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S. Hrg. 104—178

THE RECENT ECONOMIC SLOWDOWN

HEARINGS

before the

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ONE HUNDRED FOURTH CONGRESS

FIRST SESSION

June 8, 1995

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

WASHINGTON: 1995

For sale by the U.S. Government Printing Office
Superintendent of Documents, Congressional Sales Office, Washington, DC 20402
ISBN 0-16-047775-1

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[Created pursuant to Sec. 5(a) of Public Law 304, 79th Congress]

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THE RECENT ECONOMIC SLOWDOWN

Thursday, June 8, 1995

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
WASHINGTON, D.C.

The Committee met, pursuant to notice, at 11:05 a.m., in Room 628, Dirksen Senate Office Building, the Honorable Connie Mack, Chairman of the Committee, presiding.

Present: Senators Mack, Craig, Santorum and Bennett and Representatives Stark, Thornberry, Saxton, Manzullo and Sanford.

Staff Present: Robert Mottice, Brian Wesbury, Missy Cortese, Shelley Hymes, Juanita Morgan, Colleen Healy, Lee Price, William Buechner, William Spriggs and Chad Stone.

OPENING STATEMENT OF SENATOR CONNIE MACK, CHAIRMAN

Senator Mack. Good morning, and the hearing will come to order. I want to welcome our distinguished panel, and I will make introductions after some opening remarks.

The purpose of our hearing today is to examine the policy implications of the recent economic slowdown. The evidence on the economy is disturbing. After the data of the past week it appears that the economy is on the verge of a recession.

In the last two months the economy has lost almost one million jobs as measured by the household survey, the greatest two-month decline in employment in 20 years. This loss follows job performance in this recovery that has been only one-half of the normal recovery's pace.

Despite this slower growth, inflation indicators are rising. For example, import prices surged 1.2 percent in April and are up 6.7 percent in the last 12 months. In addition, the Consumer Price Index is up 3.6 percent, at an annual rate, so far this year after rising only 2.6 percent in 1994. This data represent slow growth and higher prices and has become

all too familiar. It is known as stagflation, last seen in the years of the Carter Administration.

This Administration seems intent on reproducing the same environmen. In 1993 the Clinton Administration imposed the largest nominal tax increase in our history, forcing the Federal Reserve to offset the damage by lowering interest rates.

Now with inflation rising, the Fed has boosted rates seven times, helping to slow the economy and expose the damage of the Clinton Administration's polices. With the Fed no longer artificially supporting the economy, the full effect of recent tax increases, regulatory burdens and government growth is pulling the economy down.

The country cannot continue to operate its economic policy in a yo-yo fashion. It is time to adopt responsible fiscal policies, a balanced budget, low taxes and limited government.

Equally important is the need to commit to responsible monetary policy which focuses on price stability. A leaner government with lower taxes and a balanced budget combined with a stable monetary system would free us from up and down, boom and bust economic cycles which make our economic plans uncertain.

In the current budget debate, many are arguing that Congress should hold off on tax cuts until the budget is balanced. However, there seems to be some consensus and historical evidence that tax cuts would give the economy a much needed boost. Given the economic slowdown, aren't tax cuts even more imperative now?

What are your thoughts on these conditions? Why are we facing a slowdown and to what extent are government policies responsible? What responses would you recommend?

I look forward to your testimony. In a moment or two we will have other comments from other Members of the Committee, but I just want to refer to a couple of articles in the papers in the last few days.

"Fed Official Urges Recession Alert." That is a headline as a result of Alan Blinder's comments. In the opening paragraph: "Federal Reserve Vice Chairman, Alan S. Blinder, voiced concern about the economy's recent, sharp slowdown yesterday and said the Central Bank needed to be alert to the risk of recession in setting policy."

The New York Times this morning: "Greenspan Sees Chance of Recession." The second paragraph commenting on an abrupt economic slowdown, which he called very pronounced, Mr. Greenspan acknowledged that "as a consequence of the sluggish economic outlook,

the probabilities, as some of my colleagues have indicated, of a recession have edged up, as indeed one would expect."

And the last point that I would make is an article entitled "Weak Consumer Spending Is Linked To Tax Bite," and, as you know, many of us have been making the claim that the tax increases of 1993 would in fact come back to haunt us. They would have an effect on the economy, they would affect job growth and job creation and affect consumer spending.

Two different economists are quoted in this article: "Consumers got hit with a whopping tax bill in April." A second economist: "Individuals wrote $20 billion more in checks this year than last to settle their obligations with our IRS. That's a 30 percent increase."

The point is, as I said a moment ago, the tax increases are now in fact playing out. Small businesses were hit with those tax increases. It's the reason for slower growth in jobs and, as I indicated a moment ago, we saw job creation in this recovery at roughly half the rate of previous recoveries.

So I think it is appropriate that we have this hearing today to discuss the impact of economic policy on the economy, and at this point I would turn to Congressman Stark for his opening comments.

OPENING STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

Representative Stark. Thank you, Mr. Chairman.

As you know, our Committee is not bound by legislative timetables or jurisdictional limits, and it makes this an ideal forum to conduct a pretty wide-ranging hearing on critical economic issues like the one you are suggesting we take up today, that and also signs of an economic downturn. How seriously should we take these signals? What are the causes of the economic weakness and what are the implications for economic policy?

I had wished that we had not had to rush to judgment here. There is really no reason to move with such haste. For as long as I can remember, we've normally had a week's notice. We give our witnesses and our Members a little time to prepare for this. The hearing was made late Tuesday, but the hearing really should be conducted next week I would think. And there are some other matters of timing, and I'll come to those in a minute.

There are many signs that economic momentum is stalled, at least temporarily, employment, production and the leading indicators are all

turning down. Your side of the aisle is now promoting an idea that the '93 budget somehow accounts for the slowdown.

In fact, for the first six quarters after the '93 package the economy went up at about 4.2 percent. So there is consensus among bipartisan or nonpartisan economic analysts on the cause of this slowdown. For 16 months the Fed has been jamming the brakes to slow the growth to under 3 percent, 2.5 I think, and I think they've overdone it. Interest sensitive industries, housing and autos have been on the leading edge of the slowdown. You recognized the problem yourself, Mr. Chairman. You criticized the Fed's last rate hike in February and you allude to it in your opening statement this morning.

I'm going to ask you, and I've given you as much notice as you gave me, to join with me and other Members of the Committee in a letter to the Chairman of the Federal Reserve asking him really to reduce rates as quickly as possible.

I would join with you, on the other hand, in urging the budget conference, which you've alluded to also as the need for this hearing, to back down substantially from the House tax cuts.

Interest rate cuts will go into effect immediately, mortgage rates, equity loans, credit cards, auto sales, retail sales, the effect will be felt by small businesses and average Americans instantly. Tax changes probably not until at least a year and maybe 14-months out, and this is a rather short-term problem. So, as I say, it's a question of timing, and I would like to join with you. The budget changes will not affect the economy for perhaps two years.

So if we really want to do something now, let's push quickly for lower interest rates. I would join with you in saying if the budget moves toward balancing we could cut taxes, but lower interest rates would give us a quicker result and help things like home building, the auto industry and retail sales.

I would love to see us come together on action we can take now, and I think we can anticipate a compromise between the House and the Senate position on the budget if we think about that as the result and then plan what we discussed today. We might have some interesting propositions and some advice to the Fed, and whether they're take it or not, I don't know.

But thank you for calling the hearing and giving me this opportunity.

[The prepared statement of Representative Stark appears in the Submissions for the Record.]

Senator Mack. Thank you, Congressman.

Representative Stark. I'll look forward to your joining me in that letter.

Senator Mack. I will take your letter under advisement. Senator Craig?

OPENING STATEMENT OF SENATOR LARRY CRAIG

Senator Craig. Mr. Chairman, let me thank you for holding this hearing, and I do believe urgency in all of these issues is important, especially as we debate a budget that will set a pattern and a trend that I think will have substantial impact upon the economy of this country. The messages we sent from the Congress are profound and they do have an impact, and I think we're beginning to see that in the economy.

I think from what I'm able to read, and these are the reflections of a non-economist, that we are experiencing a combination of two hits on the economy. The cost of doing business has gone up substantially as a result of interest rates and there is less money to pay for the cost of doing business, whether it be the private individual or the small business person because they are paying more in taxes. You get that kind of a combination, and the articles that you've referenced, many of us have read those with increased alarm.

We see out there a substantial downturn knowing that the full force of the 1993 tax hit is beginning and the consumers of our country and the small business people of our country especially are beginning to react. That seems to me a difficult situation in both instances that has created what appears to be a substantial downturn.

I am very anxious to hear from the gentlemen before us today and their reaction to the kinds of questions you've laid before them, the long term, short term nature of this, what is it and what do you think it means, and most importantly we understand here.

As we attempt to balance budgets and reduce government spending income for the government based on either current or new tax policy is going to be significantly important to all of us as we work on these budgets, but the signals we will send in the budgets are going to be very significant to the long-term stability of our economy.

So I think this hearing is timely and I hope it's the beginning of a series, Mr. Chairman, where we really dig into this and expose at least the thoughts of men like we have before us this morning and more to the Congress' collective consideration as we deal with these budgets. I think it's terribly important.

Senator Mack. Thank you. Senator Santorum?

OPENING STATEMENT OF SENATOR RICK SANTORUM

Senator Santorum. I just want to thank the Chairman for holding the hearing and look forward to hearing the testimony. Thank you.

Senator Mack. Congressman Saxton?

OPENING STATEMENT OF REPRESENTATIVE JIM SAXTON

Representative Saxton. I likewise am interested in hearing from our panelists, Mr. Chairman. I think there are a couple of interesting questions here that we need to explore today, including the relationship between interest rates and the control of the Fed and the value of the dollar, which I think is something that we need to take into consideration.

Also, there is one other thing that I hope our panelists will address themselves to this morning. Mr. Stark referred to this short-term problem and the way, in his view, of correcting it would be to reduce interest rates. It seems to me that I'm mindful that it was 16 months ago that the Fed started to tinker with interest rates, and here we are 16 months later seeing the serious effects of that tinkering. Therefore I guess a question could be asked if we start to tinker again today when will those effects really be felt hopefully on a positive note.

In any event, thank you, Mr. Chairman, for having this hearing today, and I look forward to hearing from the witnesses.

Senator Mack. Thank you. Congressman Thornberry?

OPENING STATEMENT OF REPRESENTATIVE MAC THORNBERRY

Representative Thornberry. Thank you, Mr. Chairman.

I, too, think it's most appropriate to have this hearing. It makes some sense to me to look at the reasons that we are having the current problems that are showing up, including leading economic indicators falling for three months in a row, as a way to look to what some of the solutions are.

So I look forward to hearing from the witness, and I appreciate the chance to hear from them.

Senator Mack. Thank you. Senator Bennett?

OPENING STATEMENT OF SENATOR ROBERT BENNETT

Senator Bennett. Thank you, Mr. Chairman.

If I knew, or if I knew anybody who knew exactly what causes business cycles to rise and fall I could successfully run for President and be reelected forever and ever.

Senator Mack. Be careful now.

(Laughter.)

Senator Bennett. I have no intention of trying that.

The things that happen in a business cycle are very hard to determine. What causes a recession and what causes a boom depends very often on the bias of the individual that's looking at it.

I will confess my bias. I think the President's tax proposals of 1993 were serious in their impact on the entrepreneurial side of the economy. I stood up on the floor of the Senate as the President was making his speech about only the rich having to pay this tax and asked the question do any of my colleagues know what a K-1 is. I didn't get very many who did. As a matter of fact, I can't recall any who knew what a K-1 was.

I made the point on the floor of the Senate that 77 percent of the tax returns filed in that big, heavy bar the President held up on television and derided as the rich showed K-1 income. K-1 income, very quickly for those who don't know, is income that derives from an S-Corporation, a partnership or a sole proprietorship where the individual is paying that portion of the income that comes from that kind of activity on his or her personal income tax.

Two hundred and fifty thousand dollars is a lot of money for an individual, but $250,000 is not a lot of money for a struggling enterprise that is in the entrepreneurial mode and needs every dime it can get to survive. New jobs are generated in this country primarily at this point by entrepreneurial activity as the Fortune 500 continue to downsize in an effort to make themselves more competitive internationally.

I would simply put out for consideration the thought that raising the effective marginal rate for those who are deriving their income from S corporations or partnerships to 42.5 percent, which is where it currently is when you add what happened to Medicare on to the President's 10 percent surplus on to the other increase, you're stifling that portion of the economy that is creating new jobs, and I believe that has as much to do with what we're doing here today as the conversation about interest rates.

Having made that point, Mr. Chairman, I would be interested in the reaction of members of the panel, and I'll shut up and listen to them.

Senator Mack. Very good. Thank you, Senator. Congressman Manzullo?

Opening Statement of Representative Donald Manzullo

Representative Manzullo. It's a real pleasure to be here this morning. I look forward to the opportunity of hearing, and perhaps it won't come from this panel, why higher taxes bring about more growth.

Thank you.

Senator Mack. Thank you.

Before I introduce the panel I just want to recognize that Senator Proxmire is in the audience. We're delighted that you're hear, a former Chairman of the Joint Economic Committee. Again, welcome. We're glad that you came by.

The four panelists this morning are:

Dr. Wayne Angell, who is currently the Senior Managing Director and Chief Economist for Bear Sterns. Prior to joining Bear Sterns he served eight years as a member of the Federal Reserve Board;

Daniel Mitchell is currently the McKenna Senior Fellow and Political Economist at the Heritage Foundation where he handles tax and economic issues;

Robert R. Davis. Bob Davis is the Director of Economics and Research for America's Community Bankers and also the President of the National Capital Chapter of the National Association of Business Economists;

And David Wyss. David Wyss is Research Director at DRI-McGraw Hill where he is responsible for DRI's economic forecasts and publications for North America and Europe.

We will begin with Dr. Angell.

Statement of Dr. Wayne Angell, Chief Economist and Senior Managing Director, Bear Stearns & Co., Inc.

Mr. Angell. Thank you, Mr. Chairman, and Members of the Committee.

I would ask that my full remarks be included in the record of the meeting.

There is no doubt that 1995 is shaping up to be a weaker year for economic activity than I expected given the developments in monetary policy. After the strongest year of economic growth since 1984 real GDP is estimated to have grown only by 2.7 percent in the first-quarter of this

year. Moreover, based on the latest jobs data, manufacturing and consumer spending, GDP in the second-quarter is likely to be broadly unchanged from its first-quarter level.

The consecutive monthly declines in non-farm payrolls in April and May, and the marked weakening in the survey of U.S. purchasing managers for May, having raised the question of whether the slowdown in activity is a temporary lull or whether it marks the onset of a recession.

No one can say for sure that the U.S. will not slip into recession, but my own view is that the economy is undergoing a temporary slowdown as companies pare back on unwanted inventory investment.

I do not believe that the slowdown that has occurred is a result of the 6 percent overnight rate delivered by the Federal Reserve. The main slowdown in final demand may well reflect the consequences of 8 percent 30-year Treasury yields and 7.5 percent two-year yields which have show up in declining home sales and falling expenditures on durable consumer goods.

Monetary policy accommodation accelerated spending on housing and consumer durables in 1994 and exhausted somewhat pent-up demand. It is perhaps not too surprising that without increasing monetary accommodation, lumpy expenditures on housing and autos should fall for a period of time after such a strong showing in 1994.

