

## **THE OUTLOOK FOR THE ECONOMY AND FOR POLICY**

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Thank you for inviting me to speak with you today. My remarks will focus on the current state of the economy and on some issues of economic policy, but of course such an overview would be incomplete without an eye to the human and economic impacts of the recent hurricanes in the U.S. Gulf Coast.

As you know, Hurricane Katrina wreaked unprecedented losses on the people of the Louisiana, Mississippi, and Alabama coasts. Many lives have been lost, communities have been destroyed, and a vital portion of our nation and our economy has been shaken. The President has directed all agencies of the federal government to devote their maximum effort to helping the victims of Katrina and begin the process of cleaning up and rebuilding the region, and he has proposed a series of measures to restore the Gulf's communities and economy. The Gulf was also hit over the weekend by a second large storm, Hurricane Rita, which did significant damage but, in most areas, less than was feared.

One of the greatest assets we have in rebuilding after a hurricane is the overall strength of the national economy. The resiliency of the economy—the product of flexible labor markets, a culture of entrepreneurship, liquid and efficient capital markets, and intense market competition—is helping it to absorb the shocks to energy and transportation from the hurricanes, and the ability of our economy to grow and create jobs will act as a lifeline to the regions and people that have been most affected. Thus these recent events make it all the more important that we keep the fundamentals of the national economy strong and continue to promote economic policies that will encourage growth and job creation.

## **The State of the Economy**

In thinking about where the economy is and where it is heading, it is useful to keep in mind just how far the U.S. economy has come in recent years. The economy's resilience was put to severe test during the past five years, even prior to Katrina. A remarkable range of shocks hit the U.S. economy, beginning with the sharp decline in stock prices in 2000 and the recession that followed in 2001. The economy was further buffeted by the terrorist attacks of September 11, 2001, of which we recently observed the fourth anniversary, and the subsequent geopolitical uncertainty. Business and investor confidence was shaken by a series of corporate scandals. By early 2003, uncertainty about economic prospects was pervasive and the economy appeared to be sputtering.

Yet, in the face of all these shocks, together with new challenges such as the recent sharp rise in energy prices, the American economy has rebounded strongly. Policy actions taken by the President and the Congress were important in helping to get the economy back on track. Notably, beginning with the President's 2001 tax cuts, multiple rounds of tax relief increased disposable income for all taxpayers, supporting consumer confidence and spending while increasing incentives for work and entrepreneurship. Additional tax legislation passed in 2002 and 2003 provided incentives for businesses to expand their capital investments and reduced the cost of capital by lowering tax rates on dividends and capital gains.

Together with appropriate monetary policies, these policy actions helped spur economic growth in both the short-run and the long-run. Today the U.S. economy is in the midst of a strong and sustainable economic expansion. Over the past four quarters real GDP has grown at a 3.6 percent rate, and over the past eight quarters real growth has been at a 4.1 percent annual rate. Prior to Katrina, the near-term forecasts of both CEA and private-sector economists had called for continued solid growth. The destruction wrought by Katrina and Rita may reduce growth somewhat in the short run, but the longer-term growth trajectory remains in place. I'll return to economic prospects in a moment.

An important reason for the recovery has been improved business confidence. To an extent unusual in the postwar period, the slowdown at the beginning of this decade was business-led

rather than consumer-led. Homebuilding and purchases of consumer durables did not decline as they typically do in cyclical downturns; instead the primary source of weakness was the reluctance of businesses to hire and to invest. Supported by appropriate fiscal and monetary policies and by the economy's innate strengths, business confidence has risen markedly in the past few years. The effects are evident in the investment and employment data. From its trough in the first quarter of 2003, business fixed investment has increased over 21 percent, with the biggest gains coming in equipment and software. Since the labor market bottomed out in May 2003, more than 4 million net new payroll jobs have been added. So far in 2005, payroll jobs have been added at a pace of more than 190,000 per month. The unemployment rate fell over the summer to 4.9 percent, well below its average level of the 1970s, 1980s, or 1990s. News from the jobs front has thus been quite encouraging.

Although growth in GDP and jobs capture the headlines, one of the biggest economic stories of the past few years is what has been happening to productivity. Productivity growth is the fundamental source of improvements in living standards and the primary determinant of the long-run growth potential of the economy. Over the past four years, labor productivity in the nonfarm business sector has grown at a 3.4 percent annual rate, and productivity in manufacturing has risen at a 5.7 percent annual rate. Productivity growth has slowed recently as businesses have absorbed millions of new workers—a normal development for this stage of an economic expansion—but it remains (in the four quarters ending 2005:Q2) at the quite respectable level of 2.2 percent (and 6.3 percent in the nonfinancial corporate sector). Thus, on each of three key indicators of the real economy—GDP growth, job creation, and productivity growth—the United States in recent years has the best record of any major industrial economy, and by a fairly wide margin.

