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THE ECONOMIC OUTLOOK

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BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED NINTH CONGRESS

FIRST SESSION

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THE ECONOMIC OUTLOOK

THURSDAY, OCTOBER 20, 2005

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC

The Committee met, pursuant to notice, at 10 a.m., in room 311, Cannon House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Representatives Present: Saxton, Ryan, English, Paul, Maloney, Hinchey, and Sanchez.

Senators present: Bennett and Reed.

Staff present: Chris Frenze, Robert Keleher, Brian Higginbotham, Colleen Healy, John Kachtik, Suzanne Stewart, Jeff Schlagenhauf, Emily Gigena, Chad Stone, Matt Salomon, Nan Gibson, and Daphne Federing.

OPENING STATEMENT OF HON. JIM SAXTON, CHAIRMAN, A U.S. REPRESENTATIVE FROM NEW JERSEY

Representative Saxton. Good morning. I am pleased to have the opportunity to welcome Chairman Bernanke and the members of our second panel as well before the Joint Economic Committee this morning.

The Committee values its long history of cooperation with the Council of Economic Advisers. The testimony today will provide a solid foundation for understanding the forces that are shaping current economic conditions, as well as the economic outlook.

The recent hurricanes have caused a tragic loss of life and property on the Gulf Coast and also have had temporary effects on the U.S. economy as a whole. One reason for this national impact is that a significant portion of U.S. oil and gas production is concentrated in the Gulf, and much of it is still damaged. Thus, it is reasonable to expect that the economic impact of the hurricanes will slow GDP growth during the second half of 2005.

In 2006, as recovery efforts proceed, many economists expect growth to be a bit higher than previously forecast. Despite the hurricane damage, a broad array of standard economic data indicates that the economic expansion has built up a strong momentum. The U.S. economy grew at 4 percent during 2004 and advanced at a rate of about 3.5 percent in the first half of 2005. A rebound in business investment has played an important role in explaining the pickup of the economy since 2003. Equipment and software investment has been strong over this period.

The improvement in economic growth is reflected in other economic figures as well. For example, since May of 2003, business

payrolls have increased by 4.2 million jobs. The unemployment rate stands at 5.1 percent. Consumer spending continues to grow. Home ownership has hit record highs. Household net worth is also at a record level, and productivity growth continues at a healthy pace.

Long-run inflation pressures appear to be contained, and that is good news. Long-term interest rates, including mortgage rates, are still relatively low, in spite of the fact that the Fed has increased short-term rates. It is clear that the Fed remains poised to keep inflation under control.

In summary, overall economic conditions remain positive. The U.S. economy has displayed remarkable flexibility and resilience in dealing with many shocks.

It is clear that monetary policy and tax incentives for investment have made important contributions to the improvement of the economy in recent years. Recently released minutes from the Federal Reserve suggest that the central bank expects this economic strength to continue. The Administration forecast for economic growth in 2006 is compatible with those of the Blue Chip consensus and Federal Reserve.

With growth expected to exceed 3 percent next year, the current economic situation is solid, and the outlook remains favorable.

At this time, we will go to Ranking Member Senator Reed for his opening statement.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 37.]

OPENING STATEMENT OF HON. JACK REED, RANKING MINORITY MEMBER, A U.S. SENATOR FROM RHODE ISLAND

Senator Reed. Thank you very much, Mr. Chairman.

I want to welcome Chairman Bernanke to the hearing today. I hope he will give us some important insights into current economic conditions and the President's policies and the direction of these policies.

I am also pleased that we will have a second panel of witnesses to provide additional perspectives on the current economic conditions and outlook.

Like many Americans, my concerns about the economic outlook and the Administration's stewardship of the economy have grown in the wake of Hurricane Katrina and Hurricane Rita and the new hurricane in the Gulf. Economic insecurity for workers is widespread as energy prices are soaring. Employer-provided health insurance coverage is falling, private pensions are in jeopardy, and American workers are still waiting to see the benefits of the economic recovery reflected in their paychecks.

President Bush's tax cuts were poorly designed to stimulate broadly shared prosperity, and it produced a legacy of large budget deficits that leaves us increasingly hampered in our ability to deal with the host of challenges that we face. The devastating impact of Hurricanes Rita and Katrina will put short-term strains on the Federal budget, strains that would be fairly easy to absorb if our budget and economic policies were sound, but they are not.

The President's goals of making his tax cuts permanent and cutting the deficit in half are simply incompatible. Large and persistent budget deficits have also contributed to an ever-widening

trade deficit that forces us to borrow vast amounts from abroad and puts us at risk of a major financial collapse if foreign lenders suddenly stop accepting our IOUs. The trade deficit of $59 billion in August is close to the record for a single month of more than $60 billion set in February.

The broader current account deficit, which measures how much we are borrowing from the rest of the world, is running at a record annual rate of nearly $800 billion, or well over 6 percent of GDP. I will be interested in the Chairman's views on whether the budget deficit and trade deficit are dangerous imbalances that pose a risk to the economic outlook. I am also pleased that we will be able to hear Dr. Setser's views, which may be somewhat different.

I hope that we would all agree that raising our future standard of living and preparing adequately for the retirement of the baby boom generation require that we have a high level of investment and that a high fraction of that investment be financed by our own national savings, not by foreign borrowing. We followed such prosperity enhancing policies under President Clinton, but that legacy of fiscal discipline has been squandered under President Bush.

Sound policies are clearly important for the long run, but I am also deeply concerned about what continues to be a disappointing economic recovery for the typical American worker. Strong productivity gains have turned up in the bottom line for the shareholders, but not in the paychecks of workers. The typical worker's earnings are not keeping up with their rising living expenses, and both earnings and economic inequality are increasing.

It is certainly hard to take seriously the President's rhetoric about wanting to lift families out of poverty when he has refused to support an increase in the minimum wage and has lifted the Davis-Bacon Act, thereby legitimizing subpar wages for workers rebuilding the communities in the hurricane-stricken gulf coast region.

Even though home heating costs are expected to skyrocket this winter, President Bush said he will not request additional funds for the Low Income Home Energy Assistance Program known as LIHEAP. Together with my colleagues, Senators Snowe and Collins, we have been trying to reverse that by providing additional funds, and I hope we succeed, but I think the Administration should be supportive, not antagonistic to that approach.

I look forward to your testimony, Chairman Bernanke, about the economic outlook; and thank you again, Mr. Chairman, for this hearing.

[The prepared statement of Senator Reed appears in the Submissions for the Record on page 49.]

Representative Saxton. Thank you.

Thank you for being with us this morning, Dr. Bernanke. Let me just say, for purposes of introduction, Dr. Bernanke was sworn in June of 2005 as chairman of the President's Council of Economic Advisers. Prior to his appointment to the Council, Dr. Bernanke served as a member of the Board of Governors of the Federal Reserve.

We are pleased to have you here today.

I might also note, as a New Jerseyan, that Dr. Bernanke has served as professor of economic and public affairs at Princeton University.

Dr. Bernanke.

STATEMENT OF HON. BEN BERNANKE, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, WASHINGTON, DC

Dr. Bernanke. Thank you.

Chairman Saxton, Vice Chairman Bennett, Ranking Member Reed and Members of the Committee, thank you for the opportunity to testify before the Joint Economic Committee. We appreciate the long-standing and mutually beneficial relationship between the Committee and the Council of Economic Advisers. My remarks today will focus on the current state of the economy, but of course, such an overview would be incomplete without an eye to the human and economic impacts of Hurricanes Katrina and Rita in the U.S. Gulf Coast.

While it has been nearly two months since Hurricane Katrina made landfall, its devastation will have a protracted impact on the Gulf region. As you know, Hurricane Katrina wreaked unprecedented losses on the people of Louisiana, Mississippi, and the Alabama coasts. Katrina took many lives, destroyed communities and shook a vital portion of our nation and our economy. The Gulf region was then hit by Hurricane Rita, which did significant damage, but in most areas less than was feared.

In response to the disasters, the President has directed all agencies of the Federal Government to devote their maximum effort to helping the victims of the hurricanes and to begin the process of cleaning up and rebuilding the region. The President has also proposed a series of measures to restore the Gulf's communities and economy.

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. The ability of our economy to grow and create jobs will act as a lifeline to the regions and people 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.

When thinking about where the economy is now 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 in the past 5 years, even prior to Katrina. A remarkable range of shocks hit the U.S. economy, beginning with a 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. Business and investor confidence was shaken by a series of corporate scandals in 2002. 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 getting 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 reduce 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 forecast 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 will return to economic prospects in a moment.

An important reason for the recovery has been improved business confidence. To an extent unusual in the post-War period, the slowdown at the beginning of this decade was business-led rather than consumer-led. Home building and purchases of consumer durables did not decline as they typically do in a cyclical downturn. 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 four million net new payroll jobs have been added. Currently, the unemployment rate stands at 5.1 percent, up from 4.9 in August prior to the job losses that followed Katrina.

Although growth and GDP and jobs capture the headlines, one of the biggest macroeconomic 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 non-farm 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 in the second quarter this year—at the quite respectful level of 2.2 percent and 6.3 percent in the non-financial corporate sector. Thus, on each of the 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, while there has been a notable rise in overall inflation this year, prices on nonenergy products have continued to increase at moderate rates. In particular, soaring energy prices have played the largest role in boosting the overall consumer price index to an increase of 4.7 percent in the past year, up from a 2.5 increase over the year-earlier period.

In contrast, core consumer prices—as measured by the consumer price index, excluding volatile food and energy prices—rose only 2 percent the past 12 months, unchanged from the year-earlier pace. Long-term expectations also remain low and stable, based on measures of inflation compensation derived from inflation-indexed Treasury securities.

To be clear, the focus on core inflation by no means implies the rise in energy prices is inconsequential. Sharply higher energy costs place a heavy burden on household budgets and increase firms' costs of production. I will discuss the energy situation in more detail in a moment. However, the stability in core inflation and inflation expectations does suggest that overall inflation is likely to return to levels consistent with price stability in coming quarters.

Let me turn now to the outlook. In the shorter term, the devastation wrought by the hurricanes has already had palpable effects on the national rates of job creation and output growth. Payroll employment declined by 35,000 in September, its first decline since May of 2003, and industrial production fell 1.3 percent, its largest monthly decline in over two decades. Both of these declines appear to be entirely accounted for as the effects of the hurricanes. The Bureau of Labor Statistics estimates employment growth would have been roughly 200,000 in the absence of the hurricanes, and the Federal Reserve estimates that industrial production would have increased about .04 percent. Consumer confidence also dropped in September, although growth in consumer spending has continued to be solid.

While the effects of the storm certainly reduced growth in the third quarter relative to what it would have been otherwise, most private-sector economists expect healthy growth for the remainder of this year and in 2006. For example, the Blue Chip panel of forecasters now projects growth at 3.2 percent in the second half of 2005 and 3.3 percent growth in 2006. Recovery and rebuilding will contribute to job creation and growth by the latter part of this year and in 2006.

The economic impact of the hurricanes included significant damage to the country's energy infrastructure. As you know, Katrina shuttered a substantial portion of U.S. refining and pipeline capacity, which led to a spike in gasoline prices in the weeks after the storm. Rita caused further damage. The Federal Government has assisted in, among other ways, by lending or selling oil from the Strategic Petroleum Reserve, arranging for additional shipment 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. In part because of these efforts and a vigorous private-sector response, oil prices have returned to roughly

their pre-Katrina levels. Wholesale gasoline prices have also retreated to the levels of mid-August, suggesting the recent declines in prices at the pump is likely to continue. National gas prices may remain elevated somewhat longer, however, because of lost production in the Gulf, the difficulty of increasing natural gas imports, and damage to plants that process natural gas for final use.

Even as the energy sector continues to recover, 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.

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. In addition, allowing prices to adjust, rather than rationing gasoline, is helping to minimize the overall impact on the economy.

House prices have risen by nearly 25 percent over the past two years. Although speculative activity has increased in some areas, at a national level these price increases largely reflect strong economic fundamentals, including robust growth in jobs and income, low mortgage rates, steady rates of household formation, and factors that limit the expansion of housing supply in some areas.

House prices are unlikely to continue rising at current rates. However, as reflected in many private-sector forecasts such as the Blue Chip forecast mentioned earlier, a moderate cooling in the housing market, should one occur, would not be inconsistent with the economy continuing to grow at or near its potential next year.

The current account deficit presents some economic challenges. At 6.3 percent, the ratio of the current account deficit to GDP is now at its highest recorded level. Gradually reducing the account deficit over a period of time would be desirable. While the current account imbalance partly reflects the strong growth of the U.S. economy and its attractiveness to foreign investors, low U.S. national saving also contributes to the deficit. The United States should work to increase its national saving rate over time by encouraging private saving and by controlling federal spending to reduce the federal budget deficit. Our trading partners must also play a role in reducing imbalances by becoming less reliant on export-led growth and increasing domestic spending and by allowing their exchange rates to move flexibly as determined by the market.

The economic challenges posed by Hurricanes Katrina and Rita reinforce, once again, the importance of economic policies that promote growth and increase the resilience of the economy. Energy issues, in particular, have come to the fore recently. The energy bill recently passed by Congress and signed by the President should help address the nation's energy needs in the longer term. As an additional step, the Administration will continue to work with Congress to take measures that permit needed increases in refinery capacity. The Administration has made a number of other proposals

to increase economic growth, including proposals to reduce the economic cost of litigation, to increase quality and reduce costs in the health care sector, and to address national needs in education and job training.

The Administration is currently engaged in several international negotiations, including the Doha round at the World Trade Organization, as well as talks with China on a number of matters involving trade, exchange rates and needed financial reforms. Liberalized trade and capital flows promote economic growth, and we should strive to achieve those objectives in the context of a gradual reduction of current account imbalances. It is important that we persist in these efforts and not retreat to economic isolationism, which would negatively affect the long-run growth potential of the economy.

Fiscal discipline, always important, has become increasingly so in the face of the likely costs of assisting the victims of the hurricanes and of helping in the rebuilding. Before the impact of the hurricanes, strong economic growth was helping to reduce the budget deficit and the government finished fiscal year 2005 with a much lower-than-expected deficit.

The President remains committed to controlling spending and cutting the budget deficit in half by 2009. His 2006 budget made numerous proposals to save more than $200 billion over the next 10 years from both discretionary and mandatory programs.

In the budget resolution earlier this year, Congress laid plans to pass $35 billion out of the President's $70 billion in savings for mandatory programs over the next 5 years. Congress should now make good on that plan by passing at least $35 billion in mandatory savings in reconciliation legislation.

Further savings beyond $35 billion would be highly desirable. The President continues to seek a decrease in non-security discretionary spending in fiscal year 2006 appropriation bills, and the Administration is working on options for spending rescissions. The President also remains committed to reforms to address fiscal challenges in the longer term, such as Social Security.

Finally, I note that the Tax Reform Advisory Panel, whose official report will go to the Secretary of the Treasury on November 1st, has kicked off a much-needed debate on how to make the Federal Tax Code simpler, fairer, and more pro-growth. We thank them for their hard work and look forward to reviewing their recommendations.

Thank you very much for the opportunity to be here today, and I would be happy to take any questions.

[The prepared statement of Dr. Bernanke appears in the Submissions for the Record on page 52.]

Representative Saxton. Thank you very much, Dr. Bernanke. We appreciate your being here.

Thank you.

Let me begin with a question on business investment. As most of us know, in recent economic analysis a lot of credit has been given to business investment that has spurred economic growth. However, when the recovery started in the last quarter of 2001, business investment was not great. In fact, it was not good in 2002, and it didn't begin to click in until the second quarter of 2003.

Coincidentally, Congress passed some tax legislation that was recommended by the President in 2003 which appears to have stimulated investment. Dr. Bernanke, do you believe that the tax legislation that was passed in 2003 had this effect; and, if so, how important do you think it was?

Dr. Bernanke. As I agreed, it was very important. As your chart shows, investment was quite weak until the middle of 2003. The President's tax proposals which were passed by Congress included, first, measures to reduce the cost of capital, including reductions in dividends and capital gains taxes; second, bonus depreciation provisions which increased the incentives for firms to make capital investment.

Of your private nonresidential investment, there were two components. There are both equipment and structures. Structures investment has remained somewhat moderate in terms of its recovery, reflecting overbuilding in the late 1990s and relatively high vacancy rates in office buildings, for example. So investment in the structure side, while we expect it to recover, has not yet fully recovered to earlier rates. However, the recovery in equipment investment has been quite strong; and I believe that the tax measures that you mentioned were an important component in that recovery.

Representative Saxton. Thank you, sir.

Let me turn quickly to another question. I would like to show you another chart that shows the history of inflation during the past several years; and it is fairly obvious by looking at the chart that inflation has remained in check since the early 1990s.

[The chart appears in the Submissions for the Record on page 40.]

As an advocate of inflation targeting, it appears to me that the Fed has successfully kept the measure of inflation in the range, as the chart shows, between 1 and 2 percent, which some refer to as the Fed's, quote, comfort zone. This appears to be similar to informal inflation and targeting, inflation targeting. By keeping inflation low and in this narrow range, hasn't the Fed reduced risk and helped keep long-term interest rates lower than they would otherwise be, in spite of the fact the Fed has increased short-term rates in recent times?

Dr. Bernanke. Indeed, sir, you are correct. Bringing inflation down has been an important accomplishment. It has been often noted that, since about 1986, that the U.S. economy has been more stable. This is referred to by economists as a so-called grade moderation. In my belief, one of the major contributors to the increased stability of the economy, the fact the recessions are less frequent and severe than they were earlier, is the fact that inflation remains low and stable.

As you point out, inflation, core inflation has remained within the 1 point to 2 percent range, which I believe is consistent with overall price stability. Looking forward, I hope the Fed will continue to maintain its commitment to keep inflation low and stable. I believe that is the best way to achieve its overall objectives of economic stability, price stability and low interest rates, as you point out.

Representative Saxton. Thank you.

Senator Reed.

Senator Reed. Thank you very much, Mr. Chairman. Thank you, Chairman Bernanke.

Much has happened since the President's tax cuts were first advocated or passed here—9/11, huge costs for homeland security, the war in Iraq—which has consumed over $200 billion. In fact, I think one of your predecessors, NEC Director Lindsey, accurately predicted that, much to the chagrin of the Administration.

We have hurricanes that we are going to spend billions of dollars in the Gulf, and yet the President seems to still be solely stuck on permanent tax cuts. Some people suggest that he is not paying attention to the reality of what has been happening in the last several years about the expenditures that we just can't avoid and the need, as you also suggested, to balance the budget, bring down the deficit. So what is more important, reducing the deficit or continued tax cuts?

Dr. Bernanke. Thank you.

First, as you point out, a good bit of the costs that have occurred are related to security expenditures, the global war on terror; second, the disasters in the Gulf. I think most economists would agree that, to the extent that deficit spending is appropriate for large expenditures of this type, using deficit spending as a partial way of funding it is not an unreasonable approach.

With respect to taxes, it is my belief, and I think many economists would agree, that low marginal tax rates are supportive of economic growth, particularly in the long run, and that keeping them low, therefore, is an important priority. The question one would ask is, "Before we begin raising taxes, have we really satisfied ourselves that we have reduced government spending as much as possible and that the existing programs that we are funding meet rigorous cost-benefit tests?" I would submit that we would want to look very hard at government spending, make sure it is controlled before we raise taxes, which, in turn, would have negative impacts on the economy.

Looking in the future, first in the near term, I do believe the President will be successful in his promise to bring the deficit down half by 2009. If that is accomplished, then, as a share of GDP, it will be significantly lower than the long-term average.

Looking further out, we face very substantial increased costs in terms of entitlement programs. I would submit that there is simply no way that tax increases could ever cover the projected costs of those entitlement programs because they, on current plans, over the next few decades will rise, will increase government spending by 50 percent or more. Therefore, both in the short run as we look at current government programs and in the long run at entitlement programs, we need to think how hard we are going to maintain discipline in fiscal spending.

Senator Reed. We have gone from a surplus in the Clinton administration, when tax policies seemed to be not adversely affecting the economy, to a situation now where we have no surplus, we have deficits, cumulative deficits going forward many years, a position of economic weakness rather than strength. Everyone is sympathetic about programs that don't seem to be working efficiently, but we are talking about cutting deeply into programs that are necessary for many Americans: those entitlement programs, et cetera.

As we approach the baby boom generation, we seem to have squandered the flexibility and strength which we had several years ago with a surplus.

Again, in the short run, what is more important, to deal with this deficit or to have permanent tax cuts?

Dr. Bernanke. With respect to the arrival of deficits in the early part of this decade, I believe that the tax revenues that were received in the late 1990s were well above normal levels and I think I attribute that to the stock boom and the unsustainable state of the economy in the late 1990s. The deficits that arose early this decade primarily, in my opinion, arose because of the decline in the stock market, the end of the Internet bubble and then, on the spending side, from the increased costs of the War on Terror in particular.

So I think——

Senator Reed. Well, I have just 30 seconds. Can you give us your estimate of how much we will be spending on homeland security and the war in Iraq over the next 5 years? Because I presume you would not want to cut those funds.

Dr. Bernanke. I think efficiency should be applied throughout the budget. Wherever we can find savings, it is important to do so. I do not know, however, what the spending will be on those items you are referring to.

Senator Reed. So you would urge us to look closely at the military budget, Iraq, everything.

Dr. Bernanke. I think the cost-benefit analysis should be applied wherever it is appropriate. However, the President has set forward proposals for savings that would double, for example, the current proposed savings under the budget resolution. So there certainly are many proposals that have been put forth by the White House, and I think we should look throughout the entire budget and see where we can find programs that are not providing value for money.

Senator Reed. Thank you.

Representative Saxton. Thank you very much, Senator Reed.

We are going now to Senator Bennett.

Senator Bennett. Thank you, Mr. Chairman.

The longer I sit on this Committee, the more I realize the debate just keeps being recycled. I remember the first time I came to the JEC as the Committee's very junior, very green, newest Member. One of your predecessors, Dr. Tyson, was the witness and her comment was, "Compared to other industrial nations in the world, we are seriously undertaxed; and this Administration is going to fix that."

Now, with the benefit of a dozen years of hindsight, looking back at the U.S. economic position vis-à-vis that of other industrialized nations, to pick a few—Germany, France, Japan, Great Britain—would you say that our tax policies have been more conducive to growth than theirs and that the level of taxation, which in my opinion should be measured as a percentage of GDP rather than in numbers of tax rates and tax brackets, but the amount, whatever the method, by which the Government takes money out of the economy relative to the GDP is the number that I think makes the most sense. Do you think our present band of GDP tax revenues

is too high or too low compared to other industrialized nations, their rate of growth? Just get into this whole question of the American economy and tax policy and growth vis-à-vis other countries.

Dr. Bernanke. Thank you, Senator.

There have been three important long-term trends in tax policy in the United States. They encompass both Democratic and Republican administrations.

Since President Kennedy, there has been generally declines in the marginal tax rates both at the highest level, but throughout the distribution. My view, and I think that this has become broadly accepted, is that lower marginal tax rates improve incentives for work and promote growth. The differences in marginal tax rates here and abroad, I think, account for a significant part of the difference in U.S. economic performance in terms of growth and productivity relative to other countries.

The other two trends are, first, that the share of taxes, the share of GDP collected in taxes has not in fact changed very much despite the declines in marginal tax rates, suggesting that growth and other measures have been sufficient to keep revenues strong.

The ultimate way to determine the appropriate level of revenue collection—I think, again, the first place to look is to ask the question, what does the Government need to spend; we need to look at spending programs in terms of whether they are providing value for money.

So my approach is to think first about government spending. It is, in fact, the share of GDP that goes to government spending which is the true measure of the burden of the government on the national economy, and that is where we have to make sure that we are getting full value for money.

Let me just add that although I think the U.S. tax system on the whole has been positive in terms of promoting growth, investment, entrepreneurship, and productivity, relative to other industrial countries, there is still a lot of improvement that can be had in the U.S. Tax Code. The President's tax panel is reporting and the objectives of tax reform would be to make the system simpler—it is incredibly complex—to make it more fair and to increase still further its tendency to increase and support economic growth. I think there is progress that can be made, but this bipartisan consensus over 40 years of reducing tax rates and improving incentives I think has paid off in terms of U.S. economic performance.

Senator Bennett. Let me just comment, my reaction to the Mack-Breaux Commission is that I am sorry they weren't more bold. The present tax system is a disaster in terms of simplicity and efficiency, and we continue to nibble around the edges as we have done ever since we created the tax in the 1930s. I would have preferred something much more dramatic than they have proposed. I would endorse the direction they are proposing, but I would like to move in another direction. Thank you very much.

Chairman Saxton has given us a chart that shows the relative unemployment in various countries. Maybe we are not doing so badly when we compare American unemployment with some of that of the other industrial nations. Thank you.

[The chart appears in the Submissions for the Record on page 39.]

Representative Saxton. Chairman Bernanke, if I may refer to the chart to my right, your left. The unemployment rate in the so-called Euro zone is shown on this chart to be about 8.6 percent; in Canada, 6.7 percent; and here in the United States at 5.1 percent. Your comments relative to and Senator Bennett's comments relative to the tax situation I suspect you would agree has something to do with this in various economies.

Dr. Bernanke. Yes, sir. In addition, another dimension of this labor market performance is job creation where over the past two or three years total job creation in the United States is greater than that of Germany and Japan and the UK combined. Our tax system makes a constructive contribution to this performance. In addition, we have flexible and diverse labor markets which also can adapt to shocks and have allowed us remarkably to deal with high energy prices, hurricanes and many other shocks to the economy and still continue to have growth and job creation.

Representative Saxton. Thank you, sir.

Mrs. Maloney.

Representative Maloney. Thank you very much and welcome. Congratulations on your appointment.

You testified that productivity growth is absolutely fundamental to the improvement of the standard of living for Americans and for our long-term growth, but in order to have productivity we have to have jobs.

At a recent forum that we had, Professor Blinder testified and said some interesting and, for me, some rather disturbing things about outsourcing for the future of this country. He argued that we can expect a dramatic increase in the amount of outsourcing because there is a huge educated population in China, India and other countries, and any job that can be remotely subject to outsourcing or can be done in another country, he says is in jeopardy. He predicts that outsourcing will be an incredible drain on American jobs in the future. I would like to hear your comments on what he has put forward, and does the Administration have policies that would address the fact that a huge number of American jobs may be at risk in the future.