In addition, the contraction in manufacturing is in part a result of economic dislocation in Mexico. U.S. exports to Mexico have fallen from a peak year-over-year growth rate of 32.8 percent in the third-quarter of 1994 to a year-over-year decline of 5.9 percent in the first-quarter of this year. However, even though the prospects for improvement in Mexico in the near future are not bright, the drag on U.S. export growth should sharply diminish in the second half of the year.

I do not believe that the slowdown in consumer spending was principally the result of the 6 percent funds rate. Market-price indicators of the future price level, such as the price of gold or the foreign exchange value of the dollar, do not suggest that monetary policy move to a restraining stance at the end of 1994. The price of gold at around $385 an ounce stands at its average level of the last 12 months.

Moreover, the Federal Reserve Board's trade-weighted index of the dollar against G-10 currencies has fallen 9.7 percent from its average level of 1994 and stands 14 percent below the level in January of 1994.

Market interest rates are now markedly lower than in December of 1994, even though the Federal Reserve raised the Fed funds rate by a further half-point on February 1, yields on two-year notes have fallen to

around 5 and 3/4 percent, a decline of two percentage points, while long-bond yields have dropped around 6.5 percent. Alongside the decline in bond yields, the 30-year fixed mortgage rate has dropped to around 7.7 percent, which has begun to spur mortgage applications for home purchases. Home sales tend to follow mortgage applications with a lag of about two months, and I would expect a rebound in both new and existing home sales in the months ahead.

The preliminary indications for the second-quarter are that overall GDP will be close to unchanged, while the factory sector looks likely to post a sharp drop in output of between 3 and 4 percent. The 108,000 decline in nonfarm payrolls during April and May and the 18-minute fall in the private workweek have left total hours worked down 2.1 percent at an annual rate from their first-quarter average. Meanwhile hours worked in the factory sector have contracted at a 7.8 percent rate so far in the second-quarter, consistent with the 3.7 percent annualized drop in industrial production in April from the first-quarter average.

There are signs, however, that consumer demand will rise modestly in the second-quarter despite the fall in jobs. Consumer spending in real dollar terms in April was 1.2 percent above the first-quarter average at an annual rate, despite a 4/10ths percent drop in retail sales in April. Preliminary indications suggest that spending will advance at a moderate pace in May as total domestic vehicle sales rose from 11.9 million units in April to 12.5 million in May.

As I have already noted, I believe that the economy will receive significant stimulus in the second half of the year form the decline in bond yields and the fall in the foreign exchange value of the dollar. The softness of the economy is being exaggerated by the adjustment to inventories. However, since overall business inventory/sales ratio at the end of March was only 1.4, not that far above its record low level of 1.37 seen in December, the inventory overhang would not appear to be particularly large.

Any move to lower rates from the Fed would tend to impact the economy in 1996 more than the 1995 economy. Such a move would risk overheating the economy in 1996 just at the time when the fallen bond yields and the weak dollar are having their full effect. It is important to remember that we have not yet seen the peak in inflation and leading inflation indicators such as gold, commodities and the foreign exchange value of the dollar have not improved significantly.

The Consumer Price Index has run at a 3.6 percent annualized pace in the first four months of this year while the ex-food and ex-energy CPI has increased at a 4.2 percent pace. Meaning, the impact of the weak

dollar is showing up in trade prices. Import prices have risen by 6.7 percent, as the Chairman indicated, but what is more troubling is that export prices are up at 5.8 percent, not at a higher rate than non-oil import prices.

The building stimulus from the trade sector can be seen if Mexico is stripped out of the export data. The 19.4 percent four-quarter growth in U.S. exports excluding those to Mexico shows the increased pace of export growth from the 4.7 percent year-over-year pace of the first-quarter of 1994.

With much of the recent decline in the dollar occurring in February, there is a lot more stimulus from the weak exchange rate yet to feed through. Meanwhile, import growth could be held in check as some of the reduction in inventories falls on foreign producers. As the trade sector moves to provide a positive contribution to growth in the second half of 1995 and housing and consumer spending revives I suspect that real GDP growth in the second half of the year will run at a pace between 2 and 3 percent. Moreover, I would suspect that without any further policy action from the Fed real GDP growth will be at a 2.5 to 3 percent pace in 1996.

It is important for the longer run financial health of the U.S. that fiscal policy is put on course to balance the budget by 2002. One question that needs to be addressed is how should fluctuations in economic activity be allowed to impact the budget planning process? I believe that the most appropriate approach is to use a trend growth projection in arriving at the outlook for fiscal policy. There should be no attempt for Congress to offset the so-called automatic stabilizers of tax revenue and economic sensitive expenditures. In years of above-trend growth the U.S. should make rapid progress toward fiscal balance, and in the years of below-trend growth less rapid progress would be made.

I also believe that more rapid progress to a balanced budget would be achieved if Congress directed the Fed to solely pursue price stability.

And I would remark also, Mr. Chairman, that the effects of tax rate disincentives should continue to be the focus of this Committee.

Senator Mack. Thank you for your testimony.

[The prepared statement of Mr. Angell appears is the Submission for the Record.]

Senator Mack. Mr. Mitchell.

STATEMENT OF DANIEL J. MITCHELL, MCKENNA SENIOR FELLOW IN POLITICAL ECONOMY, THE HERITAGE FOUNDATION

Mr. Mitchell. Mr. Chairman and Members of the Committee ---

Senator Mack. If I could, let me interrupt you for just a second. I just want to ask a clarifying point.

When you said that the second-quarter compared to the first-quarter would be unchanged, did you mean that it would be zero growth or it would be at 2.5 percent?

Mr. Angell. I mean the level of real economic output should be expected to be close to unchanged. If I were tilting at all away from zero growth for the second-quarter, it would be positive and not negative, but it's really too early to say for sure.

Senator Mack. Thank you. Mr. Mitchell?

Mr. Mitchell. Thank you. Mr. Chairman and Members of the Committee, I appreciate the opportunity to speak with you today about the economy's performance.

While the current expansion has entered its fifth year, the economy's performance is far from robust. As the Chairman pointed out, employment growth is lagging considerably behind averages of previous expansions, and GDP numbers tell a similar story.

These aggregate numbers, however, tell only part of the story. The economy statistic that may matter most to the American people, inflation adjusted income, has performed even worse, with median income falling every year since 1989. This worrisome trend hopefully will be reversed when the final 1994 figures are released, but even a surprisingly strong result for the year would offset only a small portion of the economic damage American families have experienced in recent years.

Few observers argue, of course, that the economy's performance is satisfactory. The questions which must be answered therefore are the following: What is responsible for the weakness presently apparent and what policy or policies would most likely boost growth?

First, some observations on growth. It is a tautology that increases in living standards over time are due to increases in either labor or capital or some combination of the two. In short, to have more income we must either work more hours each week, produce more for each hour worked, or some combination of the two. Any analysis of the economy, past, present or future, should therefore focus on the degree to which government policies are affecting incentives. Policies which reduce

rewards for providing labor services, for instance, will diversely affect labor supply, while policies which lower returns to capital will reduce the level of saving and investment.

Another key to economic policy is focusing on the long term. Whatever the causes of business cycles, fiscal policy, monetary policy, normal cyclical fluctuations, it is almost impossible, if not indeed impossible, for lawmakers to recognize these shifts and adopt appropriate policies in a timely fashion. The goal of public policy instead should be to create an environment that is most likely to maximize the economy's long-run growth rate.

With these simple principles of economics in mind, allow me to comment briefly on some of the major questions of concern to the Committee.

Why has the current expansion been so weak? The slower-than-average GDP and employment growth have many causes, including probably the fact that the 1990-91 slowdown was milder than average. Some statistics, however, particularly the continuing decline in median income, are much more troubling. Misguided economic policy almost certainly deserves part of the blame. Large tax increases in 1990 and 1993 have substantially lowered incentives to engage in productive behavior, while rapid increases in government spending and regulation have diverted resources from more highly valued uses.

Where is the economy headed? While I believe short-term forecasting is guesswork at best, I see no reason to quarrel with the conventional wisdom that the economy's long-term rate of real growth, given the policies now in place, will be somewhere between 2 and 2.5 percent. As Committee Members probably realize, this rate of growth is below the post-World War II average of more than three percent. And while three may not seem to be much difference between 2.5 percent growth and 3 percent growth, consider the following statistic: A sustained .5 percent increase in the growth rate over 10 years will boost national output per a family of four by more than $5,000 in the tenth year.

One of the questions you'll be addressing is whether budget cuts will have an adverse economic impact. While largely discredited, at least I believe, there are still those who adhere to this school of thought known as Keynesian economics. According to this theory, reduction in government spending will take purchasing power out of the economy, potentially causing a downward spiral. Needless to say, lower government spending does not have this impact when you consider that every dollar the government does not get to spend as a result of budget

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cuts simply increases the amount of resources available in private credit markets.

Moreover, while the short-term effects are a wash, the long-term effects are unambiguously positive given the overwhelming evidence that the private sector spends money far more wisely than the government. Of course, this entire question is somewhat irrelevant since the budgets currently being debated in Congress don't cut spending. They simply call for limiting the growth of spending to somewhere between 2.5 and 3 percent a year.

Are tax cuts wise policy? Ironically, many of the same observers who worry that limits on government spending may harm the economy by reducing the supposed stimulative impact of deficits become born-again budget-balancers on the topic of tax cuts. According to critics, tax cuts will increase the deficit, the higher deficit will boost interest rates and higher interest rates will choke off the expansion. While every link in this chain of reasoning is flawed, the premise is irrelevant anyhow since both the House budget with its tax cuts and the Senate budget without tax cuts, depending on you count that $170 billion provisional fund, they both call for balanced budgets in the year 2002. So there is no deficit impact at all.

Is monetary policy helping or hurting? Some observers contend that excessively tight monetary policy is putting the expansion at risk. While it is true that a deflationary monetary policy could have that effect, there is scant evidence to suggest this actually is the case. If anything, the central bank may have been too loose in recent years in part because of a misguided attempt to offset the anti-growth impact of the recent 1993 tax increase. The Fed appears to have abandoned that counterproductive effort and hopefully has returned to the policy that should be their sole responsibility, protecting the value of the currency.

But what should be done? The economy's performance has been sluggish in part because the burden of government is too high. The obvious solution is to reduce taxes, spending and regulation. While there are numerous policy options that move in this desirable direction, let me close by noting that the single reform that would probably have the most pronounced positive impact on long-term growth is the adoption of a flat tax, and I commend the Chairman of this Committee and others in Congress for taking a long overdue look at this plan to create a simple, fair pro-growth tax system.

Thank you very much.

Senator Mack. Mr. Mitchell, thank you.

[The prepared statement of Mr. Mitchell appears is the Submission for the Record.]

Senator Mack. Mr. Wyss, I think we'll go to you next.

STATEMENT OF DAVID WYSS, RESEARCH DIRECTOR, DRI-MCGRAW HILL

Mr. Wyss. Thank you, Chairman Mack and Members of the Committee.

I don't see that there is any mystery as to when or why the economy is slowing down. The economy is slowing down right now simply because the Federal Reserve is trying to slow it down. It has been clear since last February that the Federal Reserve, with the complicity and help of the bond market, was going to raise interest rates until the economy did slow. The evidence is that they have succeeded.

They were doing this for a simple reason. They were scared of inflation. I think they were right to be scared of inflation, and I think that what they have done so far is exactly what they meant to do. They are going to slow the economy down to a level which prevents a major acceleration of inflation.

At the moment, however, the fear is that the Fed has gone too far, that instead of creating a slowdown they are going to create a recession. Certainly the post-war history gives every reason to worry about it. In the post-War Era, we've only had two successful soft landings; we've had nine recessions. We think that this is going to be the third successful soft landing, but we've got our fingers crossed, especially given the data that have come out so far for the second-quarter.

I would tend to agree with Governor Angell that we are looking for essentially no growth in the second-quarter. In my opinion it's about as likely to be negative as positive, based on the evidence that we have so far.

But I would point out that this looks an awful lot like 1986. The interest rate pattern looks like 1986 with the rise and fall and short-term and long-term interest rates, and I would point out that the second-quarter of 1986 was also a negative quarter. But one negative quarter was enough to create a recession then, and it will not be enough now.

Even if the slowdown does turn into a recession, I do not think that Congress should change the long-term goals that it needs for fiscal policy. It's probably too late to avert a recession. Secondly, even if the Congress takes the right action, if they do it for the wrong reason there's a risk that they will lose the confidence of the financial markets, which they need in order to make balancing the budget a good policy in the short run as well as the long run. And, thirdly, I don't think Congress should be rushed into

making a wrong long-term policy choice in order to solve a short-term cyclical problem.

On the first, if 1995 is going to be a recession year, the chances are it has already started. The peak was probably March. And, incidentally, that would be exactly normal. On the average in the post-war era, it has taken 13 months from the time the Fed begins to tighten until the economy hits its cyclical peak. The Fed began to tighten in February of 1994, and March of 1995 is exactly when you would expect to see the peak. Employment peaked; it has been down the last two months.

Recessions last about 10 months, and there is actually very little variation on that. The shortest recession has been six months and the longest is about 14.

By the time fiscal policy takes effect even if Congress were to pass the bill tomorrow and even if it were not to be vetoed, it will be September by the time you get withholding schedules changed and get the extra cash out into the market. By that time, the recession will be coming to an end. That's the problem with using fiscal policy to fight recession, except for the automatic stabilizers that are built in. By the time Congress acts it's usually too late, even if they are aware immediately of the beginning of the recession.

The Federal Reserve caused this slowdown; the Federal Reserve should cure it, and they have the tools to cure it. The drop in bond yields that has occurred in the last six months is evidence that the bond market sees the inflation as diminishing, sees growth as slowing, and that drop in bond yields, as Governor Angell pointed out, is going to help bring us out of this slowdown late this year and early next.

Another problem is that I think there is a risk that financial markets would interpret a tax cut now, especially one where the legislative arguments are that we need this in order to stop the recession, as more politics as usual. I had the fortune, mis or otherwise, to be at the Council of Economic Advisers during the first two years of the Carter Administration, and I can remember in 1977 trying to push a $50 tax rebate to fight the 1977 slowdown. To financial markets a $500 child credit smells a lot like a $50 tax rebate. It's a quick fix for what should be a long-term, considered move to eliminate the federal deficit.

For too long, we've been afraid to take needed long-term actions because of their short-term consequences. If Congress delays cutting spending because it fears the short-term economic effects, is the bond market going to worry that every time the economy begins to slow Congress is going to abandon spending cuts and abandon the move towards balancing the budget.

I think promising a tax cut now and promising to cut expenditures somewhere in the future is the worst signal to send the bond market. At worst they should both be done together, and at best I would favor getting the budget in balance and giving a tax cut when the economy and the government can afford to give one. Avoiding that policy is what got us into this problem.

If it hadn't been for the borrowing we've been doing for the last 15 years, we could afford a real tax cut. We would be running a budget surplus now instead of a budget deficit. And if there is one important rule that you learn in economics, it's that when you're in a hole you should stop digging. When your problem is caused by budget deficits, the right answer is to stop running the deficits as quickly as reasonably possible.

I think that Congress needs to concentrate on the long-term problem of controlling and eliminating the federal deficit. Short-term management of the business cycle should be left to the Federal Reserve. They've had a lot of experience with it. They've created this cycle, but they're also the best equipped to end it. This division of responsibilities is much safer than constant changes in fiscal policy with, if nothing else, running a serious danger of complicating life for the Federal Reserve. The Fed would have a much easier time handling the business cycle if they could do so in a stable and balanced fiscal framework.

