Testimony
of
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Mr. Chairman, Senator Domenici, and members of the Committee, it is a pleasure to appear before you today to discuss the outlook for the U.S. economy. The terrible tragedy associated with the terrorist attacks on New York and Washington exacted an economic toll on the United States as well as a human toll.

Growth in the U. S. Economy and the Outlook Prior to September 11

Prior to the tragedy on September 11, the United States was experiencing a growth slowdown: Real GDP growth slowed to only an average 1.2 percent annual pace during the past four quarters, with a low of 0.3 percent in the second quarter of 2001. While the probability of an outright recession was low, the fact that the economy was growing slower than its potential rate of growth dictated that the unemployment rate was likely to rise in the near term. Economic disruptions emanating from the bombings in New York and Washington certainly worsened the short-run growth prospects.

Even prior to September 11, growth rates this much below their potential levels were not acceptable. Accordingly, monetary and fiscal policy moved decisively to reverse pre-September 11 recessionary pressures. The Federal Reserve cut the target federal funds rate by 300 basis points from the beginning of the year through September 11, and $41 billion was returned to taxpayers during the third quarter as a downpayment on a large permanent tax cut.

Looking outside the nation, the United States continues to have an interest in the resumption of economic growth in Japan and accelerated growth in Europe. During the first half of 2001, GDP declined in Japan, and the rate of decline accelerated. In Europe, the rate of GDP growth remains positive, but has decelerated. Moreover, European Commission surveys of the outlook for new manufacturing orders, industrial production, and consumer confidence indicate recent declines. From a direct U.S. perspective, more rapid growth in the major economies will raise our growth prospects as well. More broadly, it will enhance the likelihood of stability and progress in the rest of the world, such as developing Asia and Latin America. In the absence of resumption of global growth, trends in output and asset prices may force painful adjustments in these economies.

Economic Consequences of the Events of September 11

To analyze the effects of the terrorist attacks on the World Trade Center and the Pentagon, it is instructive to consider two steps. First, the collapse of the World Trade Center and surrounding buildings acted as an adverse supply shock to the economy—that is, an adverse effect on the economy's productive capacity. The physical damages from the attacks likely were not sufficiently consequential to affect the underlying potential growth rate of the economy. However, the loss of life, the damage to the financial sector, and the interruption of commercial aviation temporarily restricted the economy's ability to supply goods and services in the short run. These "supply shock" consequences of the attacks substantially reduce the growth rate of GDP during the third and fourth quarters of 2001, and increase significantly the likelihood that the economy is in a recession. These consequences also imply a greater gap between the economy's actual and potential growth rate, with adverse consequences for employment.

This first step treats – for strictly analytic purposes – the attacks as a contained physical event. Of course, there is a second, and more important, effect. Because the destruction on September 11 arose as a result of terrorism, the economic aftermath includes shocks to household and business confidence, and increased uncertainty regarding the overall environment. The effects on confidence and uncertainty give rise to a number of additional supply-side costs of transacting business—ranging from enhanced security to more costly insurance—which reduce output growth.

On the demand side, the attacks and their potential repercussions lowered household and business confidence about the future, and along with it their willingness to spend and invest. Prior to the attacks, a focus of policy was to ensure a continued flow of resources – incomes, cash flow, and so forth – to households and businesses to provide a base for sustained growth in aggregate demand. If confidence effects are substantial, the attacks must necessarily shift our focus somewhat – away from simply providing dollars to households, for example, and toward buttressing the confidence of households to make purchases out of those dollars.

What is the outlook for consumer confidence? To gain a sense of the magnitudes involved, one can derive estimates of the expected decline in confidence by utilizing the changes to the Blue Chip consensus forecast due to the terrorist attacks. The implied drop in confidence appears substantial and likely incorporates effects of recent equity price declines. Using the most recent Blue Chip consensus forecast as a guide, the implied decline in confidence is expected to be temporary—following roughly the path of the confidence decline and recovery during the Gulf War—and is essentially eliminated by the second half of 2002. The Blue Chip

Consensus forecast is, of course, only an estimate. More shallow declines in confidence would permit a more rapid recovery. Larger and more sustained declines in confidence would suggest a longer downturn and slower recovery, particularly if accompanied by prolonged weakness in equity prices.

To be concrete, the consensus economic forecasts of private sector economists (as reflected in the September 20, 2001 special survey of the Blue Chip Economic Indicators) indicates a modest recession, again fueled by a decline in confidence and equity values. (While a recession is declared officially by the National Bureau of Economic Research, I use the term in its common association with two quarters of negative GDP growth.) The consensus estimate is for a decline in real GDP of 0.5 percent and 0.7 percent in the third and fourth quarters, respectively, of this year. Consensus estimates of GDP growth rebound in 2002, with growth of 1.4 percent and 2.8 percent, respectively, in the first two quarters of 2002, and 3.7 percent in the second half of 2002. Even with this recovery, the unemployment rate is likely to rise through 2002.

