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Subject: : Re: TIME SENSITIVE REMINDER on LRM OGG171 - - REVISED Council of Economic
Advisers Testimony on the Outlook for the U.S. Economy
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White House Counsel approves.

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This is a reminder that comments on this testimony were due at 2:00 P.M.
TODAY. Please provide comments ASAP.
If you've already responded to this request, please disregard this
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Subject: TIME SENSITIVE LRM OGG171 - - REVISED Council of Economic
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We are seeking your review of revised CEA testimony for a hearing
tomorrow, November 28th, before the Joint Economic Committee. The
original testimony was circulated on October 17th (LRM IKK126). Please
review and provide comments by no later than 2:00 P.M. TODAY.

LRM ID: OGG171
EXECUTIVE OFFICE OF THE PRESIDENT

OFFICE OF MANAGEMENT AND BUDGET
Washington, D.C. 20503-0001

Tuesday, November 27, 2001

LEGISLATIVE REFERRAL MEMORANDUM

TO: Legislative Liaison Officer - See Distribution
below
FROM: Richard E. Green (for) Assistant Director for
Legislative Reference
OMB CONTACT: Oscar Gonzalez
PHONE: (202)395-3923 FAX: (202)395-3109
SUBJECT: REVISED Council of Economic Advisers Testimony on the
Outlook for the U.S. Economy

DEADLINE: 2:00 P.M. Tuesday, November 27, 2001
In accordance with OMB Circular A-19, OMB requests the views of your agency on the above subject before advising on its relationship to the program of the President. Please advise us if this item will affect direct spending or receipts for purposes of the "Pay-As-You-Go" provisions of Title XIII of the Omnibus Budget Reconciliation Act of 1990.

COMMENTS: We are seeking your review of revised CEA testimony for a hearing tomorrow, November 28th, before the Joint Economic Committee. The original testimony was circulated on October 17th (LRM IKK126). Please review and provide comments by no later than 2:00 P.M. TODAY

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LRM ID: OGG171 SUBJECT: REVISED Council of Economic Advisers
Testimony on the Outlook for the U.S. Economy
RESPONSE TO
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MEMORANDUM

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**Testimony
of
R. Glenn Hubbard
Chairman, Council of Economic Advisers

before the
Joint Economic Committee, U.S. Congress**

**November 28, 2001
10:00 A.M.**

Chairman Saxton, Vice-Chairman Reed, and members of the Committee, it is a pleasure to appear before you today to discuss the economic outlook for the United States.

The Near-Term Economic Outlook

Let me begin by briefly reviewing the present state of the economy and its near-term prospects. In doing so, it is useful to organize thinking around supply conditions – the capacity of the economy to produce goods and services – and demand conditions – the ability and willingness of households, firms, and governments to purchase these services and products.

The events of September 11 had dramatic human and economic implications. As is now apparent, the terrorist attacks on the World Trade Center and the Pentagon resulted in loss of life, physical damages, damage to the financial sector, and interruption of commercial aviation that temporarily restricted the economy's ability to supply goods and services in the short run. These "supply shock" consequences of the attacks substantially reduced the growth rate of GDP during the third quarter and will adversely affect economic growth in the current quarter.

Of course, there are potentially more durable effects as well. The economic aftermath includes shocks to household and business confidence, and increased uncertainty regarding the economic environment. The effects on confidence and uncertainty give rise to a number of additional supply-side costs of transacting business deriving from enhanced security and 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 household and business willingness to spend and invest. Prior to the attacks, a focus of policy was to ensure a continued flow of resources – incomes and cash flow – 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 temporary funds to households, for example, and toward buttressing the confidence of households to make purchases out of those dollars.

What is the outlook in this regard? The most recent Blue Chip consensus estimates of GDP growth indicate a rebound in 2002, with growth at an annual rate of 0.5 percent and 2.6 percent, respectively, in the first two quarters of 2002, and 3.9 percent in the second half of 2002. Even with this recovery, the unemployment rate is likely to rise through 2002. Underlying this outlook is an implicit current decline in confidence that rebounds early next year.

