MONETARY POLICY AND THE STATE OF THE ECONOMY, PART II

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BEFORE THE

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MONETARY POLICY AND THE STATE OF THE ECONOMY, PART II

Wednesday, July 18, 2007

U.S. HOUSE OF REPRESENTATIVES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The committee met, pursuant to notice, at 10 a.m., in room 2128, Rayburn House Office Building, Hon. Barney Frank [chairman of the committee] presiding.

Present: Representatives Frank, Kanjorski, Maloney, Gutierrez, Watt, Meeks, Moore of Kansas, Hinojosa, Clay, Baca, Lynch, Miller of North Carolina, Green, Sires, Hodes, Ellison, Klein, Wilson, Perlmutter, Murphy; Bachus, Baker, Pryce, Castle, Royce, Paul, Gillmor, Manzullo, Shays, Capito, Garrett, Pearce, Price, Davis of Kentucky, McHenry, Campbell, Putnam, Bachmann, and Roskam.

The CHAIRMAN. This is the semiannual Humphrey-Hawkins hearing. I do want to mention before the time starts, let me tell the timekeeper, there is one sort of general thing I want to take note of. This is, as people know, the Humphrey-Hawkins bill named for its authors, Senators Hubert Humphrey and Gus Hawkins. A month from today will be Gus Hawkins' 100th birthday. He couldn't be with us today, but we know he is aware of the hearing. His successor in Congress will be with us, the gentlewoman from California, Ms. Waters. But we did want to take note of this very significant accomplishment and wish Gus a very happy birthday as we his observe his birthday one month in advance with this very important part of his legacy.

Now, beginning my statement, I want to express my appreciation for the part of the statement that deals with consumer problems. This a very important step forward. And I want to say that I think there have been some partially inaccurate stories in the press. It appears to me there is some unhappiness with the Chairman over consumer inactivity. In fact, I have historically been concerned about the Fed's failure to do that, and particularly their failure to use the authority they have had under the Federal Trade Act to spell out unfair deceptive practices. But this is something that well pre-dated the Chairman and that he is, in fact, addressing.

And so I do not think it is appropriate for people to impute this unhappiness to him. As I read the report, and sort of the last 3 or 4 pages of the report were about this consumer issue, it became very clear to me that this is not "Uncle Alan's semiannual report." We think that we are moving forward on this. I do, however, want to, in my statement, address the economic issue, the macroeconomic issue. Obviously the subprime and some issues are economic. I appreciate the Chairman's reemphasis in his opening remarks of the Fed's commitment to the dual mandate to dealing both with inflation and the need to restrain inflation and to maximize employment. But Mr. Chairman, we have an honest intellectual difference here. I must say I think this is an instance of cultural lag. That is, I believe that the single most pressing economic issue facing the country today is the excessive and growing inequality.

And I want to read from a report issued under the auspices of Don Evans, President Bush's first Secretary of Commerce and a close friend of the President, the head of the Financial Services Forum, a 3-member panel that he commissioned, including Grant Aldonas, who was a high ranking Commerce Department official with trade responsibilities under President Bush, and Matthew Slaughter, immediate past member of the Council of Economic Advisors. And here on page 7, we have copies of this report available, and I think this is essential, this is a report put out by Secretary of Commerce Evans: Two of the three authors were high ranking economic officials of the Bush Administration, this Bush Administration.

"From the mid-to-late 1970's to the mid-to-late 1990's, the real and relevant earnings of less skilled Americans was poor relative to both economy-wide average productivity gains and also the earnings of their more-skilled counterparts. And since around 2000 the large majority of American workers has seen poor income growth. Only a small share of workers at the very high end has enjoyed strong growth in incomes. The strong U.S. productivity growth of the past several years has not been reflected in broad growth in wage and salary earnings." That is a fact that we need to accept. It is reinforced. Some statistics can be used in other ways, and people sometimes do averages, but I would call people's attention to the footnote on page 6 of the Monetary Policy Report that Chairman Bernanke has submitted.

Let me read the footnote: "According to the published data, real disposable personal income rose at an annual rate of 4¾ percent in the first quarter of this year. However, a substantial part of the increase occurred because the Bureau of Economic Analysis added $50 billion at an annual rate to its estimate of first quarter wages and salaries in response to information that bonus payments and stock option exercises around the turn of the year were unusually large. Because the BEA did not assume that these payments carried forward into April real disposable personal income fell sharply in that month." By the way, the figure that is given by that largely Republican panel on economic growth, which I talked about, is that about 3.8 percent of the population has seen real growth in income in these past 6 years and the rest have not, and some have seen a real erosion. That includes, by the way, people's college education.

Education does not appear to be the talisman that dissolves this. Here is our problem: The resentment that is generated by that is a significant problem in America today. A couple of weeks ago, the immigration bill blew up noisily. Trade promotion authority expired very unnoisily, not only not with a bang, not even with a whimper; it just went away. In neither case, in my view, were the defeat of those two measures, whether people liked them or not, due to problems and issues intrinsic to those measures. The key factor was the anger on the part of that large percentage of Americans who were not seeing any of the increase in wealth being distributed to them who say, “No, we are not going forward.”

I think, in some cases, the anger was displaced at the wrong enemy, but the anger is there. My problem, Mr. Chairman, is that the report and the proposal, in some ways, will make this worse. Here’s where we are. The report and your statements say that you expect us to grow slightly below trend for the rest of this year and next year, the trend being 3 percent of growth, and we are in the 2-plus percent. I do want to say semantically that when we are projected to be somewhat below growth, the answer is near trend. When we are above it, it says above. While mere trend means below trend. At the same time, you predict an increase in unemployment. Not a huge one, but up into the 4¾ range. You know, that softness in the labor market is one of the things that will erode real wages. The only time we got real increases in real wages for the large number of people in the population was in the late 1990’s when unemployment went to 3.9 percent. We hit a very tight labor market, because we have had an erosion of institutions that help labor in this country, as Peter Temin and Frank Levy pointed out in their MIT paper, which we have available. So we are really dependent on a high level of overall growth.

You also predict, so you say, growth below trend—a slight increase in unemployment and you expect inflation to moderate. But in fact, in an odd phrase, you say the real danger is that inflation will fail to moderate as you expect it to. So your lack of confidence in your expectation says that the likeliest thing you ought to do is to raise interest rates and slow things down. That is you see the major danger is inflation.

If you see the major danger is inflation at a time when inflation appears to be stable, and inflation expectations and the concept important to you appear to be fairly well-anchored for the long term, and we appear to be growing at somewhat below trend, not a huge amount, but below trend, and unemployment is going to go up, at best, we are going to continue this problem. You do note, and I appreciate this, that historically profits greatly increase, greatly exceed wages. Let me read the exact, and I give myself an extra minute to read this. I will make up for it in my questioning. But there is a specific reference to the fact that given historic trends, there is room for wages to go up and profits still would be in very good shape without it having an inflationary impact.

And so with that, with wages having lagged significantly for years, with a very small percentage of the population having gotten any real increase in the last 5 years, with inflation predicted to be stable, with growth predicted to be below trend by a little bit, unemployment predicted to rise, even as the labor force drops, which means slower job growth, you say the main concern is inflation. I think that is cultural lag. I would have understood that better some time ago. But given the social—and, by the way, I would throw in here the savings rate. People omit the absence of a savings rate.

When only 3.8 percent of the population has gotten any real increase in their wages, in their take-home pay in the last 5 years, what is it that people expect them to save, cancelled stamps? People can't save money if at the end of the month they don't have any, if their wages have not come up. So with all that, the conclusion that the main danger facing us now, or the more important one, is inflation, troubles me, because I think, at best, this current situation of increasing inequality, with all of its negative social, economic, and political consequences, stays as is and could get worse. I now recognize the gentleman from Alabama.

Mr. BACHUS. I thank the chairman, and Chairman Bernanke, thank you for your support and continued strong and wise stewardship of our Nation's monetary policy. As I said when you appeared before this committee in February, there is a difference of opinion on the strength of the economy. I would like to review some of the facts, which I think are hard to argue with. First of all, economic growth is robust, as illustrated by 132,000 new jobs created in June alone, and as you say in your testimony, 850,000 since the start of the year—over 8 million new jobs created since August of 2003. Unemployment remains low. Despite higher oil prices, and really it is something I am going to mention later in my remarks, oil has gone from $50 to $75 a barrel just from the middle of January.

And despite the rise in energy cost, inflation is under control following the 2.4 percent in February 2, 2007, and 1.9 percent in May. While it has slowed recently, productivity has averaged 2.8 percent growth since 2001, well above the average productivity growth experienced in the 1970's, 1980's, or 1990's. Real wages have shown a healthy increase over the past year. And are supporting concerned strong consumer spending, even in the face of declines in real estate values in many areas of the country. The stock market continues to deliver superior returns to investors. This economic success story is a result of sound economic policies pursued, I believe, by this Republican Administration, by our Treasury Department, and by the Federal Reserve.

They are also a testament to the hard work and innovation of American businesses and workers who comprise the American economy. Chairman Bernanke, I believe you deserve a great deal of credit for the performance of the economy as well. Instead of micromanaging monetary policy, you have held an absolutely steady hand for a year now balancing the tension between modest upside inflation risk and modestly slower growth.

No one has summarized your tenure at the Fed better than The New York Times. In a June 25th story, less than a month ago, they said this, "Could an ivy league academic like this ever have street credibility?" The answer is clear: yes, yes, and yes again. The same article also observed that the economy today is pretty much exactly where Mr. Bernanke hoped it would be one year ago. Economic growth has slowed slightly, gradually reducing inflationary pressures. And while job creation has slowed, unemployment remains low at 4.5 percent. That is The New York Times.

Before I conclude my remarks, Mr. Chairman, I would like to bring your attention to two topics of particular interest to members of this committee. First, as you know, Chairman Frank and I are both concerned over the recent turmoil in the subprime lending market. Just last week, Representatives Gillmor, Pryce, Miller, LaTourette, Capito, and I introduced legislation on this subject. Developing a consensus solution to this problem, while determining the Fed's proper role in regulating the mortgage industry, are priorities for Members on both sides of the aisle.

The committee would benefit from your thoughts on the current state of the subprime mortgage market and its potential impact in the larger economy. And second, Mr. Chairman, the Fed, it has often been said, has a dual mandate, and that is price stability and full employment. While that mandate has certain factors that are more subject to management and control than others, there is one wild card, possibly two, when you talk about core inflation and then backing out energy and food. The wild card to me, and the disturbing factor in our economy, is energy cost over which the Federal Reserve has very little short term or long term influence. As I said earlier, the price of oil, if you go back to July of last year, $75, where it is today, but we have gone down to $50 a barrel and back up to $75. Some people say we will get relief because there may be an economic slowdown in China or India or Europe and that may bring us relief, but that would not be good for the economy. So we get in a situation where China is growing at 11 percent. Their energy demands are growing. And U.S. manufacturing, in fact, the largest contributor to job loss in this country over the last 10 years is the high cost of energy. And yet this Congress, for 10 years—for a year or two we have talked about the subprime situation.

I would tell colleagues on both sides of the aisle, for 10 years, we have been talking about our dependency on foreign oil, we have been talking about the high cost of energy, we have talked about its devastating impact on employment and on manufacturing, but yet we have done nothing. China is building a new nuclear power plant every week. With every plant they bring online, they reduce the cost of energy and increase their competitiveness over us. Mr. Chairman, I believe that Congress' failure over many years to address this energy cost has created and will continue to create real problems for the Federal Reserve as you try to cope with both price stability and full employment, because I think the high cost of energy is a wild card over which you have no control. And it is my greatest concern, and I am sure it is a great concern to you moving forward.

Let me conclude by saying that members—both Republican and Democrat—on this committee respect your experience, your judgment, and your obvious commitment to keeping America's economy strong and competitive. We appreciate you being here and look forward to your comments.

The CHAIRMAN. The gentleman from Illinois, the chairman of the Domestic and International Monetary Policy Subcommittee, is recognized for 3 minutes.

