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# THE ECONOMIC REPORT OF THE PRESIDENT

## HEARING

before the

## JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

**ONE HUNDRED SEVENTH CONGRESS**

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# THE ECONOMIC REPORT OF THE PRESIDENT
**February 5, 2002**

**CONGRESS OF THE UNITED STATES,**
**JOINT ECONOMIC COMMITTEE,**
***WASHINGTON, D.C.***

The Committee met, pursuant to notice, at 10:07 a.m., in Room 311, Cannon House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

**Present:** Representatives Saxton, Smith and Watt; Senator Reed.

**Staff Present:** Chris Frenze, Robert Keleher, Colleen J. Healy, Darryl Evans, Brian Higginbotham, Donald Marron, Patricia Ruggles, Diane Rogers, Matthew Salomon, and Daphne Clones-Federing.

## OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

**Representative Saxton.** Good morning. It is a pleasure to welcome Chairman Hubbard of the President's Council of Economic Advisers (CEA) and Council Members Randall Kroszner and Mark McClellan to this hearing on the *Economic Report of the President*.

The Council's *Report* reviews the economic slowdown that began in the middle of 2000 and later turned into a recession. The effects of higher interest rates, surging energy prices, falling stock market and other factors slowing the economy are explained. The *Report* notes the damage after September 11 resulting from the terrorist attacks and the serious economic disruption that followed.

The Council nevertheless notes the positive effects of easing of monetary policy by the Federal Reserve and the reduction of the tax drag on the economy. The Council expects that the economy will rebound and GDP will expand 2.7 percent in 2002 if appropriate policies are in place.

Recently released economic data do suggest that the economy may have bottomed out. However, much of this improvement is too recent and tentative to be called a trend. The fragility of the economy reflected in declining investment and employment remains a concern that justifies consideration of economic stimulus legislation by the Congress. Moreover, the economy is vulnerable to risks from adverse international economic developments, high debt levels, security costs and other factors.

In the wake of the events of September 11, the prospect of economic recovery in the near future is especially impressive and reflects the remarkable resilience of the American economy and the American people. In addition, the President's success in weakening the terrorist network has improved domestic security and restored confidence, though much remains to be done.

The restoration of domestic security is a key function of government and is an important precondition for the resumption of healthy economic growth. As the President has emphasized, the war against terrorism is hardly over, but we have made a good start. To date, the terrorists have been unsuccessful in attaining their objective of seriously crippling the U.S. economy.

Turning to international economic policy, I would like to note the Council's statements endorsing reform of the International Monetary Fund (IMF). According to the CEA *Report*, IMF liquidity loan programs would appropriately involve short-term lending at penalty interest rates, to encourage and facilitate the borrower's quick return to the private capital markets. This is very consistent with the Congressional mandates for IMF reform developed by this Committee in 1998. A version of these transparency and lending reforms became law in 1998 as conditions attached to the IMF quota increase legislation. Thus, Congressional actions already taken strongly support the administration's position on needed reform of IMF lending programs.

In conclusion, these recent signs of economic recovery are encouraging but tentative. The economy has proven itself to be incredibly resilient, but it remains to be seen whether a sustained economic rebound is under way. Congressional enactment of an economic stimulus package would be a prudent insurance policy against the potential for another dip in economic activity.

Dr. Hubbard, we welcome you and your colleagues to the hearing here today, and we are anxious to hear you testimony. So the floor is yours, sir. Thank you for being here.

[The prepared statement of Representative Saxton appears in the Submissions for the Record on page 22.]

## OPENING STATEMENT OF DR. R. GLENN HUBBARD, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS; ACCOMPANIED BY DR. RANDALL S. KROSZNER, MEMBER, CEA; AND DR. MARK B. MCCLELLAN, MEMBER, CEA

**Dr. Hubbard.** Thank you very much, Mr. Chairman, for holding this hearing.

It is the responsibility and the privilege of the Council to produce the *Economic Report of the President*, to try to work with the President both in describing the outlook that the administration sees for the economy and the President's agenda for economic policy going forward.

The President has spoken very often and very eloquently of the need to focus on economic growth both in the short term and the long term, and it is obvious, as you noted, Mr. Chairman, in your opening remarks that the events of 2001 brought home new and important challenges for both the economy on the one hand and economic policy on the other.

The war on terrorism is very important as a matter of military action and as a matter of homeland security. It is also, however, important because of the demands it places on our economy; and we need economic strength and economic growth to fund those demands.

At the same time, the administration realizes the importance of making sure that the gains from economic growth are widely shared in our economy.

To begin with the outlook, as you noted, Mr. Chairman, the economy entered last year, 2001, already growing slowly, and growth did continue to decelerate through most of the year. The National Bureau of Economic Research (NBER), which is of course the official arbiter of recessions, had indicated that the recession began in March of 2001. The seeds that were important in spawning the recession came much earlier, in 2000; and the terrorist attacks of September 11th we believe delivered the key blow, tipping the economy into recession.

The experiences of 2001 have important economic lessons, most of which you reviewed, Mr. Chairman. They also, however, highlight the importance of timely economic information. Frankly, a problem in forecasting and policy-making at the time of a turning point, when we are on the up side or the down side, is the need to have very good economic data and very good economic data available in real time. The administration continues to believe – and I know that you and the Committee have advocated this as well – that investments in these kinds of data improvements are very-high-rate-of-return investments for our country; and in my written testimony, Mr. Chairman, I outline some of those that we would suggest.

The near-term recovery has begun, in our view. We believe that the economy's recovery will continue throughout 2002, that we will see modest growth in the first quarter this year and that growth will improve throughout the year. That is roughly consistent with what the private sector forecasters predict, such as in the Blue Chip forecast consensus, for example. The unemployment rate is, however, likely to continue to rise through the middle of 2002, because as long as the economy grows less than its potential, that down-side risk remains.

You teed up very importantly, Mr. Chairman, the question of down-side risks. It is quite easy for economists to talk about consensus forecasts or to give you a number as if it represented true north. We know that forecasts have big ranges, and we know that among the Blue Chip forecasters there is a range in what people are suggesting. There are down-side risks, both on the capital spending side and on the consumption side.

In the *Economic Report of the President*, we outline what we believe is the case, that the economy has largely worked through the capital overhang that existed during 2000 and 2001. That capital overhang, that excess capital, led to very significant downturns in investment. We believe that those downturns are being arrested and by the middle of this year we will return to investment growth.

Nonetheless, there is a downside risk to that, having to do with the resumption of profitability of business; and as you suggested, Mr. Chairman, there is a strong need to pass the President's stimulus package or the stimulus package that has been worked out in the House, which would have partial expensing for business investments. In addition, accelerating marginal income tax rate cuts would provide tax relief to small businesses for investment.

To give you a sense for how important the tax provisions are in managing down-side risks, our calculations at the Council suggest that the sort of stimulus package the President had proposed and has been broadly considered in the Congress might add about a half a percentage point to GDP this year, and about 300,000 jobs.

Another risk, frankly, at the moment, has to do with consumer spending. Consumers are making their robust spending conditional on expectations about income growth in the future. A key growth insurance element would be a tax cut of the sort that the President has suggested in the stimulus package.

Another risk remains energy prices, which while looking favorable at the moment, still represent a risk. The administration believes that good energy policy remains a priority and urges prompt enactment of the President's national energy policy.

Finally, I think we have to acknowledge that the security environment for the country remains a risk after September 11. In the *Report* we do some calculations suggesting that improvements in security are not free for our economy and do lead to growth slowdowns in the short term – although hopefully not too much in the long term – again suggesting the need for short-term stimulus.

The long-term outlook, as you noted, Mr. Chairman, in the *Economic Report* is relatively bright. We project that potential growth in the U.S. is about 3.1 percent, which is in the range of the Congressional Budget Office and the Blue Chip forecast. We are well within what I think many economists would suggest potential growth could be in the economy. As you know, this is largely based on what you think productivity growth is.

Our view is that productivity growth possibilities for the United States remain very bright and that much of the acceleration in productivity growth that we saw in the second half of the 1990s can be permanent, our economic challenges, of course, being to figure out how to translate what is potentially possible in the business sector into actual economic performance.

That tees up really the importance of a long-term policy agenda, which is of course the thrust of the *Economic Report of the President*. In thinking about a long-term agenda, I think it is important also to look in the rear-view mirror at where the economy has been. I would describe the 1980s and the 1990s as a long boom with a recession punctuating the middle, from which we can learn two kinds of lessons.

One is the lesson that you referred to in your opening, Mr. Chairman, of the resilience of private markets and the importance of private sector innovation and entrepreneurship in generating growth.

A second is a lesson for policy. Providing wind in the sails of the long boom of the 1980s and 1990s was a monetary policy that tried to wring out inflation from the U.S., tax cuts through most of the period, deregulation and a general policy climate promoting growth in the private sector.

The *2002 Economic Report of the President* builds on the notion that markets in the private sector are important for growth, but emphasizes the role of institutions. It is very easy for economists to talk about the value of free markets, and those are very important, but we need to remember the economic institutions that lead to growth.

To give you a quick example, productivity growth is high in the United States relative to other industrial economies. It is not because people are smarter in the United States than they are elsewhere in the world. It is not because we have access to technologies, frankly, that other people do not have. It is because the institutions that support growth are much stronger in this country.