Dr. Bernanke. Thank you.

First of all, we certainly don't want to see any American lose their job. If someone loses a job, we hope to have ways of helping them retrain and relocate as needed to find good new work. We want to support American workers in every way that we can.

There is certainly some outsourcing in terms of purchases of services abroad. There is also insourcing. For example, the United States, although we have a very large overall current account deficit, we have a surplus on services. Americans provide financial, educational, tourism, and other services to people the world over. So it is a source of prosperity in markets for us as well.

In addition, we benefit from foreign direct investment. Many Americans are employed by foreign companies with plants in the United States, for example, in the automobile industry. So trade is a two-way street. I think it is important to protect Americans who lose their jobs or whose jobs come under pressure from international trade, but I think we need to be careful not to embrace economic isolationism.

With respect to overall jobs, I dispute the conclusion that either trade or even current account deficits destroy jobs. As was just shown on the diagram, the unemployment rate here is lower than Germany, which has a larger current account surplus, lower than Japan or other countries which have large current account surpluses. The job creation is better here. I believe that the U.S. economy will prosper in an international global economy and that jobs will be created, as many as needed, to employ all those who want to work.

Representative Maloney. So, you do not see outsourcing as a challenge to American jobs. How much do you believe the United States will have to borrow from the rest of the world this year to support our swollen trade deficit? Some people have said it will be as much as 600, 700, 800 billion dollars. What is your estimate?

Dr. Bernanke. As I mentioned in my testimony, the current account deficit is currently 6.3 percent of GDP, so that would be roughly the amount of foreign acquisition of U.S. assets associated with the current account deficit. I agree that we need to bring the current account deficit down, and I believe we can do so over a period of time. Doing so requires more savings of the United States, including a reduction in the U.S. budget deficit.

Representative Maloney. That is roughly $800 billion. What would happen, Professor, if the rest of the world decided that it was too risky to hold this large amount of our debt? Would we see a collapse of the dollar, high interest rates, and possibly an international crisis if countries decided not to continue holding our debt?

Dr. Bernanke. I don't anticipate any such development. U.S. bonds are well regarded as safe and liquid investments. They are the primary source of international reserves.

Representative Maloney. Finally, what are your comments on the growing trend of inequality between the haves and have-nots that has been displayed? We have a chart. This also was a theme at our hearing with Professor Blinder, and I believe that leaders on both sides of the aisle are concerned about this trend. It is not good for our country, it is not good for our people, and what policies does the Administration have to address this growing trend of inequality between the haves and have-nots?

[The chart appears in the Submissions for the Record on page 51.]

Dr. Bernanke. Ma'am, that is a very complex question. I won't have time to answer in full detail. But I would point to one trend which is over the last 25 years or so the returns to education have risen. Therefore, people who are more educated, have college degrees or advanced degrees, the differential in their earnings to those who have high school or less has increased. This is reflective of the change in our economy toward a more technologically dynamic economy, one where higher skills are valued.

The fact that we have become more technologically dynamic is a positive thing, but the increased inequality and earnings associated with this is a concern. I think certainly one approach is to try and spread the benefits of education, skills and training more broadly to make sure everyone is equipped to deal with the demands of our current economy.

Representative Saxton. Thank you very much.

Mr. Paul.

Representative Paul. Thank you, Mr. Chairman.

On page 8, you talk about the current account deficit which you expressed concern about and you discussed, as well as expressing concern about spending and deficits. You talked about a $35 billion cut, which to me seems like a drop in the bucket and will turn out to be irrelevant. We can't even get it passed here. It is over 5 years, and the national debt is going up nearly $600 billion a year. I don't think we are addressing the real problem, and the real problem is the Government is out of control and spending is out of control.

But I think some of the problems you discuss here are probably related to monetary policy, and we never seem to connect the two. Yet in a speech a few years ago, I thought you did make a connection, and I want to just quote from that 2002 speech.

He says, "We conclude that under a paper money system, a determined Government can always generate higher spending and hence positive inflation. While there are some who are less enthusiastic about paper money than that, I don't see inflation ever as a positive because it caused some of these problems that we are concerned about." But also increased spending naturally is going to lower savings. You would like to see higher savings. So we have a system of money where free market people supposedly have total monopoly control of the money supply and interest rates so we manipulate interest rates down to 2 percent on savings and then we want people to save. These are artificially low interest rates. So people on fixed incomes aren't going to save. There is really no incentive. Then we tax them on the interest they earn.

To me, that is reflection of a very flawed monetary policy, and it does confirm Nixon's contention in 1971 that we are all Keynesians now, and we are resorting to the liquidation of debt through the debasement of currency, and it also invites concern about deflation which you have had concern about. But, since 1971, we have had a 1,300 percent increase in the money supply and we have the privilege of being the reserve currency of the world, so we are encouraged to spend.

But I think it is so unfair. It is not, as far as I am concerned, good economics, and it is unfair to the people who want to save. Then we get concerned about savings and then we create a monetary system that does increase spending not only in the private sector, but in the Government sector. As long as the Fed is there waiting ready to monetize anything we spend on, I think we are going to continue guns and butter, endless war spending, endless domestic spending.

So I would like to suggest why can't we make a better connection to monetary policy, and I think you would be the expert on this that might be able to do that, and how can we justify this as being a fair system to the elderly who would like to earn a decent interest on their savings?

Dr. Bernanke. Related back to an earlier question from Mr. Saxton, I think the best thing the Federal Reserve can do to avoid the problems you are referring to and make sure people get a fair return on their savings is to keep inflation low and stable. That has been the objective, and success has been increased over a pe-

riod of time. You keep inflation low and stable. Then the cost of living for the retirees, for example, doesn't go up as fast. The real returns to savings are not eroded by inflation.

So I think the appropriate approach is to focus on keeping inflation in the medium term low and stable. I believe that supports the Fed's other objectives of low interest rates and stable employment growth. So that would be the central part of my prescription for making monetary policy constructive in terms of economic growth and stability.

Representative Paul. But for the elderly, the cost of living is not 2 percent, so I think it is a fiction to tell the people there is no inflation. If most of their money is being spent on medical care and on energy and keeping their house warm, these people are having an inflation rate of 10, 12 or 15 percent and we deny this. So at the same time the Government says there is no inflation, therefore it is justified to have low interest rates. My contention is, why should we assume that we know what the interest rates ought to be? Why as free market people do we not resort to the marketplace to determine interest rates?

Dr. Bernanke. There have been many proposals along those lines, and some of them are quite interesting. Under our current system, the central bank has been required by Congress to manage the monetary system, and I think the best way to do that in a stable manner is again, to focus on making sure that we have price stability.

You point out correctly we do have inflation now. We have 4.7 percent inflation in the last year. The biggest contributor to that is higher energy prices, which in turn depends on a variety of factors, including the supply and demand for energy around the world. That is a real phenomenon, one that is affecting people's budgets. It is hitting a lot of people, a lot of firms. There is no question that is a negative influence on our economy.

Representative Saxton. Thank you very much. The gentleman's time has expired.

Mr. Hinchey.

Representative Hinchey. Thank you very much, Mr. Chairman.

Chairman Bernanke, it is nice to see you, and thank you for being here.

We are talking about economic growth; and it strikes me that growth, somewhat like beauty, is in the eye of the beholder. Looking at the chart over here on unemployment rates, I think that those figures in many respects do not reflect aspects of our culture that, if they were taken into consideration, would cause some dramatic differences in the levels of those charts.

For example, we have two million people in prison in the United States, more than in any other country in the world, with the possible exception of China. We don't know how many they have, but if that were reflected in that chart number it would go up considerably.

We have the highest level of homeless people of any advanced industrial country in the world. If that number were considered in there, the unemployment rate would go up substantially.

There are a great number of people who have dropped out of the economy. That number of people is not reflected in that chart over there as well.

So you have a situation where we are not just facing up to the truth. We are not addressing the real needs of people in this country, and one of the ways that we are avoiding that is pretending that the situation is rosy, rosy where for a lot of people it really isn't. One of the reasons why we have had the kind of growth that you described in your testimony over the last several years is that we have experienced an extraordinary amount of economic stimulation, both fiscal and monetary; and the fiscal stimulation, of course, has resulted in huge budget deficits, in fact, record budget deficits for the last 3 years and a record and growing national debt.

The question arises, I think, in the minds of anyone looking at this objectively, how much longer can we sustain that kind of so-called economic stimulation, which is the source of whatever growth we are experiencing? And, of course, going back to the idea of the inequality of that growth, we are seeing more and more inequality in this country.

The tax cuts that were passed by this Congress have had extraordinary economic benefits for the wealthiest people in America, but, at the same time, they are causing economic hardship for millions and millions of other people. We have 37 million people in America now living below poverty. That is an increase of more than one million in the last couple of years. We have 45 million people now without health insurance, most of them working people making incomes of above $50,000 a year. Nevertheless, 45 million Americans are without health insurance. That number has gone up by nearly 8 million in the last 5 years.

So the inequality that we are experiencing is very, very dramatic. Anyone sitting here at this table or as a member of the President's Council of Economic Advisers pretending that everything is just fine in America, that everybody is benefiting from this growth in the economy isn't really being honest about the situation.

What is it that we ought to be doing to address the real economic needs of the average America?

With another example, the median income of the average American family has been flat for the last 5 years. They are experiencing no growth whatsoever. That is the first time that that has happened in recorded history in our nation. So, what can we do, what can this Congress do and what can you recommend as the sole member of the President's Council of Economic Advisers that we can do to address the real needs of the real people of America?

Dr. Bernanke. Thank you. That was a very lengthy question.

First of all, with respect to the labor market, it is true that the unemployment rate is calculated relative to the labor force, and that in turn depends on how many people are actively seeking work and would include, for example, prisoners. If you look at other measures of the labor force, the share of the total population that is working or the number of jobs that are created, both of those also suggest a very strong labor force, so I don't think incarceration rates, for example, are the issue here.

Also, in terms of sustainability, ultimately what allows us to continue to grow is the rate of productivity growth. As I mentioned in

my testimony, we have had remarkable productivity growth going back to the mid-1990s.

Representative Hinchey. That productivity growth is not being shared equitably. We have lost 3 million manufacturing jobs in the last several years here in this country. The kind of growth that you are talking about is not being shared equitably. If we are going to put up a chart reflecting the unemployment rates between Europe and another country that I can't see or another place that I can't see and the United States, we need to take into consideration the cultural aspects of those countries. The things that you are talking about are not reflected there. The number of people that are in the employment arena in Europe is reflected in those numbers.

Representative Saxton. I am sorry, but the gentleman's time has expired.

Representative Hinchey. They are not reflected here in this chart.

Representative Saxton. Let me just remind everybody, we have this room for just 2 hours. We started right on time. We are now 55 minutes into the first hour, and we haven't finished the first round of questions. So we are going to go to Mr. Ryan.

Representative Ryan. I will try to keep under the 5 minutes.

First, I want to make a clarification and ask a quick question. I think it was Senator Reed who talked about the tax cuts, how they supposedly balloon the deficits and how we should not extend these tax cuts. Mr. English and I serve on the Ways and Means Committee that wrote that tax cut, so I looked up the spreadsheet from the Joint Committee on Taxation that we used in 2003 to estimate what they would cost.

In 2003, our official scorekeeper estimated that in the next year, 2004, the individual income tax cuts would cost this country $106 billion in revenue loss and that the corporate tax revenue loss would cost us $35 billion. So, we thought in 2003 individual receipts would go down by $106 billion. What happened? They went up 14 percent. We thought corporate receipts would go down, because of the tax cuts, $35 billion. What happened, they went up 33.4 percent. In total, in light of our scorekeeping, our estimate, we thought that in 2004 we would lose $148 billion in revenues from those tax cuts. We thought we would increase the budget deficit by $148 billion. What actually ended up happening in 2004 was revenues went up $116 billion.

Look at what is happening in 2005. In 2005, so far this year, individual income tax receipts are up 15 percent and corporate income tax receipts are up 47 percent. We have had the largest year-to-year increase in revenues in this country since 1981 and, in particular, in our budget deficit in the first quarter of this year, we have the largest drop, an unprecedented first quarter drop of $94 billion. The budget deficit is now down $94 billion pre-Katrina, and we are preparing a package to pay for that one as well.

So, I think it is very important as we talk about tax policy and what to do in the future, and what not to do in the future, not look at estimates that were done a few years ago that we already know for a fact are not only incorrect, but are way off. Let's look at reality, and let's look at actual performance, and let's look at the fact that these tax cuts not only help produce jobs and economic

growth, lower the retirement or lower the unemployment rates, but these tax cuts actually increased revenue to the Federal Government, which is helping us get this budget deficit down. So it is a very important dose of reality.

Here is my quick question. Two important tax cuts expire in 2008, dividends and capital gains; they are off the track with respect to the rest of the tax cuts which expire in 2010.

I want your opinion, Dr. Bernanke, on how the economy views this; how do the markets look at this? I am very concerned that the longer we delay in extending those two provisions that expire in 2008, the more it will produce more uncertainty in the capital markets, will make capital less attractive in the United States and more attractive in foreign countries, will depress our savings rate even more, and would be harmful to our economy. But that is just my own personal concern. Could you address what the economic ramifications, in your opinion, are of not extending the capital gains and dividend tax cuts; and are we hurting ourselves with respect to the economy by delaying extending those cuts? Is it wrong to wait until the last minute to extend those cuts, and should we do this now or should we not be concerned about that?

Dr. Bernanke. Thank you. First of all, I agree about your comments about 2005, that tax receipts have been about $100 billion more than expected, and the deficit correspondingly lower.

With respect to taxes on capital gains and dividends, the President, as you know, is in strong support of continuing those tax measures. I do think that uncertainty and delay, although sequel, would be costly in the sense that investors would not know exactly what to anticipate in making their decisions. So there is, I think, some validity to that concern.

Representative Ryan. So we will forego economic growth that we would have otherwise been able to achieve in this economy if we delay in extending those two provisions from 2008 to, say, 2010 or permanently.

Dr. Bernanke. There will be an increase in uncertainty and there may be some effect on growth, yes.

Representative Ryan. Thank you.

Representative Saxton. Thank you.

Ms. Sanchez.

Representative Sanchez. Thank you, Mr. Chairman. And I have to tell you that as a trained economist, I feel like I am in—and I am used to sitting in a room with lots of economists and everybody having different opinions—but I really feel like I am in the twilight zone here. It is just amazing to hear some of the things that are being said here.

I find it interesting that this Administration would pat itself on its back by comparing the European Union's unemployment to the United States', for example. Europe has been vigorously incorporating poor countries into its economy, cold war economies that were totally devastated by communism, and cold war workers who have had a very hard time accommodating to the market economy. So to compare their unemployment rate to the United States, I mean, I think this Administration has been terrible about accommodating poor people, about educating poor people, about bringing people who are underemployed or unemployed into the realm. And

we see it basically with the differences between the gap, income gap. And certainly Chairman Greenspan spoke about this when he was before us most recently.

I have a couple of questions. I hope I get to them. The first one would be, I am interested in the comments that were just made about the revenue levels with respect to the tax cut, because when I look at the numbers, I see that the revenue levels in the Bush administration have been actually lower as a share of GDP than at any time since 1959. So with increased spending priorities—I mean, this Administration is spending like crazy, it is just unbelievable—why is it better to have deficits than to pay for them on a pay-as-you-go basis, Mr. Chairman?

Dr. Bernanke. There was a decline in tax revenues in 2001, I believe, which I think was justified, first of all, by the recession and the appropriate fiscal response to that. And in addition, it has been the case in the past that in a short period following cuts in marginal tax rates, which, as I mentioned, occurred under both Democratic and Republican administrations, there was a period of reduced tax revenues associated in the short run with that reduction. However, over a longer period, there is a tendency to return to a more normal level, and currently income tax revenues, for example, as a share of GDP, are very close to their long-run average and they are projected to go above the long-run average by 2009.

Representative Sanchez. But over the time, they have been lower than at any time since 1959. Are you saying that all of a sudden, the next couple of years, we are just going to do such incredible things that that is not going to be true? I mean, given the fact that I have got two Louisiana Senators asking for $250 billion for Louisiana, for example, that I am sure most people here are going to try to put in a supplemental spending.

Dr. Bernanke. Well, as I mentioned earlier, I think that some deficit spending is appropriate when you are facing a global war on terror and natural disasters. It certainly would not have been—a balanced budget policy in 2001 would not have been a constructive economic policy, in my view. I think that the President is going to meet his objective of reducing the deficit in half by 2009, and if he does so as a share of GDP, we will be actually well below——

Representative Sanchez. And how do you think he is going to do that? I mean, I don't know where you got this figure from, but you just said that you thought that entitlements were going to be increasing by 50 percent, and I don't know over what time period you gave us. I mean, when I think of entitlements, I think of veterans health care, Social Security, disability benefits, a death benefit to survivors of people who have put into Social Security, Medicare. Are you trying to tell me that the President is going to cut health care to the elderly, retirement to the elderly, cut moneys to those who are disabled, cut money to orphans, cut health care to veterans, cut the retirement of our people who have served in the military? Is that what his intentions are to bring down the deficit, if you are looking at a 50 percent increase over this time period?

Dr. Bernanke. No, ma'am. I have two different time frames in mind. The President's 2009 commitment obviously is over the next few years, and over the next few years I believe that—not cutting,

but simply slowing the very rapid rate of growth of some programs will be sufficient to restore the deficit to a lower level.

However, the real challenges for America are not in the next five years, they are over the next 20 and 30 and 40 years; and that is what my figures about 50 percent were referring to, around 2030 and 2035. If you make no changes in current programs such as Social Security and Medicare and Medicaid, and they continue to grow at recent pace, reflecting the graying of America, the retirement of the baby boomers and the like, there is going to be an enormous increase in the share of national resources absorbed by Government programs, much greater than we could conceivably cover by tax increases. We will need to consider how to modify those programs so that they serve their purposes without busting the budget.

Representative Sanchez. It sounds to me, Mr. Chairman, like you are expecting the President to cut those programs——

Representative Saxton. The time of the gentlelady has expired.

Representative Sanchez. Thank you, Mr. Chairman.

Representative Saxton. Mr. English.

Representative English. I would like to move this debate a little bit, Doctor, out of the twilight zone and maybe focus on a couple of things where we are comparing apples to apples. You have been criticized, I see, for pointing out what I think is a useful point: that our unemployment rate in this country, although it is not very good in parts of my district, overall is significantly lower than that of many of our European trading partners.

I wonder if you could briefly, maybe provide a perspective of comparing the growth rate within the United States—which I think is very much affected by our tax policy, and Chairman Greenspan has conceded that point up front—would you compare our growth rate with that of our trading partners in Europe?

Dr. Bernanke. I don't immediately recall the recent growth rates in the major countries, but I am quite certain that the U.S. growth rate in recent years, and also over the last decade, for that matter, is higher by a significant margin than other major industrial countries such as Germany, U.K., France, and Japan. And job creation is significantly greater in the United States than in those countries.

Representative English. And that growth rate has a direct bearing on our ability to grow our tax base and generate revenues that in turn will move us away from a deficit position. Has that not been the experience over the last year—as Mr. Ryan was careful to point out—with, in effect, a reduction in the overall deficit picture beyond estimates of about $95 billion. That $95 billion drop—which I realize didn't take into account Katrina and some other factors—that was largely driven, as I understand it, by a growth in revenues that are directly attributable to economic growth. Am I mistaken on that point?

Dr. Bernanke. No, sir, you are correct. GDP growth in the United States has been 4.1 percent annually over the past two years. I believe that tax policy had a significant role to play in creating that growth. Revenues have grown accordingly with economic growth, and indeed in 2005 they appear to be significantly higher

than we expected, even given the amount of economic growth that we observed.

Representative English. Then I think the issue here is what do we need to do to continue that growth path despite price shocks in the energy sector. And here I want to go back to Mr. Ryan's point with regard to current tax rates on dividends and long-term capital gains. I am concerned about the message we might send to markets if we don't move now to extend the current rates.

And this week I noticed that the chief economist at Wachovia, John Silvia, published a research note in which he said, and I quote, "Policy makers can enhance employment and growth by providing a stable tax environment for capital by extending the 15 percent tax rate."

Now, opportunities lost may be difficult to quantify in the short run, but the competitive nature of a global marketplace suggests that other nations will attract the capital necessary to improve their competitiveness and long-term employment if we fail to extend the current 15 percent rate.

Now, do you think this concern is an immediate one? You have already testified that it would make sense for us to move sooner rather than later, but at what point will markets start to make the judgment that Congress may lack the political will to extend its current pro-growth policies?

Dr. Bernanke. Well, as I indicated, I think it is important that we make the tax cuts permanent. The markets will have to make their own assessment about the probabilities and the risks associated with that. And I really don't have much to add on that side, other than the more we can assure markets that we continue to favor pro-growth policies and a low cost to capital, the better off we are going to be.

I realize it is a very complex budget negotiation going on, and I want to say, in addition, that we do need to look at the spending side and make sure that spending is under control and we are eliminating programs that are not providing good value. Ultimately, if the spending grows beyond reasonable ranges, then it will be extremely difficult to maintain the low tax rate.

So part of keeping taxes low is also keeping spending low, and I think that is equally important as we look at the budget process.

Representative English. And ultimately, economic growth is critical to us in meeting our social needs, which the gentlelady from California was kind enough to catalog for us.

I yield back the balance of my time, Mr. Chairman.

Representative Saxton. Thank you very much, Mr. English.

Chairman Bernanke, thank you very much for being with us this morning. I wish we had more time; however, we are pressed, and so we thank you for being here with us. And you can be sure that we will invite you back again.

Dr. Bernanke. Thank you very much for having me.

Representative Saxton. We are now going to move to our second panel: Dr. Mickey D. Levy, who is the Chief Economist at the Bank of America in New York City; Dr. David F. Seiders, Chief Economist, National Association of Home Builders here in Washington, DC; and Dr. Brad Setser, Senior Economist and Director of

Global Research at the Roubini Global Economics in New York City. If you would be so kind as to take your places.

Representative Saxton. And, Dr. Levy, when you are ready, sir, we would appreciate hearing from you.

STATEMENT OF DR. MICKEY D. LEVY, CHIEF ECONOMIST, BANK OF AMERICA, NEW YORK, NY

Dr. Levy. Yes. Mr. Chairman, and Members of the Committee, I am very pleased to discuss the economy and associated economic policies, particularly in regard to following Ben Bernanke's comments. I think it is extraordinarily important to point out the underlying fundamentals in the U.S. economy, how strong they are. And here I refer to the flexible and efficient production processes, labor markets, the low inflation, the relatively favorable taxes and regulatory policies, and this leads to the U.S. economy growing much faster than every other industrialized nation.

This has been true, the United States has grown at least a percentage point faster than Europe every year since 1990, with the exception of 2002. Capital spending is multiples higher. And I would say U.S. potential growth is 3½ percent plus, to the plus side. And we have an $11 trillion economy. And so 3½ percent growth adds an extra output of $375 billion, which creates jobs and the like. And I think it is incumbent for policymakers to maintain policies that are consistent with sustained healthy economic growth, not just for raising standards of living, but for the best environment for budget policymaking.

There was sound economic growth prior to Katrina, showing some signs of moderation, but healthy increases in employment, modest increases in wages, healthy increases in personal income, business investment was rising, and corporate profits had reached an all-time high. And, I might note, exports had reaccelerated significantly.

The impact of Katrina will cause a temporary—and I underline the word temporary—impact on employment, consumption, trade, and inflation. And the data we have seen for September, post-Katrina, suggests that the impacts are identifiable and local, meaning that in the rest of the Nation there continues to be healthy growth. And I might note that the healthy economic expansion and the Fed's accommodation so far will help absorb displaced workers, and that is already occurring.

I expect in the next quarter and this quarter, and perhaps into early 2006, moderation in the rate of consumption growth; but then you are starting to see, as we speak, increased Government purchases, increased Government spending and fiscal policy multipliers are really going to kick in. And you can have that occur just at the same time consumption is bouncing back next year. So next we could have very strong economic growth.

I might note here that the higher headline inflation due to higher energy prices is reducing real purchasing power and is having a temporary negative impact on real wages. I do not expect that to continue. I do expect sustained productivity gains to generate increases in wages.

I would like to clarify two misperceptions I read about—I see about characteristics in the economy that are commonly viewed as

flaws. And the first is the low rate of personal saving. And I would like to point out here that the rate of personal saving, which is close to zero, is a flow variable; it does not include any appreciation of stocks or bonds, it does not include any appreciation of real estate. Therefore, this rate of personal saving is so low it excludes every avenue through which most households save. Meanwhile, total household wealth, even excluding all debt, is at an all-time high. So I say the rate of personal saving, in an odd sense, reflects confidence in the U.S. economy. People, even if they feel like they might lose their job, they can find another one, so they spend their cash flow and wealth continues to rise.

The other misperception about the economy is the trade deficit which is very, very large. Many people perceive that the high trade deficit is due to U.S. consumers, which is borrow to the hilt and spend their money on imported goods. But in fact if you look at a composition of what we import, it is amazing, because 40 percent of all imported goods to the United States are industrial materials and capital goods, even excluding oil and excluding autos. That is as much as total imports of all consumer goods.

Now, if you look at the way the United States has consistently grown faster than any other industrialized nation and its capital spending is multiples faster, the wide trade deficit, the fact that we are importing more than we are exporting, is a natural consequence of that. And it may just last a long time, and it may just be sustainable. That is, if we had a recession, and capital spending fell and consumption slowed, then, sure, the trade deficit is going to come in. What should your objective be?

But I would also point out so far this year, the trade deficit has come in, for some reason import growth is slow, the exports are accelerating nicely. And when I look around the world I see very strong economic growth in Asia, and Japan is really coming back to stronger growth. The Latin countries are doing fairly well now. All of our major trading partners, except for Europe, are doing poorly; so I think we can look forward to continued growth in exports, but the trade deficit is going to stay wide.

