Speech for the National Economists Club

Good afternoon. I appreciate this opportunity to talk to you about the U.S. in the world economy.

The Outlook for the U.S. Economy

As Assistant Secretary of the Treasury for Economic Policy, I analyze a wide range of economic data every day. I must confess that given the recent volatility in equity markets, I have been studying the numbers even more closely than usual. My staff and I have been talking to contacts in private industry on a regular basis. We have developed a 'real time' econometric model to help assess the near-term prospects for gdp, final sales, and business investment. All this work yields a clear conclusion: the U.S. economy continues to grow and we expect the pace of expansion to pick up in the second half of the year.

The economy continued to grow in the second quarter, but at a slower pace than in the first quarter. The advance estimate for the second quarter GDP growth was 1.1 percent, which was slower than almost all forecasters had expected. The advance estimate indicates that growth in final sales to domestic purchasers was up 1.6 percent, but final sales were essentially flat because of a surge in demand for imported goods. Consumers continued to spend in the second quarter, with spending on durables up 2.4 percent and on services of 3 percent. Business investment in equipment and software increased by 2.9 percent, the first increase in almost two years. Inventory investment also contributed to growth. Real exports increased by 11.7 percent.

Subtracting from second quarter growth was a contraction in state and local spending and continued contraction investment in business structures, as well as a large rise in imports.

The rise in exports, the initial pick up in equipment investment, and the apparent end of inventory contraction are all favorable developments which should contribute the stronger growth in the second half of the year.

The economy's recent durability in the face significant adverse shocks is derived from its sound and flexible structure as well as well-timed policy decisions made by the Administration and the Federal Reserve. Thanks to hard work of President Bush, Secretary O'Neill and Congressional leaders, the tax cuts signed into law in June 2001 were well timed and have boosted household incomes, supporting consumption. In March of this year, Congress finally passed and the President signed a bill providing companies with tax incentives to undertake investments in equipment. As many have noted, a pick-up in investment is a key to supporting economic expansion; the second quarter numbers of 2.9 growth in equipment and software investment suggest that this rebound in equipment investment has indeed begun and that these tax incentives, which will boost corporate cash flow, are helping to support recovery.

Of course investment, both business and residential, has benefited from the timely and decisive monetary policy actions of the Federal Reserve, which cut short term interest rates throughout 2001. I also note the important, if perhaps under appreciated stabilizing role that

long term interest rates have played. Both in the fall and this summer, as volatility and uncertainty in the equity markets rose sharply, a portfolio shift to government and agency bonds lowered long term interest rates to 30 year lows. This in turn was passed though to the mortgage market, triggering a wave of refinancings that put billions of dollars into the hands of households, significantly cushioning the otherwise dampening effect of the stock market on consumption growth.

The flexibility of our labor markets also contributed to a smaller decline in employment than in most recessions. While the Administration will not be satisfied until full employment is restored, we are encouraged by recent signs of improvement. The number of payroll jobs in June increased for a second straight month, and in the week of July 20 initial claims for state unemployment insurance benefits fell to 362,000, the lowest level since February 2001. Claims are now in the range that is associated with solid job growth and declining unemployment.

The Administration's current forecast is for 2.6 percent real growth this year on a year over year basis. That forecast, released two weeks ago as part of the Mid-Session Budget Review, was much higher than expected in the February Budget but still below private-sector forecasts. With the latest Budget Review, however, we found ourselves in the unusual position of both announcing much stronger real growth expectations and a deeper deficit. The estimate for the Federal deficit for FY-2002 was raised from $106 billion to $165 billion, which represents a deficit of 1.6 percent of GDP. As we discuss in our Mid Session Review released July 15th,

- The reason for the wider deficit is that last year's recession and stock market weakness took a much heavier toll on Federal revenues than previously thought. Non-withheld incomes and capital gains realizations were reduced substantially.

- The considerable change in circumstances from surpluses previously estimated to deficit is largely the result of the recession. We estimate that it accounts for two-thirds of the shift. Another 19 percent reduction was attributable to the vital needs of homeland security and the war effort. Finally, the tax cuts enacted last year account for only 14 percent of the budget deterioration.

