Statement of
David R. Malpass before the
House Committee on Financial Services
April 30, 2003

Chairman Oxley, Mr. Frank, members of the Committee, thank you for the invitation to testify on United States monetary and economic policy. I've organized my testimony into three parts: the economic outlook, key variables including the tax cut, and some comments on the budget deficit.

Despite slow growth in the first quarter, I think the economic outlook is good. The U.S. economy grew 2.9% in 2002 and is likely to grow well above that in 2003. Job growth should begin later in the year. We are likely to see a new record in U.S. employment in 2004, topping the 132.5 million in March 2001. Orders for durable goods grew 2% in March from February despite the weather and Iraq-related uncertainties. Consumer confidence has taken a sharp upturn.

The pace of the recovery from the 2001 recession has been modest by historical standards yet well above the prevailing pessimism. I think oil prices, business investment, and the tax cut are the primary variables in the outlook, though SARS is important for now. In my view, these variables are more important than the bearish focus on the trade deficit, the budget deficit, past deflation, excess capacity, consumer debt and housing prices.

Much of the pessimism on the economy is backward looking, reaching a grim outlook by comparing current conditions to the strong-dollar-induced bubble of the late 1990s. True, we shouldn't expect a return to the bubbly 1990s in terms of the 3.8% unemployment rate, the high-flying dollar, or regular double-digit equity returns. Those conditions felt good at the time, but left the economy on the brink of a deflationary recession. The macro-economic causes of the global recession are clear: the ever-strengthening dollar and the resulting deflation; very high real interest rates; high OPEC-controlled oil prices; and a record tax burden which drained a net $236 billion (2.4% of GDP) from the private sector in 2000 in the form of the fiscal surplus. *None of these contractionary forces is present now.*

Arrayed against these problems are the improved macro-economic polices, the small-business character of the U.S. economy, a strong, flexible labor force, and fast productivity growth. The balance, in my view, is favorable for the U.S. outlook. I will be even more confident if a growth-oriented tax cut passes Congress.

Good Platform For Growth

The platform for future economic growth is in much better shape than in 2000. Interest rates are very low. Real interest rates (the Fed funds rate minus the inflation rate for personal consumption expenditures) finally went deeply negative in late 2002, encouraging investment and inventory rebuilding.

Real Fed Funds Rate (Fed Funds Minus PCE Deflator)

Source: Haver; Bear, Stearns & Co. Inc.

The value of the dollar is back at a pro-growth level after its deflationary strengthening from 1997-2001. Inventories are low. Tax rates are lower than they were in 2000, with the prospect of more rate cuts. Corporate profits and the stock market are rising. Oil prices have fallen and the OPEC cartel seems to be losing its ability to keep oil prices artificially high.

- Yes, the economy lost 108,000 jobs in March. Still, the current level of U.S. employment is over a million and a half higher than the 1999 average. This is discussed in detail in the next section.

- I expect the next interest rate move by the Federal Reserve to be up, not down, probably in the second half of 2003. Still, the economy will enjoy lasting benefits from the current period of low interest and mortgage rates, helping make up for the damage from the high real interest rates during the bubble.

- Consumer debt has reached record levels at $8.7 trillion. Still, personal income hit a new record in March at $9.16 trillion, arguing for consumer resilience. Consumer assets are holding at $48 trillion and part of the debt buildup reflects record home and auto ownership and related debt.

- The U.S. current account deficit, at 4.8% of GDP, is in record territory. Still, U.S. economic growth is well above our trading partners, and investment into the U.S. dwarfs investment into other countries.