An example of this kind of institutional focus is in the area of trade. As you know, one of the President's key long-term economic policy agendas is trade promotion authority and the promotion of a broader free trade agenda. We believe that trade promotion authority generates very important gains, gains that aren't realizable simply by serving up the homily of free trade, even though that is important. The President needs the bargaining power in trade promotion authority.

One calculation we mention in the *Report* is that a one-third reduction in tariff barriers around the world, combined with the bargaining power of trade promotion authority, could generate a tax cut equivalent for every American family of four of $2,500 a year. That is a big number.

The other key item in the long term the President has acknowledged – and it is discussed in both the *Report* and the budget, in the trade area – is the need to acknowledge frankly that trade generates a kind of creative disruption in our economy, that is, the creation of new firms and industries and troubles in others. One of the things we must realize, and the administration plans to emphasize, is the need to make sure that we have good worker adjustment programs in place to make sure that the gains from trade can be widely shared.

For example, trade adjustment assistance and the North American Free Trade Agreement (NAFTA) transitional adjustment assistance programs provide a way of thinking about training and job support. In the administration, we are committed to improving these trade adjustment programs as a way to cushion support for workers and to promote the trade agenda which we believe is very, very important.

A caution there in thinking about institutions for worker adjustment is to remember that whenever we think about promoting training, we should not use this as an opportunity to effectively tax job creation with new mandates or costly approaches that actually harm the problem we are trying to address.

In the *Economic Report of the President*, we actually examine a whole set of institutions that we believe, while a subset of economic institutions, are among the most important for both the near-term and the long-term policy agenda. The first of those is in the area of retirement security.

We all know the headlines at the moment on private pensions and 401(k) plans, but in general we need to think about retirement security in the United States, which has been a three-legged stool of private saving that we do on our own for retirement, private pensions and Social Security. The *Report* tries to review the strengths and weaknesses of our system and tackles the issue of personal accounts, which we believe will be a very fruitful discussion this year in the aftermath of the Social Security Commission's report on personal accounts.

A second institution that we believe is worthy of serious discussion is the importance of getting competition policy right. One of the ways in which our economy prospered in the 1990s, and historically, relative to perhaps other regions is a very strong and vibrant competition policy that realizes the need to innovate both in how firms are organized and in how policy is organized. And in that regard, we particularly talk about the issue of dynamic competition that comes up in industries ranging from software on the one hand to pharmaceuticals on the other, where leap-frogging of innovation leads to the need to perhaps think strongly about competition policy.

A particularly exciting institutional discussion, I think, in the *Report* has to do with health care. The President, from early days in the campaign, has put forth a vision for health care that is very different from the debate we often have over budget policy and guarantees of access, and is centered more on patients – patient-centered care and outcomes in the health care system. The health care chapter of the *Economic Report* talks about the institutional underpinnings that we would need to move toward a system in which we focus on health care outcomes and information and not simply just budgets.

Another area of discussion in the *Report* has to do with federalism, long a strong feature of our country's institutions. As you know, the President believes that it is very important for the not-for-profit sector generally and faith-based organizations in particular to play an important role in social securities in our country. What the *Report* does is to review partnerships between the Federal Government and state and local governments on the one hand and between governments and not-for-profit organizations on the other, and to talk about how one might design incentives for better outcomes. A particular area of interest there is obviously education and the need to focus on outcomes in education as exemplified in the “No Child Left Behind” legislation.

The final two institutional pieces of the *Report* are, for lack of a better term, reaching out beyond the basic economic concerns of the domestic economy. One addresses building institutions for a better environment. As you know, there has been a sea change in economists' thinking over the past couple of decades about the powerful role that markets can play in environmental policy, and all of that is true. But that simply won't work for us without the right institutional underpinnings. So we talk about institutions for trading systems and information that have helped existing pollution policies and also the upcoming policy discussions on global climate change.

The final section of the *Report* highlights the topic you identified, which I believe is extremely important, Mr. Chairman, on the need for supporting global economic integration. This is usually cast in the trade area, and that is clearly very important. As I indicated, we are committed in the administration to the idea of free trade, and in particular to actual trade negotiations and the power of TPA. We shouldn't turn a blind eye toward international finance, as you mentioned; and here the President has two broad concerns that are highlighted in the *Report*. One is over the need to think strongly about the activities of the International Monetary Fund in its lending practices and how to give the right incentives for capital flows and the private sector role in those flows around the world.

The second piece of that has to do with the multilateral development banks' approach to development. There has been too much of an emphasis in the past, in the President's view and in the administration's view, on lending programs that have not, frankly, generated positive results. We would prefer to see programs that move toward more explicit grants, coupled with a kind of institutional reform in countries, ranging from anti-corruption regimes to emphasis on the rule of law.

All of this, if I can return to where I began, goes back to the importance of growth and, in particular, the importance of productivity growth. That is a lesson we have learned well. It is critical as a lesson for our trading partners in Europe and Japan and in the developing world.

To give you an example of the power: If you thought about even two-tenths of a percentage point change in productivity growth, which we would argue is consistent with the long-term gains from the administration's policy agenda, real GDP at the end of 10 years would be $1,000 higher per person, every man, woman and child in the country, and the budget surplus over that 10 years would improve by $350 billion – again making the point both of the power of productivity growth and the strong link between the economy and the budget.

We believe that additional resources of this magnitude are well worth the effort to improve incentives and institutions. They have even greater value elsewhere in the world.

Thank you very much, Mr. Chairman, for this opportunity. I look forward to your questions.

[The prepared statement of Dr. Hubbard appears in the Submissions for the Record on page 26.]

**Representative Saxton.** Dr. Hubbard, thank you very much. We appreciate you and your colleagues being here to share this testimony and information with us.

Let me begin with something that you mentioned early in your statement; that is the effect of the 9-11 events as an economic factor. You mentioned that you believe that the terrorist attack actually pushed us over the brink into recession, and we share that view.

I am wondering about the long-term effects of that particular attack and the activities that have ensued relative to that specific attack. Are we recovering from it? Has the activity of the American security system, if you will, reacted in a way that has restored confidence from an economic point of view? And what do you think will be the long-term effects of the expenditures that we are making for security purposes, again in the context of our national or international economy?

**Dr. Hubbard.** Well, I think you have put forward probably the core question for policy this year and for discussions of the budget.

The President's view is that, first and foremost, we need to win the war, both the war against terrorism abroad and that at home – we will need to secure the homeland in the United States. The reason for that is not just the obvious security or military aspects, but the need to promote confidence in our economy. One of the reasons we saw declines in consumer and business confidence after September 11th was a sense of uncertainty about security. So that kind of security in defense spending is actually very important in creating an environment for confidence and growth in the country.

As to the long-term consequences, a lot will depend on the pace of the war efforts and the speed with which we can win the war on terrorism. The President has indicated this is a long-term activity. It is going to be a costly activity, one which is really essential for our economic security. In terms of productivity growth, we think that as long as we don't overregulate the private sector, as we pursue security, productivity effects will be relatively modest.

**Representative Saxton.** Do you think that the expenditures themselves that we are making throughout the economy for security purposes will have effect?

**Dr. Hubbard.** Well, certainly in the short run the expenditures that are being made are providing some stimulus to the economy. In the long-term, I think the effects of those expenditures depend on how productive they are; and to the extent that they are for meaningful defense and homeland security, as the President has proposed, we believe again that creates a very positive environment for growth and is very positive for the country.

**Representative Saxton.** Here is my concern. You have correctly pointed out in your testimony that one of the reasons that we were successful in having a long period of robust economic growth during the 1980s and 1990s was that we were able to funnel investments in technology, which provided for increases in productivity and helped our economy grow.

It seems to me that, unfortunately, the necessary expenditures that we are making now in security don't have the same long-term effect in terms of increasing productivity. They are necessary. They are things that we all know that we must do, but from an economic point of view, aren't they less stimulating than the kinds of investment that we saw during the 1980s and 1990s in technology and productivity?

**Dr. Hubbard.** Well, certainly directly we would all prefer a world in which we could focus our energies on productive technology development in the private sector. I think it is important, though, not to lose sight of the security spending's role in promoting long-term growth.

We know, for example, that the U.S. defense buildup during the 1980s played an important role in a victory against one form of tyranny. It is very important to have a secure homeland and a secure world, and I think it is the President's view that this is an economic investment that we must make. So, properly managed, we believe this won't be that harmful for the economy.

**Representative Saxton.** Let me switch subjects and talk about our budget surplus.

There has been some debate relative to what caused the surplus to be diminished or to evaporate. Would you give us your thoughts on what you think happened in terms of a surplus? Did Congress go on a spending spree, or did we see some economic factors at play which were primarily responsible for reducing the surplus?

**Dr. Hubbard.** Well, certainly, as your question suggests, the largest contributing factor is really economic factors. This came both from the downward revision of the level of GDP – the national income accounts restatement – and also from lower economic growth. That would be the single largest culprit.

The spending increases have been very important in the budget surplus deterioration; the tax cut has actually played a very modest role, the tax cut enacted by the Congress last year and suggested by the President. For the current year, it is actually playing an extremely small role, maybe on the order of 15 percent. Over a 10-year period, its role would rise closer to 40 percent. But we believe that it remains sound economic policy.

So in terms of the decomposition, economics is clearly the largest single factor.

**Representative Saxton.** Some have suggested that the tax cuts that were enacted early last year be repealed because of the budget deficit situation.

