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BEFORE THE

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CONGRESS OF THE UNITED STATES

ONE HUNDRED NINTH CONGRESS

SECOND SESSION

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PROSPECTS FOR THE ECONOMIC EXPANSION

TUESDAY, JUNE 27, 2006

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, DC

The Committee met, pursuant to notice, at 10 a.m., in room 2118, Rayburn House Office Building, the Honorable Jim Saxton, Chairman of the Committee, presiding.

Representatives present: Representatives Saxton, Paul, Ryan, Brady, Maloney, Hinchey, Sanchez and Cummings.

Senators present: Senators Bennett, Reed and Sarbanes.

Staff present: Chris Frenze, Robert Keleher, Brian Higginbotham, Colleen Healy, Ari Evans, Jeff Schlagenhauf, Chad Stone, Daniel Dowler, and Matt Homer.

OPENING STATEMENT OF HON. JIM SAXTON, CHAIRMAN, A U.S. REPRESENTATIVE FROM NEW JERSEY

Chairman Saxton. Good morning.

It is a pleasure to welcome Chairman Lazear of the President's Council of Economic Advisers before the Joint Economic Committee this morning. Thank you for being with us.

The Council of Economic Advisers and the Joint Economic Committee share a common history, and we value the good relationship that we have had over many years. I would also like to welcome the members of the second panel, Dr. Mickey Levy, and Dr. Brad Setser this morning.

Thank you also for being here.

The U.S. economy has grown at a healthy pace in recent years, according to official data. The U.S. economy advanced 4.2 percent in 2004 and 3.5 percent in 2005.

The pick-up in economic growth since 2003 is largely due to the rebound in investment including equipment and software spending.

A combination of accommodative monetary policy and investment tax incentives enacted in 2003 helped to boost investment and improve economic growth in recent years.

Since August of 2003, 5.3 million new jobs have been created and the unemployment rate has fallen to 4.6 percent. As the Fed noted in a policy report last February, the U.S. delivered a solid performance in 2005.

In the first quarter of 2006, the economy expanded at a blistering pace of 5.3 percent. This performance is all the more remarkable considering the impact of high oil prices and a tightening of monetary policy by the Federal Reserve.

Although there is some weakness in the real estate sector, it appears as though a soft landing is the most likely outcome. The overall economy has proven to be quite resilient.

Very recent data suggests that the U.S. economy is no longer growing at an unsustainable rate in excess of 5 percent but advancing at a more moderate rate of about 3 percent.

According to the Blue Chip consensus of economic forecasters, this trend will continue through most of the next six quarters.

The Fed has stated that the U.S. economy should continue to perform well in 2006 and 2007. A variety of forecasts suggest that the economic growth for 2006 will be about 3.5 percent and that the economic expansion will continue into 2007.

At this time, I would like to ask the Ranking Member, Senator Reed, if he has comments that he would like to make.

[The prepared statement of Chairman Saxton appears in the Submissions for the Record on page 46.]

OPENING STATEMENT OF HON. JACK REED, RANKING MINORITY, A U.S. SENATOR FROM RHODE ISLAND

Senator Reed. Thank you very much, Mr. Chairman.

Let me also welcome Chairman Lazear to his first hearing, and I, too, am pleased that Dr. Levy and Dr. Setser will be participating in the second panel.

The latest Administration forecast, which is in line with the consensus of other forecasters, is for economic growth to continue at a more moderate pace than we have seen recently. Of course, there are risks to that forecast; high energy prices and cooling housing markets might slow consumer spending more sharply than forecasters are predicting. And our trade deficit and dependence on foreign lenders have reached alarming proportions.

The Federal Reserve has to decide how to deal with these risks while preserving its credibility on inflation. If the Fed makes the wrong choice, the economic recovery could end before it has begun for many American families. That brings me to the core of my concern about the economy and the Administration's policies. As much as the President would like to say that his policies are benefiting all Americans, the fact is that we have gone through the most prolonged job slump in many decades. Real wages are not just lagging behind productivity growth. They are stagnating.

And economic inequality is increasing. While workers are waiting to see the benefits of this economic recovery show up in their paychecks, American families are experiencing widespread economic insecurity in the face of soaring energy prices, rising health care costs, declining health insurance and pension coverage, and rising costs for a college education for their children.

The President's tax cuts have not been the answer. They were poorly designed to stimulate broadly shared prosperity and produced a legacy of large budget deficits that leave us increasingly hampered in our ability to deal with the host of challenges we face. Moreover, the President's goals of making his tax cuts permanent and cutting the deficit in half are simply incompatible. Large and persistent budget deficits have contributed to an ever-widening trade deficit that forces us to borrow vast amounts from abroad and puts us at risk of a major financial collapse if foreign lenders

stop accepting our IOUs. We had a current account deficit of nearly $800 billion last year. And our international financial debt continues to mount.

I hope we would all agree that raising our future standard of living and preparing adequately for the retirement of the baby-boom generation require that we have a high level of national investment and that a high fraction of that investment be financed by our own national saving, not by foreign borrowing. We followed such prosperity-enhancing policies under President Clinton, but that legacy of fiscal discipline has been squandered under President Bush.

Most experts believe that the budget deficits we need to worry about are the long-term structural deficits resulting from the President's tax cuts, not cyclical deficits resulting from a temporary decline in economic activity. So I'll be interested in Chairman Lazear's explanation of just how we can grow our way out of deficits as he recently wrote in the Washington Post.

I am also curious about Dr. Lazear's recent statement in the Wall Street Journal that the President's tax cuts have made the Tax Code more progressive, which narrows the difference in take-home earnings. In fact, the President's tax cuts have widened the gap in take-home earnings. According to the non-partisan Tax Policy Center, the tax cuts passed since 2001 have raised the after-tax income of the top 1 percent of Americans by 5 percent while raising the after-tax income of the bottom 60 percent of Americans by just 2 percent.

Chairman Lazear rightly points out that policies must increase the opportunities of all workers to acquire skills and training, but this view doesn't square with the President's budget, which includes cuts to elementary and secondary education, student aid and loan assistance for higher education and job training for displaced workers.

I look forward to Chairman Lazear's testimony.

Thank you, Mr. Chairman.

[The prepared statement of Senator Reed appears in the Submissions for the Record on page 47.]

Chairman Saxton. Dr. Lazear, the floor is yours, sir.

STATEMENT OF DR. EDWARD P. LAZEAR, MEMBER, COUNCIL OF ECONOMIC ADVISERS

Dr. Lazear. Chairman Saxton, Ranking Member Reed, thank you for giving me the opportunity to speak to you today on the prospects for 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. The economic outlook remains positive as well.

Let me begin with the current picture of the economy.

Chairman Saxton. Would you mind pulling the microphone a little closer?

Dr. Lazear. 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 it is forecast to be at 3.6 percent this year and 3.3 percent the following 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 2 million jobs per year for a total of 5.3 million jobs since August 2003. That trend is expected to continue with some slight modification 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 about 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.

There have been some concerns in the past couple of months that the economy may be slowing. It is better described as likely moderating from very good growth to good growth. The first quarter of 2006 enjoyed GDP growth at 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 the real GDP growth over the four quarters of 2006 to be in the neighborhood of 3.5 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 people have been instrumental in growing this economy.

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 historical perspective. Over the past 45 years, the average for housing starts has been about 1.5 million units per year with a high point actually 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 1 to 14 percent are neither sustainable nor necessarily desirable. Offsetting the moderation in residential construction has been expansion in commercial real estate and other business investment.

These latter two components signal strong confidence in the economy and its ability to expand further. 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 3 years. Exports and business-fixed investments, on the other hand, rose to account

for 50 percent of GDP growth in contrast to the earlier 3 years during which they actually subtracted to GDP growth.

The most noticeable 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 more than 40 percent and, nationally, the price of gasoline at the pump is 35 percent higher. Higher energy prices crimp 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 was only 2.4 percent, up slightly from the 2.2 percent core inflation rate over the year-earlier period.

These figures are from the consumer price index, the CPI, and other measures show even less inflation. Moreover, energy prices are expected to moderate. The futures price for West Texas Intermediate crude oil delivered 1 year from now is about $73 a barrel. At today's prices, that would mean an increase of about 3 percent over the next year. Gasoline futures are actually down relative to current prices, so the market is predicting lower gasoline prices in December than are currently prevailing.

Consistent with the improved outlook on energy prices, the consensus of professional forecasters is that overall inflation will be a moderate 2.3 percent in 2007 (Q4 over Q4).

Productivity growth is helping to keep inflation pressures moderate. It also helps the make the United States internationally competitive and leads to high standards of living. 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 5 years, it has been at an annual rate of 3.3 percent. This is the fastest 5-year growth period in nearly 40 years.

Productivity growth in the United States has been impressing economists for another reason. It is the highest level of any major industrial economy, and it is growing faster, too.

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.

Mr. Chairman, you 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 observers look at this number with concern. I would like to make a few comments with respect to the issue of the current account deficit.

First, let me point out that on the other side of the current account deficit is the capital account surplus.

Second, I would like to point out that historical records suggest that countries can be in current account deficits or surplus situations for very long periods of time.

More important, there is no clear correlation between a country's surplus or deficit position and economic growth. Given the lack of obvious correlation, should we still be concerned about large current account deficits? I believe the answer is that we should. 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 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 in our economy and its ability to grow and pay returns 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.

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 our marginal tax rates stay low. The most important way to encourage growth in the economy is to maintain high rates of returns to investments both in physical and human capital.

In order 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's recent action with the President to extend the capital gains and dividend tax cuts are very positive moves in this direction.

Second, the death tax affects saving behavior. The President has expressed his desire to see the complete elimination of the death tax, and we believe a 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 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 tax rates on wage income low.

If individuals see that the returns to investment 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. Approximately 1 in 20 workers is employed in a foreign-owned firm, and about 45 billion 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 Americans have the skills to compete in the modern world. We must continue to push for reform in K through 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 and 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 a global economy.

Career Advancement Accounts are self-managed accounts that encourage future workers to gain the skills necessary 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. Growing productivity is the key to wage growth and to rising standards of living. It is also a key picture of our international competitiveness.

Productivity grows as a result of the 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 improvements 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 any questions that you may have.

[The prepared statement of Dr. Lazear appears in the Submissions for the Record on page 49.]

Chairman Saxton. Dr. Lazear, thank you very much for a very comprehensive statement.

In a statement last February, the Federal Reserve stated that the economy had performed well in 2005 and was expected to continue to perform well in 2006.

Also on June 10th, the Blue Chip forecast was issued which essentially said the same thing, projecting that economic growth would be around 2.8, 2.9, 3 percent.

Is this consistent with what the Administration's forecast is going forward?

Dr. Lazear. Thank you, Mr. Chairman.

Yes, it is consistent. We recently engaged in an exercise that we go through a couple of times a year. It is called the troika process, and it involves three agencies: the Council of Economic Advisers, the Office of Management and Budget and U.S. Treasury. And the consensus from the group was that economic progress is strong and that it will continue to be strong over the next couple of years. In fact, we recently revised upward our estimate of the growth in the economy based on first quarter numbers. So we were initially projecting 3.4 percent growth for this year and actually revised up to 3.6 percent as a result of the very strong Q1.

That is also being reflected in the labor market. We are seeing high employment growth during the first quarter. We also saw creation of jobs at about the same rate that we had seen through the previous 2 years, which is a very high rate.

Initial claims on unemployment insurance continue to be at low rates, so all of these are indications of a strong labor market, and we anticipate that will continue into the future.

Chairman Saxton. Thank you.

In your statement, you listed four items that you think are important in terms of keeping the economy in robust shape. Three of the four included or focused on low tax rates. The first was that marginal tax rates stay low; the second was, the estate tax stay in a position where it will positively affect savings; the third was that incentives to invest in human capital should be kept in place, again referring to low marginal tax rates in order to incentivize people to increase their personal skills with a goal toward increasing their income.

I don't mean to speak for him, but in his opening statement, Senator Reed questioned how the Administration's policy relative to taxes could be sustainable in as much as we have to worry about revenue.

Would you address that further for the Committee, please?

Dr. Lazear. Sure. Obviously, we are concerned about revenue. The President stated that his goal was to cut the budget deficit in half by 2009. As you know, revenues have been coming in at rates that have been above the projected levels both last year and during the early parts of this year. So things are actually looking much better than we anticipated in terms of revenue growth. In large part this reflects the fact that the economy has been very strong and when we have a strong economy with strong GDP levels and strong growth, that tends to reflect the tax revenues as well. So the budget deficit is currently moving in the right direction and moving in that right direction at a very hurried pace and at a much more rapid pace than we expected. And this is true despite the fact that we were able to cut taxes and give more money to the American

taxpayer and put that money in their pockets rather than directly in the hands of the Government. So we view these as all being positive developments.

I have also looked at the effect of tax cuts on economic growth. I have reviewed the literature, and this literature is broadly based. Much of it comes from academia, and it is written by individuals who are on both sides of the political spectrum. The general consensus is that the tax cuts have been effective in bringing about changes that we were anticipating in 2003 in particular. The dividends in capital gains taxes have resulted in higher levels of investment and higher levels of economic growth. So we view those as all very positive developments and very positive aspects of the policies that were implemented a few years back.

Chairman Saxton. I remember sitting here during 2002 and hearing the Administration criticized because job growth was rather anemic. Then the tax changes that occurred in early 2003 seemed to have a positive effect on investment and the economic growth that followed the investment. Would you care to comment on that?

Dr. Lazear. Yes, what we saw after 2003 was that the tax cuts had an immediate effect on investment and on GDP growth. What was a bit slower to develop were movements in the labor market. So what happened initially was, we had very high rates of productivity growth; GDP went up; productivity went up, but we were able to obtain these higher levels of productivity and output without hiring more workers.

That worked for a while. We were able to get more out of fewer for a while but eventually, the economy needed additional workers and we saw job growth start to take off a couple of years ago.

As you mentioned in your opening statement, Chairman Saxton, we have seen job growth of over 5 million jobs over the past couple of years, and that trend continues. So we think that what we saw earlier has now generalized to other aspects of the economy.

I should also mention that one of the developments that I view as being quite healthy is that the expansion that was fueled earlier by housing and by consumption now seems to be generalizing to other sectors of the economy, particularly exports and business investment.

I view that as a healthy development because it means that the economic situation is more robust and perhaps less fragile than it would have been a year or 2 ago. So I am actually encouraged by the fact that these developments have occurred and that we are seeing generalization of the kind of economic activity that was very strong in the earlier couple of years to other sectors of the economy that now seem to be important in growing to us.

Chairman Saxton. Thank you.

Let me just finish up with one question that I find quite interesting. Because the investment climate has been more favorable in the U.S. than in many other countries, the United States has enjoyed a net inflow of foreign-direct investment particularly in the last few years. These net inflows are recorded as surpluses in the U.S. financial account.

Given the rules of international accounting surpluses and the U.S. financial account inevitably produced deficits in the U.S. cur-

rent account, should U.S. current accounts be seen as a sign of relative strength in the U.S. economy compared to the many other economies in the rest of the world rather than a problem?

Dr. Lazear. Right now, our deficit in the current account is about $800 billion, but as you correctly point out, you don't get to enjoy consumption of these goods without having something else go on on the other side.

Foreign suppliers are not willing to simply give us their goods for free. And what they are doing is, they are giving us their goods because they find the United States perhaps the most attractive place in which to invest.

As a result, foreign investment in the United States has been very high. And we have benefited from that foreign investment in large part through growth not only in investment activity but in growth of our output and employment as well.

So part of the—part of the story, and we always like to point out at the Council of Economic Advisers that an important part of the story whenever we talk about current account deficits, is that that means that we are getting funds from abroad, and that is we get those funds from abroad because individuals abroad see this place, this country, as the most attractive environment to invest in.

Again, I would return to what I said earlier. I believe that is because of the fundamentals of the American economy. We have flexible labor markets. We have relatively low tax rates. We have a climate of entrepreneurship. All of those factors are favorable to economic growth and economic investment, and they have enabled not only American citizens but also foreigners to invest in ours and enjoy the gains from our productivity.

Chairman Saxton. Thank you.

Senator Reed.

Senator Reed. Thank you very much, Mr. Chairman.

Let us go to the issue which I think is important, this notion of revenues versus tax cuts. You have looked at the literature. But there is recent economic analysis by the Joint Committee on Taxation, the Congressional Budget Office and the Congressional Research Service, which all find that deficit-financed tax cuts reduce long-term economic growth because of the increase in governmental deficits and the resulting decline in national saving. There is something to be said, and it was true several years ago when we were running a huge surplus, which is a thing of the past, that tax cuts could have a stimulative effect, and they would not adversely affect the bottom line. But we are literally borrowing money to make tax cuts, and according to these reports, it will, in the long-term, affect our growth in a negative way. What is your comment?

Dr. Lazear. Well, I certainly agree with you that running long-term budget deficits is a problem, and I think the President shares that view. We don't want to see deficits persist for long periods of time. It is not only not good for economic growth, but it is not good for consumption. It is good for displacing other kinds of investments. There are many angles to it, and I don't think anybody favors having sizable budget deficits.

To my mind, the question is, what do we do about deficit situations? As you know, center deficits are caused by a number of different factors. The deficit that we face today to some extent at least

was caused by unanticipated events, wars, natural disasters, of which we have had our share. And those kinds of factors do contribute to a deficit situation.

The issue, when you are hit with factors like that, is, what is the optimal way to finance those expenditures over time? No one would argue that you want to finance the expenditures on hurricanes or wars out of current consumption to finance all of it out of current consumption. Almost any reasonable economist would argue that we have to smooth that financing over time.

The issue I think that we confront there is whether we are financing it at the appropriate level at the appropriate speed and whether we are doing it at appropriate—in an appropriate fashion.

That is a tough question, to be honest with you, because people will have different views on that politically.

My way of looking at this is to rely on market estimates, and what I mean by that is that when we run a very high deficit, if we are running a deficit that is too high and one that is too high for economic growth, we see two things happening. First, we crowd out business investments. In fact, that hasn't been happening in recent years. Business investment has been strong during the first quarter. Business investment is up about 13 percent.

The second thing that I would look at, and I think the thing that probably most economists would look at, is what has it done to interest rates? When we see that the Government is borrowing at very high rates, that tends to drive up interest rates because it means that the demand for funds is high for any given supply of funds available.

Again, we haven't seen higher interest rates. In fact, interest rates right now, even though they have gone up over the past couple of years, are quite low by historical standards.

So we are looking at a situation where long-term interest rates are down at about 5.1 percent. All of those factors seem to be consistent with the markets saying that we are probably doing a good job in financing our current expenditures.

Senator Reed. What has all of this done to the national saving rate, and how important it is to have a national saving rate that is positive?

Dr. Lazear. Again, I certainly agree with your pointing out that the national saving rate is low. In fact, it has been negative. Not just low. And that is a concern. I would like to see saving get much higher in the future. I think we need to save more for the future of our country.

I focused in my earlier statement on tax cuts. I think that is probably the best way to get at this. We can't make individuals save. The question I think that you are aiming at is whether Government saving or Government consumption is driving out—crowding out—private saving, and again, if that were the case, we would see the evidence in terms of higher interest rates.

So my view of this is that, if we look at the markets, if we look at financial markets, we are not seeing a lot of evidence that private savings has been crowded out by action by the Government.

That being said——

Senator Reed. We are not showing a lot of private savings.

Dr. Lazear. Certainly not seeing private saving. But I would say, we are not seeing private savings declining because of Government action.

If it were the case that the Government were crowding out investments, other kinds of activities, we would worry about that, and we would see that reflected in financial markets. We don't tend to see that.

The one thing that I think is a concern that you point out is that this issue of private saving and the private saving rate having been low is not one that is recent. It has been true for a long period of time, although I admit it is lower now than it has been in the past. But we are a very low-saving country, and the question is, why is that the case?

Now some people believe that part of that is a statistical artifact; in part, a reflection of the fact that we are not counting savings in the appropriate fashion. For example, if we took into account the very large capital gains that we see in the housing market and in the stock market, and we look at the change in individuals' wealth, most individuals would think, gee, I am saving a lot because I have a house now that I bought at $200,000 that is now worth $400,000. I have saved $200,000 during that period.