In this regard, the extraordinarily large current account, it has widened. I do not perceive it is an immediate problem. When we think about—when we ask the question, will foreign central banks and foreign portfolio managers continue to buy dollar-denominated assets, the answer is yes; they are doing so because it is economically rational for them to do so. Put yourself in their shoes. They see stronger economic growth in the United States, higher interest rates, higher inflation-adjusted interest rates, a credible central bank, credible policymakers, predictable policymakers. If you were in their shoes, you would allocate your resources to the United States. And I don't see any dramatic shift in global asset allocation that would lead to either a dramatic decline in the dollar or a sharp rise in interest rates.

Having said that, the character of the current account deficit has changed. In the 1990s we had an investment boom and saving was OK, but insufficient relative to investment. Now the problem we have is investments bouncing back, but saving is low, OK. So you have insufficient saving relative to national investment, just like Japan has excess saving relative to investment, so the exports are

capital here. The culprit of the lack of saving is not as much the low rate of personal saving as it is the budget deficit, and this needs to be addressed.

And so the problem, I see, is we have this issue that, when I look at it, both the current trade account deficits—we should expect them to be wide—it is a natural consequence of differences.

Let me just put it as a question. If you see such large differences in economic growth across nations and large differences in rates of saving and investment and you believe in international trade and capital flows, why would you ever expect current accounts and trade accounts to be in balance? You shouldn't. But we have this problem.

Now, what is the solution? I would love to see the solution be the United States, Europe, and Asian policymakers sit around the table and say, OK, United States says we will lower our budget deficit by 2 percent GDP, Europe says we will lower taxes, reduce our burdensome regulations, increase our potential growth from 2 to 3, and Asia—China would come along and say if you do that, we will float our currency. That is a pro-growth solution. But the point here—the reason I am bringing that out is when you look at these imbalances, think about pro-growth solutions rather than just reducing imbalances just to reduce them. My expectation is that consumption growth in the United States will bounce back post-Katrina, but it will slow—it will bounce back to a more moderate level than we had. I mean, if you look at the average annualized growth of consumption, really the last 45 years it has averaged 3.6 percent, we are not much higher than that now. I think it is going to bounce back to a slower rate of growth, exports are going to surprise to the upside, and the trade deficit will decline, and that imbalance will decline a bit, but we still have this long-run budget problem.

And on the budget issue I would just note, trying to be as absolutely nonpartisan as possible, if you look at what has happened to the composition of spending in the budget and the composition of the growth in spending, in the last 3—in the 1990s, the vast majority of the move toward budget surpluses on a cash flow basis was due to the decline in defense spending. In the last 3–4 years, both sides of the political aisle have voted for increase in defense spending. Neither party has come up with a great long-run solution for Medicaid or Medicare, both of which are rising fast as a share of the budget and the GDP, and we all know the Social Security issue.

So basically, given the short-run intractability of the spending side of the budget—I am being a realist here—what fiscal policymakers should be addressing now is to address the larger budgets on an accrual basis; that is, look at the large entitlement and retirement programs, which is the larger source of the increase of the budget over the last 15 years, and have a rational debate and say—and ask the question, how can we put together programmatic changes that are fair to current participants, that put in place the right incentives——

Representative Saxton. Doctor, if I may ask you to cut it——

Dr. Levy [continuing.] And for the long run, just make the benefit structures rational. Thank you.

[The prepared statement of Dr. Levy appears in the Submissions for the Record on page 55.]

Representative Saxton. Thank you very much.

Dr. Seiders.

STATEMENT OF DR. DAVID F. SEIDERS, CHIEF ECONOMIST, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC

Dr. Seiders. Well, thank you, Mr. Chairman. It is genuinely an honor to be here today. I appreciate the opportunity to testify, and will certainly take any questions you may have.

My name is David Seiders. I am Chief Economist with the National Association of Home Builders. My written statement contains detailed forecasts for the economy and the housing sector, on a quarterly basis, through 2007.

Today, I would just like to concentrate on what the role of housing has been in the economic expansion so far, and how I view the evolving role of housing in the near-term outlook.

Let me say at the beginning, that my forecasts assume that the current economic and housing policy structure remains very much intact. Housing certainly has some beneficial provisions in both the Tax Code and the housing finance system, and I'm assuming in the forecast that they are unchanged in the near term.

There has been a lot of talk about imbalances here this morning, and you may be aware that Chairman Greenspan recently described the current "housing boom," as he called it, as one of America's great economic imbalances. I certainly don't share that opinion, and I will tell you why as we go along.

As you know, the housing sector has been a real pillar of strength for the economy, even in the recession of 2001, and certainly in the economic expansion since then. The housing production component of gross domestic product has been growing rapidly and delivering solid contributions to GDP growth. The housing stock itself produces housing services that are consumed by households, a big piece of consumer spending in the GDP accounts that also has been showing solid growth.

When housing is moving well in terms of sales and production, we are pulling other industries with us, like furniture and appliances and those sorts of things. And as Chairman Greenspan has been talking a lot about recently, the strong house price appreciation that we have seen in recent years has created huge capital gains and equity benefits for America's homeowners, about 70 percent of all households. And that equity generation has supported a lot of consumer spending. When you add all this up, we estimate, I think conservatively, that housing has been accounting for at least a full percentage point of GDP growth in recent times. That is at least a quarter of the total, so it has been quite a story.

I mentioned that this kind of performance, particularly the behavior of house prices, has generated widespread speculation that the housing "boom" is overdone, and that it is likely to "bust" and possibly cause not only serious damage to our sector, the housing sector, but also to the economy overall. And we have been seeing a lot of analogies drawn between the current housing boom, if I can

use the term, and the stock market bubble that preceded the recession of 2001. I think those analogies are really off base.

My own view is that the housing market will inevitably cool down to some degree before long, but a destructive housing bust is not in the cards. Furthermore, rebuilding in the wake of this year's hurricane season will add to housing production for years to come. Everything considered, I think that the housing sector should transition away from being this strong GDP engine—fairly soon probably—but continue to play a vital role in the economy going forward.

Recent housing market indicators, on balance, have been suggesting that the housing market may be plateauing in terms of the volume of sales and starts and so forth. We got some very strong numbers yesterday on permit issuance and housing starts in September, a little stronger than I expected. However, my surveys of builders and some other indicators suggest that there is kind of a flattening going on out there in terms of volume, certainly not yet in terms of pricing. And so I think that the housing market, in terms of sales and production, if not topping out now, is close to it.

Going forward, my forecast does recognize emerging affordability issues that have been created, first of all, by the succession of rapid house price gains in many parts of the country. We are seeing that affordability factor putting a bind on home buying now. And we expect the affordability issue to be more complicated as we go ahead, as the interest rate structure, both short and long rates, gravitates up further; and that process certainly has begun.

I am also looking for less support to the housing market from two special factors that probably are temporary. One is heavy use of what Chairman Greenspan has called "exotic" forms of adjustable-rate mortgages, including deeply discounted interest-only adjustable-rate loans and various structures like that. Certainly the financial regulators are taking a very hard look at that right now. I expect to see these types of loans recede in the market, in terms of their importance.

The other special factor we have seen is a lot of investors out there, and a lot of them probably just short-term speculators in the housing market. As the market situation evolves and housing demand does fade to some degree, because of the affordability issue, I think we will see a lot of those speculators go to the sidelines as well.

So, what does my forecast show? It says that we are going to see the housing numbers, in terms of home sales and housing starts, move off in 2006. The decline probably will be only about 5 percent from 2005, which will easily be a record for the single-family market, in particular, and also a very strong year for the condo market.

In terms of pricing, we are still seeing double-digit increases in house values nationally, 20 percent or more in 50 to 60 metro areas in recent times. As housing demand fades as I have described, and volume comes off, I think that the rate of appreciation in house values will recede. To what rate next year, I am not exactly sure. If I had to make a guess, probably 10 to 12 percent this year, next year something like half that pace.

Don't expect to be worrying about a national house price decline over the next couple of years. We may see some declines develop in some of the hottest areas where the prices have risen the most. But even in those areas, unless the economy falters, I think price declines are a low probability. One of the key things in those areas has been serious supply constraints, mainly land-use controls which prevent the builders from meeting the housing demand that is there. As we go forward, more supply will keep coming on those markets, and I think that the price rebalancing will be an orderly process.

Mr. Chairman, that concludes my remarks.

[The prepared statement of Dr. Seiders appears in the Submissions for the Record on page 60.]

Representative Saxton. Thank you very much, Dr. Seiders.

Before we go to Dr. Setser, let me just say that we have a series of votes currently on the House floor, and House Members will be scampering out to make those votes, and then we will try to get back for the question and answer period. In the meantime, Senator Bennett is going to take the Chair. Thank you.

Dr. Setser.

STATEMENT OF DR. BRAD SETSER, SENIOR ECONOMIST AND DIRECTOR OF GLOBAL RESEARCH, ROUBINI GLOBAL ECONOMICS, LLC, NEW YORK, NY

Dr. Setser. I want to thank Chairman Saxton and the Members of the Joint Economic Committee for the opportunity to testify here today.

My remarks will focus on one particular aspect of the economic outlook, the payments deficit that the United States is running with the rest of the world. I want to make five points.

First, the U.S. current account deficit has reached an unprecedented size for a major economy. Barring a sharp fall in oil prices, that deficit is likely to rise next year.

Second, the U.S. external deficit reflects policy decisions both here in the United States and abroad, not simply private savings and investment decisions. Both the large U.S. fiscal deficit and the unwillingness of many economies elsewhere in the world to allow their currencies to appreciate against the dollar are contributing to this deficit.

Third, trade deficits at nearly 6 percent of U.S. GDP are simply not sustainable over time.

Fourth, large current account deficits reflect borrowing that is needed to finance consumption in excess of income. The availability of sufficient financing to sustain deficits of the current-size—borrowing that may reach $900 billion next year—should not be taken for granted. Consequently, these large ongoing deficits will be a risk to the U.S. economic outlook for many years to come.

Finally, policy actions both here and abroad can help, first to stabilize and then to reduce the U.S. external deficit. The needed policy steps by now, I think, are well known, but no less urgent.

First, the U.S. current account deficit is now quite large. The current account deficit is, by definition, the sum of the trade deficit, the deficit on transfer payments—U.S. foreign aid, and private gifts of U.S. citizens abroad—and the balance on income. The income

balance reflects the difference between what the United States earns on its foreign assets and what the United States must pay on its liabilities. The United States pays both dividends on foreign investments here in the United States and the interest on our rising external debt.

In the second quarter, that balance—the balance on income—turned negative for the first time in some time, and over time the balance on investment income will contribute increasingly to the U.S. current account deficit.

In 2005, I expect the current account deficit to rise to a bit over $800 billion. That will reflect a trade deficit that will increase to about $720 billion, largely on the back of higher oil prices, continued transfer deficits, and for the first time in several years, an income deficit.

That $800 billion deficit is a significant increase from the $520 billion deficit of 2003 and the roughly $670 billion deficit of 2004. I expect the trend of wider deficits to continue in 2006 for three reasons:

First, the pace of growth of non-oil imports, as has been noted, has been relatively subdued this year. That reflects a lag after very strong growth at the end of 2004. As the U.S. economy continues to grow, I expect some resumption in the growth of non-oil imports.

Second, I expect the current strong export growth to slow. Why? Because the dollar has been strengthening this year, and that will impact the trade balance.

I disagree somewhat with Dr. Levy in his emphasis on strong growth in Asia and low growth in Europe. If you look at the composition of U.S. export growth this year, U.S. exports to Europe have been growing faster than U.S. exports to the Asia Pacific region for the simple reason the dollar felt substantially against the euro in 2003 and 2004.

Finally, the balance on investment income, the amount of interest that the United States has to pay on the external debt, is set to rise substantially. The roughly $800 billion that we have to borrow this year, assuming an interest rate at around 5 percent, translates into a $40 billion increase in our net payments abroad.

Second point, this rising external deficit is a function of policy choices both here and abroad—policy choices that have reduced savings relative to investment in the United States and increased savings relative to investment in the rest of the world. The key policy decision that we in the United States made is to increase our structural fiscal deficit. That deficit went up during the recession, as Dr. Bernanke noted. It has not come down commensurately as the economy has recovered. As investment has picked up from its low levels, that has correspondingly widened the gap between savings and investment here in the United States.

Abroad, savings and investment have evolved in different ways in different countries, but I think it is important to recognize the main counterparts to the U.S. current account deficit—or to the rise in the U.S. account deficit—has not been an increase in Europe's current account surplus. Europe's current account surplus, broadly speaking, has been falling. Japan's surplus has been rising, but the rise, roughly $60 billion since 1997, is in no way on the same scale as the increase in the U.S. current account deficit. The

main counterpart to the increase in the U.S. current account deficit has been the enormous increase in the surpluses that have been run by so-called emerging and developing economies. That reflects rises in savings in China and in the oil-exporting countries, and falls in investment in many other emerging Asian economies.

The vector that has carried these surplus savings to the United States, by and large, has not been the private flow of capital; rather, it has been the unprecedented increase in the accumulation of hard currency reserves by emerging economies. The increase in true reserves, the annual increase, has gone from about $116 billion in 2001 to about $500 billion last year, and I expect around $600 billion this year just in the world's emerging economies.

Third point. These deficits are not sustainable over time. Particularly trade deficits of this magnitude are not sustainable over time. Why? Because a constant trade deficit, according to basic external debt sustainability analysis, implies a rising external debt-to-GDP ratio over time, and a rising external debt-to-GDP ratio implies a rising current account deficit as the amount of interest that we have to pay on our external debt rises over time.

Indeed, should the trade deficit gradually fall to roughly zero over the next 10 years, something that would imply substantial changes, the U.S. national external debt would still rise to about 50 percent of U.S. GDP, and at the end of that adjustment period the United States would still be running a significant current account deficit.

Fourth, as I mentioned earlier, sustaining ongoing deficits of this magnitude next year requires net inflows of capital from abroad of between $900 billion and $1 trillion dollars; that implies that we have to commit some of our future income to pay for that inflow of debt. And broadly speaking, since we are relying on foreign savings to finance investment here at home, some of the benefits of investment here will flow to our foreign creditors.

More immediately, though, the risk is that the financing needed to sustain these deficits won't be available at current relatively low interest rates. Any rise in interest rates might provoke a slowdown in U.S. economic activity.

The combination of market forces and policy decisions that will bring about the necessary adjustment in the U.S. trade deficit is subject to substantial uncertainty, but there is no doubt that the adjustment, when it comes, implies substantial changes in the drivers of growth both in the United States and in our trading partners. Specifically, consumption growth here in the United States must slow, and consumption growth in our trading partners needs to rise.

Recent studies by the staff of the Federal Reserve Board offer hope that the necessary adjustment process will be relatively smooth. However, caution is in order. The United States is in many ways operating outside the realm of historical experience. But I think one lesson from international experience is pretty clear. As a country's external debt grows, it becomes more, not less, important to maintain confidence in a country's fiscal policy choices. Reducing the fiscal deficit, put simply, is the best way to raise national savings.

Policy changes are also necessary abroad. China, Malaysia, and many oil-exporting countries need to unpeg or reduce the degree to which they peg their currencies to the dollar. Spending in oil-exporting countries must rise if oil prices stay high, and China needs to take steps to stimulate consumption.

As I have argued, the expansion of the U.S. trade deficit reflects mutually reinforcing policy choices. The stabilization and the eventual fall in the U.S. deficit will also be far smoother if that process is supported by appropriate policy changes. No doubt market forces will eventually demand adjustment even in the absence of policy change. But as both the current President of the New York Fed, Tim Geithner, and former Treasury Secretary Robert Rubin have emphasized, without supporting policies the needed market moves are bigger and the risk of disrupted market moves is far higher.

Thank you.

[The prepared statement of Dr. Setser appears in the Submissions for the Record on page 67.]

Senator Bennett [Presiding.] Thank you very much. This is a very interesting and worthwhile panel, and it looks like Senator Reed and I are going to have the next 15 minutes to ourselves before the lease runs out and we are forced to leave the room.

I would like Dr. Setser and Dr. Levy to kind of go at each other here, because they have slightly different views; but there is also a degree of agreement and common ground from which to have this exchange.

Let me just make a comment before I ask the two of you to respond to each other. Everybody agrees that the American deficit has to come down; that is, the amount of borrowing by the government, whose percentage of GDP has to be stabilized—I am of the opinion that if it stays at its present level as a percentage of GDP that is within historic norms, then it is completely sustainable. However, if you look ahead at the demographics, it becomes abundantly clear that it cannot stay within its present percent of GDP without some fairly fundamental changes in the spending patterns. And we saw the peace dividend that occurred in the 1990s that brought the deficit down, and we all assumed we were responsible. All of us here in the Congress took full credit for it, and the Clinton administration took full credit for it, and that is the way politics works. But the peace dividend is a one-time dividend, and if we are going to bring the deficit down, we are going to need to have the courage to address the entitlement problem. And the entitlement problem is summarized by our friend Ted Stevens, who, when he went on the Appropriations Committee, said the Appropriations Committee controlled two-thirds of the Federal budget and one-third was mandatory spending outside of the purview of the appropriations process.

Today those numbers are reversed. We have a budget of roughly $2½ trillion, and that portion that is subject to appropriations is roughly $800 billion, a third. And the percentages keep going in favor of the mandatory spending, to the detriment of discretionary spending. And the $800 billion—$840 I think is the actual number—roughly $800 billion that the appropriations covers includes defense, which is roughly half.

So if you take away half of the discretionary spending and say it is off limits because of defense, and you are going to, quote, "balance the budget by Congress getting its act in order and holding down spending, you have a universe of $400 billion that you have to deal with out of a $2½ trillion budget, unless you are willing to tackle the mandatory spending, the entitlement spending, which means Social Security, Medicare and Medicaid. And if we say those must be held inviolate, we will see the two-thirds that is currently mandatory grow to three-fourths, or to 90 percent, or eventually 100 percent. And if you want to talk about something that is unsustainable, that is a trend that is unsustainable and affects everything else we are talking about.

OK. Having made that point, Dr. Setser and Dr. Levy, can you comment back and forth on each other, and we will try to hold what you say between the two of you for maybe the next 7 minutes, and then Senator Reed can ask his for the next 7 minutes, and we will have taken the time that is available to us because I don't think our House colleagues are coming back. Is that a fair division of time, Senator?

Dr. Levy. Let me take a crack at it. I would note in the 1990s, even as the cash flow government budget went from deficit to surplus, on an accruable basis the deficit—on an accrual basis, the budget was deteriorating because of the continued rising in the unfunded liabilities.

It is imperative to address the long-run budget imbalance because if we look realistically in the short run, many aspects of the programs that are growing the fastest are intractable. So it is now important to address in a very rational, fair way that doesn't affect current recipients, change the policies that will affect the long run, grandfather them in.

And I remember when I was working on the Hill in the late 1970s and the Social Security projections were accurate—they proved to be accurate. And the issues are the same, just the numbers are bigger. Address them in an appropriate way.

I would like to make two comments on the current account. Very frequently in my position I have to talk to portfolio managers that run all of the Asian central bank money. And I was just over there, and they are very economically rational. And they are seeking the highest risk-adjusted expected rates of return. They have no intention at all of dramatically altering their asset allocation.

Second, if you think about it, in the last year with low interest rates, when they buy, say, a 2-year debt, we are borrowing at, say, 3 percent, now it is 4 percent, the issue is what are we doing with the imported capital? To the extent we are using it—and as I mentioned it in my testimony—to finance corporate purchases of industrial materials and capital goods, I guarantee you the average rate of return on that imported capital is higher than the cost of financing it. So once again, the culprit once again is the budget deficit. And not just the budget deficit per se, but the entitlement programs, the consumption-oriented ones that increase spending without adding to the Nation's long-run productive capacity.

Senator Bennett. Dr. Setser.

Dr. Setser. Well, I do think Dr. Levy and I share a common opinion that the best way that the pace of increase in the current

account deficit can first be reduced and then the deficit can be brought down is by taking steps to increase national savings, and the first best way to do so is to reduce the fiscal deficit.

I am not convinced, however, that the debate about entitlements is totally relevant here, and I say that for the following reason, and with complete respect for the opinions of the Senator.

In my personal opinion, the trade deficit and the trends of the unsustainability about the trade deficit are likely to manifest themselves as a problem in a much shorter time frame than the time frame that is relevant for the debate about entitlements, and particularly for the debate about Social Security. And I would note in that context that at this current point in time, Social Security runs a cash flow surplus, as is well known, and this reduces the cash flow deficit of the rest of the government. So my concern would be that in the context of reforming our entitlements, we increase our near-term fiscal deficits—cash flow deficits—and increase our near-term borrowing. That would not increase our own national savings or decrease our dependence on savings from abroad.

As I have argued, our current dependence on foreign savings is already quite high. And since I don't think we are talking about a 40-year problem or a 20-year problem, I think we are talking about more of a 10-year problem, so I think the time frames are a little bit different.

The question about the continued availability of financing to sustain the U.S. current account deficit—which is much larger than the U.S. fiscal deficit—does hinge, as Dr. Levy suggested, on the portfolio decisions made by Asian central banks. I would also note it hinges on the portfolio decisions made by the Russian central bank and by the central banks of the major oil-exporting countries. One of the major evolutions that has occurred this year is that a growing share of our deficit is indirectly being financed by Saudi Arabia, by Russia, by the other countries with large oil exporters.

I differ slightly from Dr. Levy in his assessment that it is rational for these countries, on an investment basis, to be sending and to be buying U.S. treasuries at the current rate; I say that for the following reason. Most forecasts for the size of the dollar depreciation against Asian currencies that would be needed to bring the trade deficit down over time, are quite large; therefore, even the interest rates of 4 percent or 5 percent that these countries are getting on your dollar assets here, is unlikely to compensate them for the future exchange rate risk. So while I don't think Asian central banks are likely to shift their portfolio away from dollar assets, I think there is a risk that over time they may be less willing to add to their stock of dollar assets. And remember, we do need $800—or $900 billion every year. We get it 1 year, we still need it the next year. I also differ slightly in my assessment of the uses to which this imported savings is being put.

Senator Bennett. I am sorry to interrupt you, but I would like Senator Reed to——

Senator Reed. Go ahead, Doctor.

Dr. Setser. My concern is that the external debt that we are taking on right now is not being, by and large, used to finance investment in the tradables portion of the U.S. economy, and external debt is ultimately a claim on our tradable production of goods

and services. So while in the short run, shifting resources toward the residential housing sector and toward other sectors can help sustain growth, in the long run it is not obvious to me that improvement in our residential housing stock will generate the future export revenue needed to pay back the interest on that rising external debt.

Senator Bennett. Thank you.

Senator Reed. Thank you, Senator Bennett.

It strikes me that we all are saying the same thing, just in different ways. That is that we have to increase national savings. There are several ways to do that. One is to reduce the budget deficit, or to increase household personal savings. And it strikes me with all the discussion particularly around this room about tax policy, tax policy doesn't seem to produce a lot of increases in personal savings.

Do you want to comment on that, Dr. Setser?

Dr. Setser. I tend to agree with that. I think the general studies suggest that tax incentives for savings have offsetting effects, that on one level they may increase some savings at the margins, but a lot of the benefits from the tax incentives go to people who would otherwise have saved, and so are offset by reductions in tax revenues, and the overall impact on national savings is small.

Senator Reed. Dr. Levy, I will let you respond, too, but behind that question is another question. If we can't effectively—or don't choose to effectively stimulate household savings, then we are left to close the budget deficit in order to achieve this goal of increasing national savings and investment; is that——

Dr. Levy. You want to reduce the budget deficit in any way, in any case, because how you spend and how you tax determines the allocation of national resources. And once again, what you want to do is effect a policy that is best for a sustained, healthy long-run economic growth.

With regard to tax incentives, I respectfully disagree. I think they have increased saving.

I would like to embellish on one other point, and it is an oddity in the following way——

Senator Reed. Excuse me. In your testimony you indicated that the numbers suggest a close to zero household savings rate. You made some interesting points about the fact that it doesn't include residential real estate and stocks, et cetera, but I just want you to clarify now whether you are saying that tax policy is actually stimulating savings.

Dr. Levy. Well, the rate of personal savings has come down because it is a cash flow measure and people are spending their cash flow because their wealth is going up. Let me juxtapose that with the double-digit rate of saving, personal saving in Germany, because people are still pessimistic about the economy and their prospect for jobs, where there is a 7½ percent rate of personal saving in Japan where there is a lot of angst.

Let me add this oddity. In the last year oil prices have increased significantly. On an annualized basis, the doubling of oil prices has increased revenues to OPEC just in the United States by over $200 billion. U.S. consumers have smoothed their consumption pattern, that lowers their rate of saving; but because it is all denominated

in dollars, a lot of it flows back into the United States and keeps the real cost of capital low.

So it is very ironic, like circa 1970s recycling petro dollars; that is, lowering our rate of personal saving and widening our current account deficit. That is, the cost of higher energy crisis is real.

Senator Reed. And both those things are bad in terms of lowering savings and——

Dr. Levy. Yes.

Senator Reed. Dr. Setser, do you have a final comment?

Dr. Setser. I agree with the mechanism that Dr. Levy described by which the oil surplus is being recycled back on the United States. I think the ironic thing, in some sense, is that the oil surplus that these countries have comes not just from exporting oil to the United States, but to exporting oil to Asia. And one of the striking features of the current situation is while they are earning money from the entire world, it seems like a disproportionate share of their savings is flowing back to the United States.

However, I wouldn't assert that is a necessary consequence of the fact that oil is priced in dollars. In liquid capital markets, it is quite easy to sell oil for a dollar and trade that dollar for a euro, and I think over time we shouldn't assume that current patterns will continue.

Senator Reed. Well, thank you very much, gentlemen. Thank you, Senator Bennett.

Senator Bennett. This has been a most worthwhile panel. And, Dr. Seiders, you didn't get into this macro stuff because you are talking about housing——

Dr. Seiders. The House Members are probably more interested in that. Just kidding.

Senator Bennett. I found your comments to be very useful.