Would you respond to that notion?

**Dr. Hubbard.** Well, sure.

I think it is important to start with a basic understanding of where we get surpluses. We get surpluses when we have a very healthy economy, not the other way around; that is, we don't save ourselves into prosperity through surpluses. The direction goes the other way.

So having said that, the tax cut provided a very important underpinning for growth in the second half of last year. The tax cut probably provided at least a percentage point underpinning to growth. For this calendar year, existing tax cuts should provide another half a percentage point underpinning to growth.

So in terms of thinking about the cost to our economy of repealing the tax cut, we would lose growth and, of course, the jobs that are associated with that growth.

**Representative Saxton.** The President has suggested that the tax cuts ought to be made permanent. Others have suggested that just the opposite should occur. Can you explain the rationale for making the tax cuts permanent, and what advantage you see in doing so?

**Dr. Hubbard.** It is very important that the President's tax cut be made permanent. It is important first, of course, for households and businesses to have a long-term environment for planning. It is also important because of the incentive effects, both for households and businesses, of having lower marginal tax rates. It would be an odd tax policy notion for us to think that it is a great idea to lower marginal tax rates for some span of a number of years and then suddenly increase them back to what they had been in the year 2000.

So we believe it is very, very important on the tax agenda.

**Representative Saxton.** Dr. Hubbard, in your testimony you made reference to retirement funds, and I think it is a very timely issue to address. We Americans are not accustomed to seeing our retirement funds diminished, at least we would like to think that we are not.

The daily reports on the Enron situation are concerning and sometimes even alarming. The latest news report this morning was that Enron management was actually siphoning off, or is suspected now of siphoning off, sort of, monies that were put away for employees' retirement purposes.

What, if anything, do you think the Congress should do in order to restore confidence in the private retirement system?

**Dr. Hubbard.** Well, while I don't want to comment on the Enron case as a particular matter, there are two very important points I think that your question tees up.

The President, as you know, asked for two working groups within the administration to be created on this issue, one to be centered directly on pensions and retirement saving, where he asked Secretary O'Neill to work with Secretary Evans and Secretary Chao. At the same time, he asked for a broader discussion of corporate financial disclosure to be headed up, again by Secretary O'Neill, but in the context of the President's Working Group on Financial Markets.

Some of the pensions recommendations have already come to the President, and the President and the administration have suggested these to Congress, having to do with allowing workers to diversify a little more freely in their accounts, but not requiring them to do so, and also placing restrictions on so-called blackout periods.

The Labor Department has under way a review of pension security, and we do believe this is a very important issue. The broader question that is teed up by this is really the whole issue of corporate financial disclosure and whether we, as investors in our pensions or investors generally, get the right kinds of information needed for investment decisions. That was a very hard question. That is one the President has also been very concerned about, and the administration will be reporting on that to the Congress in the near future.

**Representative Saxton.** It would seem to me that one of reasons that retirement plans have been successful is because we have enjoyed the flexibility and the freedom, if you will, to manage our retirement accounts, and sometimes in creative but productive ways. Do you have any warnings as to the types of things the Congress should not do?

**Dr. Hubbard.** Well, two basic kinds of warnings: let us remember why we think these are a great idea. They are promoting healthy and responsible private retirement saving; 401(k)s are a very good thing.

That flexibility comment you mentioned goes to both households and firms. As households, we like the flexibility to make allocation decisions that we think are appropriate for our own investment strategies. Similarly, firms need flexibility to offer 401(k) plans that make sense for their firm and their employees.

Whatever we do, we should of course strengthen retirement security and information provision, but we want to make sure that we don't kill the goose that laid the golden egg. If a result of our action is the diminution of offering 401(k) plans or the diminution of people's willingness to take them up, then we have done a great disservice to our retirement security and our retirement safety net.

So I think that is really the line to walk.

**Representative Saxton.** If I may just return to the Enron case once again, there is bound to be speculation – as we move forward and hear about this case multiple times a day – as to whether this problem is more widespread beyond Enron.

Have you seen anything to lead you to believe that we need to be concerned about this conceptually spreading into other businesses, other large businesses, where similar problems may exist?

**Dr. Hubbard.** Well, I think the concern, which has already been expressed by the President in this task to the Working Group on Financial Markets is whether the disclosure that we get is sufficient in its scope to enable investors to make the wisest possible decisions. The SEC, of course, has jurisdiction over looking at particular matters of particular companies, but I think that there is a need to consider more broadly disclosure, so that we do promote investors' confidence in corporate America.

**Representative Saxton.** Is there a danger that we might find ourselves with a tendency toward overregulation of 401(k)s?

**Dr. Hubbard.** Well, I think it is a concern, frankly, Mr. Chairman. I think that our goal ought to be to shore up 401(k)s. That is, to identify areas, whether they are blackout periods or diversification provisions, where we would like to make changes, but not do damage to the entire system with regulations that are so constraining that they might stop firms from offering 401(k)s.

**Representative Saxton.** Let me turn to another issue that you mentioned, which I have had an interest in for quite some time, and that of course is the way the International Monetary Fund operates.

The IMF has had a history of transforming its function from one set of goals relative to management of – or the way it plays into economies to another set of goals, which I guess you can refer to as a kind of a bailout mentality where the IMF is – or has been used for purposes of shoring up various economies and various institutions in economies.

In 1998, I introduced some IMF reforms such as transparency and other related items, including the interest rates that are charged through the IMF.  This reform mandated IMF transparency and the use of risk-adjusted interest rates in IMF bailout lending in order to promote a

**Representative Saxton.** Would you elaborate on the effect of what you referred to as “moral hazard”? An institution like the IMF standing by, in effect saying quietly to people who are active in various countries' economies, if you fail to have a good economy, if you fail to move forward, if you fail to have growth, in fact if you fail – if your economy fails, we will stand by, and we will bail you out with low interest rates through the IMF – the mechanism of the IMF.

What does that do to economic activity?

**Dr. Kroszner.** That can set up very, very bad incentives so that the responsibility that the politician and the people have to make sure that the funds that they are getting from private sector sources are being well used disappears to some extent. It is like saying to a corporation, Well, don't really worry if you are undertaking projects that don't make profits or are not being very productive, because someone will help take care of you. And so that gives very bad incentives for looking for the good projects, looking for the high productivity projects; and of course that is what moral hazard is about, distorting the incentives.

I don't want to say that in all cases the costs of having some sort of safety net outweigh the benefits – through moral hazard outweighs the potential benefits of helping in certain situations to cushion a blow from a particular shock that comes along. But in some cases, the way that the IMF and other institutions have operated in the past has generated less than responsible policy. And I think, going forward, having strict criteria for good policy, having strict criteria for doing lending, and having risk-based lending rates are good ways to try to move forward with reform and minimize this moral hazard problem. Be there to cushion the blow when difficulties do come, but do not aggravate the problems that exist in the first place.

**Dr. Hubbard.** And if I may, going to your question about the risk-adjusted rates, another manifestation of this is in the financial markets where, particularly in the previous administration's approach to this problem, the risk associated with a country is a mixture of true country risk, along with the risk of whatever an IMF or Treasury response would be. I submit to you that this last component of risk is one that needs to be wrung out of the system.

**Representative Saxton.** Let us talk about IMF transparency for just a moment. In 1997 and 1998, I began to chair hearings on the IMF, and one of the things that I found immediately frustrating was the apparent lack of transfer of information to the public and to Congress and to, I suspect equally, other governments around the world who are participants in the IMF. And we would like to think that we cracked the door open a bit, but I suspect that we still have the same lack of transparency or near the same lack of transparency.

What are your thoughts relative to that subject, and do you have any suggestions as to what we need to do further?

**Dr. Kroszner.** Well, certainly I think the sorts of pressures from the oversight that your Committee had undertaken really helped to take a major step forward.

Before 1997-1998, when there was a program that the IMF had with a particular country, there was a confidential letter that was not exposed to public view. Starting in 1997-1998, we began to see those letters posted on the IMF website. That is a dramatic improvement because before it was a pure guessing game for people on the outside. To now know, one, that there is an explicit plan and two, what the context of that plan is, what the IMF is demanding, I think is a dramatic step forward.

The IMF does a lot of surveillance of countries and gathers a lot of information about both the financial markets and other aspects of the economies. Some of that comes out in the World Economic Outlook that the IMF puts out every six months. But it might be possible to harness that information in a better way, and make it more systematically available, because I think one of the things that we have seen is that the private sector has had some difficulty in estimating when a country is going to come into trouble.

Unfortunately, the private markets and the private rating agencies haven't always been on the cutting edge of figuring out when something is going to go wrong. Not to say that the IMF always has, but they do often get a bit more information.

What might be very valuable is if those pieces of information were made available on a more timely basis so that the private markets could process it, because the IMF spends a great deal of resources doing this surveillance, this sometimes due diligence on these countries for internal purposes. If they made that information available on a more timely basis, then the markets could use that to improve their estimates of probability of failure and crisis in particular countries.

**Representative Saxton.** Thank you.

Dr. Hubbard, let me change the subject. One very large part of our economy is encapsulated in the general term “health care.” I don't want to say we see storm clouds, but I always have concern, or have in recent years, about our ability to on the one hand provide good health care for people and on the other hand watch the economic effects of the health care system, as much as it is such a large part of our economy.

