Healthy Economic Expansion and Higher Interest Rates

Testimony of
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Chief Economist
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Joint Economic Committee
U.S. Congress
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The U.S. economy is strong fundamentally, and its sustainable potential growth is the highest of all large industrial nations. The pace of the current expansion is transitioning toward more moderate growth, following a period of robust expansion. This is a natural—and welcomed—consequence of the Federal Reserve's interest rate hikes. I project the economy to grow at a 2.75-3.0 percent pace through year-end 2006 and expand at a healthy pace in 2007. Continued gains in employment will keep the unemployment rate low. Housing activity and prices will flatten, but not fall materially, and consumer spending will continue to rise, albeit at a more moderate pace. Corporate profits and cash flows, already at all-time highs, are expected to rise further, but at a slower pace than the last several years.

Core inflation likely will drift up through year-end, but stay low relative to the average of recent decades. I expect the Fed will hike rates further, and bond yields will rise, with the 10-year Treasury bond yield reaching approximately 5.5 percent. Stable low inflation provides tremendous benefits to economic and financial performance, and the Fed's efforts to keep inflation low are consistent with sustained healthy long-run economic growth and job creation.

Several risks face economic performance in 2006-2007. The first is the risk that the Fed inadvertently pushes up interest rates too much, which would generate an economic slump. Presently, this risk is low, and the Fed is well aware of the consequences of tightening monetary policy too much. The second risk is a misguided thrust toward protectionism that could potentially disrupt global trade and capital flows. Congressional authors and supporters of protectionist legislation must be warned that such measures would damage economic performance and hurt many citizens they are intended to help.

The high U.S. current account deficit and large surpluses in select foreign nations is largely a reflection of the U.S.'s stronger economic and investment growth and low national saving, and the softer economic performance in most industrialized nations and excess saving relative to investment overseas. Although these global imbalances are large, I believe that factors are in place that will begin to narrow global imbalances, and do not anticipate a jarring decline in the U.S. dollar unless there is a dramatic shift in global economic performance.

Sustained healthy economic performance requires coming to grips with the large Federal budget imbalance. Closing the budget gap ultimately requires reforming social security, Medicare and the retirement programs by trimming future benefit structures and making them economically rational. Failure to address these issues is a disservice to the citizenry and only increases the eventual costs of adjustment.

Robust Economic Expansion

Economic performance in the last several years has been remarkable. Real GDP has grown at a 3.3 percent average annual pace since the 2001Q4 recession trough. The expansion has been evenly balanced: consumption has grown at a 3.2 percent rate, close to its long-run average, while business investment has been strong. Exports have been growing at a healthy pace, but the strong U.S. domestic demand has generated faster growth of imports, which has widened the

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trade deficit. The ability of the U.S. economy to absorb shocks highlights the flexibility of the economic structure, as well as the efficient responses of policymakers.

In the last two years, employment has risen at a 1.4 percent annualized pace—3.8 million new jobs have been created—and the unemployment rate has fallen to 4.6 percent, well below earlier expectations (see Chart 1). Labor markets have continued to improve despite foreign competition and concerns about job outsourcing. This performance is consistent with historic experience and confirms a clear message that although outsourcing does put stress on select sectors of the labor market, it increases economic efficiency and is a complement to net new job creation in the U.S.

Sustained productivity gains, reflecting numerous positive influences, have been a driving force underlying economic performance. Labor productivity in the nonfarm business sector has increased 2.7 percent annually in the last two years, and it shows every sign of being sustained. This positive trend reflects the continued improvement in production efficiencies, technological innovations and investment spending. This broad measure of productivity may understate improvement in select industries, as the U.S. Department of Commerce readily acknowledges the difficulty in measuring productivity in many service-producing industries, including finance.

In fact, labor productivity in the nonfinancial sector, which excludes banking and finance, and covers approximately 54 percent of GDP, has increased at an extraordinarily fast 4.3 percent average annual pace so far this expansion (compared to 3.3 percent in the nonfarm business sector). See Chart 2. That is, since 2001Q4, real output in the nonfinancial sector has risen on average 4.8 percent per year, while aggregate hours worked have increased at a 0.4 percent pace.

These productivity gains in the nonfinancial sector have exceeded increases in wage compensation, lowering unit labor costs. They have been a major factor driving record-breaking profits, more than offsetting higher prices of energy, commodities and materials. Noteworthy, output and profits in banking and the broader financial sector have risen significantly, suggesting healthy productivity gains in finance. Reasons to expect ongoing improvements in production efficiencies, technological innovations, and new product development remain compelling, supporting estimates of sustained high potential economic growth.

In this environment, wage and compensation increases have been somewhat disappointing. Real wages have been suppressed by higher energy costs, and have not kept pace with labor productivity gains. The Employment Cost Index, a broad measure of wages, has increased 2.8 percent in the last year. Wages may be constrained by higher employer costs for workers' health care, along with the heightened international competition related to low cost production overseas, although isolating the impact of this latter factor is very difficult. I expect real wages to pick up, particularly if energy prices stabilize. However, wages of low-skilled workers likely will lag.

