Economic Outlook and Economic Policy

Remarks
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Assessing the Economic Outlook

It is useful to begin with the broad setting for the U.S. economic outlook and policies. Over the long term, productivity growth is the most important determinant of growth and living standards. The structure of an economy, including the institutional and legal framework that support markets, is the key influence on productivity and thus on the sustainable rate of economic growth. Historically, the U.S. model is an undeniable success in this respect.

In particular, the post-1995 boom in productivity growth in the United States stands out from other industrial economies. Many have attributed this productivity acceleration to the development of new technologies. While this attribution carries a grain of truth, businesses around the world can all buy the same technology, so the roots of the U.S. advantage lie elsewhere. The U. S. model – a flexible, market system – provides rewards to entrepreneurial, private-sector investment that deploy these technologies in productive risk-taking. The preservation and support of these incentives is central to long-term productivity growth.

The recent behavior of inflation also bodes well for the long term. Inflation remains low and stable in the United States, with minimal impact on economic decisions such as the ability of businesses to plan for the future. The absence of inflation pressures also means that the Federal Reserve would have policy room in which to maneuver in the near term.

Regarding the near-term outlook, as the Administration does not prepare another official forecast until the next Budget, I would like to walk through the expected mechanics of the current recovery and how recent data affect economists' forecasts of the recovery.

After three consecutive quarters of negative growth in 2001, the U.S. economy has experienced three consecutive quarters of positive GDP growth, peaking at 5.0 percent in the first quarter of 2002. While growth did slow to 1.1 percent in the second quarter, the rate is consistent with the now-familiar mechanics of the present economic recovery. 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, with the most recent reductions occurring in December 2001. Given the well-known lags in monetary policy, these reductions will continue to provide stimulus throughout the remainder of 2002 and beyond.

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 1.4 percentage points in the second quarter. 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.

However, the key to transforming recovery into 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. 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. Moving toward faster capital-cost recovery – in the extreme, full expensing of investment outlays – represents an important step toward fundamental reform of the U.S. tax code.

In addition to being sound long-term tax policy, these provisions provide valuable support for an investment recovery. Moreover, the interest rate environment remains favorable and the corporate profitability appears to be improving. As reported in the National Income and Product Accounts, profits from domestic operations have increased 14.1 percent (not annualized) during the past three quarters. The gain in profits is partly accounted for by very modest growth of unit labor costs. Productivity grew 4.9 percent during the past four quarters (a period that includes recession and recovery) – and quite rapidly during the first quarter. The Employment Cost Index measure of hourly compensation growth was stable at about four percent, allowing profit margins to expand. Given the stronger fundamentals, investment should recover, something that has been hinted at by recent evidence on orders for durable goods and surveys of purchasing managers' intentions.

Of course, there are risks to this outlook. For example, the decline in equity prices since the end of May – reflecting shifts in the equity risk premium and concerns over, among other things, profitability and the quality of financial data – represents a clear loss of household wealth through direct holdings and 401(k) and retirement plans. Indeed, the current business cycle is

somewhat unique in this regard. During a typical cycle, household balance sheets are relatively stable, while flows of personal income suffer and subsequently recover. In contrast, during the current episode personal income – especially disposable personal income, supported by the tax cut – has held up quite well, while household balance sheets have suffered.

Weakness in household balance sheets 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 overwhelm the upward path of the recovery. Moreover, the reduction in GDP would be a transitory event, with GDP returning to its former path after three years or so.

Among the possible factors underlying the recent move in equity markets are a global rise in the equity risk premium and U.S.-specific concerns over the quality of reported corporate earnings. In this regard, the United States took quick steps to ensure that financial reporting met sufficient standards of transparency and accountability. The President outlined a ten-point plan to improve corporate responsibility and provide incentives for prompt, clear disclosure of relevant economic information. Congress recently complemented this effort with the Sarbanes-Oxley bill, which the President supported and signed into law on July 30.

It is important to recognize the link between economic diagnosis and policy response. A central lesson of the long boom in the United States has been the reliance on private markets to allocate capital. By improving the information available in capital markets, investors will be better able to pursue their desired combinations of risk and return, and equity market valuations will reflect investment opportunities better.

