In 2010, GDP growth increased to 3.2% in the fourth quarter from 2.6% in the third and 1.7% in the second. I think much of the fourth quarter improvement was a rebound from the double dip sentiment during the mid-2010 soft patch rather than a structural acceleration.

- Strong consumption that coincides with record transfer payments and fiscal deficits is not a sustainable basis for future growth – there has to be increasing private sector investment, production and labor income. This will require a major change in core economic policies.

- Treasury's data on withholding taxes is showing a strong 8% gain in the fourth quarter of 2010 from the fourth quarter of 2009…

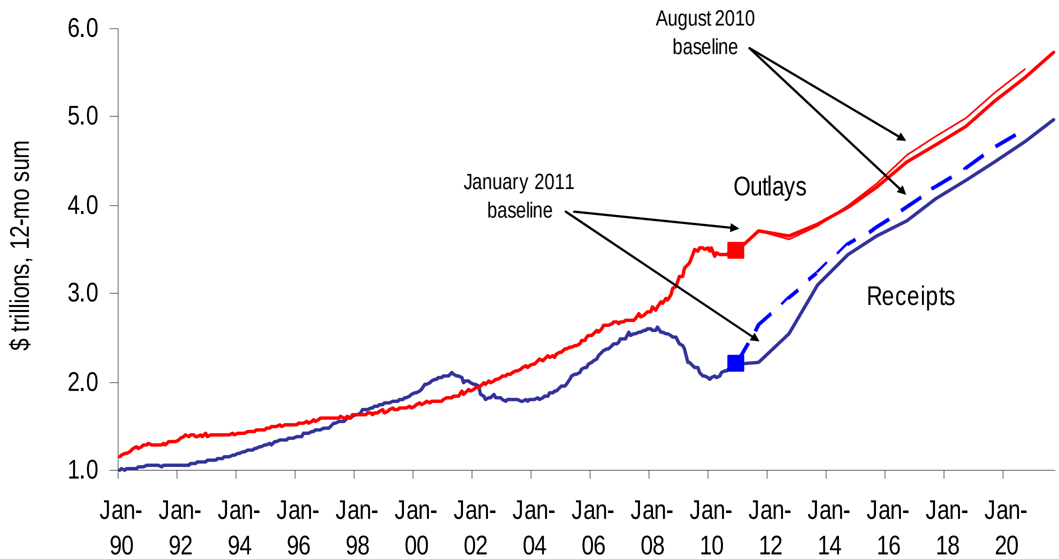
Federal Withheld Income and Employment Taxes
(year-over-year, last obs. December 2010)



Source: U.S. Treasury; Encima Global

- … but not enough recovery to materially reduce the fiscal deficit expectations.

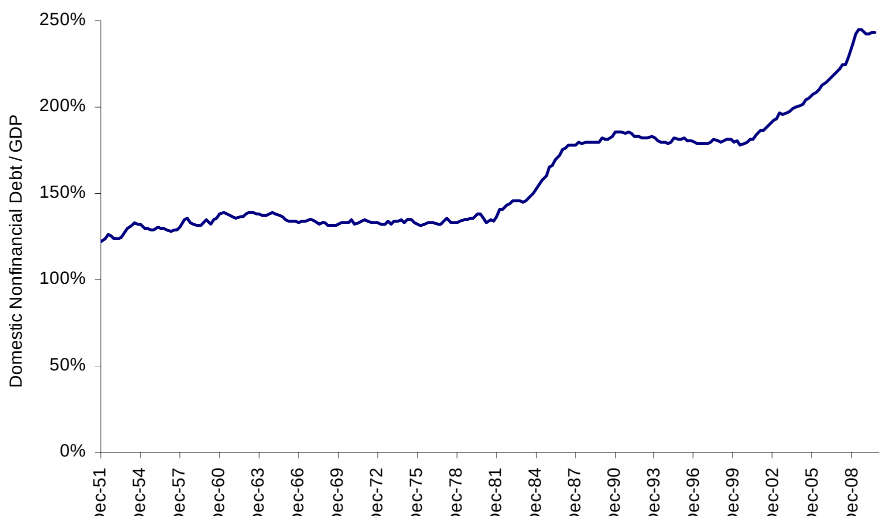
Federal Receipts and Outlays
($ trillions, last obs. December 2010, CBO projected to 2021)



Source: CBO; US Treasury; Encima Global

- **Despite private sector deleveraging, overall U.S. debt levels are near their peak due to the burst in federal debt.** At $35.8 trillion, total U.S. nonfinancial debt stands at **243% of GDP** in the Federal Reserve's most recent flow of funds data.

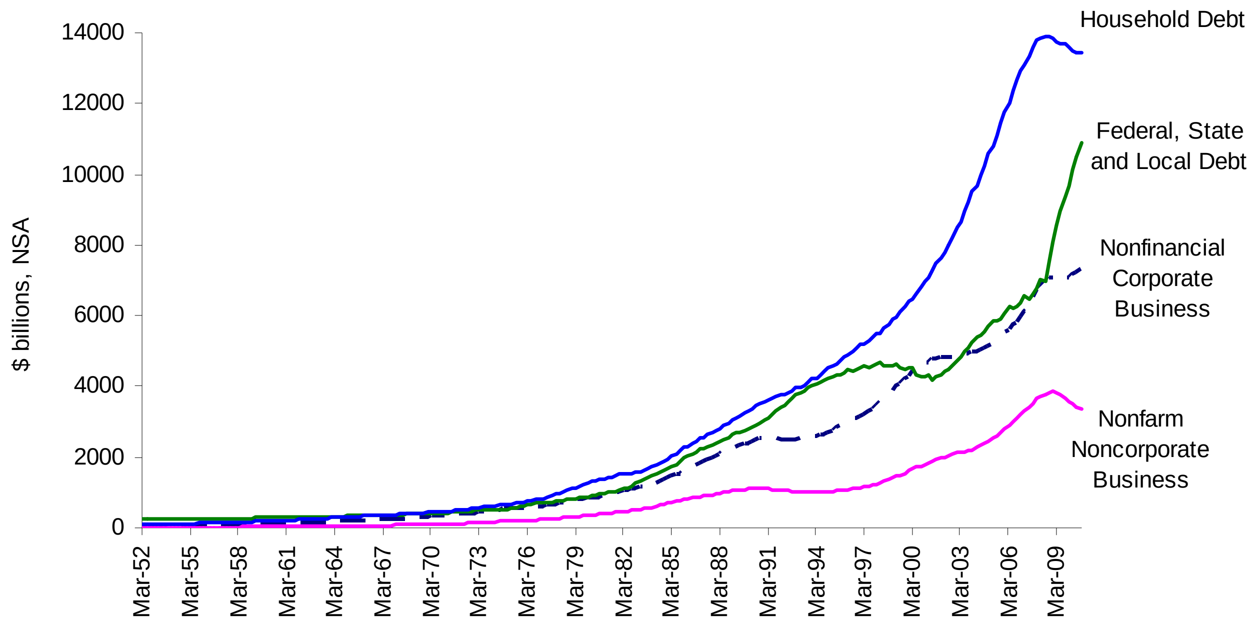
Total U.S. Debt per GDP (includes household, gov't and non-financial corporate debt, last obs. Q3 2010)