Economic policies are a crucially important element in establishing a foundation for such sustained advances. Low taxes, reasonable regulations and policies that promote free trade and labor market flexibility, along with stable low inflation, create an environment conducive to efficient production processes, technological advances, investment spending and entrepreneurship. This is particularly true as global competition intensifies. Sound economic policies enable healthy economic performance. Congress is encouraged to promote the pro-growth environment, and reject initiatives that on the surface may appeal to select groups, but in reality would detract from the U.S.'s strong economic performance and in the long run, harm people they are intended to help. Lifting the education and skills of the workforce is the best response to international competition.

Transitioning Toward Moderate, Sustained Growth

I project sustained healthy expansion in the near term, with approximately 2.75 - 3.0 percent real GDP growth. This moderation is a natural result of the Fed rate hikes from 1 percent to 5 percent

that have largely removed its monetary accommodation. To date, the rate increases have initiated a slowdown in housing activity—to a still-high level—and may be beginning to slow consumer spending growth. These are welcome trends and benevolent adjustments following years of robust growth.

Consumer spending growth remained robust through 2006Q1, despite the Fed's persistent rate hikes and the flattening of housing activity and prices that began in mid-2005. The factors that historically have driven consumer spending remain fairly positive, and I believe the notion that the current trend in housing will have a large negative impact on consumer spending is overstated. Consumer spending will continue to grow, albeit at a slower pace, despite concerns about housing, the decline in the rate of personal saving and credit burdens (see Chart 3).

Real disposable personal income, the key factor that traditionally has driven consumer spending, is still growing, despite the negative impact of higher energy prices on real purchasing power. Rising employment and wages are lifting personal incomes, a trend expected to continue (see Chart 4). If energy prices stabilize, real disposable personal income will reaccelerate. Real interest rates have risen modestly, but they remain low, particularly in after-tax terms. And real household net worth, including the value of stocks, bonds and real estate, net of household debt, is at an all-time high (see Chart 5). While these factors will support continued growth in consumer spending, the rise in interest rates, high energy prices and the slowdown in housing and mortgage refinancing are expected to moderate growth. I'm looking for approximately 2.75 - 3.0 percent growth in real consumption in the next year. This compares with 3.4 percent average growth during the last two years. The slowdown will be most apparent in motor vehicles, household durables and other goods consumption.

The substantial rise in short term interest rates and modest increases in longer-term mortgage rates clearly have slowed housing sales, and the inventory of unsold homes has risen, but the level of activity remains high, and while the earlier sharp price appreciation has ended, all signs suggest an orderly adjustment. The fundamentals underlying the housing market remain healthy: solid economic performance, low unemployment and rising personal income, and relatively low interest rates. As long as the Fed constrains inflationary expectations and the economy continues to expand, the probability of a jarring decline in housing activity or prices is very low.

Certainly, the flattening in housing and decline in mortgage refinancing activity will contribute to moderation in consumer spending, but their impacts on household balance sheets are often overstated. Real estate constitutes less than 30 percent of total household net worth—over 70 percent is stocks and bonds. Thus, even a larger-than-expected decline in real estate values would have a tempered impact on total household net worth that would be offset by other factors.

The negative rate of personal saving is unsustainable in the long run, but it is unlikely to generate an outright decline in consumer spending as long as the economy is expanding and net worth is rising. It's important to keep in mind that the rate of personal saving does not reflect any appreciation in the value of stock, bonds or real estate, and simply measures the cash flows of disposable personal income and consumption. In response to the rise in real interest rates, I expect that a moderation in consumer spending will be accompanied by a gradual rebound in the rate of personal saving, particularly if energy prices stabilize.

Household debt levels are high, and the rise in interest rates is adding to debt service burdens. Presently, those burdens are manageable, as indicated by the ratio of debt service-to-personal income and the level of wealth. Consumer delinquencies remain very low, and measures of consumer credit quality remain high.

Business investment is strong, and the recent pickup in commercial real estate is offsetting the weaker trend in residential investment (see Chart 6). Investment spending on information processing equipment and software has been rising rapidly, while investment in transportation equipment and structures has also been strong. All of the factors that tend to drive capital

spending are contributing positively: business product demand is rising, corporate profits and cash flows are strong, and reflecting the relatively low bond yields and high perceived creditworthiness, the real costs of capital are low. Accordingly, the outlook for business fixed investment is favorable.

International trade continues to grow rapidly, and the U.S. remains the world's largest exporter of goods and services. In the last year, real U.S. exports have risen 8.1 percent, reflecting improving global economic conditions and favorable trends in the U.S., including low unit labor costs of production, technological advances and product development. The mix and geographic distribution of U.S. exported goods underlie a favorable outlook for sustained export growth. In particular, the pickup in domestic demand and economic growth in Japan, the world's second largest nation, and improving economic conditions in Germany, will help to support rising demand for U.S. exports. Meanwhile, sustained growth in real imports (up 6.6 percent in the last year), driven by strong U.S. consumer and business investment, contributed to a further rise in the trade deficit (see Chart 7).

Certainly, the large U.S. trade deficit is a source of concern, but its magnitude must be put into perspective. Economic policies that "address" the large trade imbalance must be grounded in pro-growth initiatives that raise national income (and saving), while policies that "sound good to constituents" but in reality limit growth of spending and output must be avoided. A narrower U.S. trade deficit that results from legislation that harms the economy and reduces economic efficiency and initiative is no bargain.