It doesn't show up in the difference between current income and current consumption, but most individuals would think of this as saving. And so that is another way to look at it, and many economists believe that is the appropriate way to look at it.

Senator Reed. You and the Administration have been talking about not only the rising tide but one that has been fairly shared. But when you point to the data, it is all aggregate data on productivity or average income rather than looking at median wages or median income to get a better picture of how the wealth is being shared.

And when you look at some of these median numbers, it looks as though many workers are being left behind even though productivity is growing, and that the distribution of the benefits is skewed to the upper income rather than lower income. Is that accurate?

Dr. Lazear. I would say that part of it is accurate. It has certainly been true that over the past 25 years, there has been an increased dispersion between the incomes of the top and the incomes of the bottom or even the median.

Most of the growth that has taken place in wages in the economy over the 25 years has been among those individuals who have had the highest level of skills. This is, I think, something that is fundamental to our economy, and in some sense, it is a good thing. And what I mean by it is a good thing is that it reflects high rates of return to investment in human capital. We like that part of it. It is a good thing. Some people invest in skills, and those skills have high payoffs.

What we don't like is the fact that some people in the society have been left behind and have not been able to invest in those skills and enjoy the benefits that are associated with these investments in level—in high levels of human capital. And that is an issue, and it is an issue that concerns me, and I believe it is an issue that concerns the President as well.

One of the first things that he did, as you know, when he came into office was to institute No Child Left Behind. That is a step to move in that direction. Obviously, it is not the entire solution to that problem. But my view is that the only way to solve the problem of bringing up the bottom is through higher investment and skills to those individuals. And by the way, I would argue that that is generally the consensus among labor economists. I recently did a call with a large number of labor economists, many of whom were members of the Clinton administration, and we have basically all come to the same conclusion, which is that the reason for increased inequality is not something that has to do with the policies of any particular administration, Democrat or Republican, but rather reflects a long-term trend in differences in human capital. So my view is that we need to address those differences, and I think that is a very—I think you have focused on a very important issue and one that is certainly close to my heart.

Senator Reed. I just want to make a final point, which is that the data suggest that if you look at median earnings and median family income, there is a great deal of stagnation, and it goes, I think, to the point you have made several times if there is not an incentive in your paycheck to upgrade your skills, then it won't happen. And what we are seeing for the vast majority of Americans is that this economy is not producing the kind of gains in their paychecks that we saw in the past and that we hope to see again. I think that is a huge problem.

Dr. Lazear. That is the part of your statement that I—that I don't fully subscribe to. Let me tell you why. While I think your facts are correct—I certainly don't dispute that—I would interpret it slightly differently. The person who is the median worker 5 years ago is not the median worker today. So if you look, for example, at the median worker in 1994, and you ask, where is that worker today—let us take the group of workers between 25 and 34, because they are going to be moving up the distribution the most, so this in one sense, one extreme, those individuals enjoyed a 52 percent wage growth from 1994 to 2004. So it is not that the median worker is being left behind. It is that, as the economy changes, in its composition in large part, bringing in new immigrants, the person who is the median worker is a different individual. That having been said, again, I don't dispute I think what is your basic point and your basic point is we need to provide opportunity for all individuals and for individuals at the bottom as well as for individuals at the top. And I certainly subscribe to that. So whether we differ on how to interpret median income or not, I think I would say, I am on the same page as you are on that.

Senator Reed. Thank you, Mr. Chairman.

Chairman Saxton. Thank you very much.

Senator Bennett.

Senator Bennett. Thank you, Mr. Chairman. And thank you Chairman Lazear for your being here and for the cogent way in which you are responding to some of these issues. Let us go a little farther down the road that Senator Reed started us on.

The productivity growth: You indicated productivity went up, and wages lagged. And then the job growth took off as we couldn't handle it with these more productive workers. But isn't it normal that

productivity growth, particularly following recession, will always lead wage growth and job growth? Isn't that a normal pattern that we have seen for a generation or more?

Dr. Lazear. Indeed, it is. It tends to be the case that when we have a turnaround in the economy, when we have a recession followed by an economic recovery productive period at first, and then employment fix-up later and then finally wages tend to pick up. The same thing was true by the way during the 1990s, so if we look at the recession that occurred in the early part of the 1990s and we ask, what happened, then in fact what happened was productivity took off, and it took a while for wages to catch up. In fact, some of my colleagues who served in my capacity and as members of the Council of Economic Advisers during President Clinton's administration were also concerned about some of these same issues, kept thinking if productivity is growing, why aren't wages growing, and then in the late 1990s, we saw wages did start to grow and grew at fairly strong paces.

If you look at the numbers for Q1 of 2006, we saw some very strong wage growth during that period. We saw wage growth of 5.3 percent, and I am talking about hourly wages. The picture is even better I would say for wages if we take into account not just wages but total compensation.

Senator Bennett. That was going to be my next question.

Go ahead. Let us talk about the entire compensation package and not just what shows up on the W2 form.

Dr. Lazear. One of the things that has happened over the past 5 years is that, while hourly wages have gone up but not gone up by as much as we might have hoped, compensation has increased at about double the rate of hourly wage growth; in fact, by some measures, more than that.

So we are looking at compensation that was up by about 2 percent since 2001.

Much of that reflects compensation that takes the form of benefits. Some of it is health benefits. Health benefits are good when they improve the health of our workers. We don't view that as a bad thing. If workers take some of their compensation in the form of more health insurance, we would like to see that occur.

So that is not a bad thing. And we do expect that those trends will tend to—tend to slow down a bit in the future as health costs tend to get under control, and we hope they will get under control.

But we also would expect then that at the same time wages will increase to make up for some of these differences in increases in benefits.

Senator Bennett. Having been an employer, I know that, when you look in terms of your labor costs, you don't look at the W2 number. You have to figure in all of the other costs connected with the job, so that your employee has to return value to the firm sufficient to cover the entire package of compensation rather than just the amount that shows up in the wages. So I have had the feeling that some of the rhetoric around this issue has focused entirely on the W2 and not recognized that the entire package which the employer has to pay has in fact gone up rather substantially.

Taking the entire package—I think this is what I heard you say, but I want to just emphasize it and nail it down—taking the entire

package, the amount that an employer has to pay for labor or the flip side of it, the amount of benefit that the employee gets, has in fact been going up fairly substantially—in the period since the recovery. Now, is that a fair summary of where you are?

Dr. Lazear. It is a fair summary. Obviously, we always—we would prefer more growth to less growth. It certainly is the case that if we take compensation into account, compensation has grown at a much more rapid rate than hourly earnings. So as we move into the future, my expectation is that compensation, total compensation, which as you point out is what is relevant from an employer's point of view, is the cost side, it is also relevant from an employees' point of view, because when we take wages, wages are only one component of earnings. Pension benefits, vacation benefits, health benefits, which are the major components of compensation that don't show up in wages, are also important parts of an individual's well-being, and we want to make sure that those continue to grow as well. So I agree with you. I think we have to take the entire package into account.

Senator Bennett. There was a time in my career when pension benefits struck me as being completely worthless. The older I get, the more valuable they become. Thank you.

Dr. Lazear. Thank you, sir.

Chairman Saxton. Thank you, Senator Bennett.

Mrs. Maloney.

Representative Maloney. Thank you and welcome.

You testified that the deficit relative to the GDP is 3.6 percent this year.

Dr. Lazear. Deficit relative to GDP, you are talking about for 2005 I think.

Representative Maloney. Yes.

Senator Bennett. I would think it is 2.6.

Dr. Lazear. I think that is right. I want to check the number just to make sure. Why don't you continue, and I can listen to you while I am checking?

Representative Maloney. My question really pertains to long-term sustainability of economic growth with the deficit. Most economists believe that, 5 to 10 years out, the deficit will grow definitely, entitlements are going to grow and now, how can we sustain this with the revenue loss from the tax cuts and the growth and entitlements and the growth in the deficit? You have a structural problem that has long range challenges for the country.

So how do you propose to sustain economic growth with the structural deficit and expenses that are now part of our system?

Dr. Lazear. Well, I think that you——

Chairman Saxton. If I can interrupt. My sharp staff behind me here has given me this the actual percentage of GDP. GDP that the deficit represents is actually 2.6 percent.

Dr. Lazear. It sounded off. I think the 3.6 number that I cited was the projected growth for next year for GDP, but anyway, we have got our numbers straight, and I certainly understand.

Representative Maloney. The point is not the 2.6 now, which is not a problem. The problem is the sustainability of—with the structure of deficit, lost revenue and entitlements and built-in

spending with Social Security, with the baby boomers and the challenge that we face there.

Dr. Lazear. I agree with you, and in fact, I would say I would paint an even bleaker picture than you pointed out if we don't get things under control because we estimate that if we go forward into 2030 on the level of benefits projected right now and entitlements projected right now, we will have about 60 percent of our GDP devoted to the Federal budget, and that is clearly not sustainable, nor would any country tolerate levels of taxation that would support 60 percent of GDP going to that part of society.

Representative Maloney. And another challenge is wages not growing for most workers. So where will spending come from if wages are not growing? Where is the boost for the economy?

Dr. Lazear. I would disagree with your point that wages are not growing. Again, I would go back to the numbers that I just cited for Senator Reed which is that, if you look at the typical worker——

Representative Maloney. We are talking about money put into the economy from their wages. Their wages, their take-home pay is not growing. Maybe they have more vacation time, but their take-home pay is not growing.

Dr. Lazear. I even mean take-home pay. Let me go back to the number that I cited before. If we look at the median worker between 25 and 34 years old in 1994, we compare with that worker 10 years later. We ask, by how much did that typical worker's wages grow? It is 52 percent. So although the median is not growing, that doesn't mean that typical workers' wages are not growing. So those individuals do see wage increases over their careers.

Now, I thought——

Representative Maloney. Many people, many Americans feel with the high cost of gas and with the high cost of housing—and the housing market is cooling—that their wages are not growing. I just want to ask one question. You were talking earlier about the deficit, and you talked about 9/11 and Hurricane Katrina and the war. Hopefully the war will be over soon. The President announced he is withdrawing troops. I hope he will. But you talked about 9/11 and Katrina for the budget deficit. And I would say that 9/11 and Katrina are a very small, a little of the deficit compared to revenue and other items and with the large revenue that is lost from the tax cuts, and I would like to ask you just, at a basic level, do you agree that tax cuts cause a drop in the Federal revenue?

Dr. Lazear. There is no doubt in any mind the tax cuts cause a drop in the Federal revenue initially. That is certainly true. What tax cuts are able to do, though, is to help grow the economy. Now——

Representative Maloney. I would agree that some tax cuts help grow the economy. But when you have deep structural tax cuts that take out a large amount of revenue for the Government, you have a structural problem. Alan Greenspan testified before us in the seat that you are sitting in, it is very rare and very few economists believe that you can cut taxes and you will get the same amount of revenues, and he says it is very—you will get some back, but it is very small, and it is not a large part of the economy. So what I am basically concerned about is the sustainability of our

economic growth with the large deficits, the trade deficits, the growing built-in challenges with Social Security for aging baby boomers and so forth, and a major revenue source cut out of the budget. And I would add that everybody talks about the earmarks, but the Republican majority has really hurt the budget with removing the caps and not continuing the program of pay-as-you-go, the Democrats——

Chairman Saxton. The gentlelady's time has expired.

Representative Maloney. May I get his answer?

Chairman Saxton. You can get his answer, but we have to stop the question.

Representative Maloney. On PAYGO, it is a program where you do not spend money that you do not have, and that program has been removed, and that has also added to the——

Chairman Saxton. The gentlelady's time has expired.

The Chairman would like you to answer the gentlelady's question, please.

Dr. Lazear. I certainly agree with Chairman Greenspan's earlier statement that tax cuts result in an initial decline in revenue. The issue I think that you are addressing is what happens over time. And you made the point that——

Representative Maloney. His statement was over time. Over time.

Dr. Lazear. I was going to address that. Bear with me. I will get to you. I will get to it.

And I certainly would not claim that tax cuts pay for themselves nor do I think that is necessary. My view of tax cuts is not to cut taxes so that they pay for themselves but rather to cut taxes so that the economy grows and so that it has fewer distortions in it. I am more concerned about economic growth in the private sector than I am about the size of the public sector. I would rather not see the public sector grow. I would rather see a more controlled public sector, but my focus is on, as an economist, is on making sure that we create the kinds of economic conditions that are favorable to economic growth in the private sector.

In terms of sustainability, again, I certainly agree with you. I think that it is extremely important to make sure that we deal with deficits and that we deal with the expenditure side as well as the tax side. I am concerned that, as we project forward, we have not done a good job in thinking about expenditures. I actually think the President would also agree with you; he is concerned about entitlements, Social Security, Medicare, Medicaid and the programs that are going to eat up a very large part of our budget into the future.

So I don't think we have much of a disagreement there.

The one point where I would perhaps want to take a slight issue with something that you said is that the tax cuts have not been helpful or will not be helpful in the long run. In looking at the economy, and there, I say, numbers speak louder than words. If we look at the history since 2003, it is very difficult to argue with the evidence that we see there, that the growth in the economy has been very strong; the growth in the labor market has been very strong; growth in investment has been very strong. So I think we have a slight difference of opinion there.

Chairman Saxton. Thank you very much.

The gentlelady's time has expired.

Mr. Brady, it is your time, sir.

Representative Brady. Thank you, Mr. Chairman.

What was the increase in Federal revenues last year. Do you recall?

Dr. Lazear. The increase in Federal revenues, I believe, was 9 percent, was the number. Yes, I believe it is 9 percent.

Representative Brady. This year it is projected to be double digit?

Dr. Lazear. 13 percent.

Representative Brady. So just following up that point, the tax relief that helps spur the economy to create 2 million jobs every year has actually resulted in close to a 10 percent increase in Federal revenues last year, and a projected 13 percent increase this year.

Dr. Lazear. Well, revenues are certainly up. I guess the way I would like to put the point is that I view the tax cuts as having helped increase the rate of growth in the economy.

I also view a growing economy as consistent with generating more Federal revenues. So the additional Federal revenues that we see are attributable in large part to the growth of the economy, some of which I think can be attributed to the tax cuts that were initiated primarily in 2003. I would say those are the ones that were most important in stimulating economic growth.

Representative Brady. I think at the time, I know with the triple hit of the 9/11 attacks, which cost almost 2 million jobs, the recession that we were in and then the collapse of the dot-coms, at that point, we were at a critical point in the economy and needed to boost spending in a number of areas. I think the tax relief helped produce, as you pointed out, the Federal revenues that we are receiving today.

You pointed out a key issue on the trade balance, that our account deficit is really related not to just what we buy and what we sell but how much we consume, what type of investments we are seeing as a Nation compared to the rest of the world.

One of the keys in our trade balance is related to both our consuming as a Nation and selling our exports as a Nation.

Representative Brady. One of the keys is finding, not only new markets for American business services which our free trade agreements are producing, but also spurring more consumption by other nations. As you look at the world from China to Europe to Africa to Central America, to South America, do you forecast increased consumption and stronger economies outside the United States? What impact could that have on our economic growth?

Dr. Lazear. Yes. That is a very important point in that when we will look forward, and we think about where we are, we have to remember that we are only 5 percent of the world's population, and of course, since we have a very large and very rich economy relative to the rest of the world, we are much greater right now in terms of our economic importance.

But as we look forward, that situation is going to change. If you have countries like China and India growing at very rapid rates and they account for over, well over a couple billion people, we

know that they are going to be an important component in the entire picture. And we have to make sure that we have access to their markets and that we are able to trade with them.

Fortunately, the rest of the world actually is doing quite well right now. Not only are the developing countries like China and India growing at very rapid paces, but Europe is now fighting its way back, Japan, after having a very troubled decade, is doing recently well with growth rates around 3 percent right now.

All of those factors contribute to a situation that will help our economy as we trade and export and also import from those individuals and from those countries as well. So I think the picture looks quite good, and actually looks better than it did a few years ago in large part because the world is a healthier place than it was.

Representative Brady. So from your perspective does America isolating ourselves from the global market increase our economic growth, or does our engagement in the global market, especially in prying open new markets, encourage our economic growth?

Dr. Lazear. I think there is little doubt about this, and this is one you often you hear economists saying on the one hand, on the other hand. This is one in which there is no other hand. Virtually, the entire economics community believes that trade is beneficial to an economy.

And increased trade improves economic growth.

So we are very much in favor of making sure that we maintain openness in terms of trade, the Doha round, which is currently being negotiated, is one that we are hopeful will conclude in some positive achievements, the bilateral agreements we have been engaging in over the past few years, I think, have been helpful in opening up the world. We are a very productive nation. We are actually a low unit cost nation. So despite the fact that our wages are high relative to the rest of the world, we are not a high cost country because we are so productive. So our costs are actually relatively low as compared with those countries with whom we trade.

All of those developments mean we can compete and we can compete successfully when we have openness to other markets. And we are certainly pushing in that direction. And we believe that is a very important component of growth as we look forward to the 21st century.

Chairman Saxton. Thank you, Mr. Brady. The gentleman from New York, Mr. Hinchey.

Representative Hinchey. Good morning, Mr. Chairman, and welcome. As you pointed out in your testimony, we have seen significant amounts of productivity growth and substantial increases in the profitability of corporations, the corporations' bottom lines, as well as in the pay of corporate executives, which has reached extraordinarily high levels, record levels. We have even seen some growth in the economy but the growth in the economy itself has been rather modest, 2.6 percent or so, which is really odd in the face of the fact that we have experienced record amounts of economic stimulation.

We have had record low interest rates, which have been the primary reason why the housing bubble sustained the economy and prevented us from going into a deep recession. And we have seen

huge amounts of public spending which have created very, very large debts.

And given the fact that the interest rates are now going up, how much longer do you think that we can sustain even the productivity growth and the corporate profits, let alone the modest amount of economic growth that we have experienced?

Dr. Lazear. Rising interest rates have certainly had an effect on various sectors. You pointed out housing in your question, and I think that housing is one of the areas in which we have seen the most significant change. The picture in the housing market is a little bit uncertain. And what I mean by uncertain is that when we look at these numbers—and I look at these numbers almost daily—we see some numbers declining, for example, housing starts have declined by 13 percent since the beginning of the year. But then, we were surprised yesterday by the number that showed that new home sales were up by 4.6 percent last month.

So we have things moving in different directions there, and it looks like the housing market is slowing, I would say, and slowing a bit, but not slowing by as much as we had perhaps anticipated or even feared.

The other side to that, sir, that I would point out is that while the housing market has declined, so we are talking about residential construction declining, we are seeing a lot of strength in commercial real estate. And so what we have lost in housing real estate we are seeing picked up in commercial.

The other component of the economy that has been very strong is business fixed investment which has also picked up. So that, coupled with growth in exports, indicates to me that what we saw initially as being focused on consumption and housing and I think that was your concern you were worried about sort of the fragility in some sense of that those sectors——

Representative Hinchey. My concern is sustaining what little economic growth we have actually experienced in the face of the fact that interest rates are going up, somewhat, the housing market is closing down, and you are facing a growing disparity in income among people in the economy.

Most of the benefits, the economic benefits, have flown to people in the upper income brackets. But if you look at, for example, the effect on the income of the median American family, when you adjust that for inflation, their income has dropped off by more than $1,600 over the course of the last 5 years. As a result of that, we are beginning to see a decline in demand, and this is essentially a demand-based economy.

If you don't have demand, it doesn't matter how much supply you have. In fact, if you have too much supply and lessening demand, you are going to be facing a situation of deflation, which some people have raised as a potential problem for the future, and I would be interested to hear what you have to say about that.

But the fact is that what we have—all of these allegations, the so-called economic growth and prosperity and rosy pictures that have been painted—are not reflected in the experiences of the average American family.

The income of the average American family is declining. The number of people without health insurance is now up over 45 mil-

lion, and the number of people in poverty in the last 5 years has gone up by 4.5 million people.