Source: Federal Reserve; Encima Global

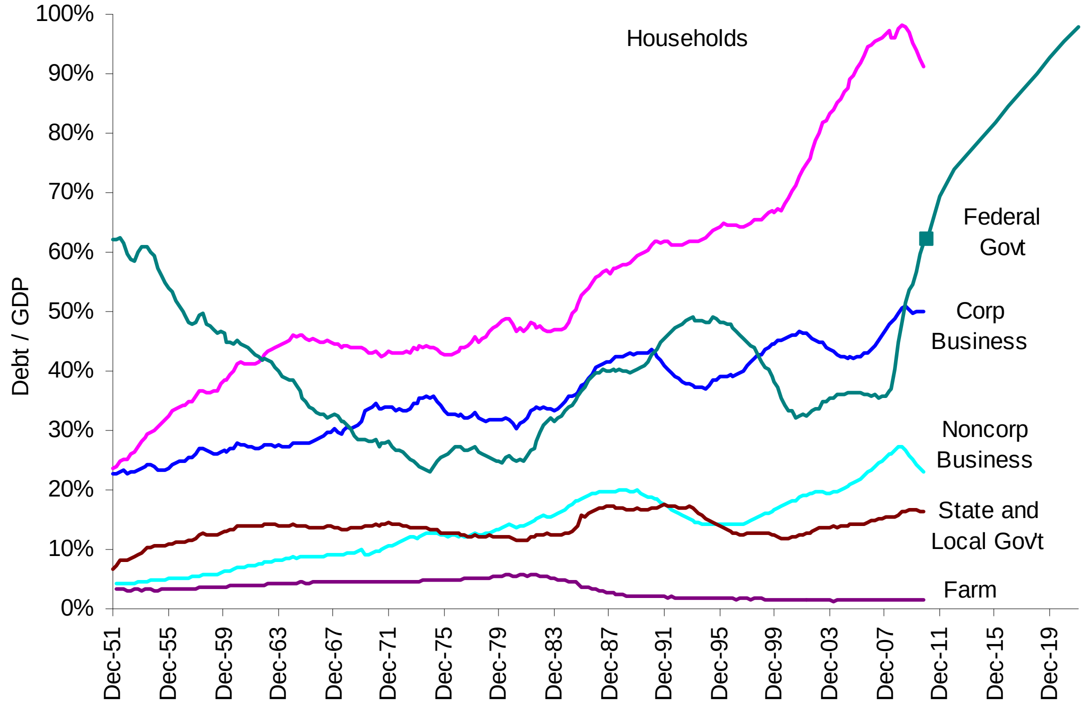
- Debt has been growing for the federal government and corporations.

U.S. Debt in $Billions By Category (last obs. Q3 2010)



Source: Federal Reserve; Encima Global

U.S. Debt per GDP (CBO-based projection of fed debt through 2021)

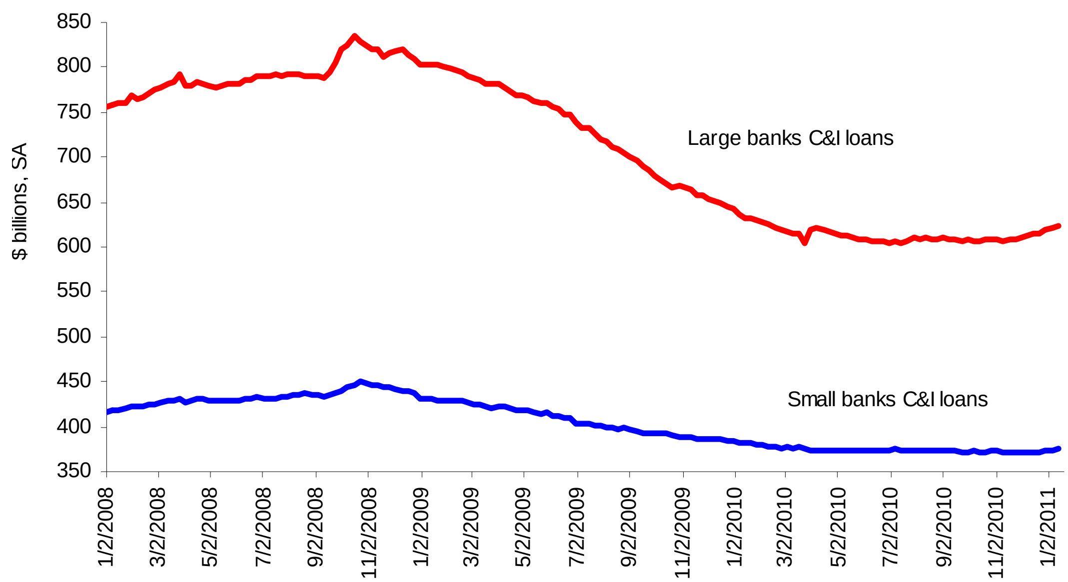


Source: Federal Reserve; CBO; BEA: Encima Global

- Through the third quarter of 2010, households and small businesses saw their debt shrink. In contrast, **federal debt has jumped to over 60% of GDP (the square on the graph above), and the latest CBO assessment shows debt rising to 100% of GDP assuming current tax rates are extended.**

- **In recent months, small businesses have been getting some oxygen** -- large banks are lending more -- but many debtors are still underwater including homeowners, small and medium sized businesses, states and municipalities. Unless growth speeds up markedly, many will be unable to maintain debt service. It will take more time in 2011 and 2012 to see how far these debt problems really extend and how severe their drag on growth.

Bank Lending Through Commercial and Industrial Loans
($ billions, last obs. January 12, 2011)



Source: Federal Reserve; Encima Global

- The **housing situation**, foreclosures and mortgages remain in bad condition, which reduces labor mobility. Some parts of the country will improve in 2011, but mortgage rates are rising and there are still severe conflicts between property owners, first and second mortgage holders and the legal system.

- Excess debt and over-spending at the **state and municipal level** will pit pensioners and current government services against lenders. This will take a long time to resolve.

- **Overall U.S. debt is $35.8 trillion**. Of that, the marketable debt of the federal government is $9 trillion. It grows with the fiscal deficit. In addition, the federal government also owes trust fund accounts $4.6 trillion. The Federal Reserve's holdings of Treasury debt were over $1 trillion in December and are expected to rise by $110 billion per month through June. Though the Fed will likely own bonds for years, the debt is still considered 'marketable' and part of the "debt held by the public."

$35.8 Trillion in Credit Market Debt Outstanding (last obs. Q3 2010)

	2010 Q3 ($ trill)	2010 Q2 ($ trill)	Yr/Yr % chg 2010 Q3	Yr/Yr % chg 2009 Q3	Yr/Yr % chg 2008 Q3
Domestic Nonfinancial Sectors	$ 35.8	$ 35.3	3.7%	4.3%	6.5%
Households	$ 13.4	$ 13.5	-1.8%	-1.7%	2.2%
Corporate Business	$ 7.3	$ 7.2	3.4%	0.3%	8.3%
Noncorporate Business	$ 3.4	$ 3.4	-7.5%	-4.8%	8.7%
Farm Business	$ 0.2	$ 0.2	0.3%	0.6%	2.2%
State & Local Govts	$ 2.4	$ 2.4	3.3%	3.7%	4.4%
Federal Government	$ 9.0	$ 8.6	19.5%	30.1%	15.3%
of which Fed Holds	$ 0.8	$ 0.8	5.5%	61.4%	-38.9%
as of Q4 $1.01 trillion					
memo:					
Federal Govt Trust Funds	$ 4.6				
of which Soc Sec	$ 2.6				

Not counting contingent liabilities from GSEs or underfunded trust funds

Source: Federal Reserve; OMB; Encima Global

Fiscal Outlook

In its new outlook, **CBO increased its deficit projections for 2011 to $1.5 trillion** from $1.1 trillion and for 2012 to $1.1 trillion from $700 billion. Under its baseline scenario (higher tax rates in 2013, but no impact on economic growth), the 10-year deficit (through 2020) and increment to marketable national debt is $7.7 trillion, up from $6.2 trillion in CBO's August 2010 outlook.