Even without the tax cut, the budget would still have been in deficit.

- The combination of sustained economic growth and strong fiscal discipline can restore the budget to balance by 2005. If we make the tough choices to slow spending in later years, we project a return to growing unified surpluses thereafter.

U.S. and World Financial Markets

Of course, the US is part of the global economy and the global capital market. I would now like to discuss three important global economic issues that I am working on at Treasury.

Current Account

The U.S. current account deficit reached an annual rate of $449.9 billion in the first quarter, or 4.3 percent of GDP. That was just below the record 4.4 percent of GDP in the fourth quarter of 2000. Many of the concerns about the deficit are misplaced, and I think that we should devote some time to understanding what the US current account deficit actually means.

As a matter of national income accounting, the U.S. current account is just the difference between national saving and investment and is equal to the *net* accumulation of U.S. assets (portfolio and direct) by foreign investors. A deficit is not necessarily bad, nor a surplus good.

In my view, the best way to interpret the present situation is as follows. The current pool of portfolio capital in the world has fewer places to invest than several years ago. Many emerging markets have become less attractive, European experts are rightly concerned about long-standing structural problems (high average unemployment, sluggish productivity growth), and Japan is entering its second decade of operation well below its potential. Not surprisingly in this setting, capital has been flowing into the US. This process has been reinforced by the stellar productivity numbers in the US during the recession which have confirmed the earlier bet by the markets in the durability of the new economy story for the U.S.

We in the U.S. government hope that over time imbalances in growth prospects will narrow, not because of any diminution in U.S. fundamentals, but rather because of improvements in the relative performance of the rest of the world. We would hope that Europe will put in place policies that will raise productivity and reduce unemployment; that Japan will resolve its structural problems and resume growth; and that more emerging market debt will once again become investment grade. Such a progress in the global economy would be most welcome. As it occurred, US exports would expand, and some of the growing pool of world capital that would otherwise flow to the U.S. would be attracted abroad and the U.S. current account deficit would naturally narrow. There is every reason to expect that such adjustments in international capital flows would be accomplished in an orderly fashion.

Sovereign Debt Restructuring

Recently, the G-7 finance ministers met in Washington and found unprecedented unity on the need to develop a predictable process for restructuring sovereign debt. They released agreement on an Action Plan to guide their efforts toward this goal.

The G-7 agreed to work together with emerging market countries and their creditors to incorporate new clauses into debt contracts, specifying the actions to be taken in the event a restructuring were necessary. Such clauses are featured in bonds issued under UK law, but for historical – not legal – reasons are not common in bonds issued under US law. These clauses would specify a majority action provision for amending the financial terms of the bond, as well an engagement clause specifying how bondholders be represented in a negotiation with a borrower. The G7 emphasized that work on this contract based approach should proceed in parallel with the statutory approach being developed by the IMF.

It is important that both creditors and debtors themselves be included in the dialogue as we move forward on this approach. I am pleased to report that this is taking place. Secretary O'Neill has expressed his goal that emerging countries that borrow in the capital markets be rates investment grade. By making the sovereign restructuring process more predictable and less uncertain, it is hoped that flows of portfolio capital to credit worthy countries can be restored.

Strengthening Financial Systems in Emerging Economies

The Treasury has recently outlined an initiative to work with key emerging economies to strengthen their financial sectors, in (important) part by allowing the provision of financial services by foreign owned firms, usually through FDI in the financial services sector itself. This goal is worthwhile for several reasons: more durable growth prospects as countries move away from 'export – led' model; a more stable global capital market; improved access to international portfolio flows for those countries that desire them; enhanced efficiency as countries benefit from international best practices in the provision of financial services; and an expanded range of financial products that could not otherwise be provided efficiently by domestic firms alone. The Treasury initiative will support other efforts to make real progress in the ongoing WTO Financial Services talks.

Conclusion

The broad array of economic indicators that I regularly examine suggests to me that the economy is on a path to sustained growth. The fundamentals are sound and set the stage for a future of extended expansion. I am convinced that when investors are able to return their attention to the economic fundamentals, those fundamentals will be judged positively.