So we are seeing people at the lower income level and the middle income level being seriously economically depressed, while everyone in the Administration is painting a very rosy picture about the economy.

It doesn't make any sense to me.

Dr. Lazear. You have covered a lot of territory in your question. Let me see if I can address a few of your points.

The first one that you made and you have made it twice now was that there was little economic growth, and I guess I don't share that view.

Representative Hinchey. It is 2.6 percent average.

Dr. Lazear. Let me read to you the numbers, specifically real GDP growth was 4 percent in 2003, 3.8 percent in 2004, 3.2 percent in 2005, 5.3 percent of in Q1 of 2006. I don't know where you got 2.6 percent out of that, maybe you are looking at a different period.

Representative Hinchey. The Bureau of Labor Statistics has provided that.

Dr. Lazear. We look at these numbers, and I am quite confident of these numbers, so I would stand by my numbers. I believe my numbers on this.

The growth rate in the economy has been very high. I don't think there is any dispute about that.

The issue I thought that you were coming to in the second half of your question was one that I did address earlier, it was this issue of wage growth and how the average individual was enjoying the gains in the society.

And as I pointed out, I do believe that we have seen growth in compensation, which it was greater than the growth in wages, albeit, perhaps not what we would like, we would like to see higher growth in wages, I agree with you on that. I certainly would like to see higher growth in wages. I believe it is coming again.

If I cite the Q1 figures, we did see very strong wage growth in Q1, and we hope it will continue. These tend to reflect lags that one sees after a turnaround in the economy.

Whether we will be right, whether the over-95 percent wage growth that we saw in Q1 will be sustained into the future, we don't know. But we certainly hope that it will be. And I would join you in cheering those efforts. But I think that what we have done and what we believe is that a growing economy and growing productivity is the best way to make sure that there is wage growth. If you look at this over the long run and it is not even a very long run, there is almost a 1-to-1 relation between wage growth and productivity growth. So for every 1 percent you get in productive growth you get in wages.

During some periods you will see a lag, as I pointed out in the mid-1990s, we saw a lag, and in the early 2000s, we saw a lag as well. But we do seem to see somewhat of a catch up right now and I hope it will continue.

Chairman Saxton. I thank the gentleman. On housing, it seems to me that the low rates of interest that we saw in the past years created a great incentive on the demand side. The housing sector

benefited greatly during those periods of time, but to the point where we saw an increase in prices that made it somewhat difficult for the average guy on the street to afford housing. Can you just comment on that and see, where do you see that going?

Dr. Lazear. Well, last year, we have seen increase in housing prices in the range of 14 percent. And housing price increases at that level, I do not believe are sustainable into the distant future.

In fact, if I felt that there was certainty that housing prices would increase at 14 percent, I think that is all I would be investing in right now. I think all of us would do that. We wouldn't need to worry about anything else.

So I think that seeing rates of growth at that level are first, not sustainable, and second, as you point out, not even necessarily desirable, because what that does is it changes the prices of housing so that the persons in older age groups are receiving capital gains relative to those in younger age groups, those outside the housing market who have to buy into the housing market suffer some capital losses as a result of that and it is not clear to me at all that that is a healthy development for the economy.

So some leveling off of housing prices that we might be seeing this year, at least to my mind, does not signal any kind of disaster scenario. In fact, it is probably a move in the direction of a more sustainable path.

Chairman Saxton. Thank you.

Senator Sarbanes.

Senator Sarbanes. Mr. Lazear, as you are well aware, the way it works here you have a certain amount of time when you are recognized to ask questions and get your answers. Now if you give long answers, we don't get to ask many questions.

In fact, if you give a long enough answer, you can get one question and then, dance off the stage and then of course, Chairman Saxton will gavel me down as I try to put another question to you, frustrated by encountering these long answers.

So I will try to give relatively short questions and hopefully get relatively short answers and maybe we can move along here, and then I won't come into conflict with the chairman, as I try to put yet another question to you.

An article in last Sunday's New York Times illustrated what has been happening in income distribution over the last 25 to 30 years.

[The New York Times chart, entitled, "The Rich Get Richer, Again," appears in the Submissions for the Record on page 61.]

Now what it shows is that the distribution of income has become about as unequal as it was in the 1920s. We had incredible growth in the post-World War II period for better than a quarter of a century. But we have seen in recent years this concentration with respect to the share of income, so that the top one-tenth of 1 percent is now getting 7 percent, and the top 1 percent gets 16 percent, and the top 10 percent get 43 percent.

Does this trend concern you? I don't need a long answer. If it concerns you, I would like to know, if it doesn't concern you, say so.

Dr. Lazear. It does concern me.

Senator Sarbanes. Now, traditionally economists have called our income tax system progressive because taxes rise as per share

of income, the higher up you go in the income scale and that, of course, narrows the difference in after-tax income compared to before-tax income.

But do you agree with that observation as a general proposition?

Dr. Lazear. It depends on the actual tax structure. Sometimes a tax structure can be made more progressive sometimes less progressive. You would have to be a bit more specific.

Senator Sarbanes. I do indeed want to be specific. In your op-ed piece in The Wall Street Journal on May 8th, you said, and I am now quoting you, the President's tax cuts have made the Tax Code more progressive, which also narrows the difference in take home earnings.

[The Wall Street Journal editorial, entitled, "America at Work," appears in the Submissions for the Record on page 58.]

Now the Tax Policy Center, which, of course, has economists across the political spectrum, has found just the opposite, that the net effect of the tax changes since 2001, has been to raise the after-tax income of the top 1 percent of the population by 5 percent, and raise the income of the bottom 60 percent of the population by only 2 percent.

And that is illustrated in this chart, this is, the effects on after-tax income of the tax cuts. And it shows the top 1 percent up 5 percent, the bottom 60 percent, in other words, more than half the population, three-fifths of it, up 2 percent.

[The bar chart, entitled, "Effects on After-Tax Income of Tax Cuts Passed Since 2001," appears in the Submissions for the Record on page 60.]

What is your evidence for the statement in The Wall Street Journal that tax changes since 2001 have narrow differences in after-tax income?

Dr. Lazear. I am going to have to give you a slightly longer answer, but I will try to keep it short so you get to ask another question. I will speak quickly. When we look at the tax cuts, first, I want to point out that there have been a variety of changes in the Tax Code, some of which move in the direction of progressivity, some of which move in the opposite direction. Remember that associated with the tax cuts during this Administration have been reductions in tax rates from 15 to 10 percent, increase in child care credits, reduction in marriage penalties and some changes in the EITC as well. Those tend to work in the direction of progressivity.

On the opposite side of that we have seen changes in the capital gains tax which tend to work against progressivity.

So the issue is really an empirical question. I don't think one can answer that ex ante.

Senator Sarbanes. This is empirical evidence that the Policy Center has done——

Dr. Lazear. And I saw your numbers. I have looked at those numbers carefully, and I have also investigated this quite thoroughly. We believe that the tax cuts that the President instituted were progressive in the following sense. If we look at those tax cuts estimated for 2006, take those right now, and ask, what would the effect of those tax cuts be on individuals in, say, the lowest 50 percent of the income distribution, we estimate that with the tax cuts,

they pay 15 percent fewer, lower taxes than they would without the tax cuts.

Additionally, if we look at the proportion of individuals who pay no taxes at all, before the tax cuts individuals who earn $32,000 paid no taxes. After the tax cuts individuals who pay, I am sorry, who earn less than $42,000, pay no taxes. So to my mind that is a move in the direction of progressivity.

Senator Sarbanes. I am not challenging that some of the tax cuts contributed to progressivity.

But if you put them all together and look at the estimates that the Tax Policy Center has made, I think these are rather spectacular findings here. In any event, Mr. Chairman, I think my time is up, as I understand it.

Chairman Saxton. Yeah it was up about a minute ago.

Senator Sarbanes. Let me ask this final question, Chairman Lazear.

I am always interested in the struggle to maintain professionalism of people who come into say the Council of Economic Advisers or other positions from private life, and then they are confronted with the political demands to, in effect, be spokesman for an administration policy. It happens in all administrations, an administration policy which is often arrived at largely on political grounds.

And I am just curious. Are you encountering that struggle now as chairman of the CEA?

Dr. Lazear. No, sir, I am not.

Senator Sarbanes. All right. That is all I want to know.

Chairman Saxton. Thank you. Before we go to the gentlelady let me ask this question as a follow-up to Senator Sarbanes' question, which I thought was a good one. When we look at the percentage of taxpayers, Senator Sarbanes talked about the top 1 percent and the bottom 60 percent. I would like to talk about the top 1 percent and the bottom 50 percent. My numbers are that the top 1 percent of the wage earners in this country pay 34 percent of the taxes, while the bottom 50 percent of the wage earners pay just 3.5 percent of personal income taxes.

And I am wondering how you could give the same percentage of tax cuts to the bottom 50 percent, given the fact that they pay just 3.5 percent of the taxes, as you would the top 1 percent? It would be a difficult chore, it would seem to me.

Dr. Lazear. Indeed it would. And that is why the numbers that were cited earlier are not compelling in my mind. It is virtually impossible to think about tax cuts that would win by that particular standard.

The reason is this: If you think about people at the bottom who are paying a small proportion of the total taxes, suppose you eliminated all of their taxes and you change the taxes for the very top individuals by 1 percent. Well, obviously, if those are the individuals who are paying all the taxes in absolute terms, they are going to get a bigger tax cut. On the other hand, most people would believe that eliminating entire, the entire amount of taxes for individuals at the bottom, and a small fraction of taxes at the top would be a move toward progressivity, but it would fail on that test. It would succeed on other tests. That is why these questions become

somewhat more difficult, somewhat more complicated, and do require a bit of, what I would say, more study before jumping to particular conclusions and that was what we were trying to point out with the numbers that we gave, and I think your numbers reinforce that point.

Senator Sarbanes. Are you asserting that the percentage cuts given to the bottom 60 percent were equal to the percentage cuts given to the top 1 percent?

Dr. Lazear. No, the percentage cuts, I am sorry, sir, the percentage cuts given to the bottom, when we look at the overall picture, just talking, again, about your—the statistic that you used, which is take all of the tax cuts combined, capital gains, dividend tax cuts, take the EITC, add those all up and then ask what proportion of the tax burden is borne by low income individuals versus high income individuals, low income individuals——

Senator Sarbanes. It wasn't a percent of the tax burden, it was after-tax income——

Chairman Saxton. I would like to thank the gentleman for his——

Senator Sarbanes. [Continuing.] inequality.

Chairman Saxton. I would like to thank you for your input. We are about 8 minutes past your time so, Ms. Sanchez, the floor is yours.

Senator Sarbanes. I was prompted to ask since you asked a question——

Chairman Saxton. Thank you.

Senator Sarbanes. I thought we ought to keep the record straight. It is important to do that.

Representative Sanchez. Thank you, Mr. Chairman. And Mr. Chairman, thank you for being before us today. I have a couple of questions that I have been following in the last year, since I have been on this Committee, one with respect to housing and one with respect to why hasn't Wall Street slapped Washington for the deficit spending that is going on, and their inability to—our ability to structure ourselves into what I think is a big hole coming out of Wall Street, and I am incredibly interested in why the markets haven't sent a message to us yet.

In talking to Chairman Greenspan, I think it was the last question that was asked before he left, by me and the Congress, one of the reasons that he gave us was, you know I asked him, why hasn't Wall Street gone after us on this?

And he suggested that one of the reasons, one of the major reasons was that productivity at the high end had increased, even though the cost for productivity had not, that the influx of people from the former Soviet Union, and India and China, high end engineering, mathematics, et cetera, that we were now using was depressing the wages or keeping the wages down at the high end of these type of people.

I have noted that high—that the graduating class out in universities in the United States actually is in high demand, and the salaries are going up this year for the first time in a long time of people coming out of there, given that less than 20 percent of the people in the United States carry at least a BA, I am thinking of them as a higher productivity class, if you will.

So my question to you is, does it, I was talking to a colleague last night, and she told me that her daughter, who is a second-year law student is making more per week than we do as lawmakers per week. So, obviously, salaries are going up for people who are getting the education out there.

Does this trouble you, given that Chairman Greenspan said this is all about to collapse on us, and he viewed that increases in this level of people were going to begin and bring down the productivity of the United States? Does this concern you?

Dr. Lazear. No, I actually view it as a positive development that the return to investment in education is high.

What does concern me, though, again, is that I would, I think we need to focus on making sure that all Americans enjoy the ability, the opportunity to take advantage of these high returns. It is a good thing when our productivity is high, when our investment in skills pay off, when our investment in any kind of capital, physical or human, pay off. And that trend, by the way, has been going on for a long period of time. So I don't view it has particularly problematic. I don't see any robustness issue there which I think is what you were getting at in your question, is this going to collapse? There doesn't seem to be any tendency at all at least in the historic data to suggest that it will.

Representative Sanchez. So you believe that if increases in the higher end, the high productivity that Chairman Greenspan at least had alluded to, that the increase in wages which if nothing else comes out, drops down the productivity, that this will not be a problem and the capital market will not see this as a problem for the United States, inflation in other words at the higher end? Again, we are talking about the top 10 percent here getting higher wages where the lower end is stuck, we can't even get a minimum wage through the Congress in over 9 years.

Dr. Lazear. I believe it actually works the other way, that it is not so much that wages will cause productivity to collapse, but rather wages are a reflection of productivity. So in large part, the reason that our individuals are wage earners at the top of the distribution, top of the skill distribution, are doing so well is because their productivity is very high, they are contributing a lot to the economy.

Representative Sanchez. Thank you, I want to get to my second question. I will add that unfortunately, this President and this Congress in raising the cost of the interest cost to student loans and in cutting moneys really to education are really not investing in education, as the rest of us would like to see, given your comment about productivity.

Back to this housing issue, you know, I talked to Greenspan and also, of course, to the new chairman of the Fed now, when he was in your position before, and coming from California and having seen the type of market that we have had, my question is to the issue of interest rates increasing, and probably for the foreseeable future, seeing them go up even more and the fact that in order for people to get into homes, they took out ARMs and, you know, quite frankly things that as an investment banker that, I just, scream about, 50-year, I think the No. 1 loan out there in California right now is a 40-year, 1 percent negative amortization loan or 50-year

loan, with 0 percent, I mean just things are incredibly crazy, I think. With this slowdown, and I know that you talked yesterday about the housing sales and the new housing sales having gone up but even developers, I watch this all day long, are very interested in this issue because Orange County is developer haven, that is what we export to the rest of the world is new development in particular.

Even all of the heads of Lennar and other companies said this surprised them, and they also said that cancellations are not noted in these housing sales. And then they said that their cancellation rates are about 30 percent right now. In other words, the new housing, that this home sales that supposedly went up yesterday, you could begin to discount by at least 30 percent, because it said their cancellation rates were hitting that high at this point in this quarter. So they said, it is definitely slowing down. Almost every major developer said this yesterday.

So my question to you is, are you worried? And what should Congress do, as a policy to these ARMs that are coming due, a quarter of them due in this next year across the Nation, people not having equity, because as we have seen the new housing starts and the lack of sales are actually beginning to show, and the developers are admitting to, will push down, I believe, even further the sales of existing homes.

Are you worried about these nontraditional or nonconservative financing methods, and what they are going to do with respect to foreclosure and lack of equity? And what do you really see? Are you tracking this? And what do you think the impact will be to the overall economy nationally, and what do you think, what do you, I think, Congress can or should do about anticipating this?

Dr. Lazear. Thank you. Again you, too, have touched a large number of areas. Let me try to answer in a comprehensive fashion.

Specifically, let me talk about the ARMs that you refer to.

In fact, we do watch these, and it is a concern for us as well as for you.

What one worries about, of course, is that as interest rates go up, one is concerned that individuals then have higher household payments. At the same time, if they can't make those payments, increases in interest rates could involve capital losses in their housing prices, and then they could be in trouble, and I think that is the concern that you have.

We looked at that actually very carefully, because we too were concerned about that.

What we are finding is at least to this point, there is no evidence of that happening, in fact, net household worth is up and bankruptcy rates have been down and down considerably. One of the good pieces of news in our economy among many but one of the ones that we focused on in the household level is that bankruptcy rates are running at about less than half of where they were in the late 1990s. So part of that, you asked what Congress could do is, I think, part of that is I think a result of some of the action you took about a year ago to reform some of the bankruptcy laws, but what we are seeing is real declines in bankruptcies right now.

And, again, I think that reflects increases in net worth, in large part coming not only from the housing market, which, by the way,

is still going up, it is still not—it hasn't declined. It is still going positive, but also from equity markets as well.

So it is a concern. It is one that we monitor. It is one that we continue to look at, and we will continue to look at it, I think you know I am also a Californian, although from the north, but I share your views. I have seen markets like this have booms and busts and it is one that we are on to.

Representative Sanchez. Let me just end, Mr. Chairman, if you will, by saying that, you know, as somebody who also invests in the stock market, I would say that the equity markets, at least from my statements, and I follow straightforward market investment portfolio, not individual stocks, has declined over a thousand points as I recall it has had a little bit of a rally in the last few days, so equities have actually come down, I believe, over the span of this year. And my realtors, who were in from Orange County, said that definitely there is a slowdown, pricing houses, may be a little up or at the same level, but the number of homes up for sale the length of the homes up for sale and people actually taking their homes off for sale, because they can't find buyers is continuing to increase, and the fact that 25 percent of the ARMs or, you know, people are going to have to redo their loans this coming year, I think is a real vital should be a vital concern to many of us, especially those who have seen heavy movements in the markets or robust economy because of housing sales.

Representative Brady. [Presiding.] Thank you. Gentleman from Texas, Mr. Paul.

Representative Paul. Thank you very much, Mr. Chairman. Good morning. I have a question dealing with inflation. I see on page 3 you talk a little bit about inflation, expressing a little bit of concern, but I don't think a whole lot.

And yet, the Fed seems to be a lot more concerned about inflation right now.

Even this week, there is the anticipation that they have so much concern that some in the market believe that the interest rates might even be raised a half a point rather than just a quarter point. So they evidently are very fearful and that is generally what the whole talk is in the financial community. But I am a little bit bewildered by the way we handle inflation.

Generally speaking, Treasury, or the Fed, or the Council of Economic Advisers, in talking about inflation, they never talk about the depreciation of money. They always talk about some external force that causes prices to go up. For instance, you suggest a significant increase in the price of gasoline and oil prices will push up inflation, of course, some of us see that as a consequence of inflation. There was a famous economist once who taught that inflation was always a monetary phenomenon. And yet we essentially never talk about it.

So here there is, this concedes there is a concern about inflation, and typically, and this has been the way it has been for decades now, and I think this is the Keynesian influence in our system.

And therefore, they make the assumption that prices go up because there are too much of a healthy economy and we have to turn the economy off, because the economy is booming too much.

So what do they do? They suggest we raise interest rates to turn off the growth. Of course, raising interest rates has a price effect too. That can be so-called inflationary as far as pushing up prices.

And besides, it challenges the whole notion that if you have a free market and it is productive and going well, productivity is the best thing in the world to drive prices down. So we have, you know, one section of the market is rather unfettered, it is in the area of TVs and computers. And you don't have an inflation, price inflation there, prices keep going down. And so here we are, we refuse to think about it as a monetary phenomenon, then we get too much growth and we say too much growth is bad. We have to turn the growth off to crash the prices or bring the prices down. And at the same time, not recognize the fact that it is the depreciation of money that really counts.

And I am just wondering whether you have an opinion of this, why is there this almost refusal to deal with the depression of money because if that is, if the economists are correct that point all the blame at monetary depreciation and we refuse to deal with it, we can forget about a healthy economy and your job becomes much worse. How can you adjust for it? How can an economic adviser give advice to cause a healthy economy if the basic flaw is in monetary policy?

Dr. Lazear. Thank you.

Well, I would say first just commenting on your sort of general theme of your question, which is that I seem to show less concern about inflation than the Fed does, at least in public statements. I guess I would say that I am, part of that is because I have confidence in the Fed.

So I don't have to worry about inflation because Ben and his partners are doing that right now for us. And I think we will do a good job and we will be successful in controlling it.