- Outlays are expected to remain very high relative to GDP, with record transfer payments currently running over 18% of personal income. Receipts will stay lower, leaving an **expected deficit of 10% of GDP in the current fiscal year.**

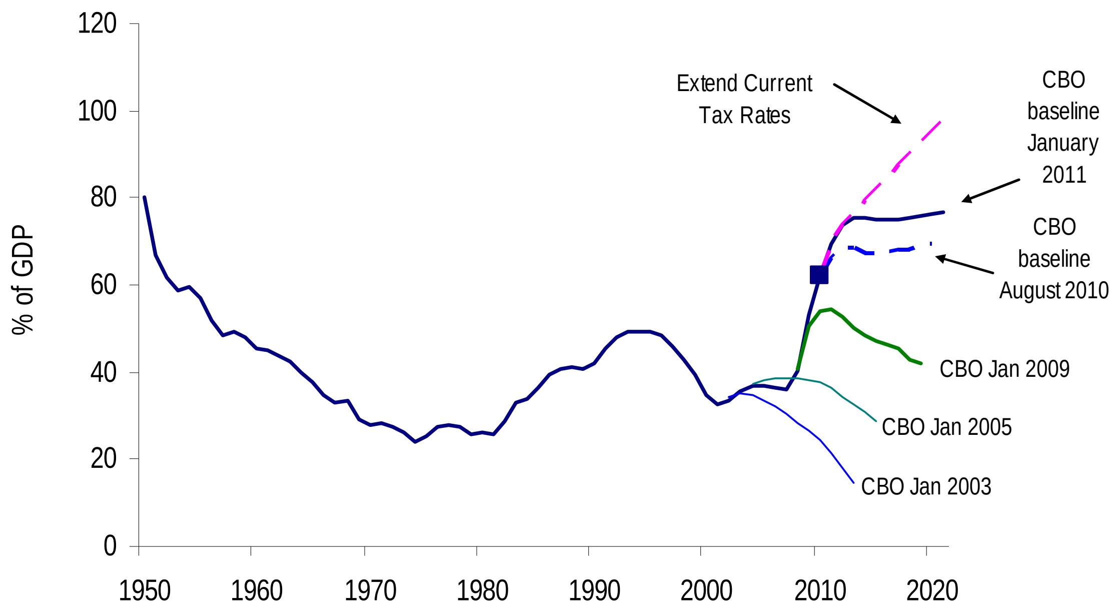
The current marketable debt is $9 trillion (62% of GDP). Under CBO's baseline, it would rise to $18.3 trillion in 2021.

- Previous CBO baseline estimates had the debt-to-GDP ratio flattening out at lower levels – at 40% of GDP in the 2009 baseline and 65% of GDP in the August 2010 baseline. The new forecasts have it flattening out around 77% of GDP (page 20 of the CBO report).

- These new debt figures are based on CBO's optimistic assumptions -- no recessions, much slower growth in discretionary spending, interest rates on the national debt stay low, and the proposed 2013 tax increase, the biggest in history, remarkably allows growth to <u>speed up</u> to an average 3.4% in 2013-2016.

- These assumptions leave a substantial understatement of the likely deficit and debt. More likely, either current tax rates are extended and CBO adjusts its deficit estimates upward to more realistic levels; or tax rates rise and hurt growth, receipts and the deficit. Assuming current tax rates are extended again in December 2012 as they were in December 2010, **CBO would adjust the national debt forecast up by an additional $5.5 trillion, pushing the marketable debt-to-GDP ratio to nearly 100% of the expected $24 trillion GDP in 2021** (CBO page 128).

CBO Forecasts of Federal Debt Per GDP (last obs. Dec 2010)

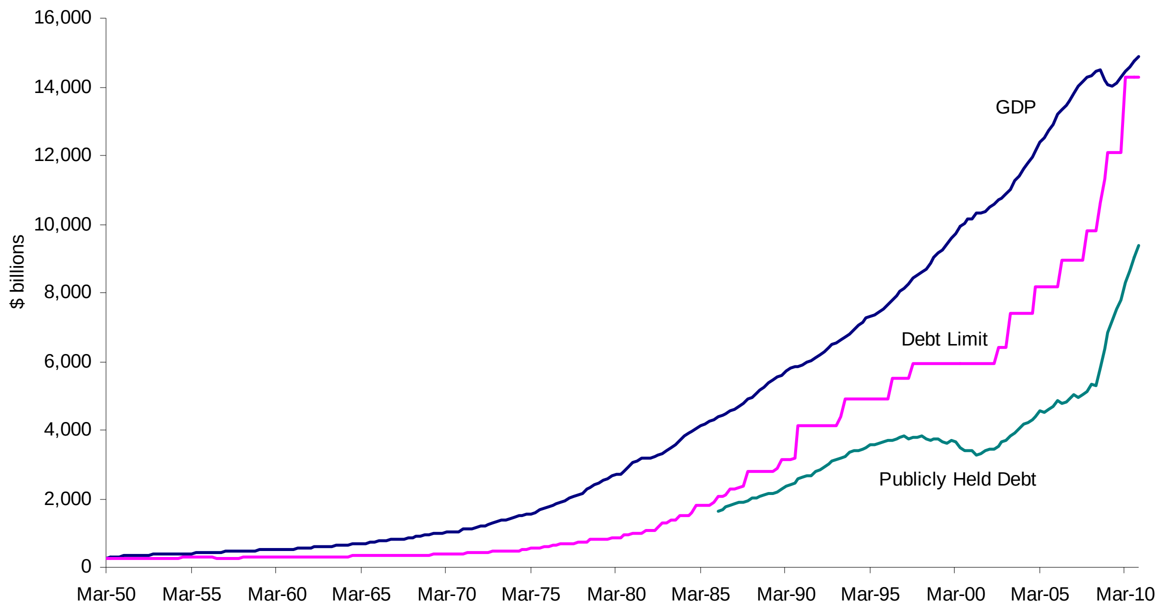


Source: CBO; OMB; Encima Global

Statutory debt is over $14 trillion, nearly 100% of nominal GDP (which was $14.66 trillion in 2010). The limit on statutory debt is now $14.3 trillion and will have to go above GDP very quickly given the $1.5 trillion deficit forecast.

- Statutory debt grows by the combination of the fiscal deficit plus the increase in the holdings of trust funds (roughly $220 billion per year). If government grew along with GDP, then statutory debt would also increase at the rate of economic growth plus inflation. Using CBO's baseline deficit (probably optimistic) plus the extension of current tax rates, **the statutory debt limit will rise to $31 trillion or 130% of GDP in the 10-year budget window** -- $31T/$23.8T (page 125 in the CBO report plus the tax extenders on page 22).

National Debt Limit At $14.3 Trillion (last obs. Q4 2010)



Source: BEA; US Treasury; Encima Global

- **The statutory debt limit stabilized for about four years in the late 1990s, while the marketable debt to GDP ratio fell** as the federal government moved into fiscal surplus.