Let me just make one comment, back to my earlier one about the mandatory spending and the entitlements. Dr. Setser, the only reason that I pick on Social Security is that it is the easy one. Medicare and Medicaid are going to be much more difficult. And if we cannot in the Congress come together to solve the Social Security long-term structural problem—I agree with Dr. Levy, we should hold the present participants harmless, because I happen to be one of them; but for my children and grandchildren, if we can't come together to deal with Social Security in a bipartisan fashion, we will never, ever get our arms around the Medicare problem.

Social Security is the easy one because it is simply moving numbers around. We know all the people, we know all the dollars that can be allocated. Medicare has so many other problems connected with it.

So I agree with you that Social Security may not be the big one, but at least I want to take it on because I think it is the easy one.

And thank you very much for your participation here. The hearing is adjourned.

[Whereupon, at 12 p.m., the Committee was adjourned.]

Submissions for the Record

PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

I am pleased to welcome Chairman Bernanke and the members of our second panel of witnesses before the Joint Economic Committee this morning. This Committee values its long history of cooperation with the Council of Economic Advisers. The testimony today will provide a solid foundation for understanding the forces that are shaping current economic conditions as well as the economic outlook.

The recent hurricanes have caused a tragic loss of life and property on the Gulf Coast, and also have had temporary effects on the U.S. economy as a whole. One reason for this national impact is that a significant portion of U.S. oil and gas production is concentrated in the Gulf, and much of it is still damaged. Thus it is reasonable to expect that the economic impact of the hurricanes will slow GDP growth in the second half of 2005. In 2006, as recovery efforts proceed, many economists expect growth to be a bit higher than previously forecast.

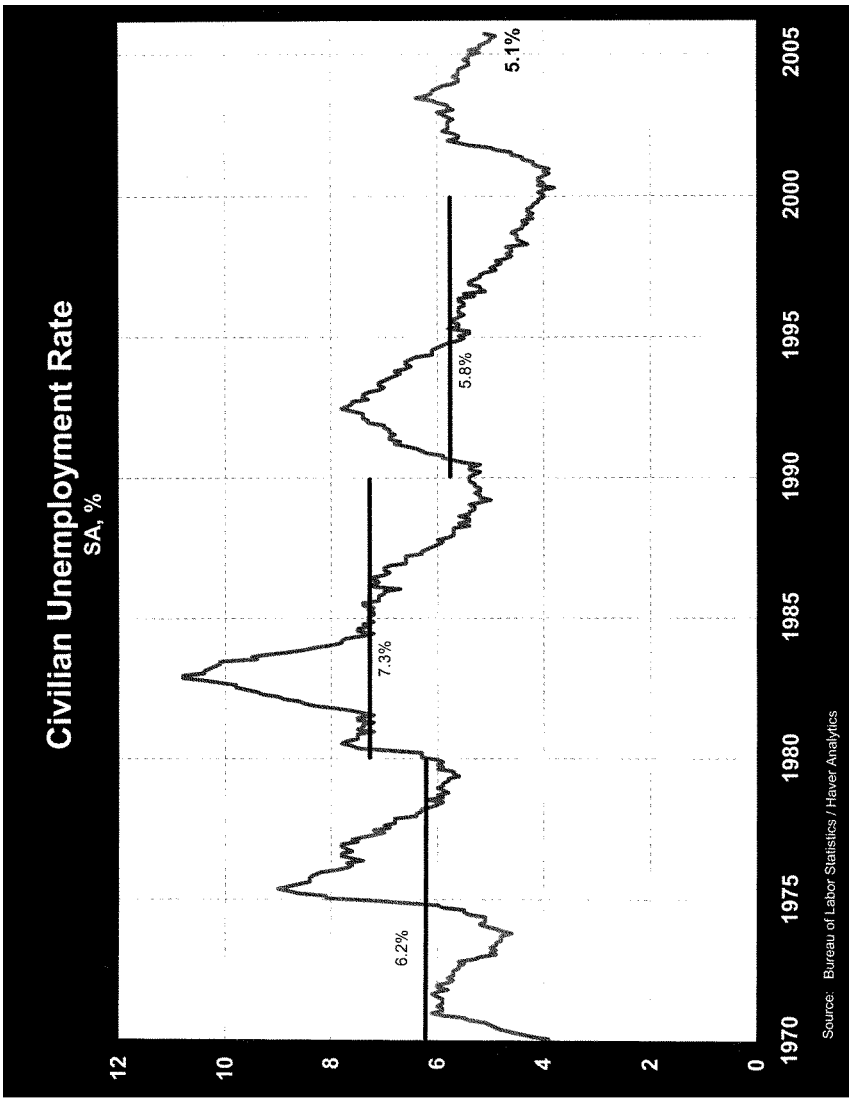
Despite the hurricane damage, a broad array of standard economic data indicates that the economic expansion has built up strong momentum. The U.S. economy grew 4 percent in 2004, and advanced at a rate of about 3.5 percent in the first half of 2005. A rebound in business investment has played an important role in explaining the pick-up in the economy since early 2003. Equipment and software investment has been strong over this period.

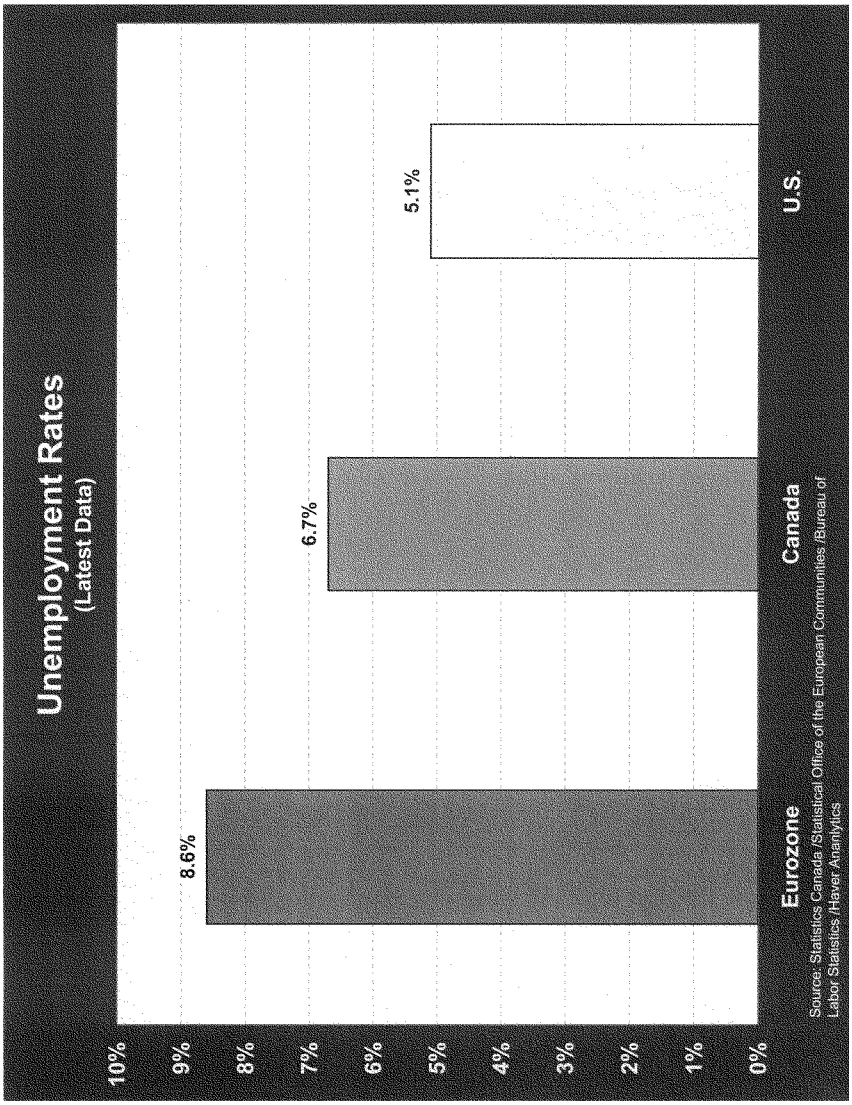
The improvement in economic growth is reflected in other economic figures as well. Since May of 2003, business payrolls have increased by 4.2 million jobs. The unemployment rate stands at 5.1 percent. Consumer spending continues to grow. Homeownership has hit record highs. Household net worth is also at a record level. Productivity growth continues at a healthy pace.

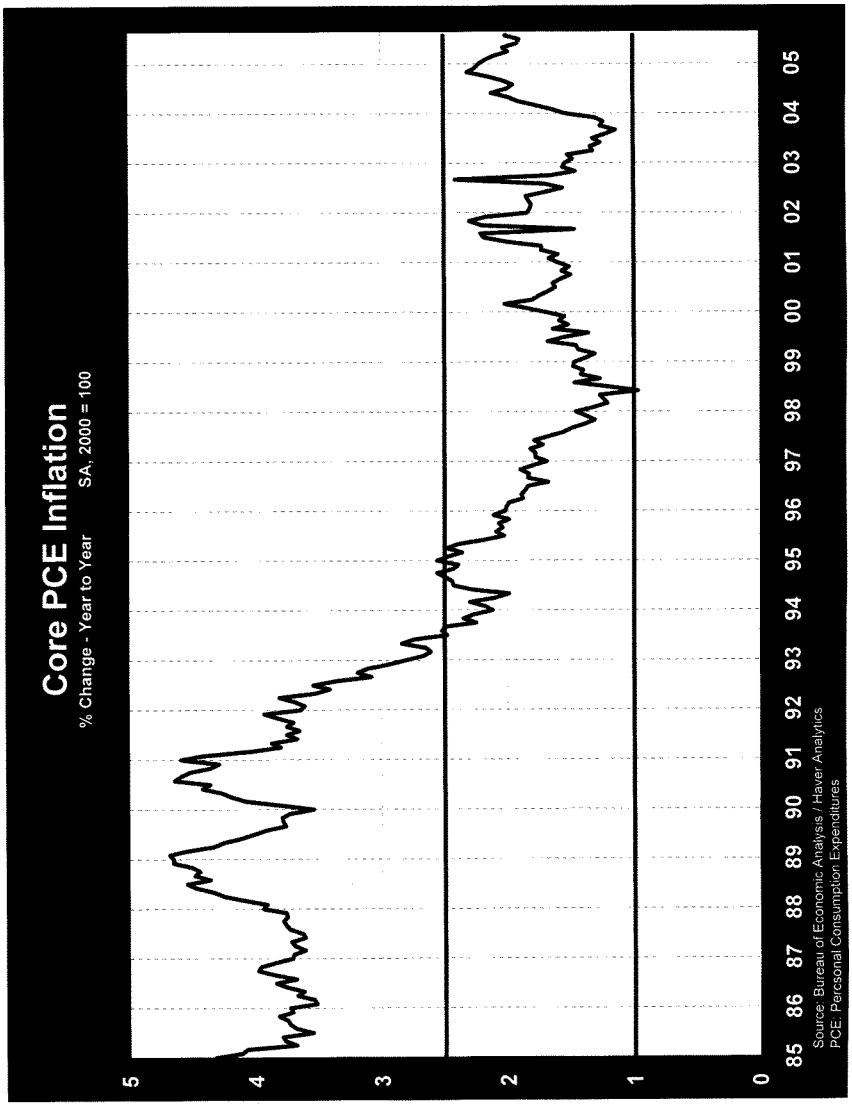
Long run inflation pressures appear to be contained. Long-term interest rates, including mortgage rates, are still relatively low. It is clear that the Fed remains poised to keep inflation under control.

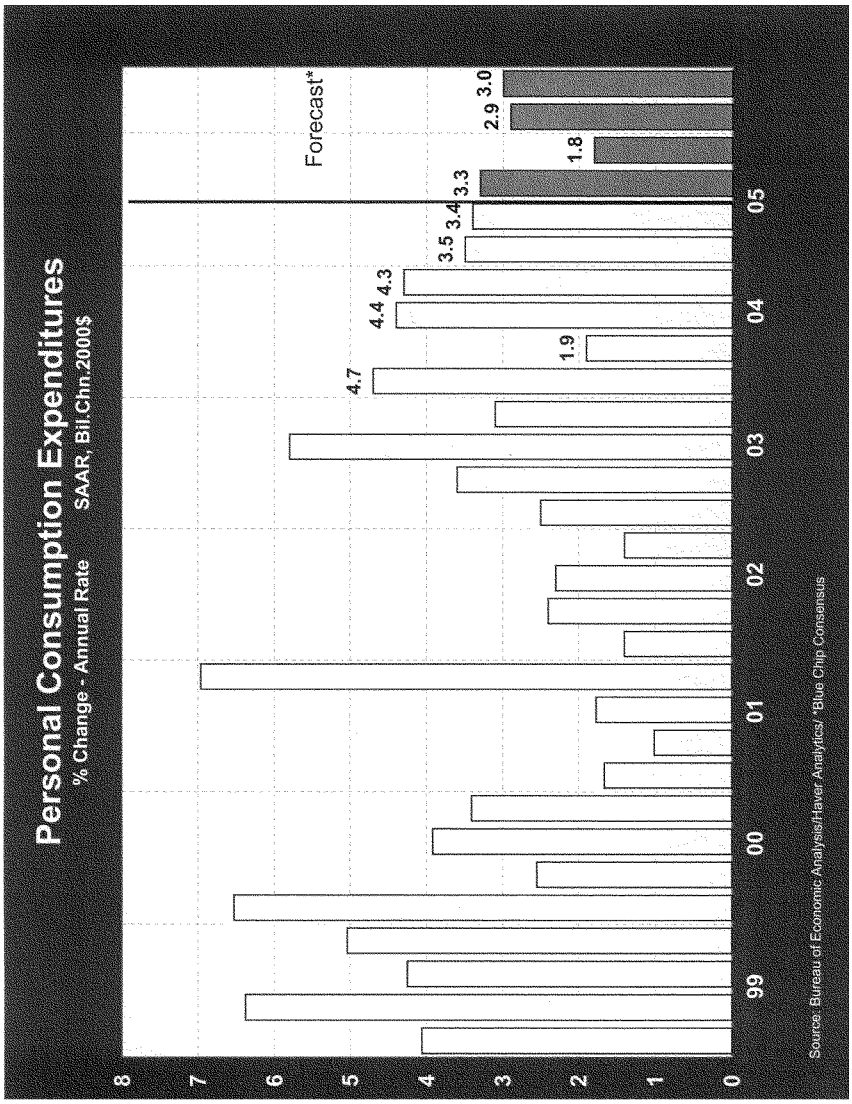
In summary, overall economic conditions remain positive. The U.S. economy has displayed remarkable flexibility and resilience in dealing with many shocks. It is clear that monetary policy and tax incentives for investment have made important contributions to the improvement in the economy in recent years. Recently released minutes from the Federal Reserve suggest that the central bank expects this economic strength to continue.

The Administration forecast for economic growth in 2006 is comparable with those of the Blue Chip consensus and the Federal Reserve. With growth expected to exceed 3 percent next year, the current economic situation is solid and the outlook remains favorable.


Civilian Unemployment Rate
SA, %
12
10
8
6
4
2
0
1970
1975
1980
1985
1990
1995
2000
2005
6.2%
7.3%
5.8%
5.1%
Source: Bureau of Labor Statistics / Haver Analytics


Unemployment Rates
(Latest Data)
10%
9%
8%
7%
6%
5%
4%
3%
2%
1%
0%
8.6%
6.7%
5.1%
Eurozone
Canada
U.S.
Source: Statistics Canada /Statistical Office of the European Communities /Bureau of Labor Statistics /Haver Ananlytics


Core PCE Inflation
% Change - Year to Year
SA, 2000 = 100
5
4
3
2
1
0
85
86
87
88
89
90
91
92
93
94
95
96
97
98
99
00
01
02
03
04
05
Source: Bureau of Economic Analysis / Haver Analytics
PCE: Percsonal Consumption Expenditures


Personal Consumption Expenditures
% Change - Annual Rate
SAAR, Bil.Chn.2000$
Forecast*
8
7
6
5
4
3
2
1
0
99
00
01
02
03
04
05
4.7
1.9
4.4
4.3
3.5
3.4
3.3
1.8
2.9
3.0
Source: Bureau of Economic Analysis/Haver Analytics/ *Blue Chip Consensus

ECONOMIC EFFECTS OF INFLATION TARGETING

After decades of debate, the case for inflation targeting is well established. This paper focuses on one key ingredient of the argument supporting inflation targeting: The proposition that a credible implementation of inflation targeting will calm and stabilize various financial markets, anchor the price system, and limit inflation as well as its variability and persistence. Other competing views—i.e., (a) that inflation targeting has no impact on financial markets and (b) that inflation targeting leads to asset price bubbles and hence to financial market volatility—are briefly outlined.

These alternative views are presented and briefly contrasted with existing empirical evidence. Some key findings include the following:

- There is little or no evidence that inflation targeting adversely affects financial markets.
- While not unanimous, the weight of the existing empirical evidence appears to support the view that inflation targeting matters and will work to calm and limit the variability of financial markets, as well as the persistence of inflation. As the empirical literature suggests, this will likely help to foster healthier economic growth. Although some research findings are consistent with competing hypotheses, this research has a number of problems.

Since there is little evidence that inflation targeting has adverse effects on financial markets or the economy, adopting inflation targeting once price stability is attainted likely will make maintaining price stability easier. As emphasized by others, adopting inflation targeting will help *future* economic performance in that gains in credibility will be preserved for future Federal Reserve chairmen.

INTRODUCTION

The theoretical case for inflation targeting (IT) has been spelled out during the course of the last 15 years in a number of publications, including several JEC studies. The case for IT is a strong one, supported by a number of compelling arguments. According to proponents, adopting IT certainly does make a difference by improving the performance of the economy, the financial system, and the inflation rate. The arguments supporting this approach, however, will not be repeated here; these arguments have been amply described elsewhere. Instead, one component of the arguments supporting the adoption of IT will be reviewed and assessed.

In particular, IT proponents contend that its adoption will help to calm and stabilize financial markets. More precisely, the adoption of credible IT will provide *an anchor* to the financial system and to financial markets. In so doing, financial markets will stabilize as inflation is driven from the price system. Temporary deviation of inflation will be ignored. This credibly reduced inflation is associated with less volatile financial markets, smaller risk premiums, and lower inflationary expectations. *In this view, then, IT is associated with more stable financial markets.*

On the other hand, some economists contend that IT is associated with asset price bubbles, and thus, asset price volatility. In particular, as credible IT works to stabilize conventional measured inflation, to reduce risk premiums, and to tame economic fluctuations, economies experience *more risk taking* and more risky investment. Economies will also experience increased stock price volatility and associated asset price bubbles. According to this view, there is a kind of "moral hazard" of economic policymaking: The more stable/predictable the economic environment, the more risk taking and risky investment take place. Proponents of this view point to several classic episodes in which asset price bubbles followed periods of price stability; e.g., the United States during the 1920s, as well as more recent episodes in Japan and the U.S. *In this view, then, IT is associated with more volatile asset prices and financial markets, the opposite contention of the above, more conventional view.*

This paper briefly describes these alternative views, reviews relevant empirical evidence, and attempts to reconcile these seemingly conflicting positions.

AN UNCONVENTIONAL VIEW: INFLATION TARGETING (IT) AND ASSET PRICE VOLATILITY

Recently, a few economists have broken rank with the conventional view supporting IT. These economists contend that low inflation environments tend not to be associated with asset price stability. Instead, they argue that IT or low inflation environments tend to be associated with asset price movements and bubbles (or financial fragility) and asset price volatility. Fildaro, for example, states that:

> . . . The achievement of a low, stable inflation environment has not simultaneously brought about a more stable asset price environment. The record over

> the last decade, in fact, has raised the prospect of asset price booms and busts as a permanent feature of the monetary policy landscape.[1]

Similarly, Borio and Lowe (2002) argue that:

> . . . financial imbalances can buildup in a low inflation environment . . . while low and stable inflation promotes financial stability, it also increases the likelihood that excess demand pressures show up first in credit aggregates and asset prices, rather than in goods and services prices . . . We stress that financial imbalances can and do buildup in periods of disinflation or in a low inflation environment,[2]

Furthermore, in reviewing the economic environment of the past 30 years or so, Borio and White (2004) maintain that this environment can be characterized as improving in price stability while at the same time experiencing more financial instability.[3]

Some endorsing this alternative view include some economists sympathetic to the Austrian School and several economists affiliated with at the Bank for International Settlements (BIS).[4]

This alternative view embodies some important implications. Notably, proponents of this view contend that price stability or IT causes sharp movements in asset prices; i.e., price stability or IT is associated with asset price bubbles.

According to proponents of this view, IT central banks themselves increasingly (but unwittingly) work to create the environment conducive to the formation of asset price bubbles or instabilities. Specifically, as modern central banks learn to control inflation and tame economic fluctuation, thereby stabilizing economic activity, these economies will experience *more risk taking,* more innovation, more investment and sometimes stronger advances in productivity. They will experience increased stock market volatility and associated asset price bubbles. Credible IT policies, therefore, stabilize conventionally measured price indices while at the same time create new incentives to take risk.

In this view, there is a kind of "moral hazard" of economic policymaking: The more stable/predictable the economic environment, the more risk taking, investment, and innovation take place. In sum, low inflation environments are increasingly associated with financial imbalances and asset price volatility.

THE CONVENTIONAL VIEW: INFLATION TARGETING CALMS AND STABILIZES FINANCIAL MARKET PRICES

There are several theoretical explanations of how financial markets are affected by the existing monetary regime. In particular, different explanations exist as to how movements in financial market prices are shaped by the adoption of IT and its associated consequent price stabilization. *One* of the direct benefits of IT, for example, is the calming, stabilizing effect it has on financial market prices and on the market price system itself. In short, IT stabilizes prices and *serves as an anchor* to the price system. According to Levin et.al., for example:

> . . . under an inflation-targeting regime, expectations about inflation, particularly at longer horizons, should be "anchored" by the target, and thus should be less affected by changes in actual inflation . . . Having inflation expectations that are well anchored—that is, unresponsive to short-run changes in inflation—is of significant benefit to a country's economy . . . Keeping inflation expectations anchored helps to keep inflation itself low and stable.[5]

More specifically, as inflation rates are credibly lowered and as stable prices eventually emerge, inflation and inflationary expectations will have less of a disturbing effect on price movements. Price reactions to both economic policy announcements and economic data releases will be tempered. This reduction in inflation and inflationary expectations will lower the variability of relative and nominal prices. And

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[1] Fildaro, Andrew, "Monetary Policy and Asset Price Bubbles: Calibrating the Monetary policy tradeoffs," *BIS Working Paper* No. 155, June (2004), p.

[2] Borio Claudio, and Philip Lowe, "Asset Prices Financial and Monetary Stability: Exploring the Nexis," *BIS Working Paper* No. 114, (July 2002), Abstract, p. 1.

[3] Borio, Claudio and William White, "Whither Monetary and Financial Stability? The Implications of Evolving Policy Regimes," *BIS Working Paper* No. 147 (February 2004).

[4] These authors, include, for example, Charles Bean, Claudio Borio, Philip Lowe, William White, Andrew Filadro, Andrew Crockett, and others.

[5] Jeremy Piger, "Does Inflation Targeting Make a Difference?", *Monetary Trends,* Federal Reserve Bank of St. Louis, April 2004, p. 1. See also Levin, Andrew T., Natalucci, Fabio M. and Piger, Jeremy M., "The Macroeconomic Effects of Inflation Targeting," Federal Reserve Bank of St. Louis Review, July/August 2004, 86 (4).

this reduction of inflation and inflationary expectations will also reduce uncertainty and thereby lower risk spreads.

Furthermore, distorting interactions of inflation with the tax code will gradually be minimized. In short, the operation and working of the price system will be improved as adopting IT will reduce market volatility.

These factors will contribute to calming and stabilizing a number of important markets including the short-term money market, long-term bond market, foreign exchange market, sensitive commodity markets, as well as equity markets. All of these improvements will work to better enable to function, improve market efficiency, and inevitably to improve economic growth and performance.

INDIRECT APPROACHES TO STABILIZE MARKETS

There are additional indirect, but important ways in which IT can work further to calm and stabilize movements in market prices. More specifically, IT necessarily involves an increase in central bank *transparency,* which can work to further stabilize markets.[6] The benefits of monetary policy transparency cited in the literature include a reduction in both the level of and variability of inflation, as well as output.[7]

IT, after all, involves the announcement of and explicit public identification of policy goals or policy rules. This involves providing more information to the market. Markets work better with more information; more specifically, they absorb new information and use it to form common, concentrated expectations about the future.[8] As markets begin to anticipate policy changes, the initial steps of the monetary transmission mechanism between policy action and economic activity begin to work more efficiently.[9] Policy surprises affecting markets become smaller and fewer in number. Central bank credibility begins to build and to anchor inflationary expectations, thereby helping to stabilize financial markets. As one proponent put it: "the strength of inflation targeting, vis-à-vis other monetary regimes lies precisely in how transparency enhances monetary credibility and anchors private expectations." [10]

In short, increased transparency changes behavior so that markets function better and in a more stable, predictable manner that works to stabilize markets.

EMPIRICAL EVIDENCE

In sum, alternative views as to the effects IT might have on financial markets suggest that, *the adoption of IT could result in these markets becoming more volatile, less volatile, or unaffected by IT. Existing evidence sheds some light on validity of these alternative views.*

Does IT result in more Volatile Financial Markets?

Hard empirical evidence supporting the view that IT causes financial market volatility appears difficult to muster. Much of the literature sympathetic to this view is not focused directly on such empirical evidence. Rather, it often deals with broader issues of monetary policy and the policy role played by asset price "bubbles". Borio and Lowe, for example, make such a connection:

> While low and stable inflation promotes financial stability, it also increases the likelihood that excess demand pressures show up first in credit aggregates and asset prices, rather than in goods and services prices. Accordingly, in some situations, a monetary response to credit and asset markets may be appropriate to preserve both financial and monetary stability.[11]

But the argument that price stability or IT itself fosters asset price bubbles, asset price volatility, or financial instability has been neither adequately nor convincingly established. And the case that financial imbalances develop because of stable price environments, has not been demonstrated; it has *not* been shown that price stability

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[6] Transparency has several dimensions. These involve explicit identification of policy objectives, issuing inflation reports, policy announcements, and testimony, i.e., providing much more information to the market. See for example, Seth B. Carpenter, "Transparency and Monetary Policy: What Does the Literature tell policymakers?" Working Paper, Board of Governors of the Federal Reserve System, April 2004. p. 1.