Risks to the Forecast

Excessive Fed rate hikes. So far, economic performance has remained buoyant even though the Fed has hiked rates from 1 percent to 5 percent. These rate increases have simply taken away the Fed's monetary accommodation, and have not involved monetary restriction (see Chart 8). The current posture of monetary policy is consistent with sustained economic expansion.

The Fed has indicated clearly its objective is to keep inflation low. I applaud the Fed's objectives and rate hikes because stable low inflation is the best foundation for sustained economic growth and job creation. Headline inflation has been pushed well above the Fed's comfort zone by several years of rising energy prices, and so far in 2006, core inflation—excluding the volatile food and energy components—has edged above 2 percent. Year-over-year, the core PCE deflator—-the Fed's inflation measure of choice—has increased 2.1 percent while the core CPI has increase 2.4 percent. I expect core inflation will drift higher as a lagged consequence of several years of excess aggregate demand. Nominal GDP growth has averaged 6.7 percent in the last two years, far above the nation's capacity to grow. Nominal growth must be moderated to approximately 5.5 percent to keep inflation around 2 percent. Accordingly, the Fed's intention is to hike rates sufficiently to be consistent with its long-run objective of low inflation and maintain its inflation-fighting credibility, without raising rates too much.

Excessive rate hikes are a potential risk to the economy in 2007. In fact, a further upward drift in core inflation through 2006 is "baked in the cake"—it will unfold even if the economy slows or if the Fed hikes rates further. Nevertheless, the Fed will respond with rate hikes, in part to maintain its inflation-fighting credibility. This increases the chances that the Fed could induce an undesired economic slump, although I presently place a low probability on this outcome. The Fed wants to avoid raising rates too much, and is aware of past episodes in which rate hikes facilitated a "soft landing" and continued expansion, and others that were excessive and contributed to recession. Unfortunately, there is no single measure of monetary policy that the Fed can rely on; furthermore, monetary policy affects the economy with an uncertain lag, increasing the difficulty of hiking rates just enough and knowing when to stop. I expect the Fed will hike rates modestly further, to 5.75 percent. In light of the upward drift in core inflation, increases in the funds rate to that level are unlikely to upend the economic expansion.

Protectionism. Concerns about a shift toward protectionism and the potential threat to economic and financial market performance should not be taken lightly. Economic logic implies that free trade and flexible and fluid global capital markets contribute to maximum economic growth and job creation. Nevertheless, free trade and international competition do generate hardship for select industries and groups of people. Even though the economic costs to those who are adversely affected by international trade and competition are far less than the positive benefits to the economy and overall standards of living, the intensity of preference to protect these select sectors and/or groups occasionally exceeds the more diverse and diluted preference for free trade, and allows protectionist initiatives to gain ground. Presently, pending legislation that would erect tariffs on all Chinese imports is an example of potentially dangerous protectionist initiatives that may interrupt and distort trade, reduce the efficiencies provided by comparative advantage, and possibly initiate highly undesirable international retaliation. Such initiatives, while often politically tempting, must be rejected.

The U.S. dollar. Another potential risk to the economy and financial market behavior is a sharp and disorderly fall in the U.S. dollar. Such a decline may trigger a sharp rise in inflationary expectations and bond yields that in turn could damage the economy. It is important to distinguish between a gradual and orderly decline in the U.S. dollar that may elicit gradual adjustments in economic performance, and a disorderly drop that could involve spikes in asset price volatility and rapid adjustments in financial markets that generate uncertainty and large negative impacts on the economy. Absent a jarring shift in global economic performance, however, this scenario too is unlikely to occur.

A Note on the U.S. Current Account Deficit

If the U.S. and other major nations had similar rates of economic growth, investment and saving, global imbalances would be minor. But they do not. The U.S. economy and investment have grown persistently faster than all other large industrialized economies since the early 1990s, pushing up its demand for capital (see Chart 9). Over the same period, its rate of national saving has diminished. Consequently, the U.S. has insufficient saving relative to investment, so it has a capital surplus and a current account deficit. It must finance the gap with imported capital. Demand for capital in Japan and European nations has been relatively soft, mirroring weaker economic performance, while their rates of saving have been generally high. As a consequence, they have excess saving relative to investment and are exporters of capital. Asian nations are the world's largest suppliers of capital relative to the sizes of their respective economies. Although China is poor in terms of GDP per capita and enjoys robust economic growth, its rate of saving is extraordinarily high, likely reflecting the lack of adequate government retirement and social safety net programs. Combined, the central banks of five Asian nations have nearly US$2 trillion in currency reserves, and are a major source of lending to the U.S. (see Chart 10.)

It is important to emphasize that the U.S. current account deficit reflects the factors underlying it, just as the current account surpluses of other nations reflect the characteristics of their economies. The international flow of capital reallocates global saving and increases global economic efficiencies and standards of living. Even though these global imbalances are not "bad" per se, their magnitudes may not be sustainable, raising concerns about the possibility of a significant decline in the U.S. dollar. Although the U.S. dollar may recede as an adjustment to the high current account deficits, I place a low probability on an abrupt, jarring decline.