Can you just comment generally on your thoughts relative to this issue?

**Dr. Hubbard.** Certainly. And with your permission, I would like to ask Mark McClellan, who is our real doctor on the Council, to give you some guidance on that.

**Dr. McClellan.** Mr. Chairman, that is a very good question. I think your concerns reflect a lot of the concerns that many Americans have today, that on the one hand we have a very productive health care system that has taken tremendous steps to improve health, extend life, improve the quality and dignity of life. On the other hand, this seems to be coming at a higher and higher cost, and many of the solutions or so-called "solutions" to the problem of rising costs in health care have contributed to a real sense of frustration among doctors and patients that can't really work together effectively to solve the problems that they face in the cheapest and most efficient way.

What we outline in the President's *Economic Report*, what the President has been trying to pursue in his policy so far, is to take the best elements of the health care system – that is, its potential for innovation and its great capacity to adapt and develop new treatments for all of a variety of health problems facing Americans – to combine that with appropriate assistance to those who have trouble meeting their health care costs without stifling innovation. That is a very important point.

A lot of the debate about Medicare reform, for example, has focused on prescription drug benefits and the importance of avoiding price controls and other deterrents to innovation in that important part of the economy. There are hundreds of new drugs introduced every year. There is a tremendous amount of economic and clinical evidence that these drugs improve life and are well worth the additional costs involved.

At the same time, we do need to take more steps to promote effective competition in health care; and we can do that by providing better information to doctors and patients and by creating an environment for medical practice where they are encouraged to use that information rather than be afraid to share it, afraid to discuss errors and problems because of fears of lawsuits, for example. And we also can take steps to provide assistance to those who have the most difficulty in getting affordable health care because they have low incomes or because they have very high health care needs, without disrupting the potential for innovation of our health care system.

So our policies are very much focused on encouraging the best of American health care, its capacity to innovate, not just in new drugs, but in good ideas that come up in a clinic or a hospital where doctors and patients and other health professionals, working together, find a new solution for avoiding medical errors or providing a treatment for a disease that keeps a patient out of the hospital or even out of the doctor's office. We are focused on combining that with appropriate help for those who need it the most, appropriate subsidies and assistance.

**Representative Saxton.** Some states are experiencing very, very difficult situations relative to professional liability insurance in the medical field.

Any thoughts?

**Dr. McClellan.** One of the President's policy priorities for the year is to try to work on the medical liability problem. This is one aspect of some broader concerns that we have at the Council and that the administration has about the costs of the tort liability system to our economy, which are substantial.

With respect to medical malpractice premiums, there is a lot of evidence right in front of us that reasonable laws that impose reasonable damage caps on noneconomic damages and other reforms to encourage alternatives to long, drawn-out judicial processes can both assure appropriate reimbursement for people that experience medical errors and are harmed and, at the same time, avoid defensive medical practices and high malpractice premiums.

For example, right now in the State of Florida, I hear from a lot of doctors who have experienced very large increases in their malpractice premiums, 20 percent or more. I also hear from my colleagues back at Stanford, where I practiced before coming to the Council, that they have had very small increases in their malpractice premiums this year, and that is because California has implemented a very effective system of tort reform to keep malpractice premiums affordable while still providing appropriate compensation to patients who are injured.

We need more steps like that at the national level, we think.

**Representative Saxton.** Let me just ask you specifically – and I shouldn't do this, but I am going to because I had an experience recently with this subject in Pennsylvania – are you familiar with the situation in Pennsylvania?

**Dr. McClellan.** Pennsylvania is facing a number of problems in its health care system – cost containment problems, reimbursement problems, as well as malpractice problems – and there are a number of issues facing the State. I think there are some good examples that we can help Pennsylvania use to address many of the problems that they are facing. But the situation is very indicative of national problems in the health care system.

**Representative Saxton.** Thank you.

Dr. Hubbard, I asked questions earlier about the economic growth that we experienced during the 1980s and 1990s. What is your view on the economic outlook? Where do you think we are headed with the economy, and what can we expect?

**Dr. Hubbard.** I think the outlook for growth remains quite bright. In the *Report*, we had forecast long-term growth to 3.1 percent, which is less than the growth we experienced in some of the peak years of the late 1990s, but still a very, very respectable rate of growth. And the economy could still do better with the right policies that promote innovation. So I think the outlook is very promising indeed.

**Representative Saxton.** What variables should we be monitoring and assessing as to the likelihood of a rebound?

**Dr. Hubbard.** I think in the short term one wants to think about the business investment picture and consumption. For business investment, I would be watching durable goods orders and shipments and qualitative information from the private sector about capital spending plans. At the Council, we do a little bit of both of those.

On the consumer side, I would want to watch expectations about future incomes, asset prices for equities and for homes and the pace of layoffs.

I think in both the areas, business on the one hand, consumption on the other, we have reason to believe the recovery will be very good this year. In both of those there is still down-side risk that points to the need for the growth insurance package.

**Representative Saxton.** We have noted some seeming changes in some economic indicators. For example, last month's job figures looked a whole lot better than several previous months. The unemployment rate came down from 5.8 to 5.6 percent. In the last quarter of last year, there appears to be a slight up-tick in GDP, two-tenths of one percent; however small that is, it is still better than we perhaps had seen previously.

The stock market seems to have bottomed out. I haven't looked today – yesterday wasn't a great day, but – I haven't looked today, but it seems as though the stock market may have hit bottom. Do you see these as the beginnings of trends, or is it too early to tell?

**Dr. Hubbard.** I see them as very hopeful and important signs. I think it is not so much the decline in the unemployment rate that I would look at, because there are actually a number of factors in that particular piece of data.

But it is true that the job losses are slowing down. Employment shedding has slowed down dramatically, and we are seeing improvements in orders in the business sector. All that is clearly good news. It is not a recovery that one can take to the bank, and while I believe that we will have a very good recovery in the country this year, I think it is very important to pursue the right policies that are consistent with that recovery.

**Representative Saxton.** Can you speak to consumer confidence? Has that shown some improvement also?

**Dr. Hubbard.** I think consumer confidence is a very important indicator. It has been improving. A lot of what we are seeing in consumer confidence improvements is consumers' thought – not so much about the current situation but about the horizon – looking better. So they are seeing income growth as improving, they are seeing the prospect of being laid off as going down, and they remain very optimistic about housing values and stock values. Those are the seeds both of the recovery and the sources of down-side risk.

**Representative Saxton.** Thank you.

We have been joined by Mr. Watt. Mr. Watt, do you have any questions at this point?

**Representative Watt.** Thank you, Mr. Chairman. I will be brief.

First of all, let me apologize to the Chairman and to the witnesses for being late. We are kind of staggering back into town here, and I just got back in. So I came on as quickly as I could.

There are two things I guess I want to ask Chairman Hubbard about. One has to do with – I am trying to shape my thinking on the stimulus package. First of all, given your sense that the economy has started to grow again and the recession is in the process of ending, do you see that there is a continuing need for a stimulus package, and if so, what would you think would be appropriately included in that stimulus package?

**Dr. Hubbard.** Well, I do think that the need for a stimulus package as growth insurance remains. The fact that the recovery is likely doesn't make us forget about the significant uncertainty surrounding forecasts.

But not all stimulus packages or growth insurance packages are equal, as your question suggests, and we continue to believe in the administration that the sort of policy elements the President originally outlined, that have come to consensus in the Congress and in most quarters of business investment – that is, partial expensing for business investment, acceleration of marginal rate cuts, rebates to low-income

The effect of deficits on interest rates is something that has been notoriously hard to measure, and I think most of the evidence in the economics profession suggests that it is very, very small.

**Representative Watt.** Three to five basis points is a very small impact. Is that what you are—

**Dr. Hubbard.** Right, not three to five percentage points, but basis points; so close to zero, in other words.

**Representative Watt.** So basically what you are saying is, your opinion is that there is no impact on long-term interest rates from deficit spending?

**Dr. Hubbard.** No, not at all. I think what I am trying to suggest to you is that it is very important to have, of course, long-term fiscal discipline for the country, and that clearly matters in interest rates. The U.S. is a very large player in the global capital market.

To go to your earlier question about the stimulus package, the kinds of packages that were talked about by the administration or here in the Congress are of a size which would, in and of themselves, lead to only a *de minimus* effect on long-term interest.

**Representative Watt.** So you don't subscribe to the notion that the reason that the spread between short-term interest rates and long-term interest rates – currently, the reason that long-term interest rates have not followed short-term interest rates down, some people are saying, is a result of the fact that the ultimate – that there is a substantial concern about going back into deficit spending.

Do you disagree with that?

**Dr. Hubbard.** Yes, sir, I would. I think the largest single contributor to the difference you suggest is the expectation that the economy will improve, which would lead to higher real and nominal interest rates in the future and higher long-term rates today. I think the best study—

**Representative Watt.** So Fed policy is driving it down? You are saying as the economy improves, the Fed raises short-term rates, and therefore long-term rates are not responding to the drops that the Fed has undertaken? This is also the Fed's fault?

**Dr. Hubbard.** No, it is really not a statement about the Fed at all.

If I expect the economy to improve in the future, then the demand for credit and loans in the future will be higher than it is today. All other things being equal and the U.S. being a very big player in the capital market, that would lead to higher interest rates in the future.