Thank you.

Senator Mack. Thank you.

[The prepared statement of Mr. Wyss appears is the Submission for the Record.]

Senator Mack. Mr. Davis.

STATEMENT OF ROBERT R. DAVIS, DIRECTOR OF ECONOMICS AND RESEARCH, AMERICA'S COMMUNITY BANKERS

Mr. Davis. Thank you, Mr. Chairman. It's a pleasure to return to the Joint Economic Committee and appear before you and the other distinguished Members of this Committee.

I had the privilege of serving this Committee on the staff in the early '80s, and I want to add here at the beginning that I'm happy to see that you've returned this forum to the active forum for discussion of ideas that it was at that time. I might also add that I recall that Senator Proxmire helped make for a lively discussion at the time when I was on the Committee staff.

I am are here today to address the prospects for the economy in 1995 and beyond. What makes economics difficult is that everything depends on everything, and I've never really known whether it's the art of economics of the science of economics that focuses on those few things that are really most important. That's always the critical task in economics as it is with most things in life. Paradoxically I am optimistic about the economic future, but I'm really fearful at this juncture that we will not seize the opportunities before us that I believe are necessary to help us secure a bright future.

Each year we tend to focus on the inevitable ups and downs of the business cycle, and in fact I suspect that the business cycle is going to be down this year and next, and because we focus on the short-run effects of the business cycle sometimes we miss a fundamental truth. I think the fundamental truth is that the long-term economic climate has been gradually declining in this country, and it has been declining principally because the size of government has grown and that has been a drag on the economy.

The burden of taxation is perhaps best approximated by the level of federal expenditures to GDP. Of course, one can look at other measures. You can include local and state expenditures, and you can of course include the burden of regulation. The burden of regulation clearly has a significant impact on the economy.

For my particular industry, the banking industry, I'm happy to see efforts going along on a parallel tracks to reduce expenditures and to reduce regulation as well with your Shelby-Mack bill. Indeed, yesterday Mr. McCollum introduced a bill in the House to help reform the deposit insurance system, which I think will also add a regulatory burden relief.

Turning back to the measure of federal spending relative to the overall economy, which is perhaps a clearer cut measure of taxation, we have seen, especially over the last 30 years, a tendency for the level of government spending as a percentage of GDP to move inversely with long-run economic growth trends. Now, you can't see this looking at the year-to-year data, but if you average it out over a sufficiently long period so you're really picking up changes in trend economic growth, it becomes clear that as we have tended to raise the size of government relative to the economy, long-term economic growth has tended to slow, and vice versa.

In fact, there is a chart in my statement for the record that I will refer to that illustrates that you can identify broad bands of history over the last 30 years. In those times when government tended to grow, the economy tended to slow, and vice versa.

The problem is that we have slipped gradually from a period where we enjoyed three percent long-term economic growth and all of the benefits growth brings to a period now where perhaps long-term trend growth is not much better than two percent. That's a problem not only because over the long run that greatly diminishes the wealth and well being of our citizens, but it also makes the economy frail and subject to serious consequences from mistakes.

Let me explain what I mean. Inevitably we're going to have cyclical impacts on the economy. The Federal Reserve, try as they might, inevitably will make a mistake, or there will be other outside shocks from the foreign markets, from weather factors and other things. And if we assume that on average we're going to be swinging plus or minus three percent from our long-term trend growth, it makes a lot of difference whether we're growing at a three percent trend or a two percent trend.

If you're growing at a three percent trend and you're swinging back and forth at three percent around that trend, you're going from zero to six percent. If you're at a two percent trend, you're going from five percent to minus one percent. So obviously we're going to increase the frequency of recession periods, and we're going to drop into negative growth because our normal cyclical swings are going to knock us below that long-term trend growth inevitably from time to time.

Perhaps most importantly, a message I would like to leave today is that I feel that the economic slowdown that is occurring now is no excuse for timorous actions on the proposals before Congress to deal with the growth of government. In the longer run perspective I feel that the slowdown we're looking at today, as much concerned about it as we are, is really a temporal and an ephemeral event that with perhaps some minor help from the Fed eventually will be self-correcting, and in the long run we'll look back at it and see it as a mere blip on the screen.

The cyclical part of the observed weakness we see today I believe is temporary and not part of long-run fiscal factors and initiatives. Rather, the fiscal initiatives that are being discussed in Congress today are the antidote for the economy's continuing slide into malaise which I think is what we're facing now.

Now I would like to add a few additional comments and also comment on my own forecast for this year, which in some ways is not too different from some of my colleagues. I think the economy is at the beginning stages of a downturn that was not expected by most, and perhaps it should have been. I will say today that I believe it's going to be more serious and longer than anticipated by most even today, even as some of us have begun to change our forecasts.

But still the biggest danger for the country lies not in the cyclical down, but rather the danger is that fear about the weakening economy is going to delay or prevent actions to control the growth of government. Again, I think that's the only formula to restore economic growth over the longer run.

Fiscal policy mistakes clearly have slowed the long-run growth of the economy to a snail's pace. It has made it more susceptible to the dangers of cyclical events that we're facing today, and let's not mistake the cure for our longer-run problems, spending and tax reform, with the cause for our mounting cyclical lows. This cyclical low perhaps has many contributing factors. I think the principal contributing factor, though, is monetary policy.

I want to state at the very outset that I think the Federal Reserve has done a credible job over the last few years. The only thing the Federal Reserve can deliver in the long run is price stability, and inflation is better behaved than has been the case for many years. Of course, we still aren't satisfied, and it would be nice if inflation was lower and the Fed could make more progress, but really I think the Fed is to be congratulated over the course of policy for several years focusing on price stability.

However, inevitably the Fed also attempts to manage near-term events, and that's partly the result of an unfortunately broad statutory mandate for the Federal Reserve, and inevitably some mistakes are going to be made. Frequently that's because the policy tools that the Fed has are not too precise, and I think the Fed as a result is a principal contributor to the monetary part of the business cycle.

I'm not suggesting this as a major of criticism. I'm not sure that any group of men and women could have done any better job than the Fed has done recently, but nevertheless I think that's a structural fact of the system, that the Fed is inevitably going to attempt to do some things that exaggerate a cyclical swing about the long-run trend, one way or the other.

The Fed's policy stance not only has brought us lower inflation, but their focus on lower inflation also led to a period of protracted slow reserve growth that was part of the recession we had in 1990, and their continued focus on inflation, which I was happy to see, was also a principal cause of the relatively slow recovery we had coming out of the recession in 1991.

Eventually the Fed became more concerned about the economic growth impact of their policies. Partly that concern reflected the fact that they saw progress on the inflation front and they felt they had more degrees of freedom, and as a result progressively in 1991 and '92, but

particularly in 1993 the Fed became more expansive. I feel that it's no surprise that the economy began to improve over the period and really began to grow rapidly in 1994. I think that was largely a monetary event caused by the rapid expansion of bank reserves in 1993 and lower interest rates.

Well, 1994, unfortunately, is history. It was the best year the economy had in about a decade, but now we're in 1995. And the change in Federal Reserve policy in response to the rapidly growing economy in 1994 set the stage for what is happening this year, and we should have been able to predict it. The Federal Reserve has been draining bank reserves from the economy. In fact, bank reserves have declined at a three percent rate over the last year. Money growth rates have declined in a similar pattern and interest rates are of course much higher.

The downturn I think was inevitable. If we look at the timing and the midpoint of the Federal Reserve's actions in terms of their interest rate increases, you really find that that was about August or September of last year in terms of the midpoint of their actions. And if we look at the normal lags that are likely to take place, I think we would really be expecting to see those actions take hold right now, and that's what we're seeing. I think that it's going to continue, and we've already ---

Senator Mack. Mr. Davis, if I could get you to wrap up.

Mr. Davis. --- we've already dealt the cards in terms of what the economy is going to do this year. I believe that the Federal Reserve is likely to respond to the weaker economy and also the decline in long-term rates after the Labor Day period with some similar declines in short rates, and I believe that will be sufficient, along with the economy's own recuperative powers, to return to a more positive growth track by the end of 1996.

Having said that, again what I see, as a final wrap-up, is a mild cyclical event generated primarily by the monetary actions of the Federal Reserve. I think that is overlaying, however, a much more serious problem with declining long-term growth rates which can only be addressed by fiscal policy, and the time to do that is now.

[The prepared statement of Mr. Davis appears in the Submission for the Record.]

Senator Mack. Thank you very much.

I think I'm going to pick up on a comment that Mr. Davis made. Fiscal policy mistakes have slowed long-run growth, and Mr. Wyss has indicated that really it's the long-term that we ought to be looking at and

not the short term, but, again, fiscal policy mistakes have slowed long-term growth of the economy.

I would be interested in hearing from, or actually we've heard from Mr. Wyss with respect to his feelings about the tax cuts, but from the other three, and I assume they will include in fiscal policy the tax side of this policy mix.

Mr. Davis. Yes, sir.

Senator Mack. Why don't we just start right down the table with Dr. Angell, your reaction to what the Congress should be doing from a long-term perspective as far as both taxing and spending policy is concerned.

Mr. Angell. There are two sides to the long-term approach, and I would put first the disincentive side. Our country for too long has had a lower saving rate than our capital investment needs for the private sector economy to enhance labor productivity. The combination of high marginal tax rates, particularly as they impact on investment income for individuals that have a CD at a bank or a money market mutual fund to pay income taxes on nominal interest, has a punitive effect on long-term saving. So we need significant tax incentive change.

I would not overlook also the disincentive of the payroll tax plus the low tax bracket rate of 15 percent on those who seek to transfer from the welfare system to the working system. When we talk about tax disincentive we see it across the board.

The second thing I would mention is that government spending needs to be curtailed so as to provide a release of resources and the curtailment of the growth rate of government purchases. The transfer system continues to grow, but government purchases of real goods and services has now been in a decline since the first-quarter of 1992. That has freed up the resources that has given us the highest capital goods expansion in recent memory, and that must continue.

Senator Mack. Very good. Mr. Mitchell?

Mr. Mitchell. As I said in my testimony, I think a flat tax would be one way of substantially increasing the long-term rate of economic growth. The impact on savings I think would be very beneficial. Although one thing I would add is it's one thing to reduce the tax burden on savings, and I think that will help, but we also have to remember that many government programs take away incentives to save as well. It used to be that people saved for their retirement, they saved for education and they saved to buy a house, and we've created government programs, and I should throw in health care as well of course, we've created government

programs that largely take away the need to have some sort of cash reserve that used to motivate savings to some degree.

So given the size of government you can do a revenue neutral tax reform that makes the system much better, but then we also have to focus on reducing over time the size of government so as to keep resources in the productive sector of the economy.

Senator Mack. Mr. Davis.

Mr. Davis. In general I think the best measure of taxation can be drawn from the level of government spending. When the government spends a dollar it taxes a dollar one way or another in the broadest sense, either through direct taxation, through borrowing, which is really borrowing on future tax receipts, or through inflation. So it's critically important in the overall scheme of things to reduce government spending, to reduce the burden of government.

Having said that, also the way in which we collect the taxes obviously can have an effect, and high marginal tax rates are a greater disincentive than a flatter system. So generally I'm in favor of moves towards flatness because that enhances economic incentives. That alone won't solve the problem, because you have to control the size of government in all the ways it takes money out of the economy if you're going to have economic growth.

Senator Mack. Mr. Wyss.

Mr. Wyss. I think Governor Angell hit the point exactly, that in the long run growth depends on investment and investment depends on saving. The low U.S. national saving rate is our primary disadvantage in the world marketplace. Remember that national savings consist of private saving plus corporate saving net of government borrowing.

Frankly, we don't know a lot about how to increase the saving incentives for individuals. We don't know how to get individuals to save more. We don't know a lot about how to get corporations to reinvest more. We do know how to get government spending and government borrowing down, and I think that's where the first concentration should be.

Senator Mack. Thank you. Let me just ask one more question, and then I'm going to turn to my colleagues, and it has to do with the role of the Fed. I mean many of you have said that you agreed generally with Fed policy, and you've indicated that you're not surprised at what has happened. There is a 13 month lag and, you know, we shouldn't be surprised that when you put the brakes on monetary growth that there is going to be a response to it.

I think the question really is, while we all might say, yes, that's what happens, is that acceptable? I mean is that the role of the Fed?

My colleague earlier asked me to sign onto a letter that I haven't had an opportunity to look at yet, but he's basically saying that the Fed should reduce interest rates. Does that just start us back into this cycle of ups and downs? Should we be looking to the Fed to create the growth, or should we be looking for fiscal policy to create higher levels of growth?

With that I will stop and ask you to respond and then I'll turn to Congressman Saxton.

Mr. Angell. Those of us in the private sector that do this business of forecasting, we have our better forecast and our not-so-good forecast. The fact of the matter is it is not exact enough to try to run monetary policy by forecasting what the real economy will do. Consequently we get faster growth when the Federal Reserve focuses on only one activity, which it may do, and that is to stabilize the price level.

This boom in housing sales that we had beginning in 1993 and that carried into 1994 was not sustainable. So whenever the Fed takes actions to be accommodative in order to get the growth rate to be faster it sows the seeds of a surge in pent-up demand. So it is so important that the Federal Reserve be given reasonable instruction from the Congress to do what it can do well and what it can do best, and that is to pursue price stability, and that is a significant in regard to going forward. I'm confident that listening to Chairman Greenspan and other members of the Board, I'm confident that they will keep their eye on price stability.

Mr. Mitchell. I would agree. The Fed's sole role should be price stability. You don't cure bad fiscal policy and bad regulatory policy with bad monetary policy, and I think the Fed is doing the right thing now, assuming this is what they're doing, by trying to restrain themselves somewhat though it's in part due to the fact that they made a mistake I think in being too easy a number of years ago.

I don't agree when I see Fed Governors at least have attributed to them the notion that economic growth causes inflation. I think that's wrong, and I hope they don't really believe that.

I think what they're doing, or at least I hope what they're doing is they don't know how to explain to the policy community that what they're really doing is trying to make up for the mistakes they made in 1993 and they're reducing what was an excessive monetary growth path down to something more reasonable and hopefully more consistent with long-term price stability. If they really believe economic growth is inflationary, then I think perhaps some economic lessons would be in order.

Senator Mack. Mr. Davis.

Mr. Davis. I believe the Fed really can't add anything to economic growth, but it can take something away. Fundamental factors determine our level of economic growth, including the decision on what type of government we want and what sort of taxation. The Federal Reserve can take something away from growth though if it creates an unstable, volatile environment, and I think we saw that during the 1970s and the early '80s.

Part of the improvement in productivity growth is directly attributable to moving to a climate of greater price stability and the greater certainty that brings. That just reinforces the importance of price stability. If the Fed can deliver that, they let the economy operate at its full potential, and if it doesn't deliver that, it's going to subtract something from our growth potential.

Senator Mack. Mr. Wyss.

Mr. Wyss. You're always going to have a business cycle in this economy. Even if the Fed were perfect, you will always be hit with shocks from outside the economy, whether from the Middle East or elsewhere, which are going to generate temporary inflation surges or real growth surges in our export markets. It's unrealistic to expect the Fed to balance that off completely, because their ability to forecast is not that precise.

Even I've been known to make mistakes in my forecasts from time to time. We're happy about this year. We only had two people on the last *Wall Street Journal* survey that were below us. I think we were a little too optimistic in retrospect, but you're not always going to be perfect in forecasting the future.