Much recent attention has focused on the possibility that the United States has entered a recession, a debate that has ended with the announcement on November 26 by the National Bureau of Economic Research that the economy reached its cyclical peak in March of this year.

To my mind this announcement is less important than looking forward and anticipating the path for economic policy best able to facilitate the economy's return to potential growth.

How would such a recovery take place? The key factors are growth of gross private domestic investment – especially business investment in equipment and software – and the strength of growth of personal consumption expenditures. The latter constituted 69 percent of aggregate purchases in the third quarter, while the former accounted for another 17 percent. In the third quarter, consumption grew at an annual rate of 1.2 percent and contributed 0.8 percentage point to GDP growth. In contrast, investment declined at an annual rate of 10.7 percent and contributed a decline of 1.8 percentage points to overall GDP growth.

Without changing any other aspect of economic performance – that is, holding growth in other components of aggregate demand at their third quarter values – simply having investment decline at a slower rate of 5 percent would yield a growth rate of GDP that was nearly a full percentage point higher.

This computation illustrates the mechanics of economic recovery. First, one can imagine a slowing rate of decline in investment spending; perhaps simply a growth rate of zero. With this – and, again, holding other growth factors in demand unchanged – GDP growth would reach 1.4 percent.

Second, raising consumption growth from its recent pace of 1.2 percent to the 3.0 percent that prevailed from the second quarter of 2000 to the third quarter of 2001 would yield GDP growth of 2.8 percent. Finally, a resumption of growth in consumption (4.2 percent) and investment (7.7 percent) at the rates averaged from 1995 through 2000 would yield robust growth of 5.0 percent.

Again, I stress, these are the mechanics of recovery. It is not appropriate to imagine that the future path of state and local government expenditures, federal purchases, and net exports will be the same as in the third quarter. However, this illustrative calculation places attention on the two key aspects of resuming rapid economic growth.

It is not necessary to have an immediate, robust rebound to positive growth in investment in order to have more rapid growth. Simply slowing the decline, or even stopping it, would contribute greatly. The substantial monetary easing since January will contribute greatly in this regard.

Recently, however, the notion that investment will not display even this modest improvement because businesses are burdened with significant excess capital – a “capital overhang” – has gained popularity. This seems unduly pessimistic. While there may be narrow sectors of the economy for which this characterization rings true – as, for example, in the telecommunication infrastructure sector – as a general matter any capital overhang is likely to have been eliminated by the weak investment performance in 2001.

Capital overhang represents the difference between the actual and desired amounts of capital in the form of equipment or structures. Because slower expected output growth lowers the amount of investment necessary to maintain the same capital stock relative to the output it produces, a slowdown in expected economic growth can lower the capital stock firms want to hold, generating a potential overhang and reducing investment. For example, if a near-term slowdown reduced the expected average growth rate from 3.5 percent to 3.0 percent, gross investment would fall \$30 billion in the first year in which the slowdown became apparent. This decline in investment might generate a capital overhang, as the capital stock might be greater for a time than the capital stock firms want to employ.

To be more specific, suppose that rapid economic growth in the late 1990s implied that firms had no excess capital in 1999, but that slower economic growth caused the growth rate of the desired capital stock to fall from 4 percent to 3 percent in 2000. Any resulting overhang would almost certainly have been eliminated in 2001. Why? The capital stock in 2000 grew at a 4.2 percent rate instead of a 3 percent rate. In this example, this result is a \$120 billion overhang. Given the pace of events thus far, the capital stock will grow by about 0.5 percent in 2001 – well below the 4 percent pace of recent years. The \$130 billion decline in investment eliminates the overhang that may have developed.

While thinking about capital overhang, it is worth noting that this is different from the conventional notion of unused capacity. During the sluggish growth in 2001, capacity utilization rates have fallen, but this does not imply a capital overhang. First, capacity utilization data focus solely on manufacturing and are not representative of the entire economy. Moreover, business capital purchases take time to plan, order, and put in place. For this reason, businesses look beyond current conditions – focusing on sales, cost of capital, and cash flow in the future – to plan investments. In a growth slowdown, the capital stock firms want to hold may continue to rise even though current capacity is not being strained.