Long rates today are what the market expects about short-term rates today and the whole sequence of future short-term rates. The best academic studies I know of on deficits and interest rates are those by Greg Mankiw at Harvard and Douglas Elmendorf at the Federal Reserve Board, and I think there, even for quite pronounced deteriorations in the deficit picture per se, again one is merely into a handful of basis points effects on long-term interest rates.

**Representative Watt.** Okay. I appreciate it. I will read your testimony and the other witnesses' testimony. I am sorry—

**Dr. Hubbard.** Thank you.

**Representative Watt.** And I appreciate you being here.

**Representative Saxton.** Dr. Hubbard, let me just follow up on the interest rate question, if I may. A good long-term interest rate to discuss would be, perhaps, home mortgages – very familiar to all of us. I followed home interest rates for many years. I used to be in the real estate business, and I remember when interest rates in the 1960s were at six percent. I remember interest rates in the early 1980s being at – on home mortgages almost 20 percent. And, out of curiosity, I have watched, over the last year or so, home mortgage interest rates go down to about 6.5 percent and have now climbed back up to seven, or near seven, percent.

It seems to me that in a historical perspective this is a relatively low interest rate, and yet all of us talk about the increase in long-term rates. How would you characterize the current long-term interest rates? Higher than they used to be but not as high as they could be?

**Dr. Hubbard.** Well, of course, in your question you want to be sure to distinguish between nominal and real interest rates. One of the reasons that home mortgage rates were so very high in the early 1980s is because inflation was very, very high and that got priced into interest rates. Long-term interest rates remain quite low for mortgages, which is what has been underlying much of the boom in housing values and in refinancing for consumers. So, at the current level, I see no reason to suggest that long-term interest rates in the housing market, or more broadly, are reflecting a lack of fiscal discipline.

**Representative Saxton.** 2001, from our vantage point, was characterized by a continuing very, very healthy construction segment of our economy. Was that because of a large demand or because – do you think it was because of interest rates being relatively low through the year, or what?

**Dr. Hubbard.** Well, interest sensitivity is certainly very, very important in construction, yes.

**Representative Saxton.** Particularly in home construction?

**Dr. Hubbard.** Absolutely.

**Representative Saxton.** And because there was a construction boom that created a demand – would that have created a demand for long-term home mortgages that was excessive?

**Dr. Hubbard.** Well, as the market works as a whole, there would be many factors that would determine people's demand for owning a home, an important one of which is interest rates. So the interest rate picture both affected and was affected by the demand for mortgages.

**Representative Saxton.** As I was listening to Mr. Watt's very good questions, it occurred to me – could the argument be that because of the high demand for mortgages, that rates crept back up? Is that a possibility?

**Dr. Hubbard.** Well, it can. If there is a sudden change in demand – sort of a shifting out of a demand curve for mortgages or for housing, if you will – that would put upward pressure on rates. Just as I was suggesting in answering the gentleman's question, if we expect conditions to improve, we would want to demand more credit, and that would raise interest rates.

**Representative Saxton.** I have no other questions at this time. I would just like to thank you, Chairman Hubbard and Dr. McClellan and Dr. Kroszner, for your contributions here this morning. It is always good to have you come and share your thoughts with us. We appreciate it very much, and we will look forward to being with you together again.

**Dr. Hubbard.** Thank you very much, Mr. Chairman.

**Dr. Kroszner.** Thank you very much, Mr. Chairman.

[Whereupon, at 11:16 a.m., the hearing was adjourned.]

# SUBMISSIONS FOR THE RECORD

## PREPARED STATEMENT OF REPRESENTATIVE JIM SAXTON, CHAIRMAN

It is a pleasure to welcome Chairman Hubbard of the President's Council of Economic Advisers (CEA), and Council members Randall Kroszner and Mark McClellan to this hearing on the *Economic Report of the President*.

The Council's *Report* reviews the economic slowdown that began in the middle of 2000, and later turned into a recession. The effects of higher interest rates, surging energy prices, falling stock market, and other factors slowing the economy are explained. The *Report* notes the damage after September 11 resulting from the terrorist attacks and the serious economic disruption that followed. The Council nevertheless notes the positive effects of an easing of monetary policy by the Federal Reserve, and the reduction of the tax drag on the economy. The Council expects that the economy will rebound and real GDP will expand 2.7 percent over the four quarters of 2002 if appropriate policies are in place.

Recently released economic data do suggest that the economy may have bottomed out. However, much of this improvement is too recent and tentative to be called a trend. The fragility of the economy, reflected in declining investment and employment, remains a concern that justifies consideration of economic stimulus legislation by the Congress. Moreover, the economy is vulnerable to risks from adverse international economic developments, high debt levels, security costs, and other factors.

In the wake of the events of September 11, the prospect of economic recovery in the near future is especially impressive and reflects the remarkable resilience of the American economy and people. In addition, the *President's* success in weakening the terrorist network has improved domestic security and restored confidence, though much remains to be done. The restoration of domestic security is a key function of government and is an important precondition for a resumption of healthy economic growth. As the President has emphasized, the war against terrorism is hardly over, but we have made a good start. To date the terrorists have been unsuccessful in attaining their objective of seriously crippling the U.S. economy.

Turning to international economic policy, I would like to note the Council's statements endorsing reform of the International Monetary Fund (IMF). According to the CEA Report, IMF liquidity loan "programs would appropriately involve short-term lending at penalty interest rates, to encourage and facilitate the borrower's quick return to private capital markets." This is very consistent with the Congressional mandates for IMF reform developed by this Committee in 1998. A version of these transparency and lending reforms became law in 1998 as conditions attached to the IMF quota increase legislation. Thus, Congressional actions already taken strongly support the Administration's position on needed reform of IMF lending programs.

In conclusion, the recent signs of economic recovery are encouraging but tentative. The economy has proven itself to be incredibly resilient, but it remains to be seen whether a sustained economic rebound is underway. Congressional enactment of economic stimulus legislation would be a prudent insurance policy against the potential for another dip in economic activity.

## OPENING STATEMENT OF SENATOR JACK REED, VICE CHAIRMAN

Thank you, Chairman Saxton, for this opportunity to discuss the economic outlook and to review the Economic Report of the President, released today. I also want to thank Council of Economic Advisers Chairman Dr. R. Glenn Hubbard and members Dr. Mark McClellan and Dr. Randall Kroszner for their testimony today.

The last time you were here, Dr. Hubbard, the National Bureau of Economic Research (NBER) announced the economy had been in recession since March 2001. Despite some recent hopeful signs, the economy remains weak.

Clearly, the task before us as policymakers is to get the economy out of recession quickly and put us back on a path of strong and sustainable growth. How we get there has been – and will continue to be – the subject of much debate. What's clear, however, is that the President's call to accelerate and make permanent the scheduled personal income tax cuts won't get us there.

Over the next decade, the non-partisan Congressional Budget Office (CBO) projects that the federal surplus will be more than $4 trillion lower than its January 2001 projection. CBO estimates that less than one-fourth this downward projection is attributable to weaker economic conditions, while more than 40 percent is attributable to the tax cut. The true budget outlook is likely to be even gloomier, because the CBO projections do not take into account any new policies, such as those just proposed in the President's budget.

Accelerating or making permanent the Administration's tax cuts is poor economic policy for both the short run and the longer run. In the short run, the tax cut goes disproportionately to the highest-income households who are least likely to spend it. In the longer run, the tax cut severely reduces public saving and would be unlikely to stimulate significant increases in private saving. Thus, national saving and economic growth will fall, just at the time when the budgetary pressures of the aging baby boom start to hit.

The attack on September 11 was a dreadful assault on this country. But the irresponsible tax cuts pressed by this administration had us headed down a road to deficits even before we faced a war on terrorism. Now we have to respond to our national, homeland, and economic security needs bereft of a surplus that was hard-earned over years of effort during the 1990s.

The consequences of not having surpluses to fund our national priorities are severe. For example, the President has proposed cuts in job training programs that help people transition from welfare to work, and an inadequate amount of money for providing prescription drugs to seniors.

Balancing our national priorities is challenging enough without imposing additional and unwise fiscal constraints. We simply cannot afford to accelerate or make permanent tax cuts for only the wealthiest Americans at the expense of immediate needs and investments for the future.

Mr. Chairman, I look forward to the testimony of and discussion with Chairman Hubbard and the other members of the CEA.

## PREPARED STATEMENT OF DR. R. GLENN HUBBARD, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Chairman Saxton, Vice Chairman Reed, and members of the Committee, it is a pleasure to appear before you today to discuss the release of the *Economic Report of the President*, along with the economic outlook for the United States and the Administration's policy agenda.

The events of 2001 brought new challenges for the U.S. economy and for economic policy. The war against terrorism has increased the demands on our economy, and we must do everything in our power to build our economic strength to meet these demands. At the same time, we must take pains to ensure that the benefits of economic growth are shared as widely as possible, both within and beyond our borders.

Economic growth is not an end in itself. As it raises standards of living – consumption, in the language of economists – growth also provides resources that may be devoted to a variety of activities beyond the traditional marketplace. Growth can fund environmental protection, the work of charitable organizations, and many other activities of interest and value to the United States, other industrialized economies, and developing economies alike.