I think the Federal Reserve could probably do a better job if it were clear that its dominant goal was to control inflation and to keep the price level stable. I think it is probably unrealistic to expect that to be the only goal of any central bank, but it clearly is the one goal that they can control most easily.

Senator Mack. Congressman Saxton.

Representative Saxton. Thank you, Mr. Chairman.

I would like to build on your last line of questioning, if I may, and I would like to ask Dr. Angell several questions and then ask the other members of the panel if they would like to comment as well.

As we all know, in early 1994 the Fed entered into a period of monetary policy in order to respond to inflationary pressures that were obvious to the members of the Fed. One of those indicators was that long-term rates had begun to increase rather substantially. As you point

out in your testimony, Dr. Angell, they had gone from a level of about six percent to something over eight, and as a result, monetary policy was adopted to try to counteract that pressure.

What was it, in your opinion, that brought about those inflationary fears and the increase in long-term rates?

Mr. Angell. My view is that in March of 1993 the price of gold gave an early warning signal, which turned out to be quite accurate, that the U.S. price level was going to rise to be in equilibrium with the price of gold at $380. That is in comparison to a very gradual disinflation to bring the price level into equilibrium with the price of gold at $330.

The Federal Reserve should be credited for beginning the move on February 4, 1995, prior to the actual bottoming out of the year-over-year CPI inflation rate. The CPI inflation rate bottomed out about one year after the price of gold made its signal at a 2.3 percent year-over-year rate. The Fed, by acting when it did, provided an opportunity for this adjustment to truly be a soft landing. The soft landing doesn't occur because what the Fed does in the latter stages it is what the Fed did by acting earlier.

Representative Saxton. I'm not trying to take issue with what the Fed did. I guess the thrust of my question was more to I know that something caused the price of gold to change and become an indicator. Perhaps I'm being too simplistic. What was it, in your opinion, that caused that activity as well as the increase in long-term rates?

Mr. Angell. Capital market-holders around the world have many currencies among which to choose to hold long-term value. It became apparent to many that the Fed funds rate at three percent with an inflation rate high enough to make the real Fed funds rate zero was not going to attract world capital. It became apparent to many that the attempt for the Fed to focus on economic growth rather than focusing on price stability, that flip flop of talking not about price stability and getting inflation so low it would not make any difference and instead talking about head winds, the talk about head winds and the events of the 1992 election, which some thought was about jobs, jobs, jobs, the world said that the Fed no longer had its eye principally upon that target. So there gets to be an estimation of the political climate in which the Federal Reserve operates and that lack of confidence then resulted in this expectation of higher inflation.

Representative Saxton. So there were economic pressures other than price stability that played a very important role in the early 1990's with regard to Fed policy, and specifically in layman's terms that meant that the Fed put into place monetary policy that was intended to keep

interest rates, short-term rates low, and in the meantime long-term rates were increasing significantly. So we entered into this period of inflation primarily because of a flawed targeting system that the Fed perhaps used at that time to try to create jobs and economic growth.

Mr. Angell. Yes, but here again I don't want to make it be just the Federal Reserve as a central bank compared to the Bundesbank as a central bank. You see, there is an element which the world judges that the political climate in Germany will favor the Bundesbank pursuing sound money in that political climate. The suspicion was in the United States politics would favor jazzing up the economy.

Representative Saxton. Yes, sir. Now let me just get into the next phase of this, if I may, before my times goes by. So then we entered into a period of different monetary policy where we had tighter policy because we wanted to check the inflation pressures, and as a result of caused seven increases in short-term rates. The Fed precipitated that as well because, as I remember hearing it, contrary to what Dan Mitchell hopes we all believe, I remember reading in the press consistently that the economy was growing too fast and that was causing inflation, when in fact I think what you're getting to is that monetary policy itself caused inflation, and it is our intent I think as policy-makers, most of us, that the Fed ought to keep its eye on one thing. So as we went through this period we were actually working against ourself at times. Is that a fair statement?

Mr. Angell. That's a fair statement. Mr. Mitchell has it exactly correct when he places his emphasis here upon not being afraid of growth. Growth is a wonderful thing. We could never get capital goods production and capital goods formation at the rate that we now have it without moving up to capacity. So getting high growth and getting to capacity is a good thing for inflation.

Representative Saxton. Mr. Chairman, I know my red light is on there, but let me just ask one more question, if I may, and then I'll conclude.

Now we're contemplating what to do with this new set of circumstances with a weak economy, and some thought in some quarters is being given to use lower interest rates to jazz up the economy again, to make the economy grow again. Is that right?

Mr. Angell. Yes, that's correct, and that runs a very high risk of destabilizing international capital flows and increasing interest rates and would thereby be a detriment. We prefer policies leading to low interest rates. Low interest rates are every bit as good as anyone thinks they are.

We want the Fed to pursue policies that will give us low interest rates, and that means focusing on price stability.

Representative Saxton. My time has expired, Mr. Chairman, and I appreciate your indulgence. I would just conclude, and I see that some others are leaning forward in their chairs and they may want to comment on this issue as well, but let me just point out that this is exactly the reason that I support your bill which would reform Fed targeting at least because we should have learned many times in the past, and I think we just got a great lesson in Fed economics and the roll of the Fed from Dr. Angell as to why I'm grateful that you have brought forward your pending legislation which will retarget the effort of the Fed in what you and I both agree is a more proper direction. So thank you for indulging me on extending my time here a little bit.

Senator Mack. Thank you for your comments. Senator Bennett?

Senator Bennett. Thank you, Mr. Chairman.

I sit through these sessions and understand why I didn't take more economics classes when I was in college. Wayne Angell knows as we've talked about other issues that in order to get me to understand it he has to take it out of the economic world and into the language of the business world. That I understand.

Let me try an analogy on you that comes out of the business world to see if I can't understand what we're talking about and perhaps make a point. I latch onto what Dr. Angell said, that growth is a wonderful thing. I think we need, all of us, as Americans, to remember that, that we're not dealing with a zero sum gain here, but we're dealing we hope with an ever-expanding pie.

I've presided over a business that was faced with the challenge of growth and grew so rapidly that some of my shareholders occasionally would say you're going to grow us into bankruptcy. We can't afford the inventory and the receivables and the other problems connected with this growth. Slow the growth down.

Well we didn't slow the growth down because we were paying for it with internally generated funds and not borrowed funds. Our margins were sufficiently high. We stopped allowing our customers to charge it. We made them put it on their own charge cards. So the bank in effect financed the receivables. We didn't have any to finance. So we could put the margins we were generating all to fund the inventory and the capital expenditures and so on related to our growth.

If that can become microcosm, if you will, for the full economy, I go back, if you will, to the tax debate. As I said, I put it in business terms.

The President was telling us in the tax debate it's okay that we are going to cut your margins, raise your taxes. You can fund the growth at a lower cost with borrowed money because we're doing something about the interest rates. Well in my business we didn't worry about the interest rates because we didn't need to borrow money. We were funding it with internally generated funds.

It seems to me there is something better about saying to the business community you can keep more of the money you generate from your growth by virtue of having a lower tax rate and fund the growth that way and therefore you don't need to go out and borrow so much to fund the growth and therefore you become immune to a certain extent from the fluctuations in interest rates one way or the other, and the economy is going to grow more rapidly if it is financed by internally generated funds you get to keep through lower tax rates than it is by lower interest costs on the money you have to borrow.

Now that's the paradigm from which I am coming. Would you comment on that. Am I completely crazy and should I have stayed in economic class more often, or does that make some sense in terms of the economy as a whole?

Mr. Angell. Senator Bennett, I can't fault anything in your background in regard to your rapid understanding and ability to explain. You have it exactly right.

One reason that we believe that this bounce back is going to be so strong is that corporate profits are strong enough that many U.S. corporations aren't really borrowing. Many corporations are almost cash cows and what we have to do is give them the incentives to move forward. So the tax moves that you contemplate are important.

The fact of the matter is that corporations do not pay taxes. Individuals pay taxes, but unfortunately it is not the owners of the business that have the greatest burden of the tax.

Senator Bennett. It's the customers.

Mr. Angell. It is the workers and the customers that have the biggest burden. It is just a false deal to hold out we can tax these people because the burden of the tax goes usually where the government would least like it to go. So people that do not have jobs have paid the burden of these higher tax rates.

Senator Bennett. Mr. Wyss, you were shaking your head while Mr. Angell was nodding it. So let's hear from you.

Mr. Wyss. Well to begin with I wish you had managed to teach the American corporate sector that lesson during the 1980s, because one of

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the problems we're suffering from today is the leverage of the American corporate sector that went on during the 1980s as they borrowed more and more money.

Senator Bennett. We built our company during the '80s and we did it without debt.

Mr. Wyss. Yes, but the average corporation didn't.

Senator Mack. If I'm not mistaken though, the tax policies encouraged borrowing, and I think the bottom line was you were better off to have borrowed money than to have raised money in the capital markets.

Mr. Wyss. The '81 Tax Bill tremendously favored borrowing money. That's what was going on during the '80s, and the '86 bill didn't change that very much. It was a rational reaction to the tax policy that existed at the time, and it was a dumb tax policy.

I wish, however, that we would carry the analogy up to the national level. It's just as dangerous for the nation to live on borrowed funds as it is for corporations, and that's why I feel the best thing to do and the thing we've got to do over the next few years, is to stop borrowing money. Let's face it, it's just like a corporation, there are only two ways to stop borrowing. You either stop spending or you raise revenue. That's all that there is.

Senator Bennett. Or you grow the corporation.

Mr. Wyss. That's raising revenue one way or the other.

Senator Bennett. Yes, that's raising revenue. Well I voted for the Balanced Budget Amendment, and I've said always I'm a reluctant convert to it for a variety of reasons. I at some point would like to substitute my own version which says I don't care whether there is an excess or a deficit in any one particular year, but the number that I would keep my eye on, which I would in a business, is the size of the debt relative to the size of the company, and I would like a Constitutional Amendment that says we can never allow the total national debt to exceed a certain percentage of GDP without a 60 percent vote in the Congress. Now that would have the same effect, but it would be a whole lot easier to enforce I would think than the Balanced Budget Amendment that we've got. I haven't been able to convince anybody to co-sponsor it with me, but at some point I'm going to try.

But I'm absolutely in agreement with you that the thing we have to keep our eye on is the size of the debt relative to the economy and our ability to service that debt, which always means borrowing more money as the debt becomes due.

Yes, sir.

Mr. Davis. Senator, following your analogy in a somewhat different direction I am very much concerned that although corporate profits are strong now, they'll not remain strong. I believe to some extent corporate profits are boosted by the activities of last year, and the demand of last year that's only trailing off now.

As we go further corporate profits will not remain strong, in my judgment, if the government still makes the demands it makes on the private sector. Ultimately I don't see how you have strong private capital growth and profitability if the government makes the demands it's currently making.

Senator Bennett. And by demands you mean taxes?

Mr. Davis. Yes, sir, and borrowing and inflation if it gets to that.

Senator Bennett. Mr. Mitchell.

Mr. Mitchell. Two comments. One, if we're concerned about corporations responding to wrong incentives in terms of their debt and equity mix I think a flat tax is exactly the right answer to that quandary.

Secondly, in terms of your original question about the impact of taxes on the entrepreneurial sector and the Administration's claims that there are no adverse consequences, I would simply point out the 1993 IRS data out showing that taxable income reported by the very wealthy went down precisely as supply-siders predicted, and in part that's because the well-to-do aren't like the average American. The vast bulk of their income is not wage and salary. It's investment income that you have tremendous discretion and control over in terms of its timing and its composition, and it's very easy, a couple of clicks at the computer keyboard, to shift out of Microsoft into municipal bonds. And I think the decline in taxable income among the rich is a very early indicator of just how misguided that policy was in 1993, not to mention 1990 which was sort of a harbinger of it.

Senator Bennett. Thank you.

Senator Mack. Thank you, Senator Bennett.

I only have a couple of other questions, and I want to throw this one out because we've focused at lot on monetary policy and Senator Bennett has focused somewhat in his questions on the tax side.

In 1993, and I forget now who raised this point earlier, and in fact it may have been Senator Bennett, but in 1993 two-thirds of the individuals hit by the Clinton Administration's tax increase were small business owners. It would seem to me that this tax hike would be a drag on employment and economic output causing the economy to perform poorly.

Do you agree with that, Mr. Mitchell, and do you agree with that, Mr. Angell?

Mr. Mitchell. Well I certainly agree with it. I mean there is a big debate of are those active business owners or passive business owners, and are they just sitting back and collective dividends or are they sole proprietors or partners in some way. I don't think it's relevant because whether you're active or you're passive you're still providing capital and generating income which is having all sorts of positive spinoff effects on the economy, and if the government is sending you a message that we're going to penalize you by confiscating a greater share of your income for being successful, whether it's passive or active, the chances are you're going to decide well I'm not going to bother taking risks and I'm just going to go take a vacation and sit down in the Caribbean some place and stick all my money in municipal bonds.

Frankly, I think in the long term our economy is better off if people have incentives to invest in the Microsoft of tomorrow rather than being extremely cautious, which is what high tax rates encourage them to do.

Senator Mack. Do you want to add anything to that, Mr. Angell?

Mr. Angell. No, thank you.

Senator Mack. Mr. Wyss?

Representative Saxton. I'll skip that one.

Senator Mack. All right. Then the last point that I would raise is that a Joint Economic Committee model suggests that for every percentage point reduction in Federal government spending as a percentage of GDP the economy will get a boost equivalent to .14 percentage points in GDP growth during the following year. What we're saying is that there is a direct correlation between the percentage of GDP consumed by government and growth. We looked at periods immediately following World War II probably through the mid-60s and we saw some rather significant changes in this trend line about growth.

The question is do you agree with that and do you think that this idea that .14 percent in real GDP is related to the level of consumption of GDP by government? Mr. Davis?

Mr. Davis. I think that that relationship is valid. In the short term, however, looking at the one-year changes, frequently those sorts of tax policy changes or spending changes result in some behavioral adjustments that really try to shift economic activity from one period to the next and some of the one-year effect is just picking that up. I feel that you probably need to look at even a longer term to see the full effect of reducing the burden of government, and probably that will be cumulative and you won't see the full effect for five years. So it's not so much like turning on the spigot and getting an immediately jump, except for the behavior of shifting activity only from one period to the next. But you do tend to raise economic growth progressively and it tends to occur over a four or five-year period.

Senator Mack. Let me point out, and maybe I didn't make it clear, that we covered a period of time of about 50 years, and we weren't looking one year to one year, but we were comparing that 50 years. Mr. Wyss?

Mr. Wyss. I would tend to take issue with it in terms of a short-term impact, but I would tend to agree in the long run. What's good for growth is to shift money from consumption to investment, and that's true whether it's government consumption or individual consumption.

However, I think the short-term correlation is picking largely war impacts, the impact of war in increasing and decreasing federal spending and the similar impact of war in increasing or decreasing the growth of the economy. Hopefully the next big move in federal spending won't be caused by a war.

Senator Mack. Mr. Angell?

Mr. Angell. Senator Mack, yes, I agree in the sign that you have there. I don't know in regard to the two decimal places and accuracy. It would be interesting for us to also consider whether every area of government spending has the same reaction relationship as every other area. That is, it might be possible that there are some things that government does that it has some specialization and the subtraction in efficiencies is not so great, but my guess would not be that its education that government would probably do the best in.

Senator Mack. Mr. Mitchell.

