The Economic Outlook: Prospects and Risks

Remarks
of
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Following a long tradition of CEA chairs, I generally begin my remarks with a brief overview of the likely economic outlook. While the basic outlook characterized by the November Blue Chip Consensus forecast that the growth rate of GDP will be 1.6 percent in the fourth quarter and will rise gradually to reach 3.7 percent by the final quarter of 2003 looks reasonable, today I want to discuss the outlook in a different way. Recently, there have been doubts raised about the vigor of the recovery of the U.S. economy – I want to start with the *risks* to the economy – that is, the less likely scenarios instead of the more likely ones.

Risks

What, then, are the principal risks that the economy faces?

A Delayed Investment Recovery. The key to transforming the current recovery into sustained robust growth is the pace of business fixed investment. Only with robust business investment will labor markets firm and the economy return to robust job creation. During this cycle this far, the decline in business investment has been sharper, and the recovery more modest, than an average postwar business cycle. On average, the peak-to-trough decline in nonresidential investment was 6.2 percent. Assuming the trough occurred during the fourth quarter of 2001 – a decision that ultimately resides with the National Bureau of Economic Research – the corresponding decline in the most recent recession was 8 percent. Comparing the

typical pace of recovery, during the first three quarters of this recovery, business investment fell 2.0 percent further, compared to a typical increase of roughly 2.7 percent.

What obstacles stand in the way of an investment recovery? The first possibility is the current state of the capital stock. Over the past two years there has been extensive discussion of a "capital overhang" – excess supply of capital in place – as a major impediment to an investment recovery. Following growth rates averaging 4.1 percent from 1998 through 2000, the real capital stock grew only 2.9 percent in 2001, and is on track to rise only 2.5 percent in 2002. If there was a widespread capital overhang – and I note that even as long ago as August 2001 only 23 percent of these responding to a National Association of Business Economists outlook survey agreed – could it still persist?

It *is* possible to construct scenarios of this type. For example, if one believed that the desired capital-output ratio were a constant, and if it were at its desired value at the start of 2001, and if the output lost during the recent downturn will never be recovered (that is, the economy will return to the long-run growth rate, but never rise above it in the near term), then a capital overhang could still persist. However, there are a lot of "ifs" necessary to make this case (though narrow, sectoral capital overhang in areas such as telecommunications may persist).

A related concern is that the low level of capacity utilization stands in the way of any forward momentum for investment. This observation carries more weight regarding investment in structures – which is down more sharply and recovering more slowly – than purchases of equipment and software. Given the relatively short economic lives of the latter, it is more sensible for managers to look past their current level of utilization and stay on track with replacement cycles. Consistent with this reasoning is the fact that, in five of the past nine recessions, capital spending began to grow at a 10 percent or greater annual rate even when capacity utilization ranged from 73 percent to 79 percent.

The second place to look for insight into an investment recovery is the "price," or cost of capital, for which there have been several developments over the past year. Of course, interest rates have declined, reducing the cost of capital for debt-financed investments. Also, the

recently passed "Job Creation and Worker Assistance Act of 2002" contains provisions to reduce disincentives to investment – specifically, 30 percent expensing. Businesses are permitted to deduct immediately 30 percent of the cost of new qualifying business investments undertaken in the three years starting on September 11, 2001. These tax-based incentives will lower the cost of capital for equipment and software investments, although they do not provide comparable incentives for investments in nonresidential structures. In the other direction, recent declines in equity markets worldwide suggest a rise in the risk premium assigned to investments in equity-financed capital.

How do these recent developments collectively affect investment incentives? To get a ballpark sense of the magnitudes, note that, in the simplest valuation model, the price-earnings ratio of the Standard and Poor's 500 depends on both the discount rate (equity rate of return) and the expected growth rate of earnings. Although the precise figures fluctuate, thus far in 2002, the roughly one-percentage-point decline in the price-earnings ratio can be "explained" by a one-percentage-point rise in the equity risk premium. Alternatively, one could appeal to declines in expected earnings. While earnings expectations have shifted during the year, using earnings forecasts available from Standard and Poor's indicates a one-percentage-point decline as well. Roughly speaking, then, observable proxies for important equity market information suggests a range from no shift to a percentage-point increase in the equity cost of capital.