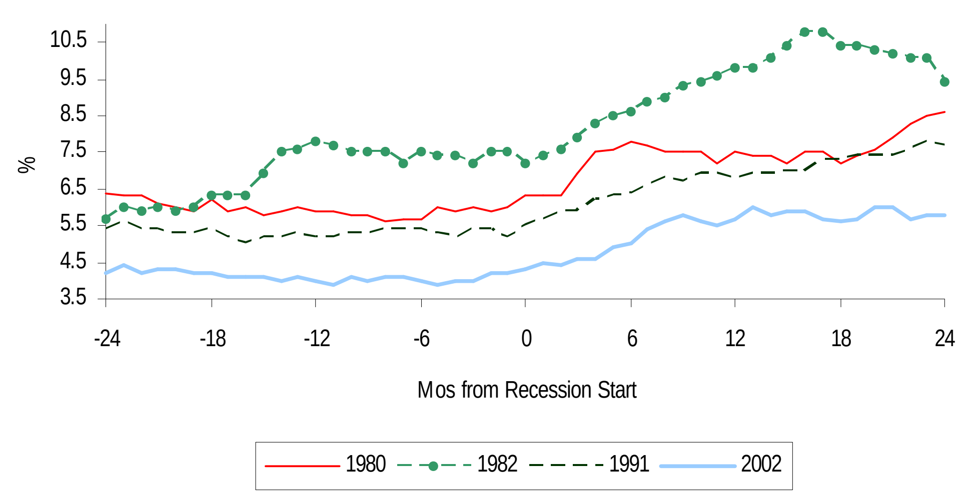
- The U.S. fiscal deficit will probably top $300 billion in fiscal year 2003. Still, at 2.7% of GDP, this is well below the 1983 peak of 6% of GDP. The debt/GDP ratio is 35.5% , well below the 49.5% recorded in 1993. Given low interest rates, the cost of servicing the U.S. government's debt is also steady relative to the budget and GDP.

- Clearly, SARS will hurt non-Japan Asia's second quarter growth and must already be having a small impact on the U.S. through our broad trade and investment relationships. Still, our current estimates show that SARS will have about one-tenth the impact of the 1997-1998 Asia devaluation crisis, roughly a $30 billion subtraction from Asia's GDP versus a $345 billion subtraction in 1998. SARS may cause some temporary disruptions in supply lines from Asia to the U.S. However, I note that the U.S. economy adjusted fast to the California energy crisis, minimizing the damage from the disruptions.

Labor-Market Conditions

Employment is a critical part of economic success. Jobless claims have grown in recent weeks, reaching 455,000 in the week ending April 19. Rather than a "jobless recovery", though, I think the economy is reacting more as if there was a bubble in employment in the late 1990s, followed by a reversal. The March 5.8% unemployment rate, which I expect to go somewhat higher in April, was relatively low by historical standards.

Unemployment Rate: Current Vs. Previous Cycles



Source: Haver; Bear, Stearns & Co. Inc.

- At 130.4 million workers in March, U.S. employment is still 1.5 million above the 1999 average achieved during the boom. With productivity growth fast, driven in part by the investment boom of the 1990s, I don't think employment will grow strongly from current levels until later in the expansion.

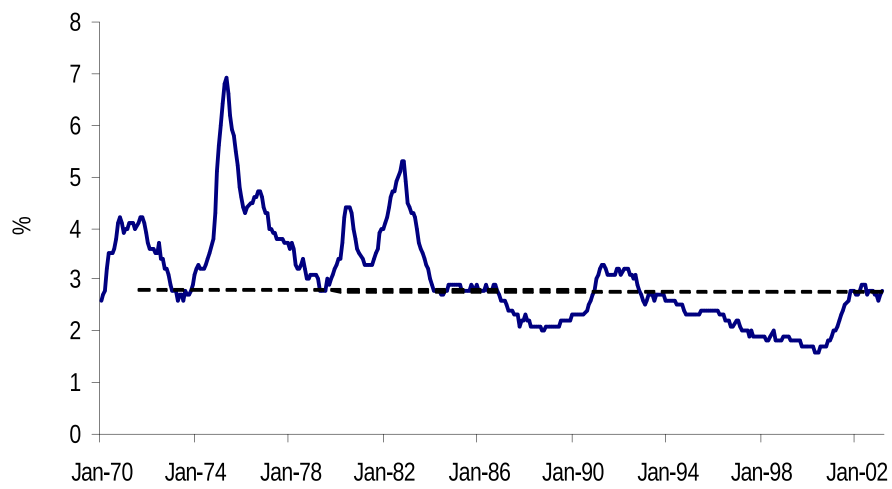
- While initial jobless claims have risen in recent weeks, they should be compared to the bigger employment base. For example, in the 1993-1996 economic expansion, jobless claims were generally 350,000 per week. However, the level of employment at that time averaged 115 million. With employment now over 130 million, the equivalent jobless claims would be 400,000 in an expansion. The graph shows that jobless claims are relatively low compared to pre-irrational-exuberance times.