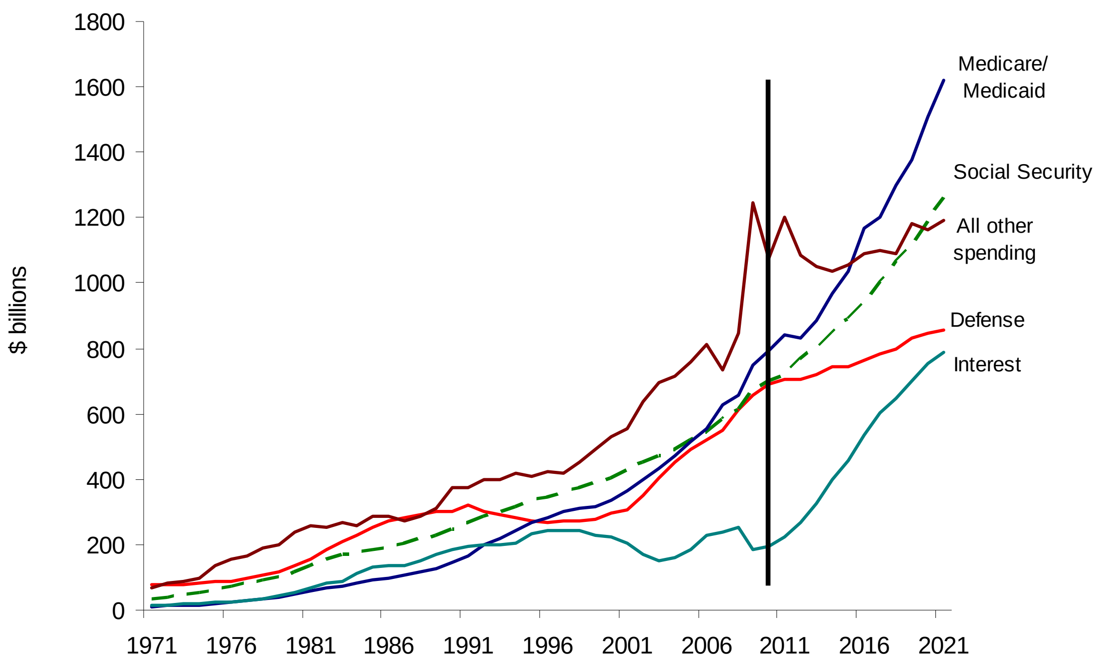
- There were strong tax receipts related to the high-tech stock market boom, a decline in noninterest outlays per GDP (mostly defense-related), and a brief demography-related period of very slow growth in entitlement spending. In addition, there was a rapid increase in the debt of government sponsored enterprises like Fannie Mae and Freddie Mac that substituted for government programs but was not counted in the statutory debt limit. **Those factors probably won't repeat in the next few years, leaving the fiscal deficit large and all debt measures -- statutory debt,**

the statutory debt limit, marketable debt and the marketable debt-to-GDP ratio – rising substantially.

Much attention has been focused on the U.S. entitlement problem and the underfunding of the social security and Medicare trust funds. **It is more clear from an economic perspective to consider all government programs as a commitment of future spending, funded pay-as-you-go** whether accounted for as an entitlement (like Medicare) or as discretionary spending (like defense.)

- CBO's baseline shows **$5.7 trillion in expected spending in 2021. Interest expense, even with very optimistic assumptions about debt levels and debt service costs, will be rising sharply while defense and non-entitlement spending barely grows.**

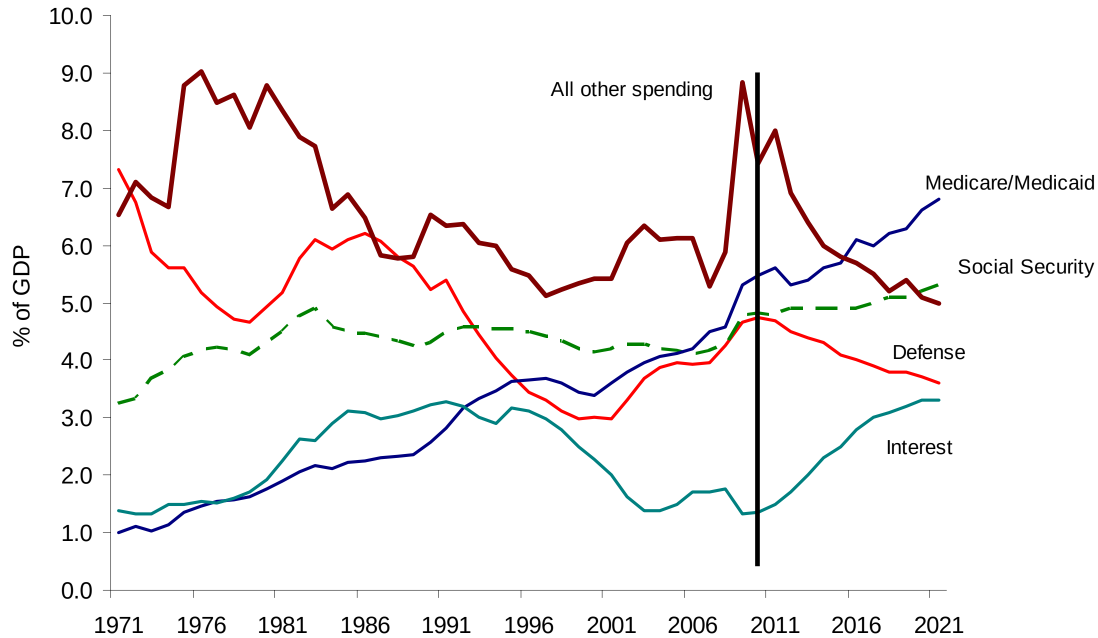
Expenditures in $ billions by Major Category (last obs. 2010, CBO projections to 2021)



Source: CBO; Encima Global

- The Administration's FY2011 budget has defense spending declining sharply relative to GDP through 2015, resuming the sharp "peace dividend" decline that occurred in the 1990s. **Future budgets will contend with fast growth in medical spending and interest expenses crowding out other spending.**

Expenditures as a Percent of GDP by Major Category (last obs. 2010, CBO projections to 2021)



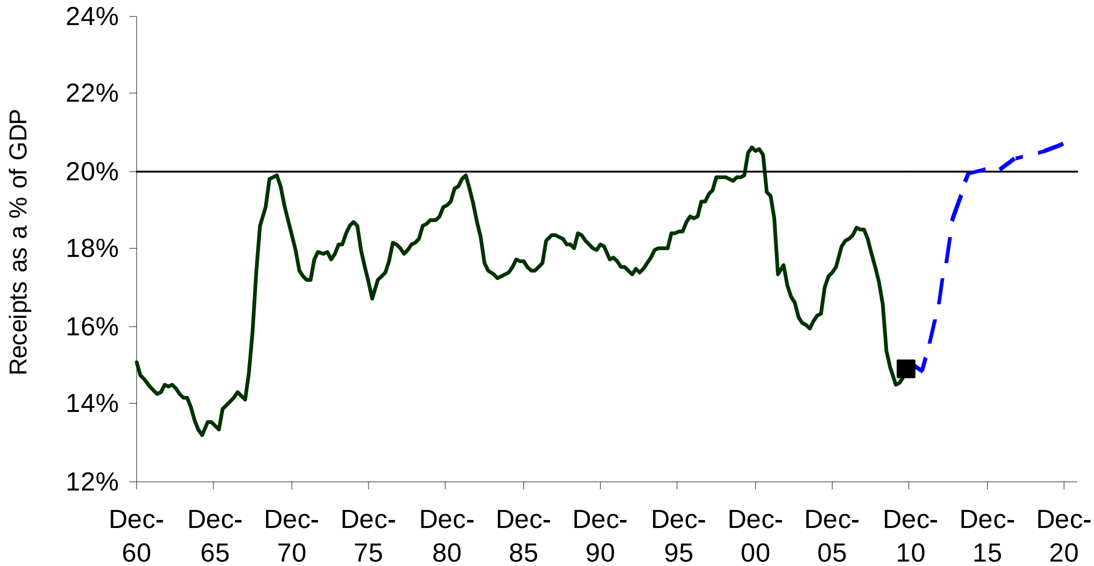
Source: CBO; Encima Global

Reaching the Limit of Washington's Debt Expansion

No one knows whether the U.S. will hit a tipping point where creditors stop buying our debt. We do know that such a problem would be catastrophic and that responsible public policy should be aimed at lowering the risk.