### RESTORING PROSPERITY

The economy entered 2001 growing slowly, and growth continued to decelerate through most of the year. After expanding at an annual rate of 5.7 percent in the second quarter of 2000, gross domestic product (GDP) – a standard measure of economy-wide production – began to falter later in the year, and the weakness persisted into 2001. Some sectors stumbled into outright decline; for example, industrial production peaked in June 2000, and then entered a prolonged slump. Although the National Bureau of Economic Research has said that the recession – the first in ten years – officially began in March 2001, the terrorist attacks of September 11 delivered a further blow to the economy. The experiences of 2001 have emphasized the importance of timely economic information, with one area deserving considerable attention being the need for readily accessible real-time data. Investment in sources of these data could yield handsome dividends, especially at key junctures in the business cycle.

Moreover, the quality of existing statistics is far from perfect and could be enhanced with further investment. Even real GDP, generally thought of as a reliable measure of overall activity in the U.S. economy, is susceptible to considerable revisions. For example, in the third quarter of 2000, real GDP was first estimated to have grown 2.7 percent at an annual rate – a subpar but respectable growth rate. That rate was then revised downward to 2.4 percent and then again to 2.2 percent. Seven months later it was further revised downward to 1.3 percent, providing evidence that the economy had begun to slow dramatically at that time. A key component of the revision came from revised data on gross private domestic investment, initially estimated to have risen 3.2 percent but later revised to show a contraction of 2.8 percent. Such revisions lead to uncertainty for both government and private decisionmakers, which can cause costly delays. Although most revisions are not that large, the average quarterly revision of real GDP growth over the last decade was about one percentage point, while real GDP growth averaged 3.2 percent. This amounts to a revision of about one-half the standard deviation of the quarterly growth rate of real GDP.

A number of steps can be taken to improve the accuracy and timeliness of economic statistics. One cost-effective measure would be to ease the current restrictions on the sharing of confidential statistical data among Federal statistical agencies. Such data sharing, which would be done solely for statistical purposes, is currently hindered by lack of a uniform confidentiality policy. Confidentiality is of key importance to all agencies and to the individuals and businesses who participate in Federal surveys, but a uniform confidentiality policy would allow agencies such as the Bureau of Economic Analysis, the Bureau of Labor Statistics, and the Bureau of the Census to compare and improve the quality of their published statistics while preserving confidentiality. In the past, attempts have been made to pass legislation, together with a conforming bill to modify the Internal Revenue Code, allowing such data sharing under carefully crafted agreements between or among statistical agencies. Meaningful data-sharing legislation still offers the opportunity to improve the quality and effectiveness of Federal statistical programs.

In addition to data-sharing legislation, the Administration is proposing new and continued funding for the development of better and more timely measures to reflect recent changes in the economy. For example, these resources would allow for tracking the effects of the growth in e-commerce, software, and other key services, and for developing better estimates of employee compensation. The latter are increasingly important given the expansion in the use of stock options as a form of executive compensation, as well as for tracking the creation and dissolution of businesses, given the importance of business turnover in a constantly evolving economy. Improved quality-adjusted price indexes for high-technology products are also an important area for future research. As the economy continues to change and grow, the need persists to create and develop such new measures, to provide decisionmakers with better tools with which to track the economy as accurately as possible.

## The Near-Term Recovery

The Administration expects real GDP growth to resume early in 2002. The pace is expected to be slow initially, followed by a pickup thereafter; over the four quarters of 2002 real GDP is expected to grow 2.7 percent. The unemployment rate – currently 5.6 percent – is projected to rise through the middle of 2002, when it is expected to peak around 6 percent.

The decline in aggregate demand during the past year was concentrated in inventory investment, business fixed investment, and exports. Of these downward pressures, inventory draw downs are anticipated to reverse course soonest and most rapidly, moving from liquidation to accumulation in the first quarter of 2002. Thus the initial source of the recovery of growth will likely take the form of the accumulation phase of an inventory cycle.

Growth in business investment and exports is likely to take longer to develop. Nonresidential investment fell sharply in 2001, and some downward momentum may still remain. Still, the financial foundations for investment remain positive: Real short-term interest rates are relatively low, prices of computers are falling, and equity prices moved up during the fourth quarter. Perhaps due to these factors there was an upturn in new orders for non-defense capital goods in the fourth quarter, a promising sign for the outlook for business fixed investment.

Personal consumption expenditure grew quite rapidly in the fourth quarter – a 5.4 percent annual rate – driven in large part by purchases of motor vehicles. While auto purchases may have been influenced by special financial considerations, the overall strength of household spending in the fourth quarter suggests a strong impact of the tax cut passed by Congress and signed by the President last spring. During the fourth quarter consumption of non-durables and services increased $39.5 billion despite the fact that personal income rose only $0.2 billion, suggesting that purchases were financed in part by the down payment on the tax relief mailed out during the third quarter. This interpretation of the data is entirely consistent with the reaction of households to a permanent tax cut, as a temporary tax cut would have been largely saved and not spent. In the same way, it also suggests that any perceived undermining of the permanence of this tax cut would have immediate adverse repercussions in the level of consumption demand.

Consumption spending is expected to continue at solid rates in 2002, albeit a bit slower than the rapid pace in the fourth quarter. One impact, however, of the war against terrorism is the need for enhanced expenditures for defense and homeland security. The growth in these outlays represents an impetus for aggregate demand in the short run; for example, in the fourth quarter, Federal government purchases rose at roughly a 9 percent annual rate. More rapid government spending in general, however, is not a sure recipe for economic growth. Indeed, the loss of fiscal discipline represents a threat to long-run growth. The need to address the terrorist threat is very real; however, we must be vigilant against a loss of budgetary discipline and remain committed to re-prioritizing our needs and controlling the growth of government spending.

Inflation is expected to remain low and stable. As measured by the GDP price index, inflation was stable at about 2.2 percent during 2001. The Administration expects this measure of inflation to fall to 1.9 percent in 2002. The unemployment rate is now above the level that the Administration considers to be the center of the range consistent with stable inflation, and capacity utilization in the industrial sector is substantially below its historical average. Despite faster-than-trend growth of output in 2003 and 2004, some downward pressure will be maintained on the inflation rate, because the unemployment rate is projected to remain above the center of the range over that period.

**Risks to the Near-Term Recovery**

The Administration forecast mirrors the outlook of private sector analysts such as the Blue Chip consensus forecast. We must recognize, however, that the basic economic outlook is subject to risks.

To begin, one downside risk to the consensus outlook is a slower recovery in capital spending. In particular, some observers have emphasized the possibility of a "capital overhang" that impedes a recovery in business fixed investment. A capital overhang develops when the amount of capital in the economy exceeds the amount that businesses desire for the production of goods and services. The emergence of such an overhang complicates both business planning and policymaking. Businesses often have to alter their capital spending plans and curtail their investment spending – sometimes quite abruptly. A large overhang may also reduce the stimulative effects of tax policies designed to boost investment, possibly lengthening the recovery time during a period of sluggish economic activity, especially for the manufacturing sector.

Empirical evidence suggests that a capital overhang did develop in 2000. The overhang was modest for the economy on average, but various types of capital equipment such as servers, routers, switches, optical cabling, and large trucks were disproportionately affected. Over the past year and a half, the decline in investment spending and depreciation of the existing capital stock appear to have combined to slow capital accumulation sufficiently to eliminate the overhang.

However, estimates of the total overhang must be interpreted with caution. There is considerable uncertainty about its size, because it is difficult to estimate precisely both the capital stock that businesses desire and the capital stock they actually possess.

The remarkable slowdown in capital accumulation during 2001 and the possibility that the capital overhang has persisted longer than the data suggest some risk to the outlook. This underscores the importance of the President's tax relief recommendations for economic stimulus. The partial expensing provision will encourage business investment, stimulating economic activity in the short run and laying the foundation for stronger growth in the long run. The reductions in marginal income tax rates will help spur investment by providing incentives for flow-through entities, mainly small businesses, to grow and create jobs. The President's tax relief will also help foster a smooth and more predictable transition to a period of sustainable growth.

One factor that contributed to the onset of the current recession was a sharp rise in the energy prices. Another risk to the outlook is another such rise, especially as the United States is heavily reliant on imported oil to meet its energy needs. The Administration has made a comprehensive energy policy a priority, as indicated in the President's National Energy Policy.

The House energy bill addresses many of the legislative recommendations contained in the National Energy Policy and the President has called on the Senate to act as well. H.R. 4 creates opportunities and provides incentives to foster conservation, improve energy efficiency, increase domestic energy production, and expand the use of renewable energy sources. H.R. 4 represents an important step in ensuring the Nation's future energy security.

Finally, we must acknowledge that in the current security environment our economy remains at risk. The events of September 11 had a pronounced, disruptive impact on the path of the economy. Certainly, we are hopeful that the economy will not be subjected to such adverse events in the future. The Administration worked with Congress to suggest legislation to provide a backstop against catastrophic terrorism risk and continues to support passage of measures to help the private sector build capacity to provide such insurance.

## The Long-Term Economic Outlook

The economic difficulties that began in 2000 and continued into 2001 and 2002 should not blind us to the fact that the outlook for the economy remains strongly positive. The Administration projects real GDP growth to average 3.1 percent a year during the 11 years through 2012. The growth rate of the economy over the long run is determined primarily by the growth rates of its supply-side components, which include population, labor force participation, productivity growth, and the workweek.