Turning to the other factors, combining interest rates, tax rates and depreciation, and inflation rates in the usual fashion allows one to construct a user cost of capital for corporate investment. Focusing on interest rates and tax parameters alone suggests a decline in the cost of capital on the order of nearly 1.5 percentage points in 2002 (and over three percentage points since the start of 2000). Comparing this decline with the offsets in the equity cost noted above indicates that price incentives to invest have been neutral to positive over 2002.

Of course, another key factor is the availability of internal or external investment funds. There appears to be little evidence of a credit crunch impinging on investment funds from external sources. In addition, although still below their recent highs, corporate cash flow and profits appear to have rebounded from recessionary lows. Measured on a year-over-year basis,

cash flow, for example, has risen over 16 percent in the first quarter of 2002, and over 10 percent in the second quarter.

What is the bottom line regarding the riskiness of the investment recovery? A mechanical assessment of investment factors suggests that conditions are set for investment to begin to recover. Most private forecasters anticipate that these factors will fall into place over the near future, with equipment investment recovering a bit sooner and quicker than investment in nonresidential structures. Even if the investment recovery were delayed by roughly three quarters, the impact on GDP growth will fall far short of undermining the baseline recovery.

A Decline in Consumer Spending. Consumer spending has not followed the typical cyclical patterns. During a typical postwar cycle, personal consumption expenditures (PCE) have remained roughly flat between the peak and trough, with increases of roughly two percent in services offsetting modest declines (-0.1 percent) in nondurable goods purchases and sharp falloffs (-6.3 percent) in durable goods spending. In the current cycle, PCE rose 2.2 percent during the downturn, with durable goods purchases up especially sharply (10.2 percent).

During the three quarters of the current recovery, durable spending as been up by 4.0 percent, compared to the postwar norm of a 9.0 percent rebound. Overall, PCE has risen 2.3 percent, which is slower than the 3.2 percent increase in the typical recovery.

The contrast in the pattern of spending mirrors a reversal of conventional income and wealth dynamics. In the current cycle personal income – especially disposable personal income, supported by the tax cut – has held up quite well, while household balance sheet positions have weakened. The latter has raised concerns over the durability of the recovery. As is well known, consumption tends to lose three to five cents for every dollar of lost wealth. In addition, investment also falls because of the higher cost of capital. Combining these effects, a *permanent* loss of, for example, 20 percent in stock-market value – together with other macroeconomic interactions in a standard model, including any offsetting action by the Federal Reserve – would reduce the level of real GDP by roughly 0.6 to 1.0 percentage point after one year. While this is a significant impact, it would not derail the recovery.

Some commentators have gone further, arguing that housing prices –which have risen by a cumulative 45 percent from between the final quarter of 1995 and the second quarter of this year – and consumer spending will undergo inevitable corrections. It is true that house prices have risen faster than rents and median incomes, with the result that both the price-rent ratio and the price-income ratio have risen. These increases do not imply a bubble waiting to burst. First, it is difficult for a bubble to develop in the housing market because of the high transaction costs. At the heart of a bubble are investors purchasing assets solely with an eye toward selling them at a higher price in the near future. This strategy is costly in the housing market, because selling a house typically requires a move, with the attendant transaction costs (such as closing costs and transaction fees).

Moreover, much of the price increase can be explained by three building blocks of the owner-occupied housing market – low interest rates, rising real incomes, and the demographics of demand. While the price-rent and price-income ratios have risen, carrying costs of debt are still within historical ranges – families are buying the houses they desire and can afford. An important source of demographic pressures on housing markets comes from increased immigration. In the 10 years preceding the 2000 Census, the number of foreign-born residents of the U.S. rose by 11.3 million, or 57 percent, compared with an increase of only 5.7 million in the previous 10-year period. As a result, the share of foreign-born individuals as a fraction of total U.S. resident population reached 11.1 percent in the 2000 Census. This compares with a 4.7 percent share in 1970 and shares ranging between 13 to 15 percent from 1860 to 1920, when immigration was dominated by flows from Europe. In short, there has been a dramatic increase in immigration to the United States since 1970.

Foreign-born residents have accounted for a sizeable share of home purchases since 1997, when the increase in house prices began in earnest. According to the American Housing Survey, there were more than 5.7 million foreign-born homeowners in the United States in 2001, and more than 20 percent of these owners purchased their first house since 1997. The surge in foreign-born first-time buyers reflects in part increased immigration in the 1980s, because it takes time for immigrants to take the financial steps toward home ownership.