But my views are not based on personal knowledge of the Fed or its board, but rather on the market. I think if we look at the market indicators, the market also seems to believe inflation is under control or will be under control.

For example, if you look at things like our forecast or look at the Tip spread, which is an estimate of what the market believes about inflation, Bloomberg estimates, all of these are in the same range, they are all about 2½ percent going forward.

So those numbers obviously take into account Fed policy. But I think that the economy and the forecasters are all pretty much singing the same song. I think the most important point you made is one I would strongly agree with, and that is the best way to control inflation—and what we are talking about in terms of inflation is increases in real prices, prices of goods going up relative to our earning power. That is what we really worry about.

And you mentioned that the best way to control that is through increases in productivity. And I certainly subscribe to that philosophy as well. I think that the most effective control against inflation, the most effective guard is to make sure productivity stays high. We have done that in the past few years, productivity growth has been very strong. And I see it continuing into the near future.

As a result, we have not experienced very high levels of inflation, even with gas prices going up and maybe we don't want to call it

inflation, because as you point out, most of us think of inflation as a monetary phenomenon, at least where I went to school, that is how we think of it, but still the fact that prices are going up is a concern obviously to consumers.

They haven't gone up very much, except for gasoline and oil prices, prices have not gone up very much, quarter prices have been contained, and I think, in large part, because of the productivity gains to which you alluded.

Representative Paul. May I have one quick follow-up? If this is true, raising interest rates may well diminish the product for productivity increase, wouldn't this be true?

Dr. Lazear. When interest rates are raised, it does have an effect on the economy. As Ms. Sanchez pointed out earlier, we are already seeing this in the housing market, there is no doubt the housing market has slowed at least relative to its past. The question that one has to address is whether we are willing to tolerate some slowing in the economy in order to keep what would be viewed as a monetary reason for inflation under control. We have full confidence that the Fed is looking at those issues and making the appropriate tradeoffs in doing that. As I said, I have confidence in them in large part, because I know the individuals involved. They are very sensible and very thoughtful people. They have all the data available to them that I have available to me. And I think they will do the appropriate and responsible thing.

Representative Brady. Chairman, thank you for your services leading the Council of Economic Advisers and taking time to enlighten us today about future prospects to the economy. Thank you very much.

Dr. Lazear. Thank you, sir.

Representative Brady. The Committee welcomes for its second panel two distinguished Members, Dr. Mickey Levy, chief economist for the Bank of America, and Dr. Brad Setser, senior economist and director of Global Research for the Roubini Global Economics Group out of New York.

Representative Brady. Gentlemen thank you for joining us today, Dr. Levy why don't we begin with you.

STATEMENT OF DR. MICKEY D. LEVY, CHIEF ECONOMIST, BANK OF AMERICA

Dr. Levy. Thank you very much for inviting me to express my views to you about the economy. In addition to giving you a brief economic overview, I would like to identify several risks facing the economy and also discuss why global imbalances are so large, and what the implications are. I see some narrowing of imbalances coming our way.

Now, without being redundant with Mr. Lazear, the economy is really fundamentally sound and, it is important to keep in mind that the U.S. has the highest potential growth of all industrialized nations. To put it in perspective, we have $11 trillion economy, so 3½ percent growth means economic output or national income is about $375 billion higher than last year and, it is spread, around and the reason why the U.S. economy has high potential is because we have generally pro-growth economic policies and it is very important to keep it that way.

Going through the economy, everything has been quite healthy, particularly productivity, and I would note that, in some sectors, productivity is much higher than the statistics suggest.

The soft spot that was alluded to in the previous testimony is while wages have been rising, they have not kept pace with productivity gains. And the rise in energy prices has tempered the rise in real compensation. When we think about the culprits, it is not just higher costs and nonwage costs to corporations, it is also international competition.

And this is going to continue. We see low cost producers overseas. It is very difficult to identify the independent impact of this, but it seems to me it is putting higher demands on high skilled workers and somewhat lesser demands on lower skilled workers. And that is just a fact going forward. It is more severe in Europe.

The right way to address this is not to address the symptoms of the problem, but rather to increase education and skill levels.

Now, as for my outlook, I am looking for continued economic expansion but at a moderating pace. As a consequence of the higher interest rates, the higher energy prices, and the impact of the higher interest rates on mortgage refinancing, a natural consequence, and actually a welcome consequence of the Fed's rate hikes, will be some moderation in consumption of the rate of economic growth.

But even with those factors, consumption will continue to grow. And if you look at the key factors that have historically driven consumer spending, real or inflation-adjusted disposable personal income is still growing, even though it has been suppressed by higher energy prices. And should energy prices stabilize here, real disposable personal income growth will accelerate.

Also while real interest rates have gone up a little bit, they still remain low, particularly in after-tax terms. And household net worth, that is, stocks bonds and real estate, net of all household debt, is at an all-time high, and of the nearly $50 trillion in total net worth, less than 30 percent is real estate. And so, even if real estate falls by more then I think, it will not affect the consumer that much. It will slow things down, but not lead to a decline.

With regard to housing activity, I expect, looking forward, further flatness, perhaps modest declines in housing activity and prices, but not large declines.

Once again when we look at the factors underlying what has historically driven housing, they are all generally positive.

Employment is rising and the unemployment rate is 4.6 percent, and personal incomes on average are rising, and real after-tax interest rates are low.

Toss in the demographics, and in my view, it is adjustment process. While I agree that the recent pace of price appreciation in housing is unsustainable, the adjustment process suggests that a flattening out and maybe a modest decline, but not much more.

Capital spending is very strong, reflecting record-breaking profits, cash flows, low real costs of capital, and other positive factors. Exports are very strong reflecting global economies that are quite strong. So if you were to look at the destination of U.S. exports and what we are exporting, the outlook is very, very favorable.

The trade deficit is widening, but a key point I am going to emphasize here is the deficit is widening because the U.S. is strong.

Imports are higher and rising more rapidly than exports. Forty percent of all U.S. imported goods are industrial supplies and capital goods, even excluding petroleum and automobiles. That is because the U.S. is growing faster than nearly every other industrialized nation—not just consumption but investments—imports are rising rapidly and a hefty portion of that rise in imports that is generating the trade deficit is for business production and expansion and associated with job creation.

The largest risk to the economy—and we shouldn't understate these—involve three sources. The first risk is if the Fed were to inadvertently hike rates too much, causing a slump in aggregate demand. In response to several questions about the housing markets and consumer debt, as long as the economy continues to grow at a healthy enough pace, in the aggregate, we can withstand higher interest rates. But if the Fed raises rates too much, which creates a slump in aggregate demand, which leads to a slowdown in employment and wages—this is the biggest risk to the economy and to housing.

The second risk is protectionism that significantly raises the cost of production or otherwise jars international trade and capital flows and/or elicits retaliatory measures. In this world of large global imbalances, barriers to trade and capital are dangerous and have to be avoided.

And the third potential risk is a dramatic or undisciplined decline in the dollar. I am not anticipating one.

Inflation has risen. It has risen due to excess demand. In the last couple years, nominal spending growth in the economy has been about 6¾ percent, which is well above common estimates of potential, about 3½. Consequently, inflation has accelerated and core inflation, even excluding food and energy, has risen above 2 percent. The Fed has told us it wants to keep core inflation at 2 percent. And so it will hike rates.

And here is the difficulty for the Fed. It doesn't want to cause a slump. It has looked at its past history at times when it is has orchestrated a soft landing and times when it has tightened too much. It doesn't want to do the latter. But the difficulty is there is no single measure of monetary thrust they can rely on. And in addition, monetary policy works with a lag. But with the markets testing the Fed's inflation fighting credibility, here is a good analogy: Let's say you told your kids it is 9 o'clock bedtime. And it is 9:15 and then 9:30 and you look in and they are still watching TV and it looks like they are getting more wound up than closing down shop.

What do you do?

The Fed is going to hike rates further. And I am looking for a 5¾ percent funds rate by year end. I do not think that would unhinge the economy.

With regard to the trade deficits and the current account deficits in the global context of large global imbalances, if all countries had approximately the same rates of economic growth and investment and saving, imbalances would be very minor.

But that is not the case.

The U.S. has been growing significantly faster than every other large industrialized nation since 1990 except for Canada. And not

just consumption has been growing faster but investments have been growing faster. So there is a tremendous demand for capital. At the same time, our rate of saving has been too low.

In the 1990s, during the investment boom, the rate of national saving was fairly high. The decline in the rate of personal saving was offset by the Government moving from deficit to cash-flow surplus. But so far this decade, the rate of personal saving has stayed so low, and we have budget deficits. And so the U.S. has insufficient savings relative to high investment.

Now, in Japan, where the economy has languished up to until a couple of years ago, it had a very weak domestic demand, flat consumption, weak investment and excess saving. Ditto Germany. While China is poor in GDP per capita terms, and has strong growth, it has an extraordinarily high rate of personal saving, over 40 percent, by their official statistics.

The reason why it is so high is they don't have a social safety net or any retirement programs.

So those countries have excess saving relative to investment and they export their capital to the United States.

I understand the current account deficit is extremely high. I am not concerned at all about the U.S. trade deficit, because it reflects relative strength. What we have to ask is, what are we doing with the imported capital? What is the rate of return on it? Are we putting it toward investment that creates future jobs? Or are we using it for current consumption?

I am concerned about the current account, not because I think there is going to be a collapse in the economy, and not because there is going to be a sharp decline in the dollar, but I think we have to address the factors underlying it.

When you think about the current account deficit in the United States, you should also think about the current account surpluses in Japan and China and look at the factors underlying them. I would like to make several points: One, the large imbalances are largely a reflection of the U.S. strength, and its low rate of saving; second, in equilibrium, don't expect the trade and current accounts to be in balance unless every country has approximately the same rate of economic growth, same rate of investment and same rate of saving. Do not expect an ultimate day of reckoning where the dollar plummets or the U.S. economy collapses.

I have had the pleasure of sitting down with the top global portfolio managers in Asia who manage nearly $2 trillion. I walk away from those meetings with the clear impression that they are absolutely economically rational in holding a very large portion of their portfolio in U.S. dollar-denominated assets.

If you think about it, the U.S. has the fastest growth and the most credible policymakers, a credible central bank, the highest interest rates in market and in inflation-adjusted terms. They are investing in the U.S. for the right reasons. Don't expect any sell-off and do not expect a sharp decline in the dollar.

That is just not how portfolio managers work.

In order to think the dollar will fall sharply, you would have to think those portfolio managers are irrational economically.

I think there are factors in place that will begin to narrow global imbalances.

Think about the following.

In the last couple years, Japan's domestic demand has picked up. That means its consumers after a dozen years of flat to declining consumption are starting to consume more.

Japan enjoys record breaking profitability, and that is generating higher investment. Its domestic demand is picking up, which is going to boost its demand for capital. At the same time, their rate of personal saving is coming down as confidence builds.

Dr. Levy. Their excess saving is starting to shrink, and they will become smaller exporters of capital to the U.S. and around the world.

Ditto Germany. We are finally starting to see a pick-up in the German economy largely due to lower German tax receipts and spending as a percentage of GDP. European economies are picking up and, once again, you are going to see a pick-up in domestic demand. Germany's current account surpluses will come down.

Finally, China. In the U.S., consumption is nearly 70 percent of GDP. In Europe, it is about 58 percent. In China, it is 42. That is going to increase. As the Chinese citizens start to spend more of their disposable income, the excess of national savings relative to investment will shrink, and there will be less sources of capital available to the U.S.

From the U.S. perspective, the Fed's rate hikes and higher real interest rates are beginning to slow down domestic demand, and we are seeing that in housing and we are going to see it in consumption. We are going to see a slowdown. So the demand for capital is going to come down a little bit. At the same time, the excess capital from around the world is going to shrink a little bit.

This is going to serve to begin to narrow the current account imbalance. It will not eliminate it, because if we consider the sources of insufficient saving in the U.S., the primary source is the budget deficit (that is, the Government's "dissaving"). This has to be addressed. You can't just go through this exercise by "arithmetically" closing the budget gap as if it was a deficit bean-counting game. You have to think about policies that both reduce the imbalance, increase the rate of national savings, and, at the same time, are pro-growth. In my mind, in most people's minds, this requires addressing the entitlement programs and the retirement programs. I think once you do that, it is going to provide you a lot of flexibility to address a lot of other budget needs.

If you look at the total Government budget imbalance, not just the cash-flow deficit now, but the long-run imbalance based on rational estimates of the unfunded liabilities of Social Security retirement, Medicare, Medicaid, and divide that by GDP and take the present values, the numbers are scary and very large: perhaps up to 6 percent of GDP. In the long run, raising taxes to close that gap in an arithmetic way could cripple the economy and you end up further away from your objective, and hurt exactly the people you are trying to help.

And so once again, I think addressing the entitlement programs is not just a direct way of increasing the rate of national saving, but it is also an indirect way to provide you a lot of flexibility to reallocate national resources in a way that helps current citizens and future citizens. And I will stop right there.

Representative Brady. Dr. Levy, thank you very much.

[The prepared statement of Dr. Levy appears in the Submissions for the Record on page 62.]

Representative Brady. Dr. Setser.

STATEMENT OF DR. BRAD SETSER, DIRECTOR, GLOBAL RESEARCH, ROUBINI GLOBAL ECONOMICS; AND RESEARCH ASSOCIATE, GLOBAL ECONOMIC GOVERNANCE CENTER

Dr. Setser. I too would like to thank Members of the Committee for inviting me to testify here today.

I am going to focus my remarks on the one risk to the outlook. That is the United States' very large current account deficit. The current account deficit in the fourth quarter of 2005 reached about 7 percent of U.S. GDP, about $900 billion. It fell slightly in the first quarter, but I think most people believe that it is likely to remain at least at $900 billion and perhaps widen during the remaining course of this year.

Current account deficits of 7 percent of GDP in an advanced economy like the United States cannot be directly compared to those of major emerging market economies, but it is still worth noting that a 7 percent of GDP current account deficit is equal to that Mexico ran in 1994 and 1995 on the eve of its crisis. The U.S. deficit is quite large. It is also unprecedented for a major advanced economy to be running deficits of this size.

In my view, these large deficits pose two risks to the outlook. The first risk is the financing necessary to sustain deficits of this kind, financing that by and large, despite what some people have argued, continues to come from official sources, will not continue to be available. If that financing should dry up, there would be a sharp adjustment to the dollar, perhaps a sharp rise in interest rates, and a major change in both the pace of growth and in the composition of growth. Sectors such as the housing sector which have benefited from low-income rates would contract and the export side would benefit. However, if the adjustment is too abrupt, the sectors which are contracting would contract faster than the sectors which are expanding. You cannot create an export industry overnight.

I think the second risk is that the possibility that there may not be any adjustment. The U.S. deficits will not only remain at the current size but perhaps expand. Those deficits have to be financed by taking on additional debt. That debt is a claim on our future income. And looking ahead right now, the net claims on the U.S. are around—net foreign claims are around 25 percent of GDP. That is certainly going to double in any gradual adjustment scenario. It could more than double if an adjustment does not start soon. That implies that the United States' population isn't just going to be paying for its own retirees, but will also be contributing to the retirement income of our creditors in Japan, our creditors in China, and our creditors in Russia and other oil-exporting states.

These two risks interrelate. If the deficit continues to expand and the policies needed to reduce the deficit not be put in place, the risks of a disorderly adjustment go up. That is, the bigger the deficit, the bigger the risk that the adjustment process will not be benign, gradual and so forth, but rather sharp, disruptive, and painful.

Before outlining the specific policies that I believe should be put in place to address the United States current account deficit, I want to make three analytical points.

First, the U.S. current account deficit has increased not because of a rise in investment but, rather, because of a substantial fall in savings. That was most noticeable in the years between 2000 and 2003 when net Government savings fell substantially. Recently, the budget deficit has trended somewhat down, improving Government savings but household savings have fallen.

It is true that investment has picked up somewhat since 2003. But that rise in investment has been overwhelmingly concentrated in residential housing and residential real estate. There has been, more recently, a bit of a pick-up in business investment. However, that increase needs to be put into context. Current rates of investment are still well below the levels of the 1990s. I would also note, neither residential real estate nor investment in commercial real estate seems like an obvious source for the future export revenues that will be needed to pay our external debt.

Second analytical point. These deficits have not been financed because the United States is an attractive location for equity investment. Net equity flows into the United States have been substantially negative for most of the past 5 years. The exception is last year, 2005, I think most analysts believe those flows were influenced heavily by the Homeland Investment Act. Certainly in the first quarter the pattern of net equity outflows from the United States reappeared.

There has been a substantial rise in the amount of U.S. debt that foreigners have been buying, I would argue that rise has not come exclusively because U.S. debt is attractive to private individual investors but, rather, because foreign central banks and, increasingly, oil investment funds. Official creditors have been providing very large funds of financing to the United States.

Recorded flows from official creditors fell in 2005. But I share the judgment of the former chairman of the Council of Economic Advisers, Martin Feldstein, that the U.S. data significantly understates official flows in the United States. Specifically, it does not capture a major fraction of the flows from China and is failing to capture any of the flows from the Gulf States.

Third point. In order to keep the current account deficit at around 7 percent of GDP, the trade deficit has to fall. The current account deficit is the sum of the trade deficit, the transfers deficit, and balance on investment income. Over the past few years, the interest rate that the U.S. has to pay on its external debt fell substantially. It was above 6 percent in 2000. It fell to around 3 percent in around 2003 and 2004.

As we all know, interest rates are rising. That means the interest that we will be paying on our external debt is soon going to rise, and rise significantly. As a result, because of those increasing net interest payments in order to keep the current account deficit just at its current elevated level, the trade deficit needs to begin to fall. I don't see the necessary steps either here or abroad for that to happen.

The president of the New York Federal Reserve Bank, Tim Geithner, observed that private markets will eventually force the

United States to adjust, even if policy changes that would support that adjustment are not put into place. However, he has also noted that the risk of disruptive adjustments are higher in the adjustment process is not supported by appropriate policies.

Here in the United States the most direct, most significant, and best way we can increase our national savings is to reduce our fiscal deficit. Academic work suggests a $1 reduction in the fiscal deficit will lead to a roughly 50 cent increase in national savings—or up to a 50 cent reduction in the current account deficit. We could also take measures to produce or demand for foreign oil, something that Menzie Chinn of the University of Wisconsin has highlighted. Those measures directly reduce the volume of oil that we need to import, and also would have impact on global market prices.

What policies are needed outside of the United States? I would put an emphasis on three:

First, China and other Asian countries need to allow their exchange rates to appreciate. Their exchange rates are being held down by their central banks intervening heavily in the foreign exchange markets.

China needs to do more than just adjust its exchange rates. It also needs to put in place policy steps that would lead its low rate of household consumption to rise. I would note that China's savings rate is rising this year and that its current account surplus is also rising. That is, necessary policies to change haven't yet been put in place and haven't yet put into effect.

Second, more emphasis should be placed on the role of oil-exporting countries. I don't think Saudi Arabia and the other Gulf States should be pegging to the dollar. That means that their currency's external purchasing power has fallen even as their oil revenues have surged. They need to find more creative ways to inject some of their huge oil windfall into their economy rather than lending it back to the United States.

Now I put more emphasis on the role of emerging policies and less on that which is needed in Europe and Japan because the increase in the U.S. current account deficit has been associated with the rise in the surplus of European economies. But there is little doubt that the willingness of Europe and Japan to accept further appreciation of their currencies and base their future growth on current demand will be critical to sustain an orderly adjustment process.

The United States is undoubtedly an important market for many of these countries and everyone has a stake in an orderly rather than disorderly process. But we in the United States, in my judgment, should not base our policies on an expectation that other countries will provide us the financing we need, no matter what we do.

The majority of economists believe that the odds favor an orderly adjustment process. I certainly hope they are right. I would also note that this process is yet to begin. It should begin soon if the odds of an orderly adjustment are to be as high as the majority think.