A range of estimates underlies the Blue Chip forecasts, and that range reflects a divergence of views about the depth of the initial decline in confidence and the persistence of that decline. For example, the range between the average of the top ten and bottom ten estimates is 0.4 percent to –1.5 percent for the third quarter of 2001, 1.5 percent to –2.4 percent for the fourth quarter of 2001, 3.3 percent to –0.8 percent for the first quarter of 2002, 4.0 percent to 1.0 percent in the second quarter of 2002, and 3.8 percent to 1.8 percent for growth during 2002 as a whole. This range suggests the need to think seriously about downside risks and policies that address the source of the economy’s vulnerability in the quarters ahead.

Existing public policies also continue to buffer against the downward pressure on aggregate demand. On the monetary side, the Federal Reserve reduced its federal funds rate target on September 17 by 50 basis points, and interest rates were reduced in Europe and Canada. From a fiscal perspective, the $40 billion general emergency appropriation and the Aviation Disaster Relief bill will provide additional stimulus later this year and throughout 2002. These policy moves will mitigate somewhat the effects of the terrorist attack on output growth and unemployment, and should aid a recovery in 2002, though again downside risks remain.

Implications for Public Policy

This simple analysis of the short-term economic consequences of the events of September 11 suggests important lessons for public policy. Consumer and business confidence is a key factor in calibrating the depth of any downturn occurring as a result of the terrorist attacks and the pace of the subsequent recovery. Indeed, improvements in confidence are themselves a potent stimulus; a rapid rebound of household and business sentiment will hasten the arrival and pace of recovery in 2002. A longer decline in confidence could lead to a significant period of mediocre output growth and rising unemployment, as I noted earlier.

Hence one way to evaluate policy responses is by their effect on household or business confidence. What is the framework for policies?

First, the tragedy of September 11 is a seminal event and policies should be forward-looking, not attempting to simply replicate the world of September 10. Policies should provide consumers and businesses with confidence that the policy infrastructure is in place to ensure the conduct of economic activity in this new environment. As an example, consider the response of the Administration and the Congress to the immediate problems in commercial aviation.

The problem is not simply one of keeping commercial aircraft flying. Instead, a key feature of the policy response is the provision of funding for enhanced security, thereby addressing the root cause of the airline industry downturn – diminished confidence by travelers. This funding should address aircraft security, security personnel and screening of passengers and baggage. Prudent investment in aviation security can restore confidence in air travel, and a more secure infrastructure in aviation will also support the numerous industries related to the travel and tourism sectors of the economy.

On a broader scale, a policy focus on security – the hardening of American economic activity against terrorist intrusions – will be a linchpin in institutional setting for restored confidence. This kind of security is not merely physical, it has economic dimensions as well. For example, we must pay attention to the need for financial insurance against increased risks and ensure that private insurance markets are able to function as well in the future as they have served us in the past. These considerations require great deliberation—as I argue below, there are pitfalls in pursuing these policies, as an inappropriately heavy-handed approach may impede the private sector's inherent speed and flexibility in responding to new challenges.

Second, policies should minimize to the greatest extent possible the increased transactions costs induced by the terrorist attacks. Again, consider the recent disruption in commercial aviation, which contains elements of higher transactions costs for the airlines– greater security costs. However, it also contains higher transactions costs – greater cargo transport costs, loss of speed and flexibility in transport and business meetings, and so forth – for the business sector as a whole. A policy response that addresses the underlying need for security infrastructure in a cost-effective way will reduce overall transactions costs in supply, and minimize the loss in economic efficiency in adapting to this new environment.

Cost-effective responses are an important aspect of this adaptation. As an example, consider the need for increased security of economic activity, both physical security and the security of transactions – backup computer systems and the like. To the extent that our economic response results in duplicative security efforts by multiple parties, or excessive mandate of security policies, we will wastefully siphon funds that could be devoted to productivity enhancements and other investments into this effort.

The key to our recent economic success – and the foundation of economic performance in the future – is productivity growth. The historical lesson is that private markets are resilient, efficient, and flexible in meeting new challenges. We should seek as our objective new standards for the security of the economy, but should be wary of dictating *how* to achieve our objectives. One of the success stories of the past thirty years has been the productivity benefits of deregulation. We should be wary of losing these benefits via excessive new regulation.

The third aspect of policy is to provide support for the transition to new features of economic environment. Toward this end, it is no accident that the Administration, the Federal Reserve, and financial regulatory authorities focused attention in the aftermath of the tragedy on the smooth functioning of securities markets and financial institutions. More generally, my remarks above on transactions costs are part of a focus on reducing disruptions on the supply side. The President has displayed leadership in enhancing security and building the infrastructure for the supply of goods and services.