To summarize, the basic path of economic recovery incorporates more rapid growth in consumption and a slowing in the decline in investment in the next few quarters. Thereafter, a recovery of positive investment growth would coincide with growth at or above potential.

This baseline forecast corresponds roughly to the consensus of private forecasters. However, it is associated with considerable uncertainty. To see this, consider the range of estimates that underlies the most recent available Blue Chip forecasts. The range reflects a divergence of views about both the depth of the initial decline in confidence and the persistence

of that decline. For example, for the fourth quarter, the range between the average of the top ten estimates and bottom ten estimates is from a low of -0.1 percent to a high of -3.3 percent for the fourth quarter of 2001. For the first quarter of 2002, the same gap is from 2.9 percent to -1.7 percent, and 4.3 percent to 0.6 percent in the second quarter of 2002. The gap is from 2.6 percent to -0.1 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 – vulnerability especially to slower growth of consumption and a less rapid slowing of the decline in investment.

Public Policies to Promote Economic Security

A key impact of the terrorist attacks has been to introduce new risks into the economic environment. One of the policy challenges is to develop policies that address these risks, but utilize the strengths of the private sector in doing so.

Growth Insurance

This perspective informs the Administration's efforts regarding economic growth insurance, or "stimulus." In the current setting, it is important to focus on the potential for downside risks, and develop policies as insurance against a slower and/or more sluggish upturn in economic growth than currently expected – that is to guard against a sustained downturn in business and household confidence or another adverse event.

Insurance, of course, has to be purchased in advance to have any value. Thus the first implication of this view is that we should move now to put into place the correct package of

measures. In response to the President's leadership, the House of Representatives acted quickly to pass its stimulus legislation. It is time for the Senate to follow suit.

There has clearly been substantial debate of what should be included in a stimulus package. The growth insurance perspective provides considerable guidance. First, it should be pro-growth – it should enhance long-run incentives to work, invest, take risks, and expand our productive capacity.

Of course, it should also be cognizant of short-term needs. The President recognized this early on, incorporating tax relief for low-income families and targeted extensions of assistance for displaced workers. This addresses their needs and provides some demand-side insurance for businesses. As a general matter, though, throwing money at the problem does not buy meaningful growth insurance.

Over the past year, the household sector has sustained economic growth in the face of weak business investment. More recently, there is evidence that consumer spending has begun to soften somewhat. Because personal consumption spending is over two-thirds of aggregate purchases, negative growth in consumption is an important downside risk – declines in consumption would be at the heart of any severe contraction.

However, in part due to the tax cut proposed by the President and passed by Congress last spring, disposable income has held up quite well through the third quarter. Instead, the slowdown in household spending tracks the decline in consumer confidence. Consumer confidence is the issue.

How can public policy address confidence? One part of this response is attention to security and progress against terrorism. On the economic front, surveys of consumer sentiment

indicate that individuals are less optimistic in the face of job losses and the prospect of future softening in the labor market. To address confidence, we need to focus on job creation.

One key to this is small businesses, traditionally a source of new jobs in the economy. The best policy for small businesses and entrepreneurs is to reduce their marginal tax rates. For this reason, the President wisely focused on moving forward the marginal tax rate cuts that were passed by Congress in the spring. Lower marginal tax rates both improve incentives and augment the cash flow of small businesses. Research shows that through these channels entrepreneurs will expand their payrolls and increase their investments. For example, research by Harvey Rosen at Princeton University indicates that cutting the top marginal tax rate from 39.6 percent to 35 percent raises the fraction of high-income small businesses that undertake a capital expansion by 8.7 percent, and raises the average size of the capital outlays by 8.3 percent.

Looking at the employment side, the studies show that lowering the top marginal tax rate raises the fraction of high-income small businesses whose prospects are good enough to afford to hire outside help by 8.4 percent and permits payroll growth of 2.8 percent, taking the form of both higher wages and more workers.

The second key is to help businesses overcome the current uncertainty and restart investment spending. At the aggregate level, the resumption of rapid economic growth requires resumption in the growth of capital expenditures. Employment losses have been concentrated in the manufacturing sector – a sector heavily dependent on the health of business investment. For this reason, the Administration has focused on investment incentives – partial expensing – and corporate cash flow – eliminating the corporation Alternative Minimum Tax (AMT), which raises effective tax rates on business in downturns. These growth incentives target the source of

the problem, diminished private sector job creation that is associated with the decline in consumer confidence.

