THE ECONOMIC OUTLOOK

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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, but of course such an overview would be incomplete without an eye to the tragic aftermath of Hurricane Katrina.

Katrina wreaked unprecedented losses on the people of the Louisiana, Mississippi, and Alabama coasts. Untold lives have been lost, communities have been destroyed, and a vital portion of our nation and our economy has been shaken. Federal, state, and local governments are doing everything possible to assist the victims with water, food, shelter, and other basic necessities of life. Last week 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 beginning the process of cleaning up and rebuilding the region.

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

Turning to the topic of this meeting, I will review some recent developments, as well as the prospects, for the U.S. economy. Those of us whose job it is to monitor the economy follow literally hundreds of economic data series, but four are particularly crucial: (1) the gross domestic product, the basic measure of aggregate economic activity; (2) the unemployment rate, which (together with key employment statistics such as payroll employment) measures the utilization of our labor resources; (3) productivity growth, a fundamental determinant of how fast the economy and living standards can grow; and (4) inflation, a basic indicator of monetary and financial stability. In brief, for the past several years each of these indicators has been signaling a strong economy: GDP has grown at a healthy pace, labor market conditions have continued to improve, productivity growth has been strong, and—with the important exception of energy prices—inflation has been low. In my comments I'll briefly touch on each of these indicators.

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, 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. Targeted policy actions taken by the President and the Congress, together with supportive monetary policies, 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 to work and save. 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. 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, which helped 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. The Sarbanes-Oxley Act of 2002 and other measures helped to strengthen corporate governance and restore faith in the integrity of financial markets. Together with appropriate monetary policies, these policy actions helped to stimulate economic growth. 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 this quarter and next, but the longer-term growth trajectory remain 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—my second key indicator, you will recall—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—the third key economic indicator. 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. As someone who received his economic education during the 1970s, a time during which productivity gains virtually vanished, I find these numbers impressive indeed. 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). On each of these 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.

These favorable economic developments are already being translated into higher living standards. Real disposable income per person has been rising at about a 1.6 percent pace since 2001, with tax relief responsible for half of those gains. Household wealth has recovered substantially from the effects of the stock market collapse and is currently $49 trillion; this figure is about 5.4 times disposable income, above the long-run average ratio of 4.8. Increases in financial assets as well as increased home values have contributed to these gains in wealth. Wages and salaries, however, have not performed as well; real wages of production workers, for example, have been essentially flat in the past couple of years. Rapid increases in energy prices are one reason for slow growth in real wages; another is the increasing cost of employer-provided health insurance, which has reduced the share of total compensation taken in the form of take-home pay. However, in the past, when real wage growth has lagged behind productivity growth—as has been the case recently—real wages have tended to catch up over time. There is consequently reason for optimism that real wages will grow more quickly as the labor market continues to strengthen.

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 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 2.4 percent per year, down from earlier this year.

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 in the third and fourth quarters,

while recovery and rebuilding should increase growth rates 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 gasoline have already begun to moderate, 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.

Some observers have also expressed concerns about housing prices, which have risen rapidly in the past few years. In my view, although speculative forces may be at work in some local areas, recent house price increases are attributable mainly to economic fundamentals, including growing incomes and jobs, low mortgage rates, demographic factors, and limited supply in some areas. Those fundamentals have helped lift the national homeownership rate to nearly 69 percent in the second quarter of 2005, near the all-time high set last year. At the same time, it is unlikely that house prices will continue to rise rapidly; instead, they are more likely to flatten out and may even decline in some local markets. Slowing appreciation in house prices may lead to a more moderate pace of housing starts than we have seen recently (though Katrina may change this calculus as well, depending on the scale of the reconstruction effort). However, this potential slowdown in the housing market is already built into most forecasts, such as the Blue Chip forecast which (pre-Katrina) anticipated economic growth in 2006 slightly slower than this year but still strong.

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.

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 deficit, strengthening retirement and health security, fostering a healthy and well-educated workforce, promoting fair and open trade, and enhancing energy security. Getting the fundamentals right is the best thing economic policy can do. The energies and creativity of the American people and the flexibility of our market system will do the rest.

Thank you.