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before the

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## Introduction

Co-chairman Simpson, co-chairman Bowles, distinguished members of the Commission, thank you for the opportunity to participate in today's hearing and to share a perspective regarding our nation's fiscal circumstances.

My name is Rob Nichols and I serve as the president and chief operating officer of the Financial Services Forum. As you may know, the Forum is a nonpartisan financial and economic policy organization comprised of the chief executives of 19 of the largest and most diversified financial institutions with business operations in the United States. The purpose of the Forum is to promote policies that enhance savings and investment and that ensure an open, competitive, and sound global financial services marketplace.

The Forum is of the view that the nation's fiscal condition, which as you know has deteriorated appreciably since the onset of the recent financial crisis, represents perhaps the greatest single threat to financial stability, the nation's standard of living, and the productive vitality of the U.S. economy over the longer term. More specifically, given current Congressional Budget Office (CBO) projections, there is reason to conclude that, unless significant structural changes are made to balance revenues and spending, within the next few years the United States will likely approach a point where global market sentiment regarding the nation's fiscal condition could change abruptly and sharply for the worse, making corrective action far more urgent and painful than if such steps are taken in the next year or two.

With that in mind, the importance of the Commission's charge – to identify and recommend policies to improve the nation's fiscal situation in the medium term and to achieve fiscal sustainability over the long run – cannot be overstated. The Forum and its members thank each of you for your service in this critical effort.

## Recent Rapid Deterioration in Public Finances

As the Commission is aware, the United States' fiscal condition has deteriorated significantly since the onset of the recent financial crisis and the subsequent economic downturn. Over the period 1963 to 1987, the nation's debt as a portion of annual GDP remained below 50 percent. From 1988 to 2008, the ratio averaged about 61 percent. In 2009, however, the ratio surged to 83 percent, and according to CBO estimates will reach 94 percent this year.

Our annual budget deficit has shown similar deterioration. After averaging about 2.5 percent of GDP between 1982 and 2008 – including several years of surplus in the late 1990s – the 2009 deficit jumped to $1.4 trillion, or 9.9 percent of GDP, and is projected to reach 10.6 percent of GDP this year.

In 2010, the United States will spend $165 billion servicing its debt, an 18 percent increase from fiscal year 2009, and more than will be spent to run the departments of Treasury, Interior, Labor, Commerce, Justice, Agriculture, and Energy, the EPA, NASA, and the National Science Foundation, combined.

The marked increase in the annual budget deficit reflects in large part the effect of the weak economy on tax revenues, new high-cost domestic initiatives, as well as the extraordinary policy actions taken to stabilize the financial system and broader economy. But even after financial and economic conditions return to normal, federal debt will remain at unsustainable levels.

## Risks of Inaction

Failure to meaningfully address the nation's fiscal circumstances entails a number of financial dangers that could significantly impact the productive vitality and job-creating capacity of the U.S. economy. Principal among these is the risk that global investors could become increasingly worried about America's debt position and begin demanding higher risk premia to continue purchasing U.S. government debt. At current elevated levels of debt, rising interest rates could quickly compound an already challenging debt situation, adding further to the nation's debt burden, increasing investor anxiety, leading to even higher interest rates – and touching off a viscous circle of deterioration referred to as a "debt trap."

Moreover, given that Treasury bills and bonds are the basis for borrowing structures in private credit markets, the impact of rising government debt rates on the cost of capital, economic growth, and job creation would be far-reaching and decidedly negative.

In March, Moody's announced that while the United States is not in immediate danger of a rating downgrade, "the distance to downgrade has substantially diminished."

Given the likely impact of higher rates on U.S. economic prospects, another risk associated with further deterioration in the nation's debt position is that investors may become increasingly reluctant to hold dollar-denominated assets. As investors increasingly choose foreign investment opportunities, the relative value of the dollar would fall, undermining Americans' purchasing power and standard of living. A falling dollar also has dangerous implications for inflation.

Finally, given the likely impact of higher interest rates, slower growth, and a falling dollar on asset prices and market confidence, further deterioration in the nation's debt position would likely be associated with greater financial market instability.