Some critics have suggested that investment incentives will not work because of a capital overhang. To the contrary, there is good reason for one to expect the Administration's economic stimulus proposals to be effective in the current setting. Investment incentives – partial expensing – lower the expected cost of capital, raising the amount of capital that firms want to hold. Elimination of the AMT raises firms' expected cash flow, again lifting the amount of capital that firms wish to have put in place. In the absence of a capital overhang, these incentives translate into an impetus for more investment. Investment incentives work through expected reductions in the future cost of capital and increases in corporate cash flow. The longer the investment incentives are in place, the greater the stimulus to investment.

To summarize, the Administration's approach is a growth insurance package that contains both demand-side support for purchases and incentives to expand investment and jobs. We expect that timely adoption would raise GDP growth by 0.5 percent in 2002 and help the private sector to create an additional 300,000 jobs.

Because the focus is on delivering incentives and support via the tax system, it can be put into place quite quickly. Because it contains supply-side incentives, it is not heavily dependent on precise timing and fiscal fine-tuning. Also because it is focused on using the private sector – crowding in private activity instead of crowding out – it will not harm the long-term outlook.

The notion of “crowding out” has surfaced in another aspect of the debate over the macroeconomic response to the terrorist attacks – effects of policy responses on interest rates. The right policy at the right time will not cause long-term interest rates to rise. Recent research

by Douglas Elmendorf of the Board of Governors of the Federal Reserve System and N. Gregory Mankiw of Harvard University indicates that reduced surpluses for the sort of modest confidence-building package the President outlined would raise long-term interest rates by only three to five basis points. A well-constructed fiscal stimulus will affect the out-year budget by only a fraction of this amount, and will have trivial effects on long-term interest rates.

This is not surprising. Bond market participants recognize that the modest tax cuts under discussion are small in the context of the global capital market. More importantly, the markets have absorbed more quickly than some observers the lesson that a strong economy is the source of Federal surpluses and not the reverse. Policies that insure against sub-par growth will also insure against sustained reductions in Federal surpluses.

The principal threat to long-term discipline is the other approach featured in the public debate – spending. Japan is the best example of trying to spend one's way to faster growth. It has not worked and will not work. Many such proposals are disguised special interest subsidies and pork-barrel public works proposals.

At the center of the debate, however, have been proposals to expand the scope of social insurance. The President recognized early on that there would be a need to address these aspects of the repercussions of the terrorist attacks. The Administration has proposed tax relief for lower-income families, and extension of Unemployment Insurance (UI) benefits in those areas experiencing a marked increase in unemployment, and flexible National Emergency Grants to provide funds for health insurance and other needs. These approaches are timely and flexible.

An alternative is broad-based expansion of social insurance programs. This alternative does not, however, fit the perspective of growth insurance. It will not stimulate demand in the very near-term nor provide supply side incentives. It is not timely, and does not address the

underlying problem of job creation, and in some cases would serve to raise – not lower – unemployment.

Some proposals would impose substantial additional costs on businesses and states for hiring new workers – working against job creation and adding fiscal burdens for states. In the past, UI has reflected federalism principles: states determine benefits and payroll tax rates. The proposals endorsed by the Senate Finance Committee contain an unprecedented Federal mandate for large benefit increases and expansions of coverage requirements for all states. The annual cost of the expansion in benefits exceeds \$8 billion per year – equivalent to a UI payroll tax increase of around one percentage point. Put differently, over \$8 billion annually in states' revenues would be forced into a new Federal mandate.

In addition to raising the costs of doing business, these proposals would almost certainly increase the unemployment rate. Research suggests that raising benefits by 15 percent will increase the likelihood that an individual “takes-up” unemployment insurance benefits by 7 percentage points and extend the duration of unemployment by about one-half a week. If one were to also extend benefits for 13 more weeks, there is an additional effect of extending unemployment by another week. Collecting the effects of increased participation and longer duration of unemployment suggests the overall effect would be to raise the unemployment rate from 5.4 percent to 5.7 percent. This ignores the effects of any additional subsidies for health insurance benefits, which would add to these effects.

