Mark W Olson: Update on the U.S. economy and fiscal outlook

Remarks by Mark W Olson, Member of the Board of Governors of the US Federal Reserve System, at the Albers School of Business and Economics, Executive Speakers Series, Seattle University, Seattle, 13 October 2005.

Governor presented identical remarks at the Fraser Institute Roundtable Luncheon, Vancouver, Canada, on 12 October 2005.

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Thank you for inviting me to speak to you today. My remarks will focus on the near-term economic outlook of the United States in the immediate post-hurricane aftermath. Then I will address the fiscal challenges that the country confronts. As always, and perhaps even more so this time, I will be speaking for myself and not necessarily for my colleagues at the Federal Reserve.

In July, when I accepted your invitation to speak, I chose as my title "Update on the U.S. Economy." On the basis of how the U.S. economy was performing around midsummer, I anticipated that an October presentation on the economy would be quite positive. At that time, the first-quarter increase in real GDP had been revised up to almost 4 percent, and after a slightly softer second quarter, most estimates pointed to another increase in the 4 percent range or higher for the third quarter. The economy was generating, on average, 175,000 private nonfarm jobs per month, and the unemployment rate was down to 5 percent. Core consumer price inflation was running at about 2 percent. In short, at midyear, the U.S. economy appeared to be on firm footing, and inflation appeared to be well contained. Canada's economy appeared to be in a roughly similar position, as inflation was running at about 2 percent--approximately the midpoint of the Bank of Canada's inflation-target band--and the unemployment rate at about 6-3/4 percent.

As always, the positive picture in the United States was not without potential risks, and the Chairman noted them in his midyear report to the Congress: Rising prices of energy and other commodities had put upward pressure on costs. Labor costs had also picked up. Already lofty housing prices that allowed homeowners to convert equity appreciation into consumption continued to rise and in some markets had reached levels that our Chairman had described as "frothy."

On balance, the FOMC continued to believe that policy accommodation could be removed at a measured pace. However, the Committee noted that it would need to be alert to inflationary pressures and would respond to changes in economic prospects as required to fulfill its obligation to maintain price stability.

An additional benefit of the solid economic performance of the U.S. economy was that federal tax revenues were coming in faster than expected, an indication that the budget deficit for the fiscal year would be at its lowest level in the past three years. However, despite the near-term positive fiscal news, no progress had been evidenced on addressing the longer-term fiscal issues involving the significant projected rise in spending for federal health and retirement programs.

In any event, I had expected that I would be going into the September FOMC meeting, and then speaking to you, with the U.S. economy on an upward trajectory. But that expectation changed dramatically when Hurricanes Katrina and Rita came along. Although the combined effect of the hurricanes was contained within a geographic area that accounted for just under 2 percent of the nation's population and roughly the same amount of the nation's production and income, the potential for spillover effects on the economy more broadly was difficult to assess. The disruptive effect on oil refining, natural gas distribution, and chemical production; the damage to major ports and transportation infrastructure; and the significant devastation of a major city raised the risks of an effect on the economy that exceeded the direct effects on the areas battered by the storms. To be sure, these disruptions also had adverse implications for costs and prices. Further clouding the picture, the fiscal policy implications of funding the rebuilding and restoration had not yet been fully defined.

As our September FOMC meeting followed Hurricane Katrina by approximately three weeks and was held concurrently with the formation of Hurricane Rita, I felt that there was insufficient information as well as great uncertainty about how these forces would play out in the near term. As a result, I voted to pause in the removal of policy accommodation until more was known.

What was clear then, and has become even more evident in the time since, is that the Gulf Coast of the United Sates suffered extraordinary human and economic losses. The news reports have graphically displayed the tragic dislocations of millions of people, loss of life, and destruction of

property. As well, we have seen moving examples of the efforts directed toward the rescue of and care for the victims of the storms. More recently, the massive cleanup operations have gained momentum, and it has been awesome to witness the determination of people beginning to rebuild their lives. These forces--the destruction wrought by the hurricane and the reconstruction efforts--will be two of the key factors shaping economic activity in coming months.