Productivity growth in the United States accelerated during the second half of the 1990s, and economists generally believe that much of that faster productivity growth is permanent. New technology deserves much of the credit – but by no means all of it. Better, more efficient ways of doing business also contributed, and only a fraction of the many possible improvements have yet been made. Our economic challenge is, in large measure, to discover how to reap the benefits of the remainder.

The Administration expects non-farm labor productivity to grow at a 2.1 percent average pace over the projection period, the same as over the entire period since the previous business cycle peak in the third quarter of 1990. This projection is noticeably more conservative than the 2.6 percent average annual growth in actual productivity from 1995 to 2001.

## The Long-Term Policy Agenda

The 1980s and 1990s witnessed a long boom (punctuated by a short recession) in which private sector technological advances and entrepreneurial innovation fueled productivity growth and increases in our standard of living. This strong productivity performance derives from advantages of our economic approach – notably, the strength of our institutions and the flexibility of our business culture. Public policy was in many ways supportive, with tax cuts in the 1980s, deregulation, and a stable anti-inflationary monetary policy leading the way. With some exceptions, policy generally promoted economic growth in the private sector.

The 2002 *Economic Report of the President* focuses on those institutions and on that culture, and proposes strategies for improving them and putting them to use, to sustain our growth and broaden our prosperity. Institutions are a key issue. Productivity growth does not arrive from the heavens. New technologies, process innovations, and other aspects of private-sector productivity gains are the result of investment, effort, testing, and implementation. In Europe, commentators from both the OECD and the European Central Bank have noted the lack of acceleration in productivity growth comparable to that witnessed in the United States. Rigidities in labor and product markets, sometimes exacerbated by regulatory impediments, are often cited as culprits.

Put differently, the important economic *outcome* – productivity growth – hinges on the structure of economic *incentives*. It is now understood that the effective use of economic incentives hinges upon the institutions in which they are embedded. The *Report* is organized around the need to build strong institutions to support a flexible economy and rapid economic growth.

As an example, one of the President's priorities is the U.S.-led effort for more open global trade. The large contribution of reduced trade barriers to growth in our standard of living has long been recognized. In 2001, the United States exported over $1 trillion in goods and services – or 10 percent of GDP.

The United States has the opportunity to reap significant gains from the future trade agreements. A recent study finds that a new World Trade Organization (WTO) round that lowers barriers to services and reduces tariffs by one-third on agricultural and industrial products would yield gains roughly equivalent to a $2,500 permanent increase in the annual income of the average family of four. An agreement on the Free Trade Area for the Americas that removes bilateral tariffs would increase GDP by about $53 billion, or about an $740 permanent increase in the annual income of a family of four.

These are important benefits for the *average* American household. Trade is sometimes portrayed as a threat to lower-income individuals. This is not the case. To take one example, in 1997 there was roughly $18 billion in tariffs, with nearly one-half on clothes and textiles. Who pays those tariffs? In a $10 trillion dollar economy, this might not seem like an important question – after all, $9 billion in clothing tariffs is a trivial fraction of overall consumption spending. The reality is that – measured as a fraction of their income – tariffs paid by the lowest -income quintile were roughly three times that of the highest-income quintile.

Trade helps our domestic productivity. Expanding global trade allows the most efficient producers to grow because selling goods in the competitive international marketplace demands higher productivity. In fact, exporting plants have up to 20 percent higher productivity non-exporting plants.

Furthermore, many domestically produced goods are shipped abroad for further processing or assembly and then returned to the United States. In 1998, for example, the United States imported $27 billion of "production sharing" goods from Mexico, and these goods may be re-imported subject to lower duties. <u>Not</u> duty-free. Nearly 60 percent of the value of these imports derived from U.S.-made components – roughly 16 percent of all U.S. imports from Mexico.

The benefits of free trade are substantial and investments in the institutions that support a global trading system are valuable. Indeed, an institutional commitment is a good way to overcome instances of shortsightedness. In developing countries, the advantages of international trade produce income for not only commercial consumption, but also access to better food, better health care, better education, and technologies that will help improve the environment. In a developed country, stiff import barriers on labor-intensive goods from developing countries such as clothing, leather, or agriculture not only harm consumers but reduces the income of people in developing countries as well.

A recent World Bank study identified developing countries as "globalizing" on the basis of the growth in trade related to GDP and their reduction in average tariff note. It found that, in the 1990s, the income per person in globalizing developing countries grew more than three-and-a-half times faster than it did in non-globalizing developing countries. In the six years following completion of the Uruguay Round, exports from developing nations grew by nearly $1 trillion, to a level of $2.4 trillion last year. The United States in particular has been an engine of export growth for developing nations. There has been an 82 percent increase in U.S. imports from developing countries (87 percent increase in chemical products and 72 percent increase in textiles) between 1994 and 2000.

Building on this success is important. One study indicates that new global trade negotiations would generate income gains for developing countries greater than recent flows of official assistance, and roughly comparable to total inflows of foreign direct investment. An IMF/World Bank study notes that eliminating all barriers to merchandise trade would yield static welfare gains of between $80 and $180 billion to developing countries. These numbers are well in excess of annual aid flows to these countries.

That there is tremendous value to multilateral agreements that institutionalize a commitment to free trade among countries is clear. Trade Promotion Authority (TPA) provides the President with negotiating flexibility and gives the United States additional credibility in the international community. It enhances our bargaining power in these negotiations. It also ensures that trade agreements will maintain a focus on trade, as intended by the negotiating parties. TPA sends a signal to other countries that the U.S. is united in active engagement in trade negotiations that will benefit all participating countries. Obviously, Congress still has its final, rightful say on whether or not the United States signs any trade agreement.

International trade is one force behind the "creative destruction" – the continual competitive pressure to innovate, improve, and outperform competitors – that is central to our economy. Of course, for an individual worker, finding a new job in another firm or another industry may be difficult. The United States recognizes this possibility and has put programs in place to assist those who lose their jobs due to trade in finding a new position. Workers who are displaced from their jobs due to imports are given special assistance by the Federal government to smooth their transition to new jobs. For example, the Trade Adjustment

Assistance (TAA) and NAFTA-Transitional Adjustment Assistance (NAFTA-TAA) programs provide those misplaced workers with training, income support, and out-of-area job search aid, and relocation allowances; these benefits are in addition to unemployment insurance, employment-related services under the Workforce Investment Act, and other programs. The Administration is committed to reauthorizing and improving the existing TAA and NAFTA-TAA programs that expired last September and were continued through FY 2002 by the action of the appropriators. The Bush Administration has worked this year to improve the TAA programs so that they more effectively ease the transition into new employment.

Another example is the President's proposed Health Insurance Tax Credit. The tax credit proposal included in President Bush's budget for 2003 is a refundable income tax credit to cover the cost of health insurance purchased by individuals under age 65. It would provide a subsidy for a percentage of the health insurance premium, up to a maximum credit of $1,000 per adult and $500 per child. A two-parent family with two children would be eligible for a maximum credit of $3,000. The maximum subsidy percentage would be 90 percent for low-income taxpayers and would phase down with income. A broad-based policy of this type anticipates the insurance needs of workers – dislocated or otherwise – and permits labor market adjustments to be less impeded by health insurance considerations.

There is great value to institutions that meet the short-run needs of displaced workers *and* move them quickly toward productive activities. The events of the past year has illustrated – in an extreme form – the shocks to which our economy is subjected. The President's vision of economic security recognizes that many events impact the economy all the time. We should think comprehensively about these policies and focus our efforts on incentives for getting workers back to work, and quickly. Resources should be devoted flexibly to basic needs, job search for re-employment, and retraining, without creating an incentive for unnecessarily long spells between jobs, because benefits extended under the wrong conditions create a "tax" when a new job is taken and those benefits are lost.

Finally, getting the most out of the economy will require an emphasis on efficiency in government as well. If government spending grows without discipline, billions of dollars will be siphoned away from private sector innovation, taxes will rise, and growth will suffer. The President's Management Agenda seeks to shift the emphasis of government toward results, not process. It aims to replace the present Federal government hierarchy with a flatter, more responsive management structure and to establish a performance-based system.

## THE 2002 *ECONOMIC REPORT OF THE PRESIDENT*

The importance of using policies to set in place valuable economic institutions is not limited to displaced workers and government programs. These areas come immediately to mind in the current setting where fiscal discipline and the genuine costs of recession are apparent. However, looking toward the future, there are many areas for such improvements. The 2002 *Economic Report of the President* is devoted to the foundations of these improvements in our institutions. These institutions figure prominently both in agenda for long-term growth and in assuring that the benefits of growth are spread throughout society.

**Strengthening Retirement Security**

No area of American life could benefit more from enhancements to its institutional underpinnings than retirement security, and the President has made the reform of the Social Security system a central part of his economic agenda. As he has stressed, “Ownership in our society should not be an exclusive club. Independence should not be a gated community. Everyone should be part owner in the American Dream.”

The *Report* examines the changing nature of retirement security and the institutional changes needed to meet this challenge. There is little dispute about the need for reform, and there is growing agreement that personal accounts within the Social Security system are an indispensable part of any reform plan. Personal accounts would enhance individual choice – the very foundation of the success of our market economy. The current Social Security system collects 12.4 percent of all covered wages and essentially constrains all working Americans to place their retirement security in a single asset – one that demographic change is rendering increasingly inadequate to support the system’s obligations.