A final factor in the demographic demand is that studies show that minorities accounted for over 40 percent of net new owners during the past five years. Basic demographics and continued immigration also point to continued high household formation among minorities. Harvard's Joint Center for Housing Studies notes that the number of minority households is projected to rise by 15.3 million over the next two decades, contributing a substantial portion of household growth.

Thus there appear to be solid foundations to housing price movements. In any event, the refinancing gains alone appear too small to be the pillar of the broad-based strength of consumption spending over the past several years. A study by the Federal Reserve Board estimated that the refinancing wave of 1998 and early 1999 added roughly $10 billion to consumption spending – against $6.2 trillion of consumption expenditures in 1999. Refinancing has also been high in 2001 and thus far in 2002, but the same lesson appears to apply. Freddie Mac estimates that in 2001 about $140 billion in equity was cashed out by holders of conventional conforming mortgages, with $50 billion cashed out in the first half of 2002. If a similar percentage of this equity is spent on consumption and home investment as in the earlier refinancing boom, the boost to consumption will be only a part of healthy consumption growth in these years. Instead, robust growth in personal incomes and lower prices – especially for automobiles – appear to be a more central feature of the sustained strength in household spending.

Oil Price Increases. Another potential risk is increases in crude oil prices. Oil prices have risen roughly $5 per barrel since the beginning of the year. In September the spot price of low-sulfur West Texas Intermediate crude rose above $30 per barrel for the first time since February 2001, while the OPEC basket price index (which includes both high- and low-sulfur crude oils) rose above OPEC's target band of $22 to $28 per barrel. The OPEC basket price is now roughly

Terrorist Events. The terrorist attacks indicated that the probability of catastrophic economic losses – in addition to the human toll – was higher than anticipated. While one cannot rule out another attack, two broad sets of policies may mitigate the costs. The payoff to enhanced homeland security is reduction in the risk of future terrorist events and reductions in their consequences.

Another important policy is successful completion of terrorism risk insurance legislation during the lame-duck session of Congress. The presence of potential terrorist attacks raises the degree of uncertainty in the economic environment. Property and casualty insurance is one mechanism by which economies respond efficiently to risks in the environment. Risks are spread, converting for each business a potential cost of unknowable size and timing into a set of smaller, known premium payments. The events of September 11 induced a dramatic revision in perceived risks. In normal circumstances, increased risks are translated into higher premiums. This serves the useful economic function of pricing risk, leading the private sector toward those activities where the risk is "worth it" -- there might be losses now and then, but on average society will benefit – and away from foolhardy gambles.

A well-functioning insurance market is part of the financial infrastructure that underpins our economy. The Administration has worked with Congress to bolster the capacity of private insurance markets to provide the risk-sharing services that benefit commerce and consumers. The basic approach taken encourages the private sector in several ways. First, it is forward-looking. It respects the insurance industry's proven ability to develop the capacity to price, market, and service products for new types of risks. In the past, naysayers deemed reinsurance against the risks of natural catastrophes such as hurricanes as beyond the reach of private insurance markets. Experience has proven them wrong. By providing a temporary bridge of three years, a steadily receding federal presence, and an explicit sunset, we will permit the industry to grow into this new market.

Second, because the industry shares in the losses – up to a maximum loss – there will be a strong profit motive for insurance companies – and actuaries and economists – to begin now to refine pricing models. There are economic benefits to the efficient pricing of risks. While no

covered individual company can control whether terrorists strike, efficient pricing can lead every covered company to take actions that lessen the damage that results from terrorist incidents.

External Imbalances. The recent shifts in equity markets and trade flows have caused some to raise the specter of a dramatic adjustment in the U.S. current account and exchange rates. Is this a large risk? To put things in perspective, note first that it is far from obvious that the current account deficit is not sustainable. Clearly, debt cannot increase without limit. Because debt has to be serviced, the ratio of a country's debt to its income has to stabilize at some point, otherwise, servicing the debt would eventually require the entirety of national income, a clearly unsustainable situation. However, there is no precise point at which the ratio of the current account deficit to GDP is defined to be "unsustainable." All that can be said is that an increase in the ratio means that more debt service is required. So long as investors remain confident in the policies and growth potential of the United States relative to the rest of the world, they will be willing to invest in the United States and the current account deficit can increase.