A frustrating aspect of the situation is that even now, some six weeks after the first of the hurricanes made landfall, the incoming data are only beginning to shed some light on the economic ramifications of the storms. Clearly, however, the destructive power of these hurricanes reduced economic activity by forcing the evacuation of millions of people from their places of work, destroying factories and offices, shuttering businesses, and closing schools and government offices. The overall magnitude of many of these effects will be difficult for economic statisticians to measure. In the industrial sector, however, a number of real-time indicators are available, and they show the effect in that sector to have been significant. The Federal Reserve estimates that Hurricane Katrina reduced industrial production by 0.3 percent in August, even though it struck near the end of the month. Oil and gas production and refining were particularly hard hit. Hurricane Rita further damaged the Gulf Coast infrastructure and set back the pace of recovery. In normal times, the Gulf produces 1-1/2 million barrels of crude oil per day--about 30 percent of the national total--and 10 billion cubic feet of natural gas per day--about 20 percent of the national total. After Hurricane Rita struck, 100 percent of the oil production in the Gulf region was shut in for a time, as was 80 percent of the natural gas production. Petroleum refining, chemical plants, and electricity distribution were also relatively hard hit by the hurricanes. All told, industrial production was held down significantly in September as a result of lower output in these sectors.

That said, various daily and weekly data sources indicate that the industrial sector is beginning to recover in October as oil and gas production come back on line and repairs to factories and distribution advance. The resilience and resourcefulness of the U.S. economy is illustrated by the reactions of firms and industries to the disruptions. For example, the reduction in refining capacity in the Gulf has been partly replaced by higher operating rates in other areas, shifts in the composition of refined products, and an increased reliance on imports. As a result, stock-outs and supply disruptions in the energy sector have not been widespread, at least thus far. Industry sources suggest that much of the repair and recovery effort will likely be undertaken over the course of the next several months, and as that occurs, production rates should gradually return to normal.

Beyond the industrial sector, one indicator of economic activity more broadly is the behavior of employment. Last week's employment report for September indicated that private nonfarm employment fell 66,000, compared with increases averaging around 175,000 per month over the preceding twelve months. The shortfall of roughly 240,000 jobs from the earlier trend is a crude measure of the direct disruption effects of the hurricane. More important, the apparent absence of significant indirect effects in other areas of the United States is an indication that the underlying gains in employment and income were well maintained outside the Gulf region.

An important question for policymakers is how inflation and economic activity will respond in coming months. One concern is that the rise in energy prices, as well as the downshift in consumer confidence seen in recent readings, may hold back aggregate demand at least for a time. However, the rebuilding itself should provide some impetus to demand in coming quarters. At the same time, of course, higher prices for energy items, including gasoline, heating oil, and natural gas, will be adding to top-line inflation in the near term. As well, these price increases will put upward pressure on the costs of the producers of other items, thereby posing the risk of some impetus to core inflation. Whether these pressures are, in fact, passed through to core inflation will depend on a host of considerations, including the willingness of producers to absorb those cost increases and experience, at least for a time, lower profit margins. Needless to say, developments in this area will be the subject of intense scrutiny on my part in coming months.

A vital contributor to the rebuilding and recovery effort will be the various actions of the federal government. The magnitude of the devastation called for a significant response from the federal government, and the Congress and the President acted quickly to provide emergency spending and tax breaks to aid the areas affected by the hurricanes. Whether these emergency fiscal measures will ultimately be financed by increased federal borrowing, or by finding offsetting spending decreases or revenue increases, is still an unsettled issue in the Congress. To a certain extent, temporary emergency federal borrowing may be viewed as appropriate, as the costs would ultimately be spread out across all U.S. taxpayers over time. Nonetheless, given the current size of the federal deficit,

additional federal borrowing raises issues because of the potential negative effects that higher deficits can have on the economy.