Initial Jobless Claims as % of Employment

Source: Haver; Bear, Stearns & Co. Inc.

- The number of workers receiving continuing unemployment compensation as a percentage of total employment is also low relative to past business cycles. The current rate (slightly less than 3%), even though well above the 1999 low, is consistent with strong expansions in past business cycles.

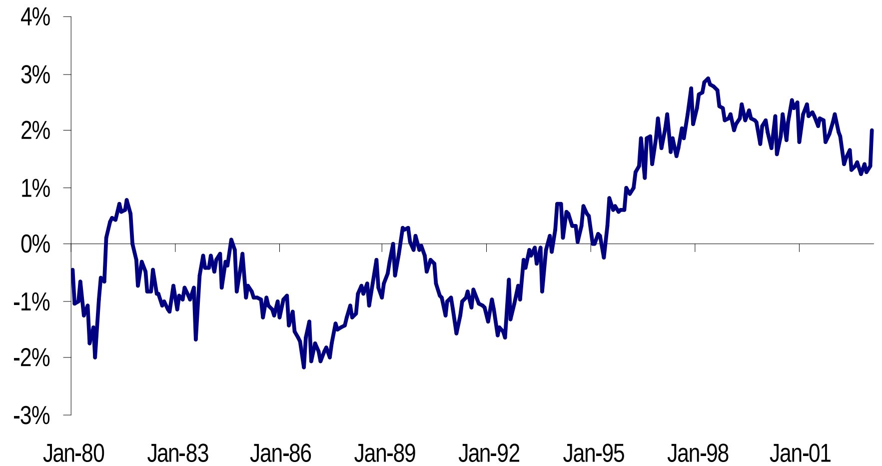
Continuing Unemployment Claims as % of Employment



Source: Haver; Bear, Stearns & Co. Inc.

- Real wage growth held up well through the 2001 recession. This and the 5.8% unemployment rate help explain the steady growth in consumption in recent years.

Real Wage Growth (using Core PCE Deflator)



Source: Haver; Bear, Stearns & Co. Inc.

Key Variables

Due to the dollar's decline, I expect a constructive, multi-year reflation process. This will be a challenging environment for business profits but a decided improvement over deflation. In most other parts of the world, economies are substantially weaker than ours, with unemployment higher, government spending and unfunded pension liabilities bigger, health care systems less effective, and currencies even more volatile. Even so, world nominal dollar GDP looks like it will grow well over 7% in 2003, twice as fast as in 2002 and a sea-change from the 1.4% decline in 2001's deflationary recession. Clear U.S. leadership will play a critical role in helping improve growth policies elsewhere, including promoting tax reform, currency stability, and restraint on the size of government.

I would like to emphasize three key variables in the U.S. growth outlook – oil prices, business investment and the tax cut.

Oil prices. With the regime change in Iraq, oil prices have fallen sharply to $25 per barrel from $37. I expect further declines as Iraqi oil begins to ship and U.S. inventories build. This will be a significant stimulus to the economy, including the consumer effect and, more important in my view, the positive effect on the business outlook.

Business investment. Low interest rates, low inventories, the prospect of a tax cut, and less Iraq-related uncertainties should improve "animal spirits", the willingness to take business risk. I expect investment in business equipment to grow 7.7% in 2003 (fourth quarter over fourth quarter), up from 3.3% growth in 2002. This is modest growth by the standards of previous recoveries, reflecting caution after the investment boom of the late 1990s.

I disagree with the bearish concerns over the 74.8% capacity utilization rate. 1) Capacity utilization data covers only about one-third of the economy. 2) Idle capacity is heavily concentrated in telecommunications and semi-conductors. 3) Business investment usually recovers while the government's measure of capacity utilization is still declining. 4) Much of the capacity was short-lived and installed prior to or during the late-1990s boom, meaning a boom in obsolescence in many sectors. 5) I think the government data on capacity utilization can't effectively measure write-offs, obsolescence, or innovation and can't keep up with the economy's rapid structural changes. This makes capacity utilization a lagging and unreliable indicator of future investment.