[7] See Carpenter, *op. cit.,* p. 1.

[8] See, for example, Gavin, William, "Inflation Targeting," *Business Economics,* April 2004, pp. 30, 36.

[9] See, Charles Freedman, "Panel Discussion: Transparency in the Practice of Monetary Policy," *Review,* Federal Reserve Bank of St. Louis, July/August, 2002, p. 155.

[10] Klaus Schmidt-Hebbel and Matias Tapia, "Statement" (2002), p. 11)

[11] Borio Claudio and Philip Loew, "Asset Prices, Financial and Monetary Stability: Exploring the Nexis," BIS Working Paper No. 114, July 2002, Abstract.

causes financial instability. In short, no direct "hard core" or formal statistical or econometric evidence supports this view. Instead, anecdotal compilations of "stylized facts" are used to assess historical episodes in support of the view. Additionally, only a few episodes appear to have the characteristics (low inflation, credit growth, asset price bubbles, etc) consistent with this view. Instead of such evidence, proponents rely on assumptions relating to the credibility of policymakers, investment activity, technological advances, or productivity gains that can serve to constrain the price increases of goods and services. In sum, little *hard empirical evidence* supporting the view that price stability or IT contributes to or causes volatile financial markets exists.

Empirical Evidence: Does IT matter? Is IT unrelated to economic performance or to market volatility?

A number of studies have examined whether the adoption of IT improves economic performance (as measured by movements in inflation, output, and/or interest rates) or affects the volatility of market variables. In short, they have tested to see if IT matters.

Several researchers have addressed this question. Despite a good deal of effort, however, some of their empirical results have been mixed. As a result, this research in turn has raised a number of methodological questions. More specifically, in assessing these questions in recent years, researchers have often used a common methodology. The reason for this is that recently both IT and non-IT countries experienced improvement in economic performance as measured, for example, by inflation or the level of interest rates. Focusing on any one IT country in isolation might lead researchers to falsely conclude that IT caused the improvement. But non-IT countries may have experienced similar affects. Some researchers contend, therefore, that to test for the effects of IT, improvements in IT countries must be made relative to improvements in non-IT countries.

Examples of research results: Implying IT doesn't matter include the following:

• Ammer and Freeman (1995) surveyed three IT countries, New Zealand, Canada, and the United Kingdom. They found that although each reached its inflation goal, bond yields suggested that long-term inflationary expectations exceeded targets as did short-term measures of inflationary expectations. This suggests that these countries did not attain the credibility necessary to properly anchor other prices and stabilize the price system. Moreover, there is no evidence that announcement of an explicit IT policy would reduce inflationary expectations.[12]

• Johnson (2002) employed data from 11 countries. He adopted a methodology which divided up his sample into inflation targeting and non-inflation targeting countries. His results are mixed. Specifically, he found that while the level of inflationary expectations falls after announcing explicit inflation targets, the variability of expected inflation does not. In describing his results, Johnson contended that "inflation targets allowed a larger disinflation with smaller forecast errors to take place in targeting countries." [13]

• Recent research by Ball and Sheridan (2003) is perhaps the most forceful example of empirical work concluding that IT does not matter. These authors, for example, conclude that:

> . . . on average, there is no evidence that inflation targeting improves performance as measured by the behavior of inflation, output, or interest rates . . . overall it appears that targeting does not matter. Inflation targeting has no effect on the level of long-term interest rates, contrary to what one would expect if targeting reduces inflation expectations . . . targeting does not affect the variability of the short-term interest rates controlled by policymakers . . . we find no evidence that inflation targeting improves a country's economic performance.[14]

In short, some research clearly concludes that IT does *not* matter.

SOME QUESTIONS AND CRITIQUE

There are, however, a number of fundamental reasons why this research and its conclusions are both questionable and in conflict with the results of other research.

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[12] John Ammer and Richard T. Freeman, "Inflation Targeting in the 1990s. The Experiences of New Zealand, Canada, and the United Kingdom," *Journal of Economies and Business,* 1995, 47:165–192, pp. 165,189.

[13] David R. Johnson, "The Effect of Inflation Targeting on the Behavior of Expected Inflation: Evidence from an 11 country panel," *Journal of Monetary Economies,* 49 (2002) 1521–1538, p. 1537.

[14] Ball, Laurence and Niamh Sheridan, "Does Inflation Targeting Matter?," Paper presented at NBER Inflation Targeting Conference, January 2003 (March 2003), pp. 2,3,4,29.

For example, many economists question the methodology employed in these studies. The selection and identification of "non-IT countries," for example, is one of these issues. Several economists, analysts, and even Federal Reserve officials have pointed out that a number of key countries, including the U.S., are identified as *non IT countries* in the studies because they do not have *explicit inflation targets.* But many of these countries consistently pursued an implicit inflation targeting strategy. *So the label may be misleading and inappropriate for several countries.* This misspecification also applies to countries pegging their currencies to a currency whose central bank is following ITs; (i.e., some countries in Europe and Asia). These observations were made by, Gertler, Mankiw, Federal Reserve officials and others.[15] These contentions draw into question the validity of the methodology and results of these empirical studies.

Furthermore, recent IMF research surveys and delineates the many dimensions to and ways of classifying and categorizing IT. This research underscores the large number of variables that can be used to select and define IT. It is a reminder that there may be no easy, simple way of neatly identifying an IT central bank.

Because of the multi-dimensional character of IT regimes, it is difficult to clearly and neatly dichotomize existing central banks into IT and non-IT categories. Definitions of IT, for example, should be adjusted to reflect the realities of "flexible" IT. The clean dichotomization maintained by theoretical researchers may not be nearly as clean as suggested by the authors. Consequently, the empirical results may not be as clean as suggested by some of the results of these papers.

Additionally, several statistical or econometric issues and critiques were identified in much of this literature. In his comments on Ball and Sheridan, for example, Gertler notes that "existing evidence in favor of inflation targeting is open to identification problems."[16] Ball and Sheridan themselves assert that their empirical results are often not strictly comparable to the results of other studies because of unusual techniques that were employed.[17]

Empirical Evidence: IT is related to macroeconomic performance and to financial market volatility: IT does make a difference.—Despite the widespread practical support accorded IT in recent years, not much hard empirical support was found favoring IT in early, initial research.[18] As time passed and more historical data has come to the fore, however, researchers have uncovered a number of important empirical regularities tending to support IT. Some of the evidence comes from single-country case studies suggesting that IT tends to stabilize markets. Other evidence is cross-section support. For example, a number of recent empirical studies examined the relationship between IT and macroeconomic performance, as well as between IT and financial market behavior: i.e., these studies attempted to assess whether IT matters. While mixed, the bulk of the new evidence indicates that IT matters; IT has a positive significant impact on economic and financial market performance.

The following "bullet points" supply an abbreviated summary of the recent key empirical studies relevant to this topic:

- In a (1996) report to the FOMC, David Stockton surveyed existing literature related to price objectives for monetary policy.[19] In that survey, Stockton identified several well-known established empirical relationships pertinent to this topic. They included the following:
  - * Both cross-country and time-series evidence supports the notion that inflation reduces the growth of real output (or productivity).
  - * Inflation is positively related to the variability of relative prices.
  - * Inflation is positively related to inflation uncertainty.
  - * In general, relative price variability and inflation uncertainty adversely affect real output.
- In his recent book *Inflation Targeting* (2003), Truman summarizes the principal conclusions of the empirical literature on inflation targeting.[20] In particular, IT generally:

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[15] See Gertler, Mark, "Comments on Ball and Sheridan," Prepared for the NBER Conference on Inflation Targeting, January 2003. (June 2003), pp 1, 3–5; Mankiw N. Gregory, (2001), "U.S. Monetary Policy During the 1990's. NBER Working Paper No. 8471, Cambridge, Mass Sept 2003; and Marvin Goodfriend, "Inflation Targeting in the United States?," (2003) Paper prepared for the NBER Conference on Inflation Targeting, January 2003.

[16] Gertler, Mark, "Comments on Ball and Sheridan," June 2003, Paper prepared for the NBER Conference on Inflation Targeting, January 2003, p. 1.

[17] Ball and Sheridan, *op. cit.,* p. 28. (The unusual technique was regression to the mean.)

[18] See Neumann and Von Hagen, p. 127.

[19] David J. Stockton, "The Price Objective for Monetary Policy: An Outline of the Issues," A Report to the FOMC Board of Governors, June 1996.

[20] Edwin M. Truman, *Inflation Targeting in the World Economy,* Institute for International Economics, Washington, D.C. October 2003, p. 72.

* Has had a favorable effect on inflation, inflation variability, inflation expectations, and the persistence of inflation.
* Has not had a negative effect on economic growth, the variability of growth, or unemployment.
* Has had mixed effects on both the level and variability of real, nominal, short-term, and long-term interest rates.
* Has had positive effects on exchange rate stability.
* Has affected the reaction functions of the central banks that have adopted the framework.[21]

• For the most part, economists have established empirically a negative relationship between inflation uncertainty and real economic activity. Elder (2004), for example, relates that:

> Our main empirical result is that uncertainty about inflation has significantly reduced real economic activity over the post-1982 period . . . Our findings suggest that . . . macroeconomic policies that reduce volatility in the inflation process are likely to contribute to greater overall growth.[22]

• In a early study, Ammer and Freeman (AF) (1995) examined three IT countries. This study provided mixed results for IT. On the one hand, inflation did not exceed the targets and this result occurred without sharp increases in short-term rates. These researchers found that "inflation fell by more than was predicted by the models in the early 1990s, an indication of the effect of the new regime."[23] However, "longer term interest rates suggest that none of these countries rapidly achieved complete long-term credibility for their announced long-run inflation intentions.[24]

• Some of the earlier (pre-2000) literature was summarized by Neuman and von Hagen (NvH) and included the following observations:

* Some authors find that "IT might . . . serve to lock in gains from disinflation rather than to facilitate disinflation."[25] After introducing IT, inflation and interest rates remained below values predicted by existing models.
* Other authors found that the "volatility of official central bank interest rates . . . declined substantially after the introduction of IT."[26]

• *Neumann and von Hagen* (NvH) (2002) reviewed earlier studies of inflation targeting episodes. They presented "evidence on the performance of IT central banks."[27] In particular, NvH showed that ". . . IT has reduced short-term variability in central bank interest rates and in headline inflation . . ."[28] (The NvH paper) "suggests that IT has indeed changed central bank behavior . . ." (NvH) "looked at different types of evidence in order to validate" (the claim that inflation targeting) "is a superior concept for monetary policy." "Taken together, the evidence confirms that IT matters. Adopting this policy has permitted IT countries to reduce inflation to low levels and to curb the volatility of inflation and interest rates . . ."[29] In discussing this paper, Mishkin reminds us that NvH "produce several pieces of evidence quite favorable to inflation targeting."[30]

• Johnson (2002) shows that inflation "targets reduced the level of expected inflation in targeting countries"[31] . . . "The evidence is very strong that the period after the announcement of inflation targets is associated with a large reduction in the level of expected inflation . . . that (significant) reduction took place in all 5 countries with inflation targets. This is an important success of inflation targets.". . . "inflation targets allowed a larger disinflation with smaller forecast errors to take place in targeting countries."[32] In sum, inflation targeting presumably favorably affected the bond and other markets by influencing inflationary expectations and reducing uncertainty premiums.

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[21] *Ibid.* p. 72. (The points outlined were taken from Truman, p. 72.)
[22] John Elder, "Another Perspective on the Effects of Inflation Uncertainty."
[23] Neumann and von Hagen, *op.cit.,* p.128.
[24] John Ammer and Richard T. Freeman, "Inflation Targeting in the 1990's: The Experiences of New Zealand, Canada, and the United Kingdon," *Journal of Economics and Business,* 1995; 47: 165–192, p. 189.
[25] Neumann and von Hagen, *op.cit.,* p.128.
[26] *Ibid.,* p. 129.
[27] Manfred J.M. Neumann and Jurgen Von Hagen, "Does Inflation Targeting Matter?," Federal Reserve Bank of St. Louis, Review, July/August 2002, p. 130.
[28] *Ibid,* p.127.
[29] *Ibid,* pp. 128, 144 (parenthesis added).
[30] Frederick Mishkin, "Commentary," FRB St. Louis *Review,* July/August, 2002, p.144.
[31] David R. Johnson, "The Effect of Inflation Targeting on the Behavior of Expected Inflation: Evidence from an 11 country panel."
[32] Journal of Monetary Economics 49 (202), p. 1522. ibid, pp/1537. (parenthesis added).

• Levin, Natalucci and Piger (LNP) (2004) find "evidence that IT plays a significant role in anchoring long-term inflationary expectations and in reducing the . . . persistence of inflation"[33] The evidence suggests that IT practitioners can more readily delink their inflationary expectations from realized inflation.[34] In short, IT plays a significant role in anchoring long-term inflation expectations and long-term interest rates themselves.[35]

* LNP find that "inflation targeting affects the public's expectations about inflation" . . . "under an inflation targeting regime, expectations about inflation, particularly at longer horizons, should be 'anchored' by the target, and thus should be less affected by changes in actual inflation." "Keeping inflation expectations anchored helps to keep inflation itself low and stable."[36]

* In commenting on this paper, Uhlig (2004) . . . "concludes that these figures seem to suggest that an environment of low and stable inflation helps to reduce output volatility and support economic activity."[37]

• Recent empirical research at the Federal Reserve by Gurkaynak, Sack and Swanson (GSS) (2003) shows that the Fed could boost the economy by being more transparent about its long-term inflation objectives.[38] GSS "show that the long-term interest rates (of non-IT countries) react excessively to macroeconomic data releases and to news about monetary policy. This overreaction is caused by changes in the market's long-term inflation expectations."[39]

IT, however, works to anchor (or prevent excess volatility in) long-term market's. Consequently, in IT countries (like the UK), markets do not overreact or display over-sensitivity. The empirical results of the paper suggest "that the central bank can help stabilize long-term forward rates and inflation expectations by credibly committing to an explicit inflation target."[40] Commitment to an explicit target will help stabilize both long rates and inflation expectations.

• Other research conducted at the Federal Reserve also relates to this evidence. Carpenter (2004), for example, surveyed empirical studies of transparency.[41] The summarized results are mixed, but suggest there is evidence of a relationship between IT and both transparency and lower inflation. Moreover, it is emphasized by several authors that there is no evidence that IT causes any harm. Swanson (2004) showed that increased central bank transparency acts to reduce financial market surprises and uncertainties. This suggests that IT—which is tantamount to increased transparency of policy goals—may aid in reducing financial market volatility and stabilizing financial markets.[42]

• Several studies establish that additional central bank transparency in the form of announced inflation target, works to lower inflation and stabilizes output. Recently Fatas, Mihov, and Rose (FMR), for example, found "that both having and hitting quantitative targets (like IT) for monetary policy is systematically and robustly associated with lower inflation . . . Successfully achieving a quantitative monetary goal (like ITs) is also associated with less volatile output."[43] These authors find that ". . . countries with transparent targets for monetary policy achieve lower inflation."[44] They found "that having a quantitative *de jure* target for the monetary authority tends to lower inflation and smooth business cycles; hitting that target *de facto* has further positive effects. These effects are economically large, typically sta-

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[33] Andrew T. Levin, Fabio M. Natalucci, and Jeremy M. Pager, "The Macroeconomic Effects of Inflation Targeting," Federal Reserve Bank of St. Louis, Jan. 23, 2004. Abstract.

[34] *Op.cit.,* Abstract.

[35] *Op. cit.,* p.2.

[36] Jeremy Piger, "Does Inflation Targeting Make a Difference?" *Monetary Trends,* April, 2004.

[37] Jeremy M. Piger and Daniel L. Thornton, "Editor's Introduction," *Federal Reserve of St. Louis Review,* July/August 2004, Volume 86, Number 4, p. 5.

[38] See Refet S. Gurkaynak, Brian Sack, and Eric Swanson, "The Excess Sensitivity of Long-Term Interest Rates, Evidence and Implications for Macroeconomic Models," *Finance and Economic Discussion Series, Federal Reserve Board,* November 17, 2003; William Gavin, "Inflation Targeting, Why It Works and How to Make it Work Better," *Business Economics,* Vol XXXIX April, 2004, p. 32.

[39] See Gavin, *op cit,* pp. 32, 36 (parenthesis added).

[40] GSS, *op.cit.* p. 28.

[41] Seth Carpenter, "Transparency and Monetary Policy: What Does the Academic Literature Tell Policymakers?, "Working Paper, Board of Governors of the Federal Reserve System, April 2004, pp. 11–13.

[42] Eric T. Swanson, "Federal Reserve Transparency and Financial Market Forecasts of Short-Term Interest Rates," Working Paper, Board of Governors of the Federal Reserve System, February 9, 2004.

[43] Antonio Fatas, Ilian Mihov, and Andrew K. Rose, "Quantitative Goals for Monetary Policy," NBER Working Paper No. W 10846, October 2004, Abstract (parenthesis added.)

[44] *Ibid,* p. 1.

tistically significant and reasonably insensitive to perturbations in (their) econometric methodology."[45]

• Siklos (2004) found that "inflation-targeting countries have been able to reduce the nominal interest rate to a greater extent than have non-inflation targeting countries . . . It is also found that central banks with the clearest policy objectives have a relatively lower nominal interest rates."[46]

This abbreviated review of some of the recent literature suggests that overall, there is a good deal of evidence supporting the case for IT. This review suggests that inflation targeting does matter. More specifically, credible commitment to an explicit IT likely will work to help lower and stabilize the level and variability of inflation. This result occurs in part because of the reduction and stabilization of inflationary expectations. Hence, it will likely lower both the level and variability of the long bond rate. IT will anchor the price system and help to stabilize short-term interest rates, long-term interest rates, the foreign exchange and stock markets. Some research suggests IT also helps to dampen the business cycle and stabilize movements in output. Additionally there is a body of evidence indicating that transparency helps to stabilize markets and fosters central bank credibility.

SUMMARY AND CONCLUSIONS

After decades of debate, the case for inflation targeting is well established. This paper focuses on one key ingredient of the argument supporting inflation targeting. Namely, it examines the proposition that a credible implementation of inflation targeting will calm and stabilize various financial markets, anchor the price system, and limit inflation, as well as its variability and persistence. Other competing views—i.e., (a) that inflation targeting has no impact on financial markets and (b) that Inflation Targeting leads to asset price bubbles and hence to financial market volatility—are briefly outlined.

These alternative views are presented and briefly contrasted with existing empirical evidence. Some key findings include the following:

• There is little or no evidence that inflation targeting has adverse effects on financial markets.

• Research finding that inflation targeting does not matter has problems, in part related to the selection and definition of inflation targeting countries.

• The weight of the existing empirical evidence appears to support the case for inflation targeting; i.e. overall, it supports the view that inflation targeting matters and will work to calm and limit the variability of financial markets as well as the persistence of inflation. It will serve to anchor the price system. As the empirical literature suggests, this will likely foster healthier economic growth.

There is little evidence that inflation targeting has adverse effects on or hurts financial markets or the economy.[47] Accordingly, adopting inflation targeting once price stability is attained likely will make it easier to maintain.[48] As emphasized by Gertler, "the case made for adopting formal targets in the U.S. is not that this system would have improved past performance, but rather that it would help future performance by preserving gains in credibility for Greenspan's successor."[49]

PREPARED STATEMENT OF SENATOR JACK REED, RANKING MINORITY MEMBER

Thank you, Chairman Saxton. I want to welcome Chairman Bernanke, who I hope will give us useful insights on current economic conditions and where he thinks the President's policies are taking us. I am also pleased that we will have a second panel of witnesses to give us further perspectives on the economic outlook.

Like many Americans, my concerns about the economic outlook and the Administration's stewardship of the economy have grown in the wake of Hurricane Katrina. Economic insecurity for workers is widespread as energy prices are soaring, employer-provided health insurance coverage is falling, private pensions are in jeopardy, and American workers are still waiting to see the benefits of the economic recovery reflected in their paychecks.

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[45] *Ibid.* p. 21. (parenthesis added).

[46] Pierre L. Siklos, "Central Bank Behavior, The Institutional Framework, and Policy Regimes: Inflation Versus Non-Inflation Targeting Countries," Contemporary Economic Policy, vol 22, no. 3, July 2004, 331–343, pp 331, 332.

[47] Ball and Sheridan, *op.cit.,* p. 29.

[48] See Anthony M. Santomero, "Monetary Policy and Inflation Targeting in the United States," *Business Review,* Federal Reserve Bank of Philadelphia, Fourth Quarter 2004, p. 1.

[49] Mark Gertler, "Comments on Ball and Sheridan." A Paper presented to the NBER conference on Inflation Targeting, January 2003, p. 5. The point was also made by Ball and Sheridan, *op. cit.,* p. 30

President Bush's tax cuts were poorly designed to stimulate broadly shared prosperity and have produced a legacy of large budget deficits that leave us increasingly hampered in our ability to deal with the host of challenges we face. The devastating impact of Hurricanes Katrina and Rita will put short-term strains on the Federal budget—strains that would be fairly easy to absorb if our budget and economic policies were sound, but they are not. The President's goals of making his tax cuts permanent and cutting the deficit in half are simply incompatible.

Large and persistent budget deficits also have contributed to an ever-widening trade deficit that forces us to borrow vast amounts from abroad and puts us at risk of a major financial collapse if foreign lenders suddenly stop accepting our IOU's. The trade deficit of $59 billion in August is close to the record for a single month of more than $60 billion set in February. The broader current account deficit, which measures how much we are borrowing from the rest of the world, is running at a record annual rate of nearly $800 billion, or well over 6 percent of GDP.

I will be interested in Chairman Bernanke's views on whether the budget and trade deficits are dangerous imbalances that pose a risk to the economic outlook. But I am also pleased that we will be able to hear Dr. Setser's views, which may be somewhat different.

I hope that we would all agree that raising our future standard of living and preparing adequately for the retirement of the baby boom generation require that we have a high evel of national investment and that a high fraction of that investment be financed by our own national saving—not by foreign borrowing. We followed such prosperity-enhancing policies under President Clinton, but that legacy of fiscal discipline has been squandered under President Bush.

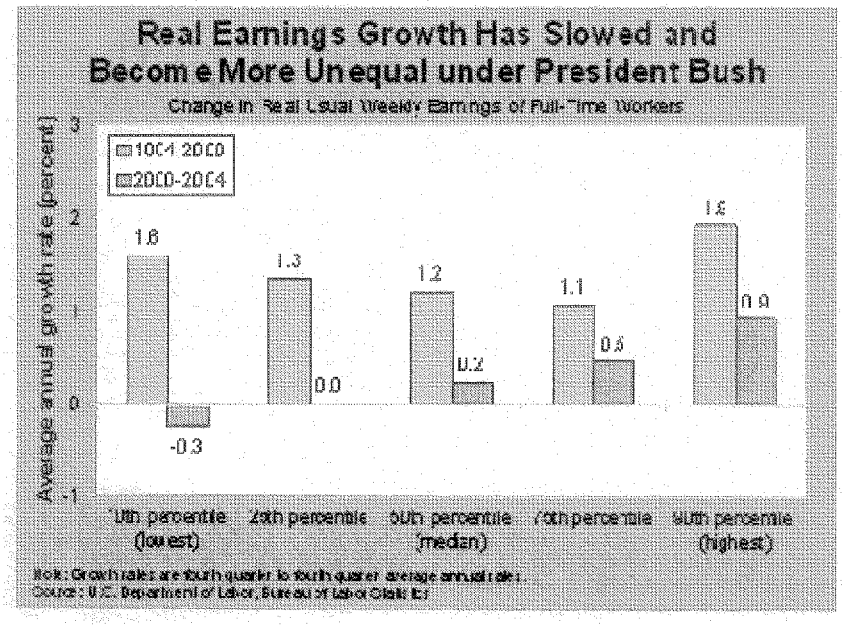
Sound policies for the long run are clearly very important, but I am also deeply concerned about what continues to be a disappointing economic recovery for the typical American worker. Strong productivity gains have shown up in the bottom lines of shareholders but not in the paychecks of workers. The typical worker's earnings are not keeping up with their rising living expenses. And both earnings and income inequality are increasing.

Instead of addressing these problems, the President's policies seem to be piling on. It's certainly hard to take seriously the President's rhetoric about wanting to lift families out of poverty when he has refused to support an increase in the minimum wage and he has lifted the Davis-Bacon Act, thereby legitimizing sub-par wages for workers rebuilding their communities in the hurricane-stricken Gulf Coast region.

And even though home heating costs are expected to skyrocket this winter, President Bush has said he will not request additional funds for the Low Income Home Energy Assistance Program, known as LIHEAP. Together with Republican Senators Susan Collins and Olympia Snowe, I have offered an amendment to increase LIHEAP by $3.1 billion, so that low-income Americans won't be left out in the cold this winter. I would like to know if the Administration is willing to reconsider its position on providing additional LIHEAP funds and if not, why not?

It seems to me that the President's compassionate words hardly match his Administration's actions. Now is not the time to cut funding for important programs such as LIHEAP and Medicaid that support working families and seniors, while the President continues to push for irresponsible tax breaks for those who are already well-off.

I look forward to Chairman Bernanke's testimony about the economic outlook, and I will listen with interest to anything the Chairman and our witnesses can tell me that will allay my concerns about that outlook.


Real Earnings Growth Has Slowed and
Become More Unequal under President Bush
Change in Real Usual Weekly Earnings of Full-Time Workers
1004-2000
2000-2004
Average annual growth rate (percent)
3
2
1
0
-1
1.6
-0.3
1.3
0.0
1.2
0.2
1.1
0.5
1.9
0.9
10th percentile (lowest)
25th percentile
50th percentile (median)
75th percentile
90th percentile (highest)
Note: Growth rates are fourth quarter to fourth quarter average annual rates.
Source: U.S. Department of Labor, Bureau of Labor Statistics

PREPARED STATEMENT OF HON. BEN BERNANKE, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, WASHINGTON, DC

Chairman Saxton, Vice-Chairman Bennett, Ranking Member Reed, and Members of the Committee, thank you for the opportunity to testify before the Joint Economic Committee. We appreciate the long-standing and mutually beneficial relationship between the Committee and the Council of Economic Advisers. My remarks today will focus on the current state of the economy, but of course such an overview would be incomplete without an eye to the human and economic impacts of hurricanes Katrina and Rita in the U.S. Gulf Coast.