Mr. GUTIERREZ. Thank you, Chairman Frank, and good morning, Chairman Bernanke, and welcome back. I think you will hear some of the same major themes from this side of the aisle that you heard in February. There is good reason for this, I believe. I can tell you that when I go back to my district and meet with middle class and lower middle class working Americans, they just aren't feeling the benefits of a growing economy. Jobs can be found, but they aren't necessarily steady, well-paying jobs. And those who have steady work are facing stagnant wages. So much of the discussion I am hearing from economists about inflationary concerns caused by rising labor costs just don't ring true with many workers, at least not in my district. More than tangible concerns, many of my constituents just feel uneasy about their economic security. Of course, these are the same families who are feeling the crunch of rising health care costs and increasing costs of education, all the while trying to save for retirement. It is not just that these families are living paycheck-to-paycheck; it is that they have little or no savings, and in some cases, no bank accounts at all, so they pay higher interest rates and more fees for basic financial services than they should. I raise the issue of inequality, Chairman Bernanke, because I believe economic inequality is a product of monetary policy choices. And I believe that inequality is inside the scope of the Federal Reserve's "dual mandate." Yesterday, Chairman Frank assembled an excellent panel of economists that he referred to earlier in a hearing held before the committee on the dual mandate. One of the economists who testified, James Galbraith, recently completed a study on whether the Federal Reserve has observed the dual mandate. One of the findings of the study is that inequality in pay or earnings, especially in the manufacturing sector, does react to rate setting decisions of the Federal Reserve, and that in the statistical sense monetary policy causes inequality.

I would like you to respond to Mr. Galbraith's assertions and discuss whether or not the Federal Open Market Committee considers economic inequality issues as a factor in setting our monetary policy. I thank you and I yield back the balance of my time.

The CHAIRMAN. The gentleman from Texas, Mr. Paul, the ranking member of the subcommittee.

Dr. PAUL. Thank you, Mr. Chairman, and welcome Chairman Bernanke. I share your concern for the inequality that has developed in our country. I think it is very real, I think it is a source of great resentment, and unfortunately, I think it is one of those things that puts a lot of pressure on Congress to increase the amount of government programs and government spending, which I do not think is the answer. I believe the inequality comes specifically from the type of currency we have. When there is a deliberate debasement of a currency, it is predictable that the middle class is injured, the poor are hurt, and there is a transfer of wealth to the wealthy, and until we understand that, I do not believe we can solve this problem.

And if we resort to continued monetary inflation and more government programs, we will only make this inequality worse. This is exactly the opposite of what happens when you have a sound currency and free markets, because it is the sound currency and free markets which creates the middle class and creates prosperity and allows the best distribution of this wealth. Inflation is a monetary phenomenon. It comes from the Federal Reserve system. The Federal Reserve has tremendous pressure put on them, because almost everybody wants low interest rates, except if you happen to be a saver, then you might not like artificially low interest rates.

But, of course, that contributes to the lack of savings, which is another problem that we have in this country. We concentrate on inflation by implying, and everybody casually accepts that inflation is a price problem. But the prices that go up are one of the consequences of inflation. Inflation causes malinvestment, it causes excessive debt, and it causes financial bubbles that we have to deal with. But we have a lot of information today available to us to show that there is a lot of monetary inflation going on.

For instance if you look at MZM, it is growing at almost a 9 percent rate. M3 is no longer available to us from official sources, but private sources tell us it is growing at a 13 percent rate. Of course, we can reassure ourselves and say that the CPI is growing at a 2.6 percent rate. But if you go back to the old method of calculating the CPI, closer to what the average person is suffering, and one of the reasons why there is inequality going on, is it is growing at over a 10 percent rate.

The fact that the dollar is weak on the international exchange markets cannot be ignored. For instance, in just 6 months, the Canadian dollar increased 11 percent against our dollar. This should stir up some concerns. But one concern that I have, that I think is causing more problems and keeps us from coming to a solution, is the divorce between the exchange value of a dollar on the international exchange markets and the effort to lower the value of a dollar in order to increase exports, which can only be done through inflation, at the same time, believing that we can have stability in prices at home, because that is a disconnect that is not possible. If we strive for a lower dollar in exchange markets, we will have price increases here at home and we have to deal with it. I yield back.

The CHAIRMAN. Thank you. Mr. Chairman, I appreciate, as I said, the comments and the efforts you are now undertaking regarding subprime, and we will work more with those. I will be talking not much about those this morning, but I do want to acknowledge that is a significant advance, and we look forward to working together. I also want to comment, I was just reading my clips as they come in, and I had one commentary saying that the difference between us was that I continued to believe in the Phillips Curve, and you do not. And I don't. In fact, one of the things that I have credited Chairman Greenspan for was in the 1990's ignoring those who told him that if unemployment dropped below first 6 percent, then 5½ percent, then 5 percent, and then 4½ percent, it would be inevitably inflationary. It seems to me that this whole notion of a nonaccelerating inflation rate of unemployment turned out only to be a lagging indicator of unemployment.

As unemployment dropped, people dropped that rate, but it never had that prediction. I think we were dealing with the real economy, and here are the issues, but here is my concern: It is on the inequality issue, which I think has become a significant political problem, and I assume you were not happy to see trade promotion authority die. My guess is that you thought we should have some form of an immigration bill. And again, I would stress, I don't think that the solution to either of those problems is intrinsic to those problems. It is the sea in which they have to survive that has turned against them. We know what the numbers are in inequality.

What troubles me a little bit is that in the report, and I do remember in previous reports references to wages, there are no wage indexes in here. There are compensation indexes, which as you acknowledge, and we know, include pensions and include healthcare. But given what you expect to go forward, let me ask you, for I think it is one of the most important predictions, going forward do you see any abbreviation of this trend of the distribution of wealth being as concentrated as it now is. It is documented in the report that I assume you are familiar with that Don Evans put forward, where 3.8 percent of the population has gotten real wage increases in the last 5 years. Do you see any abbreviation of that trend going forward?

Mr. BERNANKE. Well, I have discussed this issue in a number of contexts. I think that in order to alleviate—

The CHAIRMAN. I apologize. You haven't given your opening statement yet. And you can comment now if you want to. I was wondering why the time hadn't started yet. If this had been my first hearing, I could explain that mistake a little bit easier. No good explanation comes to mind. You can comment now or just do your opening statement and come back to it.

STATEMENT OF THE HONORABLE BEN S. BERNANKE, CHAIRMAN, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

Mr. BERNANKE. I will do my opening statement. Thank you.

Chairman Frank, Ranking Member Bachus, and members of the committee, I am pleased to present the Federal Reserve's Monetary Policy Report to the Congress. As you know, this occasion marks the 30th year of semiannual testimony on the economy and monetary policy for the Federal Reserve. In establishing these hearings—Mr. Hawkins and Mr. Humphrey were mentioned—the Congress proved prescient in anticipating the worldwide trend toward greater transparency and accountability of central banks in making monetary policy. Over the years, these testimonies and the associated reports have proved an invaluable vehicle for the Federal Reserve's communication with the public about monetary policy, even as they have served to enhance the Federal Reserve's accountability for achieving the dual objectives of maximum employment and price stability set forth by the Congress.

I take this opportunity to reiterate the Federal Reserve's strong support of the dual mandate. In pursuing maximum employment and price stability, monetary policy makes its greatest possible contribution to the general economic welfare.

Let me now review the current economic situation and the outlook beginning with developments in the real economy and the situation regarding inflation before turning to monetary policy. I will conclude with comments on issues related to lending to households and consumer protection, topics not normally addressed in monetary policy testimony, but in light of recent developments deserving of our attention today.

After having run at an above-trend rate earlier in the current economic recovery, U.S. economic growth has proceeded during the past year at a pace more consistent with sustainable expansion. Despite the downshift in growth, the demand for labor has remained solid with more than 850,000 jobs being added to payrolls thus far in 2007 and the unemployment rate having remained at 4½ percent. The combination of moderate gains in output and solid advances in employment implies that recent increases in labor productivity have been modest by the standards of the last decade.

The cooling of productivity growth in recent quarters is likely the result of cyclical or other temporary factors, but the underlying pace of productivity gains may also have slowed somewhat. To a considerable degree, the slower pace of economic growth in recent quarters reflects the ongoing adjustment in the housing sector.

Over the past year, home sales in construction have slowed substantially and house prices have decelerated. Although a leveling off of home sales in the second half of 2006 suggested some tentative stabilization of housing demand, sales have softened further this year, leading the number of unsold new homes in builders' inventories to rise further relative to the pace of new home sales. Accordingly, construction of new homes has sunk further, with starts of new single family houses thus far this year running 10 percent below the pace in the second half of last year.

The pace of home sales seems likely to remain sluggish for a time, partly as a result of some tightening and lending standards and the recent increase in mortgage interest rates. Sales should ultimately be supported by growth in income and employment, as well as by mortgage rates that—despite the recent increase—remain fairly low relative to historical norms. However, even if demand stabilizes as we expect, the pace of construction will probably fall somewhat further as builders work down the stocks of unsold new homes. Thus, declines in residential construction will likely continue to weigh on economic growth over coming quarters, although the magnitude of the drag on growth should diminish over time.

Real consumption expenditures appear to have slowed last quarter following two quarters of rapid expansion. Consumption outlays are likely to continue growing at a moderate pace, aided by a strong labor market. Employment should continue to expand, though possibly at a somewhat slower pace than in recent years as a result of the recent moderation in the growth of output and ongoing demographic shifts that are expected to lead to a gradual decline in labor force participation. Real compensation appears to have risen over the past year, and barring further sharp increases in consumer energy costs, it should rise further as labor demand remains strong and productivity increases.

In the business sector, investment in equipment and software showed a modest gain in the first quarter. A similar outcome is likely for the second quarter, as weakness in the volatile transportation equipment category appears to have been offset by solid gains in other categories. Investment in nonresidential structures, after slowing sharply late last year, seems to have grown fairly vigorously in the first half of 2007. Like consumption spending, business fixed investment overall seems poised to rise at a moderate pace, bolstered by gains in sales and generally favorable financial conditions. Late last year and early this year, motor vehicle manufacturers and firms in several other industries found themselves with elevated inventories, which led them to reduce production to better align inventories with sales. Excess inventories now appear to have been substantially eliminated and should not prove a further restraint on growth.

The global economy continues to be strong. Supported by solid economic growth abroad, U.S. exports should expand further in coming quarters. Nonetheless our trade deficit, which was about 5¼ percent of nominal gross domestic product in the first quarter, is likely to remain high.

For the most part, financial markets have remained supportive of economic growth. However, conditions in the subprime mortgage sector have deteriorated significantly reflecting mounting delinquency rates on adjustment rate loans. In recent weeks, we have also seen increased concerns among investors about credit risk on some other types of financial instruments. Credit spreads on lower quality corporate debt have widened somewhat and terms for some leveraged business loans have tightened. Even after their recent rise, however, credit spreads remain near the low end of their historical ranges and financing activity in the bond and business loan markets has remained fairly brisk.

Overall, the U.S. economy appears likely to expand at a moderate pace over the second half of 2007 with growth then strengthening a bit in 2008 to a rate close to the economy's underlying trend. Such an assessment was made around the time of the June meeting of the Federal Market Committee by the members of the Board of Governors and the presidents of the Reserve Banks, all of whom participate in deliberations on monetary policy. The central tendency of the growth forecast, which are conditioned on the assumption of appropriate monetary policy, is for real GDP to expand roughly 2¼ to 2½ percent this year and 2½ to 2¾ percent in 2008. The forecasted performance for this year is about ¼ percentage point below that projected in February, the difference being largely a result of weaker than expected residential construction activity this year. The unemployment rate is anticipated to edge up between 4½ and 4¾ percent over the balance of this year and about 4¾ percent in 2008, a trajectory about the same as the one expected in February.