Tax Cut Would Improve The Capital And Incentive Structure

My testimony has lauded various structural aspects of the U.S. economy. It stands out around the world in terms of productivity and flexibility, auguring well for long-term growth.

However, one area where the U.S. is sorely deficient is the tax code. We suffer from very high marginal income tax rates, a heavy payroll tax on both the employer and employee, and huge tax incentives encouraging all types of debt – high-yield corporate debt, state and local debt, mortgage debt, etc.

A growth-oriented tax cut is a critical part of the U.S. and global recovery and one of the key variables in the outlook. Economic health depends on the efficiency of the capital and incentive structures. The President's proposal to complete the 2001 tax cuts and eliminate the double taxation of dividends (which heavily biases the corporate sector toward debt) would, in my view, add strongly to both the near- and longer-term growth outlook. It would provide important benefits in terms of jobs, economic growth, capital mobility, and corporate governance.

When you tax something less, you get more of it, in this case more capital, labor, and wealth. Under the Administration's proposal, that would mean more productivity, jobs and economic growth. In terms of near-term and long-term growth, I think the President's proposal is much superior to cash rebates or other consumption-oriented tax cuts. It is preferable to targeted investment incentives such as equipment expensing -- we need to improve the quality of investment as much as the quantity. Though intangible, one big benefit from enacting the Administration's tax cut proposals would be the positive implication for the direction of future tax reforms.

Mis-scoring the Tax Cut

The President's full proposal, including income tax cuts and other provisions, was scored as a $726 billion "cost" over 10 years. This is only 0.5% of the Congressional Budget Office's $146 trillion GDP expectation for those years, but even so I think the $726 billion estimate overstates the cost and ignores the benefits. I don't claim to know exact numbers for a proper estimate. Economics isn't a science. But I know that simply looking at the static cost to the government (the current approach) is incomplete and highly misleading.

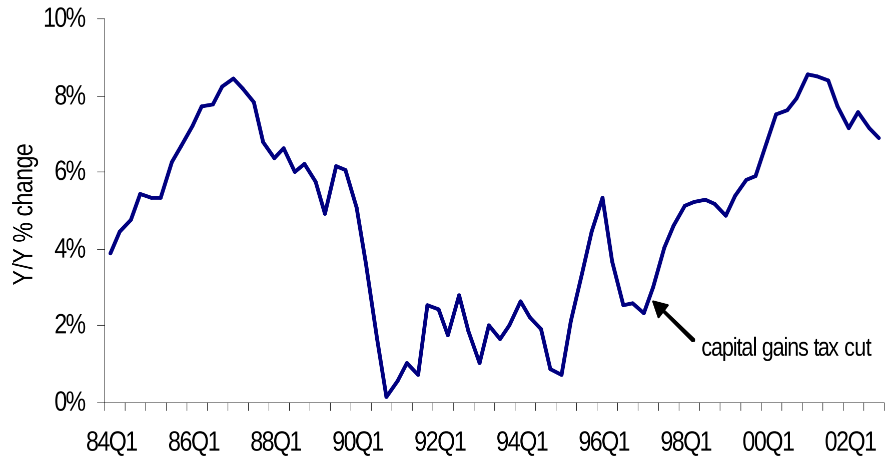
- First, most of the "cost" to the government is a straight benefit to taxpayers. From the standpoint of national well-being, the first-order effect is a wash, not a $726 billion loss.

- Second, the cost estimate drastically understates the impact of tax changes on economic growth. If the tax cut raises the growth rate by just 0.25% -- I think it would due to increased entrepreneurism, a lower tax on work, more capital, and a better allocation of capital – the 10-year revenue gain to the government might be $500 billion. (This estimate is based on CBO's Budget and Economic Outlook for FY2004-2013, p. 132, calculation of a $208 billion loss in 10-year receipts from a 0.1% decrease in the growth rate.)

- Third and most important, the cost estimate is a purely income statement concept, ignoring changes in national wealth. I think the elimination of double taxation of dividends would quickly add $1.5 - $2 trillion to equity market capitalization (works out to 13% - 18% of the $11 trillion equity market capitalization) with large collateral benefits for business confidence and employment. The scoring estimates ignore this benefit completely, yet the gains to the economy and employment would be real. Taxing dividends reduces the value of corporations and encourages debt. Reversing that would cause higher stock prices, more capital gains, more capital gains taxes, a lower cost of equity capital, and a more efficient allocation of capital. None of these benefits is reflected in the "scoring" process, which puts the scoring "loss" of a dividend rate cut at roughly $30 billion per year (still only a fraction of the gains in national wealth from lowering the asset tax).