In 2005, the U.S. current account deficit was $792 billion, or 6.4 percent of GDP. This deficit represents a net flow of capital that adds to the stock of net U.S. assets owned by foreigners. Borrowing from abroad effectively exchanges current spending (on consumption and investment) for claims on future U.S. income. That's not necessarily bad, depending on what is done with the imported capital, and whether its rate of return exceeds its costs of financing. In this regard, it's important to emphasize that U.S. business investment is large and growing rapidly, and 40 percent of total U.S. imported goods are capital goods and industrial supplies used by businesses for production and expansion.

The net stock of U.S. assets now owned by foreigners minus stock of foreign assets owned by U.S. entities is approximately $2.5 trillion, over 20 percent of GDP, and rising. Despite the magnitude of this imbalance, income earned on U.S. investments in overseas activities still (narrowly) exceeds income earned by foreigners from their U.S. dollar-denominated assets; that is, the U.S. still maintains a narrow net income surplus, as U.S. entities earn significantly higher returns on overseas investments than foreigners earn on dollar-denominated investments. This reflects the fact that the largest portion of foreign portfolios of dollar-denominated investments is fixed income products (i.e., U.S. government debt securities) that provide relatively low yields, while U.S. investors have a significantly larger share of their overseas portfolios in direct investment in foreign activities.

The global dynamics of today's large current account imbalances are very likely to change in coming years, as high-saving nations experience a reduction in excess saving and become smaller net exporters of capital, while the U.S. rate of national saving rises from its recent low level. This will be driven by slower domestic demand growth in the U.S. and stronger domestic demand in large capital exporting nations.

Until recently, Japan's economy languished with weak growth, low investment and consumption and high saving. As a consequence, it persistently ran a high current account surplus, which reached 3.7 percent in 2005. Japan's economy has gained significant momentum since 2005, and its strengthening domestic demand is expected to lift investment and reduce the rate personal saving. This will lower its current account surplus and capital available for export, although the decline in Japan's government budget deficit will partially mitigate this trend. China's extraordinarily high rate of personal saving likely will recede and its gap between national saving and investment decline. In recent years, China's economy has been driven by robust exports, while consumption has remained relatively modest, constituting approximately 42 percent of GDP. Looking forward, domestic consumption is expected to rise as a share of GDP as personal incomes rise and confidence in sustainable growth mounts, while China's pace of investment growth simmers down. On net, these adjustments will generate a narrower current account surplus. Similarly, Germany's economy is showing signs of picking up, following a long period of poor performance. Faster growth in domestic demand and stronger investment would contribute to a narrower current account surplus, presently approximately 3.8 percent of GDP (like Japan, these influences would be partially offset by Germany's declining budget deficit).

As these large excess saving nations experience narrower current account surpluses and become smaller exporters of capital, the U.S. current account deficit will naturally narrow. This transition may involve adjustments in U.S. economic and investment growth, the rate of national saving and/or interest rates and exchange rates. For example, if sustained, higher real interest rates associated with the Fed's removal of monetary accommodation and global economic strength should induce a higher U.S. household saving rate and restraint on U.S. domestic demand. These trends, which are currently underway, could represent the early stages of a significant adjustment. The precise nature of the adjustment will depend on a variety of factors, including changes in U.S. and foreign economic policies. However, insofar as some differences in economic performance across nations will persist, it is misleading to presume that current accounts in "equilibrium" should be in balance.

Stronger economic performance of key U.S. trading partners likely would increase the demand for assets denominated in those currencies and be associated with an appropriate decline in the exchange value of the U.S. dollar. A lower real dollar exchange rate would reduce U.S. purchasing power and contribute to slower growth of U.S. consumption and imports, lifting personal saving. However, there is concern that the very large U.S. current account deficit will elicit a "boycott" by foreign portfolio managers who will sell their U.S. dollar-denominated assets, leading to a dramatic decline in the U.S. dollar. In recent years, in light of strong U.S. economic performance and higher U.S. interest rates—in nominal and inflation-adjusted terms—global portfolio managers have been economically rational in holding such large amounts of dollar-

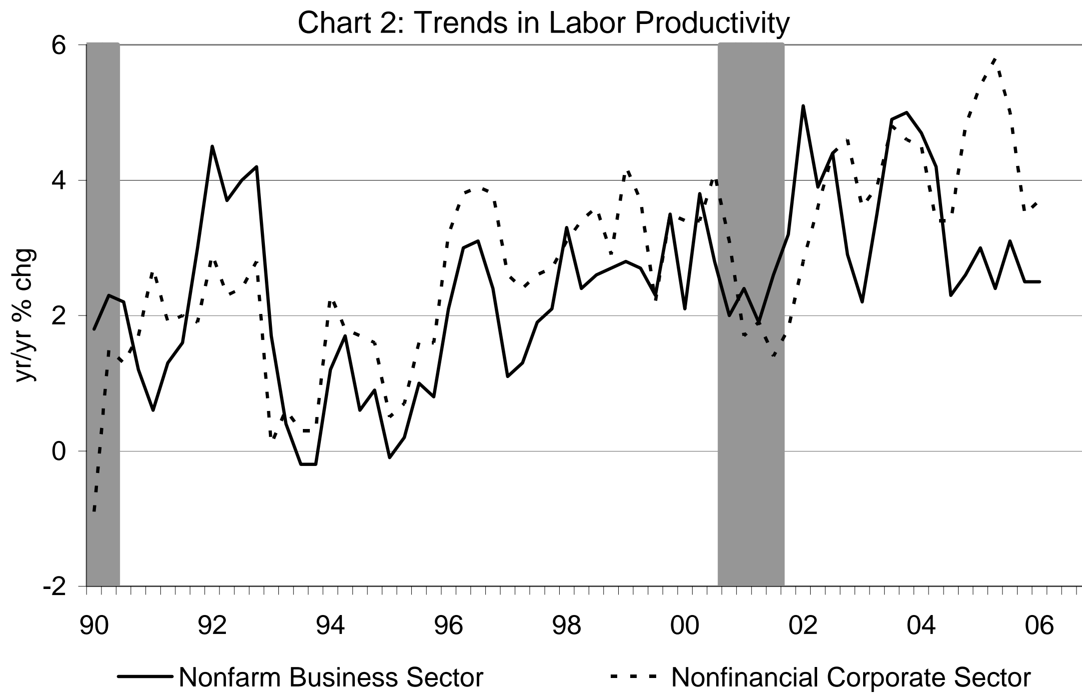
denominated assets. Barring a jarring shift in relative economic performance, I do not anticipate a sharp decline in the U.S. dollar.