While it has been nearly 2 months since Hurricane Katrina made landfall, its devastation will have a protracted impact on the Gulf region. As you know, Hurricane Katrina wreaked unprecedented losses on the people of the Louisiana, Mississippi, and Alabama coasts. Katrina took many lives, destroyed communities, and shook a vital portion of our Nation and our economy. The Gulf region was then hit by Hurricane Rita, which did significant damage but, in most areas, less than was feared. In response to the disasters, the President has directed all agencies of the Federal Government to devote their maximum effort to helping the victims of the hurricanes and to begin the process of cleaning up and rebuilding the region. The President has also proposed a series of measures to restore the Gulf's communities and economy.

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. 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 ECONOMIC EXPANSION

When thinking about where the economy is now 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 5 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. Business and investor confidence was shaken by a series of corporate scandals in 2002. 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. Currently, the unemployment rate stands at 5.1 percent, up from 4.9 percent in August, prior to the job losses that followed Katrina.

Although growth in GDP and jobs capture the headlines, one of the biggest macroeconomic 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 4 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, while there has been a notable rise in overall inflation this year, prices on nonenergy products have continued to increase at moderate rates. In particular, soaring energy prices have played the largest role in boosting the overall consumer price index to an increase of 4.7 percent over the past year, up from a 2.5 percent increase over the year-earlier period. In contrast, core consumer prices (as measured by the consumer price index excluding volatile food and energy prices) rose only 2.0 percent over the past 12 months, unchanged from its year-earlier pace. Long-term-inflation expectations also remain low and stable, based on measures of inflation compensation derived from inflation-indexed Treasury securities. To be clear, the focus on core inflation by no means implies that the rise in energy prices is inconsequential; sharply higher energy costs place a heavy burden on household budgets and increase firms' costs of production. I will discuss the energy situation in more detail in a moment. However, the stability in core inflation and inflation expectations does suggest that overall inflation is likely to return to levels consistent with price stability in coming quarters.

THE ECONOMIC OUTLOOK

Let me turn now to the outlook. In the shorter term, the devastation wrought by the hurricanes has already had palpable effects on the national rates of job creation and output growth. Payroll employment declined by 35,000 in September, its first decline since May 2003, and industrial production fell 1.3 percent, its largest monthly decline in over two decades. Both of these declines appear to be entirely accounted for as the effects of the hurricanes. The Bureau of Labor Statistics estimates that employment growth would have been roughly 200,000 in the absence of the hurricanes, and the Federal Reserve estimates that industrial production would have increased about 0.4 percent. Consumer confidence also dropped in September, although growth in consumer spending has continued to be solid. While the effects of the storms certainly reduced growth in the third quarter relative to what it would have been otherwise, most private-sector economists expect healthy growth for the remainder of this year and in 2006. For example, the Blue Chip panel of forecasters now projects growth at 3.2 percent in the second half of 2005 and 3.3 percent growth in 2006. Recovery and rebuilding will contribute to job creation and growth by the latter part of this year and in 2006.

The economic impact of the hurricanes included significant damage to the country's energy infrastructure. As you know, Katrina shuttered a substantial portion of U.S. refining and pipeline capacity, which led to a spike in gasoline prices in the weeks after that storm. Rita caused further damage. The Federal Government has 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. In part because of these efforts and a vigorous private-sector response, oil prices have returned to roughly their pre-Katrina levels. Wholesale gasoline prices have also retreated to levels of mid-August, suggesting that the recent decline in prices at the pump is likely to continue. Natural gas prices may remain elevated somewhat longer, however, because of lost production in the Gulf, the difficulty of increasing natural gas imports, and damage to plants that process natural gas for final use.

Even as the energy sector continues to recover, it remains true that the prices of oil and natural gas have risen sharply in the past 2 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. 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. In addition, allowing prices to adjust, rather than rationing gasoline, is helping to minimize the overall impact on the economy.

House prices have risen by nearly 25 percent over the past 2 years. Although speculative activity has increased in some areas, at a national level these price increases largely reflect strong economic fundamentals, including robust growth in jobs and incomes, low mortgage rates, steady rates of household formation, and factors that limit the expansion of housing supply in some areas. House prices are unlikely to continue rising at current rates. However, as reflected in many private-sector forecasts such as the Blue Chip forecast mentioned earlier, a moderate cooling in the housing market, should one occur, would not be inconsistent with the economy continuing to grow at or near its potential next year.

The current account deficit presents some economic challenges. At 6.3 percent, the ratio of the current account deficit to GDP is now at its highest recorded level. Gradually reducing the current account deficit over a period of time would be desirable. While the current-account imbalance partly reflects the strong growth of the U.S. economy and its attractiveness to foreign investors, low U.S. national saving also contributes to the deficit. The United States should work to increase its national saving rate over time, by encouraging private saving and by controlling Federal spending to reduce the budget deficit. Our trading partners must also play a role in reducing imbalances, by becoming less reliant on export-led growth and increasing domestic spending, and by allowing their exchange rates to move flexibly as determined by the market.

CONCLUSION

The economic challenges posed by hurricanes Katrina and Rita reinforce once again the importance of economic policies that promote growth and increase the resilience of the economy. Energy issues in particular have come to the fore recently. The energy bill recently passed by Congress and signed by the President should help address the Nation's energy needs in the longer term. As an additional step, the Administration will continue to work with Congress to take measures that will permit needed increases in refinery capacity. The Administration has made a number of other proposals to increase economic growth, including proposals to reduce the economic costs of litigation, to increase quality and reduce costs in the healthcare sector, and to address national needs in education and job training.

The Administration is currently engaged in several international negotiations, including the Doha round of the World Trade Organization, as well as talks with China on a number of matters involving trade, exchange rates, and needed financial reforms. Liberalized trade and capital flows promote economic growth, and we should strive to achieve those objectives in the context of a gradual reduction of current account imbalances. It is important that we persist in these efforts and not retreat to economic isolationism, which would negatively affect the long-run growth potential of the economy.

Fiscal discipline, always important, has become increasingly so in the face of the likely costs of assisting the victims of the hurricanes and of helping in the rebuilding. Before the impact of the hurricanes, strong economic growth was helping to reduce the budget deficit and the Government finished fiscal year 2005 with a much lower-than-expected deficit. The President remains committed to controlling spending and cutting the budget deficit in half by 2009. His 2006 budget made numerous proposals to save more than $200 billion over the next 10 years from both discretionary and mandatory programs. In the budget resolution earlier this year, Congress laid plans to pass $35 billion out of the President's $70 billion in savings from mandatory programs over the next 5 years. Congress should now make good on that plan by passing at least $35 billion in mandatory savings in reconciliation legislation. Further savings beyond $35 billion would be highly desirable. The President continues to seek a decrease in non-security discretionary spending in FY2006 appropriations bills, and the Administration is working on options for spending rescissions. The President also remains committed to reforms to address fiscal challenges in the longer term, such as Social Security.

Finally, I note that the tax reform advisory panel, whose official report will go to the Secretary of the Treasury on November 1, has kicked off a much-needed de-

bate on how to make the Federal tax code simpler, fairer, and more pro-growth. We thank them for their hard work and look forward to reviewing their recommendations.

Thank you for the opportunity to be here today. I would be happy to answer your questions.

PREPARED STATEMENT OF DR. MICKEY D. LEVY, CHIEF ECONOMIST, BANK OF AMERICA, NEW YORK, NY

My outlook for U.S. economic performance is upbeat, based on sound fundamentals that underlie high potential growth and a history of resilience to shocks. The negative effects of Katrina on employment, consumer spending, trade and inflation will be temporary, and growth will bounce back in 2006, aided by a significant jump in Government purchases. Increases in wages and personal incomes will continue to support consumption. Housing activity is slowing, and prices are beginning to recede, but it is very unlikely that average values will decline sharply and unhinge the economic expansion. As always, the economy faces risks: present concerns include higher energy prices and further aggressive monetary tightening, a negative shock or a global slump. The Federal Reserve is expected to raise rates to 4.5–4.75 percent, but this would not be considered excessive. The probability of recession in 2006 is very low. Sustained long-run economic health requires fiscal reform involving programmatic changes to the Government's retirement and health care policies that are fair to current participants, incorporate the right incentives, and slow the growth of future benefits.

(1) *Solid fundamentals provide a favorable long-run outlook for U.S. economic growth, and the efficiency and flexibility of the economy and capital markets provide resilience to external shocks. Potential growth is 3.5+ percent.*

Long-run annualized growth has averaged 3.4 percent, and recent positive trends in productivity point to sustained healthy economic growth and rising standards of living. Favorable foundations, often overlooked in short-term assessments of economic conditions, include the efficiency and flexibility of U.S. production processes and labor markets, favorable tax and regulatory environment facilitating the entrepreneurship and business investment that support technological innovation, extraordinarily efficient capital markets and a well-capitalized banking system, and low inflation and the inflation-fighting credibility of the Federal Reserve. Following an elongated early expansion spurt in productivity, labor productivity gains have moderated but are expected to remain healthy, which combined with labor-force growth points to sustained economic growth over 3.5 percent.

Growth of U.S. GDP and capital spending has exceeded all other large industrialized nations, and its potential growth is higher. Moreover, combined with the responsiveness of economic policymakers, sound fundamentals provide significant resilience to external shocks. All recent economic expansions, including the current one that began in 2001Q4, have experienced external shocks that potentially could have sidetracked performance: Latin American debt crises in the early 1980s and mid-1990s, the Russian default and Asian financial crisis in 1997, the collapse of LTCM in 1998, 9–11, and most recently, Hurricane Katrina. In each case, adjustment processes unfolded more quickly than widely anticipated and, following temporary slowdowns, economic growth quickly snapped back. The resilience provided by these built-in stabilizers and smoothed cycles have reinforced confidence in U.S. economic performance.

(2) *Economic growth, which was solid prior to Katrina, will moderate for several quarters, followed by a reacceleration to trendline in 2006. Risks to the outlook are slower growth as a consequence of tighter monetary policy and higher energy prices, or a negative shock or global slump.*

The economy grew at an estimated 3.8 percent annualized pace in the first three quarters of 2005, and displayed healthy characteristics and surprising vigor prior to Katrina. In particular, consumer and business investment spending was quite resilient to the negative impact of higher energy prices. This reflected several factors: energy consumption per unit of GDP has declined significantly in recent decades in response to higher energy prices, and nominal spending growth has exceeded 6 percent, reflecting the Federal Reserve's monetary accommodation, so that the higher outlays for energy have not significantly "crowded out" real spending on non energy goods and services. Employment gains averaged 177,000 per month, and the unemployment rate dipped to 4.9 percent. Wages were increasing modestly, contributing to healthy increases in disposable income. Businesses were very disciplined, and inventories were very low relative to sales. Corporate profits and cash-flows rose to all-time highs.

Katrina generated huge declines in national wealth (by some estimates, up to $150 billion), caused unprecedented displacement of households and workers, involved large uninsured business losses, and impaired and disrupted oil and gas refining facilities as well as the port of New Orleans. Although large, these losses in wealth must be judged relative to the $11 trillion U.S. economy and its high growth potential, and household net worth of nearly $50 trillion. The loss in wealth has little direct impact on measured GDP, while the clean up and rebuilding, however financed, count as production and adds to GDP.

As a result of Katrina, U.S. economic growth will temporarily slow and its composition will change. Consumption growth is projected to slow sharply from its estimated 3.8 percent pace over the past 4 quarters, to approximately 1 percent annualized in Q4, followed by a modest rebound in 2006Q1. Business investment is unlikely to be significantly affected, while both imports and exports may be temporarily delayed, which may temporarily slow production. Aided by a sharp boost in Government purchases and associated "fiscal policy multipliers," real GDP is projected to rebound significantly in the first half of 2006, just when the growth of private consumption is rebounding.

Certainly, the economy faces risks. Domestic demand would slump in the second half of 2006 if the Fed inadvertently hikes rates too much and energy prices rise further. With the Federal funds rate at 3.75 percent, monetary policy remains accommodative, and the inflation-adjusted funds rate is below its long-run average. It is likely the Fed will raise interest rates to 4.5–4.75 percent by mid-2006, which I consider toward the higher end of the range of a "neutral" funds rate. Monetary tightening far beyond "neutral" would accentuate the impacts of higher energy prices. Internationally, a negative global shock, sharply lower global growth that generated declining U.S. exports, or a sharp fall in the demand for U.S. dollar-denominated assets that led to global financial turmoil would harm the U.S. economy. However, such international events are unlikely, and the risks of an economic downturn in 2006 remain modest.

(3) *Consumer spending growth is projected to slow significantly through year-end 2005 and rebound to a moderate pace in 2006, while business investment spending is expected to continue rising at a healthy pace.*

The expected temporary sharp slowdown in consumption growth in Q4 stems from several factors: The disruptions to economic activity in the hurricane/flood-affected region, including the negative impact on consumption and provision of services (business, personal, health and education services, etc.); the depressing impacts of higher energy prices and the temporary rise in unemployment on real disposable personal income; and the decline in motor vehicle sales from earlier unsustainable incentive-driven levels. Through August, increases in employment and wages had more than offset the higher energy prices, with real disposable personal income averaging 2.3 percent year-over-year growth in the first half of 2005. Consumer spending will find additional support from low real-interest rates and household net worth-which measures the total value of stocks, bonds and real estate held by households net of all household debt—that reached an all-time record in its last reading. Noteworthy, however, the sustained rapid growth of consumer spending in the face of higher energy prices has lowered the rate of personal saving even further.

In the near term, the combination of temporary declines in employment and higher energy prices will dent real purchasing power, but the impact must be put into perspective: Even displaced households will continue to consume (shelter, food and clothing) regardless of how the purchases are financed, and declines in consumer activities in the Gulf Coast region will be partially offset by increases in other regions. Look for consumer spending to rebound, but to a slower pace of growth.

Business investment spending is projected to continue to grow at a healthy pace, and is unlikely to be materially affected in the near term. Factors underlying investment, including product demand, corporate profits and cashflows, and low real costs of capital, remain positive. The rebuilding of structures and the reconstruction of damaged infrastructures in the Gulf Coast, including oil and gas refining facilities, will boost investment spending.

(4) *Employment has fallen modestly and the unemployment rate has risen in the aftermath of Katrina, but these are temporary effects, and labor markets remain generally healthy. Wages are rising to reflect sustained productivity gains, but the sharp increases in energy prices have temporarily suppressed real wage gains.*

Katrina's displacement of businesses and households will temporarily disrupt otherwise healthy labor markets. Employment fell modestly in September and the unemployment rate rose to 5.1 percent. A hallmark of the current expansion has been the slow return to health of the U.S. labor market, following the 2001 recession and severe equity market declines in 2000–2002. Business caution was unusually high

and slow to recede, contributing to the above-trend pace of productivity gains. However, prior to Katrina, the pace of layoffs, measured with initial unemployment claims, had receded to very low levels, and businesses were both hiring and expanding the hours worked of existing employees.

This slow cyclical rebound in employment and business caution and discipline will serve to mitigate the impact of Katrina on net payrolls. Importantly, outside the affected Gulf Coast region, economic conditions and business hiring have remained strong. These conditions provide a positive backdrop for facilitating the re-absorption into the workforce of many displaced workers. In addition, labor shortages and temporarily high wages have begun to attract workers back into the affected region. Following temporary weakness, employment is projected to resume its growth, and the unemployment rate should again recede below 5 percent.

Until recently, real wages had been rising, although not as fast as gains in labor productivity. Rapid increases in nonwage costs, including employer contributions for worker health care, partially explain the gap. The recent sharp rise in energy prices has pushed headline inflation above wage gains, reducing real wages. This too is likely to be temporary, as the rising demand for labor lifts wages while headline inflation recedes.

(5) *The jump in Government spending for the Katrina cleanup and rebuilding and the expected fiscal policy multipliers will support economic growth in Q4 and boost it in 2006, but will contribute to a renewed spike in budget deficits.*

Prior to Katrina, rapid growth in tax receipts (a whopping 14.6 percent in the just completed FY2005) had contributed to a faster-than-expected decline in the budget deficit. The deficit for FY2005 fell to less than $320 billion or 2.6 percent of GDP, a significant reduction from 3.5 percent in 2003 and 3.6 percent in 2004. Fiscal responses to Katrina may raise the deficit by as much as 1 percent of GDP, as tax receipts temporarily slump and outlays surge. So far, Congress has authorized more than $60 billion in Katrina-related spending, and the total Federal fiscal response almost certainly will be higher.

To date, the financial market reaction to Katrina and the anticipated fiscal response has been modest: The U.S. dollar has been virtually unchanged and bond yields have drifted up, reflecting both related and unrelated concerns. Inflationary expectations have risen, the underlying economy has shown strength and resilience, and markets fear a letdown by fiscal policymakers in the wake of the hurricanes. The longer-run costs are not trivial. The higher deficit will add to the stock of Government debt, raising net interest costs. The net costs to sustainable economic growth depend on a host of factors, including how the Government funds are spent, the returns on such spending and investments and how they influence private incentives, and how the outlays are financed—through offsetting spending reductions, tax increases or higher debt. All of these factors have important implications for the allocation of national resources. I urge fiscal policymakers to consider these issues in all of their dimensions, and encourage a rational debate about how to allocate the Government funds in the most economically efficient manner.

(6) *Corporate profits, which have grown to record levels, are projected to continue increasing through 2006, although higher energy prices will adversely affect profits in select industries.*

Operating profits—after-tax profits with inventory valuation and capital consumption allowance adjustments—have risen 9.9 percent in the last year and almost 59 percent cumulatively since the 2001Q4 recession trough, modestly faster than profits gains during prior economic expansions. Profits have benefited from healthy growth in product demand, firm margins generated by modest pricing power and strong productivity gains that have constrained unit labor costs, low interest rates that have allowed businesses to restructure their financial balance sheets and the low U.S. dollar that has boosted repatriated profits from overseas activities. Higher energy prices have depressed profits unevenly, with outsized impacts on the airline, automobile and other select industries.

I project profits to rise at a moderating pace in 2006, reflecting ongoing business discipline, enhanced production efficiencies and global demand for U.S. products. The Fed rate hikes will slow growth in nominal spending, which will dampen business top-line revenue growth. Business pricing power will be limited, but sustained productivity gains should largely offset upward pressures on wage compensation and help constrain increases in unit labor costs. Nonlabor costs may rise however, largely reflecting, among other influences, higher insurance costs.

(7) *Housing activity is expected to soften and average prices decline modestly, but the probability of sharp declines that would unhinge consumer spending and the economy is low.*

Following the unprecedented rise in residential sales, housing construction and home prices, the real estate market is showing signs of cooling. In select regions in

which prices had soared, inventories of unsold homes have jumped up—presumably in response to the high prices—and the volume of sales transactions has begun to slow. In response to the Fed's rate hikes and flattening yield curve, there has been a clear shift in mortgage applications toward longer-term mortgages and away from short-term variable mortgages that had contributed to real estate price speculation.

Clearly, the rate of real estate appreciation in recent years is unsustainable. A crucial issue is how and why the market will adjust, and whether any fall in real estate prices will harm overall economic performance. My assessment is that housing values will decline from lofty levels in select "speculative-driven" regions, but average housing prices will dip only modestly, and as long as the economy continues to expand at a healthy pace and inflation and bond yields remain reasonably low, the adjustment in housing activity and prices will not unduly harm the macro economy.

Concerns that the sharp appreciation of real estate has been the primary factor driving consumer spending are overstated; while housing appreciation has contributed positively to net worth and the propensity to spend, real disposable income, which has continued to rise, remains the crucial variable underlying consumer spending. A slump in overall economic activity, employment and incomes would generate sharp declines in housing; however, a flattening in housing, including significant price declines in speculative markets in response to the Fed rate hikes and modestly higher mortgage rates, may slow the rate of consumption growth, but is very unlikely to unhinge the economic expansion.

(8) *Exports are projected to continue rising rapidly, reflecting improving global economic trends; but recently slower import growth has begun to narrow the trade deficit.*

Real exports, which rose very sluggishly early this expansion, but accelerated to a rapid 9.1 percent average annualized growth pace in the last 2 years, are projected to grow strongly through 2006, as global economic conditions continue to improve. Imports have been much more volatile: After declining during the 2001 recession, they have increased at a 7.5 percent average annual pace, faster than exports, and the trade deficit has widened. However, so far in 2005, import growth has slowed significantly to a 3.5 percent pace-contributing to a narrowing trade deficit.

With the exception of economic weakness in core European nations, the economies of major U.S. export markets are healthy. Asia, destination for approximately 26 percent of U.S. exports, continues to grow significantly faster than the global average. Importantly, Japan, the world's second largest economy, is rebounding to sustainable healthy growth following prolonged stagnation and deflation. I expect Japan will grow significantly faster than consensus estimates through 2006. China's economy shows no signs of slowing from its long-run 9+ percent rate of expansion. U.S. exports to China have grown 46 percent in the last year, reaching $39 billion, and should continue to increase rapidly. India's economy and trade with the U.S. are also expanding rapidly. Growth in Canada remains healthy, Mexico is growing on the coattails of the U.S. expansion, and Brazil, Argentina and Chile are expanding and enjoying relative stability. Europe's economic performance will remain uneven. Misguided tax and regulatory policies constrain potential growth in core European nations, while other European nations, including some that will be joining the European Union, are growing rapidly.

The substantial widening of the U.S. net export deficit in recent years implies that foreign producers have supplied a growing share of domestic demand. Moreover, fueling concerns about the trade deficit, the common perception is that "excessive consumer spending" is the primary culprit of rapid import growth. In fact, nearly 40 percent of total U.S. imported goods are industrial supplies and capital goods (excluding automobiles and petroleum), which directly contribute to business production and expansion. The growth and composition of imports suggest strongly that the wide trade deficit is to some extent a reflection of the U.S.'s economic strength, and is not as bothersome as is commonly perceived.

As long as the U.S. continues to grow faster than other industrial nations, and its investment growth is stronger, its trade deficit will tend to remain wide. However, the strength in exports and recent slowing in import growth, which must be interpreted cautiously, have reduced the trade gap. As economic growth improves in other regions of the world, investment in these nations will expand, and real interest rates will rise. Slower growth in U.S. consumption, higher household savings rates, a greater reliance on exports to spur domestic economic growth and a gradual narrowing in the U.S. trade gap are natural and necessary consequences of an improved balance in world economies. The best contribution for U.S. economic policy is to encourage the positive trends abroad while sustaining healthy domestic economic fundamentals.

(9) *Headline inflation has risen due to higher energy prices, but core measures of inflation, excluding food and energy, have remained low. Core inflation may rise modestly in response to Katrina, but I expect that any rise will be temporary, and project inflation to remain low in 2006.*

Following the energy price spike that accompanied Katrina, the CPI has now risen 4.7 percent in the past 12 months, highest since mid-1991 and a substantial jump from 2.5 percent only a year ago. Core measures of inflation that exclude food and energy have drifted up very modestly: both the core PCE deflator and core CPI have risen 2.0 percent in the past 12 months, ending in August and September respectively. Presently, the core PCE deflator is at the top end of the Fed's central tendency forecast of 1.75–2.0 percent through 2006. The Fed and most macroeconomists generally focus on core measures of inflation because historically, the food and energy components have been very volatile, and have tended to regress to their long-run averages, while core measures of inflation have provided the most reliable forecasts of future inflation.

Core inflation may rise gently through year-end 2005 as a consequence of Katrina-related price increases of materials and commodities, but I expect that will prove to be temporary, and core inflation will remain relatively low in 2006. I am very impressed with the Fed's inflation-fighting resolve. The Fed rate hikes will slow nominal spending growth, which will constrain excess domestic demand relative to productive capacity (the Fed's central tendency forecast for nominal GDP is 5.25–5.5 percent for 2006, a meaningful deceleration from its 6.1 percent year-over-year pace). Moreover, the rapid expansion of the economies of low-cost producers China and India has lifted global productive capacity, and should continue to put downward pressure on the prices of traded goods. A widening array of services is also traded, helping to lower accompanying cost structures. These trends increase real output globally while constraining inflation.

(10) *The Federal Reserve's primary focus remains low inflation, and it will continue to hike short-term rates into 2006. Bond yields are projected to rise, but not as much as short-term rates, contributing to a flatter yield curve.*

Even though the Fed has raised its Federal funds rate target from 1 percent to 3.75 percent, it perceives that monetary policy remains accommodative, and it will continue to raise rates in order to constrain core inflation. The Fed does not have a "formal" numeric inflation target like many central banks, but it has clearly signaled that low inflation is its primary goal. Beyond the typical issues of forecasting inflation and the economy amid uncertainty, the difficulty the Fed faces is that there is no reliable measure of monetary thrust that provides a clear, forward-looking guideline for conducting policy, and there are many crosscurrents in various monetary indicators. The "neutral" Federal funds rate is uncertain. At present, the funds rate remains below its long-run average in inflation-adjusted terms, nominal spending growth remains too fast to be consistent with stable low long-run inflation, and the unemployment rate is low. However, growth of the monetary aggregates has not provided reliable estimates of nominal spending; although their recent moderate growth points to slower nominal GDP growth, the seemingly excess liquidity in financial markets in recent years has not been reflected in money supply measures. The sharp flattening of the yield curve historically has implied monetary restrictiveness, but the real costs of capital remain low. The lags between monetary policy and economic activity always add a degree of difficulty to Fed decisionmaking.

I expect that the Fed will raise rates through mid-2006, to approximately 4.5 to 4.75 percent. Core inflation is unlikely to recede appreciably, and the Fed will remain concerned about inflation in light of sustained economic growth, low unemployment and scattered production bottlenecks. Although a "neutral" funds rate is unobservable, my assessment is these anticipated rate hikes would lift rates to a level consistent with a neutral monetary policy, and would slow nominal spending and help constrain inflation. Following several years of very low rates and monetary stimulus, the Fed will perceive it necessary to hike rates to the high end of estimated range of neutrality. Rising world real interest rates also imply a higher equilibrium funds rate target.