We have a recent example of the impact of lower asset taxes on the value of assets and the related economic impact. In 1997, the government cut the capital gain tax rate on houses, losing a small amount of revenues but creating a tremendous gain in the national wealth. (By my rough estimate, the U.S. housing stock has increased roughly $4 trillion since the 1997 tax cut, though not all of that is attributable to the tax cut.) Jobs in residential construction surged.

U.S. House Prices



Source: DLX Haver; Bear, Stearns & Co. Inc.

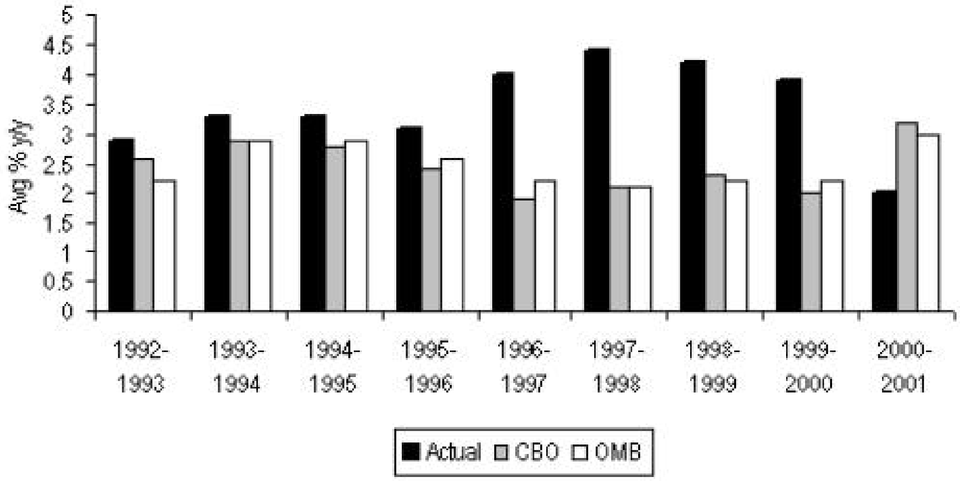
I would expect the same type of reaction to a dividend tax cut – a massive increase in national wealth and a surge in economic activity -- at a relatively small cost to the federal government. The current dividend tax distorts the capital structure. It creates an expensive wedge or toll gate between retained earnings and the shareholder, plus it encourages debt and unproductive acquisitions over equity capital and dividends. Its elimination would improve the allocation of capital, adding substantially to near-term and long-term U.S. economic prospects.

Budget Deficits Hard To Forecast

I would like to offer some comments on the budget deficit and its economic impact. We should accept at the outset of a budget discussion that no one knows, even roughly, what the budget deficit will be over the next ten years.

- Forecasting budget deficits isn't accurate. For example, in the 1990s U.S. GDP growth was consistently above OMB and CBO forecasts (as well as private sector forecasts). Conversely, the recession produced growth well below forecasts.

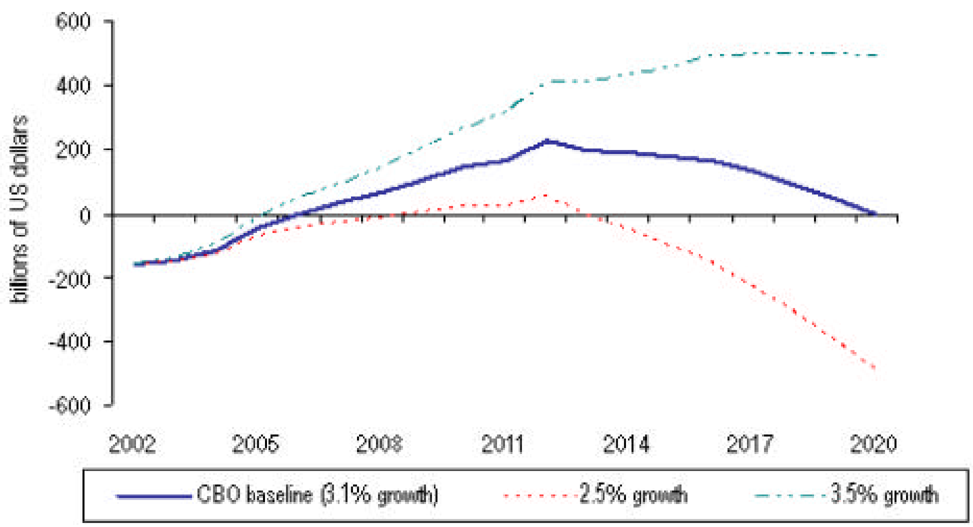
Two Year Real GDP Growth: Actual Vs. Forecast



