EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, DC 20502

Testimony of Edward P. Lazear, Chairman

Before the
Joint Economic Committee

Tuesday, June 27, 2006

Chairman Saxton, Vice-Chairman Bennett, Ranking Member Reed, and Members of the Committee, thank you for giving me the opportunity to speak to you today on the "Prospects for the Economic Expansion."

The American economy is strong. Even as world growth outside the United States has strengthened, the U.S. has maintained leadership in economic growth and job creation. The economic outlook remains positive as well.

Administration Economic Forecast

Let me begin with the current picture of the economy and the Administration's forecast for the next couple of years. First, real growth of gross domestic product (GDP) was at 3.2 percent over the four quarters of 2005, and is forecast to be at 3.6 percent over the four quarters of this year and 3.3 percent over the next year. We expect rates of inflation of about 3 percent, and even lower going forward from this point. These expectations are consistent with market data and with the consensus of private forecasts.

Job growth has been strong over the past couple of years. The economy has been producing about two million payroll jobs per year for a total of 5.3 million additional jobs since August 2003. That trend is largely expected to continue with some slight moderation in 2006 and 2007. Our monthly estimates of employment growth for 2006 and 2007 are 156,000 and

140,000, respectively. The unemployment rate, which was 5.1 percent in 2005, is forecast to average 4.7 percent in 2006 and 4.8 percent in 2007. In short, the economy continues to grow, inflation expectations are moderate, and the labor market is strong.

Economic Growth and Fundamentals

There have been some concerns in the past couple of months that the economy may slow this year. It is better described as likely moderating from very good growth to good growth. The first quarter of 2006 enjoyed real GDP growth at an annual rate of 5.3 percent. While we do not expect growth rates to continue at that level throughout the remainder of the year, we do expect that they will be sufficiently high to cause real GDP growth over the four quarters of 2006 to be in the neighborhood of three-and-a-half percent, as mentioned earlier.

We lead the industrialized countries in economic growth and we have very good fundamentals for continued economic expansion. These fundamentals include a flexible labor market, few impediments to business formation, high levels of investment in skills and human capital, strong property rights, well developed and sophisticated capital markets, low taxes, and an entrepreneurial spirit. Americans' pioneering attitudes and openness to new ideas and new peoples have been instrumental in growing this economy.

Housing and Consumer Spending

Although the economic situation is favorable, there are always risks to continued economic growth. The one that has received the most attention recently is the housing market. Partly as a result of higher interest rates, the housing market has not expanded at the same rapid rates as it has in the recent past. Most notably, housing starts have fallen by about 13 percent since January of this year. But that decline is best understood when put in the historical perspective. Over the past 45 years, the average for housing starts has been about 1.5 million

units per year, with the high point coming in the early 1970s. Right now, with housing starts at 1.957 million for May, they are currently above the level of housing starts throughout the 1990s.

While some specific housing markets have seen price declines, in most markets the movement has been limited or slightly up. The recent nationwide price increases in the range of 12-14 percent over 4-quarter periods are neither sustainable nor necessarily desirable.

Offsetting the moderation in residential construction has been an expansion in commercial real estate and other business investments. These latter two components signal strong confidence in the economy and its ability to expand in the future.

Recent moderation in consumer spending has been offset by higher growth in exports. During the last year, consumer spending accounted for about 72 percent of GDP growth, which is down a fair amount considering its importance to GDP growth during the previous three years. Exports and business-fixed investments, on the other hand, rose to account for 50 percent of GDP growth in contrast to the earlier three years during which they subtracted to GDP growth.

Energy Prices and Inflation

The most notable change in the economy since last summer has been a significant increase in the price of gasoline and oil products. Since last May, the price of crude oil is up about 40 percent and nationally the price of gasoline at the pump is up about 35 percent. Higher energy prices strain family and business budgets, but thus far the economy has once again exhibited resiliency.

Although higher energy prices have played a role in boosting inflation over the past year to 4.2 percent, the rate of core inflation (excludes volatile food and energy prices) was only 2.4 percent, up very slightly from the 2.2 percent core inflation rate over the year-earlier period. These figures are from the consumer price index (CPI). Other measures show less inflation.

Moreover, energy price increases are expected to moderate. The futures price for West Texas Intermediate (WTI) crude oil delivered one year from now is about $73.15 per barrel (as of June 26, noon), which at today's price would reflect an increase in the price of crude of less than 3 percent over the next year. Gasoline futures are predicting a decrease in the price of conventional gasoline during the next six months of 2006 with futures prices for December gasoline being about 12 percent lower than the prices for July gasoline. Consistent with the improved outlook for energy prices, the consensus of professional forecasters is that overall inflation will moderate to 2.3 percent in 2007 (Q4 over Q4).

Productivity Growth

Productivity growth is helping to keep inflation pressures moderate. It also helps make the United States internationally competitive and leads to higher living standards.

Productivity growth – how much workers produce per hour – has been remarkably strong over the past 10 years at an average annual growth rate of 2.9 percent. Over the past five years it has been an even more impressive annual rate of 3.3 percent. This is the fastest five-year growth period in nearly 40 years.

America's workers are already among the most productive in the world and productivity is growing faster in the U.S. than in any major industrialized economy. While there are no direct ways for policymakers to increase productivity, as I will discuss later, there are a number of steps we can undertake to help.

Global Imbalances

Mr. Chairman, you have asked me to comment on the issue of global imbalances. The United States is running a current account deficit on an annualized basis of about $800 billion, or

6.4 percent of GDP. Many look at this number with concern. I would like to make a few comments with respect to this issue.