**How Much Debt is Too Much?**

It is difficult to say with precision how much debt is too much or how much time the United States may have to get control of its fiscal position. There is no obvious threshold beyond which investors will demand higher real yields for holding U.S. debt, or flee from dollar-denominated assets. That inherent uncertainty has tended to make fiscal discipline seem less urgent, or easier to postpone.

But two numeric tools strongly suggest that the time to focus intently on fiscal reform has arrived. In their book "*This Time It's Different*," Ken Rogoff of Harvard and Carmen Reinhart of the University of Maryland examine the experience of sixty-six nations on five continents, spanning eight centuries of data on central government debt, inflation, and economic growth. Rogoff and Reinhart find that throughout financial history, in advanced and emerging nations alike, debt-to-GDP levels surpassing 90 percent are strongly associated with notably slower economic growth, more frequent and severe financial crises, higher inflation, and overall economic decline. America's debt-to-GDP is expected to surpass 90 percent this year and, according to the IMF, will reach 108 percent by 2014 – the highest level since the historical peak of 121 percent of GDP in 1946, following expenditures related to World War II.

Acknowledging the comparison is imperfect, by way of reference the so-called "PIIGS" – Portugal, Ireland, Italy, Greece, and Spain – have current debt-to-GDP levels of 86, 79, 118, 124, and 67, respectively.

Secondly, a nation's cost of servicing its outstanding debt is a critical metric used by credit rating agencies in reviewing a nation's fiscal strength – how much of what a government collects in revenue is needed merely to pay the interest on its debt. Earlier this year, Moody's confirmed that for the United States, a debt service of 18 to 20 percent of federal revenue is the outer limit of Aaa-territory. According to CBO estimates, interest payments will top18 percent of revenue by 2018. Under more adverse scenarios than CBO considered, including higher than expected interest rates, debt service could hit 22 percent of revenue as early as 2013.

**Conclusion**

Some analysts argue that the United States' position in the global economy is unique and, therefore, conventional debt metrics that might signal trouble for other countries simply do not apply. It is certainly true that the United States enjoys a favored position in the global economy – it is the world's largest and most diversified economy, remains the center of global trade and finance, and is supported by flexible markets and open trade and financial regimes. And, of course, the dollar serves as the global reserve currency.

But the United States is not immune from economic decline. The trajectories of former historical powers make clear that failure to achieve fiscal sustainability will slowly but surely undermine the nation's economic vitality, reduce our standard of living, and increase the risk of financial instability. The nation's various metrics of debt burden have deteriorated sharply, and even after the recent crisis are likely to remain higher than those of other Aaa-rated countries.

We cannot know with precision how much debt is too much in the collective opinion of global markets, or precisely when the markets might determine that a tipping point has been reached. But we do know a few important things. First, our current course is unsustainable. Second, with every passing quarter our dilemma becomes more precarious. Third, the longer we wait to make the inevitable adjustments, those adjustments become more difficult and painful. And finally, the stakes – financial stability, the productive capacity of the economy, our nation's standard of living, the dollar's status as the global reserve currency and, indeed, the position of global economic leadership the United States has enjoyed for 80 years – are extremely high.

In the course of its deliberations, therefore, the Commission should bear in mind that history teaches that sharp reversals in market confidence occur abruptly, often with little if any advanced warning, and most often in response to circumstances that may appear beyond what is immediately relevant. Greece is but the most recent example of this historical pattern. Because broader circumstances – not to mention global markets' reaction to them – cannot be predicted or even anticipated with any kind of certainty, prudence strongly suggests that the United States act decisively long before crisis becomes a realistic possibility.

Achieving long-term fiscal sustainability is difficult and will entail many challenges. But as Federal Reserve Chairman Ben Bernanke recently warned in testimony before the House Budget Committee: "…unless we as a nation make a strong commitment to fiscal responsibility, in the longer run we will have neither financial stability nor healthy economic growth."

Again, thank you for the opportunity to appear before the Commission today.

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