Mr. Mitchell. The one comment I would make is just as there are different tax cuts that will have better economic effects than other tax cuts, the same thing on government spending. Presumably there is some rate of return to a physical infrastructure whereas other types of government spending would have presumably negative rates of return. But certainly the academic research out there is consistent with the kind

of numbers and certainly the sign that you're talking about with the JEC's model.

Senator Mack? Very good.

Well again I want to thank all of you for giving us your time this morning and I appreciate your being here.

The hearing is adjourned.

[Whereupon, at 12:35 p.m., the Committee adjourned.]

SUBMISSIONS FOR THE RECORD

PREPARED STATEMENT OF REPRESENTATIVE PETE STARK, RANKING MINORITY MEMBER

The Joint Economic Committee is not bound by legislative timetables or jurisdictional limits. That makes it ideally suited to conduct a thorough and wide-ranging hearing on critical economic issues like the one we take up today, the recent signs of an economic downturn. How seriously should we take these signals? What are the causes of the economic weakness? What are the implications for economic policy?

There is absolutely no justification to give hasty treatment to such an important and serious topic. Yet we have effectively been given just one day's notice of today's hearing. For as long as anyone can remember, the standard notice for hearings at the Joint Economic Committee has been one week. We have been told that the decision to hold the hearing was made late Tuesday. That is no excuse. The hearing should have been conducted next week when it would still have been quite timely.

There are many signs that economic momentum has stalled, at least temporarily. Employment, industrial production, and the leading indicators have all recently declined.

The argument that the 1993 budget agreement somehow accounts for the current slowdown is a Republican fairy tale. For the first six quarters after the August 1993 reconciliation package, the economy boomed at an average annual rate of 4.2 percent.

There is a consensus among nonpartisan economic analysts on the cause of the slowdown. For the last 16 months, the Federal Reserve has been slamming on the brakes to slow growth down to 2-1/2 percent and has overdone it. The interest-sensitive industries such as housing and autos have been on the leading edge of the slowdown. You recognized this problem yourself, Mr. Chairman, when you criticized the Fed's last hike in February.

The most sensible policy response to the current economic weakness is an immediate and significant rate cut by the Federal Reserve. The financial markets already anticipate such a cut and the Fed should not disappoint them or the rest of us who want to avoid a recession. I have a draft letter to send to Chairman Greenspan that I call on you Chairman

Mack, and all other members of the JEC, to sign. We would be happy to work with you on the exact wording to get the point across.

Let us be clear about what will not help us get out of the current slowdown and possible recession: the proposed Republican budgets. They would not take effect for some time, and will depress the economy when they do take effect.

Mr. Chairman, I look forward to our witnesses and to your consideration of a joint letter to Chairman Greenspan.

PREPARED STATEMENT OF DR. WAYNE ANGELL

WEAK NOW, STRONGER LATER

There is no doubt that 1995 is shaping up to be a weaker year for economic activity than I expected given the developments in monetary policy. After the strongest year of economic growth since 1984, real GDP is estimated to have only grown by 2.7% in the first quarter of this year. Moreover, based on the latest data for jobs, manufacturing, and consumer spending, GDP in the second quarter is likely to be broadly unchanged from its first quarter level. The consecutive monthly declines in nonfarm payrolls in April and May, and the marked weakening in the survey of US purchasing managers for May, have raised the question of whether the slowdown in activity is a temporary lull or whether it marks the onset of a recession.

No one can say for sure that the US will not slip into recession, but my own view is that the economy is undergoing a temporary slowdown as companies pare back on unwanted inventory investment. However, I do not believe unwanted inventories are that large and I strongly suspect that the economy will reaccelerate in the second half of the year. While the $49.8 billion build up of nonfarm inventories in the first quarter was not far out of line with the $46.9 billion average of the prior three quarters, there were emerging signs that some of this inventory was unwanted. The diffusion index of supplier-delivery promptness from the US purchasing managers' survey peaked at 65.7 in December 1994, and has fallen in each month since then to stand at 52.9 in May. This index of vendor performance has proved in the past to be a reliable indicator of future inventory investment and when promptness increases, it has reliably pointed to a slowing in inventory additions. Attempts to pare back inventories have already resulted in three consecutive monthly declines in manufacturing production, and manufacturing output likely dropped sharply again in May.

I do not believe that the slowdown that has occurred is a result of the 6% overnight rate delivered by the Federal Reserve. The main slowdown in final demand may well reflect the consequence of 8% 30-year Treasury yields and 7 1/2% two-year yields, which have shown up in declining home sales and falling expenditures on durable consumer goods. Monetary policy accommodation accelerated spending on housing and consumer durables in 1994 and exhausted pent-up demands. It is perhaps not too surprising that without increasing monetary accommodation, lumpy expenditures on housing and autos should fall for a period of time after such a strong showing in 1994.

In addition, the contraction in manufacturing is in part a result of economic dislocation in Mexico. US exports to Mexico have fallen from a peak year-over-year growth rate of 32.8% in the third quarter of 1994 to a year-over-year decline of 5.9% in the first quarter of this year. However, even though the prospects for improvement in Mexico in the near future are not bright, the drag on US export growth should sharply diminish in the second half of the year.

What caused the consumer slowdown?

I do not believe that the slowdown in consumer spending was principally the result of a 6% fed funds rate. Market-price indicators of the future price level, such as the price of gold or the foreign exchange value of the dollar, do not suggest that the monetary policy moved to a restraining stance at the end of 1994 or early in 1995. The price of gold, at around $385 an ounce, stands at its average level of the last 12 months. Moreover, the Federal Reserve Board's trade-weighted index of the dollar against the G-10 currencies has fallen 9.7% from the average level of 1994 and stands 14.6% below the level of January 1994. This is a very different picture from March 1989, when the trade-weighted dollar had risen 9.0% over the prior 12-months, while the price of gold had fallen $50 an ounce from its average level in 1988 of $442 an ounce.

I believe that the slowdown resulted from the sharp increase in market yields across the entire spectrum of the yield curve. In December 1994, two-year yields hit 7.73%, up sharply from the 6.0% level seen at the end of July 1994. Meanwhile long-bond yields rose from 7.4% at the end of July to hit a peak of 8.19% in November 1994. As a result of these market moves, contract rates on 30-year fixed mortgages hit 9.25% in December 1994, and no doubt had a restraining impact on housing activity. Meanwhile, high interest rates on Treasury year-bills, two-year notes and comparable instruments, raised the incentives to postpone durable goods purchases. In addition, disposable personal income has been held back by slow processing of tax refunds in 1995, as the IRS has been scrutinizing returns for fraud, and payment of the second installment of the administration's retroactive tax hike of 1993.

Market interest rates are now markedly lower than in December 1994, even though the Federal Reserve raised the fed funds rate by a further half point on February 1. Yields on two-year notes have fallen to around 5 3/4%, a decline of two percentage points, while long-bond yields have dropped to around 6 ½%. Alongside the decline in bond yields, the 30-year fixed mortgage rate has dropped to around 7.7 %, which has begun to spur mortgage applications for home purchase. Home sales tend to follow mortgage applications with a lag of about two months, and I would

expect a rebound in both new and existing home sales in the months ahead.

Weak second quarter

The preliminary indications for the second-quarter are that the overall GDP will be close to unchanged, while the factory sector looks likely to post a sharp drop in output of between 3% and 4%. The 108,000 decline in nonfarm payrolls during April and May, and the 18 minute fall in the private workweek, have left total hours worked down 2.1% at an annual rate from their first quarter average. Meanwhile, hours worked in the factory sector have contracted at a 7.8% rate so far in the second quarter, consistent with the 3.7% annualized drop in industrial production in April from its first quarter average.

The weakness in the factory sector is confirmed by the National Association of Purchasing Managers' survey. The NAPM's diffusion index of overall activity fell to 46.1 in May from 52.0 in April, and is well down from its peak of 59.9 in November 1994. With the economy adjusting to unwanted inventory levels and economic contraction in Mexico, it is to be expected that the brunt of the adjustment is being borne by the factory sector.

There are signs, however, that consumer demand will rise modestly in the second quarter, despite the fall in jobs. Consumer spending in real dollar terms in April was 1.2% above the first quarter average at an annual rate, despite a 0.4% drop in retail sales in April. However, preliminary indications suggest that spending will advance at a moderate pace in May as total domestic vehicle sales rose from 11.9 million units in April to 12.5 million in May, while departments store sales advanced 0.4% from April's level measured by the Johnson Redbook survey. At this point, I would estimate that consumer spending will grow at a pace close to the first quarter's 1.8% gain in real terms. A modest advance in consumer spending, combined with continued strength in investment in business equipment and nonresidential structures, will likely offset the negative impact on the economy as a whole from the downward adjustment to inventory investment.

Are policy actions needed?

As I have already noted, I believe that the economy will receive significant stimulus in the second half of the year from the decline in bond yields and the fall in the foreign exchange value of the dollar. The softness in the economy is being exaggerated by the adjustment to inventories. However, since the overall business inventory-sales ratio at the end of March was only 1.40, not that far above its record low level of

1.37 seen in December 1994, the inventory overhang would not appear to be particularly large.

Any move to lower rates from the Fed would tend to impact the 1996 economy more than the 1995 economy. Such a move would risk overheating the economy in 1996, just at the time when the fall in bond yields and the weak dollar are having their full effect. It is important to remember that we have not yet seen the peak in inflation, and leading inflation indicators of gold, commodities and the dollar have not improved significantly. The Consumer Price Index has run at a 3.6% annualized pace in the first four months of this year, while the index ex food and energy has increased at a 4.2% pace. Meanwhile, the impact of the weak dollar is showing up in trade prices, as import prices have risen 6.7% over the last 12 months, while export prices are up 5.8%.

The building stimulus from the trade sector can be seen if Mexico is stripped out of the export data. The 19.4% four quarter growth in US exports excluding those to Mexico shows the increased pace of the export growth from the 4.7% year-over-year pace of the first quarter of 1994. However, with much of the recent decline in the dollar occurring in February, there is a lot more stimulus from a weak exchange rate yet to feed through. Meanwhile, import growth could be held in check as some of the reduction in inventories falls on foreign producers. As the trade sector moves to provide a positive contribution to growth in the second half of 1995, and housing and consumer spending revives, I suspect that real GDP growth in the second half of the year will run at a pace between 2% and 3%. Moreover, I suspect that without any further policy action from the Fed, real GDP growth will run at a 2 ½ % to 3% pace in 1996.

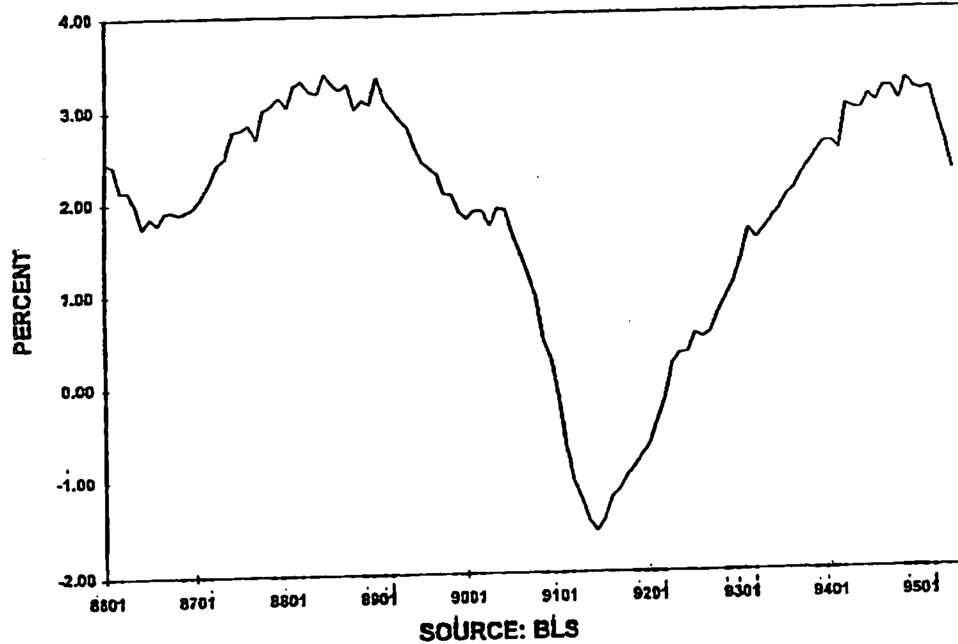
Balanced budget thoughts

It is important for the longer run financial health of the US that fiscal policy is put on course to balance the budget by 2002. However, one question that needs to be addressed is how should fluctuations in economic activity be allowed to impact the budget-planning process? I believe that the most appropriate approach is to use a trend growth projection in arriving at the outlook for fiscal policy. There should be no attempt for Congress to offset the so-called automatic stabilizers of tax revenues and economy-sensitive expenditures. In years of above-trend growth, the US would make more rapid progress toward fiscal balance, and in years of below-trend growth less rapid progress would be made.

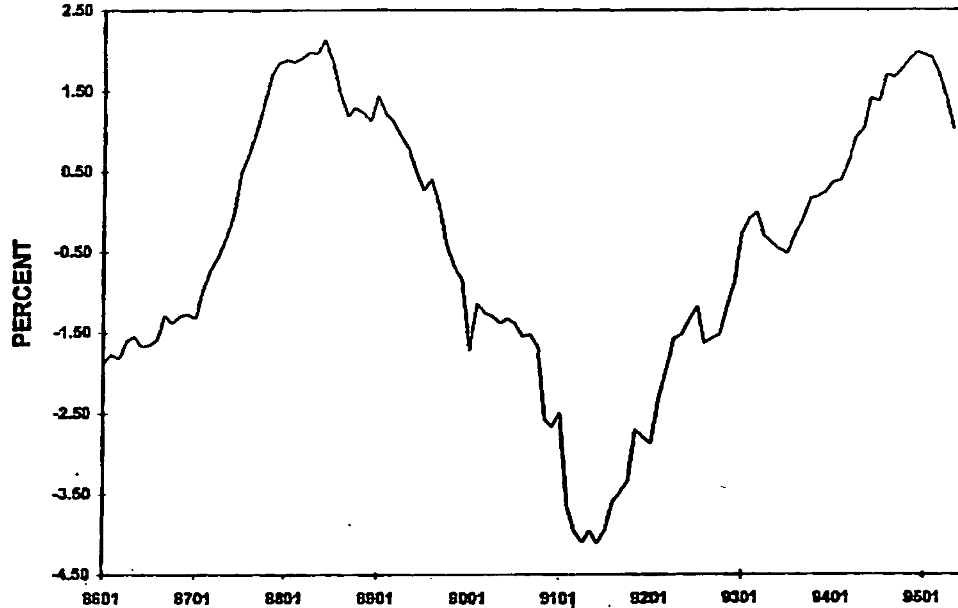
I also believe that more rapid progress to a balanced budget would be achieved if Congress directed the Fed to solely pursue price stability. This change to the Humphrey-Hawkins legislation would greatly reduce the monetary policy uncertainty premium in bond yields , thus lowering

the interest cost on the federal debt. As I have testified on a previous occasion before this Committee, I believe that this change would also enhance investment, saving and the overall growth rate of the US. Monetary policy is not well suited to fine-tuning the US economy, whereas it is well suited to achieving and maintaining stable prices.