Source: Bloomberg; Bear, Stearns & Co. Inc.

- Budget deficits are very sensitive to the future growth rate.

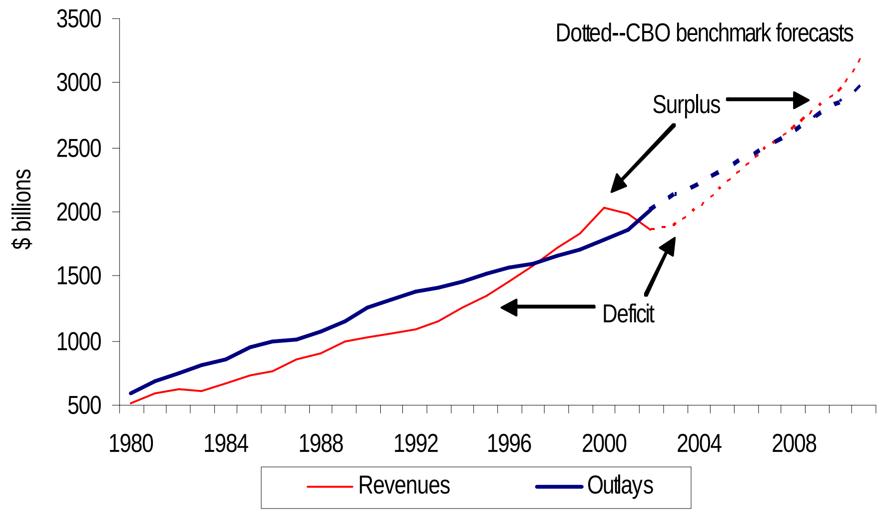
Long-term Government Budget Paths Under Different Growth Assumptions



Source: Congressional Budget Office and Bear, Stearns & Co. Inc.

- The result is wide, relatively unpredictable swings in the budget deficit based on fluctuations in economic growth rates, government spending binges, and the effectiveness of tax policy.

Government Revenues and Outlays



Source: Congressional Budget Office; Bear, Stearns & Co. Inc.

It looks to me as if CBO has used very conservative estimates for GDP growth in its current estimates of the 10-year budget deficit. Both near-term and longer-term growth are likely to be higher than CBO estimates. If so, the 10-year budget deficit might be substantially lower than now expected.

CBO estimates that the growth rate will slow over the next ten years, sinking to 2.6%. It assumes that U.S. output remains below its potential throughout the entire 1-year budget window. By the end of the budget, it assumes potential U.S. growth is only 2.8%.

I think these assumptions are decidedly too pessimistic. One simple double check: The labor force may grow about 1% per year (trend) and labor productivity may grow 2.25% per year (below recent trends). This would yield roughly a 3.25% long-term growth rate, higher if innovation takes place.

A small increase in the estimate of potential growth may not appear to be significant, but it really is—especially to the budget deficit outlook. According to CBO estimates, a 0.25% increase in real GDP growth over 10 years will reduce the budget deficit by more than $600 billion.

Based on its cautious growth forecast, CBO estimated that the President's January budget would generate a total deficit of $1.8 trillion over the next ten years. If my estimates of potential growth are closer to the mark, either due to the positive effects of the President's tax cut or faster productivity growth, the cumulative deficit would be more than one-third lower.

Over the ten-year budget, CBO estimates the revenue baseline at $27.9 trillion. This is likely to be off by $1-2 trillion. As I understand it, the gap between the Senate and House is $200 billion, 0.7% of tax receipts.