Moreover, current account deficits do not necessarily lead to sharp exchange rate adjustments. The adjustment might take place via relative national price levels – that is via the real, not the nominal, exchange rate – or, not the nominal value of the dollar – or any adjustment need not be abrupt. A gradual shift of portfolios away from dollar-denominated claims might entail a smooth nominal dollar depreciation that also would narrow the current account deficit.

Finally, even if the nominal dollar exchange rate were to depreciate sharply there need not be substantial, negative effects on the real economy. Some commentators have suggested that a sharp decline in the nominal exchange rate would drive up U.S. interest rates and depress U.S. equity prices as investors took their money elsewhere. These adjustments would slow U.S. economic activity, achieving a correction in the U.S. current account mainly through a reduction in imports. This outcome was not, however, the experience of the United States during the sustained dollar depreciation from 1985 to 1987.

Deflation. For most of the postwar era, deflation has been off on the radar screen of economic policymakers in the industrialized world. The United States has not experienced a sustained fall in the general price level since the Great Depression. Combating inflation, not deflation, has been the main goal of most central banks. Yet today's newspapers are dotted with claims that a ruinous 1930's-style deflation lies just ahead for the United States.

Modern deflation scenarios have some appeal – until you get out your calculator. To start with, analysis of the productivity data over the past six quarters confirms some of the best news that economists have delivered in a generation – the acceleration in productivity growth that began in 1995 continues unabated. While the stock market decline has gotten all of the press—and indeed, some investors overestimated the profitability of "new economy" investments—the productivity gains brought about by these investments deserve more attention. Productivity growth points to rising living standards in the future. A central lesson of modern economics is that current consumption decisions are influenced by the expectation.0001 Tc -vunuoprespre wea

is a monetary phenomenon, low aggregate demand is not likely to push the country toward in this direction.

What's Left: The Baseline Economic Outlook

This review of the popular list of "risks" to the recovery suggests an important lesson. A realistic assessment of the magnitudes involved suggests that offsetting the underlying strength of the U.S. economic recovery in unlikely. The November Blue Chip Consensus forecast anticipates that the growth rate of GDP will be 1.6 percent in the fourth quarter of 2002 and will rise gradually to reach 3.7 percent by the final quarter of 2003. These growth rates are sufficiently robust that delayed investment recoveries, oil price shocks, and equity declines each unlikely to produce a "double-dip."

The underlying strength is built on both long-term fundamentals and short-term dynamics. Over the long term, the post-1995 boom in productivity growth in the United States stands out from other industrial economies. Most economists now agree that the trend rate of productivity in the United States rose markedly after 1995 – from 1.4 percent from 1973 to 1995 to 2.5 percent from 1995 to 2000 – probably due to long-awaited payoffs from the revolution in information technology. Productivity has continued to grow at an annual rate of 3.1 percent over the past seven quarters, a period which includes both a recession and recovery, so recent data suggest that the productivity acceleration improvement remains intact.

Turning to the near-term outlook, the Administration does not prepare another official forecast until the next Budget. Still, the broad contours of the likely path are clear. After three consecutive quarters of negative growth in 2001, the U.S. economy has experienced four consecutive quarters of positive GDP growth, peaking at 5.0 percent in the first quarter of 2002. While growth did slow to 1.3 percent in the second quarter, it rose to 3.1 percent in the most recent quarter.

The starting point for upward momentum is the legacy of aggressive monetary easing by the Federal Reserve during 2001. Over the course of that year, the Fed cut its target federal funds rate eleven times, lowering the target from 6.5 percent to 1.75 percent . Given the well known lags in monetary policy, these reductions continued to provide stimulus throughout 2002. The most recent rate reduction of 50 basis points undertaken on November 6 will provide further support for the recovery in 2003.

Among components of final demand, solid consumption growth continues to provide the foundation of continued strength in the growth of GDP. Indeed, as is well known, the household sector has been a source of strength in final demand over the course of the recession and recovery. In addition to enhancing long-term economic efficiency, the tax cut proposed by the President and passed by Congress last spring provided valuable support for disposable incomes. Substantial cuts in the target federal funds rate by the Federal Reserve have translated into lower mortgage interest rates, supporting housing starts and mortgage refinancing. The upshot has been solid growth in personal consumption expenditures and residential investment that are supporting the recovery.