- The CBO forecasts discussed above give a sense of **sustainability by using the optimistic assumptions of faster GDP growth, no recessions, interest rates staying low, and receipts rising quickly** above their historical limit as a share of GDP (Hauser's limit graphed below). Using these assumptions, we might have years to solve the problem if all goes well. However, **for responsible policy-making, we should use more cautious assumptions. This argues for deep, urgent spending cuts so that we don't test the tipping point.**

Federal Receipts as a Percent of GDP Exceed 20% in CBO Baseline (last obs. Dec 2010, CBO projected to 2021)



Source: CBO; US Treasury; BEA; Encima Global

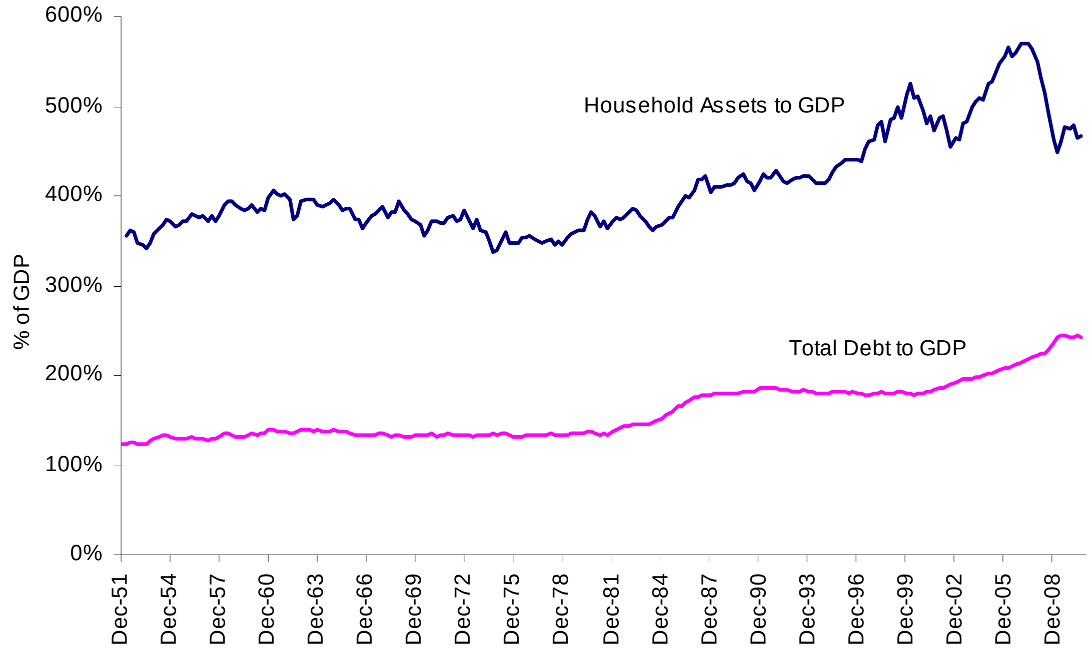
In evaluating the U.S. debt problem versus other countries, I look at the current debt burden relative to GDP (our's is now high); the rate of growth of the debt burden (our's is fast, given the fiscal deficit); the foreign currency exposure (our's is minimal); the nation's offsetting assets (our's have fallen, but are still very high); and the maturity of the debt (our's is way too short).

- On the positive side, very little of the U.S. national debt is non-dollar. Crises in Asia and Russia in the late 1990s and Mexico in 1994 involved foreign currency debts that mushroomed during their devaluations.

- And U.S. household assets are the largest in the world by far ($69 trillion or 425% of GDP).

- By these metrics, the U.S. is in a less precarious debt position than several European countries, arguing against a near-term federal crisis.

Household Assets and Total Debt / GDP (last obs. Q3 2010)



Source: Federal Reserve; BEA; Encima Global

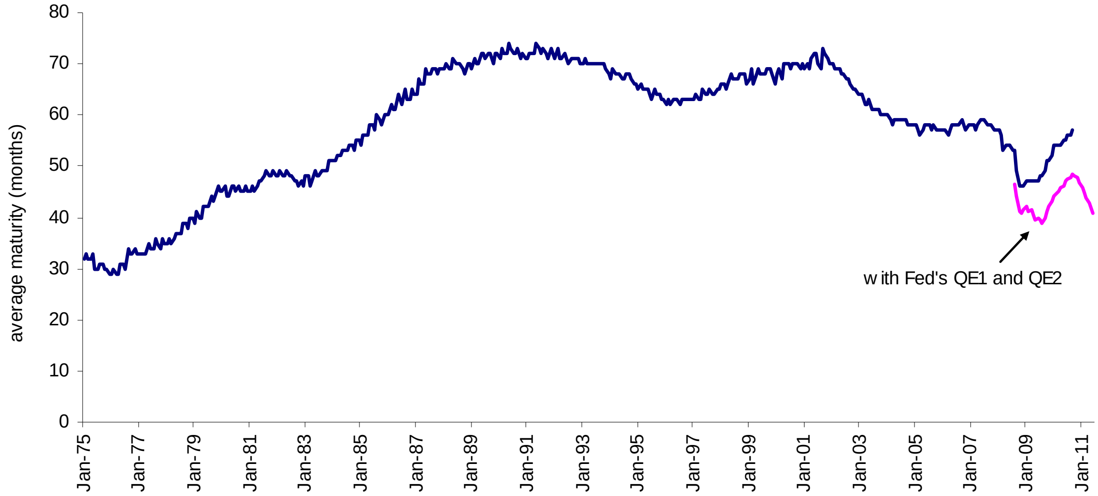
However, federal spending and debt are growing so fast from a very high level that they are already clouding the U.S. outlook, especially given the short maturity of the debt.

- **The stated maturity of the U.S. national debt has shortened from 70 months in the 1980s and 1990s to under 60 months**. One goal of good financing policy is to lengthen the maturity of the debt – the U.S. is doing the opposite in the extreme. This is a major risk in the event that interest rates rise.

- **The Federal Reserve's large buyback of longer-dated Treasury notes and bonds, paid for by over-night deposits from commercial banks, has substantially shortened the effective maturity of the U.S. national debt – to roughly 40 months, near the crisis point of the 1970s.**

- In addition to Treasury bonds, the Fed holds $1.1 trillion of long-maturity MBS and GSE agency notes financed overnight, an added exposure for the taxpayer in the event markets require higher interest rates -- as they did in the 1970s when the debt maturity was also short.