NONFARM PAYROLLS
12-MONTH CHANGE

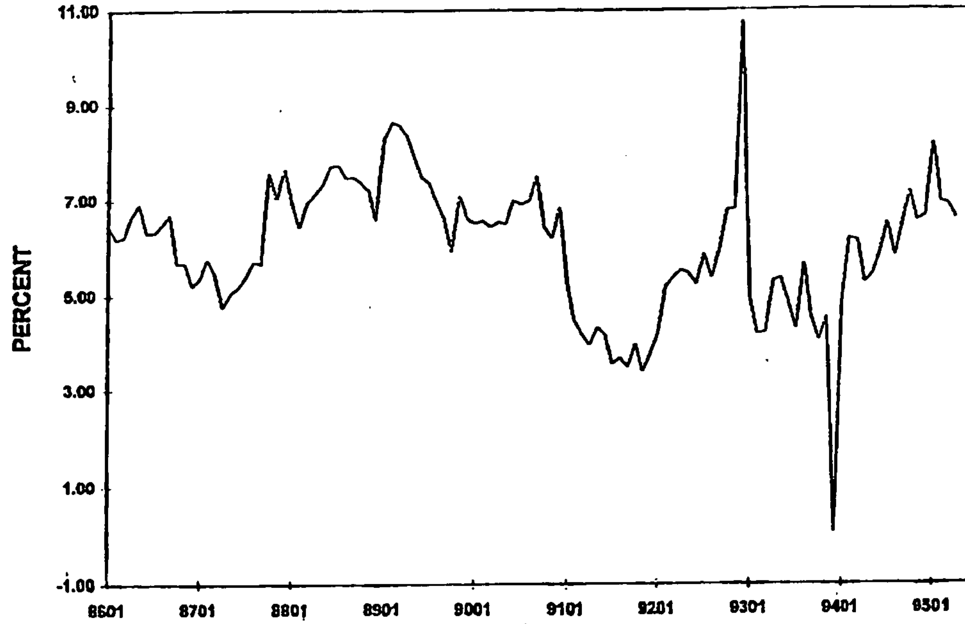


MANUFACTURING PAYROLLS
12-MONTH CHANGE



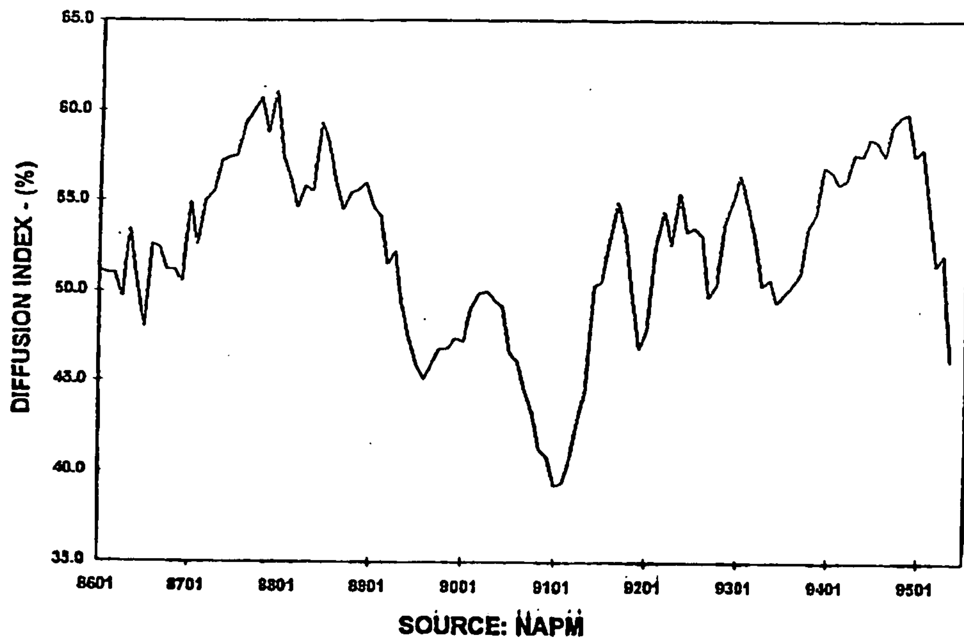
SOURCE: BLS

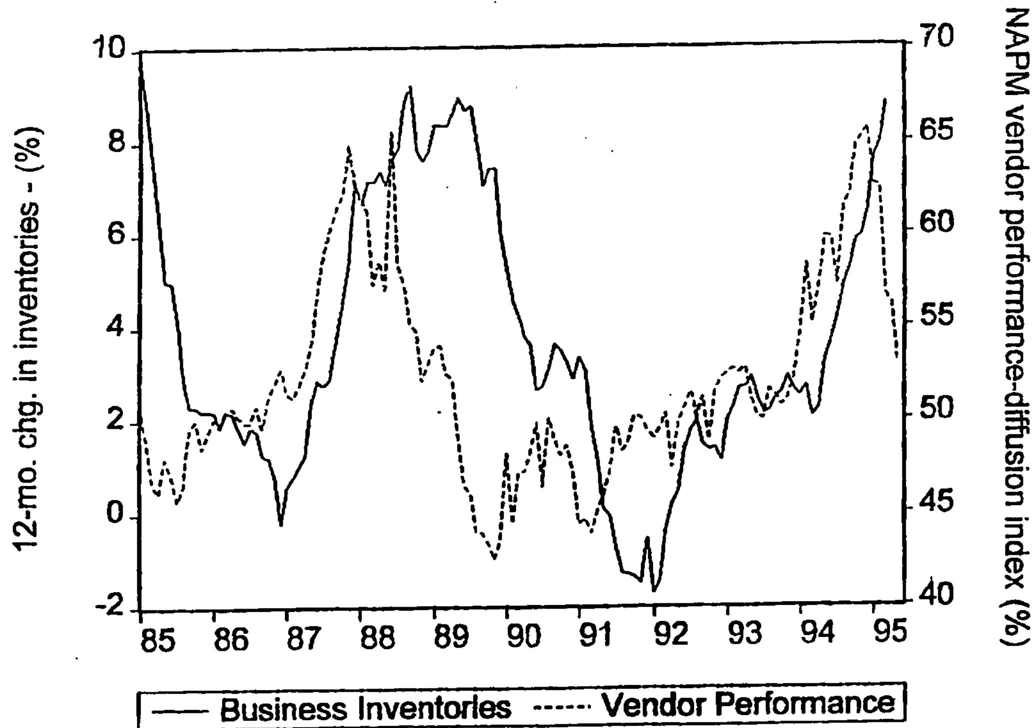
PERSONAL INCOME
12-MONTH CHANGE



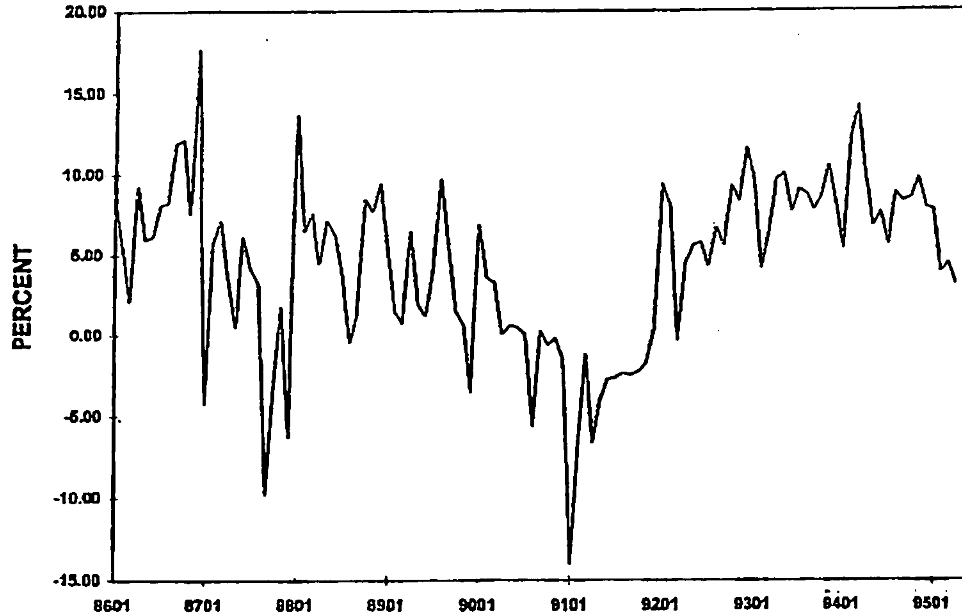
SOURCE: DEPARTMENT OF COMMERCE

NAPM COMPOSITE INDEX



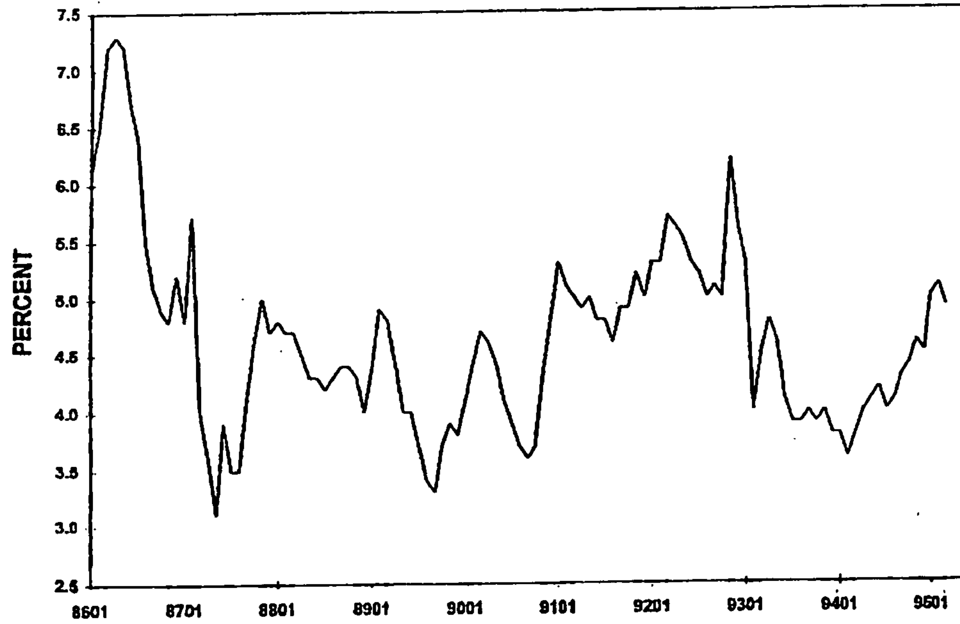

Business Inventories and Vendor Performance
12-mo. chg. in inventories - (%)
NAPM vendor performance-diffusion index (%)
10
8
6
4
2
0
-2
70
65
60
55
50
45
40
85
86
87
88
89
90
91
92
93
94
95
Business Inventories
Vendor Performance

PERSONAL SPENDING: DURABLE GOODS
12-MONTH CHANGE (Bil. 87$)