Finally, high energy prices notwithstanding, inflation remains well-controlled. Core inflation (as measured by the consumer price index excluding volatile food and energy prices) has averaged 2.1 percent over the past twelve months, and recent readings continue to be low. The favorable inflation environment is widely expected to persist. For example, expected inflation over the next ten years as inferred from inflation-indexed Treasury bonds stands at about 2.5 percent per year, down from earlier this year.

## **Short-Term Outlook**

Looking forward, most private-sector economists expect healthy growth in the longer run. In the shorter term, the devastation wrought by hurricane Katrina, and to a lesser extent by Rita, will have a palpable effect on the national economy. In particular, the virtual shutting-down of the Gulf Coast economy will leave its imprint on the national rates of job creation and output growth, especially in the third quarter, while recovery and rebuilding should ultimately increase growth rates and rates of job creation, perhaps by the fourth quarter and certainly in the first half of next year.

Katrina's economic impact included significant damage to the country's energy infrastructure, as you know, and the shutdown of a substantial portion of U.S. refining and pipeline capacity in particular led to a spike in gasoline prices in the weeks after that storm. Prior to Rita, whose arrival prompted precautionary shutdowns of many facilities, substantial progress had been made in repairing damaged facilities and restoring electric power. The federal government assisted, in among other ways, by lending or selling oil from the Strategic Petroleum Reserve, arranging for additional shipments of oil and refined products from abroad to the United States, and providing appropriate regulatory waivers to increase the flexibility of the energy supply chain.

Consequently, near-horizon futures prices for oil and gasoline declined substantially in the weeks after Katrina, and retail gasoline prices fell about thirty cents from their post-Katrina peak.

Energy prices rose again with the advent of Rita, but in the past few days they have receded in light of what has been, thus far, generally favorable news about Rita's impact on the energy infrastructure. It seems likely that retail gasoline prices in most areas of the country will fall in the next couple of months close to the levels seen this past summer, before the hurricanes hit.

Natural gas prices may remain elevated somewhat longer, however, because of damage to plants that process natural gas for final use.

Even as the energy sector recovers from the effects of Katrina and Rita, it remains true that the prices of oil and natural gas have risen sharply in the past two years, reflecting a tight balance of supply and demand. High energy prices are burdening household budgets and raising production costs, and continued increases would at some point restrain economic growth. Thus far at least, the growth effects of energy price increases appear relatively modest. The economy is much

more energy-efficient today than it was in the 1970s, when energy shocks contributed to sharp slowdowns, and real energy prices remain below the peaks attained in the 1970s and early 1980s. Well-controlled inflation and inflation expectations have also moderated the effects of energy price increases, since those increases no longer set off an inflation spiral and the associated increases in interest rates, as they did three decades ago.

### **Economic Policies and Economic Growth**

In the near term, some of the most crucial policy decisions will involve the response to the Katrina disaster. Sectors in the Gulf region, such as energy and agriculture, play a significant role in our economy. The region should be rebuilt and the Federal government has an important role in helping the victims and assisting in the rebuilding of critical infrastructure. Ultimately, however, the private sector, not the public sector, must lead the rebuilding effort. To facilitate that rebuilding, the President proposes to make the area what he has called the Gulf Opportunity Zone, or GO Zone. Within the opportunity zone, tax incentives for investment, including generous expensing provisions, and loans and tax incentives for small businesses will incentivize the private sector to take the lead in the rebuilding effort.

The President also proposes to promote ownership by providing assistance to victims in the form of vouchers rather than in kind. He has proposed to create Worker Recovery Accounts that will give unemployed workers up to \$5,000 to spend on training, child care, transportation, relocation, and other items that will help them find new work. These accounts, modeled after the Personal Reemployment Accounts proposed by the Administration in 2003, are based on the premise that workers themselves, rather than a government bureaucracy, are the best judges of what they need to do to become productively re-employed. Recovery will be supported in many other ways, as well; for example, the President proposed an Urban Homesteading Initiative to try to help lower-income evacuees build their own home and on Friday the federal government announced implementation of housing assistance for those who have been displaced. Federal authorities have also been working with states and localities to ensure that they are reimbursed for the costs they incur to educate and provide medical care to Katrina evacuees.

We must also keep working for good policies for the national economy. The Bush Administration has emphasized that good tax policy is an important source of economic growth. Tax relief played a central role in the economic recovery of recent years by reducing marginal tax rates and creating incentives for firms to invest and hire workers. The President continues to work with Congress to make tax relief permanent. The President has also appointed an advisory panel to make recommendations on how the tax code can be reformed to make it simpler, fairer, and more conducive to growth. Because of the need for the Administration and Congress to focus their energies on responding to the impact of hurricanes Katrina and Rita, the panel's work has been briefly delayed, but their recommendations will be presented in due course and will doubtlessly be a valuable contribution to the tax policy debate.

To make tax relief more effective, government spending needs to be controlled. Unfortunately, the costs of rebuilding after Katrina will be substantial, reflecting the extensive damage done by the storm. These costs cannot be avoided, given our commitment to help the victims and to restore the Gulf coast infrastructure, as is required to allow that economically important region of the country can return to normal. We must ensure, however, that the funds we commit are spent wisely and with careful oversight. We need to use the substantial controls and safeguards in place and in law now to prevent improper use of funds. Katrina will require all of these systems to be up to the task and scaled up just as spending is being scaled up. For example, a special inspector general has been appointed at the Department of Homeland Security specifically for the response to hurricane Katrina.