In addition, growth in GDP has benefited from government purchases associated with enhanced homeland security and short-run inventory dynamics; the latter are estimated to have contributed 2.6 percentage points to GDP growth during the first quarter, and 1.3 percentage points in the second quarter. Combined, these factors are likely to continue to contribute a bit in the near term, while there is little basis for expectation of dramatic aggregate demand growth stemming from the international sector.

Inventory investment contributed to the economic slowdown, but by early in 2002, the pace of inventory decline slowed, providing a significant boost to production. In some sectors of the economy, evidence suggests that inventory restocking is underway. Over the next several quarters, as inventory and sales growth come together, inventory investment's role in real GDP growth should provide momentum. As noted earlier, an assessment of the underpinnings of business fixed investment suggest conditions leading to an investment recovery.

These mechanics describe a recovery in overall GDP growth along the lines outlined in the most recent (September) NABE survey or (October) Blue Chip Survey. The median NABE forecast showed GDP growth averaging 2.9 percent over the second half of 2002, and rising steadily from 3.3 percent in the first quarter of 2003 to 3.8 percent by the final quarter. As noted earlier, the Blue Chip Consensus suggests quantitatively more modest growth rates, but a similar pattern.

Economic Policy in an Uncertain Environment

Let me close with a few remarks regarding the structure of policies in the face of risks. The first observation is that policy itself should reduce – not increase – the risks facing the economy. One source of uncertainty is the specter of failing to make the tax cut permanent, and facing the diminished growth opportunities that would follow. Princeton University economist Harvey Rosen has estimated that the marginal tax rate reductions passed in 2001 will lower the efficiency cost – the "deadweight loss" or pure drag on the economy – by roughly $40 billion in 2010. To put this figure in perspective, note that it is about the same size as last year's tax rebate of $36 billion – and it would happen every year.

Returning to a less efficient tax system reduces growth. Professor Rosen's results suggest that doing a U-turn on taxes would reduce growth by 0.15 percent annually – an impact that CBO projections would translate to $24 billion in 2010, but rise to $350 billion in 2020. The basic message is straightforward: Placing the future of pro-growth tax policy at risk raises the level of uncertainty and mitigates against rapid recovery and growth. The uncertainty may be removed by the simple act of making the tax cut permanent.

What are examples of an effective policy in the current environment? One aspect, as noted above, is to provide a temporary catastrophic backstop to ensure the functioning of insurance markets – to "crowd in" the private sector and use market mechanisms to spread risks efficiently. In addition, we have witnessed a shift away from equity investments toward safer assets. In light of the importance of productive risk-taking to economic progress, it is useful to

ensure that policies reflect an appropriate "supply" of and "demand" for productive risks. It is important to promote policies that support an ownership society with a broad-based commitment to productive risk-taking. Individual benefits to risk-taking the reflect their social productivity. Even with the most recent equity market downturn, the stock market remains above the long-run trend that prevailed in 1996 – before the large market run-up. And the return on equities for "buy and hold" long-term investors greatly exceeds "safer" bonds. For example, from 1929 to 1994, total real returns on 10-year Treasury bills averaged 1.7 percent. In contrast, the S&P yielded 6.5 percent – a risk premium of 4.8 percent.

An important aspect of reaping individual benefits from risk-taking is learning to manage risk. The starting point is investor education – an area in which the President has taken an important leadership role. On February 1, he proposed to enhance investor education of self-directed pension funds, a policy rapidly enacted by the House of Representatives. In addition to education, it is important to remove impediments to diversification and portfolio management. As part of his proposals on pension reform, the President called for the ability of 401(k) participants to diversify away from company-specific stock after three years in a plan. More generally, it is useful to recognize that taxes both impeded the rebalancing of portfolios – capital gains are taxed upon realization, for example – and lower the after-tax return to risk-taking.

Conclusion

I want to thank you for the opportunity to join this important discussion of risks facing businesses and the economy as a whole. A sensible assessment of risks is a core activity of businesspeople and policymakers. However, at the conclusion of such an exercise, I believe that the upward momentum of the current economic recovery exceeds the likely impact of the most prominently discussed risks facing our economy.