Although expected outlays and tax breaks for hurricane disaster relief raise concerns about future deficits, budget developments over the past year had turned positive before the hurricanes for the first time in a while. For the 2005 fiscal year that just closed at the end of last month, the U.S. federal government's budget deficit shrank, as federal tax revenues came in at a greater-than-expected pace. Although the final accounting for the fiscal year is yet to be tallied, Treasury data indicate that the federal budget deficit was probably equal to about 2-1/2 percent of GDP--below its level of about 3-1/2 percent of GDP in the preceding two years.

That said, the budget figures for the fiscal year just ended were little affected by the fiscal policy response to the recent hurricanes. Only a small portion of the emergency federal outlays budgeted for hurricane relief were actually spent in September, the last month of the fiscal year. The bulk of the hurricane-related spending and tax relief will show up in the budget accounts in the current and next fiscal years. Moreover, the total magnitude of the federal response is still unknown, adding to the uncertainty associated with the fiscal outlook.

Viewed from a longer-term perspective, the financial position of the U.S. federal budget has oscillated dramatically over the past ten years. Ten years ago, the federal budget had a deficit that amounted to about 2-1/2 percent of GDP, roughly similar to the current percentage, and forecasts at that time pointed to some widening in this budget gap in future years. Budget agreements in earlier years--1990 and 1993--had both raised taxes and reduced spending, and the combination of these actions had helped lower the federal budget deficits from the levels of previous years. These budget agreements demonstrated the desire of policymakers to undertake some hard steps necessary to reduce the deficit. They had also put in place caps on so-called discretionary federal spending--that is, the portion of federal spending that is allocated annually--and had required that legislative changes to taxes or entitlement spending be deficit neutral, a requirement called the PAYGO rule. The PAYGO rule mandated that changes in taxes or entitlement spending be offset by other changes in taxes or entitlement spending so that the deficit was not increased. Despite the enactment of deficit-reducing legislation and the existence of these budget rules, the best estimates ten years ago had the federal budget still running deficits far into the future. However, as it turned out, a number of positive developments pushed the budget into surplus in 1998 through 2001.

Importantly, bipartisan support in the Congress for establishing and maintaining some measure of budget discipline was demonstrated by adherence to the guidelines set by the PAYGO rule and the discretionary spending caps. In the 1990s, the discretionary spending caps appeared to be effective in limiting the rise in annual spending appropriations. Defense spending declined by more than 2 percent of GDP, as the federal budget was able to claim a "peace dividend" after the breakup of the Soviet Union. Furthermore, nondefense discretionary spending was held about constant as a share of GDP. Discretionary spending was eventually allowed to exceed the spending caps but only after budget surpluses appeared in the late 1990s. The PAYGO rule was also effective in the later half of the 1990s when legislative changes to taxes and entitlement spending were relatively small and were essentially neutral in their estimated effects on future budget balance.

The federal budget also benefited significantly from economic developments that occurred outside of policy actions. In particular, federal tax revenues increased substantially more rapidly than expected and at a rate greater than the robust pace of economic growth seen in the late 1990s. Also, the rate of growth of medical care costs slowed somewhat from its high previous rate, in part because of legislative changes. Remarkable as it now seems, progress on the deficit was sufficiently dramatic that only five years ago serious policy discussions were undertaken concerning the possibility of effectively retiring all outstanding U.S. federal government debt. Obviously, the federal budget did not continue to unfold in the manner projected at that time.

The rapid pace of ascent from deficit to surplus in the late 1990s was exceeded by the pace of descent back to deficits beginning in 2002. This development was the result of a number of factors. In 2001, tax cuts approximately the size of projected on-budget surpluses were passed. Defense and homeland security spending increased in the wake of the attacks on September 11, 2001, and other nondefense domestic spending also increased at a substantially faster rate. The budget rules put in place back in 1990 and extended several times thereafter--both the caps on discretionary spending and the PAYGO rule--were allowed to expire after 2002, though the commitment to these rules had waned considerably over the preceding years. Besides these policy actions, spending for federal health programs also increased at faster rates as a result of a reacceleration in medical costs. During

this time, the economy experienced a mild recession, and the stock market declined for several years after its peak in 2000.

