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 tragedy of Hurricane Katrina.

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. Shortly after the tragedy I attended several meetings in which the President spoke in moving terms about the challenges that people on the Gulf Coast are facing, and he 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. The President will be delivering an address to the Nation tonight about the relief efforts and steps to help the region's economy.

One of the greatest assets we have in rebuilding after Katrina is the overall strength of the national economy. The resiliency of the economy is allowing it to absorb the shocks to energy and transportation from the hurricane, and the ability of our economy to grow and create jobs will act as a lifeline to the regions that have been most affected. Thus the disaster makes it all the more important that we keep the fundamentals of the national economy strong and that we continue to promote economic policies that will encourage growth. Significant challenges will have to be met in the months and years ahead, but I remain confident that the communities on the Gulf Coast will be rebuilt, and that the Gulf economy and the U.S. economy as a whole will emerge from this tragedy as strong as ever.

The Current State of the Economy

As I just noted, one of the most impressive aspects of America's market economy is its resilience and adaptability, which if anything have increased over time. Flexible labor markets, a culture of entrepreneurship, efficient and highly liquid financial markets, and intense market competition all help to explain the ability of the economy to perform well even in difficult circumstances.

The economy's resilience has been 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 observed the fourth anniversary this week, and the subsequent geopolitical uncertainty. In 2002 a series of corporate scandals further shook business and investor confidence. 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. 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.

Policies outside the tax arena were also helpful. For example, the President and the Congress addressed the aftermath of 9/11 and the associated geopolitical uncertainty by creating the Department of Homeland Security, supplying reconstruction funds for cities hit by terrorism, providing temporary relief for certain industries (such as airlines), and by passing the Terrorism Risk Insurance Act, to temporarily help make insurance against the risk of terrorism more broadly available for commercial properties. Other legislation provided targeted relief for small businesses and temporarily extended the period that workers could draw unemployment benefits.

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. Katrina's effects 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 has fallen to 4.9 percent, 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 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, perhaps by the fourth quarter and certainly in the first half of next year. Of course, the economic consequences of this devastation are secondary to the human impact, and for now the top priority for all of us in government is to help those displaced by the disaster to put their lives back together.

Katrina's economic impact included 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. Substantial progress has been made in repairing damaged facilities and restoring electric power, and the government has assisted, among other ways, by providing oil from the Strategic Petroleum Reserve and arranging for additional shipments of oil and refined products from abroad to the United States. Consequently, near-horizon futures prices for oil and gasoline have already begun to moderate substantially, and retail prices should follow them down very soon.

Although it looks as if the effects of Katrina on energy markets will be contained, it remains true that the prices of oil and natural gas have risen sharply in the past two years, reflecting a tight balance of global 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.

Long-Term Economic Policies and Economic Growth

In the wake of Hurricane Katrina, a critical objective for policy will be helping to restore the communities and the economy of the Gulf Coast. We must also continue the types of economic policies that have brought us through these shocks and that will ensure continued healthy growth. These policies include making tax relief permanent, reducing the budget deficit by limiting spending, strengthening retirement and health security through efforts like Social Security reform, fostering a healthy and well-educated workforce, promoting fair and open trade, and enhancing energy security.

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, increasing disposable income, 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 hurricane Katrina, 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. This year the President's budget proposes to cut non-security discretionary spending by 1 percent from last year's level; it does this by eliminating or substantially reducing numerous duplicative programs and providing only limited increases to others. We are already on track to reduce the budget deficit over time. In the mid-session review of the budget, the Office of Management and Budget was able to report that strong economic growth this past year increased tax revenues more than expected, reducing the estimated 2005 budget deficit by $94 billion (to $333 billion, or 2.7 percent of GDP). As of June, tax receipts were running 13.8% higher than a year earlier. This development puts the federal government ahead of schedule to meet the President's target of cutting the deficit in half by 2009. The costs of rebuilding after Katrina are of course substantial and will add to the budget deficit in the near term; incurring those costs is essential if we are to repair the unprecedented damage wrought by that natural disaster. This necessary spending should not, however, jeopardize the President's long-term deficit reduction goals.

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 and to do so in a progressive manner that will keep the system an effective safety net for lower-income retirees. Social Security has an $11 trillion unfunded liability that cannot be ignored for long.

The President has also proposed to give all workers, including low-income workers, the opportunity to build retirement wealth by investing a portion of their payroll taxes in a voluntary personal account. Voluntary personal retirement accounts in Social Security would give workers a greater sense of ownership and control over their retirement assets; by enhancing financial education, they may also stimulate workers to do additional saving on their own.

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.

To make insurance easier to obtain for those currently without it, the President has proposed to provide financial assistance to individuals or families who enroll in HSA plans, with additional options for low-income individuals. He has also proposed the creation of Association Health Plans, which would allow small businesses to join together to purchase health insurance for their employees. Reform of medical liability laws, another important measure supported by the Administration, would help to lower costs by reducing defensive medicine and the costs of litigation. The President also supports initiatives to make better use of modern information technology in the provision of healthcare

Medicare and Medicaid will also be improved by greater competition and flexibility. Medicare beneficiaries now have the option to choose among competing health insurance plans, including plans that implement Medicare's new prescription drug benefit. Competition is already lowering the costs and improving the quality of the program. To strengthen Medicaid, which provides medical services to low-income Americans, the President's budget includes proposals to increase the flexibility with which states administer the program.

An effective workforce must be not only healthy but also have the education, training, and skills needed to support a modern economy. 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.

The President has also proposed reforms to Federal student aid programs that reduce lender and guaranty agency subsidies and other program costs and redirect funds to the Pell Grant program to help low-income students pay for college. His budget increases the maximum Pell award by $500 over five years, helping more than 10 million needy students cover the costs of college.

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 from 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. In the spirit of giving people out of work more control over their job search and retraining, the President has proposed the creation of Personal Reemployment Accounts. These accounts would provide unemployed workers a fixed sum of funds to use at their discretion (e.g. retraining, child care) in their search for a new job. Recipients would retain any balance in the account remaining when they find new work, a powerful incentive to engage in active job search.

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.

Finally, the President recognizes that we can count on continuing growth only if we reject economic isolationism and engage fully in the world economy. To open new markets and new opportunities for American firms and workers, the President, using his Trade Promotion Authority, has completed trade agreements with twelve countries since assuming office, and he recently signed the CAFTA-DR agreement, which lowers barriers to trade with our neighbors in Central America and the Dominican Republic. The President has recently challenged the world to lower tariffs and trade-distorting subsidies as part of ongoing Doha Round trade negotiations.

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 hurricane Katrina 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.