Sound Fundamentals Underlie a Favorable Economic Outlook

Testimony of

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Joint Economic Committee
U.S. Congress
October 20, 2005

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

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

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

Growth of U.S. GDP and capital spending has exceeded all other large industrialized nations, and its potential growth is higher. Moreover, combined with the responsiveness of economic policymakers, sound fundamentals provide significant resilience to external shocks. All recent economic expansions, including the current one that began in 2001Q4, have experienced external shocks that potentially could have sidetracked performance:

[*] Prepared for the Joint Economic Committee, U.S. Congress, October 20, 2005

Latin American debt crises in the early 1980s and mid-1990s, the Russian default and Asian financial crisis in 1997, the collapse of LTCM in 1998, 9-11, and most recently, Hurricane Katrina. In each case, adjustment processes unfolded more quickly than widely anticipated and, following temporary slowdowns, economic growth quickly snapped back. The resilience provided by these built-in stabilizers and smoothed cycles have reinforced confidence in U.S. economic performance.

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

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

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

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

Certainly, the economy faces risks. Domestic demand would slump in the second half of 2006 if the Fed inadvertently hikes rates too much and energy prices rise further. With the Federal funds rate at 3.75 percent, monetary policy remains accommodative, and the inflation-adjusted funds rate is below its long-run average. It is likely the Fed will raise

interest rates to 4.5-4.75 percent by mid 2006, which I consider toward the higher end of the range of a "neutral" funds rate. Monetary tightening far beyond "neutral" would accentuate the impacts of higher energy prices. Internationally, a negative global shock, sharply lower global growth that generated declining U.S. exports, or a sharp fall in the demand for US dollar-denominated assets that led to global financial turmoil would harm the U.S. economy. However, such international events are unlikely, and the risks of an economic downturn in 2006 remain modest.

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

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

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

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

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

Katrina's displacement of businesses and households will temporarily disrupt otherwise healthy labor markets. Employment fell modestly in September and the unemployment rate rose to 5.1 percent. A hallmark of the current expansion has been the slow return to health of the U.S. labor market, following the 2001 recession and severe equity market declines in 2000-2002. Business caution was unusually high and slow to recede, contributing to the above-trend pace of productivity gains. However, prior to Katrina, the pace of layoffs, measured with initial unemployment claims, had receded to very low levels, and businesses were both hiring and expanding the hours worked of existing employees.

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

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

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

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

To date, the financial market reaction to Katrina and the anticipated fiscal response has been modest: the U.S. dollar has been virtually unchanged and bond yields have drifted up, reflecting both related and unrelated concerns. Inflationary expectations have risen, the underlying economy has shown strength and resilience, and markets fear a letdown by fiscal policymakers in the wake of the hurricanes. The longer-run costs are not trivial. The higher deficit will add to the stock of government debt, raising net interest costs. The net costs to sustainable economic growth depend on a host of factors, including how the government funds are spent, the returns on such spending and investments and how they influence private incentives, and how the outlays are financed—through offsetting

spending reductions, tax increases or higher debt. All of these factors have important implications for the allocation of national resources. I urge fiscal policymakers to consider these issues in all of their dimensions, and encourage a rational debate about how to allocate the government funds in the most economically efficient manner.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Even though the Fed has raised its Federal funds rate target from 1 percent to 3.75 percent, it perceives that monetary policy remains accommodative, and it will continue to raise

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

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

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

11) The high U.S. trade deficit has resulted largely from the U.S.'s relative economic strength, while the unprecedented U.S. current account deficit reflects global differences in growth, saving and investment, and is not likely to be the primary source of economic destabilization.

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

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

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

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

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

Although the government's long-run budget imbalance is unlikely to hamper near-term economic performance, addressing future rapid growth in projected outlays and the government's unfunded liabilities is crucially important to the nation's long-run economic health. Delays in policy changes only raise future economic costs. The estimated

difference between projected spending and taxes under current law is so large that raising taxes to "close the gap" on paper would damage economic performance and adversely affect the financing gap. Successfully achieving fiscal responsibility requires programmatic changes to the major entitlement programs, the sources of the recent and projected future spending increases, that are fair to current program participants, provide the right incentives, and are financially viable for the long run.