Former Treasury Secretary Larry Summers has reminded us recently that just because large deficits have been financed relatively easily in the past doesn't mean they will be in the future. Here in

the U.S. we rarely pay attention to the developments in financial markets in places like Iceland, New Zealand or Turkey. But all their currencies have fallen sharply this year, and interest rates in all of these markets are up. Large and growing current account deficits in each of these countries helped trigger these market concerns.

This turmoil should provide us with a warning. Experience teaches us it is better to adjust our policies when markets are calm, not wait until markets demand change. Thank you very much.

[The prepared statement of Dr. Setser appears in the Submissions for the Record on page 74.]

Representative Brady. Thank you.

Dr. Levy, in your statement you note, and I think it is important, 40 percent of imported goods flowing in the U.S. is comprised of capital goods in industrial supplies. In other words, these are not goods that my family is buying to consume. These are goods that a business is purchasing to produce something else here in the United States.

Won't these types of imports facilitate increased U.S. production? Shouldn't they be viewed as favorable, rather than an item that is being purchased for and imported for consumption?

Dr. Levy. Yes, sir. They are. Absolutely positive. The reason why I included those statistics is to dispel the myth that it is just the profligate consumer that is generating excess import growth; that it is evenly balanced between the consumer and business expansion. And once again, if you look at the record, the U.S. has been growing persistently faster than nearly every other industrial nation, and that is why imports are growing rapidly.

So the issue is, let us say we want to address the trade deficit. How do you do it? Well, presumably we want to do it in a way that increases growth and increases standards of living rather than a way that hurts the economy and hurts those citizens that we want to help.

We need to look at the composition of the imbalances, get a clear understanding of why the imbalances have occurred, and then think rationally of what policies can be put in place that both sustain strong economic growth and reduce the imbalances.

Representative Brady. Thank you.

Dr. Setser, over the past 25 years—and I am not an economist—but the current account deficit tends to mirror the U.S. economy. The stronger our American economy, the stronger the accounts deficit is. The larger it is, the weaker our economy, the smaller it is. And you make the point today that foreign countries are not investing in the United States because we are a strong economy, a good place to invest. What are the reasons for investing—for the foreign investment in the United States? If we are not a strong economy, why are they investing?

Dr. Setser. I want to clarify my remarks. My point was that equity investment from foreigners has been quite low recently, unlike in the late 1990s. There have been substantial inflows into U.S. debt markets. Foreigners do find our bonds attractive. I think that is for several reasons. One, as Dr. Levy has noted, that some U.S. interest rates are somewhat higher than those of other advanced

industrial countries. I don't think that those interest rates differentials alone, though, are sufficient to generate $800 or $900 billion in net inflow into our debt markets from private individuals and private market players alone.

And I think if you look closely at the data, a significant fraction of those votes aren't coming from private individuals; they are coming from foreign central banks and from oil investment funds. Why do foreign central banks buy U.S. dollars? Well, in part, they are buying U.S. dollars in order to keep the value of their currencies down in the face of trade surpluses and net capital flows into their own economy. They take those dollars in and they have to invest them somewhere. Until now, the majority of those funds have found their way back to the United States.

Some have characterized this relationship as vendor financing. Countries want to export to the United States and lend us the money we need in order to buy their goods.

The oil investment funds have just had a huge influx of cash. Obviously with oil at 70, there is a lot of money sloshing around the Gulf, sloshing around Russia, sloshing around any place that has oil. Their revenues have gone up far faster than their capacity to spend that money. They haven't been very creative about finding ways to inject that money into their economy. The cash is building up faster than they can find ways to spend it. And they are lending it back to us. That may not last forever.

Representative Brady. Thank you.

Congressman Hinchey, do you have a question?

Representative Hinchey. Thank you, Mr. Chairman.

First of all, I want to thank both of you for your very thoughtful and articulate testimony. It was interesting to listen to both of you.

I want to insert something in the Record to make it clear about the general economy. Contrary to what we may have got the impression of as a result of the last testimony, the average annual growth rate over the last 5 years has been 2.6 percent. The Chairman left out growth rates of 1.2 and 1.6. And after you adjust for inflation, compensation of employees' wages plus benefits has grown at just 1.6 percent, which is half of the growth in productivity. And after adjusting for inflation, the income of the typical household has declined by more than $1,600.

So I would like to ask you to comment on that situation. I mean, we are confronting a problem in this economy where the income of the median family, middle-income people, is going down. It has been dropping off more severely as you get further down the income scale.

But it is impacting middle-income people very severely, and that, I think, is going to have a major impact on the economy.

Also, I would be interested if you have any thoughts on the impact of the alternative minimum tax on median income, and how that is affecting the economic situation that we are confronting. We are debating now a major reduction in the estate tax, but this Congress is paying no attention whatsoever to the aspect of Federal taxation which is impacting most severely the middle-income part of our economy.

Dr. Levy. Let me tackle those questions. Firstly, your 2.6 percent includes the 2 years of very soft growth that brings down your

average. But if you look over a 10-year period or 20-year period, the average economy has been growing about 3.4 percent.

Over the last 5 years it is 2.6 percent.

Dr. Levy. I agree with you.

I think the key point with regard to the median household is the No. 1 factor we all have to strive for is sustained economic expansion. All the policies in the world are not going to help that middle-income household if the economy slumps. So it is healthy economic growth that is absolutely required, and that requires healthy economic policies. And we have had healthy economic policies the last couple of years in particular. We are now in this transition where the Federal Reserve has been taking away the monetary accommodation and it should slow things down, but we have to recognize that stable inflation is the best foundation for sustained economic expansion and job creation.

Now with regard to wages, I have been disappointed that wages have not kept pace with labor productivity gains. There are reasons for this. One is the higher nonwage costs.

The other is higher energy prices which clearly push up headline inflation, and we can't do anything about that. We have to hope energy prices stabilize so real wages rise.

Another factor is international competition. As I noted in my testimony, it is very hard to isolate the impact of international competition on wages, but my hunch is the higher supply of low-wage workers around the world is increasing the global supply of low-wage workers and putting downward demand on low-wage workers here.

Meanwhile, there is high demand for high-skilled workers. This is one of the factors that we have to deal with because it is not going to go away. And I would say the absolute best way to deal with it is pro-growth policies that help the people that you really want to help: build education and skills. Trying to address the symptoms, like raising the minimum wage, would absolutely hurt exactly the people you are trying to help, because it makes them less competitive in a global world where the costs and the price of tradable goods are falling.

So there is no question we have a major dilemma, and it is not going to go away, and we have to address it in a fair and efficient way.

Finally, with regard to the AMT, put it close to the top of your priority list because it is affecting people in a way it wasn't designed. The AMT is going to become more and more onerous; not just the tax burden, but going through the calculation of how you consume, how you invest: Everything is being affected by the AMT.

Representative Brady. Thank you, Dr. Levy.

Congressman Hinchey, I would point out that the mitigation of the AMT was included in the President's tax relief bill he just signed a few weeks ago and has been a part of all of the major tax relief measures in the last 5 years.

Mr. Paul——

Representative Hinchey. Could we hear Mr. Setser's response to my question?

Representative Brady. Yes.

Dr. Setser. I too think that the priority that was placed on reducing the estate tax relative to the—or limiting the estate tax—relative to the priority that has been given to addressing other national needs and other potential reforms in the tax system has been misplaced.

I certainly agree with Dr. Levy that an economic slump is unlikely to be good for the median or average worker. But the problem has been that the economic expansion that we have seen over the past few years hasn't been very good to the median or average worker either, for many of the reasons that he outlined.

I think the policy response that has been adopted by the Congress and the Administration has tended to augment rather than to help the situation. Specifically, the priority that has been placed on steps like reducing the estate tax, steps like reducing the capital gains tax, steps like reducing the dividends tax all have come at a time when global competition has been placing downward pressure on the wages of relatively low-skilled workers and increasing the returns on capital. So at a time when international markets are moving in one direction, increasing inequalities within our society, we have made policy changes at the Government level that have continued to add to those inequalities. I think that is a problem.

Representative Brady. Thank you. Mr. Paul.

Representative Paul. Thank you, Mr. Chairman.

It seems to me that the two of you have a slightly different interpretation of amount of concern we should have for the current account deficit. I wanted to get just a quick clarification if I could from Dr. Levy. Your argument is that these funds aren't just going to consumption, that it represents some business expansion and business investment when it comes to the purchase of mortgage securities. Is that considered consumption or is that considered a business investment in our calculation?

Dr. Levy. Doesn't matter. Capital is fungible.

Representative Paul. You are arguing that a lot of these funds are going into business, and Dr. Setser is arguing the other case.

Dr. Levy. Here is my point. Let us say an Asian central bank that has excess savings buys U.S. mortgage-backed securities. Well, that frees up funds for investment in whatever, including business investment or construction or residential housing or consumption.

Representative Paul. Let me follow up with Dr. Setser because his statements are rather emphatic that the current account deficit has risen largely because of the fall in savings and a rise in residential investment, not because of a surge in business investment, arguing the case that it is not business investments we are borrowing a lot of money from overseas for consumption.

Now following that, he mentions that this is not an economic decision by individual investors. This is not a private market participation. This comes from central banks, which I think muddies the water. And I just wonder if there is any reason to think that central bankers—you know, in their planning that is what central bankers are; they are planners domestically to centrally—run the economy. Why wouldn't central bankers get together and say, look, tit for tat; you buy our securities and we will keep the consumption going.

And because there is this fantastic trust in the dollar, a remnant of the Bretton Woods Agreement that it is still a reserved currency, it seems to me like we could be working toward a dollar bubble. I know Dr. Levy says don't worry about it. But I think there is room for concern about the setup that we have, and the dollar being so unique that this is why the deficit's going to—maybe it will—you suggest there are two problems: One, it will correct; and two, it will continue to do it. Let us say the psychology is so powerful and the dollar is so strong and our military stays strong and we have success overseas and there is no reason to doubt our preeminence in economics because we can continue our economic power through borrowing, what if we continue this until we get a 10 or 12 percent current account deficit? Doesn't this just mean that someday we have to be prepared for some serious adjustments?

Dr. Setser. Certainly if the U.S. account deficit were to rise to 10 percent of U.S. GDP, which is where it will be in 3 or 4 years if we don't or our markets don't demand—if we don't implement corrective policies or the markets don't demand that we do—that's the track we are on. The deficit has been growing at a pace that would imply 10 percent of GDP current account deficits by 2010. So I think your concerns are well placed.

I think that it is important when talking about the dollar to differentiate between the exchange rate between the dollar and euro, which is largely determined by market forces and the exchange rate between the dollar and, say, the Chinese currency, which is not set by market forces. It is set by the intervention of the Chinese central bank and the amount of intervention that China has to do in order to maintain it has been growing.

At some point—I don't know when that point will be—I think it is likely that China will conclude that there are better ways of spending their money than subsidizing American consumption, and that the domestic monetary consequences of this very rapid reserve growth will become such that there will be a reevaluation inside China of this policy choice.

Now that reevaluation hasn't come yet. It may not come next year, it may not come the year after; but at some point it will come. The People's Bank of China in my judgment is unlikely to extend an infinite credit line to the United States, which implies at some point something will change.

I think it is also important to recognize that right now a very large amount of the central bank financing from the United States is coming from a set of countries which are not necessarily either democracies nor necessarily our allies: China, Russia, many countries in the Middle East.

Finally, I do disagree with Dr. Levy's argument that we are currently largely taking on external debt to finance a surge in investment, including a surge in business investment.

Unambiguously, business investment today is lower than it was in the 1990s. Unambiguously, residential investment today is higher than it was in this 1990s. Unambiguously, household savings today is lower than it was in the 1990s. Unambiguously, the Government deficit today is bigger than it was in this 1990s. On all of those measures, the overall characterization that we are taking

on more external debt not to finance a surge in business investment relative to the 1990s is accurate.

Dr. Levy. Let me respond. There is no question the rate of business growth is lower than the 1990s. In the 1990s we said it was way, way too high and we were worried about it. Business investments so far this expansion is growing double digit. That is very, very healthy. And I like what I see in terms of the allocation.

I think it is a misuse of the term to imply that the Chinese are going to get tired of subsidizing the U.S.

Nations that have excess savings relative to investments have to do something with it. They allocate their resources to generate the highest risk-adjusted expected rate of return.

As long as the U.S. continues to have healthy economic fundamentals and healthy economic policies, it will continue to not have problems attracting foreign capital.

But once again, I think it is critically important to look underneath the imbalances. But why are they there? Once again, if we had economic growth along the lines of Europe, less than 2 percent, with unemployment rate twice what we have; or, if in the last 15 years we had 1 percent economic growth like Japan, with declining investment, then we wouldn't have such a large trade deficit. But the fact that there are imbalances, we all benefit from international trade and international capital. And not only does the U.S. benefit because we are able to import capital and put it to work not just for consumption but for business expansion, but nations that have excess savings are able, through international capital flows, to put their capital to work.

So globally the saving in the world seeks investment opportunities.

There is no question but that when the U.S. runs a current account deficit. It implies that we are exchanging current consumption and investment for claims on future U.S. income. That is OK as the returns on our imported capital are higher than the cost of financing it. And therein lies the rub.

The Government deficit spending for consumption-oriented activity does not add to future productive capacity, yet it does reduce the rate of national savings and that is one area we need to address.

And I think there is this other area where, Brad, I think we totally agree, and that is in response to the more than doubling of energy prices in the last couple of years. You suggest consumers have maintained their rate of consumption growth, which has lowered the rate of personal saving and lowers the rate of national saving. That capital has flowed to OPEC producers (oil transactions all transacted in dollars) and a lot of it flows back into the U.S. This rise in oil prices has clearly been something that 4 or 5 years ago none of us anticipated, and has clearly increased the current account. We have to hope that energy prices stabilize and come down; and if they do, that should contribute to a higher rate of personal savings in the U.S. and higher rate of national savings. If, on the other hand, energy prices go up significantly from here, now that monetary policy is more neutral than accommodative, then the economic impact could be negative and it could keep our rate of personal savings in the negative territory.

Representative Brady. I want to thank the panelists for being here, the Members as well. And this meeting is adjourned.

[Whereupon, at 12:50 p.m., the Committee was adjourned.]

Submissions for the Record

CONGRESS OF THE UNITED STATES

JOINT ECONOMIC COMMITTEE

CHAIRMAN JIM SAXTON

PRESS RELEASE

For Immediate Release
June 27, 2006

OPENING STATEMENT OF CHAIRMAN JIM SAXTON

Press Release #109-81
Contact: Christopher Frenze
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PROSPECTS FOR THE ECONOMIC EXPANSION

It is a pleasure to welcome Chairman Lazear of the President's Council of Economic Advisers (CEA) before the Joint Economic Committee (JEC) this morning. The CEA and the JEC share a common history, and we value the good relationship that we have had over many years. I would also like to welcome the members of the second panel, Dr. Mickey Levy, and Dr. Brad Setser.

The U.S. economy has grown at a healthy pace in recent years. According to the official data, the U.S. economy advanced 4.2 percent in 2004 and 3.5 percent in 2005. The pick-up in economic growth since 2003 is largely due to the rebound in investment, including equipment and software spending. A combination of accommodative monetary policy and investment tax incentives enacted in 2003 helped to boost investment and improve economic growth in recent years.

Since August of 2003, 5.3 million new jobs have been created, and the unemployment rate has fallen to 4.6 percent. As the Fed noted in a policy report last February, "the U.S. delivered a solid performance in 2005." In the first quarter of 2006, the U.S. economy expanded at a blistering pace of 5.3 percent. This performance is all the more remarkable considering the impact of high oil prices and a tightening of monetary policy by the Federal Reserve. Though there is some weakness in the real estate sector, it appears as though a soft landing is the most likely outcome. The overall economy has proven to be quite resilient.

Very recent data suggest that the U.S. economy is no longer growing at an unsustainable pace in excess of 5 percent, but advancing at a more moderate rate of about 3 percent. According to the Blue Chip consensus of economic forecasters, this trend will continue through most of the next six quarters.

The Fed has stated that, "the U.S. economy should continue to perform well in 2006 and 2007." A variety of forecasts suggest that economic growth in 2006 will be about 3.5 percent, and that the economic expansion will continue into 2007.

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CHAD STONE
STAFF DIRECTOR

Opening Statement
Senator Jack Reed
Joint Economic Committee Hearing
June 27, 2006

Thank you, Chairman Saxton. I want to welcome CEA Chairman Lazear to his first JEC hearing, and I look forward to discussing with him the President's policies and the prospects for the economic recovery. I am also pleased that we will have Dr. Levy and Dr. Setser on a second panel to give us further perspectives on those issues.

The latest Administration economic forecast, which is in line with the consensus of other forecasters, is for economic growth to continue, but at a more moderate pace than we have seen recently. Of course there are risks to that forecast. High energy prices and a cooling housing market might slow consumer spending more sharply than forecasters are now predicting, and our trade deficit and dependence on foreign lenders have reached alarming proportions. The Federal Reserve has to decide how to deal with these risks while preserving its credibility on inflation. If the Fed makes the wrong choice, the economic recovery could end before it has even begun for many American families.

That brings me to the core of my concern about the economy and this Administration's policies. As much as the President would like to say that his policies are benefiting all Americans, the fact is that we have gone through the most protracted jobs slump in many decades; real wages are not just lagging behind productivity growth, they are stagnating; and economic inequality is increasing. While workers are waiting to see the benefits of this economic recovery show up in their paychecks, American families are experiencing widespread economic insecurity in the face of soaring energy prices, rising health care costs, declining health insurance and pension coverage, and rising costs for a college education for their children.

The President's tax cuts have not been the answer. They were poorly designed to stimulate broadly shared prosperity and have produced a legacy of large budget deficits that leave us increasingly hampered in our ability to deal with the host of challenges we face. Moreover, the President's goals of making his tax cuts permanent and cutting the deficit in half are simply incompatible.

Large and persistent budget deficits have contributed to an ever-widening trade deficit that forces us to borrow vast amounts from abroad and puts us at risk of a major financial collapse if foreign lenders suddenly stop accepting our IOU's. We had a current account deficit of nearly $800 billion last year and our international financial debt continues to mount.

- more -

I hope we would all agree that raising our future standard of living and preparing adequately for the retirement of the baby boom generation require that we have a high level of national investment and that a high fraction of that investment be financed by our own national saving—not by foreign borrowing. We followed such prosperity-enhancing policies under President Clinton, but that legacy of fiscal discipline has been squandered under President Bush.

Most experts believe that the budget deficits we need to worry about are the long-term structural deficits resulting from the President's tax cuts, not cyclical deficits resulting from temporary declines in economic activity. So, I will be interested in Chairman Lazear's explanation of just how "we can grow our way out of deficits" as he recently wrote in the *Washington Post*.

I am also curious about Dr. Lazear's recent statement in the *Wall Street Journal* that "the President's tax cuts have made the tax code more progressive, which also narrows the difference in take-home earnings." In fact, the President's tax cuts have widened the gap in take-home earnings. According to the nonpartisan Tax Policy Center, the tax cuts passed since 2001 have raised the after-tax income of the top 1 percent of Americans by 5 percent, while raising the after-tax income of the bottom 60 percent of Americans by just 2 percent.

Chairman Lazear rightly points out that "policies must increase the opportunities of all workers to acquire skills and training." But this view doesn't square with the President's budget, which includes cuts to elementary and secondary education, student aid and loan assistance for higher education, and job training for displaced workers.

Instead of addressing our real economic problems, the President's policies seem to be piling on.

I look forward to Chairman Lazear's testimony about the economic outlook, and I will listen with interest to anything the Chairman and our witnesses can tell me that will allay my concerns about that outlook.

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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.

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May 8, 2006

COMMENTARY

America at Work

By EDWARD P. LAZEAR and KATHERINE BAICKER
May 8, 2006

WASHINGTON -- There is no question that the U.S. is experiencing strong economic gains, with GDP growing at an impressive annual rate of 4.8% in the last quarter. The economy created about two million jobs last year, and Friday's jobs report for April showed that we are on track to add more than two million new jobs this year.