A review of federal government outlays--both on and off budget--and revenues since the early 1990s helps put the issue in perspective. In the early 1990s, total federal outlays averaged about 22 percent of GDP, while revenues during that period were about 18 percent of GDP. Annual deficits were the result. By the late 1990s, outlays declined to under 19 percent of GDP, primarily as a result of significant reductions in defense spending relative to GDP, while revenues, boosted especially by a strong economy and a strong stock market, rose to a high of nearly 21 percent of GDP, thus yielding surpluses. Canada experienced an even larger consolidation of its government budget during the 1990s. More recently in the United States, total outlays have climbed back up to almost 20 percent of GDP, while revenue has dropped to about 17 percent of GDP and deficits have reemerged. In contrast to the U.S. fiscal situation, Canada has maintained its budget surpluses in recent years.

Worrisome as these short-term fiscal issues are for the United States, they pale in comparison with the fiscal issues that are projected to begin emerging by the end of this decade. In a few years, the U.S. baby-boom generation will start to retire. Thus, the ratio of retirees to workers in the United States is expected to increase rapidly. Indeed, this demographic phenomenon is confronting Canada and other major developed countries to an even greater degree than that expected in the United States. Population aging will put substantial pressure on the U.S. federal government budget, as spending for federal government retirement and health programs will rise rapidly. A more slowly growing workforce could also tend to damp economic growth and, thus, federal tax revenues.

So far, solutions to these long-term challenges have eluded policymakers. It is imperative, however, that solutions be identified and implemented. The sooner such changes are made, the less painful and disruptive they will be. Of course, I do not want to minimize how difficult these problems will be to solve. The Congressional Budget Office's long-run estimates for the United States indicate that demographic trends would boost federal spending by 5 percentage points of GDP by 2030, and even more thereafter, in the absence of changes to old-age programs.

The most important factor in ultimately achieving a federal government budget that balances over the business cycle and maintains that fiscal discipline over time is the will of the political system to make the necessary hard choices on government spending and taxes. One possible means of expressing that will, would be for the Congress to reinstitute a set of budget rules, possibly along the lines of the discretionary spending caps and the PAYGO rule originally included in the 1990 budget act; these rules may assist in the process of making the difficult choices among competing budget priorities. However, although the PAYGO budget rule, for example, appeared to help keep legislation from increasing federal deficits for a number of years, PAYGO did not provide a mechanism to deal with the long-term budget imbalances already in place. Thus, it is worth considering whether future budget rules should go beyond the scope of PAYGO and require more fundamental adjustments to spending and taxes. Clearly, there are numerous ways in which budget policy could be adjusted to bring the budget back into balance in the short run and to maintain it over the long run. In any event, these difficult choices must ultimately be made. If left unchecked, persistent and widening federal government deficits will have an increasingly corrosive effect on the U.S. economy because, all else being equal, federal government borrowing takes up some of the funds that would otherwise go to finance capital accumulation or to purchase capital assets from abroad. A good deal of controversy has swirled around the question of whether increased federal borrowing reduces domestic investment, and presumably increases interest rates, or whether it increases U.S. borrowing from abroad. Viewed from a broader perspective, however, that distinction is probably not very consequential because future national income is lower in either case. For the federal government to run a deficit in the short run as a temporary response to an emergency event, such as the recent devastating hurricanes, or a recession or a war is not the type of fiscal policy imbalance that tends to have a negative long-run effect on an economy. To the contrary, appropriate discretionary fiscal responses to these types of situations can have beneficial economic effects, as I suggested earlier in my remarks. However, it is imperative that the nation come to grips with the fiscal implications of the retirement of the baby-boom generation. Creating a budget strategy and implementing policy changes to balance the federal government's budget over the long term will require hard choices, which will become more difficult the longer they are delayed. Moreover, changes made to federal government spending programs and taxes to bring the budget toward balance should also be evaluated with regard to the economic effects on work and retirement behavior, private saving, and the distribution of income likely to result from particular policy choices. The benefits of taking timely and appropriate federal budget actions are important for the long-run health of the U.S. economy.