So far this decade, the large and growing U.S. current account deficits have been primarily related to low rates of national saving. Whereas the 1990s investment boom outpaced a fairly steady rate of national saving (the decline in the rate of personal saving was offset by the temporary shift from government budget deficit to cash flow surplus), the low rate of national saving in recent years has been aggravated by large government cash flow deficits. As personal saving rates increase (and consumption growth slows) in response to the Fed's rate hikes, associated with the removal of monetary accommodation, along with rising real interest rates and the flattening housing market, and budget deficits continue to recede, contributing to rising government net saving, the current account deficits will ease. These adjustments in the U.S. will be accompanied by adjustments overseas related to improved economic performance.

The high U.S. budget deficits are a primary source of low national saving, and fiscal policy reform would play a crucial role in reducing the current account deficit. I am mostly concerned with the huge long-run budget imbalances that reflect the unfunded liabilities for Social Security, Medicare and Medicaid, which in terms of magnitude overwhelm near-term budget deficits. It is imperative to adjust future benefit structures for social security and retirement programs to make them affordable for future generations and fair for the elderly. Reform of Medicare and Medicaid necessarily will involve the introduction of incentives that influence the supply of and demand for medical services.

It is important to emphasize that the primary objective of such fiscal reform efforts should be to fix U.S. government finances to make them conducive to maximum sustainable economic growth. Efforts to reduce the current account deficit without regard to how changes in the structure of the underlying tax and spending programs would affect economic performance are unwise and could generate unintended economic side effects.

Source: Bureau of Labor Statistics / Haver Analytics



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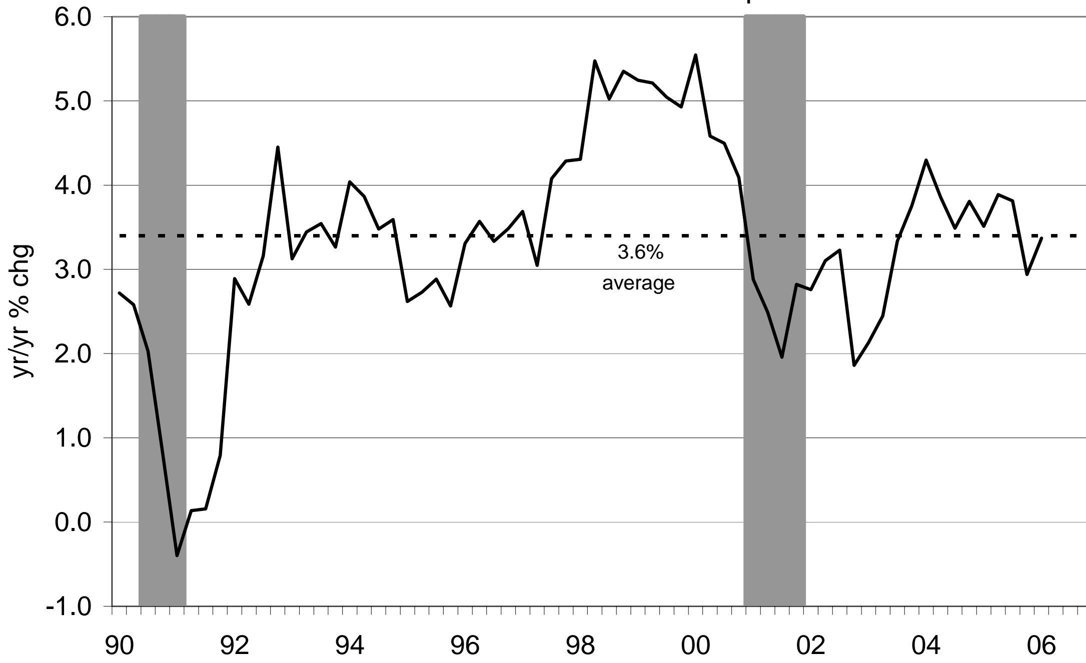