I turn now to the inflation situation. Sizable increases in food and energy prices have boosted overall inflation and eroded real incomes in recent months, both unwelcome developments. As measured by changes in the price index for personal consumption expenditures (PCE inflation), inflation ran at an annual rate of 4.4 percent over the first 5 months of this year, a rate that, if maintained, would clearly be inconsistent with the objective of price stability. Because monetary policy works with a lag, however, policymakers must focus on the economic outlook. Food and energy prices tend to be quite volatile, so that, looking forward, core inflation (which excludes food and energy prices) may be a better gauge than overall inflation of underlying inflation trends. Core inflation has moderated slightly over the past few months, with core PCE inflation coming in at an annual rate of about 2 percent so far this year.

Although the most recent readings on core inflation have been favorable, month-to-month movements in inflation are subject to considerable noise, and some of the recent improvement could also be the result of transitory influences. However, with long-term inflation expectations contained, futures prices suggesting that investors expect energy and other commodity prices to flatten out, and pressures in both labor and product markets likely to ease modestly, core inflation should edge a bit lower, on net, over the remainder of this year and next year. The central tendency of FOMC participants' forecast for core PCE inflation—2 to 2¼ percent for 2007 and 1¾ to 2 percent in 2008—is unchanged from February. If energy prices level off as currently anticipated, overall inflation should slow to a pace close to that of core inflation in coming quarters.

At each of its four meetings so far this year, the FOMC has maintained its target for the Federal funds rate at 5¼ percent, judging that the existing stance of policy was likely to be consistent with growth running near trend and inflation staying on a moderating path. As always, in determining the appropriate stance of policy, we will be alert to the possibility that the economy is not evolving in the way we currently judge to be the most likely. One risk to the outlook is that the ongoing housing correction might prove larger than anticipated with possible spillovers onto consumer spending.

Alternatively, consumer spending, which has advanced relatively vigorously, on balance, in recent quarters, might expand more quickly than expected; in that case, economic growth could rebound to a pace above its trend. With the level of resource utilization already elevated, the resulting pressures in labor and product markets could lead to increased inflation over time. Yet another risk is that energy and commodity prices could continue to rise sharply leading to further increases in headline inflation, and if those costs pass through to the prices of nonenergy goods and services, to higher core inflation as well. Moreover, if inflation were to move higher for an extended period and the increase became embedded in longer-term inflation expectations, the reestablishment of price stability would become more difficult and costly to achieve. With the level of resource utilization relatively high and with the sustained moderation in inflation pressures yet to be convincingly demonstrated, the FOMC has consistently stated that upside risks to inflation are its predominant policy concern.

In addition to its dual mandate to promote maximum employment and price stability, the Federal Reserve has an important responsibility to help protect consumers in financial services transactions. For nearly 40 years, the Federal Reserve has been active in implementing, interpreting, and enforcing consumer protection laws. I would like to discuss with you this morning some of our recent initiatives and actions, particularly those related to subprime mortgage lending.

Promoting access to credit and to home ownership are important objectives, and responsible subprime mortgage lending can help to advance both goals. In designing regulations, policymakers should seek to preserve those benefits. That said, the recent rapid expansion of the subprime market was clearly accompanied by deterioration in underwriting standards, and in some cases, by abusive lending practices and outright fraud. In addition, some households took on mortgage obligations they could not meet, perhaps in some cases because they did not fully understand the terms. Financial losses have subsequently induced lenders to tighten their underwriting standards. Nevertheless, rising delinquencies in foreclosures are creating personal, economic, and social distress for many homeowners and communities, problems that likely will get worse before they get better.

The Federal Reserve is responding to these difficulties at both the national and the local levels. In coordination with other Federal supervisory agencies, we are encouraging the financial industry to work with borrowers to arrange prudent loan modifications to avoid unnecessary foreclosures. Federal Reserve banks around the country are cooperating with community and industry groups that work directly with borrowers who are having trouble meeting their mortgage obligations. We continue to work with organizations that provide counseling about mortgage products to current and potential homeowners. We are also meeting with market participants—including lenders, investors, servicers, and community groups—to discuss their concerns and to gain information about market developments.

We are conducting a top-to-bottom review of possible actions we might take to help prevent recurrence of these problems. First, we are committed to providing more effective disclosures to help consumers defend against improper lending. Three years ago, the Board began a comprehensive review of Regulation Z, which implements the Truth in Lending Act (TILA). The initial focus of our review was on disclosures related to credit cards and other revolving credit accounts. After conducting extensive consumer testing, we issued a proposal in May that would require credit card issuers to provide clearer and easier-to-understand disclosures to customers. In particular, the new disclosures would highlight applicable rates and fees, particularly penalties that might be imposed. The proposed rules would also require card issuers to provide 45 days' advance notice of a rate increase or any other change in account terms so that consumers will not be surprised by unexpected charges and will have time to explore alternatives.

We are now engaged in a similar review of the TILA rules for mortgage loans. We began this review last year by holding four public hearings across the country during which we gathered information on the adequacy of disclosures for mortgages, particularly for nontraditional and adjustable rate products. As we did with credit card lending, we will conduct extensive consumer testing of proposed disclosures. Because the process of designing and testing disclosures involves many trial runs, especially given today's diverse and sometimes complex credit products, it may take some time to complete our review and propose new disclosures.

However, some other actions can be implemented more quickly. By the end of this year, we will propose changes to TILA rules to address concerns about mortgage loan advertisements and solicitations that may be incomplete or misleading and to require lenders to provide mortgage disclosures more quickly so that consumers can get the information they need when it is most useful to them. We already have improved a disclosure that creditors must provide to every applicant for an adjustable rate mortgage to explain better the features and risks of these products, such as "payment shock" and rising loan balances.

We are certainly aware, however, that disclosure alone may not be sufficient to protect consumers. Accordingly, we plan to exercise our authority under the Home Ownership and Equity Protection Act (HOEPA) to address specific practices that are unfair or deceptive. We held a public hearing on June 14th to discuss industry practices, including those pertaining to prepayment penalties, the use of escrow accounts for taxes and insurance, stated income and low documentation lending, and the evaluation of a borrower's ability to repay. The discussion and ideas we heard were extremely useful, and we look forward to receiving additional public comments in coming weeks. Based on the information we are gathering, I expect that the Board will propose additional rules under HOEPA later this year.

In coordination with the other Federal supervisory agencies, last year we issued principles-based guidance on nontraditional mortgages, and in June of this year, we issued supervisory guidance on subprime lending. These statements emphasize the fundamental consumer protection principles of sound underwriting and effective disclosures. In addition, we reviewed our policies related to the examination of nonbank subsidiaries of bank and financial holding companies for compliance with consumer protection laws and guidance.

As a result of that review, and following discussions with the Office of Thrift Supervision, the Federal Trade Commission, and State regulators, as represented by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, we are launching a cooperative pilot project aimed at expanding consumer protection compliance reviews at selected nondepository lenders with significant subprime mortgage operation. These reviews will begin in the fourth quarter of this year and will include independent State-licensed mortgage lenders, nondepository mortgage lending subsidiaries of bank and thrift holding companies, and mortgage brokers doing business with or serving as agents of these entities. The agencies will collaborate in determining the lessons learned and in seeking ways to better cooperate in ensuring effective and consistent examinations and improved enforcement for nondepository mortgage lenders. Working together to address jurisdictional issues and to improve information sharing among agencies, we will seek to prevent abusive and fraudulent lending while ensuring that consumers retain access to beneficial credit.

I believe that the actions I have described today will help address the current problems. The Federal Reserve looks forward to working with the Congress on these important issues. Thank you, Mr. Chairman.

[The prepared statement of Chairman Bernanke can be found on page 65 of the appendix.]

The CHAIRMAN. Thank you, Mr. Chairman. And sometimes you do get a second chance not to screw up, which I apparently have, and I can ask my questions at an appropriate time with the parties. Let me just ask two questions. The monetary report on page 2, and although unit labor costs in the nonfarm business sector have been rising, the average market for prices or for unit labor costs is still high by historical standards, an indication that firms can potentially absorb higher costs, at least for a time, through a narrowing of profit margins. That is where wages have gone, to some extent, in higher profit margins.

And then in the Don Evans, Grant Aldonas, Matthew Slaughter, Robert Lawrence report, here is their summary on page 36 in the Financial Services Forum, during this period, 2000 and 2005, an astonishingly small fraction of workers, just 3.4 percent, was an educational group that have enjoyed any increase at all in mean inflation adjusted money earnings. Those with doctorates and JDs, MBAs and MBs, in contrast to earlier decades, even college graduates and those with nonprofessional masters degrees, 29 percent of workers suffered declines in mean real earnings. So the question is, is there anything in sight that would alleviate this situation?

Mr. BERNANKE. First, we have seen some recent increases in real wages over the last year. Average hourly earnings are up more than a percentage point. Secondly, I think that part of what has happened in the last few years has been the effective energy prices which have risen rather rapidly and absorbed a good bit of buying power from consumers. Over the longer period of time, people with greater education—college education and so on—have been seeing real increases in their incomes, and I expect that to continue. But many of the points you raise about inequality I would be happy to address, but I do think that we will see improvement.

The CHAIRMAN. Well, I am troubled by kind of a complacency there, Mr. Chairman. First of all, yes, they went up some in the first quarter and went down in the second quarter according to your report, real wages. Second, you said, well, it is fuel. Well, 3.4 percent of the people, what, are they flying around on broomsticks? I mean, the fact is that it is not everybody. There is a real inequality here. The 29 percent who had college degrees and masters degrees have suffered real declines in the mean there over the last 5 years. I have to say, I know that education is always the answer. I am struck again. This is a report put forward by some very thoughtful Republican members of the Bush Administration in which they essentially say education is greatly exaggerated as a near-term improvement.

And they point out there is a generational issue. But part of the problem with education is that some people were educated 10 and 15 years ago and they were told, well, learn these software skills, learn these other skills, and many of those jobs are now either outsourced directly, or because of the threat of outsourcing, they are subject to competitive pressures that hold it down. And then it does seem to me what you talk about going forward, is inflation a greater danger to you than a continuation of this trend? I predict you are going to see this continued gridlock. Are there no things you think we should be able to do to try and reduce this trend of inequality than just sit and hope?

Mr. BERNANKE. No, Mr. Chairman. I have discussed some of these issues. First, the trend of inequality is not something in the last 5 years. We have seen this for at last 30 years, if not more.

The CHAIRMAN. But it has gotten worse in the last 5 years.

Mr. BERNANKE. Well, again, I think that part of what you are seeing just in the last few years is the disproportionate effects on lower income people.

The CHAIRMAN. No, no, Mr. Bernanke, that simply is not true. We are talking about the 29 percent in the last 5 years, the 29 percent of the population with college graduates and masters. I think there is a cultural lag here. This is Don Evans' report; 29 percent of the population in those groups with college degrees and masters have suffered real declines in the last 5 years. They are not lower income people.

Mr. BERNANKE. I would like to look at those data, but the fact is that over the last few decades, and this is the kind of thing you need to look at over a long period of time, we have seen a substantial spreading apart of incomes, which is key, in part to education, not entirely, but is key, in part to education.

The CHAIRMAN. What do we do about it?

Mr. BERNANKE. There are several things we can do about it. First of all, the Federal Reserve can maintain a strong and stable economy, which we intend to do, and that will be helpful. But more importantly, there are several elements. First, I think the reference to education is a little bit too pessimistic because it refers, I believe, to sort of K–12 type education, which takes a very long time to work.

The CHAIRMAN. No, they are talking about higher education.

Mr. BERNANKE. And higher education. But there are many other forms of skill acquisition. There is short-term job training, there are vocational schools, and so on. We are hearing in the field that finding someone with plumbing skills or welding skills or who can put lines on a telephone pole is very difficult, and they command high wages.