At the same time, increases in UI benefits will distort firms' decisions. A large part of unemployment is temporary layoffs – regular seasonal changes in work. Two-thirds of UI recipients expect to be recalled, and one-half return to the same employer. More generous and longer benefits undercut the need for careful planning to avoid unnecessary layoffs.

The Administration's approach is both more timely – the President's proposals can be implemented quickly because they rely on existing mechanisms and permit states to target Federal funds effectively -- and does not impose new taxes on employers or new costs on states. It is a better approach to handling the needs of displaced workers.

The public policy response to the terrorist attacks rightfully includes a carefully constructed set of measures designed to address risks of prolonged and adverse shocks to business and household confidence. Again, these risks are most effectively addressed using the private sector; tax cuts crowd-in the private sector by supporting its job creation, providing support to demand, enhancing supply-side incentives, and doing these things in a timely fashion. Spending-oriented alternatives are both less timely and fail to exploit the creativity, flexibility, and innovation of the private sector.

Terrorism Risk Insurance

The terrorist attacks indicated that the probability of catastrophic property and casualty losses was higher than anticipated. In the short run, insurers face difficulties in responding; in particular, the current difficulty of evaluating the probability of more events or handling catastrophically large events has made the reinsurance industry reluctant to cover terrorist events. For example, Keith Buckley, an insurance analyst with Fitch Ratings Company, states that it is “the universally stated plan of reinsurance companies to add specific terrorism exclusions to reinsurance coverage.” Without reinsurance, primary insurers will be forced to exclude terrorism coverage, charge very high premiums, or withdraw from the market entirely.

The loss of property and casualty insurance against terrorist acts eliminates a mechanism by which the economy can respond efficiently to such contingencies. In general, insurance

spreads risks, converting for each business a potential cost of unknowable size and timing into a set of smaller, known premium payments. In normal circumstances, increased risks are translated into higher premiums. This serves the useful economic function of pricing risk, leading the private sector toward those activities where the risk is “worth it” – there might be losses now and then, but on average society will benefit – and away from foolhardy gambles.

For insurance markets, unfortunately, the distinction between risk – not knowing when an event will happen, but having solid knowledge of the odds of an occurrence – and genuine uncertainty about the frequency of an insured event is the key to being able to price efficiently. Only experience with our new security environment will allow businesses to appropriately price the contingencies that businesses now face.

An interruption of coverage is another, and extreme, version of an increase in transactions costs as a result of terrorist-associated risks. If existing lines of coverage are renewed, it will quite likely involve substantial increases in premiums.

A withdrawal of insurance coverage would cause large costs as well. Lenders usually require businesses to insure any property they use to secure loans. The terms of terrorism coverage could diminish bank lending for new construction projects. It could as well act as a sharp impediment to transactions that permit existing commercial properties – skyscrapers, pipelines, power plants, and so forth – to change hands. It is important to point out that this “changing hands” is an important economic function. The relative efficiency with which our economy reallocates capital from less productive to more productive uses sets it apart from the economies of many other nations.

Without adequate insurance, it will be difficult to develop, operate, acquire, refinance, or sell property. Now, it may be the case that lenders accept alternative terms for their financing,

but this just disguises the problem. Instead of risk being borne efficiently by the insurance industry, it will be shifted to the banking sector.

In either event, the absence of insurance coverage for terrorism risks will likely raise the difficulty of financing existing commercial structures and deter the construction of new projects. The result could look like a “credit crunch.” A rough estimate is an overall reduction in 2002 GDP of 0.3 percentage point if the problem is not solved, with most of the loss early in 2002. This reduced growth rate of GDP would likely be equal to 0.8 percentage point in the first quarter of 2002, 0.7 percentage point in the second quarter of 2002, and lower thereafter. The decline is caused by a reduction in asset values that reduces the consumption purchases of the household sector. In addition, lower valuations reduce the incentive to invest in new structures. The overall liquidity effects also reduce the path for investment in non-residential structures.

