THE ECONOMIC OUTLOOK

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

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

One of the greatest assets we have in rebuilding after a hurricane is the overall strength of the national economy. The resiliency of the economy—the product of flexible labor markets, a culture of entrepreneurship, liquid and efficient capital markets, and intense market competition—is helping it to absorb the shocks to energy and transportation from the hurricanes. The ability of our economy to grow and create jobs will act as a lifeline to the regions and people that have been most affected. Thus these recent events make it all the more important that we keep the fundamentals of the national economy strong and continue to promote economic policies that will encourage growth and job creation.

The Economic Expansion

When thinking about where the economy is now and where it is heading, it is useful to keep in mind just how far the U.S. economy has come in recent years. The economy's resilience was put to severe test during the past five years, even prior to Katrina. A remarkable range of shocks hit the U.S. economy, beginning with the sharp decline in stock prices in 2000 and the recession that followed in 2001. The economy was further buffeted by the terrorist attacks of September 11, 2001, and the subsequent geopolitical uncertainty. Business and investor confidence was shaken by a series of corporate scandals in 2002. By early 2003, uncertainty about economic prospects was pervasive and the economy appeared to be sputtering.

Yet, in the face of all these shocks, together with new challenges such as the recent sharp rise in energy prices, the American economy has rebounded strongly. Policy actions taken by the President and the Congress were important in helping to get the economy back on track. Notably, beginning with the President's 2001 tax cuts, multiple rounds of tax relief increased disposable income for all taxpayers, supporting consumer confidence and spending while increasing incentives for work and entrepreneurship. Additional tax legislation passed in 2002 and 2003 provided incentives for businesses to expand their capital investments and reduced the cost of capital by lowering tax rates on dividends and capital gains.

Together with appropriate monetary policies, these policy actions helped spur economic growth in both the short run and the long run. Today the U.S. economy is in the midst of a strong and sustainable economic expansion. Over the past four quarters real GDP has grown at a 3.6 percent rate, and over the past eight quarters real growth has been at a 4.1 percent annual rate. Prior to Katrina, the near-term forecasts of both CEA and private-sector economists had called for continued solid growth. The destruction wrought by Katrina and Rita may reduce growth somewhat in the short run, but the longer-term growth trajectory remains in place. I'll return to economic prospects in a moment.

An important reason for the recovery has been improved business confidence. To an extent unusual in the postwar period, the slowdown at the beginning of this decade was business-led rather than consumer-led. Homebuilding and purchases of consumer durables did not decline as they typically do in cyclical downturns; instead the primary source of weakness was the reluctance of businesses to hire and to invest. Supported by appropriate fiscal and monetary policies and by the economy's innate strengths, business confidence has risen markedly in the past few years. The effects are evident in the investment and employment data. From its trough in the first quarter of 2003, business fixed investment has increased over 21 percent, with the biggest gains coming in equipment and software. Since the labor market bottomed out in May 2003, more than 4 million net new payroll jobs have been added. Currently, the unemployment rate stands at 5.1 percent, up from 4.9 percent in August, prior to the job losses that followed Katrina.

Although growth in GDP and jobs capture the headlines, one of the biggest macroeconomic stories of the past few years is what has been happening to productivity. Productivity growth is the fundamental source of improvements in living standards and the primary determinant of the long-run growth potential of the economy. Over the past four years, labor productivity in the nonfarm business sector has grown at a 3.4 percent annual rate, and productivity in manufacturing has risen at a 5.7 percent annual rate. Productivity growth has slowed recently as businesses have absorbed millions of new workers—a normal development for this stage of an economic expansion—but it remains (in the four quarters ending 2005:Q2) at the quite respectable level of 2.2 percent (and 6.3 percent in the nonfinancial corporate sector). Thus, on each of three key indicators of the real economy—GDP growth, job creation, and productivity growth—the United States in recent years has the best record of any major industrial economy, and by a fairly wide margin.

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

The Economic Outlook

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

The economic impact of the hurricanes included significant damage to the country's energy infrastructure. As you know, Katrina shuttered a substantial portion of U.S. refining and pipeline capacity, which led to a spike in gasoline prices in the weeks after that storm. Rita caused further damage. The federal government has assisted, in among other ways, by lending or selling oil from the Strategic Petroleum Reserve, arranging for additional shipments of oil and refined products from abroad to the United States, and providing appropriate regulatory waivers to increase the flexibility of the energy supply chain. In part because of these efforts and a vigorous private-sector response,, oil prices have returned to roughly their pre-Katrina levels. Wholesale gasoline prices have also retreated to levels of mid-August, suggesting that the recent decline in prices at the pump is likely to continue. Natural gas prices may remain elevated somewhat longer, however, because of lost production in the Gulf, the difficulty of increasing natural gas imports, and damage to plants that process natural gas for final use.

Even as the energy sector continues to recover, it remains true that the prices of oil and natural gas have risen sharply in the past two years, reflecting a tight balance of supply and demand. High energy prices are burdening household budgets and raising production costs, and continued increases would at some point restrain economic growth. Thus far at least, the growth effects of energy price increases appear relatively modest. The economy is much more energy-efficient today than it was in the 1970s, when energy shocks contributed to sharp slowdowns. Well-controlled inflation and inflation expectations have also moderated the effects of energy price increases, since those increases no longer set off an inflation spiral and the associated increases in interest rates, as they did three decades ago. In addition, allowing prices to adjust, rather than rationing gasoline, is helping to minimize the overall impact on the economy.

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

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

Conclusion

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

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

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

Finally, I note that the tax reform advisory panel, whose official report will go to the Secretary of the Treasury on November 1, has kicked off a much-needed debate on how to make the federal tax code simpler, fairer, and more pro-growth. We thank them for their hard work and look forward to reviewing their recommendations.

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