The CHAIRMAN. Well, my time has expired. I just want to say that I would urge people to read this report. And I think, first of all, debunking by Mr. Slaughter who served on the Council of Economic Advisors, I believe under your chairmanship, along with you as a colleague, Grant Aldonas, they say that education is a good thing, but being made to tow too much weight. But here is the problem, even with education. Getting people that education requires, to a great extent, some public participation. We can't expect the private sector to pay for this out of what it does. And this is another factor. As long as we have the current situation in which government is considered to be a bad thing, etc.—let me put it this way: The way in which we finance education in the country today, particularly beyond K–12, reinforces inequality, it doesn't alleviate it. So yes, education properly done could do this. But kind of oh, well, that is the way the world is and we will just have to hope for the better, is a problem. The notion that a stable economy, and this is where I think, again, we have a fundamental difference, yes, I would like to see a strong, stable economy. That is a necessary condition for diminishing inequality. But it is clearly an insufficient condition, and in the absence of any recognition of that, you are going to continue to see the kind of gridlocking in which trade promotion and immigration and other issues don't go anywhere. I just urge people who want to see us move in this direction to help us diminish inequality, or you will have continued economic gridlock. The gentleman from Alabama.

Mr. BERNANKE. Mr. Chairman, if I can just respond very quickly. In my remarks in March on inequality, I talked a little bit about education and training. I talked about other policies as well, such as helping people move between jobs and other types of policies, more affordability of health insurance.

The CHAIRMAN. I appreciate that. In fairness, could we have a hearing, perhaps, in which you might come and talk about this?

Mr. BERNANKE. Certainly.

The CHAIRMAN. Thank you.

Mr. BACHUS. Thank you, Mr. Chairman. The chairman of the committee talked about how he was troubled by complacency. I am also troubled by complacency, and every member of this committee ought to be troubled by complacency. But it is not in the Federal Reserve. The Chairman of the Federal Reserve has come in here this morning, as many other people have said to us, that the rise in energy and food cost are impacting the poor and middle class and it is one of the chief reasons for income inequality. The National Association of Manufacturers recently said that high cost of energy is a cap on the wages of blue collar workers. And yet this Congress, for 10 years, has failed to turn to the cheapest form of energy, which would give relief for every American's electric bill, heating oil bill and everything, and that is nuclear energy; 86 percent of the energy produced in France at a much lower cost than most of our electricity is nuclear. France has done it, India and China are building a nuclear power plant every week—I mean, every week, I think it is, or every month, one comes on line.

We can reduce the cost of not only energy costs, which the Chairman has said, he says right here, food and energy costs have eroded real incomes. And it hits us, he said, the poor and the middle class are the worse. The biggest component and the biggest contributor of the rise in food cost is the cost of energy, and one of the things we are doing, which does give us some relief, we are taking corn and turning it into ethanol. So whether that is good or bad, it is resulting in an increase in the cost of food. Fertilizer, the biggest component of fertilizer is energy, and it is the biggest component in producing food.

So if any of us are concerned about, and I am, and I think we all are concerned about the poor and the high cost of their gas bills, their electric bills, their heating and oil bills, we will pass a bill next month, if not this month, and we will do away with all this regulatory and legal burdens that have prevented us from decades from building a nuclear power plant, and have cost millions of American jobs, mostly blue collar workers, their ability to exist and stay in their community.

Visit some of the communities in Pennsylvania and Ohio and you will see the result of us standing and not doing anything about nuclear power. Mr. Chairman, I am going to change subjects. As I said in my opening statement, one of your biggest challenges has been created by the government's inability to address energy concerns, and you said that the wild cards are energy and food, and the biggest wild card in food is energy. This committee and this Congress has within its bull's-eye, as you probably read, private pools of capital, hedge funds and venture capital private equity funds. Would you like to address some of the benefits of private pools of capital, and if we do drive those private pools of capital offshore, what detrimental effects it may have on us?

Mr. BERNANKE. Certainly Congressman. Private pools of capital—hedge funds—raise a whole range of issues. I am not going to address them. But they certainly do provide some important benefits, and these include providing some ability to share risks. We now take risks and share them, so that they are held by lots of different people and not just by the banking system, for example. They provide a good deal of liquidity to help markets work more efficiently. And private equity in particular, plays an important role in the market for corporate control.

We need to have a mechanism whereby poorly run companies' weak managements are subject to being taken over, replaced and their companies improved. When it is working right, at least, private equity, as LBOs in the past, helps to serve that function.

So they serve some positive functions. They raise many issues of financial stability and the like, making sure that their counterparties are paying appropriate attention to their risks and the like. And we discussed some of the President's Working Group's principles. But they certainly are a benefit to the economy.

Mr. BACHUS. Thank you.

My last question is this: When we looked at the subprime lending problem last year, we found that probably about 3 percent of the brokers and actually, also, not only brokers, but mortgage bankers, people who worked for nationally regulated bankers—about 3 percent of them caused about 90 percent of the mischief and the fraud, and they will lose their licenses in one State. Then they go to another State, and they set up shop, and they are really creating havoc. These are basically—to me, they are criminals, and they are inflicting a tremendous amount of pain. Would you like to comment?

I introduced a bill, along with several of my colleagues, which called for a national registration and licensing standard for all mortgage originators. Would you like to comment on that, or on the legislation we introduced?

Mr. BERNANKE. Yes, sir. I will talk about the registration.

I do think there is an issue about brokers who lose their licenses, who perform badly in one area, and then simply move to a new State. The Conference of State Bank Supervisors had been trying to develop a database essentially so they could provide information to each other.

I think that, one, we should seriously consider some Federal licensing or at least some kind of Federal database that will allow States to know if a new broker who is coming into the State has some kind of previous problems in another location.

Mr. BACHUS. Would you look at the national registration and licensing provisions that we have introduced and maybe get back with us on any recommendation? Thank you.

The CHAIRMAN. Thank you.

Now, to explain the order here, this being a very large committee, not everybody gets to ask questions, especially if they wait until opening statements have been given, so I am going to go to the list of members on our side who did not get to ask a question the last time, by seniority, and then get back to the others. The first of those is the gentleman from Texas, Mr. Green.

Mr. GREEN. Thank you, Mr. Chairman. I thank you for your judicious approach in managing the committee, and I am honored to associate myself with your comments, and I also thank the ranking member.

Mr. Chairman, thank you for visiting with us today. I would like to visit with you very briefly about a crisis that continues, and it seems to go unabated, notwithstanding cyclical and temporary factors; notwithstanding excess inventories and the lack thereof; notwithstanding core inflation; commodity prices, whether they increase or flatten; notwithstanding energy prices and how they impact the economy; headline inflation, core inflation.

We have a crisis, in my opinion, and we consistently find that one segment of our society has an unemployment rate that is always twice that of another segment of our society. White unemployment is, as of June 2007, 4.0 percent. Black unemployment is 8.5 percent. Poverty among whites is 10.4 percent. Poverty among blacks is 25.6 percent. This is not something that is anomalous. It occurs consistently. There is a trend that is easy to track, and we consistently find that black unemployment is always twice that of white unemployment and is likely to be twice that of the national unemployment. The trend is there. The poverty trend is there.

The question that I have for you is similar to the one that the chairman posed, but it relates to this segment of society, and the question is: Do you see a change in this trend? Is it possible for us to have African American employment to achieve parity with white employment? Is this trend going to continue?

Mr. BERNANKE. Well, I am hopeful to see improvement over time. There have been some improvements in terms of the average family income, in terms of the share of minorities who are what would be called the “middle class.”

Mr. GREEN. Because my time is limited, what must we do to change this trend so that we can achieve the parity that we really want in this country?

Mr. BERNANKE. You are a bit beyond my area of specialization, Congressman, but, again—

Mr. GREEN. Well, if I may, though, Mr. Chairman, let me just say this now. You have talked about how we can impact employment generally speaking, and you have talked about how we can impact poverty generally speaking. Now, we have this one segment of society that is consistently higher than all other segments of society. Surely there must be some intellectual thought that you have to help us with this segment of society as well.

Mr. BERNANKE. Certainly, I was going to, at the risk of repeating myself, talk about the importance of training and skills, making sure young people have the opportunity to learn job-qualifying skills, to finish school. A lot of young, minority teenagers are out of school and have very high unemployment rates. We need to make sure that there is equal opportunity for both young people—

Mr. GREEN. Let us focus on the equal opportunity, because I think that you and I may find some agreement here, Mr. Chairman. By the way, I admire you and respect you greatly, but as to the equal opportunity aspect of it, as the chairman has so eloquently put it, the way we fund higher education beyond the 12th grade promotes unequal opportunity in education because those who have the ability to acquire the education can achieve educational parity. Those who do not will not. There are still some systemic things that have to be addressed when we talk about achieving this parity in education, so how we do this is becoming a part of the debate that we have to contend with.

Mr. BERNANKE. Congressman, my wife is a high school teacher; she teaches in the D.C. public school system. She has been working for some time with minority students, and her objective is to work with students to get them into college. Many of them have parents who are single parents who have never been to college.

Mr. GREEN. Mr. Chairman, if I may, listen, I hope to meet your wife, I am sure she is a lovely lady, but that will not help me with where I am trying to go.

Mr. BERNANKE. I am trying to explain that there is a whole mix of educational issues, social issues, opportunity, making sure that the opportunities that exist are open to everybody in a free way that does not discriminate, making sure that everybody has an opportunity to gain skills and education. That is the kind of society we want. I recognize that we do not have it yet. I think we need to work in that direction. Monetary policy can try to—

Mr. GREEN. One other question quickly. Would you be amenable to attending an event—I will not say "hearing"—but an event wherein you talk about—just as you talk about how you impact poverty and unemployment in society in the main, how we can deal with this one segment of society that for 300 years has consistently been at this level of inequality as it relates to employment, as it relates to poverty, as it relates to opportunity. Would you be amenable to such a thing?

Mr. BERNANKE. Yes, sir. I have been consistently available to talk about community development issues, about minority issues, and I think this is extremely important for our society.

Mr. GREEN. Thank you, Mr. Chairman. I yield back.

The CHAIRMAN. The ranking member tells me he is also going to follow the policy of giving preference to the people who did not get to ask questions, this being a larger-than-it-needs-to-be committee, and so we now recognize the gentleman from North Carolina, Mr. McHenry, for 5 minutes.

Mr. MCHENRY. I thank the chairman.

Chairman Bernanke, I am certainly glad to have you here. It seems your presentation today is largely about residential real estate. You mentioned that declines in residential construction will continue to weigh on economic growth over the coming quarters.

Do you have any words for Congress—at a time when lending standards have been tightened—on whether or not we should further tighten lending with additional rules and regulations on the mortgage marketplace?

Mr. BERNANKE. Well, I think there is a balance. I have discussed this in a number of speeches. I do believe the legitimate subprime lending in particular helps expand homeownership. It helps expand access to credit. At the same time, it is very important that we protect those who are possibly subject to abusive or to fraudulent lending, so we have to draw a fine line. We have to make sure we find ways to prevent the bad actors, the abusive lending, while preserving this market, which is an important market, both for the sake of those people who would like to borrow and to become homeowners, and also for the broad sake of our economy in maintaining the demand for housing.

So it is really a case-by-case issue, but it is very important to try to walk that fine line between protecting consumers adequately by making sure that we do not shut down what is, I think, essentially, a valuable market.

Mr. McHENRY. Can the Federal Reserve and the regulatory bodies within the Federal Government adequately address those concerns?

Mr. BERNANKE. Congressman, I think I really need to leave that for the Congress to determine. We hope that we are taking steps, the steps I have outlined today, and we are prepared to take additional steps if necessary. I believe it will go some distance towards resolving some of these concerns. However, Congress may feel they need to take additional steps, and I think that is really up to the Congress to decide.

Mr. McHENRY. Last month, the Federal Trade Commission had a very interesting new study on mortgage disclosures—you mentioned mortgage disclosures in your presentation—and it concluded in this study that current disclosures fail to convey key mortgage costs to many consumers, and in the study they found that about a third of consumers cannot identify their interest rate, whether it is prime, whether it is the prime and subprime marketplace; half could not correctly identify the loan amount; two-thirds could not recognize that they would be charged a prepayment penalty; and nearly nine-tenths could not identify the total amount of upfront charges.

Do you believe that changes in mortgage disclosures can help the marketplace so that individuals can decide for themselves? If they have those clear and upfront pieces of information, can they better decide for themselves?