I emphasize the fallibility of budget deficit assumptions (and the scoring of tax cuts). In my view, tax policy should not be made on the basis of these estimates, but should instead reflect our economic values -- common sense, fairness, a preference for low rates and a broad base.

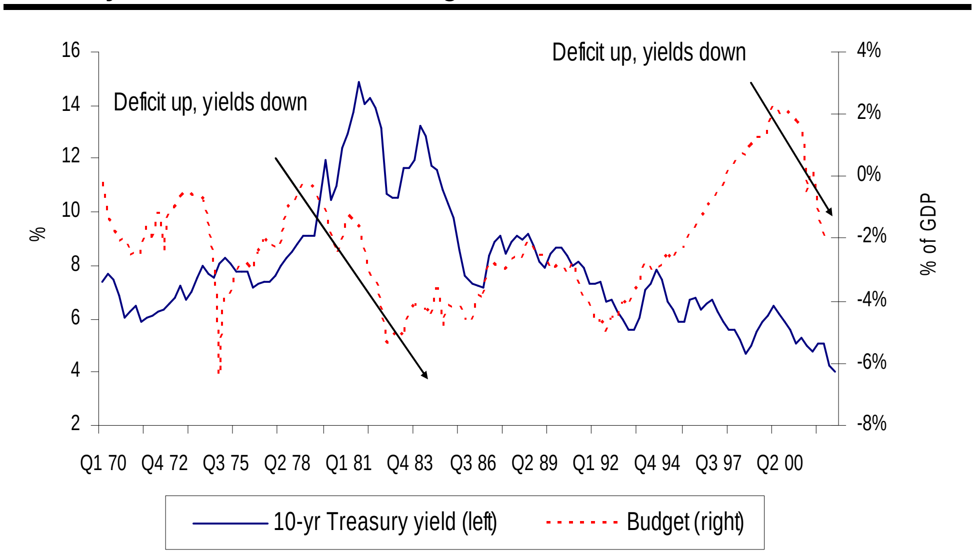
No "Crowding Out"

I want to take strong exception to another part of the budget debate, the idea that a tax cut would somehow "crowd out" private sector activity through higher interest rates or reduced national savings, worsening the economy. This concept has been studied extensively. I think the evidence definitively rejects that hypothesis, but it's clearly one of the many issues on which economics simply hasn't been able to reach a consensus.

Comparing bond yields and interest rates among developed countries turns up no discernable relationship between a country's debt burden and its interest rate. Japan has a huge budget deficit (nearly 8% of GDP) and a similarly huge national debt (more than 140% of GDP). Yet it's overnight interest rate is 0% and its ten-year bond yield is 0.7% (versus 4% for the U.S.)

Likewise, the historical data on the U.S. doesn't simply show a relationship between the level of government borrowing and interest rates. Deficits were large in the 1980s and government debt grew sharply, yet interest rates and bond yields fell and job growth was rapid. Deficit projections have worsened over the last three years, yet interest rates and bond yields have fallen sharply.

Treasury Note Yields and The Budget Deficit



Source: Datastream; Bear, Stearns & Co. Inc.

I expect interest rates and bond yields to rise in coming months based on faster growth and higher long-term inflation expectations. Some will blame that on the budget deficit, which will also be growing. I don't think there will be much connection between the two developments.

Some argue that, apart from interest rates, a tax cut will reduce national savings and take funds away from the private sector. Again, this is a static analysis that views the national "savings pool" as fixed and unresponsive to a more vibrant economy. Lower tax rates leave more capital available for savers, create faster growth, and actually increase capital and savings. For those worried about the government's impact on private sector investment, the focus should be on government spending, not the fiscal deficit.

In sum, we are running a cyclical deficit during a period of war at the early part of an economic recovery with the national debt/GDP ratio at only 35%. Whatever the theoretical view about fiscal deficits, interest rates, and the national debt, I think there are higher budget priorities than the 2003 deficit. The tax code is a huge drag on the economy. Social security and medicare need reforming. New health care proposals would impose big new drains from the private sector to the public sector. I think these should be given more attention, and the budget debate should move away from inherently inaccurate guesses about future spending and tax receipts.