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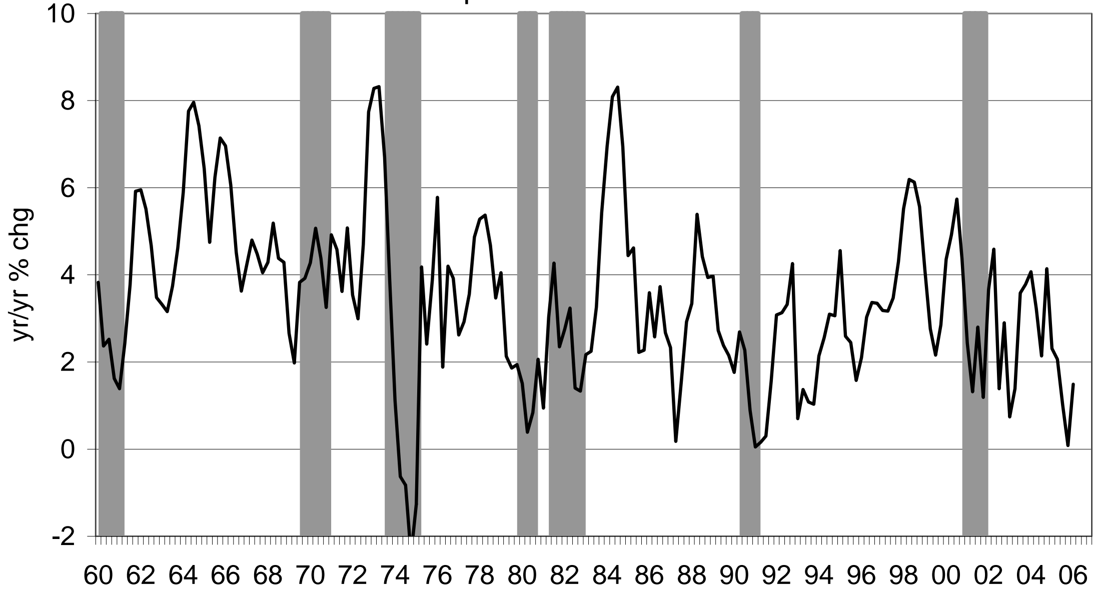
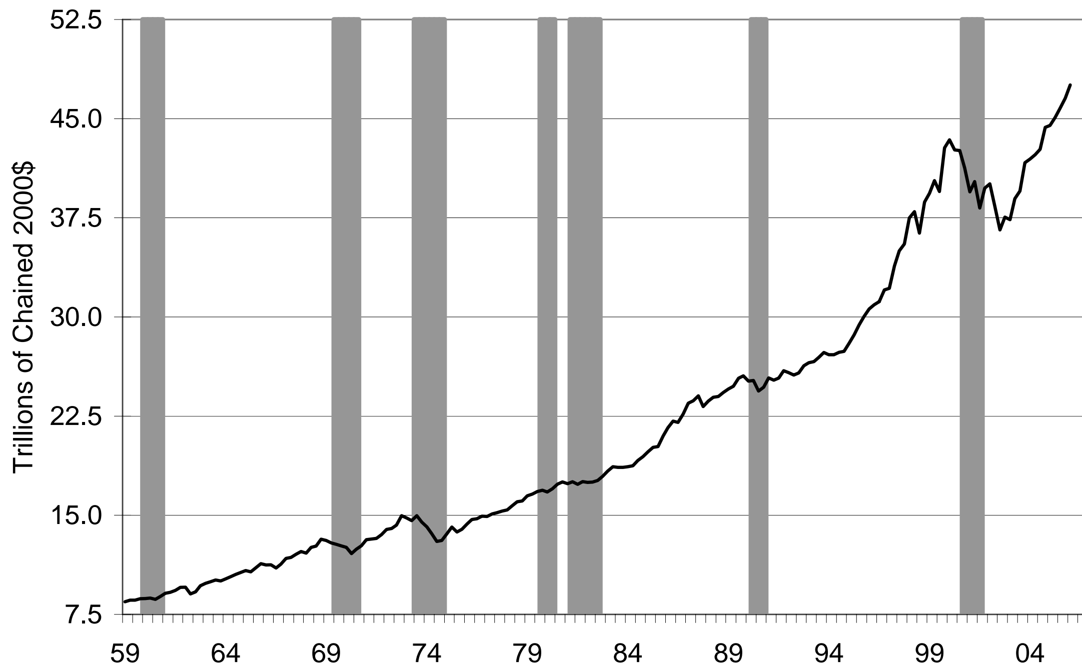
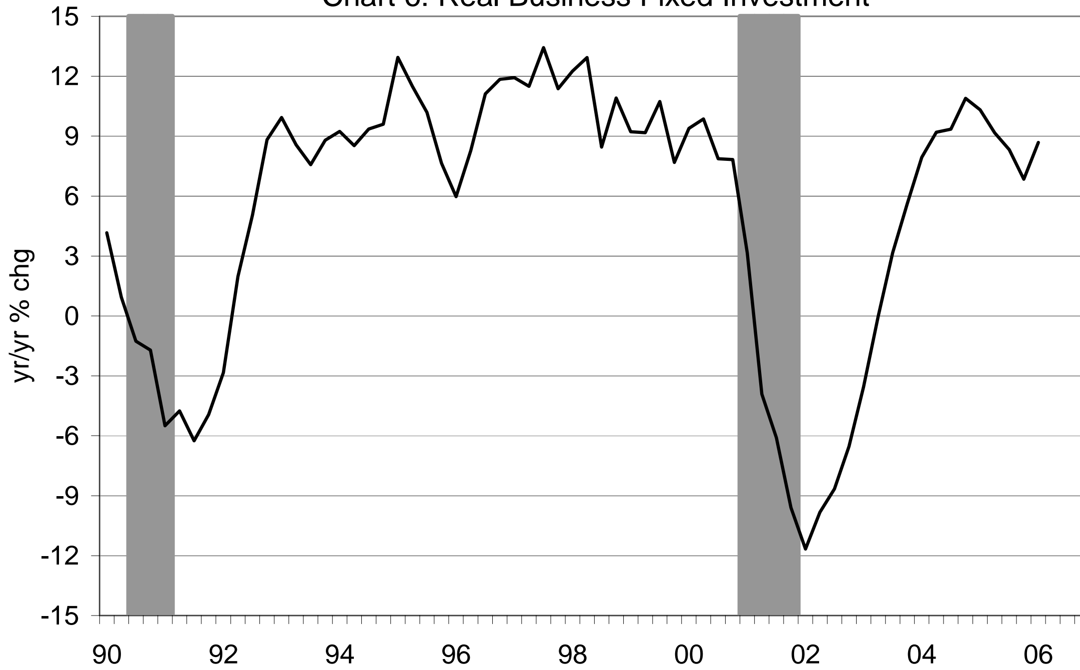