Mr. BERNANKE. We think good disclosures are a critical part of a well-functioning market. We have had a series of hearings, and we have gotten exactly the same comment that you were just saying, which is that many borrowers simply do not understand all of the details of their mortgage. They do not get the information in a timely way. They do not understand the basics of what they need to know. So, as I mentioned, we are currently doing a complete overhaul of Regulation Z disclosures for mortgages. In particular, one thing we have found is that it is really essential to have real consumers look at these disclosures, because lawyers can write down these disclosures and say, "This looks fine to me." If you give it to a real consumer, they will not know what to do with it.

So one of the things we consider to be very important—and we have found this to be very helpful in our credit card disclosure work—is to do focus groups, consumer testing, to make sure, and to test people afterwards to see what they remember and what they understand, and to make sure those disclosures are effective. So I do not think there is any shortcut to getting good disclosures. You really have to make sure that the people can understand them.

Mr. McHENRY. Can that largely be done through the regulatory structure?

Mr. BERNANKE. Yes. As I said, we are currently undertaking that, and I hope that we will produce a good result that you will see, and you can make your own judgment.

Mr. MCHENRY. Well, Congress is targeting policy pursuits when it comes to the equality of outcome as opposed to, really, the equality of opportunity in this country. You speak of ensuring that we have solid employment as well as low inflation. Now, Congress has actually had a great focus on income inequality and the disparities in income in this country. Should the focus be more on eliminating poverty and offering opportunities to move up the income ladder, or should it be focused on the top and ensuring that we pull down those top income numbers to ensure greater equality?

Mr. BERNANKE. The fact that there are some very wealthy people does not necessarily make me or you worse off if they are creating value. You know, I am a baseball fan. I like to watch Alex Rodriguez, and I do not particularly care that he earns a lot more money than I do. But we do need to make sure that people throughout the income scale have opportunities to raise their own standards of living and to make progress in our society. That is why I have advocated the principle of trying to give people opportunity through education, through skills, and through support during periods of transition between jobs to make them more productive and more able to deal with the disruptions that come with a globalized economy.

Mr. MCHENRY. Touching on that, expanding on that in my final question here, as to the taxation of capital gains and Congress' discussion now on taxing partnerships, do you believe that a lower capital gains tax that is lower than income rates is good for investment and strengthens our economy and growth in this country and helps lead to lower unemployment rates?

Mr. BERNANKE. Congressman, I think I could talk about the pros and cons on this, but as you know, I am trying to avoid taking positions on specific tax and spending measures on the grounds that the Federal Reserve needs to maintain its nonpartisan status. So I am sorry. I really cannot give you a good answer on that one.

The CHAIRMAN. The gentleman from Illinois.

For 15 seconds, if I could, I would like to say when energy costs are blamed for the fact that real incomes are going down, I do want to congratulate the corporate sector. They have apparently found a way to insulate profits from the impact of energy costs, because, as noted in the report here, and as we have seen, profits have gone way up. So, while energy costs appear to have this terrible impact on college graduates' real incomes, somehow the corporate sector has managed to avoid that.

I think, in fact, energy costs are being given much more blame than credit, and there are institutional other factors, and the soaring profit sector is a bigger, I think, explanation of the stalled wages.

The gentleman from Illinois.

Mr. BACHUS. Would the gentleman yield just so I could respond?

The CHAIRMAN. Well, it is the gentleman from Illinois' time.

Mr. BACHUS. Okay.

The CHAIRMAN. The gentleman from Illinois.

Mr. GUTIERREZ. Thank you very much.

Welcome back, Chairman Bernanke.

Just a side note, as Chairman, when you get together with the Governors, you might want to take a look at what I feel is going to be a real looming crisis, and that is for our generation of college kids today, because there is not a week that goes by that my daughter does not get another credit card. Worse yet, now she is getting loans to take a vacation, and to get a laptop. I mean, you should see the stuff that is coming in the mail. Fortunately, she has a very fiscally responsible dad who has taught her about money and monetary policy, at least I hope so, until I get the credit card bill in the mail.

Very seriously, I really fear this can get out of hand, especially with the rising costs of how young people are going to manage their college. I would hate to see the next generation in such debt, but no matter what monetary policy you come up with, we are not going to be very helpful to them.

Chairman Bernanke, at the February hearing, in response to a question from my good friend Congressman Cleaver regarding the positive role that immigrants have played and continue to play in our economy, you comment briefly on immigration reform. You state, "So I certainly agree that immigrants have played a big role, they continue to play a big role, and we need to have a national policy on that. This is a very tough issue, and I think Congress really has to take the lead about how many people and under what conditions we admit, but it certainly is the case today that immigrants are playing a major role in our economy. There is no question about that."

I appreciate your response, and agree with you in many respects, and I am not trying to play "gotcha" here by asking you to endorse any particular panacea—you just answered the last question in that regard—but I would like for you to expand a little bit on part of your answer from February.

Specifically, do you think that the uncertainty with respect to the availability of a vibrant workforce created by Congress' failure to act on immigration reform has a negative impact or could have a negative impact on our economy?

Mr. BERNANKE. Well, as you know, the immigrant workforce is very important in some industries—construction, agriculture, and others. Some of them are seasonal, and I think the employers in those industries are interested in knowing where the workforce is coming from, and would like to have some clarity. But I understand that one of the key issues here is that many of the concerns about immigration go beyond purely economic considerations, and I understand that.

So, within the economic sphere, as I said in February, immigrants do play a very substantial role in our workforce, and they represent a significant portion of the growth of our workforce. They are very important in some industries, and, from an economic point of view, we need to recognize that role they play.

Mr. GUTIERREZ. We deported 160,000 undocumented workers from the United States last year, in the last 12 months. At that rate, it would take us about 65 years to "rid ourselves" of the 12 million undocumented as some would wish to do. But let us just say that we could do a better job, and that we could do it in 5 years. What do you think the economic impact would be on our economy if we just, all of a sudden "rid ourselves" of 12 million workers in our economy?

Mr. BERNANKE. Well, I do not think it is very surprising to say that would be a fairly disruptive event if it happened very quickly.

As I said in February, I do think it is important for Congress to think through how many immigrants they would like to have and under what conditions, because it is important to try to create some certainty and some ability to forecast what workforces are going to look like.

Mr. GUTIERREZ. Mr. Bernanke, I want to focus a minute on what I believe is an ongoing currency misalignment or manipulation by China and the effect of this practice on the American economy.

The American workers' currency undervaluation by China is reaching critical mass. For over 10 years, China has fixed the exchange rate by intervening in currency markets. Economists estimate that the yuan is undervalued by at least 9.5 percent and as much as 54 percent. In the past, even you, Mr. Chairman, have characterized this undervaluation as a subsidy for exports from China. Suffice it to say, we cannot compete with this ongoing government subsidy, especially with our largest trading partner.

In 2006, the U.S. gross trade deficit with China rose almost 15 percent, nearly $233 billion, a record high. Meanwhile, because China's government must buy U.S. dollars to keep the value of the yuan low, China holds more in foreign exchange reserves than any country in history. The latest tactic used by U.S. and third-party officials to try to convince China to allow its currency to fluctuate is to explain to the Chinese that doing so will benefit their own economy; that is, the Chinese economy.

If you were to have a one-on-one meeting with your counterpart at the People's Bank of China, what arguments would you use to convince him or her that it is in the best interest of China and makes good economic policy for China to allow their currency to fluctuate?

Mr. BERNANKE. Congressman, I have had that meeting on a couple of occasions. I do think that it is in China's interest to allow their currency to float, to appreciate. There are two principal reasons why it is in their own interest.

The first is that without a flexible exchange rate, they are unable to run an independent monetary policy. They are having some issues right now with a bit of inflation and some massive price changes that may reflect excess liquidity in their system, and that is a potential problem down the road.

The other reason that it is in their interest to adjust the currency is one you already alluded to, which is that the level of the currency essentially distorts the economy and puts more resources into the export sector. In China right now, less than 40 percent of total GDP goes to domestic household consumption. They need to reorient their economy towards producing more for the domestic market and being less oriented to the external market, and changing the value of the currency is one step to doing that.

I think, in addition to currency change, though, that they ought to take additional structural measures to try to encourage domestic consumption so that, even at a given value of the exchange rate, the economy would be more focused on domestic demand rather than on the global market.

Mr. GUTIERREZ. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from New Mexico.

Mr. PEARCE. Thank you, Mr. Chairman.

Thank you, Chairman Bernanke.

It is a positive report of our economy and on the world economy in general. On page 5, you make a statement that if energy prices level off, if anticipated. I will now ask you what would cause you to anticipate the prices to level, what factors?

Mr. BERNANKE. Well, we approach this at the Federal Reserve on, essentially, two levels. First, we try to do a fundamental supply-and-demand analysis and try to look at how we expect demand to grow not only in the United States, of course, but in emerging markets around the world, and where we see supply emerging in OPEC and outside of OPEC, and try to make some sense of where that market is going.

Another very important piece of information is the futures markets. Investors, in dealing with NYMEX and with other futures markets, put their money where they think the price of oil is going to be at various horizons going out to 6 or more years. Those futures markets have been wrong in the past. They have underestimated the increase in oil prices that we have seen, which is one reason why we are very cautious about them. But over long periods of time, they are probably about the best source of information we have about where the markets see energy prices going. Those energy markets currently see oil prices remaining high, but leveling off over the next couple of years to the point where, if that actually happens, overall headline inflation would be about the same as core inflation.

Mr. PEARCE. I would note that the National Petroleum Council met just yesterday—these are inside industry experts—and they forecast that supply will be very tight and that prices will be high, trending higher, and then I think that we are doing things—I have seen the bill that we have marked-up in the Committee on Resources that would begin to limit access internally to Federal lands and to also slow the process down so that our supplies internally are beginning—will collapse.

I will tell you that, as a life-long member of the oil industry and growing up in an oil town that already—because of the things that we are doing here, that as to the remedial work on the wells that keeps the production curve steady instead of declining, it is beginning to shut down. That utilization of equipment is beginning to lag nationwide, but also, specifically, in the remedial area, and so you have to anticipate that there might be some clouds on the horizon in that forecast and then the effect.

Now, there are about three pages of your report from about the bottom of page 6 on where we are dealing with the subprime market, and some portion of that is a difficult market. My question is as to the worst-case scenario: I am wondering why we have so much attention on the subprime market.

If the entire market collapsed—let us take the worst, worst, worst-case scenario—how much effect would that have on our economy? I would like that answer in kind of the context of, recently, Dow Chemical announced, because of high energy prices, that they are building a $22 billion facility in Saudi Arabia, another $8 billion facility in China, and together, 10,000 jobs are going to those places. Those would be high-six-figure jobs here, and yet they are building.

So my question is that 30 percent of your report is about subprime, and the addressing of things that we should be addressing, but I am not sure that 30 percent of our time should be addressed versus the effect of high energy prices.

Could you give me some understanding of those two factors?

Mr. BERNANKE. Well, the Federal Reserve has multiple roles, and the primary purpose of this hearing is to talk about monetary policy in the economy, and that is normally the only topic I would cover. In this case, though, the Federal Reserve also has some regulatory roles in reference to subprime mortgage markets in particular, and I thought this would be a useful opportunity to update this committee on some of the actions we are taking specifically in this particular market.

The concerns are in terms of what the effects of tightened lending standards might be on the housing demand, for example, which is one of the factors affecting the growth of the overall economy. But the main concerns I was addressing in the latter part of my testimony were really the maintenance of legitimate subprime lending and the protection of consumers from abusive practices.

Mr. PEARCE. I appreciate that and hope that we do more of that. I think there are factors that are going to have a potential upset to our economy that would be important to get your perspective of, and that is the cost of energy long term seems to me to be the greatest threat to our economy, and with the National Council saying supply is limited and price is high, I would hope that we could get input on that also. But I appreciate your work, and again, it is a good report. I appreciate that.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you.

The gentleman from Texas.

Mr. HINOJOSA. Thank you, Mr. Chairman.