Another potential risk is increases in crude oil prices. Oil prices have risen roughly $10 per barrel recently. The spot price of low-sulfur West Texas Intermediate crude has risen 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) has remained within OPEC's target band of $22-$28. A sustained increase in oil prices of $10 per barrel would be expected to lower GDP by about 0.25 to 0.50 percent after six months to one year. Larger increases pose a more substantial risk.

Some commentators focus on the return of U.S. federal budget deficits as a risk to economic recovery; indeed, in the minds of some, proposals to *raise* taxes become necessary. Despite essentially no empirical evidence that moderate changes in budget surpluses are related to long-term interest rates, proponents of this view argue that increasing the budget surplus is the key to faster growth. In reality, these concepts are linked. However, the causal links are reversed – a stronger economy produces higher revenue and larger surpluses.

At present, the budget is on track to return to unified surplus in the middle of the decade, with the near-term shortfalls reflecting primarily the combined influences of recession, the need to prosecute the war on terrorism, and the demands of homeland security. In this setting, the greatest economic risk associated with the budget is failing to prioritize national needs and control the growth of spending. Spending discipline limits the need for growth-reducing taxes in the present and future. Pro-growth tax policies that lower marginal tax rates and reduce the tax on productive risk-taking are good long-run policies to build budgetary resources over the long-term. Economic growth is a direct consequence of millions of individual decisions to produce, save, and invest. Any added tax burden today would be a step in the wrong direction.

Of course, there are upside wild cards as well. An important recent development for the long-run growth outlook was the passage of Trade Promotion Authority (TPA) legislation. Having signed TPA into law, the President has the authority to pursue an ambitious agenda of agreements to enhance global free trade, with benefits in the United States and the world economy.

To summarize, the U.S. economy has faced serious challenges during the past year. The policy response has been an aggressive monetary easing paired with advances in fiscal policy

and structural reform. In the former, tax policy has focused on long-run fundamentals – lower marginal tax rates, faster capital cost recovery as incentives for investment, and recognition of the need for spending restraint. Structural reforms have focused on the role of increased transparency and accountability in financial reporting in providing improved performance of capital markets.

Recalling Lessons of the Long Boom

One of the lessons of the past two decades is the centrality of private firms and markets in superior economic performance, their ability to drive innovation and growth, and the importance of maintaining vigilance against impaired market incentives.

Deregulation, reductions in marginal tax rates, and victory in the Cold War fueled a long boom in the United States that was interrupted only briefly during the early 1990s. Despite the success of the long boom, during the 1990s a new orthodoxy took root in Washington. While ostensibly adherent to market principles, this view placed the government at the center of good economic performance. A recent manifestation of this orientation has been the focus on accumulating government budget surpluses as the key, at times to the exclusion of good economic performance.

It is remarkable that we hear it suggested that growth-oriented tax policy might be making matters worse, and some urge its repeal. Economic growth is a direct consequence of millions of individual decisions to produce, save, and invest. Entrepreneurs are at the heart of this equation.

Recent research shows that cutting marginal tax rates allows entrepreneurial businesses to grow faster, enables greater purchases of capital, and allows small business to afford workers and increase payrolls. Reductions in marginal tax rates also improve access to capital and the vitality of the entrepreneurial sector. These impacts are not confined to the income tax. The estate tax acts as a tax on entrepreneurship. While entrepreneurs constitute a minority of people, they are

three times more likely to be subject to the estate tax, making the tax a drag on asset accumulation and risk-taking in 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.

Some commentators argue that this misses an important offsetting channel to the extent that *repealing* the tax cut would promote growth by reducing long-term interest rates and stimulating investment spending. While this claim is generally asserted, some reflection is instructive. First, the tax cut must be repealed—including the 10 percent bracket—without without any other legislative add-on. Second, Congress must actually save every dollar of the incremental funds. If so, the estimates of effects of changes in the government budget surplus on interest rates in recent work by Gregory Mankiw of Harvard University and Douglas Elmendorf of the Federal Reserve Board suggest interest rates would decline by roughly 35 basis points or so. I am skeptical that the effects of these changes in long-term interest rates on GDP growth are comparable to the direct incentive effects.

The economics of pro-growth tax policy looks good by comparison.

Emphasizing Productive Risk-Taking

I want to highlight one aspect of the lessons of the long boom that is of particular importance in the current setting – productive risk taking. As I have emphasized earlier, productivity growth is the fundamental determinant of long-run economic success. And productivity growth reflects the success of our economy in identifying, developing, and deploying new innovations and technologies. For this reason, capital allocation – channeling scarce savings to the right capital investments – is the key to efficiently using investment funds to generate productivity growth.