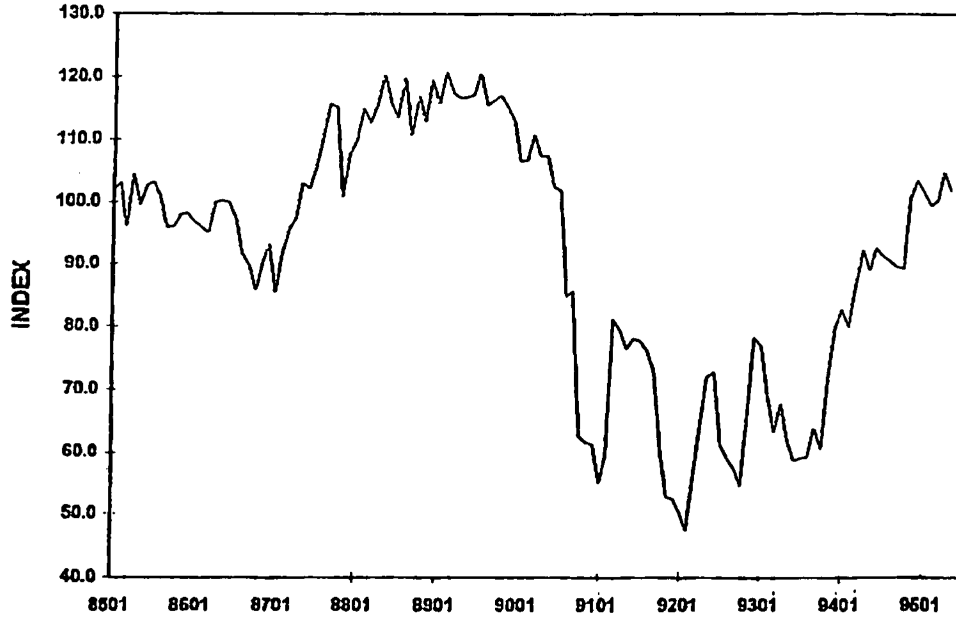
SOURCE: DEPARTMENT OF COMMERCE

SAVINGS RATE
MONTHLY

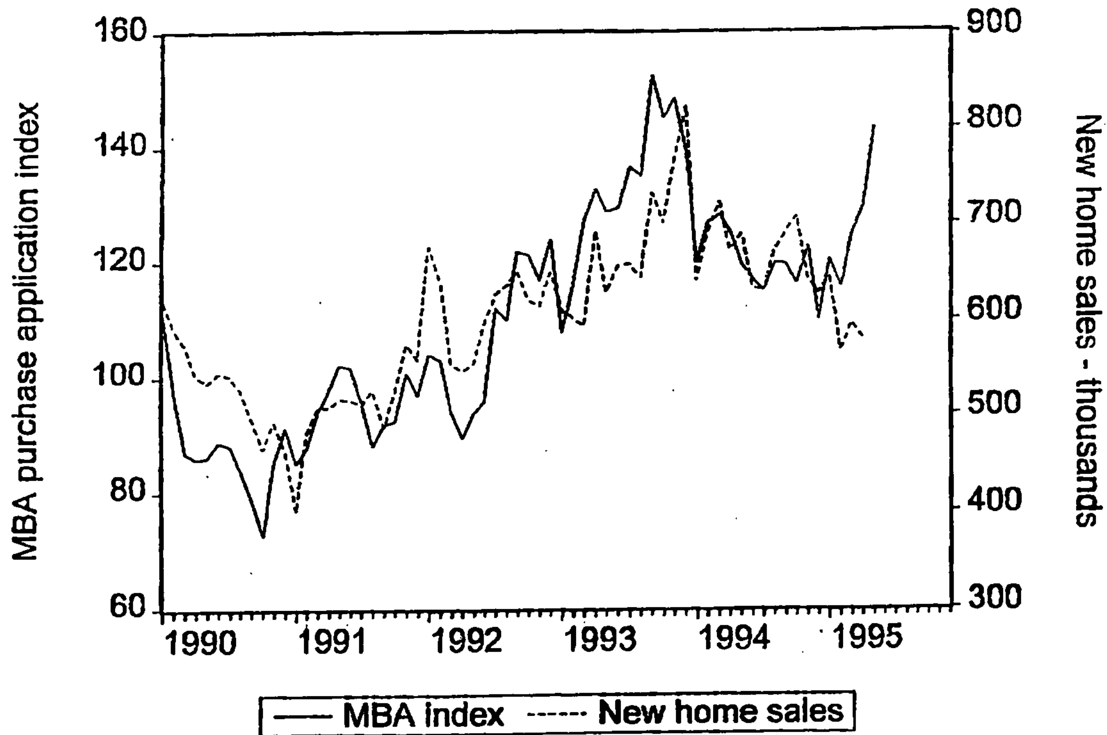


SOURCE: DEPARTMENT OF COMMERCE

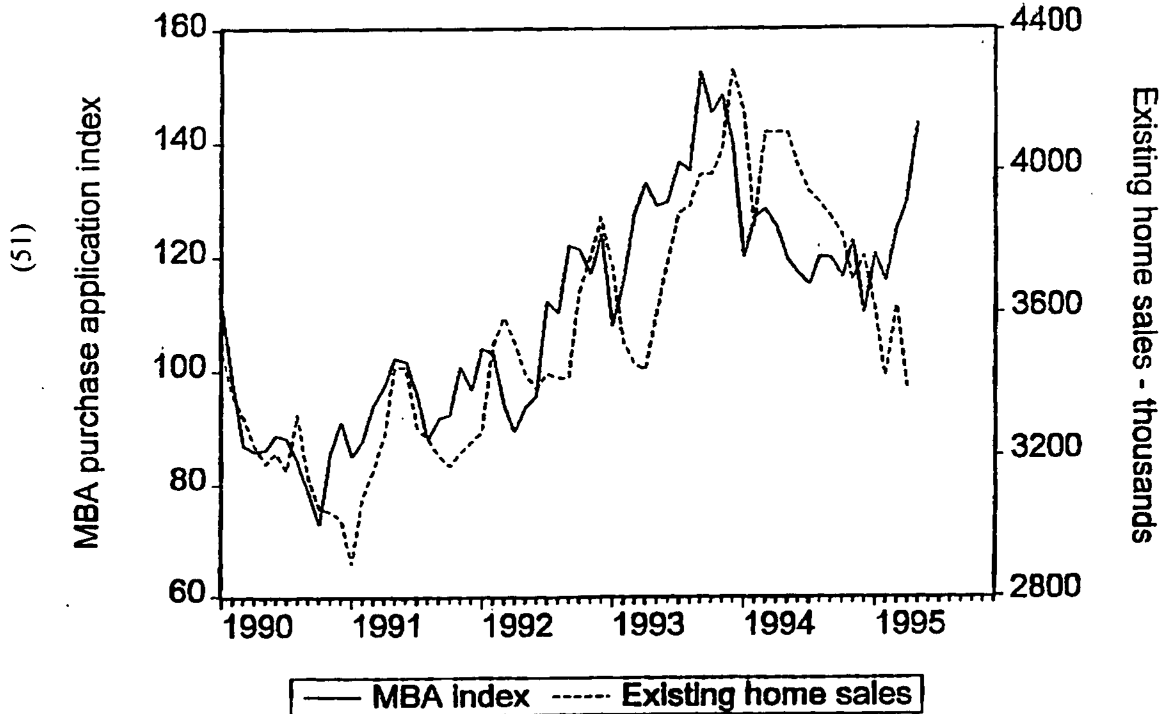
CONSUMER CONFIDENCE
MONTHLY



SOURCE: CONFERENCE BOARD


MBA Purchase Index & New Home Sales
MBA purchase application index
New home sales - thousands
160
140
120
100
80
60
900
800
700
600
500
400
300
1990
1991
1992
1993
1994
1995
MBA index
New home sales

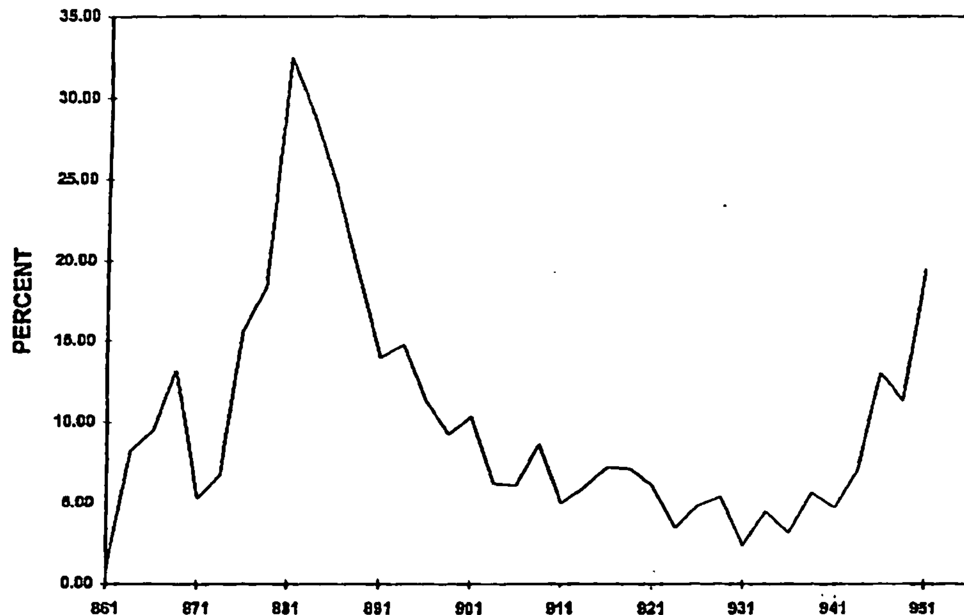
MBA Purchase Index & Existing Home Sales



EXPORTS TO MEXICO
4-QUARTER CHANGE

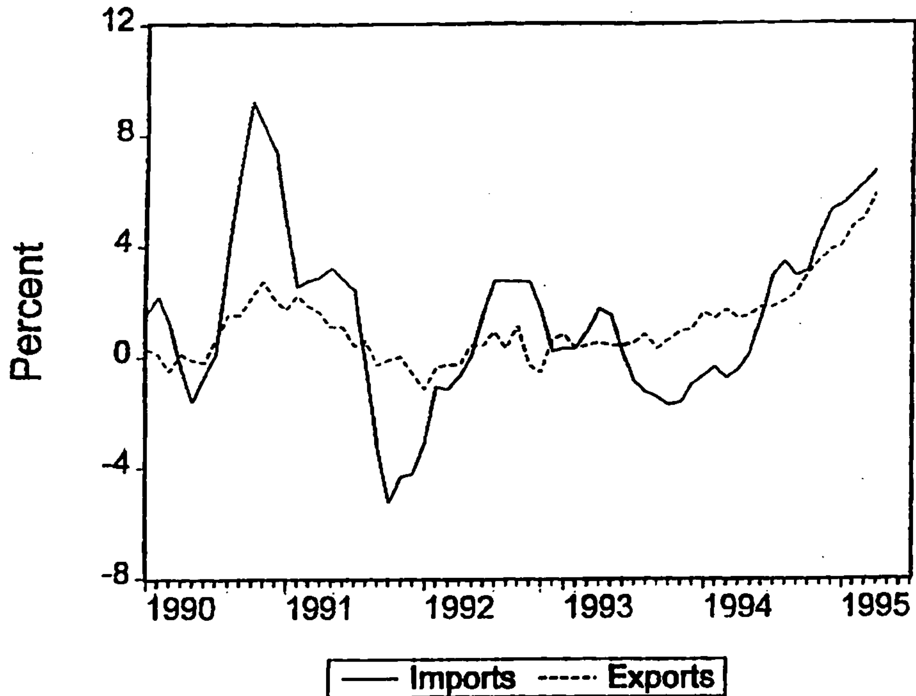
SOURCE: DEPARTMENT OF COMMERCE

TOTAL EXPORTS EXCLUDING MEXICO
4-QUARTER CHANGE



SOURCE: DEPARTMENT OF COMMERCE

U.S Import and Export Price Indexes



PREPARED STATEMENT OF DANIEL J. MITCHELL

Mr. Chairman, members of the Committee, I appreciate the opportunity to speak with you today about the economy's lackluster performance. My name is Dan Mitchell and I serve as the McKenna Senior Fellow in Political Economy at the Heritage Foundation, though the views I express are entirely my own.

While the current expansion has entered its fifth year, the economy's performance is far from robust. As the attached chart indicates, employment growth is lagging considerably behind averages of previous expansions. GDP numbers tell a similar story. These aggregate numbers, however, tell only part of the story. The economic statistic that may matter most to the American people -- inflation-adjusted income -- has performed even worse, with median income falling every year since 1989. This worrisome trend hopefully will be reversed when the final 1994 figures are released, but even a surprisingly strong result for the year would offset only a small portion of the economic damage American families have experienced in recent years.

Few observers argue, of course, that the economy's performance is satisfactory. The questions which must be answered therefore are the following -- What is responsible for the weakness presently apparent and what policy or policies would most likely boost growth?

First, some observations on growth. It is a tautology that increases in living standards over time are due to increases in either labor or capital. In short, to have more income we must work more hours each week, producing more for each hour worked, or some combination of the two. Any analysis of the economy -- past, present, or future -- should therefore focus on the degree to which government policies are affecting incentives. Policies which reduce rewards for providing labor services, for instance, will adversely affect labor supply, while policies which lower returns to capital will reduce the level of saving and investment.

Another key to economic policy is focusing on the long-term. Whatever the causes of business cycles -- fiscal policy, monetary policy, normal cyclical fluctuations, it is almost impossible for lawmakers to recognize these shifts and adopt appropriate policies in a timely fashion. The goal of public policy instead should be to create an environment that is most likely to maximize the economy's long-run growth rate.

With these simple principles of economics in mind, allow me to comment briefly on some of the major issues of concern to the Committee:

Why has the current expansion been so weak?

The slower-than-average GDP and employment growth have many causes, including the fact that the 1990-1991 economic slowdown was milder than average. Some statistics, however, particularly the continuing decline in median income, are much more troubling. Misguided economic policy almost certainly deserves part of the blame. Large tax increases in 1990 and 1993 have substantially lowered incentives to engage in productive behavior, while rapid increases in government spending and regulation have diverted resources from more highly valued uses.

Where is the economy headed?

While I believe short-term forecasting is guesswork at best, I see no reason to quarrel with the conventional wisdom that the economy's long-term rate of real growth, given the economic policies now in place, will be somewhere between 2.0 and 2.5 percent. As Committee members realize, this rate of growth is below the post-World War II average of more than 3.0 percent. And while there may not seem to be much difference between 2.5 percent growth and 3.0 percent growth, consider the following statistic: A sustained 0.5 percent increase in the growth rate over ten years will boost national output per family of four more than $5,000 in the tenth year.

Will budget cuts have an adverse economic impact?

While largely discredited, there still are those who adhere to the school of thought known as Keynesian economics. According to Keynesian theory, reductions in government spending will take purchasing power out of the economy, potentially causing a downward spiral. Needless to say, lower government spending does not have this impact. For every dollar the government does not get to spend as a result of budget cuts, there is an increase in the amount of resources in private credit markets. Moreover, while the short-term effects are a wash, the long-term effects are unambiguously positive given the overwhelming evidence that the private sector spends money far more wisely than the government. Of course, this entire question is somewhat irrelevant anyhow, since the budgets currently being debated in Congress simply limit the growth of federal spending to between 2.5 percent and 3.0 percent annually. The so-called cuts are nothing more than reductions in the projected rate of growth.

Are tax cuts wise policy?

Ironically, many of the same observers who worry that limits on government spending may harm the economy by reducing the supposed stimulative impact of deficits become born-again budget-balancers on the

topic of tax cuts. According to critics, tax cuts will increase the deficit, the higher deficit will boost interest rates, and higher interest rates choke off expansion. While every link in this chain of reasoning is flawed, the premise is irrelevant anyhow since both the House budget with its tax cuts and the Senate budget without tax cuts call for a balanced budget in the year 2002.

Is the monetary policy helping or hurting?

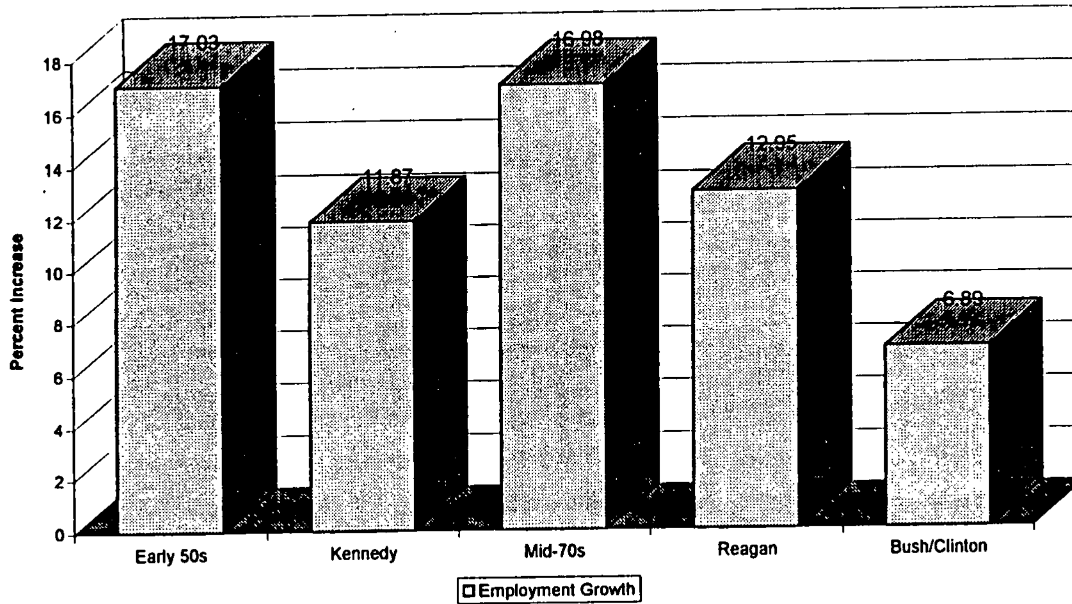
Some observers contend that excessively tight monetary policy is putting the expansion at risk. While it is true that a deflationary monetary policy could have that effect, there is scant evidence to suggest this actually is the case. If anything, the central bank may have been too loose in recent years, in part because of a misguided attempt to offset the anti-growth impact of the record 1993 tax increase. The Fed appears to have abandoned that counter-productive effort and hopefully has returned to the policy that should be their sole responsibility -- protecting the value of the currency.

What should be done?

The economy's performance has been sluggish in part because the burden of government is too high. The obvious solution is to reduce taxes, spending, and regulation. While there are numerous policy options that move in this desirable direction, let me close by noting that the single reform that would probably have the most pronounced positive impact on long-term growth is adoption of a flat tax and I commend the Chairman of this committee and others in Congress for taking a long-overdue look at this plan to create a simple, fair, pro growth tax system.

Thank you very much, and I would be happy to answer any questions.

Anemic Job Creation During Current Expansion



Prepared Statement of David Wyss

The U.S. economy is slowing down. This should be no surprise. The Federal Reserve has been trying to slow the economy since last February, and the data indicate they are succeeding. Two consecutive declines in employment, three in leading indicators, and sharp drops in housing, autos, and orders certainly show weakening.

The question is whether the Fed has gone too far, and pushed the economy into recession. The odds of a recession are certainly rising. The May employment data are scary. But one scary month does not make a recession. The second quarter of 1995 could well show a decline in real GDP, but the year is still likely to look more like a growth recession than a recession, with end-of-year to end-of-year growth in the 1.5 to 2% range.

DRI has been the pessimist in our forecast of the economy. In last January's Wall Street Journal survey of 59 forecasters, only one participant had a lower forecast than us. We were probably too optimistic.

Even if the slowdown turn into a recession, we do not believe it should effect Congressional action on the deficit. First, such action is likely to come too late to help the recession. Second, taking even the right action for the wrong reason could lose Congress the confidence of the financial markets. Third, Congress should not be rushed into making the wrong long-term policy choice to solve a short-run problem.