Source: Bureau of Economic Analysis / Haver Analytics



Source: Federal Reserve System / Bureau of Economic Analysis / Bank of America calculation/ Haver Analytics



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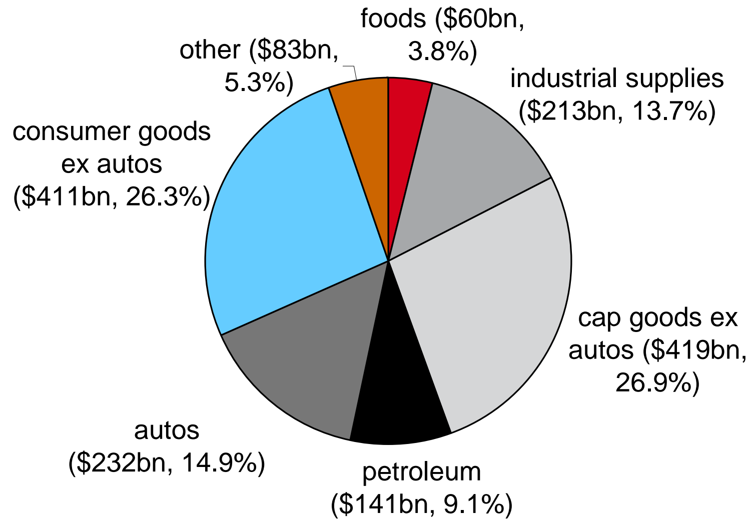
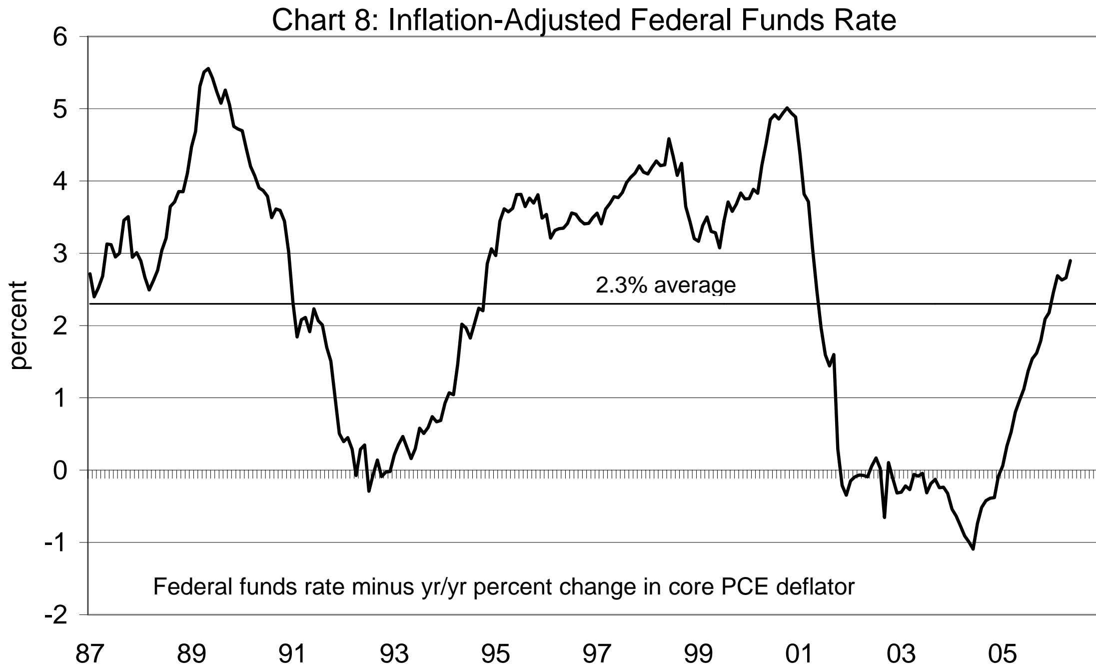
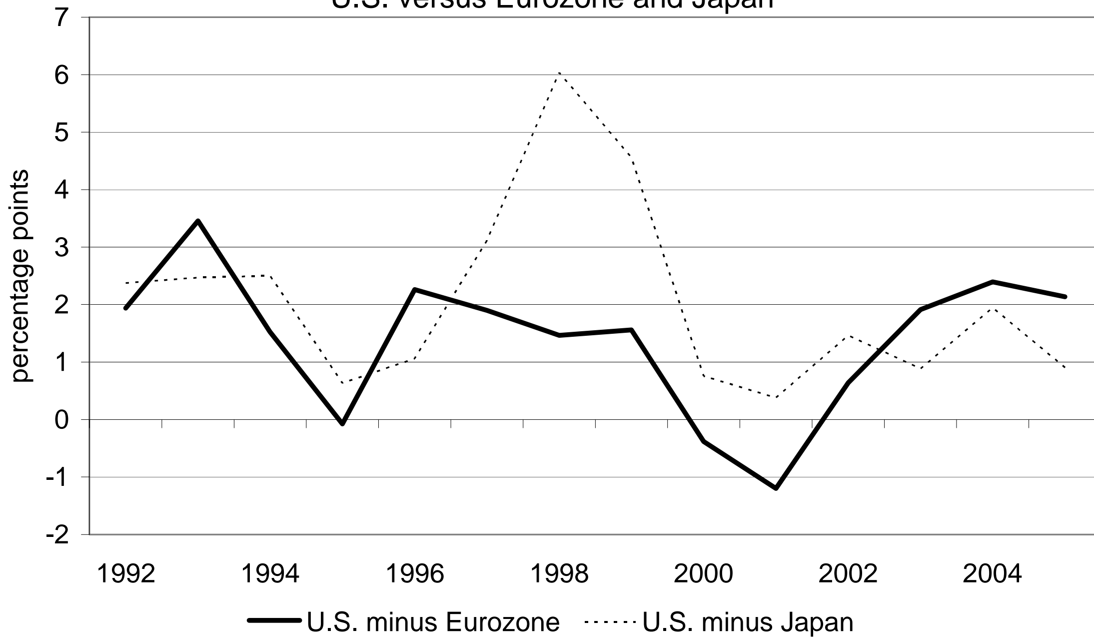