It is important to distinguish between forward-looking policies and investments that smooth the transition to a new environment and backward-looking attempts to compensate industries and activities that may grow more slowly or contract. A source of tremendous economic benefits is market-driven restructuring, and its associated reallocation of capital, workers, and ideas to new uses. Bailouts that attempt the preserve a lost status quo can be tempting, but will interfere with this valuable market function.

However, there are transition issues on the demand side as well. While I am not advocating an Administration position on what should be in a specific economic stimulus package, some general comments on economic recovery are possible. Businesses face uncertainty along many dimensions, among them the overall state of aggregate demand, and policies may be helpful in this dimension as well. As I noted earlier, the key aspect of policies is not merely dollars. To some, it might be appealing to follow a Japanese-style public works program of construction outlays. However, this does not address the issue of confidence – it instead covers it in an unproductive and economically wasteful fashion. Prudent supplements to unemployment insurance and health insurance are stabilizing. However, augmenting aggregate consumption demand through one-time transfers to households is less likely to be successful. The evidence from a similar effort in the 1970s is that households largely save – not spend – such one-time transfers. In the current environment, the decline in confidence has the potential to produce even stronger precautionary instincts.

To draw the distinction more sharply, consider the recently enacted tax cut. Despite all the talk about "rebates," the underpinnings are quite different from one-time fiscal stimulus. Americans received checks that are a downpayment on a large, permanent tax cut. Put differently, these dollars are part of a larger policy that enhances the security of their long-term disposable incomes. By addressing both the flow of resources and their "security" this policy can support the growth of consumption demand. The tax cut is a model for any further policies to address transitional shortfalls in consumption demand. In this light, accelerating provisions of the tax law changes for individuals enacted in June will be stimulative, as well as good tax policy.

Similar considerations apply on policies to bolster business investments in physical and human capital. To the greatest extent possible, such policies should be consistent with the support of long-term fundamentals. Also, in the corporate sector, a reduction in corporate income tax rates raises corporate cash flow for investments, employment, and restructuring; if enacted for a significant period of time, such tax reductions will also reduce the present double taxation of equity-financed investment and raise equity values, reducing the cost of capital for investment and raising household net worth. Corporate income tax rate reductions also raise after-tax profitability for a broad cross-section of companies, including both physical-capital-intensive and human-capital-intensive firms. To be effective, such a tax change should be accompanied by a reduction in the corporate Alternative Minimum Tax rate. In the noncorporate sector, similar benefits could be obtained by accelerating the reductions in marginal personal income tax rates recently enacted.

Also in the corporate, sector a promising change in business taxation would be to lower the cost of capital for investment by shifting toward expensing of fixed investment. Partial expensing—in which a proportion of investment is expensed and the balance depreciated—would stimulate fixed capital investment and would be consistent with many economists' vision of fundamental tax reform. Sound tax policy requires that such expensing be permanent; a permanent change would not generate large long-run budget costs, as expensing is a form of accelerated depreciation.

Finally, any discussion of confidence-building proposals is likely to stimulate debates over fiscal responsibility. Proposals for action should be fiscally responsible, in that they should not lead to a deterioration in the federal government's long-term budget position. It is important, however, to remind ourselves that budget surpluses are the product of a strong underlying economy—not the other way around. Particularly in the current context, policies to bolster confidence and asset values may mitigate declines in economic activity, and corresponding declines in revenue, in the future.

Going Forward

The events of September 11 represent a human disaster and an economic loss to our nation and the world. Going forward, the potential for terrorism raises concerns about the ability of the economy to produce goods and services and household and business demand for goods and services. It is appropriate to view the terrorist attacks as an important historical demarcation, and I have stressed the role that appropriate policies can contribute to addressing the need for security and confidence, the reality of new transactions costs, and the strains of transitions.

However, it would be an oversight to fail to point out that another part of confidence in the transition is not losing sight of those things that remain unchanged. Even in this new environment, an open global trading regime and a more efficient tax system remain a route to increases in our standard of living. The United States would gain substantially from further reductions in world barriers to trade in agricultural and industrial products and services. To take another example, significant economic gains for the United States remain possible from fundamental tax reform—in particular, from reducing the multiple layers of taxation on productive capital and the complexity associated with those layers of taxation.

To conclude, the U. S. economy is very resilient, and, with prudent investments in security and public policies to promote confidence, I have little reason to suspect that the economy's long-term fundamentals have been shaken by the tragedy of September 11.

Thank you again, Mr. Chairman, for the opportunity to appear before you today. I am happy to answer your questions.