Average Maturity of Treasury Debt; Effective Maturity with Fed's QE (in months, last obs. Sept 2010, QE2 projected through June 2011)



Source: U.S. Treasury; Federal Reserve; Encima Global

- A key underlying assumption in the CBO outlook that stabilizes the out-year budget deficit is that U.S. interest rates stay well-behaved, rising gradually with the recovery. CBO assumes that federal interest costs converge from the current 2% average interest rate on the national debt to a stable 4.4% in 2021, exactly the same as the nominal GDP growth rate.

- In the past, however, the average interest rate on the national debt has often been above nominal GDP growth, including most of the 1980s and 1990s. With the maturity of the national debt much shorter now, the likelihood is that interest rates will spend substantial time above the nominal growth rate in the next few years, increasing the deficit forecasts.
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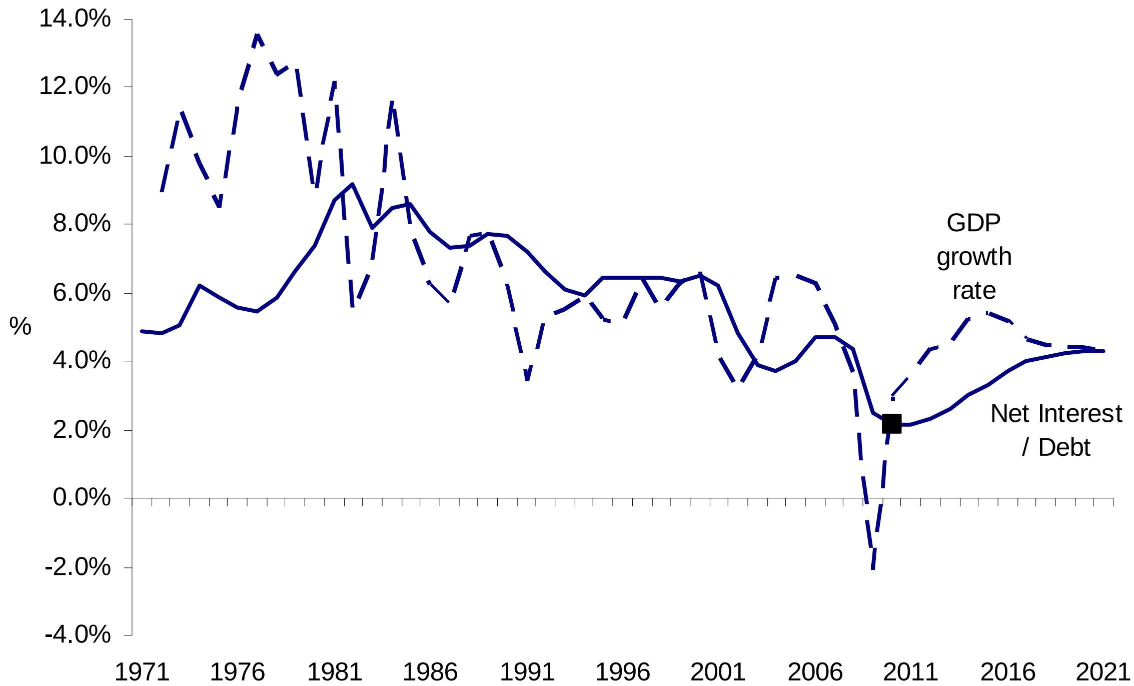
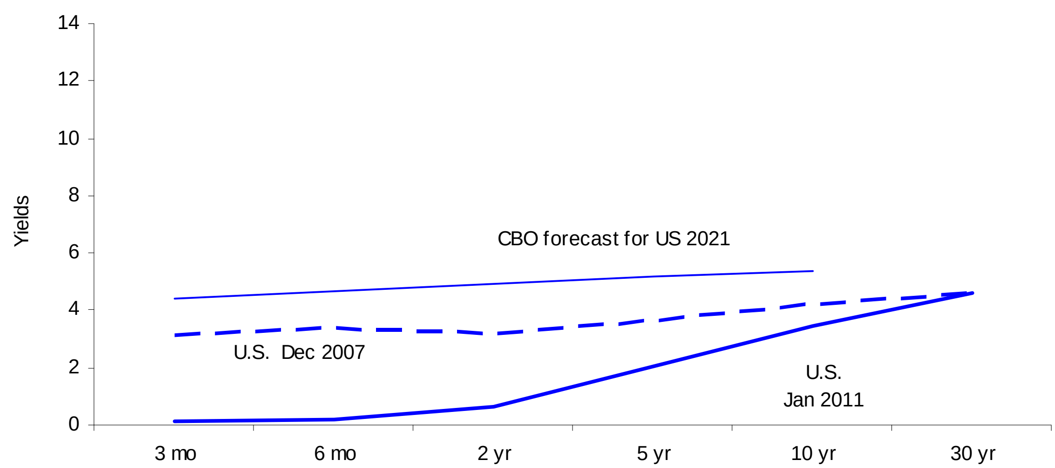
Nom GDP Growth Vs. Int Rate Paid (last obs. 2010, CBO proj to 2020)



Source: CBO; Encima Global

- After the 2008 financial crisis, U.S. interest rates moved down sharply. CBO assumes that short-term interest rates rise to more normal levels, while longer-term bond yields stay relatively stable even as debt-to-GDP rises toward 100% of GDP.

Yield Curve for US (last obs. January 27, 2011)



Source: Bloomberg; CBO; Encima Global

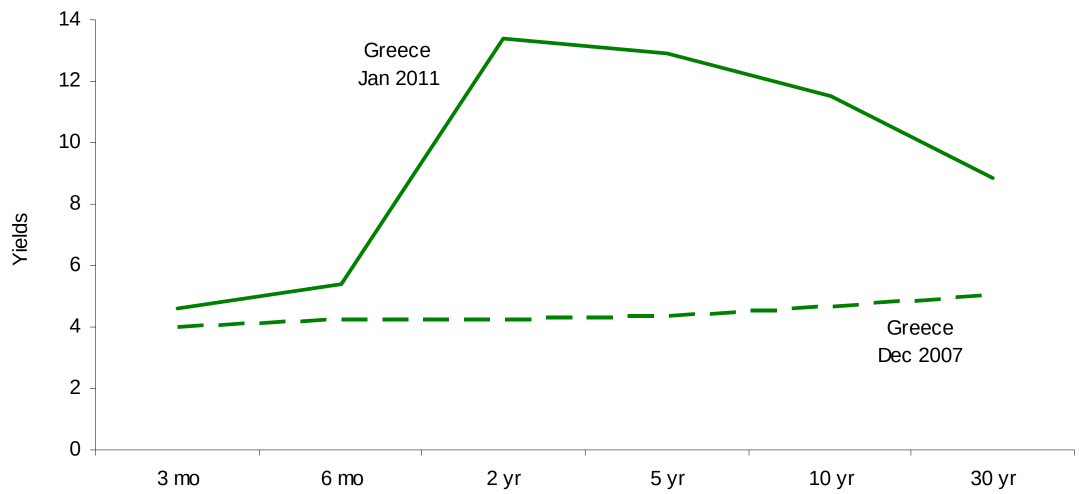
At tipping points, countries experience a sharply different market reaction than the CBO projection for U.S. interest rates.

- Greece was not having a debt problem in 2007 and enjoyed a relatively flat yield curve at roughly 4% (a bit lower than the U.S. 2021 expectation.)