Fiscal Policy Will Not Avoid the Recession

If 1995 goes down as a recession year, the peak is likely to be dated in March. In other words, we may already be in a recession. Even if there is no veto, fiscal policy would have little effect until fall. Most spending changes would not take effect until then, and the tax changes would not be absorbed into withholding until September at the earliest.

Recessions last about ten months, with very little variation around that number. By the first quarter the economy will be climbing out of the recession in any event. The tax changes might accelerate that recovery, but we are not convinced acceleration is needed.

The growth or actual recession is primarily an inventory phenomenon. Inventory accumulation over the last year has been nearly $60 billion, about three times the sustainable rate. An inventory correction will come; the best course is to try to smooth the adjustment, not to prevent it or to try to offset it with an artificial surge in demand.

The Federal Reserve caused this slowdown; the Federal Reserve should cure it. It is time for the Fed to begin loosening, reversing the tightening of last year. I expect the Fed to begin at its July meeting. Given the lags in monetary policy, this may not prevent a recession. But given the lags in legislative processes, neither will fiscal policy.

In our forecast is correct, the Fed will accomplish exactly what it said it would. Interest rates will drop and allow the economy to reaccelerate in 1996. The bond market is already working to accomplish that. The 1.5 percentage point plunge in bond yields since November will by itself help pull us out of recession materializes, bond yields will drop further.

Confidence and Fiscal Policy

The risk that the financial markets will interpret a quick tax cut as "politics as usual" should also be considered. I had the fortune (good or bad) to be working at the Council of Economic Advisers in the early days of the Carter Administration. At the time, the Administration proposed a $50 tax rebate to everyone in the country as a way to spur the economy out of the recession that was feared.

In fact, the economy was already recovering from the 1974-75 recession. The tax rebate might have accelerated the recovery, but the Administration should have been worrying about the next recession in 1980, not the last one in 1975.

A look at past cycles suggests that fiscal policy, beyond the "automatic stabilizers," has never succeeded in pulling the economy out of recession. In most cases, it appears to have been counterproductive, raising growth during the boom and helping to create the next recession. There are natural speed limits on the economy. Too often, fiscal actions are an attempt to evade those limits.

The bond market could well treat quick passage as a sign of panic about the economy, and abandonment of the principal of reaching budget balance by 2002. This perception could send bond yields up rather than down, especially once growth resumes early next year. Markets will always be skeptical about promises of future virtue from politicians -- they have heard too many in the past.

A quick tax cut looks like more old-fashioned Keynesianism. I'm probably the closest to a closet Keynesian on this panel, and even I think this is a bad idea. The demand side boost could help add speed to the recovery, but I am not sure we need more speed.

The Long Term Verses the Short

For too long we have been afraid to take needed long-term actions because of their short-tern consequences. Every time Congress has talked about cutting spending for the last fifteen years, progress has stalled because of fears of recession. If we pass a tax cut to fight recession, can we credibly promise that the neat time the economy slows, the deficit fight will not be abandoned.

Giving a tax cut now and promising to cut expenditures in the future has been tried before. The results have been disastrous for fiscal policy. Having raised two children, it works much better to give the medicine first and the candy as a reward than to give the candy first if the child promises to take the medicine later.

Fiscal policy is out of balance. Until it is back in balance, the best we can do is leave the Fed to the task of smoothing growth. So far, they are doing a good job. An activist fiscal policy is likely to make their job more, not less difficult.

Supply-Side Effects

The only way in which a tax cut could be sold as fighting inflation is if it improves the potential supply of the goods in the economy. The current House tax proposal, however, has little such impact. A child tax credit has no impact on the incentive to supply anything except children.

The only supply-side measure that is in the bill is the capital gains exclusion. We have favored this change as a way of encouraging capital formation. Its impact is long-term, however, not immediate. Investment is unlikely to respond to a capital gains cut in an atmosphere of falling orders. New capacity is not needed in a recession, and investment is a lagging, not leading sector in a recovery. Moreover, the leading supply-side problem is the lack of domestic savings in the United States. Unless the availability of capital is increased, all policy can do is shift investment among sectors. If the "quick fix" of a tax cut is taken, the deficit will widen, reducing the supply of capital for private enterprise.

Summary

Congress should concentrate on the long-run problem of controlling the deficit. Short-term management of the business cycle should be left to the Federal Reserve. This division of responsibilities is much safer than constant changes in fiscal policy. It is much sounder than ignoring long-term problems in a quest for short-term patches.

PREPARED STATEMENT AND CHART OF ROBERT R. DAVIS

Chairman Mack, it is a pleasure to return to the Joint Economic Committee and appear before you and the other distinguished members of this committee. I had the privilege of serving the committee during the early 1980s, and am happy to see that you have restored the Committee as the active forum for ideas that it was at that time.

I am here today to address the prospects for the economy in 1995 and beyond. Paradoxically, I am optimistic about the future, but fearful that we will not seize the opportunities before us necessary to make that future bright. As we focus each year on the inevitable ups and downs of the business cycle, and I expect the business cycle to be down in 1995 and 1996, we have tended to miss the fundamental truth. The long-term economic climate has gradually become much less favorable as the size of government has grown.

The burden of taxation and government spending is rising, increasing the burden of government on the private sector. The burden of government regulation further impedes incentives and economic growth. The growth of government spending must be restrained, and regulatory burdens reduced. For my industry, that means important initiatives such as the Shelby-Mack regulatory burden relief bill, and the bill introduced yesterday by Rep. McCollum to reform the structure of federal deposit insurance.

The effective level of taxation, best approximated by the level of government expenditures as a proportion of GDP, is rising. In the past, this measure of taxation has moved inversely with long-term trends in economic growth. As the trend toward government intervention has grown over the last 30 years, long-term economic growth has declined from 3 percent, to 2.5 percent, to a level that I believe is now little better than 2 percent. Unless current initiatives in Congress succeed, the expansion of federal spending that started in 1989 will be extended, and an improvement in the underlying economic growth trend is unlikely. Regardless of any temporary cyclical rebound that may be achieved beyond 1995, the economy will soon fall back to its dismal steady-state growth track.

Perhaps most importantly, I am hear today to say that the economic slowdown occurring in 1995 is no excuse for timorous actions on proposals to control the growth of government. In the longer-run perspective, the slowdown we face today is a temporal and ephemeral phenomenon that, with minor help from the Federal Reserve, will be self-correcting. The cyclical part of the observed weakness is not a result of

current fiscal initiatives. Rather, these fiscal initiatives are the antidote for the economy's continuing slide into malaise.

The Long-Term Growth Trend

A variety of factors contribute to long-term economic growth, including technological innovation, changes in labor quality, growth of the work force, and the environment for private enterprise. One proxy for quality of the business environment, the ratio of Federal expenditures to Gross Domestic Product (GDP), has been clearly and inversely related with the long-term growth trend of real GDP for over 30 years.

The relationship between expenditures as a percentage of GDP and economic growth in part reflects the fact that periods of weak economic growth increase demand for government services. More fundamentally, however, the ratio of expenditures to GDP represents the broadest measure of tax drag on the economy. Every dollar spent by government represents a dollar extracted from the private sector, creating an economic disincentive and diminishing economic growth potential. This is true regardless of whether government expenditures are financed through direct taxation, borrowing (collecting the net present value of future taxes), or inflating the money supply.

The accompanying chart illustrates the relationship between Federal expenditures and economic growth over the past 30 years (GDP growth rates are averaged for 5 year periods to emphasize longer-term trends and reduce the influence of cyclical swings). Two factors are evident. First, the gradual growth of government as a percentage of GDP is related to a sustained decline in average economic growth rates. Although the economy has grown by 3 percent annually since 1963, that trend growth rate has become less likely to be attained. Currently, the long run growth trend appears to be only 2 percent. Second, during each of the relevant sub-periods indicated, rising expenditure levels as a percentage of GDP have been associated with pronounced declines in the economic growth trend.

In the most recent sub-period since 1988, Federal expenditures as a percentage of GDP have reached peak levels last realized in the early 1980s. Once again, this increasing burden has been associated with declining growth potential. Looking forward, the trend toward growth of government cannot be broken, and the potential for economic growth cannot be realized, without bold and concerted actions now.

The economy is likely at the beginning stages of a downturn not expected by most observers, and it likely will be more serious and longer than anticipated as well. The biggest danger the country faces, however, is not the cyclical downturn. Rather, the danger is that fear of the

weakening economy delays or prevents actions to control growth of government, the only formula to restore economic growth over the longer run. Fiscal policy mistakes have slowed the long-run economy to a snails pace, and made it more susceptible to the dangers of cyclical events. Let's not now mistake the cure, spending and tax reform, as the cause of our mounting cyclical woes.

Cyclical Swings

The Federal Reserve has done a credible job over the last few years. The only thing the Fed can deliver in the long run is price stability, and inflation is better behaved than has been the case for many years. However, the Fed also attempts to manage nearer term events, partly as a result of an unfortunately broad statutory mandate. Inevitably, some mistakes are made, frequently because the policy tools are imprecise. As a result, the Fed sometimes contributes to, or is the cause of, a monetary business cycle.

Let's look at the past few years. We had a recession in 1990, and an unusually slow recovery of only about 1.5 percent during the four quarters starting IIQ/91, the slowest first year recovery ever recorded. Most of us didn't even think it was a recovery. Why did this happen? The Fed provided only about 1 percent growth of bank reserves in 1988-1990, and the money supply only grew about 2.5 percent. This raised interest rates or kept them higher than the market wanted. Money was scarce and credit was expensive, and the economy languished.

The Fed's policy stance began to change in 1991, but because changes in Fed policy usually do not effect the economy for about a year, 1991 remained weak. However, bank reserve growth was pushed to double digit levels between 1991 and 1993, with the most rapid reserve growth in the latter part of that period. The growth of reserves allowed money supply to accelerate as well. Not surprisingly, economic growth rebounded in 1992, 1993, and 1994.

Unfortunately, we said goodbye to 1994. It's history, even though it was the best year for the economy in about a decade. In 1994 the economy showed over 4 percent growth, inflation remained below 3 percent and unemployment fell below 6 percent and approached the 5 percent level.

For fixed-income investors, 1994 was one of the worst years. Bond holders watched the market values of their securities decline 10 to 20 percent, depending how far out the yield curve they were. Depository institutions are coming off two of their best years ever, but are faced with higher funds cost and investments that are only recently recovering value lost last year.

The 1995 Forecast

Just as the Fed set the stage in 1991-93 for above average economic growth in 1994, the Fed has been setting the economy up for a slowdown since the beginning of last year. Reserve growth has fallen from double digit growth for two to three years prior to 1994, to a 3 percent decline over the last year. Money supply growth has slowed in the same pattern, and short-term interest rates are still up 300 basis points. I have been predicting that the economy will turn down during the first half of 1995 for almost a year. The only questions now are by how much, and for how long.

The downturn was inevitable and will persist, a fact that is becoming more obvious to everyone. The mixed signals now being received indicate that we are well into a transition to slower growth. Housing starts and sales were strong enough through 1994, partly fueled by adjustable rate mortgage products that allowed the consumer at least temporarily to buy insulation from the bite of higher interest rates. Employment has continued to rise, and industrial production hit its highest level since 1979. But, housing starts have fallen in 1995, both existing and new homes sales are down, retail sales are falling off, inventories of unsold goods are increasing to troubling levels, employment growth has slowed, and industrial production is now down for three months in a row. To make matters worse, the Fed continues to starve the banking system of reserves and keep short-term interest rates higher than the market wants them

The lags between Fed actions and economic response have run out. In fact, the mid-point of the Fed's interest rate increases was in August 1994. We are really at the point where the Fed's past actions really begin to take hold. This is already locked into the "cards" we have been dealt, and a bond market rally generated by a weakening economic is not going to have much of an impact this year to reverse the slide.

The following scenario should play out in 1995.

- The Fed's interest rate increases are over, especially in the light of the growing signs of weakness and the apparent end of the dollar "crisis." However, every day that the Fed holds short rates at these levels, the weaker the economy will be ahead, and the longer a rebound will be delayed. The Fed likely will hold pat until Labor Day, then cut short-term interest rates.
- The yield curve will become even more inverted across some maturities. The bond market is forecasting a slowdown in the economy and a weakening credit demand. Long-term interest

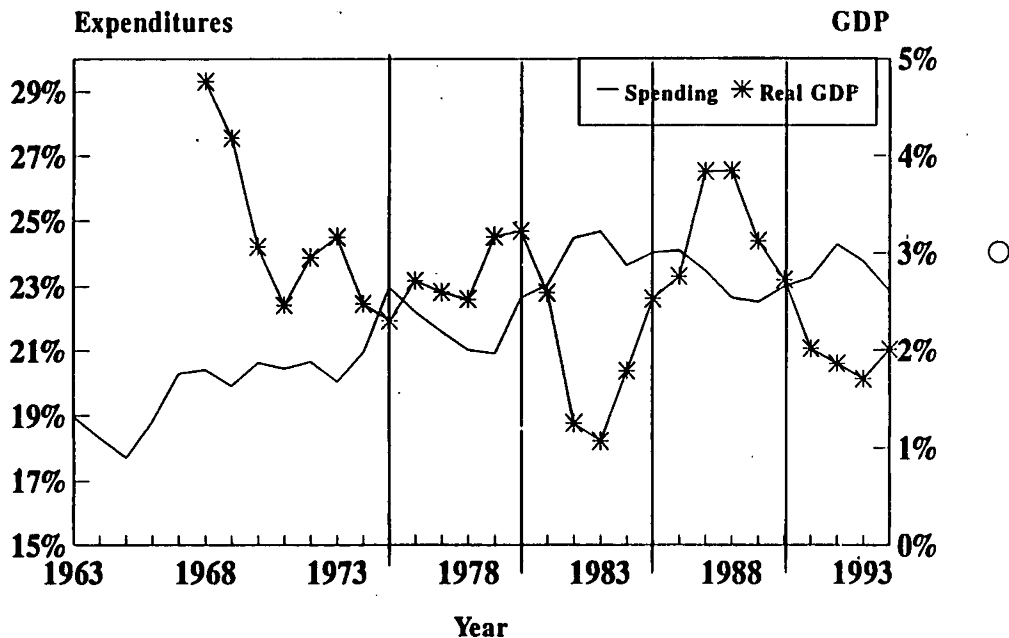
rates have obviously seen the highs of this cycle, and may decline further in 1995's second half, especially after a short-rate cut.

- The economy will continue to slow. Now is likely the time of most pronounced economic slowdown, even though long-term interest rates have fallen. Quarterly GDP growth should be less than 2 percent in the 2nd, 3rd or 4th quarters of 1995, and some quarters may be less than 1 percent.
- Existing home sales will decline about 10 to 15 percent to an annual rate under 3.5 million units. Housing starts will decline by 15 to 20 percent to an annual rate of 1.25 million units.

The most critical question in 1995 is how will the Fed react to events in determining the course of its policy actions. The Fed is likely to stand pat for most of 1995, until it sees or anticipates further weakening in the economy. If the economy slows as much as I anticipate, the Fed should begin cutting rates as soon as Labor Day.

The bond market currently appears to be forecasting slower growth ahead, as the continuing rally in long-term bonds this year shows. The 30 year bond yield has declined from a high of about 8.2 to about 6.5 percent. By the end of 1995, the yield curve should have a more normal shape, depending on the Fed's willingness to reverse field and lower short-term rates. I see two 50 basis point rate cuts, one in the fall, with a second at year-end or early in 1996.

Federal Expenditures
as a Percentage of Current GDP
and 5-Year Average GDP Growth



Source: Dept. of Commerce

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