Bond yields, which have drifted up recently reflecting concerns about inflation, are projected to rise to 5 percent by mid-2006. This would involve a further flattening of the yield curve; I do not expect the Federal funds rate to rise above 10-year Treasury bond yields. Low core inflation and the Fed's credibility anchor bond yields. With inflation expectations around 2 percent, a rise to 5 percent bond yield would provide an ex ante 3 percent real interest rate, in line with the long-run average of inflation-adjusted bond yields.

(11) *The high U.S. trade deficit has resulted largely from the U.S.'s relative economic strength, while the unprecedented U.S. current account deficit reflects global*

differences in growth, saving and investment, and is not likely to be the primary source of economic destabilization.

Since 1990, U.S. economic and investment growth has been persistently and significantly stronger than Europe, Japan and other industrialized nations, and its future potential growth is estimated to be higher. The rising U.S. trade deficit reflects and is consistent with its relative economic strength, as its strong domestic demand and investment spending support rapid growth in imports. As long as the U.S. maintains this growth advantage, which boosts the demand for imports, and the demand for U.S. dollar-denominated assets remains high, the trade deficit will remain large.

In general, the large current account imbalances of many nations and international capital flows reflect the large difference in rates of economic growth, investment and saving. The unprecedented U.S. current account deficit—now exceeding 6 percent of GDP—reflects the U.S.'s insufficient saving relative to investment, other nations' excess saving, and the strong demand for U.S. dollar-denominated assets as global portfolio managers seek the highest risk-adjusted rates of return on investment. While U.S. investment remains strong, its large budget deficit and low rate of personal saving drag down national saving.

In contrast, Asian nations tend to be large savers. Japan exports capital, as its weak investment and high saving have generated current account surpluses (Japan has been running a large government deficit, but its private sector saving has been very high, reflecting the prolonged deflation and long-run concerns about government finances and pensions). Barring a sharp change in global economic fundamentals, I do not expect a dramatic shift in asset allocations away from U.S. dollars that would generate a sharp fall in the U.S. dollar and/or rise in interest rates that would damage U.S. economic performance. That said, there are initiatives that international policymakers could agree on that would reduce global imbalances and boost growth at the same time. A coordinated package that would reduce U.S. budget deficits, institute pro-growth tax cuts and regulatory reforms in Europe, and involve agreement by select Asian nations, including China, to float their currencies, is such a package.

(12) *The largest risks to the medium-term U.S. economic outlook are excessive monetary tightening and higher energy prices or an unanticipated slump in global economies. The U.S. economic expansion is not likely to be sidetracked by large global imbalances or falling housing prices. Addressing the U.S.'s large Government budget imbalances remains crucially important to long-run economic health.*

Beyond the widely anticipated temporary economic slowdown following Katrina, the largest risks to U.S. macro performance in 2006 are not the negative ripple effects of a collapsing housing market or financial turmoil resulting from a dramatic withdrawal of foreign capital from U.S. dollar-denominated assets. Rather, my concerns center on the lagged impacts of significant monetary tightening coupled with sustained high energy prices, or some unforeseen global slump. So far, the economy has been very resilient to higher energy prices and Fed rate hikes, but consumer and business investment spending could be hurt by further energy price increases and rate hikes beyond the neutral range. The Fed's top priority should be constraining inflation, but it must mind its lagged policy impacts, particularly in light of leveraged household balance sheets. However, the low real costs of capital and lean business inventories provide important buffers and substantially reduce the probability of economic downturn.

Although the Government's long-run budget imbalance is unlikely to hamper near-term economic performance, addressing future rapid growth in projected outlays and the Government's unfunded liabilities is crucially important to the Nation's long-run economic health. Delays in policy changes only raise future economic costs. The estimated difference between projected spending and taxes under current law is so large that raising taxes to "close the gap" on paper would damage economic performance and adversely affect the financing gap. Successfully achieving fiscal responsibility requires programmatic changes to the major entitlement programs, the sources of the recent and projected future spending increases, that are fair to current program participants, provide the right incentives, and are financially viable for the long run.

PREPARED STATEMENT OF DR. DAVID F. SEIDERS, CHIEF ECONOMIST, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, DC

Thank you Chairman Saxton and Members of the Joint Economic Committee, I appreciate the opportunity to testify before you today on behalf of the National Association of Home Builders (NAHB). NAHB represents more than 220,000 members

involved in home building, remodeling, multifamily construction, property management, subcontracting, and light commercial construction. NAHB is affiliated with more than 800 State and local home builder associations around the country. Our builder members will construct approximately 80 percent of the more than 1.84 million new housing units projected for construction in 2005.

The home building industry has been one of the strongest contributors to the national economy in recent years. We have had record years of production that have led to the highest homeownership rate in U.S. history—69 percent. It is in America's interest to assure that the home building industry maintains its leadership role in the economy, not only because housing and related industries account for 16 percent of the gross national product (GDP), but most importantly because of the benefits of home ownership to our country.

INTRODUCTION

The current U.S. economic expansion began almost 4 years ago, payroll employment has been growing for about 2 years, and the unemployment rate has come down substantially in the process.

The housing sector has been a pillar of strength throughout this economic expansion. The housing production component of GDP (residential fixed investment) has delivered major contributions to growth, particularly since early last year, and surging home sales and residential construction have pulled related components of GDP ahead as well—including the furniture and household equipment component of consumer spending. The volume of services produced by the housing stock and consumed by households also has been a large and growing component of GDP. Finally, surging house prices have generated massive amounts of wealth for America's homeowners, and debt-financed "extraction" of housing equity has supported spending on residential remodeling and a variety of consumer goods and services. Everything considered, it's safe to say that the housing sector has contributed at least a full percentage point to overall GDP growth in recent times, conservatively accounting for between one-fourth and one-third of the total.

The extraordinarily strong performance of housing, including the large cumulative increase in house prices, has prompted widespread charges of an unsustainable housing boom, as well as projections of a bust that could wreck not only the housing market, but also the entire economy. Indeed, analogies have been drawn between the current housing market and the stock market bubble that preceded the recession of 2001.

The housing market inevitably will cool down to some degree before long, but a destructive housing bust is not in the cards; furthermore, rebuilding in the wake of this year's hurricane season will add to housing production for years to come. Everything considered, the housing sector should transition from a strong engine of economic growth to a more neutral factor in the GDP growth equation, but housing will continue to play a vital role in U.S. economic activity going forward.

It should be noted that the housing forecasts presented below (attachment) assume that the current U.S. housing policy structure remains essentially intact, with some temporary enhancements to deal with the extraordinary housing issues created by hurricanes Katrina and Rita and with maintenance of current benefits to housing in the tax code and the housing finance system.

FORECAST HIGHLIGHTS

• The U.S. economy was performing quite well prior to hurricanes Katrina and Rita and has enough fundamental strength to easily weather the storms.

• The hurricanes took an immediate toll on growth of economic output and employment and may shift energy costs upward for an extended period of time. But the recovery and reconstruction process will soon provide enough economic stimulus to outweigh the negatives, thanks largely to the Federal Government response.

• The higher energy costs provoked by the hurricanes are putting upward pressures on headline inflation numbers, but that effect will diminish with time. Core inflation (excluding prices of food and energy) promises to accelerate modestly during the next year or so as labor markets tighten further and high energy prices inevitably leak into the core.

• The Federal Reserve tightened monetary policy another notch on September 20, judging that the longer-term inflationary implications of Katrina outweigh the short-term economic negatives. Additional quarter-point hikes are likely at the next three FOMC meetings, taking monetary policy to an approximately "neutral" position as Chairman Greenspan's term runs out at the end of January 2006.

• Long-term interest rates have firmed up from their post-Katrina lows as the bond markets have judged that the economy will weather both storms and generate

an inflation issue in line with the Fed's concerns. Long-term rates should move up somewhat further in coming quarters, lessening the risk of yield curve inversion as the central bank raises short-term rates.

• Katrina and Rita destroyed more than 350,000 housing units and significantly damaged another 330,000, creating the potential for a huge repair and rebuilding process with major implications for residential remodeling, manufactured home shipments and conventional housing starts—both inside and outside the impacted areas.

• NAHB's housing forecasts incorporate tentative assumptions regarding the timing and the patterns of repair and rebuilding in the wake of the hurricanes. We're assuming that existing rental vacancies and available subsidized housing units in the Gulf region and elsewhere will meet some of the current need. We've also bolstered our outlook for residential remodeling and manufactured home shipments through 2007 while phasing in increases in conventional housing starts (single-family and multifamily) over an even longer period of time.

• Recent housing market indicators, on balance, suggest that home sales and housing starts were toying with cyclical peaks prior to Katrina, and surveys of builders and lenders conducted since then seem consistent with that judgment. However, the housing market still has a lot of fundamental strength and home prices still are trending upward—at least according to most measures we have in hand.

• NAHB's housing outlook recognizes declines in housing affordability measures that so far have been caused by sustained rapid increases in house prices and that figure to be further eroded down the line by a persistent upshift in the interest rate structure. We're also anticipating less support to the single-family and condo markets from "exotic" forms of adjustable-rate mortgages and from investors/speculators that have been relying on short-term capital gains—two factors that undoubtedly have contributed to the recent housing boom in some areas.

• NAHB's housing forecast through 2007 shows a definite cooling down of the single-family and condo markets, with relatively strong performances turned in by rental housing, manufactured homes and remodeling—owing in part to Katrina and Rita. Everything considered, the housing production component of GDP (residential fixed investment) should soon fall out of the economic "growth engine" category and exert a slight drag on GDP growth in both 2006 and 2007.

• The anticipated fade in demand for single-family houses and condo units will result in some deceleration of price gains in 2006–2007, but national average prices will not actually fall in the type of economic and financial market environment portrayed in our forecast. Prices could fall in some local markets that have experienced particularly strong increases in recent times, although persistent supply constraints in such areas should continue to support home prices for some time.

• Homeowner finances currently are quite healthy, despite a huge volume of borrowing against accumulated housing equity in recent years, and the Fed's Financial Obligations Ratio for homeowners still is in a manageable range. Furthermore, the vast majority of homeowners will not be disadvantaged by perspective increases in market interest rates and most have equity positions that could easily absorb declines in house values—should they occur in some local markets.

ECONOMIC GROWTH

Incoming data suggest that annualized growth of real gross domestic product (GDP) was heading toward a robust pace of about 4.5 percent in the third quarter before Hurricane Katrina hit the Gulf Coast on August 29. We estimate that Katrina took nearly a percentage point out of third-quarter GDP growth (dropping it to an estimated 3.6 percent) and that the one-two punch from Katrina and Rita will hold fourth-quarter growth to 3.2 percent—still a trend-like performance that displays the resilience of the U.S. economy to serious shocks.

GDP growth should accelerate in the first half of 2006 as rebuilding activities gear up in the wake of this year's unprecedented hurricane damage. A bit further out, GDP growth should settle down to a sustainable trend pace (around 3.25 percent), reflecting minimal remaining slack in labor markets and maintenance of solid growth in labor productivity.

LABOR MARKETS

The employment report for September contained upward revisions to payroll employment for both July and August, bringing the average monthly gain to a robust 244,000. The preliminary estimate of net job losses in September came to only 35,000, much less than the consensus expectations, although data collection problems in the Gulf region definitely created a wide range of uncertainty.

For now, the Labor Department suggests that, in the absence of Katrina, employment growth probably would have followed its recent trend (an average gain of 194,000 for the previous 12 months), meaning that Katrina probably subtracted around 230,000 jobs from the national numbers in September. It's also worth noting that strikes subtracted 22,000 from the September payroll employment numbers, implying that, ex-Katrina and ex-strikes, payroll employment increased by about 225,000—in line with the strong July-August performance.

The labor market report for October will have to cope with hurricanes Katrina and Rita, both because more Katrina casualties will drop off payrolls and because Rita destroyed additional jobs of her own. However, the September-October disruption to job markets will be temporary, and national net job growth should regain a solid trend before long. Indeed, we're looking for resumption of strong payroll employment growth in 2006, aided by rebuilding activities, followed by a slowdown in 2007 as GDP growth recedes to around trend. The unemployment rate should sag a bit next year from the current hurricane-related level (5.1 percent) but then edge up a bit in 2007.

ENERGY COSTS AND INFLATION

The hurricanes have seriously complicated the inflation picture, boosting energy prices and headline inflation in the near term and putting some upward pressure on core inflation down the line as energy prices inevitably seep into the business cost structure.

The disruptions to energy production and transmission in the Gulf region caused energy prices to spike sharply after Katrina, but prices subsided within a few weeks as the supply situation improved. However, the arrival of Rita caused energy prices to surge again, particularly for gasoline and natural gas, and prices for these products are likely to remain elevated for quite a while.

We're currently assuming that the spot price of WTI crude oil averages a record $65/barrel in the fourth quarter and gradually recedes to about $45/barrel by late 2007. We expect the retail price of gasoline to continue to recede gradually from the post-Katrina peak (above $3.00/gallon) but remain historically high across the forecast horizon. We also assume that persistently higher prices for natural gas will make their way into the prices for residential gas and electric service as utilities gain regulatory approval to raise their rates.

We expect core inflation to firm up to some degree, particularly in 2006, reflecting tight labor markets and stronger growth of hourly compensation, as well as some pass-through of high energy prices. Core consumer price inflation is likely to rise from year-over-year rates of slightly below 2 percent in the third quarter of this year to about 2.5 percent by 2007. That pace may be around the upper end of the Federal Reserves "comfort zone."

INTEREST RATE STRUCTURE

The apparent strong forward momentum of the U.S. economy, along with the prospects for higher headline and core inflation, apparently have steeled Federal Reserve resolve to keep the inflation situation under control and have sent long-term rates upward.

The Fed enacted another quarter-point increase in short-term interest rates at the September 20 meeting of the Federal Open Market Committee (FOMC), raising the Federal funds rate to 3.75 percent (the bank prime rate went to 6.75 percent in the process). While acknowledging the negative economic effects of Hurricane Katrina, the FOMC characterized these negatives as temporary and focused heavily on the evolving threats to core inflation. And while continuing to say that remaining monetary policy accommodation can be removed at a "measured" pace, the FOMC held open the possibility of a more aggressive approach in the event that inflation concerns become more serious than expected.

In recent weeks, various Fed spokespersons have stressed the evolving inflation threat, and another quarter-point rate hike at the next FOMC meeting on November 1 seems a foregone conclusion. Furthermore, we're assuming additional rate hikes at the December 13 and January 31 meetings, as Chairman Greenspan's term runs out. We're assuming the 4.5 percent funds rate will be considered "neutral" and that monetary policy will hold steady for some time.

The bond markets apparently share the Fed's perspectives on economic growth and inflation, and market expectations for monetary policy are essentially the same as ours. As a result, long-term interest rates have backed up considerably from their post-Katrina lows and the long-term home mortgage rate edged over 6.0 percent in the second week of October. Our forecast shows some additional increase in long-

term rates in coming quarters, with the home mortgage rate reaching 6.6 percent by the fourth quarter of 2006.

HURRICANE HOUSING DAMAGE

According to the October 3 Red Cross "disaster assessment" for hurricanes Katrina and Rita, the two storms destroyed an estimated 356,000 housing units, with 353,000 attributed to Katrina. This was more than 12 times the number destroyed in any previous natural disaster (or series of disasters) in the Nation's history.

Furthermore, 146,000 units suffered "major" damage (not currently habitable), 184,000 had "minor" damage (could be occupied), and an additional 206,000 had "extremely minor" or "nuisance" damage such as a few missing shingles or broken windows. Four-fifths of the "destroyed" housing units (uninhabitable and beyond repair) are in Louisiana and nearly one-fifth are in Mississippi, while Alabama and Texas got off quite lightly in this regard. Total damaged housing units (needing major, minor or extremely minor repairs) amounted to 329,000 in Louisiana, 173,000 in Mississippi, 33,000 in Texas, and about 1,000 in Alabama.

The Red Cross has been trying to categorize destroyed or damaged homes by type of unit. Current estimates say 88 percent of destroyed units are single-family homes, 11 percent are apartment units and less than 1 percent are manufactured homes. Census Bureau numbers, on the other hand, show that about 15 percent of the housing stock in Louisiana, Mississippi, and Alabama consisted of manufactured homes in 2000. Thus, it's likely that the Red Cross has been categorizing many destroyed or damaged HUD-code housing units as conventionally built single-family homes.

Whatever the exact numbers, it's perfectly clear that the cleanup, repair and rebuilding process in the wake of Katrina and Rita will be immense and that the implications for residential maintenance and repair, spending on improvements (including replacements of major systems), manufactured home shipments and conventional housing starts are profound. The timing and composition of the process will depend heavily on the pattern of Government responses.

REPAIR/RECONSTRUCTION ASSUMPTIONS

It's extremely difficult to estimate the patterns of repair and reconstruction of the housing stock that was destroyed or damaged by hurricanes Katrina and Rita. Experience with previous natural disasters, along with evolving patterns of Federal Government assistance in the wake of Katrina-Rita, have led us to the following working assumptions for the 9-quarter period extending through the end of 2007:

- $1.8 billion for outlays on residential maintenance and repair.
- $4.7 billion for improvements to residential structures (including replacements of major systems such as roofs and heating systems).
- 38,000 manufactured home shipments (HUD-code units).
- 90,000 conventional housing starts (80 percent single-family units), including units built on existing foundations in the Gulf region.

RECENT HOUSING PERFORMANCE

Housing market indicators painted a fundamentally positive picture through the pre-Katrina period (essentially through August). Single-family starts and permits for August held in the record range established during other recent months, sales of existing homes (based on closings) displayed a similar pattern, and "pending" sales of existing homes (based on contracts signed) actually moved up to a new record in August. Sales of new homes (contract basis) fell off in August following a record pace in July, but statistical problems definitely contributed to volatility in those months (hardly a new problem with this series).

For the post-Katrina period, NAHB's single-family Housing Market Index fell by two points in September, but regained that loss in October, leaving the index slightly below the cyclical peak in June. The weekly index of applications for mortgages to buy homes (Mortgage Bankers Association series) was essentially flat throughout August, September, and early October (4-week moving average basis).

Everything considered, it seems fair to say that single-family housing activity has been toying with a cyclical peak and is poised to show some fade before long. Measures of home-buying affordability have been eroding in the face of ongoing rapid increases in house prices in many areas, and the recent upshift in short- and long-term interest rates figures to take some toll as well. Furthermore, there's a good chance that those "exotic" forms of adjustable-rate mortgages are losing some luster under the public scrutiny of Federal financial regulators and the rating agencies.

Finally, there's some tentative evidence of decline in the investor shares of purchases of single-family homes and condo units, and this component of demand can be quite fragile.

THE HOUSING FORECASTS

NAHB's forecast shows a slight decline in total housing starts in the fourth quarter of this year, partly because of hurricane effects in the Gulf region, and we expect total starts to be down moderately in both 2006 and 2007, despite hurricane-related additions.

Our forecast for 2006–2007 shows a cumulative decline of 9 percent in single-family starts from the 2005 record. The multifamily sector is essentially flat in this forecast, thanks primarily to a good performance by the rental sector. We expect manufactured home shipments to pick up significantly in coming quarters, reaching 150,000 units in 2006 before settling back toward a pre-Katrina pace. Residential remodeling should post solid growth (in both nominal and real terms) throughout the forecast period, supported by a massive amount of homeowner equity and swollen repair/improvement needs in the wake of the hurricanes.

Everything included, the residential fixed investment component of GDP should soon move out of the strong "growth engine" category occupied since the 2001 recession, although the real value of RFI should remain within a few percentage points of the record high reached in the third quarter of this year.

HOMEOWNER FINANCES

Various media reports have been insisting that heavy borrowing against housing equity has been pushing homeowner finances to the brink of disaster. Indeed, Federal Reserve Chairman Alan Greenspan recently unveiled Fed research showing net home equity "extraction" of $600 billion in 2004 (6.92 percent of disposable income), and borrowing against equity could be even bigger this year.

These are staggering numbers, of course, but they don't actually mean that something has gone wrong. Indeed, the Fed's own national balance sheets show that homeowner equity grew to $10.5 trillion by mid–2005, up by 18 percent from a year earlier. Furthermore, the aggregate housing debt-to-value ratio stood at 43 percent at mid-year, lower than at any time in recent years.

It's also clear that mortgage debt repayment is not placing an undue burden on the income of America's homeowners—partly because mortgage debt has been substituting for a lot of shorter-term, higher-cost, consumer debt. Indeed, the Fed's Financial Obligations Ratio for homeowners was only 16.37 percent in the second quarter, compared with 28.87 percent for renter households.

While it's possible to find debt-strapped homeowners, the overall picture shows remarkably healthy homeowner finances and a housing equity nest egg that could withstand sizable shocks. Indeed Chairman Greenspan recently pointed out that "only a small fraction of households across the country have loan-to-value ratios greater than 90 percent" and that "the vast majority of homeowners have a sizable equity cushion with which to absorb a potential decline in house prices." *

Mr. Chairman, that concludes my remarks. Again, thank you for the opportunity to appear before you today. I look forward to answering any questions you or the Members of the Committee may have for me.

* Alan Greenspan, remarks on "Mortgage Banking" to the American Bankers Association Annual Convention, September 26, 2005

NAHB ECONOMIC AND HOUSING FORECAST

14-Oct-05

	Economic Activity			Interest Rates				New Housing Units					Home Sales		
						Mortgages*		Starts							
	Real GDP	Consumer Price Index	Unemp. Rate	Federal Funds	Prime	Fixed Rate	Adjustable Rate	Total	Single-Family	Multi-family	Mfg. Home Shipments	Total New Housing	New	Single-Family Existing	Residential Fixed Investment**
	Percent Change		Percent					Thousands of Units							Percent Chg.
Annual Data ***															
1992	3.3%	3.0%	7.5%	3.5%	6.3%	8.4%	5.6%	1,201	1,032	170	210	1,412	614	3,143	13.8%
1993	2.7%	3.0%	6.9%	3.0%	6.0%	7.3%	4.6%	1,292	1,131	161	255	1,546	674	3,421	8.2%
1994	4.0%	2.6%	6.1%	4.2%	7.1%	8.4%	5.3%	1,446	1,191	255	305	1,751	667	3,554	9.6%
1995	2.5%	2.8%	5.6%	5.8%	8.8%	8.0%	6.1%	1,361	1,082	279	341	1,702	670	3,514	-3.2%
1996	3.7%	2.9%	5.4%	5.3%	8.3%	7.8%	5.7%	1,469	1,154	314	362	1,830	756	3,783	8.0%
1997	4.5%	2.3%	4.9%	5.5%	8.4%	7.6%	5.6%	1,475	1,136	338	354	1,828	806	3,973	1.9%
1998	4.2%	1.5%	4.5%	5.4%	8.4%	6.9%	5.6%	1,621	1,278	344	374	1,995	889	4,492	7.6%
1999	4.4%	2.2%	4.2%	5.0%	8.0%	7.4%	6.0%	1,647	1,306	341	348	1,996	879	4,626	6.0%
2000	3.7%	3.4%	4.0%	6.2%	9.2%	8.1%	7.0%	1,573	1,232	341	250	1,823	880	4,607	0.8%
2001	0.8%	2.8%	4.8%	3.9%	6.9%	7.0%	5.8%	1,601	1,272	330	192	1,793	907	4,723	0.4%
2002	1.6%	1.6%	5.8%	1.7%	4.7%	6.5%	4.6%	1,710	1,363	347	168	1,878	976	4,995	4.8%
2003	2.7%	2.3%	6.0%	1.1%	4.1%	5.8%	3.8%	1,854	1,505	349	131	1,985	1,091	5,441	8.4%
2004	4.2%	2.7%	5.5%	1.3%	4.3%	5.8%	3.9%	1,950	1,604	345	130	2,080	1,200	5,913	10.3%
2005	3.6%	3.4%	5.1%	3.2%	6.2%	5.8%	4.5%	2,032	1,683	349	134	2,166	1,275	6,167	6.4%
2006	3.5%	2.8%	5.0%	4.5%	7.5%	6.5%	5.4%	1,940	1,590	350	150	2,090	1,215	5,894	0.6%
2007	3.3%	2.2%	5.0%	4.5%	7.5%	6.6%	5.5%	1,883	1,533	350	143	2,025	1,171	5,707	-0.9%
Quarterly Data ****															
2004															
Q1	4.3%	3.9%	5.7%	1.0%	4.0%	5.6%	3.5%	1,929	1,562	367	126	2,055	1,189	5,563	5.1%
Q2	3.5%	4.4%	5.6%	1.0%	4.0%	6.1%	3.9%	1,923	1,600	323	127	2,050	1,203	6,070	17.8%
Q3	4.0%	1.6%	5.4%	1.4%	4.4%	5.9%	4.1%	1,974	1,635	339	129	2,103	1,164	5,970	2.6%
Q4	3.3%	3.6%	5.4%	1.9%	4.9%	5.7%	4.1%	1,973	1,621	352	138	2,111	1,243	6,047	1.6%
2005															
Q1	3.8%	2.4%	5.3%	2.5%	5.4%	5.8%	4.2%	2,083	1,709	374	137	2,220	1,249	5,980	9.5%
Q2	3.3%	4.2%	5.1%	2.9%	5.9%	5.7%	4.2%	2,044	1,693	351	129	2,174	1,289	6,297	10.8%
Q3	3.6%	4.8%	5.0%	3.5%	6.4%	5.8%	4.5%	2,020	1,690	330	125	2,145	1,300	6,290	3.3%
Q4	3.2%	4.2%	5.1%	4.0%	7.0%	6.1%	5.0%	1,980	1,640	340	145	2,125	1,261	6,101	-0.8%
2006															
Q1	3.8%	1.8%	5.0%	4.4%	7.4%	6.3%	5.2%	1,959	1,609	350	150	2,109	1,237	5,993	-0.6%
Q2	3.5%	1.4%	5.0%	4.5%	7.5%	6.4%	5.3%	1,944	1,594	350	150	2,094	1,218	5,902	-0.2%
Q3	3.3%	2.2%	4.9%	4.5%	7.5%	6.5%	5.4%	1,934	1,584	350	150	2,084	1,208	5,864	-0.7%
Q4	3.2%	2.2%	4.9%	4.5%	7.5%	6.6%	5.5%	1,924	1,574	350	150	2,074	1,199	5,817	-0.7%
2007															
Q1	3.3%	2.2%	4.9%	4.5%	7.5%	6.6%	5.5%	1,910	1,560	350	145	2,055	1,189	5,773	-1.2%
Q2	3.2%	2.2%	5.0%	4.5%	7.5%	6.6%	5.5%	1,880	1,530	350	145	2,025	1,180	5,724	-1.3%
Q3	3.3%	2.2%	5.0%	4.5%	7.5%	6.6%	5.5%	1,870	1,520	350	140	2,010	1,159	5,673	-1.2%
Q4	3.2%	2.2%	5.0%	4.5%	7.5%	6.6%	5.5%	1,870	1,520	350	140	2,010	1,156	5,659	1.1%

* Freddie Mac Commitment Rates: 30-Yr. Average conventional mortgage rate and 1-Yr. Adjustable Rate; forecast of these rates are produced by NAHB.