- In late 2009, Greece's newly elected prime minister announced that the national debt was more than the country had been reporting, obscured in part by derivatives that lowered the current deficit at the expense of future debt (akin to the U.S. shortening its debt maturity to reduce interest).

- Greece saw its short-term interest rates jump to over 12% as it hit a tipping point and fell into a severe debt crisis. With much of its debt short-term, the impact of the spike in interest rates on Greece's budget deficit has been devastating.

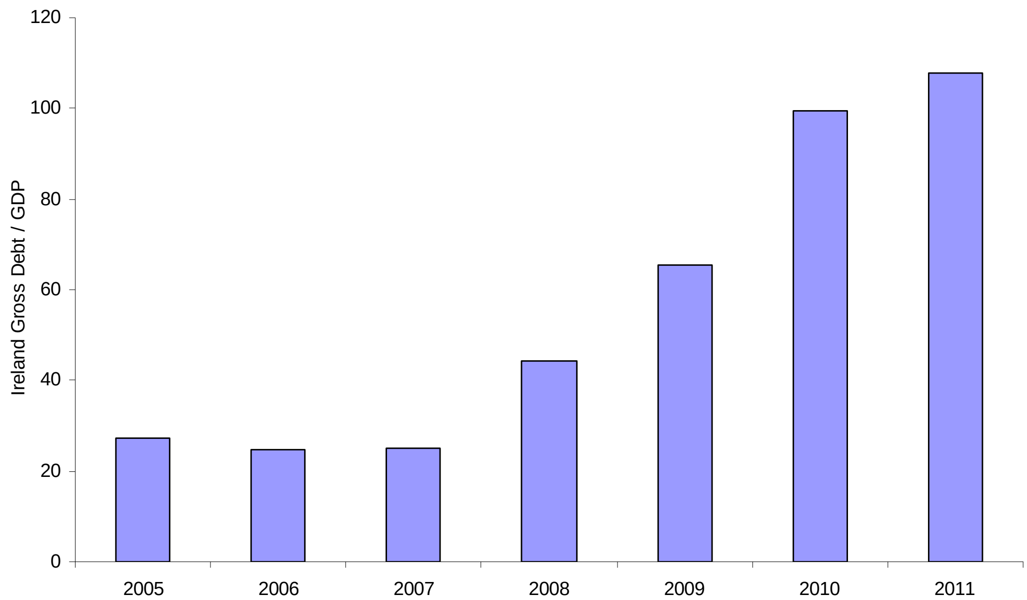
Yield Curve for Greece (last obs. January 27, 2011)



Source: Bloomberg; Encima Global

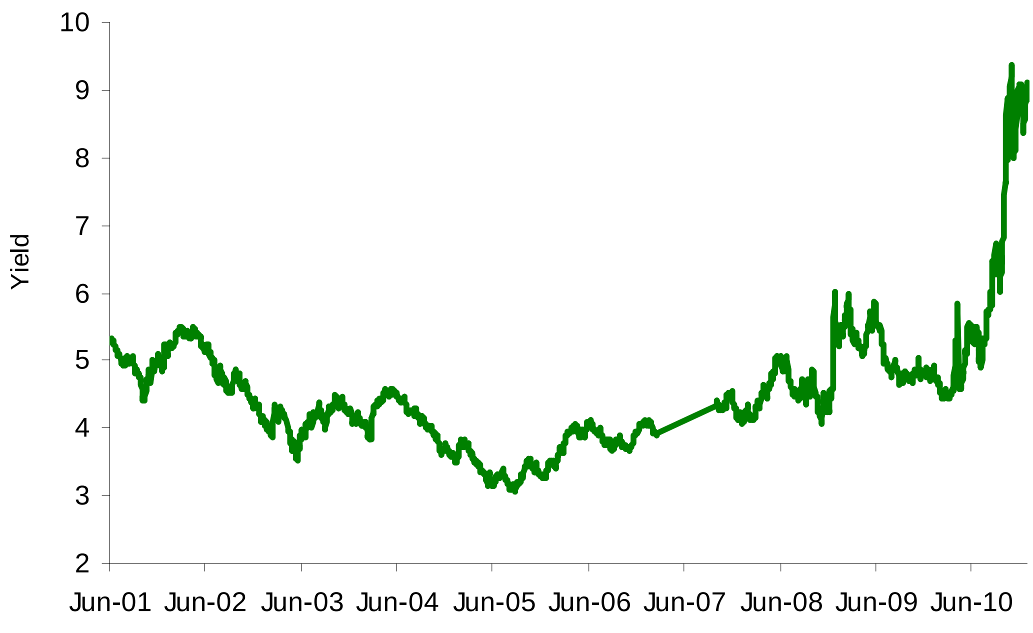
- In mid-2010, Ireland hit a tipping point in which markets would no longer finance its debt. The risk at the tipping point is a creditor's strike.

Ireland's Debt To GDP Ratio Hit A Tipping Point at 90%
(last obs. 2010, IMF forecast for 2011)



Source: IMF; Encima Global

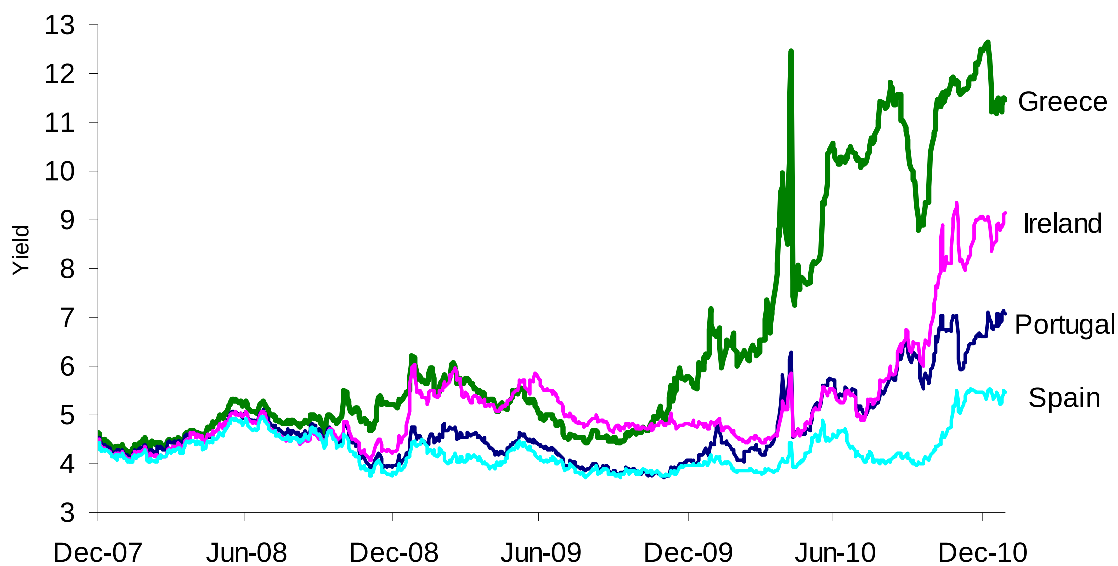
Ireland's Ten-Year Bond Yield (last obs. January 28, 2011)



Source: Bloomberg; Encima Global

- The combination of large deficits, high debt levels, debt surprises and a spike in interest rates has created a severe European debt crisis spreading from one country to another as weaker countries wait for bailouts from stronger countries.