Chairman Bernanke, thank you for giving us an update on the economy of the United States and abroad and for giving us an opportunity also to ask some questions that are of concern to us. I hope that in this brief time that we have, I can address housing, the NADBank, immigration, and possibly the college student loan industry as it refers to the for-profit entities.

This week the House of Representatives passed two of my rural housing bills, authorizing funding for the Housing Assistance Council and the Rural Housing and Economic Development Program. I introduced those two bills in my capacity as chairman of the Congressional Rural Housing Caucus to improve the affordability and the availability and the quality of housing in rural America.

What data can you share with us as to the economic wellbeing of rural America, and what types of Federal policy changes do you recommend to improve their livelihood?

Mr. BERNANKE. Well, one suggestion that I will just put out for consideration is that the Congress is looking at farm support bills, and the payments are made to individual farmers on different crops.

Certainly one way to think about supporting the farm economy is less through direct payments to individual farmers and more to supporting the broader infrastructure of the rural economy—irrigation, land preservation, erosion, roads, some of the things you have been talking about—to make the rural economy healthier and stronger more generally. I think that would be one thing to consider under the general rubric of the agricultural bill.

Mr. HINOJOSA. I agree with you because, in my district, I have seen that we give out about 7,500 checks a year as subsidies, and 10 percent of the biggest farms in our district receive 80 percent of the total amount of money given by the Federal Government. So I agree with you.

The second question refers to Mexico and to the fact that it is the United States' second leading trade partner. This is especially visible on the border in my congressional district in south Texas. The communities along the Mexico-U.S. border have faced great burdens on their infrastructure due to such trade growth.

Do you support an increase in resources for the NADBank to support local projects such as wastewater treatment facilities, roadways, and bridges to address this regional challenge?

Mr. BERNANKE. Congressman, I am afraid I have not really had a chance to evaluate that particular issue.

I do know that there is an awful lot of economic activity along the border there, and my very first trip as a member of the Board of Governors some years ago was to Brownsville. I saw a building there of some new colonias and the cooperation between Mexicans and U.S. citizens. So I think that is a very vibrant area, and I hope that its infrastructure is well-served, but I am afraid I do not know enough about your specific proposal.

Mr. HINOJOSA. Yes. I may want to point out to you that the Administration zeroed out the amount of money for the BEC Board, which is the one that receives the applications for those entities that are asking for assistance, even though the North American Free Trade Agreement has caused us to increase our trade with Mexico so much, and yet this Administration failed to allow some money so that the NADBank could continue to do what it was intended to.

The third question is on immigration, and I want to say that since immigration reform appears to be set aside by the Senate, at least for now, what strategies for increasing the labor force must be pursued to meet the future needs of United States' businesses? If immigrants are not encouraged to be employed as legal workers or are not brought in as temporary employees, what alternatives must we pursue to make sure we have enough workers for all of our industries, especially agriculture, construction, manufacturing, hotels, restaurants, and landscaping? Those are areas where we are hurting from not having enough employees.

Mr. BERNANKE. Well, there are two ways, essentially, to increase the effectiveness of our labor force. One, of course, is to improve the skills and training of U.S. citizens and bring more people into the labor force here. The issues concerning the immigration bill notwithstanding, I do not think anyone is arguing that we should not have a legal immigration policy, and bringing in people with the appropriate mix of skills can be productive and useful for the economy.

In particular, currently there is something of an imbalance between low-skilled and high-skilled workers, and I think it would be beneficial to our economy to allow additional high-skilled workers as well as some of the workers whom you were alluding to, working in agriculture and the like.

Mr. HINOJOSA. I agree with you that we ought to spend more money in retraining and in helping our own folks here in the United States to be able to fill those jobs and to possibly increase the amount, but when the government and the Administration took 10 years to raise the minimum wage, you can see why it is difficult to get people to take those jobs.

So, again, I thank you for coming to speak to us.

I yield back.

The CHAIRMAN. The gentleman from California, Mr. Campbell.

Mr. CAMPBELL. Thank you, Mr. Chairman.

Oddly enough, Chairman Bernanke, I have a series of economic questions for you.

I believe I am correct in characterizing that about 6 months ago, you said that you thought one of the greatest risks to economic growth would be a hard fall in the residential housing market. You have said that today some of our slow-down in growth is largely attributable to that sector.

How would you assess the risk of a hard fall in that market at this point? What are the risks to that happening, or what are the opportunities for its not happening?

Mr. BERNANKE. Well, we think it remains a risk.

It is important to understand that even should demand begin to stabilize—and it has shown signs at times of stabilizing—we have what you might call an "inventory problem." That is, homebuilders have a large number of unsold homes. So, even if demand were to stabilize, homebuilders would have to continue to cut back on construction in order to eventually bring those inventories into line. So that would, of course, reduce economic activity. It might have some impact on the construction employment and so on.

The related concern in terms of the downside risk is that, in order to clear out those inventories, we might start seeing falling prices, and for many people the equity in their homes is their major financial asset. So, the question is whether price declines, moderate price declines, have any significant impact on consumer spending?

The evidence so far is that there really has been no spillover that we can see. We are certainly watching for any potential impact of changes in housing values on consumers and on their moods, attitudes, sentiments. It is part of what we are doing, and we are following that market very closely.

Mr. CAMPBELL. Are there any policy actions we should be considering in that regard, or is the best policy action to do no harm?

Mr. BERNANKE. I think that there is an adjustment correction going on. The housing market expanded to very high levels of production. Despite the fact that we are off 30 percent in terms of construction this year from the peak, we are at levels that were reached in the late 1990's, for example, so the housing market is still producing more than 1 million homes a year.

So I think we have to watch very carefully what is happening. We need to make sure our mortgage markets are functioning well and so on. But I think this is a process that is going to have to work its way out, and it has been working its way out, and we will be watching it as it does.

Mr. CAMPBELL. Okay. The dollar has been falling on currency markets of late, but our trade deficit has not. Why is that occurring, and are you concerned about either trend?

Mr. BERNANKE. Well, the dollar is the responsibility of the Treasury. We do not comment on the dollar. We simply take the dollar as given, and make monetary policy as best we can given the performance of the dollar.

The trade deficit actually has shown some signs of looking a bit better. That has been disguised, to some extent, by the fact that oil prices have gone up so much. And so the oil import bill has risen, but other components of our net trade balance do seem to have stabilized somewhat, and there are some encouraging signs in that direction.

As I alluded to in my earlier comment about the Chinese currency, I think that relying entirely on exchange rate changes to improve the trade balances is a mistake. It is important that there be structural changes that affect the ratio of domestic and foreign demand that different economies are relying on so—particularly in China—that they make changes that will allow a greater portion of their output to be devoted to domestic consumption, domestic demand. Whereas, here in the United States, we save more in order to rely less on imported capital.

So exchange rates notwithstanding, I think some changes in the balance of saving and investment—and the changes in the balance of domestic versus foreign production—need to take place in order to move us in the direction towards a better balance.

Mr. CAMPBELL. On the inflation front, you talked about the energy versus the core inflation rate and that you expect, based on futures contracts, energy and food price increases to soften to some degree.

If that does not occur, at what point does that become a concern for you?

Mr. BERNANKE. Well, first of all, we are unhappy with inflation, including energy and food prices running higher than we would like, so it is already a concern in that respect.

Looking forward, I think the real issue for us is, if there are temporary bursts in prices of food and energy, will those higher prices somehow get embedded in the long-run, underlying trend of inflation. There are a couple of ways in which that could happen. One would be if say, higher crude costs, materials costs, were passed through by producers into the higher prices of other consumer goods, for example. The other possibility would be if consumers, having seen for many years very high increases in their food and energy costs, began to lose confidence in the Federal Reserve and to worry that inflation would be higher in the future. Their expectations of inflation would begin to move upward. Once that happens, it is much more difficult to keep inflation low, because people are building into their wage and price decisions higher expectations of inflation.

So there are some concerns there, and it is part of the reason why I think we do have to be quite vigilant on inflation at this juncture.

Mr. CAMPBELL. Thank you. I am not out of questions, but I am out of time.

The CHAIRMAN. The gentleman from New Jersey.

Mr. SIRES. Thank you, Mr. Chairman.

Thank you, Mr. Bernanke, for being here with us today. I just want to follow up on the housing issue.

I represent a district that is across from New York, the northern part, the Jersey City area, which has seen a boom of housing over the last few years. With that, the prices really went up high. A lot of people had to resort to subprime lending to get housing, and it created a lot of jobs, a lot of good-paying construction jobs. I do not know whether this is regional, but I have seen the prices of the houses not really going down when we are losing a lot of those jobs that were created. I would just like to know the impact on these construction jobs.

I know that approximately 10 percent of the jobs created in this country are through construction. What effect is this going to have on the economy? Do you see it as regional? Because I know they are going to—I have friends in Florida, and they are going through the same process, the same things where good-paying jobs are being lost. Do you see this trend changing? I know mortgages are getting tighter. Subprime is very difficult to get. Home equity loans to create these jobs are impossible in some cases.

Do you see this trend changing anytime soon?

Mr. BERNANKE. Congressman, first of all, you are quite right that there is a very strong regional component in the housing market. Florida is an example where there is quite a bit of weakness. There are other parts of the country that are doing better—where prices are still rising and where the real estate markets are pretty healthy. So it does depend a lot on where you are.

We would expect, as the residential real estate market adjusts towards a more sustainable level, that there would be some loss of residential construction jobs, but there are some offsets. In particular, the nonresidential construction offices—commercial real estate, factories—are growing at a very rapid pace, and a lot of the labor that has left residential construction has been absorbed by nonresidential construction.

In addition, we are seeing increases, for example, in home improvement. People are saying, well, we cannot move because of the housing market. We are just going to redo our kitchen. That has also proved to be a source of employment.

So, although the official statistics have some puzzles, frankly, they so far do not show a significant decline in construction employment, and partly for those reasons that I have just described.

Mr. SIRES. But these other jobs that people are taking are not as good, obviously, as the jobs that were in the construction field.

Mr. BERNANKE. Well, again, many of the construction workers are finding construction work, but in nonresidential or in home improvement-type sectors.

Mr. SIRES. Not as well-paying as those jobs.

Mr. BERNANKE. I think it varies. Some of the specialty contractors who are building apartment buildings or who are building office buildings and the like are pretty well-paid, and those are pretty productive jobs.

Mr. SIRES. I know the lending rate seems to have stabilized. Do you see any changes downward for the future?

Mr. BERNANKE. Well, in terms of the mortgage rate, a lot depends on what the bond market does, and, as you know, the Federal Reserve does not have perfect control over the bond market.

Mr. SIRES. Thank you very much.

The CHAIRMAN. The gentleman from Texas.

Dr. PAUL. Thank you, Mr. Chairman.

I find it rather ironic that the Federal Reserve has complete control over the money supply, yet it is the Treasury that is supposed to protect the value of the dollar. It seems like you have a little bit of responsibility for the value of the dollar as well.

I have a question about the GDP. In the first quarter, our GDP did not do so well; it was less than 1 percent. Our population growth averages about 1.5 percent. So, if we have total wealth divided by the population, we actually have negative growth. Could this not be a part of the explanation as to why some people feel there is inequality and that they are not doing as well in the economy? Wouldn't this explain some of the concerns that we have?

Mr. BERNANKE. Well, Congressman, that was, of course, a single quarter, and there were a number of temporary factors that held down GDP growth in the first quarter, including the liquidation of the inventory overhang, which I mentioned before, a swing in our trade balance—a temporary swing—and a temporary decline in Federal defense spending. All of those things have been reversing now, so I think we will be seeing in the second quarter something closer to a 3 percent growth. Between the first half of the year overall, it will be a more healthy rate of growth.

Dr. PAUL. We have a savings rate which is negative, and if we had true capitalism, this would be very, very serious because we would have no savings and no capital to invest. Today, with our monetary system, we resort to other means. We can create credit and money out of thin air, and it acts as capital by stealing value from the existing currency, and we have been doing that for a long time, so the process can continue, but it literally is inflation. Also, we can resort to borrowing overseas, and we are permitted, because we have the reserve currency of the world, to export our inflation, and that seems to be a free ride for us as well.