First, let me point out that on the other side of the current account deficit is the capital account surplus. The fact that we have a current account deficit of about $800 billion also means that foreign individuals, businesses and governments are purchasing assets of the U.S. at a rate of about $800 billion per year. Almost all economists view the supply of foreign savings for investment in the U.S. as positive for our economy.

Second, I would like to point out the historic record suggests that countries can be in a current-account deficit or a surplus situation for very long periods of time. New Zealand and Australia have had deficits for decades. Australia in particular has been running a current account deficit that has created a level of foreign indebtedness equal to about 72 percent of their GDP, whereas our foreign indebtedness was only about 21 percent of GDP in 2004 (most recent available published data). Yet, the Australian economy has been very strong and growing at robust rates over the past decades. Australia's real GDP has grown at an average rate of 3.5 percent over the last decade. Conversely, Japan has struggled economically in the past decade and has been running current account surpluses for a very long period of time. Closer to home, the most obvious contrast now is between the United States and China. The U.S. is at one end of the spectrum with the world's highest deficit, and China is at the other end of the spectrum with extremely high surpluses, and yet both countries are growing at the highest rate in their respective classes.

What then do we take from this? There is no clear correlation between a country's surplus or deficit and economic growth. Given the lack of obvious correlation, should we still be concerned about a large current account deficit? We should still be concerned. We must

constantly monitor our international situation for the reason that abrupt changes could create problems for the U.S. economy. In particular, a rapid decline in the U.S. current account deficit would correspondingly imply a rapid decline in the U.S. capital account surplus. Were this to happen, there could be significant adverse consequences to the U. S. economy and to the rest of the world. We do not anticipate abrupt changes like this occurring. But we do not ignore the possibility. Most importantly, we must make sure that we maintain the kind of investment climate that allows foreign individuals and institutions to remain confident that our economy and its ability to grow and pay return to investments that they are making. We should also consider the causes of and potential remedies to our current saving dearth in the United States. Major progress could be made by removing impediments to saving that are incorporated in our current tax structure, and also by continuing to bring down the federal budget deficit.

Economic Policies

This brings me to issues that are perhaps more directly relevant to the Congress. Mainly, what can we do specifically to ensure that we grow at high rates and encourage additional economic growth? First, we must make sure that marginal tax rates stay low. The most important way to encourage growth in an economy is to maintain high rates of return to investments, both in physical and human capital. To allow for high rates of investment in physical capital, business taxes and returns to capital investments through dividends, capital gains and other payments must not be taxed at high rates. Raising the level of capital per worker makes workers more productive and leads to higher wages in the long run. Congress' recent actions with the President to extend the capital gains and dividends tax cuts are very positive moves in this direction.

Second, the Death Tax affects saving behavior and capital formation in harmful ways. The President has expressed his desire to see the complete elimination of the Death Tax and we believe that such a policy would be favorable to create a climate that is positive for saving.

Third, we must ensure that we do not discourage investment in human capital. The most important source of capital in the economy is the capital that is embodied in people through their skills. To make sure that individuals have incentives to invest in skills by going to college, graduate school, or vocational schools to obtain other forms of skills on the job, it is necessary to keep the tax rates on wage income low. If individuals see that returns to investments in their skills will only be dissipated through high tax rates on moderate to high wage earners, the incentives to invest in human capital will be dampened.

Fourth, we must remain open to foreign investment. As I mentioned earlier, foreign investment has been an important source of capital for the United States. The amount of investment in the U.S. accounted for by foreign individuals and institutions is currently 34 percent. Approximately one in 20 workers is employed in a foreign-owned firm and about 45 million workers are employed by firms that engage in significant amounts of international trade. As such, we must make sure that we keep pushing for freer trade, especially in the area of services which has become a larger and larger part of our economy.

Fifth, the President has outlined a competitiveness initiative to make sure that Americans have the skills to compete in the modern world. We must continue to push for reform in K-12 education, which has been the weakest component in our human capital investment structure. Fortunately, our colleges and graduate schools are the best in the world. We export education by training large numbers of foreign students in our American colleges and universities and it is good for us to continue to do that, but we must also make sure that those U.S. individuals who do

not necessarily go on to college also get the skills that are important for them to compete in a modern American economy. As such, keeping students in high school, reducing our drop-out rates, and ensuring that the education quality that is provided to all of our young citizens is high will be important not only in the near future, but as we move into the later years of the 21st Century. The President's efforts over the past several years to improve education with the No Child Left Behind Act and community college initiative will help.

Furthermore, we must also strengthen our human capital infrastructure by working to raise the skill levels of American workers by increasing opportunities for education and training. As part of the competitiveness initiative, the President has proposed Career Advancement Accounts that workers could use to obtain the education and training they need to compete in the global economy. Career Advancement Accounts are self-managed accounts that enable current and future workers to gain the skills needed to successfully enter, navigate, and advance in the 21st century labor market.

In conclusion, our economy is currently very strong, and it should continue to grow and remain strong because our fundamentals are positive. There are a number of issues policymakers need to address, including some that I have not mentioned here this morning, but ultimately we must ensure that we do everything possible to keep productivity growing rapidly. Growing productivity is the key to wage growth, and to rising standards of living. It is also a key measure of our international competitiveness.

Productivity grows as a result of investment in physical and human capital, and physical and human capital are amplified when incentives remain strong. This means that we must keep tax rates low, keep openness to investment and foreign trade, and keep our economy and labor

markets flexible. The President's initiatives for low taxes and his focus on the improvement of the skills of all Americans are the right moves for the U.S. economy.

Again, thank you for the opportunity to discuss these issues with you. I would be happy to answer questions you may have.