At the heart of this process lie our financial markets – the most efficient and flexible mechanism yet discovered for allocating funds to risky ventures. Financial markets serve the socially invaluable role of distributing investment dollars to the most promising firms and distributing the risk associated with investments to those most willing to bear it. In the aftermath of the recent accounting and corporate governance failures, the President and Congress have undertaken important efforts to improve the timeliness, completeness, and transparency of financial disclosure, which will serve to improve the performance of our capital markets.

However, at the same time we have witnessed a shift away from equity investments toward safer assets. While some commentators have focused on issues in corporate governance in the United States, it is important to recognize that this shift is global in scope. This argues against explanations that are specific to the United States alone, and is indicative a rise in the risk premium associated with equity investments.

What is the source of this rise in the risk premium and how should it affect views of economic policy? To some extent, global markets may be reflecting greater risks associated with the economic recovery in the United States, which has clear implications for the worldwide pace of economic growth. Some of the underlying uncertainty also relates to policy. While Congress has finally passed, and the President signed into law, Trade Promotion Authority legislation, pro-growth policies like making the tax cut permanent, passing terrorism risk insurance, and demonstrating the spending restraint called for in the President's budget remain unresolved. To

the extent that the commitment of the United States to pro-growth policies is resolved, this source of uncertainty may be readily resolved in the policy process.

However, the evident rise in the risk premium may reflect as well a rise in aversion to risk by equity investors. 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. The President has taken a leadership role in supporting the research, entrepreneurs, and firms that undertake risky investments. The largest Federal investment of research dollars provides a foundation of basic research on which innovation may develop. Lower marginal tax rates and elimination of the death tax support the start-up, survival and growth of entrepreneurial ventures. Permanent extension of the R&E tax credit will support new technologies. And expensing of 30 percent of new investment provides incentives to adopt new technologies and modernize facilities.

These policies serve to reduce the hurdle rate of return for a new risky investment. Partial expensing of new capital investments has reduced the cost of corporate capital equipment by 2.4 percent. Lowering the marginal tax rates has a comparable impact on small business and entrepreneurs who file under the individual income tax. In each case, the impact of these policies has been to lower the barriers to investments in productive, if risky, activities.

It is equally important to devote attention to the other side of the market for investment funds and 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.

These facts are a reminder that at the core of an ownership society is a reduction in the tax-based impediments to saving and wealth accumulation. In the near-term, it is desirable to make permanent the marginal tax rate reductions in the President's tax cut. Over the long-term, the United States must continue down a path of fundamental tax reform that promotes saving, investment, and international competitiveness.

Extending Pro-Growth Policies to International Economic Policy

Let me close by noting that the President is engaged as well in enhancing the globalization of productive risk-taking and the philosophy of an ownership economy. A longstanding question in development economics has been succinctly put by Nobel Prize winner Robert Lucas, who asked why capital does not seem to flow to the poorest countries. After all, in such countries, with investment and growth at very low levels, marginal returns to capital accumulation would likely be high, so capital should flow in from richer countries. Also, domestic citizens in those countries should save and allocate their saving to these same high-return projects.

An important piece of the puzzle is that developing financial capacity for growth is more complicated in practice than in theory. Clearly defined rules of law, accounting, and investor protection are required to make external financing by firms, investment, and growth possible. These linkages are important; research by economists has identified large effects of "good governance" on the cost of capital, investment, and growth. Simply trying to attract foreign

capital via efforts at financial liberalization or aid that ignore this critical link to building private-sector financial capacity are unlikely to generate growth.

Likewise, in discussions of emerging markets, it is essential to observe that economic growth is the key to improving living standards. Economic growth does not appear like manna from heaven. Instead, pro-growth policies are important. Over the long term, good policies are needed to achieve growth. Proper domestic policy choices are not only in the direct interest of individual countries, but are required for assistance from international financial institutions to be useful. The central economic policy issue is not how to use international financial institutions to provide assistance, but to ensure that policies promote economic growth.

The President's international agenda – global free trade, Millenium Challenge Accounts, and emerging markets strategies – place an emphasis on building the infrastructure for capital markets improves both the response to inflows of capital and the capacity for domestically-generated growth.