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Consequences of the Current Fiscal Trajectory - Opening Remarks

I think we should begin this discussion distinguishing between what we call the short term, medium term and the long term. Unfortunately we don't have very good and precise measures of what that difference means. But I think we're talking about short term up here, at least I and Alan, we're thinking about you know the next couple of years, where frankly we haven't talked about the underlying economic assumptions. But I'm in the camp that believes that the underlying economy, both the US economy and much of the global economy, is likely to remain pretty weak. And its for reasons having to do with that we're in a balance sheet recession and balance sheet recessions don't get over with quickly. Consumers are not going to recover quickly, they're not going to rebuild their wealth quickly, the unemployment rate is not going to recover quickly. We're going to have substantial head spins in the credit markets and capital markets. And I think that that means that we're going to have a relatively slow recovery with substantial amount of downside risk. And I frankly do worry about the financial drag next year as the stimulus begins to slow down and then of course more fiscal drag in 2011 when the tax cuts are rolled back. So I think that we need to say that there's a real balancing act here, in the short term, between taking action on the deficit too soon, which will really I think undermine the recovery, and trying to build a sustained recovery with momentum.

Now the long term issues—2030, 2050, 2080—I have nothing to add. They're unsustainable paths, and the sooner we get on a path with a pre-committed solution to that, the better we are. Because these long-term deficits, do, seeing the evidence by Peter Orszag, Gale and many others, do suggest that long term deficits do have a pattern on long term interest rates. It does slow down trend growth. And frankly it's less painful to take action very slowly and gradually to deal with problems that 10, 20, 30 years out. It's much better to do it now—begin to do it now, by setting up a pre-committed path. And then when the economy has become a strong, robust recovering economy, begin to introduce that. So now the medium term I see is somewhere to the next decade. Let's assume we get out of the recession. We don't have a double dip. We have an anemic recovery for several years. We have unemployment rates above any measure of full employment. We have a lot of underutilized capacity both in the US and by the way we'll have it in Europe as well. So we end up with these 4-5 percent budget deficits in the medium term. And we end up with debt-to-GDP going to 80 percent or maybe the IMF says 100 percent. Is that sustainable? Will the rest of the world help finance that and at what interest rate might it be financed?

I think that forces us to look back carefully at what just happened. What just happened is we had a period, 2002-2008, where the US went on a massive dis-saving binge. And we actually focused on the budget deficit here, but the household sector went on a dis-saving binge. The household savings rate went to 0 and households accumulated massive amounts of debt relative to their income. Why did they do this? Well in part they were able to do this because the rest of the world was perfectly happy to finance this. We had,

despite a significant increase in US borrowing from the rest of world as measured by a current account imbalance which went up to 7 percent, we had abnormally low real long term interest rates by historical standards. Yields on fixed-income assets, government bonds, corporate bonds, securitized debts, all fell because there was a 'global savings glut'. I do believe that hypothesis. There were huge amounts of foreign capital made available to the United States, to all kinds of borrowers. It was mainly mediated through China and others buying US Treasuries, securities. But believe me, that affected the price of all the other fixed-income assets. So while we were going on our way able to finance our deficit and our personal collapse of savings with the rest of the world's funds, why was the rest of the world doing this? They were actually trying to accumulate a lot of foreign exchange reserves to ensure themselves against another foreign exchange crisis like 1997-1998. So part of this was insurance for them. And part of it was essentially using an export model to drive capacity, development and growth. And of course the country we always think about here is China. And just let me give you some amazing numbers. Because I see 2002 and 2008 as a bubble of many types. And one bubble was the savings bubble in China and the export boom in China. Another bubble is the US housing boom and the collapse of personal savings financed by the Chinese primarily. Between 2002 and 2007 China's exports grew at 30 percent a year; China's investments grew at 25 percent a year; China's exports plus fixed investments hit 60 percent of GDP. Out of history, there isn't a precedent for that. You can't find it in Japan; you can't find it in Korea. China went from a current accounts balance—a balance—essentially it did not have a surplus—in a few years to about 10 percent current account surplus. That's about 10 percent of their GNP being pumped into the rest of the world as savings. And what did they do with that? They bought dollars. They had no reserves to speak of in 2002, and now they have 2 trillion dollars of reserves, held in various things including dollar securities. And frankly, they are caught in a dollar trap. Every time you hear them talk about US interest rates, US exchange rates, US inflation rate, they are trapped all right. They chose to run an export-driven economy and build up these reserves. And they chose to hold them in dollars.

Going forward, what does it say about our ability to finance the debt? Well, I think a couple of things are really changed. I was very impressed about what happened at the G-20 meeting at the announcement. The first thing that changed is the US consumer, the US household, sadly, because for many of US households their median income hasn't gone any place in years. They are saving more. It is my hypothesis that will continue to save more. They have lost trillions of dollars of wealth. They have lost income generating capabilities. Their savings rate is 0. Their debt-to-income are still highly elevated. They have to save. They have to save. While government dis-saving in the US is going up—personal saving, excuse me, government dis-saving is going up, personal saving in the US going up. If the US household gets back to a steady state several years of household saving rate of 6-7 percent, the US government can finance a deficit of 4-5 percent with a US current account imbalance of only 3-4 percent. The US current account imbalance is down, its down by half already. So think about this, part of this savings comes from US households. They're saving more; the government is saving less. What about the rest of the world? What about the rest of the world, here? Well there are two scenarios. One is the Chinese do, and other countries follows them as well, shift to more domestic demand

drive growth. Their current account surpluses come down. They have less savings they are generating to us and the world. But they also don't depend upon us anymore for consumption. That's actually a good scenario because while we will be growing more slowly, they can pick up some of the slack by growing their domestic demand. The most worrisome scenario I see for the medium term is the following. The US government is running a deficit of 4 percent, households are saving, current account is down, but the US is not growing very fast and by the way neither is the rest of the world and because China doesn't deal with its savings glut. So there's still a savings glut in the world. Long term real interest rates are still low. But the world is not growing very fast either. And I think that to me is a scenario we have to take as a serious scenario. Stephen Roach studies the Chinese economy a lot, has said it'll take 3 years or more likely 5-10 years for China to fill the global demand void that has been created by a reduction in the US savings gap. If the US savings gap comes down from 6 percent GDP to 3 percent GDP—that's the current account imbalance, there's a sucking in of demand from the rest of the world. Where does it come from? If it takes China 3-5 years to make it up, the world is going to be a slower place.

During this period of time, the most important thing the US can do to try to make sure that our foreign creditors, as they bring down their own savings glut, are willing to continue to finance what we need, which would be less as a share of GDP—the most important thing we can do for creditors and for ourselves, is pre-commit to a long term deficit reduction policy. We need credibility with our foreign lenders as they begin to move their savings home. And that credibility would come from a program now of graduate deficit reduction for the future. But I don't think, given the increase in personal savings in the United States and given the availability of savings in the rest of the world, that we're going to see either a precipitous decline of the dollar or a dramatic spike in interest rates if the US runs a deficit of about 4 percent. I don't think it'll be fun; I don't think it's advisable. I think the world economy will be weakened by that. But frankly, I don't see either a collapse of the dollar or a spike in the real interest rates. I do see some long term decline in the dollar as a possibility. But let me just end by saying, when the imbalances were at their peak in 2007, everyone — the predictions were that it would cause either a spike in long term interest rates or a collapse of the dollar. That's how the imbalances would be corrected. What people didn't predict was what actually happened, which was a collapse of the financial markets through a variety of different means. So it's very difficult to make these predictions, but my prediction would be as I said.