How long can we fool the world? How long can we continue with the current account deficit of 6 percent? If our productive jobs are going overseas—and like the gentleman mentioned earlier about more jobs going overseas—eventually, this is going to catch up with us.

Is it conceivable that we could live on capital formation by the creation of money and credit out of thin air? If that is the case, we would never have to go to work again if that is true. It seems like we really have to go to work. We really have to save, and we really have to invest, and we really have to get these jobs back. But I see so many of our problems as a consequence of a monetary system that discourages savings and encourages a free ride for us because there is still a lot of trust for the dollar, although that trust is going down every day. I think we have to face up to the consequences of what this might mean to us.

Mr. BERNANKE. Well, first, our national savings includes corporate savings as well as household savings. If you put those together, you get a positive number, so there is some net savings going on in the United States.

Congressman, you are absolutely right that we are also relying pretty heavily on borrowing from abroad, which is our current account deficit. I think that is sustainable for a while because foreigners seem quite interested in acquiring U.S. assets. We have very deep and liquid financial markets. However, I also agree with you that that is not a long-term, sustainable situation by any means, and we need to be working to try to bring that current account deficit down over time.

In answer to a previous question, I talked a bit about the importance of a structural change—increasing savings here in the United States, increasing attention to domestic demand with our trading partners.

Dr. PAUL. You did say in your talk that the predominant policy concern was inflation, which is encouraging that there is a concern. Of course, once again, inflation is a monetary phenomenon, and we have to deal with it. War sometimes is not healthy for a currency or for keeping prices down, at least inflation. It is hard to find throughout all of history when war did not create price inflation because, even in ancient times, countries resorted to clipping coins and diluting values or whatever—they inflated the currency—because people do not generally like to pay for the war. Yet, in the 1970's, we had consequences of guns and butter. Now we are having guns and butter again, and we are having consequences, and it just looks like we may well come to a 1979/1980.

Do you anticipate that there is a possibility that we will face a crisis of the dollar such as we had in 1979 and in 1980?

Mr. BERNANKE. The Federal Reserve is committed to maintaining low and stable inflation, and I am very confident we will be able to do that.

Dr. PAUL. So you are not answering whether or not you anticipate a problem.

Mr. BERNANKE. I am not anticipating a problem like in 1979 and in 1980, no.

Dr. PAUL. With your fingers crossed, I guess. Okay.

Thank you.

The CHAIRMAN. The gentleman from New Hampshire, Mr. Hodes.

Mr. HODES. Thank you, Mr. Chairman.

Chairman Bernanke, I am glad to see you here. Chairman Frank and the staff made available to us the Financial Services Forum report to which he referred. I want to follow up on some of the questions that arise from reading that report and from reading your monetary policy report.

The Financial Services Forum report talks about—and you will have to pardon me, this is their word—the astonishing "skewness" of U.S. income growth. They point out that, since the year 2000, U.S. corporate profits have nearly doubled, and say that in recent years the large majority of American workers has seen poor income growth. Indeed, 96.6 percent of Americans are in educational groups whose mean total money earnings have been falling, not rising, since 2000. Only a small share of workers at the very high end has enjoyed strong growth in incomes. The strong U.S. productivity growth of the past several years has not been reflected in wage and salary earnings, and instead, it has accrued largely due to the earnings of very high-end Americans and to corporate profits.

The New York Times reported the other day that 5 percent of the wealth of this country is concentrated in the hands of 15,000 families. In a large sense, given that productivity is up, and you talk about the continuing expansion of the economy, and you predict at least moderate growth in the economy, we are seeing the rich get richer, the poor get poorer, and the middle class get squeezed.

How can productivity and expansion serve as accurate measures of the true strength of an economy when what the Financial Services Forum reports to be happening is, in fact, happening?

Mr. BERNANKE. Well, in the past I have taken a view very similar to what Chairman Frank advanced, which is that I do believe that globalization, technological change, those factors, do make our country richer. But there is essentially a political problem if the majority of the population does not feel that they, personally, are benefiting from that, and so we need to pay attention to how—

Mr. HODES. Can I just stop you for a moment?

It is not about what people feel. If these statistics are correct, almost 97 percent of Americans are going backwards in terms of their real wage income growth, while, at the very top, things are getting better, and corporate profits are up. So it is more than a feeling, isn't it?

Mr. BERNANKE. I do not want to dispute the study. I am sure they have picked some period of time and have looked at it. I do not think that is a good characterization of the last few decades, for example.

For example, if you take the families with children and look at the middle quintile—so that is sort of a typical middle-class family—the real income of that family is about 30 percent higher today than it was in 1980, and about 15 percent higher than it was in 1995, and about 5 percent higher than it was in 2000.

There are many different ways to cut these data, and I absolutely agree that there is increased inequality, and that we are not seeing gains as large as we would like in the middle. But characterizing 97 percent as falling backwards is not really a fair representation of the trends in the United States over the past decade or two.

Mr. HODES. Assuming that these figures are accurate, and that since the year 2000 there has been this astonishing skewing of growth for those at the very top as compared to those in the middle or in the lower rungs, what role do you think tax policy since the year 2000 has played in the skewing of that picture?

Mr. BERNANKE. I think tax policy is not the major factor. Empirically, the major factors are technological change, which particularly favors people with high sets of skills, and to a lesser extent globalization. I think that most of the research points to that. Over time, of course, the tax system is progressive, but it has not offset these other factors which have made incomes more unequal.

Mr. HODES. What are the long-term implications for an economy if this trend continues, where the rich get richer and corporate profits go up, but real incomes for the rest fall?

Mr. BERNANKE. Well, as I was indicating before, what a superstar baseball player makes does not necessarily affect me. But even putting that aside, it is important that the mass of people see improvements in their living standards. That is very important, and I know of no other approach other than trying to make our economy more productive for the broad swath of society, and that involves research and development, education, saving—it involves doing all of the things that make an economy strong. Congress has a tremendous role here in making good economic policies that will strengthen our economy and will allow the benefit of that economic growth to be spread more widely.

Mr. HODES. Thank you very much.

Thank you, Mr. Chairman.

The CHAIRMAN. The gentlewoman from Ohio.

Ms. PRYCE. Thank you, Mr. Chairman.

Thank you, Mr. Chairman, for the time you take with us in these Humphrey-Hawkins marathons twice a year. You are very gracious. I know you are required to do it, but thank you for doing it so graciously.

I also want to thank you for the initiatives the Fed has taken in terms of consumer protections, especially in my State of Ohio, with the mortgage problems that we are having. Your attention to that is critical and very, very much appreciated. So thank you for that.

I would like you to talk a little bit today to us about the extent and the impact of the use of credit or the overuse of credit, as Mr. Paul might refer to it, in our country. I am particularly interested in credit card debt, but you can go beyond that if you would like, because I think that this committee will be addressing some of those issues in the fall.

We would love to have some of your guidance in terms of consumer protections when it comes to things like data breaches. In my home State of Ohio, we have had major financial institutions, universities, retailers—even our own State government has had just a series of terrible breaches in data and has the identity theft issues that go along with those things. Credit is a wonderful convenience, and credit is one thing that is keeping our economy healthy or unhealthy, as the case may be in your perspective.

How can we better address the issue of data breaches and securing people's information in every way we use it when the use of credit is so pervasive and is on the Internet?

Mr. BERNANKE. Thank you.

On the general issue of credit, there is sort of a paradox where, on the one hand, we want people to have access to credit. Credit allows you to buy a home much earlier than you otherwise could, for example. But as I was discussing with Congressman Paul, there is a very low savings rate, and we would like people to save more and to build more wealth.

In particular, as to the discussion we were having on inequality, the inequality in wealth-holding is much more severe than the inequality of income, because many people just simply do not build wealth in terms of acquiring financial and real assets. So that is very important.

Specifically, and as to the two things you mentioned on the credit cards, as I said, we have just put out a very extensive set of new disclosures. We believe that they will help people understand the terms of their card, so they are not surprised by unexpected fees and penalties, and we are prepared to take additional steps. Congress has given us and other regulators a good bit of power to try to make sure that credit cards are marketed in an honest way and that people understand what their accounts are about. So we want to proceed along those lines, and Congress will have to judge whether they need to take additional steps.

On the issue of data breaches, we have a model that you might want to look at. The Gramm-Leach-Bliley law of 1999 instructed the Federal regulators to develop a set of data breach policies for depository institutions, banks essentially, which we have done.

So we have a set of rules, a set of principles, which, of course, promote safeguarding of information—methods of doing that—and also give some advice under what circumstances notification is needed. If there is a trivial problem, maybe it is not necessary to notify the public. If there is a serious breach of security, then obviously the public needs to know about it. So that exists. I might suggest that in drawing up legislation for the broader market, you might take a look at some of the things we have learned in the banking agencies.

Ms. PRYCE. Let me ask you one specific question that seems to be the subject of some controversy. How do you feel about the consumer's ability to freeze their credit? Do you think that will have any impact on our economy? Do you think technology is at a place where that can be turned off and on at will? Do you have any opinion at all on freezing?

Mr. BERNANKE. If a consumer wishes either to prevent access to their credit records or prevent additional credit charges being made, that seems perfectly reasonable to me. I am not aware of any particular technological problems, but I could be unaware of something. I am not sure. But certainly, the consumer should have some control, significant control over their credit records, and preventing unwanted access is certainly part of that.

Ms. PRYCE. Thank you very much.

The CHAIRMAN. The gentleman from Florida.

Mr. MAHONEY. Thank you, Mr. Chairman. Thank you, Mr. Chairman, for being here today. I appreciate you coming before us. First, a general question, and then a couple of specific questions on debt. Yesterday, the Dow hit a milestone mark of 14,000, which is not a question of benefit to the haves and have-nots; it is a good thing. We appreciate the fact that the market has hit this high for those investors in this country. It is a very positive statement. But at the same time, we know that there are many people in the country who are still struggling. They may or may not be investors.

There is still a big portion of our country that is not invested in the market, and whether it is relating to energy costs or food costs or the staples that impact people's day-to-day lives, we know that these are things that are at their gut level impacting them. I think one of the questions that we keep looking at is why is it that some of these gains in large business sectors or the market side are not translating into the middle class, if you will. And I know that we look at unemployment being low. I am from Florida. And in Florida we do, as you mentioned, have a softening of the real estate sector, which has had a big impact. We also have a lot of hospitality jobs, which traditionally are relatively low wage jobs in large quantities. So even unemployment figures don't always tell the whole tale when people are getting paid minimum wage or relatively small numbers. What can be done in terms of monetary policy, if there is anything, to help the middle class, or people who are in a small business, or trying to get an upper hand in trying to benefit from an economy that through the Wall Street public security side is doing very well, but maybe in the small business, private closely held businesses or people that are workers are just not accomplishing as much?

Mr. BERNANKE. Well, in terms of monetary policy, I react to a comment that Chairman Frank made earlier, which is that, on the margin, good monetary policy can do a bit about inequality. I notice that when the poverty reports are issued periodically, they show the recession periods and the expansion periods of the economy—because poverty tends to rise during recessions, as you might espect. And therefore to the extent that the Fed can maintain a stable economy—low inflation, sustainable expansion—there is a modest benefit in terms of income for the poor and for the middle class. But I think that to make real changes—real differences in terms of across groups differences—you need to have structural changes, changes in behavior.

We know, for example, that the Federal Reserve manages the Survey of Consumer Finances, which is the leading source of information about wealth holdings. You mentioned stocks before—across the population—and what we find there is that a very large fraction of the population really has almost no savings. It is a paycheck-to-paycheck situation. Now, obviously, it is hard to save when your income is low or irregular. But there certainly should be opportunities for low- to moderate-income people to build some wealth, to gain financial literacy, to learn how to get a checking and savings account. And helping people do those kinds of things could be one way of improving their situation. I have referred many times to skills, and I do believe that it does not require a Ph.D. to get a good-paying job. There are a lot of what we used to think of—and still think of—as blue-collar type jobs that are now paying pretty good salaries given the supply and demand. So that is another important dimension of this. But from a monetary policy perspective, our main goal is trying to maintain maximum employment price stability in a stable economy as best we can.