This job growth is undeniable, but some have questioned whether workers' wages are growing as well. Friday's report brings good news on this front, too, showing that average hourly earnings rose this year at the fastest rate in nearly five years. In recent months, hourly compensation grew at an impressive annual rate of 5.7%. Per capita personal disposable income, a good measure of Americans' spending power, has grown over 8%, or $2,100, since 2001. Consumer behavior is further evidence of this economic well-being: Markets are strong, and investment and consumption are robust.

Still, some claim that the benefits of this economic boom are being enjoyed only by the relatively well-off, and that we have left the rest of our workforce behind. Is this true? Over the last 25 years, the wages of the skilled have continued to grow faster than the wages of the less skilled. For example, the wages of the college-educated have grown by 22% since 1980, while the wages of high-school drop-outs has fallen by 3%.

This does not mean, however, that the rich are benefiting at the expense of the poor. Instead, it means that the return to investing in education and training continues to grow. Most economists believe that the increased divergence between the wages of the skilled and the unskilled reflects technological advancements that make workers' skills more valuable. Having an economy that places a greater value on skills and education is a good thing. Our economy can grow more quickly when the returns to investment are high, and human capital investment is the most important form of investment.

This presents us with opportunities and challenges. We have the opportunity to increase our standard of living as our workers reap the benefits of the skills that they have acquired. We face the challenge of ensuring that all Americans have access to the education and training that the modern economy values so highly.

The data show that it is this greater return to investing in education that is driving the long-run widening of the income distribution. The cause is not increases in immigration or international trade, as some have alleged. First, wages for less-skilled workers have not declined with growing trade, even in sectors of the economy with the greatest import competition. Second, some of the groups that have experienced the highest wage growth have also seen increased immigration swelling their ranks. Silicon Valley is full of highly paid immigrants and native-born Americans who work side-by-side, earning very high salaries in the high-tech sectors of our economy. For less-skilled workers, studies suggest that immigration has only a modest effect on wages of the native-born. Third, those who have examined the data systematically find that trade and immigration can account for at most a small proportion of the increased wage spread that has occurred over the past 25 years.

To make sure that the gains from technology are enjoyed by all, we must be vigilant in providing training and educational opportunity for all. Programs such as the No Child Left Behind education reform and American Competitiveness Initiative are vital steps in that direction. Perhaps even more important are steps that families can take to provide the environment and encouragement that is so helpful in producing an educated population. The president's tax cuts have made the tax code more progressive, which also narrows the difference in take-home earnings.

Through education, hard work and entrepreneurship, there is great opportunity for Americans to improve their economic circumstances over their lifetimes. Half of those who are in poverty escape that status within three years. One-fifth of those in the bottom quarter of the income distribution move up within a year. Most Americans' income rises substantially the longer they are in the labor force. The average worker who was between 25 and 34 years old in 1994 earned 52% more in real terms in 2004. Those who invest in education increase dramatically the likelihood that they will enjoy these improvements in their standard of living.

The labor market is strong. Job growth has been impressive, and unemployment is at a very low 4.7%. Productivity is increasing at more than 3% per year. This strong economy means that we can look forward to even higher wages and living standards in the future. We should continue to strive to ensure that all Americans are able to obtain the skills that will enable them to share in this prosperity.

Mr. Lazear is chairman, and Ms. Baicker a member, of the President's Council of Economic Advisers.

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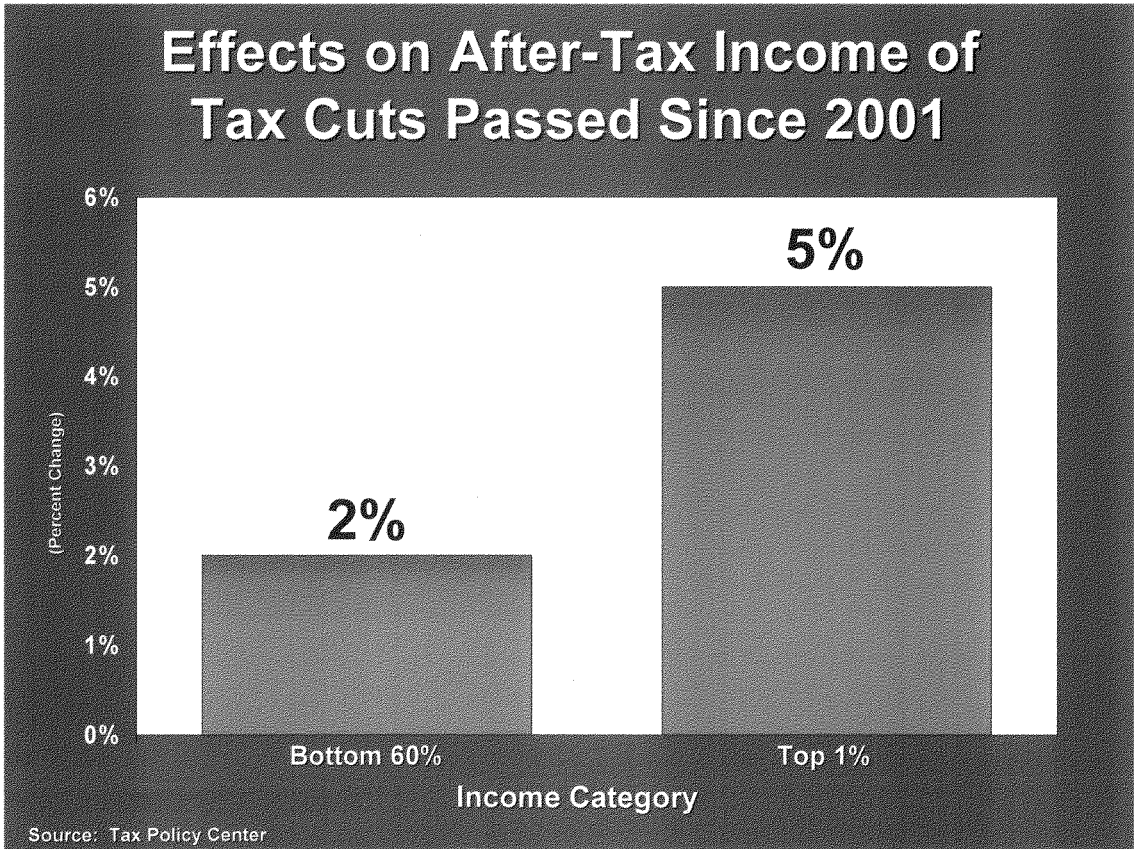
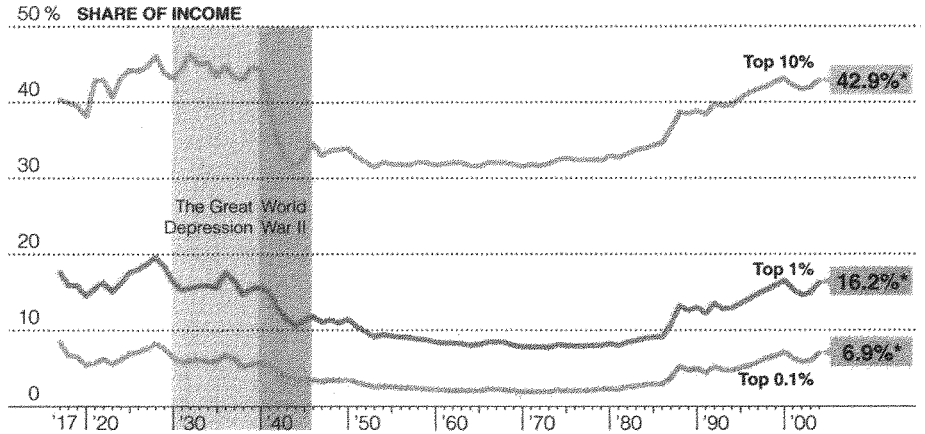

Effects on After-Tax Income of
Tax Cuts Passed Since 2001
6%
5%
4%
3%
2%
1%
0%
(Percent Change)
2%
5%
Bottom 60%
Top 1%
Income Category
Source: Tax Policy Center

The New York Times

SUNDAY JUNE 25, 2006

The Rich Get Richer, Again

Not since World War II have the top 10 percent of earners had such a large share of total income. The shares of those in the top 1 percent and top 0.1 percent have risen to levels not found in more than 60 years.



Source: Thomas Piketty of École Normale Supérieure in Paris and Emmanuel Saez of University of California, Berkeley

*Latest data as of 2004

The New York Times

Healthy Economic Expansion and Higher Interest Rates*

Testimony of

Mickey D. Levy
Chief Economist
Bank of America

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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* Prepared for the Joint Economic Committee, U.S. Congress, June 27, 2006.

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-

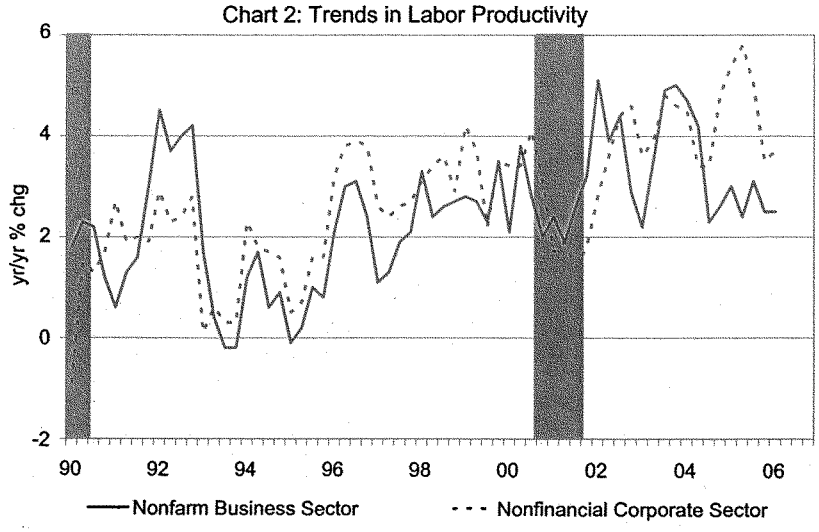
denominated assets. Barring a jarring shift in relative economic performance, I do not anticipate a sharp decline in the U.S. dollar.

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.

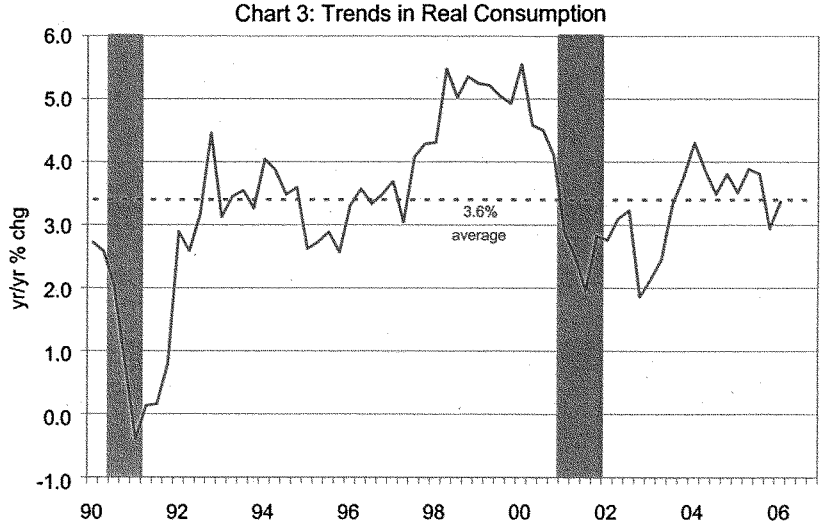
It is important to emphasize that the primary objective of such fiscal reform efforts should be to fix U.S. government finances to make them conducive to maximum sustainable economic growth. Efforts to reduce the current account deficit without regard to how changes in the structure of the underlying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

Source: Bureau of Labor Statistics / Haver Analytics



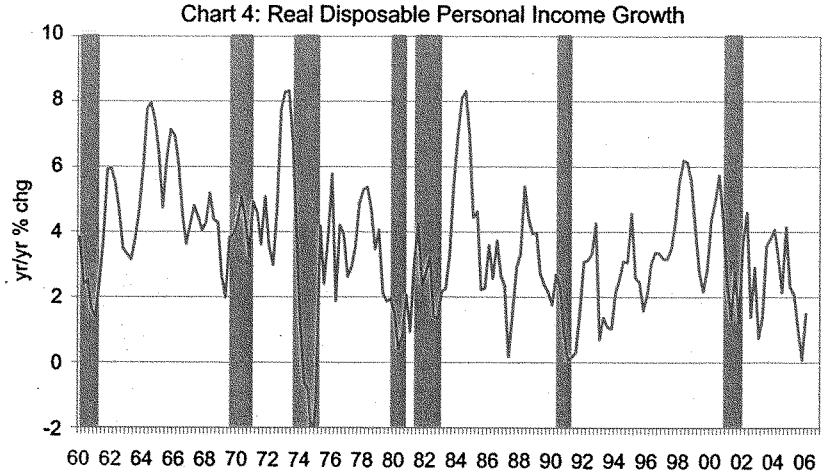
Source: BLS/ Haver Analytics

Chart 3: Trends in Real Consumption



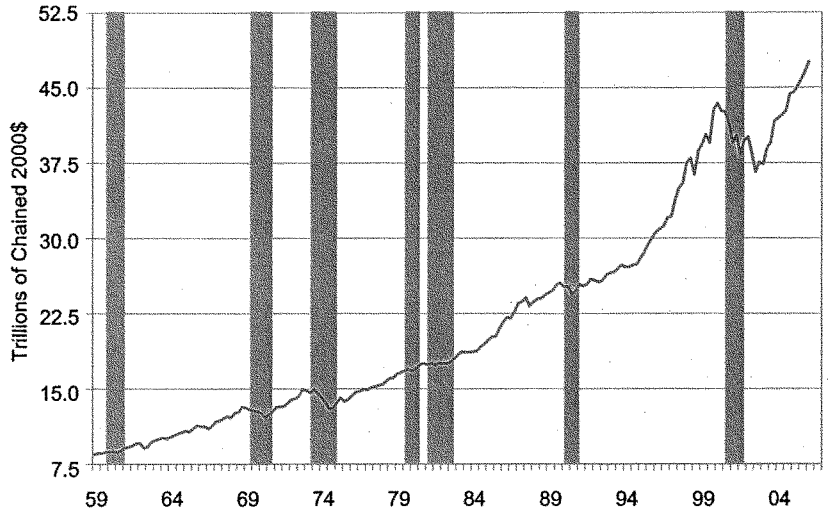
Source: Bureau of Economic Analysis /Haver Analytics

Chart 4: Real Disposable Personal Income Growth



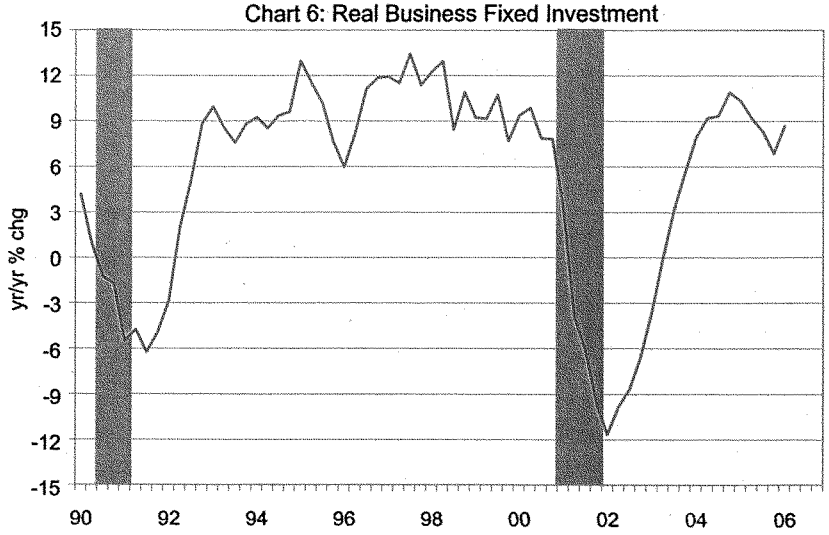
Source: Bureau of Economic Analysis / Haver Analytics

Chart 5: Real Household Net Worth



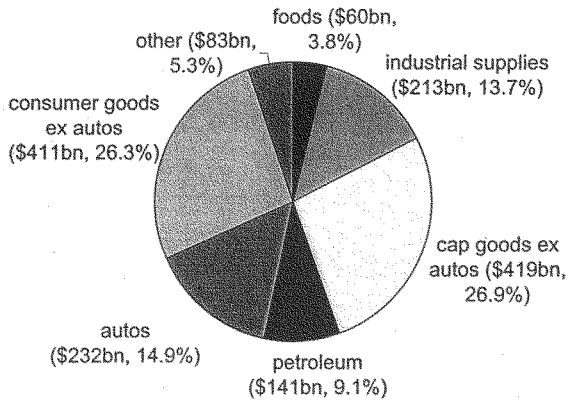
Source: Federal Reserve System / Bureau of Economic Analysis / Bank of America calculation/ Haver Analytics

Chart 6: Real Business Fixed Investment



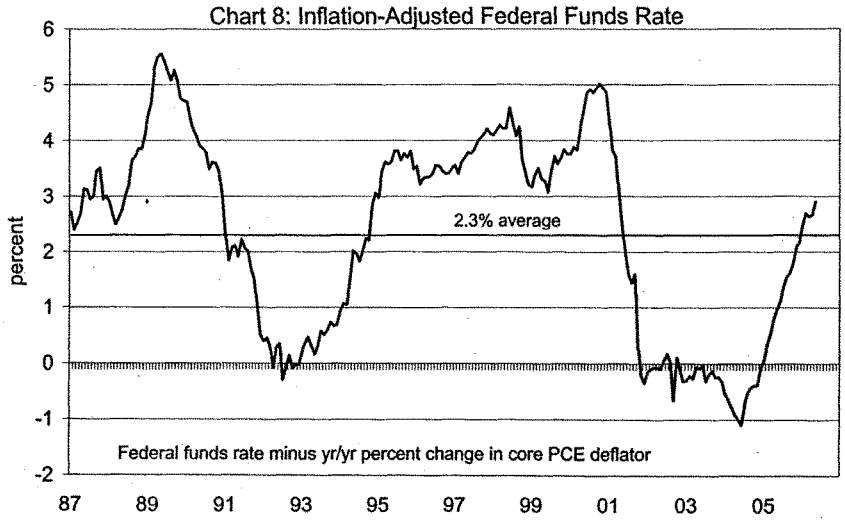
Source: BEA/Haver Analytics

Chart 7: Composition of U.S. Goods Imports
(2005 total $1.56 trillion in chain-$2000)



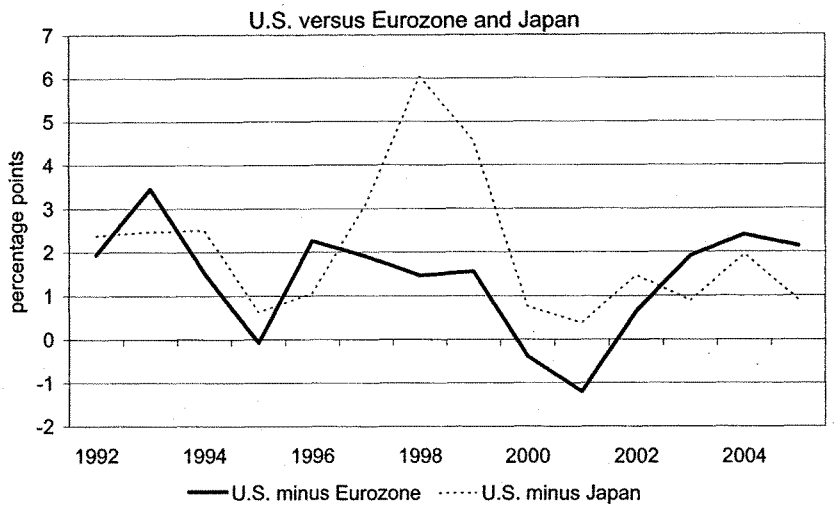
First term is value of imports, second term is the share of real goods imports
Source: Bureau of Economic Analysis / Haver Analytics / Bank of America

Chart 8: Inflation-Adjusted Federal Funds Rate



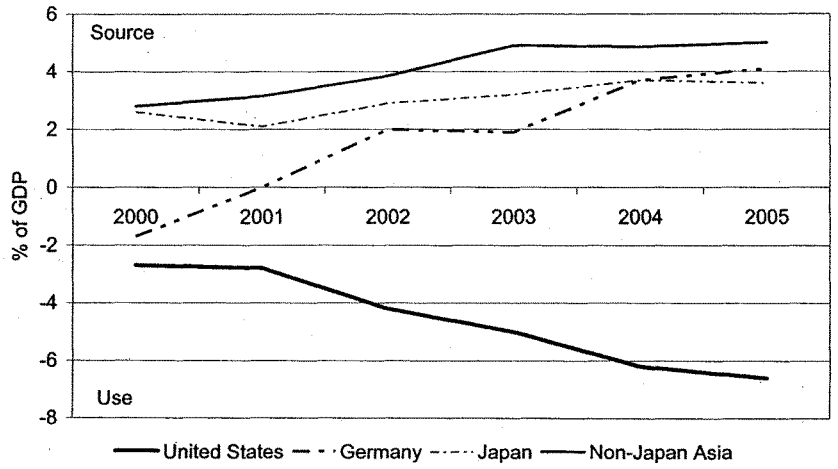
Source: Federal Reserve Board/BEA/Haver Analytics/Bank of America

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

Testimony of

Brad Setser
Director of Global Research,
Roubini Global Economics
And Research Associate,
Global Economic Governance Center,
University College, Oxford

Before the
Joint Economic Committee

"The Economic Outlook"

June 27, 2006

Ongoing risks from the large US current account deficit

I want to thank Chairman Saxton and the Joint Economic Committee for opportunity to testify. Today I would like to focus on a key risk to the outlook: the United States' dependence on foreign savings to make up for its own low rate of savings and to finance large current account deficits.