The appropriate policy response in this environment is to encourage private market incentives to expand its capacity to absorb and diversify risk. Thus we should seek an approach that recedes as the private market becomes capable of insuring losses on its own, provides customers and firms with appropriate incentives to minimize the expected costs of such an event, and reduces uncertainty about liabilities that arise from the events.

Congress and the Administration have each developed proposals in recent weeks which I hope will soon provide a catastrophic backstop for the private sector that retains market incentives. One part of these efforts has not been well understood, however. The Administration has proposed sensible litigation procedures for mass tort terrorism cases. Specifically the proposals would: (1) consolidate terrorism cases in single Federal court, (2) preserve the pool of defendant resources and provide for equitable plaintiff recovery by eliminating punitive damage awards, (3) prevent unfair and unnecessary bankruptcies caused by joint and several liability for

non-economic damages, and (4) maintain the pool of defendant resources for equitable plaintiff recovery by preventing double recovery by some plaintiffs.

These proposals should not be confused with or made part of the debate over general tort reform. In fact, there should not be – and in the past has not been – political or philosophical disagreement about the need for alternative litigation procedures in mass tort cases. In fact, the Administration’s litigation proposals would apply only in a modest sub-category of mass tort cases, namely, mass tort terrorism cases.

These litigation procedures will help reduce the substantial uncertainty faced by the insurance industry in pricing terrorism risk. A significant component of the terrorism risk to insurers is likely to be the liability component of property and casualty insurance. The Administration’s proposed litigation procedures will help to manage that risk and crowd in the private market. Absent these procedures, the resources of liable defendants, including resources from their liability insurance policies, will not suffice to compensate the class of successful plaintiff-victims in mass tort terrorism incidents. For that reason, mass torts often are resolved through bankruptcy (where plaintiffs rarely receive full compensation) or settlement (again, where plaintiffs rarely receive full compensation). Put differently, the procedures will preserve the assets in order that successful plaintiffs are compensated fairly and equitably.

The Longer-Term Outlook

Turning toward the longer-term outlook, a few issues arise. The first, and most important, is that the long-term fundamentals of the U.S. economy remain sound. Even during the recent slowdown productivity growth remains strong. Productivity grew at an annual rate of 2.7 percent in the third quarter and averaged 2.5 percent since 1995. The growth in productivity

is one of the most important factors determining our long run prosperity, which determines our ability to meet both public and private goals.

Second, over the longer term, one of those objectives will be to address the generalized need for greater security and to “harden” the U.S. economy against the threat of terrorism. In doing so, it is important to do so in a way that minimizes its impact on underlying productivity growth. To date, the impact of meeting these needs appears likely to have a modest impact on productivity growth. Our estimate is that doubling private security spending would lower productivity by 0.5 percentage point over the next several years; a modest impact on productivity growth.

Now, it may be the case that the Nation determines that adequately addressing these needs requires devoting more resources. If so, one possible manifestation would be a genuine need for enhanced outlays for security in the Federal budget. If so, it is sensible to re-prioritize –not just augment – budget resources to address these needs. As with other aspects of addressing terrorism risks, we should not forget the historical lesson that private markets are resilient, efficient, and flexible in meeting new challenges. We should seek as our objective new standards for the security – and perhaps augment Federal resources – but should be wary of dictating how to achieve our objectives. Instead, we need to work to identify the range of risks and the appropriate level of security to require of the private sector. Having done so, it is in our national interest to be both vigilant in ensuring that these standards are met, but flexible in allowing the private sector to do so in an efficient fashion.

Another possibility would be an attempt to hide the costs of addressing terrorism risk by keeping expenditures off public sector budgets, instead mandating security measures in a heavy handed way. One of the success stories of the past thirty years has been the productivity growth

derived from deregulation. We should be wary of losing these benefits via excessive new and burdensome regulation, even in the name of enhanced security, as there are more efficient approaches to the same problems.

To conclude, the U.S. economy is very resilient and, with prudent investments in enhancing the private sector's ability to address the risks of terrorism, we have every reason to expect a timely recovery of economic growth and a continuation of our economy's long-term progress.

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