Select European Yields (last obs. January 28, 2011)



Source: Bloomberg; Encima Global

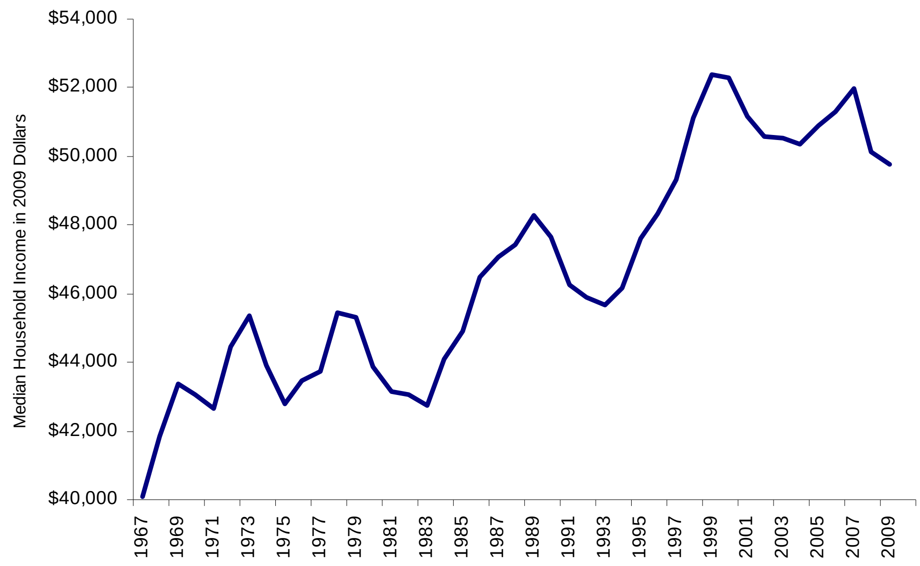
How might a U.S. crisis evolve? Each time budget deficits go up, it discourages private sector investment and pushes capital away from the U.S. That creates a vicious circle – weak investment means fewer jobs and less tax receipts, causing another overshoot in the fiscal deficit.

- As long as interest rates stay low, it's not a debt crisis. The bond analogy comes to mind – as long as the rating agencies call it AAA, then everything is ok.

- In reality, we're already suffering a slow-motion growth crisis in which interest rates have been artificially low for nearly a decade, obscuring the true debt, undercutting the dollar and hurting living standards. This in turn invites higher transfer payments and hurts tax receipts, worsening the fiscal deficit.

- Median household income is well below the late 1990s and is falling fast, the result, in my view, of a harmful weak dollar policy, artificially low interest rates and high levels of government spending.

Median Household Income, Inflation-adjusted (2009$, last obs. 2009)



Source: Bureau of Census; Encima Global

Some Policy Views

I. The expiration of the continuing resolution on March 4 should be used as an opportunity to make numerous spending cuts now -- to put Washington on a diet where it shrinks day by day. Waiting for a deficit reduction package ducks responsibility and is a recipe for continued out-of-control deficit spending.

II. The debt limit increase should be used to install a lasting limitation on the U.S. marketable debt-to-GDP ratio, enforced by escalating penalties on Washington when the limit is exceeded. There should also be a minimum average maturity for the debt to stop the government from artificially lowering near-term interest costs.

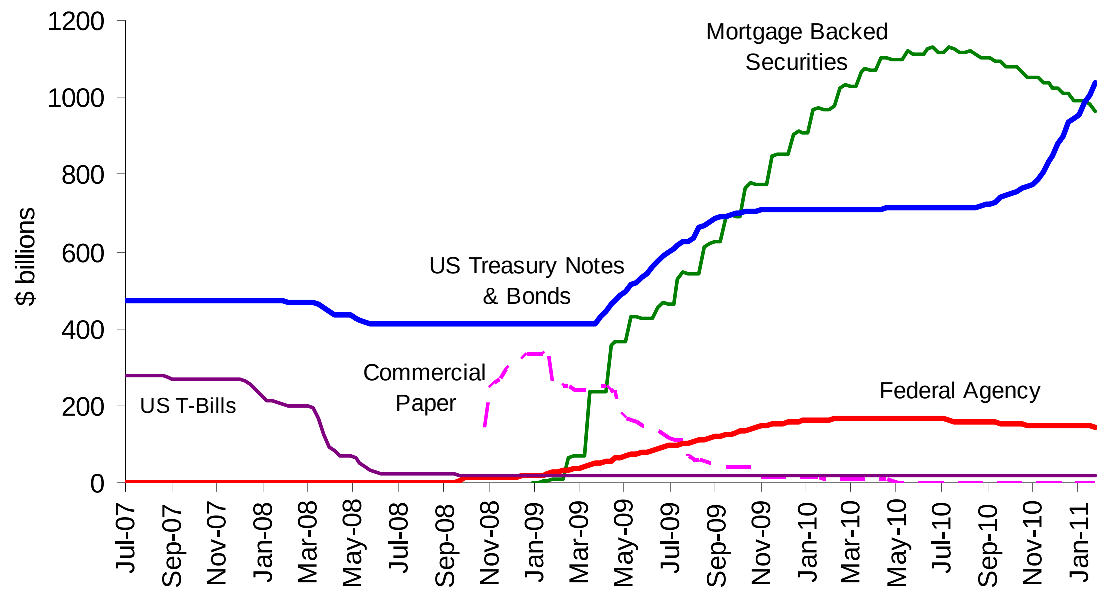
- Article I, Section 8 of the **Constitution** reads: "The Congress shall have power to lay and collect taxes… and to **borrow money on the credit of the United States**." But there are **no boundaries on this power in the section 9 limits on Congress**. If the Founding Fathers had realized that a future Congress would borrow $9 trillion much less the $31T envisioned by CBO for statutory debt, they might have installed a lasting debt limitation. For example: "**Total borrowings shall not exceed half the annual output, and their average maturity shall be at least five years.**"
- **Absent a constitutional protection from excessive debt and short debt maturities, Congress should legislate one**. The existing statutory debt limit is flawed because it is a nominal dollar amount, currently $14.3 trillion, and is repeatedly overtaken by the country's growth, inflation and the buildup in trust funds. It doesn't include a floor on maturity. I think it would be highly disruptive to the economy and financial markets to try to avoid increasing the statutory debt limit by channeling tax receipts to debt

service while stopping other expenditures. In effect, the government would be shutting down, but in an arbitrary sequence, causing disruptions because of uncertainty about payments.

- A better limit would be based on the marketable debt-to-GDP ratio, say at 50% of GDP, enforced by escalating penalties on government leaders and institutions if the limit is exceeded. Like the Constitution, this type of limit might last decades or centuries. As a complement, I would support a spending per GDP limitation, though federal expenditures vary substantially from decade to decade based on demographic needs, defense posture and interest rates.

III. By buying long-term assets, the Federal Reserve is conducting fiscal policy. QE2 should be wound down. It is shortening the effective maturity of the national debt and is causing substantial market distortions. The Fed's total assets are climbing rapidly toward $3 trillion, an unprecedented expansion. The Fed's holdings, now some of the world's biggest, create a major conflict of interest in setting interest rate policy.

Federal Reserve Assets (last obs. January 26, 2011)



Source: Federal Reserve; Encima Global

IV. Tax reform is a high policy priority. I favor including permanent extensions of current tax rates in the baseline to facilitate growth-oriented tax reform and modifying scoring rules to stop the practice of temporary tax rates.

I believe these four policy approaches would give new confidence to businesses and financial markets, causing an inflow of jobs and capital to the U.S. private sector. Thank you again for the invitation to testify on these critical issues.