The US current account deficit reached 7% of US GDP – roughly $900 billion --- in the fourth quarter of 2005. Despite a small fall in the first quarter, it will likely continue to expand during 2006. A current account deficit of 7% of GDP is comparable in size to the deficit of Mexico prior to its 1994/95 crisis, to the deficit of Thailand prior to its 1997 crisis and to the deficit of Turkey prior to the lira's recent sharp fall. The United States is not directly comparable to these emerging economies. However, the US deficit is of an unprecedented size for a large advanced economy – and certainly for the issuer of the world's leading reserve currency.

Sustaining a deficit of this size requires that the United States borrow close to $1 trillion dollars a year from the world, sell close to $1 trillion of American assets to foreign investors or do a mix of the two. Recently, the US has financed its deficit entirely with debt. That is a change from the late 1990s, when surging investment in the new economy attracted large equity flows into the US. Nor has US debt proven all that attractive to private market participants over the past few years. Much of the debt the US has sold to finance its current account deficit over the past few years has been bought by foreign central banks and government-controlled oil investment funds. Our biggest creditors are increasingly other governments, and not necessarily either democracies or allies – a key difference from the 1980s.

Ongoing trade and transfer deficits of the current size imply that total foreign claims on the US will increase rapidly, even taking into account the favorable currency composition of the United States external debt and external assets.[1] The 2005 United States net international investment position, the broadest measure of total foreign claims on the US economy,[2] is likely to be around 25% of US GDP -- higher than it has been since the 1880s. It will soon be much bigger.

Going forward, the current account deficit will only stay at 7% of US GDP if the trade deficit starts to shrink. The current account deficit is the sum of the trade deficit, the deficit in transfer payments and the balance between the payments the US makes on its external debt and the income the US receives on its investment abroad. From 2000 to 2004, the interest rate the US had to pay on its rising debt stock fell substantially, falling from over 6% to around 3%. With both the stock and the interest rate now rising, interest payments on the United States' growing external debt stock are poised to increase

[1] Many US external assets are denominated in foreign currency and rise in value as the dollar declines, helping to offset some of the rise in US debt from ongoing deficits.
[2] The net international investment position is the difference between all US external assets – including US direct investment abroad – and all US external liabilities, including foreign direct investment in the US.

sharply. Consequently, the current account deficit will continue to grow even if the trade deficit stabilizes.

Large deficits pose two distinct risks. One risk is that the external financing needed to sustain the United States' current pattern of growth will not be available. Forecasts of continued US growth implicitly assume that the world – including the People's Bank of China, the Bank of Russia, the Saudi Arabian Monetary Agency and other official actors -- will continue to provide the US with the large credit line needed to finance large ongoing deficits. Any shortfall in financing would likely result in a falling dollar, higher US interest rates, slower overall growth and a shift in the composition of the US economy. Sectors that have benefited from low interest rates would be hurt; sectors that export or compete with imports would benefit. The more abrupt the adjustment, the greater the losses in the sectors that stand to be hurt and the smaller the offsetting gains. Export industries don't develop overnight.

The other risk is that the US trade and current account deficit will continue to expand, increasing the stock of foreign claims on the US economy. The US is currently taking on external debt to finance a mix of government deficits, current consumption and investment in sectors – like housing – that seem unlikely to generate future export revenues. If the US were to finance its 2006 deficit with equity not debt, it would need to sell the equivalent of 45 companies the size of Unocal to foreign investors – and then sell even more similarly-sized companies in 2007. The larger the deficit now, the larger the share of future US income that will have to be devoted to making payments on the United States' external debt. Future US workers will need to support a larger retired population here in the US and contribute to the retirement income of Chinese, Japanese, and others holding US debt. A growing deficit now also increases the risk of a sharp adjustment in the future.

Policy changes both here in the US and in our trading partners abroad could help to limit these risks. The recent rise in the US external deficit has been associated with rising external surpluses in the world's emerging economies, and specifically a rise in the surplus of China and the major oil exporters. The fall in US savings – and the rise in savings in many emerging economies – has not simply been the product of private market forces. US government policies have played a significant role in reducing the US savings rate and in encouraging investment in residential real estate, increasing our dependence on savings imported from abroad. Government policies in our key trading partners have blocked natural market pressures for their exchange rates to rise, resulting in unprecedented growth in reserves and large capital flows from poor countries to the United States.

Before going into the needed policy changes, I want to explore three analytical points in greater detail:

- The US current account deficit has risen largely because of a fall in savings and a rise in residential investment – not because of a surge in business investment.

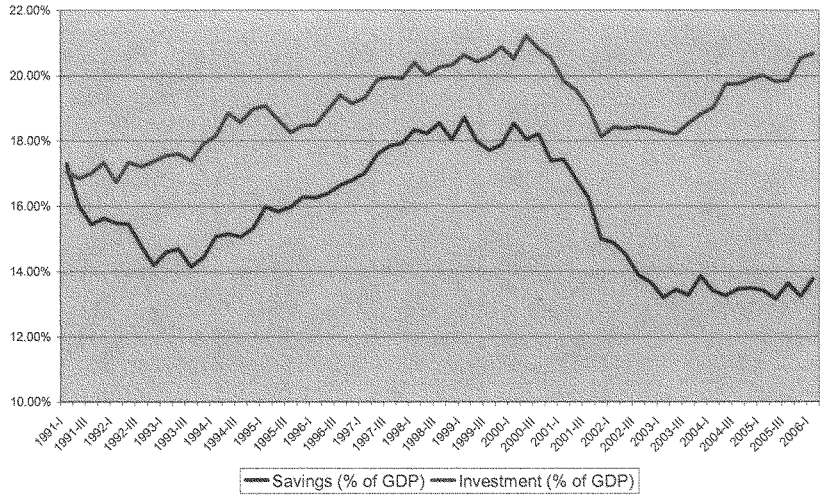
- Foreign central banks – not private market participants – have played a key role financing the increase in the US current account deficit. US data likely understates US dependence on financing from central banks and oil investment funds.

- Even if the pace of both import and export growth moderates, the US current account deficit is poised to grow significantly. Significant reductions in the trade deficit – and much faster export growth relative to import growth – will be needed to keep the US current account deficit stable as the amount of interest the US has to pay on its net external debt begins to rise sharply.

The rise in the current account deficit reflects a fall in savings

The current account deficit can be thought of as the gap between what the US earns abroad – whether from selling goods and services or from its existing investments – and what the US pays abroad. It is also reflects the gap between what the US saves and what the US invests. A country that invests more than it saves must borrow savings from abroad – and in the process, runs a current account deficit.

Savings v. Investment

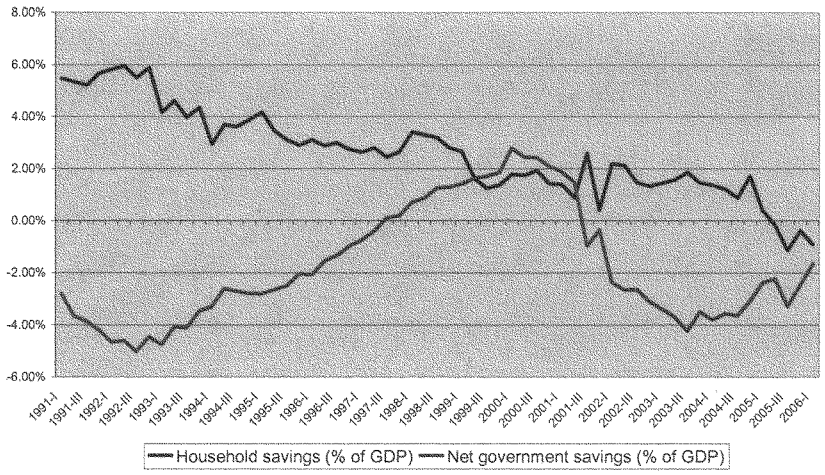


In the late 1990s, both savings and investment were increasing, though investment increased more than savings. The recent increase in the United States' current account deficit however stems from a steep fall in national savings between 2000 and 2003. Indeed, net savings in the US are so low that the majority of net new investment –

investment in excess of what is needed to replace the existing capital stock – if financed by borrowing from abroad.

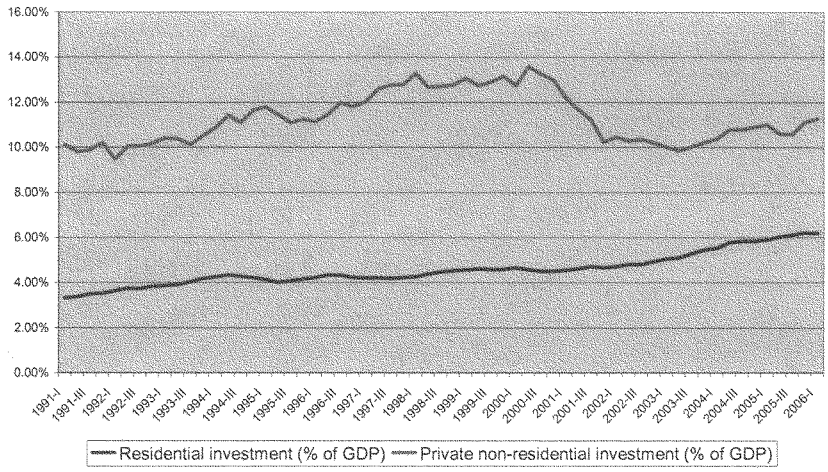
The recent fall in savings stems both from the shift from fiscal surpluses to fiscal deficits and the fall in household savings.

Both government and households contributing to low national savings



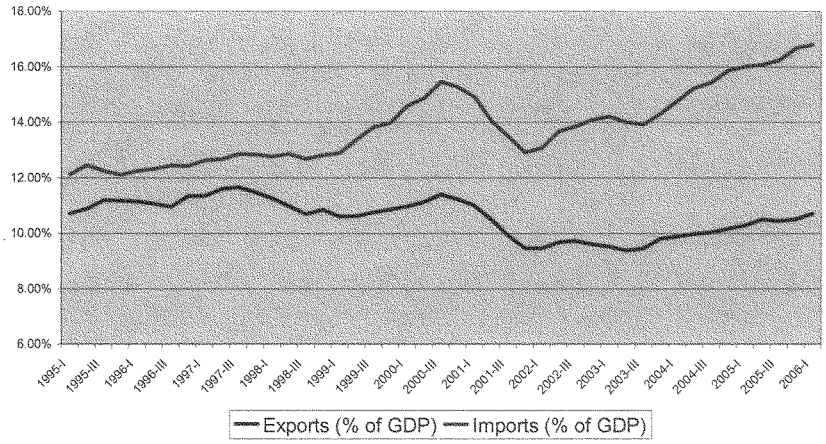
Large current account deficits are generally considered less of a concern if they stem from surge in investment, particularly investment in sectors likely to generate future export revenues. A country that borrows to import the capital goods needed to develop a newly discovered large oil field is borrowing to invest in a project that will increase both the country's future income and its capacity to generate the export revenues needed to make payments on country's external debt.

Recent rise in gross investment stems from investment in real estate; business investment below levels in late 1990s



Unfortunately, the recent rise in US (gross) investment primarily reflects a surge investment in residential housing. Business investment is up a bit, but remains well below its levels in the late 1990s.

**Imports growing relative GDP;
exports no higher as a share of GDP
than in the middle of the 1990s**



US exports have increased relative to GDP since 2003, spurred by the dollar's fall against the euro and relatively strong global growth. But even so, goods and services exports remain smaller, relative to US GDP, than they were in the mid-1990s. Little evidence suggests current US investment is biased toward likely sources of future export receipts. It is difficult to see how suburban housing will generate future export revenues.

US data understates US dependence on financing from foreign central banks

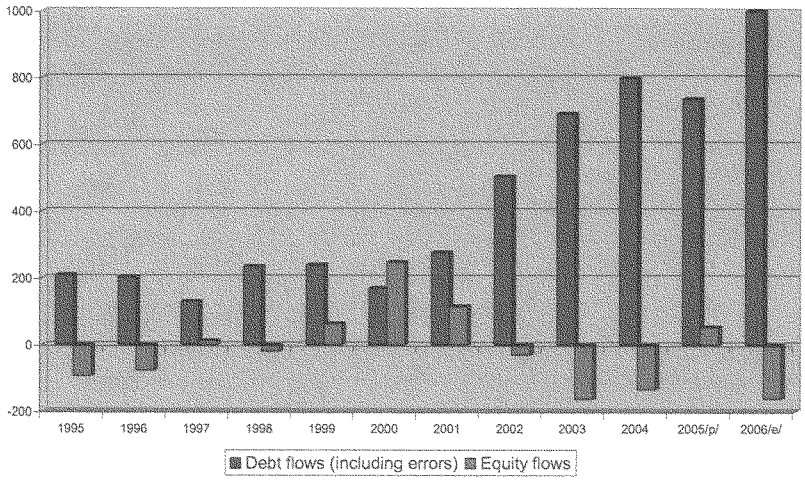
In the late 1990s, the growing US current account deficit was financed by surge of foreign demand for US equities – and strong foreign direct investment into the US. Everyone wanted to participate in the new economy. Those equity flows have disappeared. Recently, US investment in foreign equities – both foreign stocks and direct investment – has exceeded foreign investment in US equities.[3]

As a result, the recent increase in the US deficit has been financed entirely with debt.

[3] 2005 is a bit of an exception. However, the net equity inflow in 2005 stems entirely from the Homeland Investment Act. US firms with investment abroad stopped reinvesting ongoing earnings in their foreign operations and instead opted to bring their existing profits home. The result was a big fall in outflows. Net outflows resumed in the first quarter of 2006.

US external deficits financed with debt

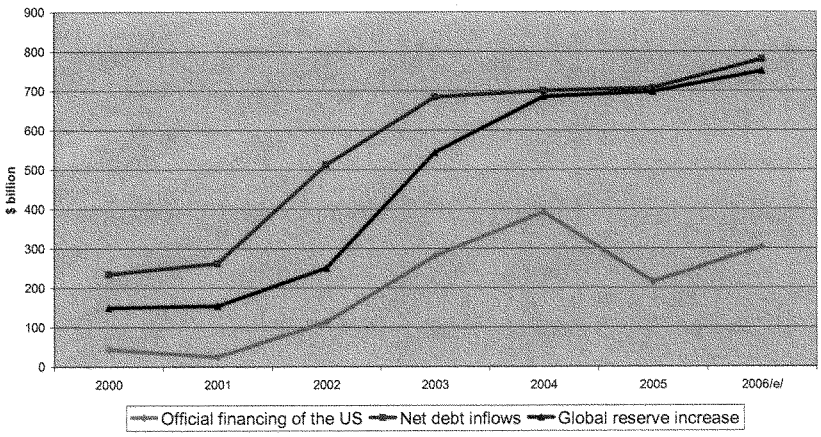
Capital flow data in $ billion. All data from BEA; 2006 estimate based on q1 data



Much of the demand for US debt has not come from private investors, but rather from foreign central banks and oil investment funds. This is clearly visible in the US data for 2003 and 2004. In both these years, a surge in global reserve accumulation was matched by a surge in recorded central bank inflows to the US. In 2005, however, recorded official flow to the US fell even though global reserve accumulation did not.

Total debts flows track global reserve data better than the official inflow data in 2005 ...

Official financing and debt flows data from the BEA; 2006 based on q1 data, Global reserve growth estimates from Roubini Global Economics



Central banks also built up dollar deposits in the international banking system, which, as Lars Pedersen of the IMF has noted, indirectly helps to finance the US,[4] even if such deposits are not formally inflows into the US. Combining these two data sources, it is possible to track a large share of the increase in global reserves in 2003 and 2004, but not in 2005. Only around $310 billion of an estimated $690 billion increase in global reserves[5] shows up in the US data and international banking data reported by the Bank of International Settlements.[6] Central banks did increase their purchases of euros, pounds

[4] See Box 1.6 of the IMF's April 2006 International Capital market report. Pedersen writes: "Over the same period (the year 2005 through September), deposits of all monetary authorities in BIS reporting banks denominated in dollars rose by $110 billion. The largest offshore component of these dollar flows is not part of the US balance of payments although near-perfect arbitrage between offshore and onshore funding markets means these deposits effectively support the value of the dollar exactly as would an onshore deposit."

[5] My estimate for global reserve growth is based on the IMF data, but includes three additional items: the increase in the foreign (non-reserve) assets of the Saudi Monetary Agency, the growth in Taiwan's reserves (Taiwan is not a member of the IMF) and reserves that the People's Bank of China shifted to Chinese state banks. My estimates also take into account changes in the dollar value of the existing stock of reserves stemming from changes in the euro's value against the dollar. The euro's rise against the dollar contributed to the headline increase in reserves in 2003 and 2004, and the euro's fall against the dollar in 2005 reduced the headline increase in 2005. My calculations try to adjust for this.

[6] See Robert McCauley, "Distinguishing global dollar reserves from official holdings in the United States," BIS Quarterly Review, September 2005. For more on different measures of central bank financing of the US, see Matthew Higgins and Thomas Klitgaard, "Reserve accumulation: implications for global capital flows and financial markets," Current Issues in Economics and Finance, Volume 10, no. 10. Federal Reserve Bank of New York. September-October 2004.

and other reserve currencies in 2005, but the $380 billion gap between known flows into dollars and total increase in global reserves is extremely large.

	Official inflows (U.S. data)	Dollar reserves in int. banks (BIS, table 5c)	Bank of Japan deposits in Japanese banks	Known increase in dollar reserves (BIS methodology)	Estimated increase in reserves (IMF data, adjusted for valuation, in dollars)	Increase counting Saudis, Taiwan And Chinese bank recap	"Gap" between known and estimated reserve increases
2002	115.9	14.3	-0.2	130	221	250	120
2003	278.3	84.3	60.9	423.5	442	543	119.5
2004	387.8	100.5	-2.1	486.2	626	685	199.8
2005	199.5	80.2	-3.1	276.6	602	691	414.4

This gap is presumably explained by a change in the set of countries adding to their reserves. Japan not only keeps most of its reserves in dollars, but almost all purchases of US securities by the Bank of Japan seem to show up in the US data. However, Japan stopped adding to its reserves in early 2004 and by the middle of 2004 had finished investing most of those dollars in US securities. In 2005, by contrast, all of the increase in the world's reserves came from emerging markets, and particularly from China and the world's oil exporters. There is good reason to believe that the US data does not fully capture central bank purchases of US debt. A relatively small fraction of China's reserve increase shows up in the US capital inflows data.[7] The same point applies with even more force for the world's oil exporters. Recorded flows from the Gulf to the United States actually fell in 2005, despite the increase in oil prices and the rapid growth in Gulf foreign assets. Most observers believe that the Gulf states use London based custodians for many of their purchases of US assets.