Personal accounts would permit individuals to diversify their retirement portfolios, thus increasing their retirement security. The individuals would for the first time acquire rights of ownership, wealth accumulation, and inheritance within Social Security. These advantages are widely recognized. Less well appreciated, however, is that ownership and inheritability will enhance Social Security’s role in making our economic system more equitable. Some groups in our society with lower average incomes also have lower life expectancies, and as a consequence, they receive less today in Social Security retirement benefits than do other, wealthier groups. Under a system of personal accounts, the early death of a worker would no longer mean the loss to that worker’s heirs of much of what he or she has paid into Social Security. Instead, those assets could be passed on to the next generation. For all these reasons, personal accounts are an important part of reforming Social Security, and thereby of strengthening retirement security for all Americans.

Although not covered in the *Economic Report of the President,* I would be remiss if I failed to mention the President’s announcement last week of proposals to strengthen the security of retirement savings in 401(k) plans. These proposals would give workers more freedom to diversity their portfolios. Also, workers would have the same ability as corporate officers to trade company stocks during so-called “blackout” periods when trading is restricted.

## Realizing Gains from Competition

One source of the United States' superior economic performance over the past decade has been the success of its institutions for promoting open, competitive markets. Strong incentives to compete are what drive firms to exploit new opportunities, and so achieve faster growth throughout the economy. Deregulation of several key industries during the 1970s and 1980s brought substantial benefits to consumers and to the economy as a whole, recognizing that it took time for those benefits to be realized.

The task of competition policy is to promote competition in a way that ensures the efficient allocation of resources and serves the interests of consumers. In doing so, however, competition policy must walk a fine line: Efforts to prevent anticompetitive changes in the behavior and organization of firms may inadvertently keep firms from taking steps that could lower their costs or improve their products. Such ill-advised interventions would ultimately harm consumers rather than benefit them.

The recent past has witnessed a remarkable shift in the competitive landscape. Mergers and acquisitions have reshaped and continue to reshape the organization of firms and the nature of competition itself. Our competition policy must be flexible enough to acknowledge and support the quest for efficiency that drives these changes, while remaining vigilant against changes that would harm competition. To fail in this task would be to hinder the growth of innovative firms, the adoption of new technology, and the enhancement of productivity.

The markets in which American firms compete today are increasingly global markets, and globalization motivates further changes in firms' organization. Our competition policy should acknowledge and reflect these motivations. Other countries have their own competition policies, of course, and inefficient policies in any one of them may impose costs on firms and consumers in the United States and around the world. The United States should therefore pursue the convergence of national competition policies – but should do so in a way that spreads best-practice, efficient competition policy worldwide.

Finally, competition policy must also deal with the increased importance of "dynamic competition," in which firms compete not just for increments of market share but for absolute (if temporary) market dominance, through rapid innovation. Policies should recognize that, at any given moment, high profits and substantial market share – indicators that might warrant concern about competition in some industries – may mask vigorous dynamic competition among firms in industries undergoing rapid technical change.

## Promoting Health Care Quality and Access

Health care is one of the largest and most vibrant sectors of the economy. Biomedical research, both public and private, has generated stunning advances in our understanding of biology and disease and achieved major therapeutic discoveries. As a result, Americans today are living longer lives with less disability. However, the health care delivery system today is troubled, as medical expenditures are again rising rapidly. The costs of private health insurance to working Americans and the costs to taxpayers of government health programs, including Medicare and Medicaid, are increasing at rates far surpassing the growth of the economy. Managed care is under fire from patients and physicians alike. With the economic slowdown and rising costs, concerns about the growing number of uninsured are again coming to the fore.

Much of the discussion about Federal policies to address these concerns has been framed through a narrow lens that focuses on "guarantees" for access and treatment, to be achieved largely through expanding government programs that rely on regulation and price setting. Yet this approach does not ensure access to innovative care that meets the diverse needs of patients in an efficient way – evidence of which is Medicare's lack of coverage for prescription drugs and integrated disease management.

The *Report* explores the President's vision for an alternative framework, one that focuses on achieving better health care through solutions that emphasize both shared American values and sensible economics. These solutions build on existing support; they encourage flexible, innovative, and broadly available health care coverage; they emphasize the central role of the patient in making health care decisions; and they improve those decisions by creating an environment for medical practice that encourages steps to improve quality and reduce costs. This approach emphasizes patient-centered health care, with individual control and individual responsibility.

If we move toward a system of informed choice and well-crafted economic incentives, and away from rigid regulation, the health care system will improve from the resulting flexibility and competition. In this vision, incremental government support would be used to broaden access and to encourage competition in both the private and the public sectors. Support should be targeted to improving the health care of those most in need – the uninsured and those with significant health expenses. New incentives should strengthen the market by improving information about quality and cost, broadening choice, rewarding quality, and addressing costs by encouraging value purchasing by both employers and patients.

The Administration's emphasis on patient-centered health care reform focuses on three objectives. First, we must develop flexible, market-based approaches to providing health care coverage for all Americans. Second, we must support health care providers in their efforts to meet the demand for higher quality and value, in part by making better information available about providers, options, outcomes, and costs. Finally, we must provide the foundation for further innovation through strong support for biomedical research. Providing competitive choices for all Americans, and meaningful individual participation in those choices, will encourage innovation in health care delivery and coverage. Improving incentives and information, and taking steps to help patients and providers use information effectively, will help ensure continued improvements in the health of Americans in the future.

## Redesigning Federalism for the 21st Century

Throughout its history, the United States has relied heavily on State and local governments to provide certain goods and services. Our federal system has been a source of greater efficiency and of innovation in government practice. History reveals several tensions as well, most vividly evidenced by Washington's all-too-frequent practice of providing funds to State and local governments without allowing flexibility in their use. This tension between flexibility and control can be resolved efficiently by specifying standards for outcomes but leaving it to State and local providers to determine how best to achieve those outcomes.

Focusing on outcome standards and flexibility to improve efficiency can also imply a role for the private sector in providing public services. The choice of where to draw the line between the public and the private sector depends on the characteristics of the services to be provided. The nature of some services makes it difficult for markets to meet the needs of the population effectively. Even then, it may be efficient to let competition among State and local governments decide what and how much shall be provided but to rely on the private sector to *produce* the service.

The *Report* describes the principles underlying the roles of differing levels of government, and of for-profit firms and not-for-profit organizations, in identifying and meeting needs for public goods and services. Specifically, allowing public and private organizations to compete in meeting preset standards can improve the efficiency of programs in education, welfare, and health insurance for needy populations.

In education, evidence supports the benefits of competition in improving quality, with public, private, and charter schools vying with each other to provide the best education most efficiently. Increased competition for students requires the right institutions so that school systems help make schools accountable for results. Similarly, the providers of safety net benefits such as welfare must be accountable to taxpayers for the quality of services they provide and the resources they use to provide them. By tying payments to these providers to results, and by allowing private nonprofit providers to compete with them on an equal footing, the market discipline that yields innovation and efficiency in the private sector can be brought to bear in the public sector as well.

## Building Institutions for a Better Environment

Not so long ago, environmental protection and market-based economic growth were widely regarded as fundamentally in conflict. The past 30 years, however, have seen dramatic improvements in environmental quality go hand in hand with robust growth in GDP. Releases of many toxic substances have been reduced, and many of our natural resources are better protected. Rivers are cleaner and the air is clearer.

In many of these early environmental interventions, the anticipated benefits were clear, large, and achievable at relatively low cost. The next generation of environmental issues, however, is certain to be more challenging. Ongoing efforts to protect endangered species, maintain biodiversity, and preserve ecosystems will require carefully balancing the welfare interests of current and future generations. But those early initiatives also taught us that the costs of environmental protection can be minimized through careful policy design. Part of the challenge for environmental protection today is to identify the best institutions to address each of an array of stubborn environmental problems. Another part is to design those institutions so that they can evolve to address new problems in the future.

The *Report* describes how flexible, market-based approaches to environmental protection – using tradable permits, tradable performance standards, and similar mechane.5(clerctiterc4hallowb usireshes t purssuw)]
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leadership in this area is essential to safeguarding and enhancing both our own economic prospects and those of the rest of the world.

## CONCLUDING REMARKS

The past year has shown that we cannot be complacent about America's rate of economic growth, gains in productivity, and successes in global markets. We must be cognizant of risks that we face in the near-term, and the value of investing in institutions that raise our rate of growth in the long-term. In this way, we will be able to shoulder additional demands on our economy such as the war against terrorism.

This goal is neither narrow nor parochial. The additional resources generated by wise policies are a source of improvements with and beyond markets. To gain a sense of the importance of this issue note that Administration forecast embodies a long-run (potential) growth rate of 3.1 percent. Suppose that the long-run growth rate were to fall by a small amount, just 0.2 percent, to 2.9 percent due to the impairment of incentives to work, take risks, and accumulate capital. Over a decade real GDP would be lower by $266 billion – roughly $1,000 for every man, woman, and child in America today. Similarly, Federal receipts would be roughly $70 billion lower at the end of 10 years, and reduced by about $350 billion over 10 years.

Certainly, additional resources of this magnitude are worth the effort to improve incentives in the United States. However, they have even greater value for others in the world. Policies that remove impediments to growth are the key to prosperity for the whole world, and we can contribute to this goal by wise economic policy and farsighted institutional reform.

Thank you again, Mr. Chairman, for the opportunity to appear before you today. I am happy to answer your questions.