First term is value of imports, second term is the share of real goods imports
Source: Bureau of Economic Analysis / Haver Analytics / Bank of America



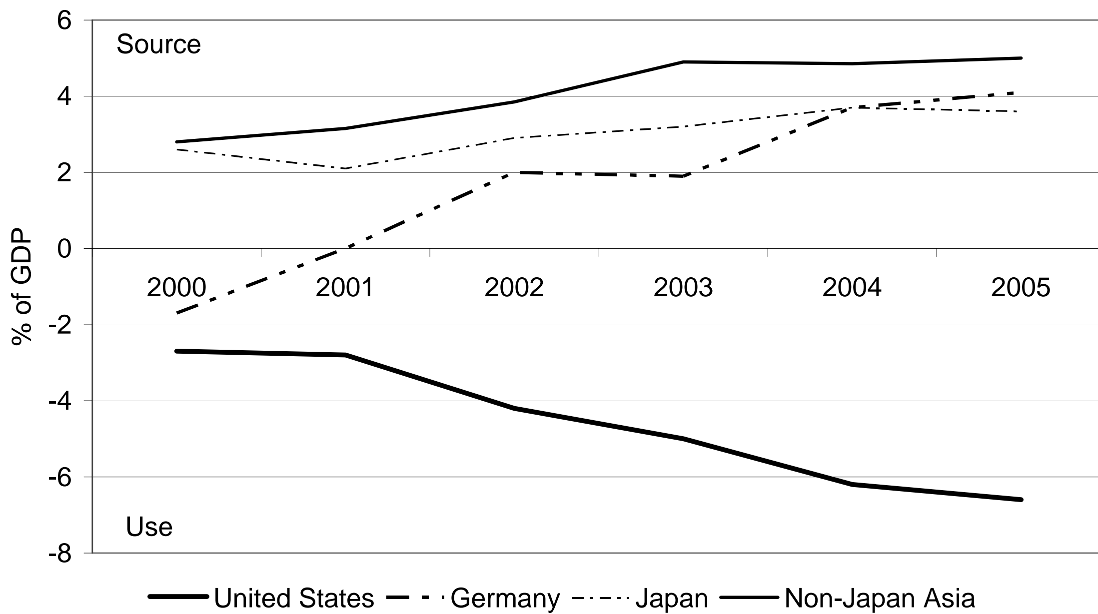
Source: Federal Reserve Board/BEA/Haver Analytics/Bank of America

Chart 9: Real GDP Growth Differentials: U.S. versus Eurozone and Japan



Source: Bureau of Economic Analysis / Eurostat / Japan Cabinet Office / Haver Analytics

Chart 10: Sources and Uses of World Saving



Source: IMF World Economic Outlook 2006