Counting the increase in the various oil investment funds of the Gulf states (estimated at nearly $100b by the IMF) along with the growth in Saudi central bank assets, the total increase in official assets in 2005 likely approached $800 billion. More than $200 billion of that almost certainly was invested in the US. Like Harvard's Martin Feldstein, I believe that the US data now significantly understate true demand for US assets from foreign central banks and oil investment funds.[8]

Judging from the pace of their reserve growth, the central banks of China, Russia and Saudi Arabia have become the three most important sources of demand for US debt. In

[7] Interestingly, the annual survey data showed a much larger increase in Chinese holdings of US debt than was recorded in the monthly flow data (the Treasury international capital system data).

[8] See Feldstein's December 1995 speech at the Central Bank of Mexico. Lars Pedersen of the IMF makes a similar point Box 1.6 in Chapter 1 of the IMF's April 2006 International Capital Markets report. He notes: "Oil exporter assets in mature markets are not fully reported, creating an understatement of official transactions. Chinese official asset buying is more fully reported than the oil exporters, but together these official flows may be significantly understated in the U.S. balance of payments." Pedersen observes that the "officially managed" assets of the large oil-exporting nations rose by between $300-450 billion in 2005. That total should be higher in 2006.

the past – whether in the 1960s or the 1980s – most of the financing for US deficits came from close US allies, and from democracies. That is no longer the case.

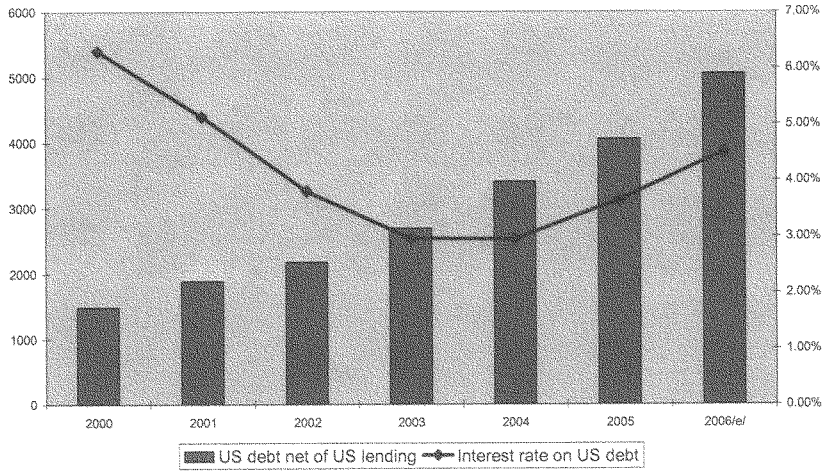
A fall in central bank demand for US assets would not be disruptive so long as it came during a time of very strong private demand for US debt. But a meaningful risk exists that a fall in central bank demand for US debt could trigger a fall in private demand for US debt, at least at current interest rates. Perhaps an even greater risk is that central banks may not be willing to increase the amount of financing to the US given the already elevated levels should private demand for US debt falter – as it did in 2003 and 2004.

The US current account deficit will remain close to 7% of US GDP even if the US trade deficit begins to fall

Over the past few years, a rise in the United States external debt stock has not led to a rise in the interest payments that the US must pay on its external debt. Falling interest rates offset the rising stock. Interest payments actually fell from around $275 billion in 2000 to $185 billion in 2003, even though the United States gross external debt rose from $4.35 trillion to $6.2 trillion, as the interest rate on US debt fell from 6.3% to around 3%. The interest rate has now started to rise, but estimated 2005 interest payments of $315 billion were rather low relative to gross US debts of $8.6 trillion. Unfortunately, with short-term rates heading above 5%, the average interest rate on US external debt will not remain at 3.65% for long. Some US external debt is offset by the loans the US makes to borrowers abroad. But US debt net of US lending is rising fast. In 2000, US lending exceeded US borrowing by 1.5 trillion. In 2005, that total was more like $4 trillion.[9] Barring a change in the composition of financial inflows into the US, it will continue to increase by about a trillion a year even if the US trade deficit stabilizes.

[9] The US net international investment position can be divided into three parts: US borrowing net of US lending; US equity investment abroad net of foreign equity investment in the US and US currency held abroad. The last is an interest free loan to the United States. The final 2005 data is not yet available. I estimate that the US borrowed about $4 trillion more than it lent, US equity investments abroad were worth about $1.2 trillion more than foreign equity investments in the US and foreigners held around 0.35 trillion in US currency. That would imply a net international investment position of around negative $3.1-$3.2 trillion.

Falling rates won't continue to offset rising debt
US external debt is net of US external lending



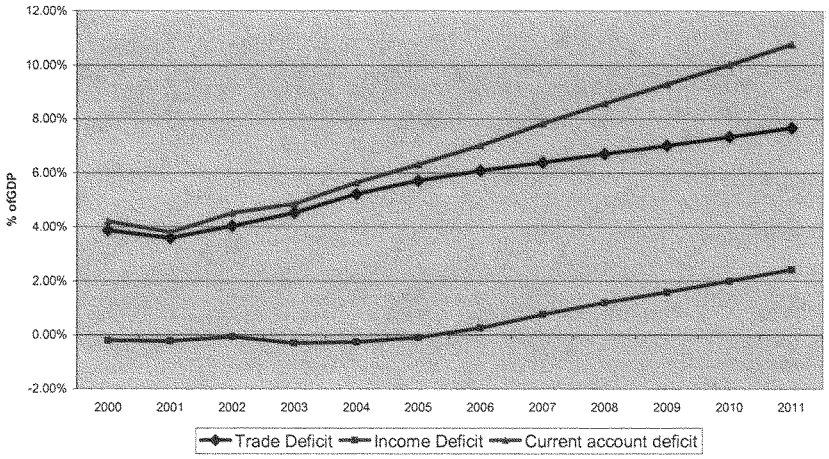
US foreign direct investment (FDI) abroad has consistently has had a higher reported return than foreign direct investment in the US, largely because reported returns on foreign direct investment in the US are very low.[10] Combined with low US interest rates, the returns on US FDI combined to keep the income balance[11] in surplus. That is about to change.

Rising debt will soon combine with rising rates to generate a significant deficit in income payments. In some sense, the increase in interest rates will make the real cost of all the debt the US has taken on to finance ongoing deficits more apparent. The shift in the income balance has an important implication. Even if the pace of expansion of the US trade deficit slows, the overall current account deficit will continue to increase.

[10] Daniel Gros of CEPS has noted that this difference largely stems from differences in reported reinvested earnings. US firms report large reinvested earnings; foreign firms operating in the US report very low reinvested earnings. As a result, the reported return on foreign direct investment in the US has consistently been below the interest rate foreigners could have earned if they had bought long-term US government bonds. Dr. Gros does not believe that this difference is real but rather reflects data limitations. If Dr. Gros is right, the US income balance is already in a substantial deficit.

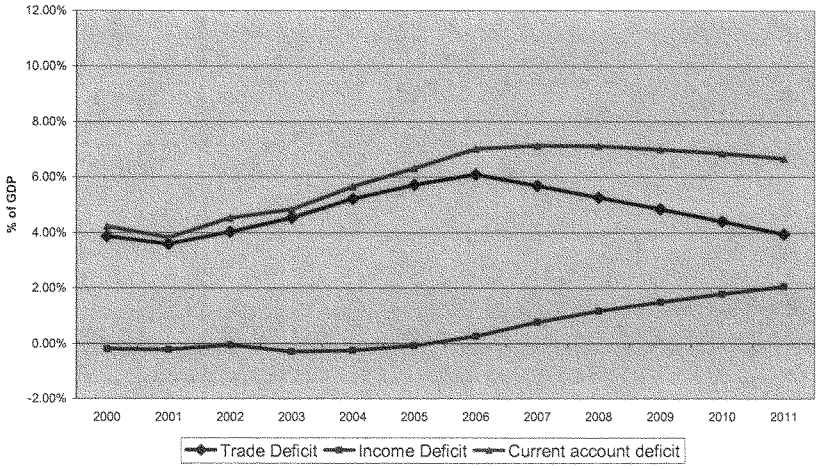
[11] The income balance is the difference between what the US has to pay on its external debt, the dividends the US pays on foreign portfolio investment in the US stock market and the returns foreign investors earn on their direct investment in the US relative to what the US earns on its investment abroad

Status quo is unsustainable --
It implies 10% of GDP/ $1600 billion current account deficit in 2010,
even if pace of deterioration of the trade deficit slows



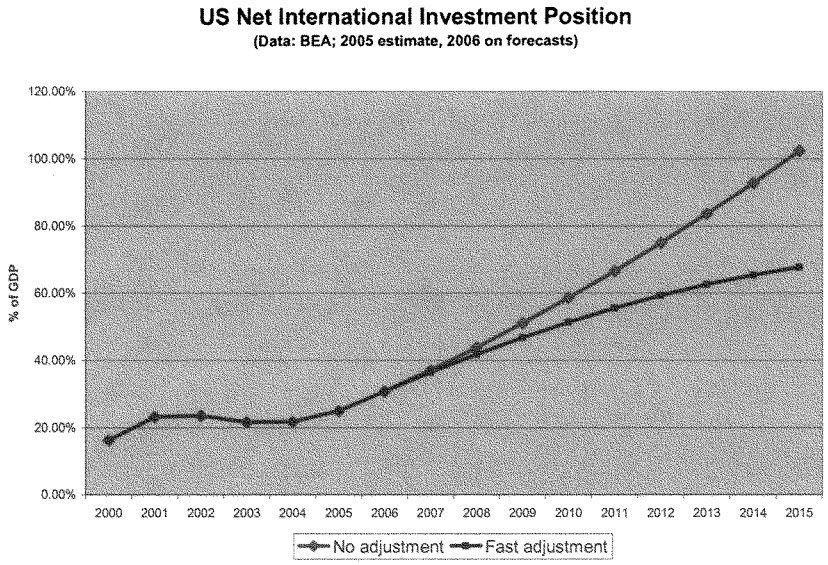
Even if the US trade deficit stabilizes at current levels – something that requires US exports to grow 60% faster than US imports on a sustained basis – the current account deficit will continue to expand on the back of rising net interest payments. Keeping the US current account deficit roughly constant over the next few years requires that the US exports grow about twice as fast as US imports – 9% v 5%.

Large US deficits even with adjustment -- 2010 deficit is still around 7% of GDP ($1100 billion)



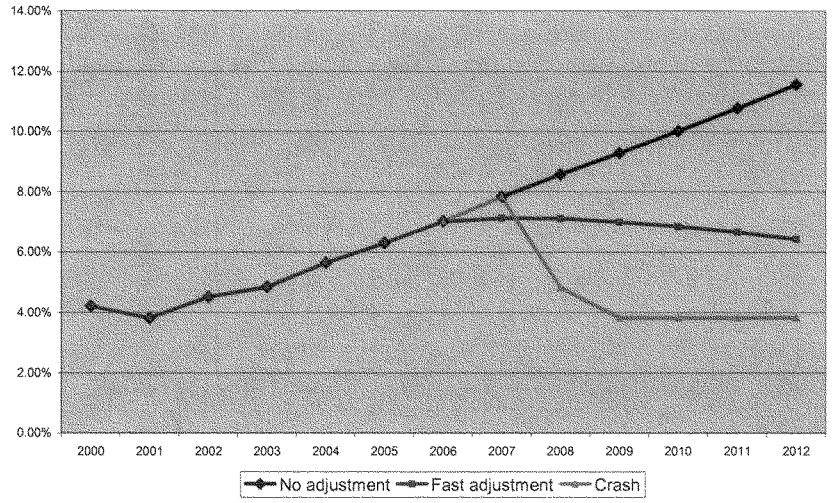
In both the case where the US trade deficit continues to expand and the case where the trade deficit begins to fall, total US external liabilities will increase much faster than US assets. The net international investment position of the United States – the broadest measure of amount that the US owes the world[12] -- will deteriorate substantially.

[12] The net international investment position (NIIP) includes foreign direct investment, portfolio equity investments ("stocks) as well as external debt.



The projections shown here do not take into account the possibility that future falls in the value of dollar will increase the dollar value of the United States external assets. Consequently they may slightly overstate the likely deterioration in the US net external debt. However, they provide a rough guide to the future. Even if the US puts itself on a path that would bring the US trade deficit down to around zero in about ten years, US net external debt would still increase to around 60% of US GDP as a result of the deficits associated with a process of gradual adjustment. If the adjustment is delayed, the total increase in US external debt will be even larger – or the adjustment process will be more rapid.

Possible future evolution of the US current account deficit



Conclusions

The President of the New York Federal Reserve Bank, Tim Geithner, has observed that private markets will eventually force the US and the world to adjust even if existing policies are unchanged. But he also has noted that the risk of disruptive market moves that might significantly lower US growth during the adjustment process is far lower if that process is supported by appropriate policy changes.

Here in the US, reducing the budget deficit remains the most obvious way to increase overall national savings. Recent estimates by both the IMF and Menzie Chinn of the University of Wisconsin suggest that a one dollar reduction in the fiscal deficit could lead to a reduction of up to fifty cents in the US current account deficit – far more than the Treasury argued in a recent paper. In my judgment, bringing the revenues in line with expenditures likely requires more than just spending restraint. Government revenues – excluding those revenues dedicated to Social Security – remain quite low. The recent improvement in the fiscal deficit reflects a surge in corporate tax revenues that may not be sustained.

Efforts to reduce US demand for oil, as Menzie Chinn of the University of Wisconsin has emphasized, could also help. Such measures would both reduce the volume of oil the US needs to import and, by taking pressure off global supply, help to reduce the price the US pays for its imports.

Policy changes are also needed by our trading partners. They include:

- Greater willingness by China, some other Asian economies and many oil exporters to allow their currencies to appreciate against the dollar. Natural market pressures are pushing for appreciation: keeping the RMB around 8 to the dollar requires that China's government intervene massively in the foreign exchange market. China's central bank alone likely spent $250 billion[13] – over 10% of its GDP – in 2005 buying dollars. China likely will need to spend more in 2006, as its current account surplus has continued to grow. Many oil exporters' dollar peg has led their currencies' value to fall in real terms even as their export revenues soared. The annual increase in global reserve accumulation was around $150 billion in 2000 and 2001. It rose to nearly $550b in 2003 and close to $700 billion in 2004 and 2005. All the 2005 increase came from emerging economies.[14]

- Greater distribution of the profits of Chinese firms, which are currently used to finance investment, and the development of a stronger system of social insurance in China. Both would help to lower China's exceptionally high savings rate – and turn China into an engine of global demand growth for a broad range of products, not just for commodities.

- Finding innovative ways to inject – prudently -- more oil revenues into the economies of the oil-exporting countries rather than just using the surge in oil prices to build up the government's offshore dollar and euro deposits. Many oil exporters have budgeted for $30 barrel oil even as oil has risen toward $70. As a result, the surge in oil revenues has led to a surge in government savings – and, one expects, a surge in oil-state financing of the US.

I have emphasized the policy changes needed in emerging economies since the offsetting surpluses that balance the rise in the US current account deficit are found in the emerging world. Europe is roughly in balance: deficits in Spain, France, the UK and Eastern Europe offset surpluses elsewhere. Japan's surplus has not risen like that of the world's emerging economies. However, the willingness of European economies to accept further appreciation of their currencies relative to the dollar and the willingness of Japan to accept a stronger yen will be an essential part of the global adjustment process. A

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[13] China reported a somewhat smaller increase in its reserves in 2005. However, it reduced its reserve accumulation by transferring $15 billion to one of its four large state commercial banks, and by another $5 billion by engaging in various swap transactions. Moreover, the headline increase understates China's actual intervention, as the overall number was reduced by the falling dollar value of China's euro reserves. The $250 billion estimated increase adjusts for such valuation effects, for the transfer to the state bank and for the currency swaps.

[14] These totals are adjusted to reflect valuation changes. They assume around 65% of the world's reserves are invested in dollars, and around 35% are in euros, yen, pound and other non-dollar assets. This split is consistent with the IMF's data on the currency composition of the world's reserves. The IMF's data does not include China, but this split is also consistent with most estimates of the currency composition of China's reserves (over 70% of China's reserves are likely to be in dollars). The totals also include Taiwan's reserves (which are not included in the IMF data), the Saudi Monetary Agency's non-reserve foreign assets and reserves China's central bank has transferred to three Chinese state banks.

stronger euro and a stronger yen will require that both Europe and Japan base their growth on domestic demand.

It is often argued that the necessary adjustment to close the US trade deficit poses little risk to the US economy, but a substantial risk to the economies of our trading partners. They no longer will be able to rely on a growing US trade deficit to spur their own economies. Moreover, dollar depreciation would reduce the value of our creditor's external assets while increasing the value of US assets abroad.

Both points are true, but they come with important caveats. First, if the global economy slows during the adjustment process because other countries can no longer rely on the US, it will be much harder for the US to increase its exports. Second, the US will still run large current account deficits and need to import large sums of savings from the rest of the world even after the trade deficit stabilizes and begins to fall. If our creditors increase the interest rate they charge to compensate for the risk of dollar depreciation, the negative impact of higher interest rates on the US economy would likely more than offset the positive impact of greater demand for US exports. The US only wins in a financial sense from dollar depreciation if our creditors do not demand adequate compensation for this risk.

Changing from a pattern of global growth based on expanding US trade deficits to one based on a slowly contracting US trade deficit will not necessarily be easy, for either the US or the rest of the world. Yet change is necessary. Gradual adjustment starting from a trade deficit of around 6% of GDP and a current account deficit of 7% of US GDP likely implies, as I noted before, ongoing current account deficits of close to 7% of US GDP for the next five years or so. If the adjustment process is delayed, the ongoing deficits associated with a gradual adjustment process will be larger and the United States final level of external debt will be greater. Moreover, the risk that that adjustment process won't be gradual is larger.

The US current account deficit is not a reflection of slow global growth – global growth has actually been very strong recently, contributing to relatively strong US export growth. Nor is it likely that an acceleration of global growth alone will be sufficient to allow the US trade deficit to adjust.[15] Rather, the likely challenge will be to sustain the current pace of global growth with less impetus from domestic demand growth in the US.

The United States is an important market for many countries, giving nearly everyone a stake in the orderly adjustment of the US deficit. But the US should not base its own policies on the risky expectation that the US is too big and too important a market for other countries to allow it to fail – or assume that any shortfall in private demand for US assets will be offset by a surge in central bank financing. We don't know precisely the limits of our creditors are, but the willingness of the world's central banks to extend an unconditional credit line to the United States must be limited.

[15] See recent research from Mann and Plueck

The United States has unique advantages that have allowed it to finance large current account deficits at relatively low rates for some time. The majority of economists believe that the odds still favor an orderly adjustment process. I hope they are right. But this process – supported by appropriate policy changes – needs to get started. So far there hasn't been any adjustment. All historical comparisons are subject to one important caveat: never before has an economy as big and as important as the United States run deficits of the current magnitude.

Former Treasury Secretary Larry Summers reminded us recently that just because large deficits have been financed relatively easily in the past does not mean that that they will continue to be financed as easily in the future. We in the US do not typically pay attention to financial markets in Iceland, New Zealand and Turkey. But the value of all their currencies has fallen sharply this year, in large part because of concerns about their current account deficits. Interest rates in all countries are up. Turmoil in these markets should provide another warning. Experience teaches us that it is better to implement necessary policy changes when markets are calm – not to wait until markets demand change.

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