** Includes the dollar volume of construction put-in-place for new single-family and multifamily structures, manufactured home shipments, brokerage commissions on home sales, and improvements to existing structures (additions, alterations, and major replacements).

*** Annual totals are averages of seasonally adjusted quarterly data and may not match reported annuals from other sources.

**** All quarterly data are at annual rates, and all data except interest rates are seasonally adjusted.

PREPARED STATEMENT OF DR. BRAD SETSER, SENIOR ECONOMIST AND DIRECTOR OF GLOBAL RESEARCH, ROUBINI GLOBAL ECONOMICS, LLC, NEW YORK, NY

I want to thank Chairman Saxton and the Joint Economic Committee for the opportunity to testify. My remarks will focus on one particular aspect of the economic outlook—but a very important one—the payments deficit the United States is running with the rest of the world. I will make five key points:

• The U.S. current account deficit has reached an unprecedented size for a major economy. Barring a sharp fall in oil prices, this deficit is likely to continue to increase in the next year, in part because of rising interest payments on the United States growing external debt.

• The U.S. external deficit is a reflection of policy decisions, both here in the U.S. and abroad, not just private saving and investment decisions. Both the large U.S. fiscal deficit and the unwillingness of many economies to allow their currencies to appreciate against the dollar have contributed to the United States large deficit. Net private flows have not been large enough to finance the United States current account deficit.

• Trade deficits of nearly 6 percent of U.S. GDP are not sustainable over time. They imply a rapid increase in the U.S. external debt to GDP ratio and a growing current account deficit.

• The availability of sufficient financing to sustain deficits of this size at current U.S. interest rates should not be taken for granted. The larger the deficit, and the longer adjustment is delayed, the greater the associated risks.

• Policy actions, both at here and abroad, can help first to stabilize and then to reduce the U.S. external deficit. The needed policy steps are by now well known, but no less urgent. A reduction in the U.S. fiscal deficit would increase national savings, and thus reduce the United States' need to draw on the world's savings. Our trading partners need to show greater willingness to allow their currencies to appreciate and to take policy steps to encourage domestic consumption growth.

The current account deficit looks likely to continue to grow in 2006.—The current account deficit is the sum of the trade deficit, the balance on transfer payments, and the balance on labor and investment income. This deficit totaled $395 billion in the first half of the year, largely because of the $346 billion trade deficit. The trade deficit is set to widen further in the second half of the year on the back of higher oil prices and the disruption to U.S. oil production and refining created by Katrina and Rita. The current account deficit has, until now, largely tracked the U.S. trade deficit, but this is likely to change going forward. The balance on investment income turned negative in the second quarter, and further deterioration is to be expected as higher short-term rates work their way through the U.S. external debt stock. A surge in incoming transfer payments as European re-insurers make Katrina-related claims may offset some of this increase.

The 2005 trade deficit is likely to approach $720 billion and, in conjunction with a transfers deficit of $85 billion and a negative income balance, push the current deficit to around $815 billion, or about 6.6 percent of U.S. GDP—up substantially from the $520 billion (4.6 percent of GDP) deficit of 2003 and the $668 billion deficit of 2004 (5.7 percent of GDP). In dollar terms, the 2005 deficit will be about twice as large as the $413 billion deficit of 2000, the peak deficit of the .com investment boom.

If both the U.S. and the world continue to grow at close to their current rates in 2006, the current account deficit is likely to continue to widen in 2006. The recent increase in the trade deficit has been driven almost exclusively higher oil prices; monthly non-oil imports have been roughly constant since January. Subdued non-oil imports combined with strong export growth to lead the non-oil trade deficit to fall ever so slightly in the second quarter. However, this improvement in the non-oil balance is likely to be difficult to sustain in 2006. Strong export growth in 2005 reflects the lagged impact of falls in dollar/euro in 2003 and 2004, plus a cyclical recovery in demand for civil aircraft. By 2006, the recent rise in the dollar is likely to begin to slow export growth. The slowdown in the growth of non-oil imports is therefore partially a reaction to the exceptionally rapid growth of these imports at the tail end of 2004. So long as the U.S. economy continues to grow as expected, it is reasonable to expect growth in non-oil imports to resume, though at a lower rate than 2004.

The balance on investment income is likely to continue to deteriorate. Remember, the U.S. will take on $800 billion in new external debt over the course of 2005 to finance its ongoing external deficit. If that debt only carries an average interest rate of 5 percent, it implies an additional $40 billion in external payments. The full impact of the Fed's recent tightening on short-term rates will also begin to manifest itself in 2006, as existing short-term debt is refinanced at a higher rate. The result-

ing 2006 current account deficit is likely to top $900 billion, and exceed 7 percent of GDP.

The current account deficit essentially measures of how much we have to borrow from the rest of the world to support the amount we consume in excess of our income. It consequently is equal to the gap between what the U.S. saving and U.S. investment. The U.S. budget deficit—a drain on national savings—is likely to increase in 2006 on the back of Katrina. Barring a fall in investment or rise in household savings, so the overall gap between overall national savings and investment is likely to continue to widen. Put differently, savings imported from the rest of the world will finance an increasing share of domestic U.S. investment.

	2003	2004	2005 (f)	2006 (f)
Trade balance	−495	−618	−720	−780
o/w oil	−130	−175	−241	−260
Non-oil trade balance	−365	−443	−479	−520
Transfers balance	−71	−81	−85	−90
Income balance	46	30	−10	−65
Current account	$520	$668	$815	$935
(% of GDP)	(4.7%)	(5.6%)	(6.6%)	(7.1%)

Policy choices in the U.S. and abroad have contributed to the increase in the deficit.—Current account deficits of this magnitude are without precedent for a major economy. As Dr. Bernanke has emphasized, these deficits have, to date, been financed at remarkably low interest rates. Indeed, current U.S. interest rates seem, on their face, insufficient to compensate the central banks of the emerging market economies now financing the United States for the risk of further dollar depreciation. Consequently, it is interesting to review the forces that have led to the emergence of such a large U.S. external deficit.

The U.S. current account deficit, by definition, has to be matched by a current account surplus in rest of the world. The fall in savings relative to investment in USA necessarily has been matched by a rise in savings relative to investment in rest of world. The U.S. external deficit started to widen in the late 90s, as investment in the U.S. surged and investment in certain Asian economies fell sharply. The U.S. external deficit, surprisingly, did not fall when U.S. investment fell sharply in 2001 and 2002, largely because changes in tax policy—along with an upturn in expenditure growth—turned a small structural fiscal surplus to a structural fiscal deficit of around 3 percent of GDP.[1] Since the fiscal deficit peaked as a share of GDP in 2004, the recent deterioration in the U.S. current account deficit has been driven by a fall in household savings and a rebound in investment. This reflects a surge in investment in residential property, and, as Chairman Greenspan has emphasized, rising house prices also seem to be closely linked to the fall in U.S. household savings.

Dr. Bernanke has noted that the main counterpart to the recent rise in the U.S. current account deficit is not found in either Japan or Europe.[2] The eurozone's current account surplus fell between 1997 and 2005.[3] The roughly $60 billion rise in Japan's current account surplus between 1997 and 2005 is far too small to account for the much larger rise in the U.S. current account deficit. Rather, rising U.S. deficits have been matched by rising surpluses in emerging and developing economies.

These surpluses have different causes. Emerging Asia's surplus has increased since 1997, driven first by the Asian crisis and, more recently, by the surge in China's current account surplus. Setting China aside, the savings rates in most Asian emerging economies have been constant. Their surpluses reflect a fall in investment, which fell (from quite high levels) during the crisis and have yet to recover. China is a different story: its national savings rate has soared to over 50 percent of its GDP, with most of the increase occurring recently. It is hard to find evidence of a global savings glut, but it is hard to deny the presence of savings glut in China. Latin America has shifted from a deficit to a surplus, largely because improvements

[1] IMF, 2005. See Table of 14 of the statistical appendix of the WEO. William Gale and Peter Orzag have reached a similar conclusion; see *http://www.brookings.edu/views/articles/20050214galeorszag.pdf.*

[2] Ben Bernanke, "The Global Savings Glut and the U.S. Current Account Deficit," The Homer Jones Lecture, April 14, 2005. *http://www.federalreserve.gov/boarddocs/speeches/2005/20050414/default.htm.*

[3] The eurozone's surplus fell from $96 billion in 1997 to an estimated $24 billion in 2005; Japan's surplus rose from $97 billion to an estimated $153 billion in 2005. The surplus of the Asian NICs rose from $6 to $80 billion, and a $85 billion deficit in "other emerging markets and developing economies" turned into a $410 billion surplus in 2005. IMF data and estimates.

in the fiscal position of most Latin governments have pushed national savings rates up. Finally, rising oil prices have led to higher savings in the world's oil exporters.

It is important to note that private capital flows have not carried the savings surplus of emerging economies to the U.S. Rather the large scale flow of capital from emerging economies to the U.S. is a function of policy decisions on the part of many emerging economies to resist pressures for currency appreciation—pressures stemming, in some cases, from rising current account surpluses and, in other cases, from private capital flows. In 2004, IMF data shows that private investors put $150 billion more into the emerging world than they took out. Such private flows potentially could have financed a substantial current account deficit, or at least allowed emerging economies to reduce their large current account surpluses. However, in aggregate, these economies maintained current account surpluses, in some cases, quite large surpluses even as private flows picked up. Consequently, private flows to emerging economies generally have financed faster reserve growth, and thus have been recycled back to the U.S. and Europe.

IMF data indicates that reserve accumulation by emerging economies has gone from $116 billion in 2001 to $517 billion in 2004.[4] In 2003 and early 2004, Japan also intervened heavily to prevent the dollar from depreciating against the yen. According to official U.S. data, central bank financing of the U.S. rose from $116 billion in 2002 to $278 billion in 2003 and $395 billion in 2004—and U.S. data almost certainly understates total dollar reserve growth, and thus foreign central bank's indirect role in the financing of U.S. deficits.

U.S. data shows a substantial reduction of central bank flows so far in 2005. This data needs to be interpreted with some caution. Reserve accumulation, once adjustments are made for the falling dollar value of euro reserves, is still running at a roughly $600 billion annual pace. Overall, global growth has not fallen, but the composition of countries adding to their reserves certainly has changed. Japan has stopped intervening, while reserve growth in both China and the world's oil exporters has picked. Almost all of Japan's increase in reserves showed up in the U.S. data. However, recorded Chinese purchases of U.S. debt in both 2004 and 2005 have equaled only about 40 percent of China's reserve increase. OPEC and Russia combined to run a current account surplus of perhaps $200 billion in the first half of 2005, but—at least according to U.S. data—they only purchased only $5 billion in U.S. long-term debt (and $1.5 billion in U.S. stocks). There are several ways to reconcile this data: China and the oil exporters may account for some of the increase in "onshore" central bank dollar deposits in the second quarter; they may have added to their offshore dollar deposits; they may have purchased U.S. securities via intermediaries (inflows from the UK have been strong); or they may have built up their holdings of euros—driving down yields on European bonds and thus encouraging private capital to flow to the U.S.

Consequently, in my view, rapid reserve growth my emerging economies continues to be a key reason why the U.S. has been able to finance its current account deficit without difficulty.

Large trade deficits are not sustainable over time.—The current U.S. position differs from the U.S. position in the 1980s in two key ways: The underlying deficit now is substantially larger, and U.S. is by now a substantial net debtor. The 2005 current account deficit, combined with the reduced dollar value of American assets in Europe, is likely to lead the U.S. net external debt[5] to increase to around 30 percent of U.S. GDP at end of 2005.

Basic external debt sustainability analysis implies that sustained trade deficits of the current level will lead to the United States net external debt to rise relative to GDP. Sustained trade deficits also imply a rising current account deficit, as the current account deficit includes interest payments on external debt. Stabilizing the U.S. net external debt-to-GDP ratio at between 50–60 percent of U.S. GDP (a relatively high level) requires the elimination of the trade deficit over the next 10 years. Even in that scenario, the U.S. current account deficit is likely to remain close to 3 percent of U.S. GDP. If this adjustment is delayed, U.S. external debt-to-GDP will stabilize at higher levels, net interest payments will be higher, and the U.S. could eventually need to run substantial trade surpluses to avoid ongoing increases in its external debt-to-GDP ratio.

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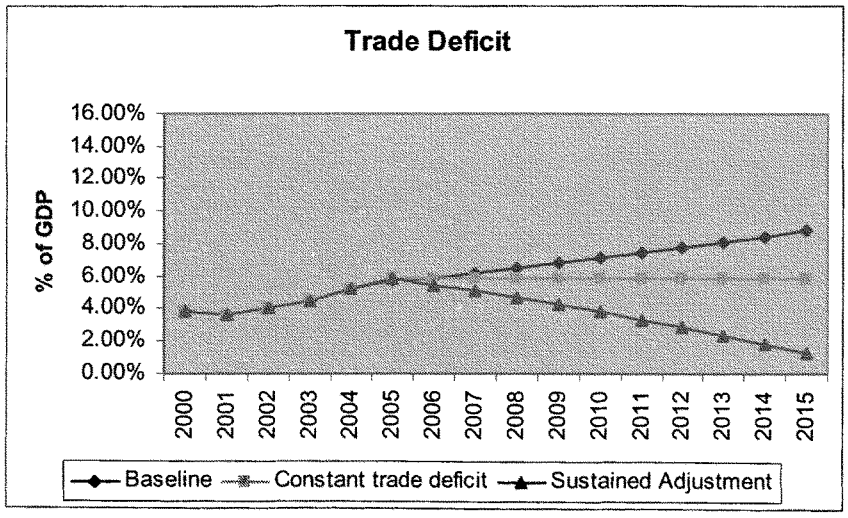
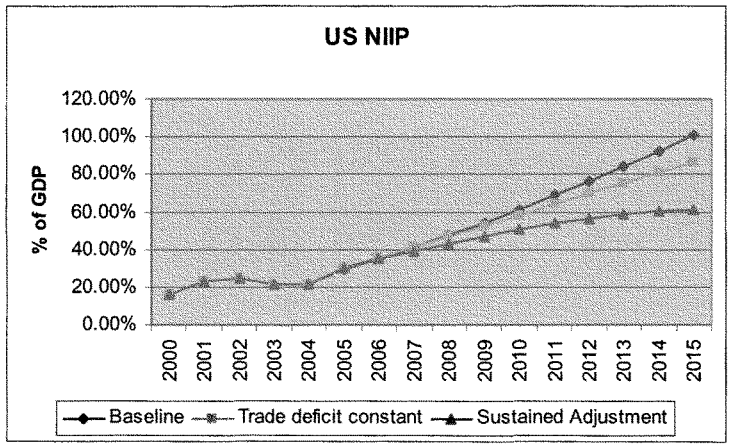
[4] The 2004 increase was inflated by perhaps $60 billion as a result of the rising dollar value of euro reserves.

[5] I am using net external debt as shorthand for the United States Net International Investment position. The international investment position includes U.S. equity investment abroad, and foreign equity investment in the U.S. Since U.S. equity (FDI and portfolio equity) investment abroad is worth more than foreign equity investment in the U.S., the negative U.S. Net International Investment position is entirely the product of a large negative net debt position.

US trade deficit as a share of GDP: scenarios



Evolution of US net international investment position: Scenarios



Note: no adjustments for valuation gains associated with future dollar depreciation; dollar depreciation, particularly against the euro, pound and Canadian dollar, tends to increase the value of US external assets, and thus reduce US net debt

Relying on foreign savings to finance a substantial share of investment in the U.S. implies that, over time, more and more of the income earned on investment in the U.S. will need to be sent abroad. Here is one way to think about it: A Chinese company believed that the future income of Unocal, a U.S. oil company, was worth about $20 billion. Financing this year's current account deficit would therefore require selling off the future income of 40 Unocals. Since next year's deficit is larger, it would require selling off the future income of another 50 Unocals. The U.S. has been financing its external deficits by selling debt not equity, but the basic principle is the same.

International experience also suggests that deficits associated with fiscal deficits and low levels of national savings are of greater concern than deficits associated with high levels of investment. The recent shift in composition of investment toward residential property is not particularly encouraging either: Housing is not an obvious source of future export income.

Short-term risks can be reduced with coordinated policy action.—Even if the trade deficit stabilizes in 2006 and beings to fall in 2007, the U.S. is likely to still need between $900 billion and a trillion in financing from the rest of the world in each of the next 2 years. In the long-run, failing to make the adjustments needed to raise national savings and bring the U.S. trade deficit down over time poses real risks to the U.S. economy. In the short-run, though, the biggest risk is that market conditions will change suddenly. Should the market's demand for adjustment would exceed the capacity of the U.S. economy to adjust smoothly, U.S. growth could slow—perhaps significantly. The dollar would fall and interest rates would rise, and the drag on the economy from higher interest rates would exceed the stimulus to the U.S. export sector from a falling dollar. U.S. trade and current account deficits have built over time; we do not want to be forced to get rid of those deficits over night.

The combination of market forces and policy decisions that will bring about the necessary adjustment in the U.S. trade deficit is subject to substantial uncertainty. But there is no doubt that the adjustment, when it comes, will require substantial changes in the drivers of growth, both in the U.S. and among our trading partners. In the U.S., consumption must grow more slowly than overall income, generating an increase in savings. Some sectors of the economy that currently are doing well may do less well, and resources will likely shift into the production of tradable goods and services. As former Treasury Assistant Secretary and long-term Director of the Federal Reserve's international staff, Edwin Truman has emphasized, overall U.S. growth could slow even during a relatively orderly adjustment process. Conversely, countries that until now have relied heavily on U.S. demand growth to spur their own economies will have to find new motors to propel their own growth. Just as the composition of growth must change here in the U.S., so too must it change abroad. After a period of time when U.S. imports have grown faster than U.S. exports, the world is likely looking at an extended period when U.S. exports will grow faster than U.S. imports.

Recent studies by the staff of the Federal Reserve Board offers hope that the adjustment process will prove to be relatively smooth, and need not involve either a sharp rise in interest rates or a large slowdown in growth. However, caution is still in order. The U.S. is in many ways operating outside realm of historical experience. The U.S. current account deficit now is far bigger than the deficit of the 1980s. The U.S. trade deficit is exceptionally large relative to the U.S. export sector. In 2004, the U.S. exported more "debt" than "goods." The U.S. is starting the adjustment process with very low long-term interest rates. The U.S. has significant assets abroad, which can help ease the adjustment process, but also very large gross external debts. Any sustained increase in U.S. interest rates could have a significant impact on the size of U.S. external interest payments. The adjustment process in the world's largest economy will have far larger impacts on the rest of the world than past adjustments in smaller economies.

International experience certainly suggests one clear lesson: As a country's external debt grows, it becomes more, not less, important to maintain fiscal policy credibility. Reducing the U.S. fiscal deficits is the easiest and most certain way to bring about the needed increase in U.S. national savings; it is likely to prove central to maintaining the confidence of the United States external creditors during what could be a long period of adjustment. Work by the IMF and OECD suggest that a $1 reduction in the fiscal deficit would lead to a 40 to 50 cent reduction in the U.S. current account deficit.

Just as policy changes here in the U.S. can help to increase U.S. savings relative to investment, policy changes in the rest of the world can raise their consumption growth relative to their income growth, raise their imports relative to their exports and reduce their savings relative to their investment. China, Malaysia and many oil exporting countries need to be willing to allow their currencies to appreciate against the dollar. All these countries are now running large current account surpluses, and countries with big surpluses cannot peg, or otherwise tie their currencies tightly to dollar, without impeding effective adjustment in the global balance of payments. If higher oil prices are sustained, oil exporters will need to spend more and save less. The low level of consumption in China relative to Chinese GDP suggests that there is substantial scope, with appropriate policies, for strong consumption growth in China to replace strong consumption growth in the U.S. as the driver of global demand growth. Continental Europe needs to direct its domestic macroeconomic policies toward supporting domestic demand during the adjustment process.

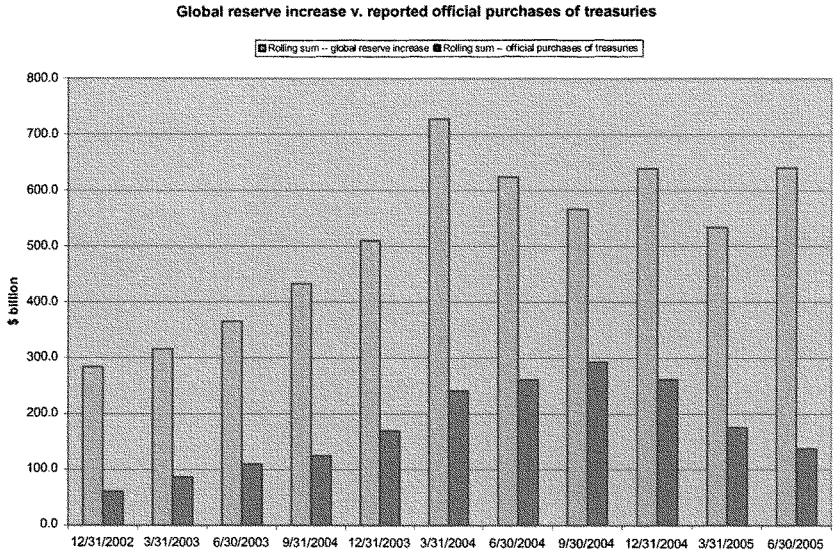
The expansion of the U.S. trade deficit reflects mutually reinforcing policy choices, both here in the U.S. and abroad. The stabilization and eventual fall of the U.S. deficit will also be far smoother if this process is supported by appropriate policy changes. No doubt, market forces will eventually demand adjustment even in the

absence of policy changes. But, as both New York Federal Reserve President Timothy Geithner and former Treasury Secretary Robert Rubin have emphasized, without supportive policies, the needed market moves are bigger and the risks of disruptive market moves are substantially higher.

Central bank financing of the U.S. current account deficit

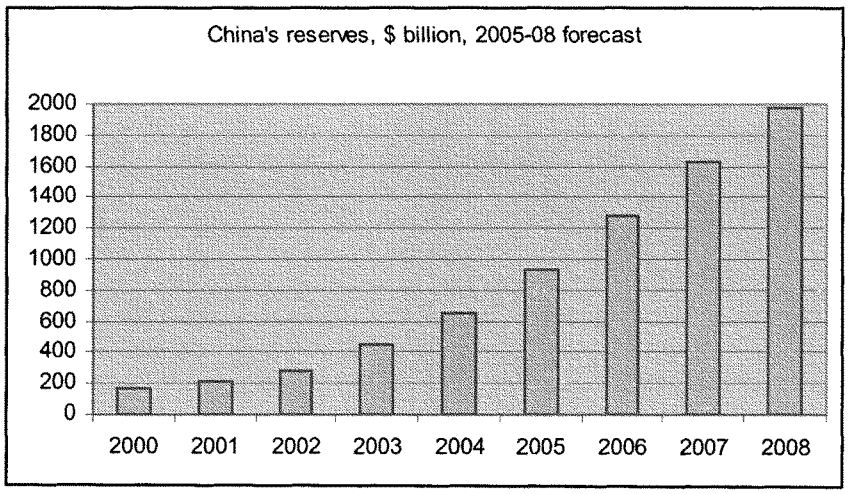
	2002	2003	2004	2005 (f)
U.S. current account deficit	475	520	668	815
Central bank financing (BEA data)	116	278	395	205
As percent of deficit	24%	53%	59%	25%
BIS estimate for increase in dollar reserves [6]	187	423	498	?
As percent of U.S. deficit	39%	81%	75%	?
Memo: Global reserve increase, all currencies (Setser estimates, based on IMF data with adjustments for valuation changes)	285	510	640	600

Four quarter sum of increase in global reserves v. four quarter sum of central bank purchases of US Treasuries.



[6] Includes the increase in central banks "offshore" dollar deposits reported in the international banking system. See Robert McCauley, "Distinguishing global dollar reserves from official holdings in the United States," BIS Quarterly Review, September 2005. For more on different measures of central bank financing of the U.S., see Matthew Higgins and Thomas Klitgaard, "Reserve accumulation: implications for global capital flows and financial markets," Current Issues in Economics and Finance, Volume 10 No. 10. Federal Reserve Bank of New York. September–October 2004.

Chinese Reserves, including reserves transferred to state banks



Recorded Chinese Purchases of U.S. Assets v. Chinese Reserve Accumulation

	T-bills	Treasuries	Agencies	Corp. Bonds	Foreign	Total in U.S. data	Estimated change in reserves (adjusted for valuation)	%
2002	0.2	24.1	29.3	6.1	3.5	63.1	74.5	85%
2003	0.3	30.1	29.4	4.5	4.0	68.4	157	43%
2004	17.3	18.9	16.4	12.1	3.0	67.4	194	34%
Jan–June 2005	2.5	17.3	11.3	13.2	14.3	48.7	137	35%
2005 f	.....	.....	.....	.....	.....	110	275	40%

From: Derived from Prasad and Wei (2005), updated to reflect 2005 TIC data. See http://www.hbs.edu/units/bgie/seminarpdfs/Prasad%20IFC%20Supplement.pdf

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