Every effort should also be made to offset the cost of Katrina with reductions in other government programs, most especially those which have proven to be wasteful, duplicative, or ineffective. The President has directed the Director of the Office and Management and Budget to revisit the budget to identify potential savings. One good step would be for Congress to revisit the Administration's 2006 budget proposal and to reconsider the proposed cuts in spending and programs not incorporated in the Congressional budget resolution. The President remains committed to halving the federal budget deficit by 2009, and I believe that that goal remains feasible despite these added costs.

For the longer term—I am speaking now of the outlook over the next few decades—budget discipline will require controlling entitlement spending, notably spending on Social Security and Medicare. The President has called for reforms to Social Security to make it permanently solvent, to do so in a progressive manner that will keep the system an effective safety net for lower-income retirees, and to give all workers, including low-income workers, the opportunity to build retirement wealth by investing a portion of their payroll taxes in voluntary personal accounts.

Medicare poses particularly difficult long-term budget challenges. Although the American health-care system has many strengths, including a high level of technological sophistication, the continually rising costs of health care have made Medicare an increasingly heavy burden on the federal budget while raising costs for families and employers as well. Additional concerns about our health care system include inadequate portability of health insurance between jobs and the fact that many people remain uninsured. The President has made a number of proposals to improve coverage and to make the health-care system more consumer-driven, which will increase quality and reduce costs.

A key element of the strategy to make the health-care system more responsive and effective is the Health Saving Account, or HSA, created as part of the Medicare Modernization Act of 2003. HSAs allow individuals or families to pay for health care with before-tax funds, so long as their health insurance policy includes a sufficiently high deductible (\$1,000 for an individual, \$2,000 for a family) and catastrophic coverage (a limit on out-of-pocket expenditures). HSAs, which are increasing rapidly in popularity, have many advantages: the funds in an HSA may be rolled over indefinitely, the account is portable between employers, and the greater affordability of high-deductible policies will make it easier for small businesses to offer coverage as well as strengthen the non-employer market for insurance. Importantly, HSAs provide consumers greater incentive and ability to take charge of their own health care; together with other measures to improve information and increase competition in the health-care industry, the empowerment of consumers will help to reduce cost and increase quality.

The Administration has been active in a variety of other policy areas. Recent developments bring home to us the need to strengthen our energy security. In August, President Bush signed an energy bill that will encourage energy efficiency, promote alternative energy sources, modernize the electricity grid, and ultimately reduce our dependence on foreign sources of energy. Among its many measures, the bill provides tax credits for energy-efficient hybrid, clean-diesel, and fuel cell vehicles; promotes the use of renewable energy sources, including wind, solar, and biomass energy; expands research into developing hydrogen technologies; and encourages the development of clean coal and nuclear technologies. The experience of Katrina suggests that we should take another look at the issue of refinery capacity in the United States. Although existing refineries have expanded their capacity somewhat, no new refinery has been built in this country for more than thirty years. Refineries are running as hard as they can, and we are importing more gasoline. Katrina and Rita have demonstrated the potential vulnerability of our existing capacity. To the extent that adding refinery capacity can be made consistent with the maintenance of a clean environment, we should consider measures that will advance that objective.

Finally, we must continue to promote economic opportunity in America. Strong rates of economic growth and job creation are essential for attaining this objective. But we also need to ensure that people have the education, training, and skills that will allow them to take advantage of a strengthening job market. The Administration has made education and job training a priority. On the education front, building on the early success of the No Child Left Behind Act of 2001, the President has proposed to continue to challenge public schools, including high schools, to demonstrate quantifiable progress in teaching both basic and more advanced skills. Supporting school choice, perhaps initially on a pilot or experimental basis, will give parents and students the option to leave failing schools while creating incentives for those schools to improve. On job training, the federal government currently disburses about \$15 billion in funds annually through more than 40 separate programs. The President's Job Training Reform Proposal would provide a greater bang for these fifteen billion bucks, by consolidating the funds into a smaller number of programs and providing governors greater flexibility and accountability to manage these funds. The President supports Congress' recent approval of \$250 million for job training grants for vocational schools and technical colleges. I have already alluded to the



President's proposal to create Personal Reemployment Accounts. These accounts would provide unemployed workers a fixed sum of funds to use at their discretion in ways that help them find productive new work.

### **Conclusion**

In sum, the American economy remains one of the most resilient in the world. It recovered vigorously from the severe shocks it experienced between 2000 and 2003, and I believe that it will sustain growth in the face of the new challenges brought by the two hurricanes and recent high energy prices. Much of the credit for this resilience goes to American workers, employers, entrepreneurs, and investors, as well as to our market-based economic system itself. But economic policies have an important role to play in creating an environment in which the nation's economic potential can be fully realized.

Thank you.