Mr. MAHONEY. As we go through this, we may want to continue to have these discussions with your Board and with Congress as far as what policies. We can promote some of its communication and promotion of educational understanding of savings. That is a segue to a second question; in your speech today, you mentioned that consumer spending has advanced vigorously over the last number of quarters. Sort of looking at the trend over the last number of years, savings have been going down, as you have said.

Many people during this boom of real estate started with a lot of home equity loans, taking equity out of their home to support consumer spending, building up more debt that way. And now with the real estate market in many parts of the country very flat, interest rates having gone up, adjustable rates, that is not available for many people, so they have debt on top of that. And then a lot of the consumer spending is on the backs of more consumer debt in terms of credit cards. Congresswoman Pryce mentioned that as well. Again, what impact do you see that having on the long-term basis of the stability of the economy when people are borrowing more and more and more and not saving? And again, what can we do through your offices or through the Congress?

Mr. BERNANKE. Well, one of the reasons that the personal saving rate declined, and actually has gone negative, is that capital gains in an individual's house, stocks, or any other assets are not counted as part of saving. It is only the part of one's income that you set aside out of current income that is counted as saving. Part of the reason that people saved less over the last decade or so is precisely because home values and stock values went up. People felt wealthier. Maybe they didn't feel they had to put aside part of their income and spent out of their wealth. Therefore we had negative saving rates. As you point out, though, the stock market has still gone up this year, but housing prices are flattening out. To the extent that house prices no longer generate home equity gains that they have in previous years, consumers won't be able to tap that source of spending power.

Mr. MAHONEY. And the costs have gone—I know in many parts of the country, between insurance and mortgage rates and everything else, the net amount has.

Mr. BERNANKE. So, they will have to begin to save more out of their current income, and that might lead to some increase in the household saving rate. In the short-run, we don't want consumption to drop too quickly because it is a huge part of the demand that drives our economy. But over our medium term horizon, we do want to see more saving, and that would be a positive thing.

Mr. MAHONEY. Thank you.

The CHAIRMAN. The gentleman from California.

Mr. ROYCE. Thank you very much, Mr. Chairman. We discussed that since 2000, we have seen stagnant wages for low skilled workers. Well, supply and demand are a reality, and certain business interests on the right want low skilled labor because it will drive down wages. They want more low skilled labor in the country. On the other end of the spectrum, there are those who believe in open borders for the disadvantaged. But the result of the policy is that until we have enforcement against illegal immigration, wages will lag. They are going to lag if you have massive illegal immigration of low skilled wages in the United States. You can't expect anything else to happen if you have 20 million people here illegally other than to have the pressures of supply and demand force down wage rates.

Indeed that has happened since—well, for the last decade. To encourage monetary inflation, shifting to that subject, is to encourage a return of the boom and bust in a business cycle and to abandon a stable monetary unit. That is what I think the effect would be if we move towards the direction that didn't attempt to really control inflation.

Now, Chairman Bernanke, as you know, in the past decade we have also seen unprecedented growth in the mortgage industry. If you went back to the 1960's, there was very little movement back then in home ownership rates until the development of technology and tools such as risk based pricing, which allowed lending institutions to more accurately calculate the risk associated with potential borrowers. As a consequence of that, in 2004, the home ownership rate went up to just under 70 percent, hitting record highs. Much of this growth which we had not seen in the decades prior was in a sector of the population which was previously locked out from obtaining mortgages, therefore, they rented instead of owning homes.

For the most part, they had blemished credit, and they benefited greatly from the transformation in the industry as a result. As you know, the subprime lending market has come under tremendous scrutiny. Some believe we should rush to legislate. I believe we should approach this topic with tremendous caution. While deceptive lending practices should be prevented, I believe effective disclosure is the proper anecdote. Expanding liability to include secondary market participants for abusive loan originations would be a misguided policy. My fear is that if we overlegislate, which we have been known to do, it will prompt a credit crunch for Americans.

I believe that the availability of credit has been good for consumers, by and large. The economy has benefited as a result, and any potential solution to concerns that have arisen should be very closely scrutinized.

So Chairman Bernanke, I would like to get your thoughts on this issue and whether you believe an ill-conceived legislative fix will have any potential unintended consequences. Lastly, as you know, the outflow of capital from our markets has been discussed at length over the last few months. Much of the debate is centered around two major burdens faced by our public companies. One is cumbersome regulation and the prevalence of securities class action lawsuits. The threat of overregulation and overlitigation has caused many companies to reconsider listing on our public markets. This has resulted in a growth in the amount of capital in a private equity and hedge fund industry.

So my second question, Chairman, is if our private equity and hedge fund industries are subjected to a sharp increase in regulation and taxation, what do you believe will be the end result? Thank you.

Mr. BERNANKE. Earlier, we mentioned the 30th anniversary of the Humphrey-Hawkins Act. Thirty years ago was also the creation of the Community Reinvestment Act (CRA), the premise of which was to address the fact that banks were not lending in certain neighborhoods—there was red lining—and that it was important to extend credit to low- and moderate-income people. The development of the subprime lending market made that feasible to a significant extent. And I agree with you that legitimate, well-underwritten, well-managed subprime lending has been constructive. It does give people better access to credit and better access to home ownership.

Moreover, regulations should take care not to destroy a legitimate part of this market, even as we do all that we can to make sure that bad actors are not taking unfair advantage or confusing or misrepresenting their product to people who are essentially being victimized by them.

So it is our challenge—and we take it very, very seriously—to provide regulation and disclosures that will allow this market to continue to function, but at the same time to eliminate some of the bad aspects that we have seen in the last couple of years.

The CHAIRMAN. The gentleman from Connecticut, Mr. Murphy.

Mr. MURPHY. Thank you, Mr. Chairman, and thank you, Mr. Chairman, for coming here today. I want to spend just a few minutes on a subject that within, we think, the next 5 or 10 years is going to account for about $1 out of every $5 spent in this economy, and that is health care spending. We talked a lot about food and energy costs today, and that is probably in part because they tend to rise and fall with some degree of drama, and they tend to get some headlines in the newspapers. But the fact is what we have seen in health care spending is a very slow but steady growth in the rate of our GDP that is dedicated to health care spending going from about 8 percent in 1980 up to bordering on 16 to 17 percent today.

There seem to be two schools of thought, and I probably fall in the first one, but I would like to get your thoughts on this, Mr. Chairman. The first is that this is a very dangerous trend with $1 out of every $5 being spent on health care spending; that is less money available to our economic sector for growth, and less money available to consumers for discretionary spending. On the other hand, as opposed to the increases in spending in energy and food costs, that money is generally almost completely being recycled back into our own economy rather than with energy costs and food costs. Much of that money is going outside of the United States economy.

So that is a very broad way of asking what your thoughts are and how troubling you believe the trend is towards more of our GDP and more of our economy being dedicated to health care spending.

Mr. BERNANKE. Well, there have been interesting studies about the cost-benefit of this extra spending that we have been doing. The general view is that the money we have spent on things like improving recovery from heart attack, on mental illness, and on some other major categories of disease has been worthwhile in that the benefits of life expectancy, productivity, and so on does exceed the cost. That being said, it is not inconsistent to say that we probably could achieve the same health outcomes at a lot less cost if we had a more efficient system.

Of course, this is a huge issue about how to achieve greater efficiency. I would like to point out that this has become extremely important, not just to the share of GDP issue as you mentioned, but also as a fiscal matter—as Medicare and Medicaid become huge portions of Federal spending, and also as a generational matter, as we have become an increasingly older society and young people are responsible for the maintenance of the retired. To the extent that older people require additional medical care, that care is becoming more and more expensive and puts a heavy burden on the younger generation. So there are some important reasons. While health care is a wonderful thing and is certainly worthwhile, there are very good reasons to improve the efficiency of the system.

Mr. MURPHY. I certainly appreciate your thoughts on that. I share your view that we can get very similar, if not better, outcomes for less money spent within the system. The last related question is in regard to global competitiveness in relation to the costs being borne by American businesses on health care costs versus competitors in other countries who simply aren't required to bear the burden of providing health care for their employees. Do you, as you look at the future outlook of American competitiveness, worry about the burden that American businesses have to bear regarding health care costs?

Mr. BERNANKE. Well, there is some complexity to that issue because, even in a society where government provides health care, corporations still have to pay taxes to support that. So, it isn't free. That being said, the more resources are unnecessarily consumed by health care—as opposed to the part which is valuable—clearly lowers the overall productivity of our society and the lower our living standards will be in the long run. So, it is a first-order issue to make sure that our health care system is delivering good outcomes, but at a reasonable cost.

Mr. MURPHY. Thank you very much. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Delaware.

Mr. CASTLE. Thank you, Mr. Chairman, and thank you, Chairman Bernanke. I would like to go to something that you have in your written comments, and you also spoke about orally when you spoke, and that is inflation. I am afraid maybe I didn't understand inflation as well as perhaps I thought I did coming in here. But you talk about core inflation here, which apparently excludes food and energy prices. And there is also a reference to an annual inflation rate of 4.4 percent in the first 5 months of this year. I don't know if that does include the food and energy.

Mr. BERNANKE. Yes.

Mr. CASTLE. Apparently it does. Why are food and energy excluded from core inflation? And when you speak generally about inflation, or giving the rate such as 4.4 percent, are you generally giving a noncore inflation and giving inflation including energy and food? I mean, energy is a major component of virtually every household in this area, but also there is a lot of major businesses in the country as well. I realize it is subject to short-term happenings, and obviously food prices are also subject to short-term weather events and other things. There may be some logistical problems in terms of inflation. But it just seems to me to exclude them from any form of inflation measurement would not be correct.

And my follow-up to that question, if you can answer at the same time, is should we be concerned that persistently elevated food and energy inflation might presage an increase in that core inflation, since it is already not included there.

Mr. BERNANKE. The dual mandate says price stability, it doesn't say price stability without energy and food. The Federal Reserve is concerned about the overall inflation rate, that is our long-term objective in the sense of maintaining price stability. But there are some technical issues involved in achieving that. In particular, when oil prices rise sharply, as they have in the last few months, there is really not much the Federal Reserve can do in a short period of time to reverse that. Rather, what we have to do is look forward 1 to 2 years, which is the horizon over which monetary policy has its effect. And so we really have to ask ourselves, what is the underlying trend of inflation going forward?

What is the best forecast of inflation going forward? Because energy and food prices have been so volatile up and down historically, the core portion, which excludes energy and food, is sometimes a better indicator of where sort of the trend of inflation is going to be a year or 2 from now. So, it is not that we think core inflation is more important in itself, or rather we think it is an important indicator of the underlying inflation trend.

So by paying attention to core inflation, we are, in a way, saying that this is how we hope to maintain stability in overall inflation over the horizon in which the monetary policy can be effective. It is a concern, as I mentioned in my remarks, if energy and food prices rise a lot and you have very high overall inflation. It is a concern that the public will begin to expect higher inflation. That will, perhaps, then creep into core inflation and raise the inflation trend, which we don't want to happen. So we pay attention not only to core inflation, we also look at inflation expectations as an indicator of what people think is the longer term behavior of inflation.

Mr. CASTLE. I want to change subjects here, but I hope that because something that has volatility wouldn't necessarily be excluded from the inflationary rates, as far as I am concerned. I want to ask you about where you are with Regulation Z. I don't know if Regulation Z is going to be the answer. As far as credit card plans are concerned, this obviously is what you, the Fed, look at in terms of the disclosures of what should be in there. It is the first comprehensive review of Regulation Z since, I think, 1980 or 1981, something like that. We have had a hearing on that here. And I know that you have issued your initial statement and comments being made. What have you learned in the comments and when do you expect to finalize the rule? Are you at a comfort level to resolve some of the concerns that I think most of us on this committee have with the credit card industry?

Mr. BERNANKE. We issued the Regulation Z rules on credit cards in May for comment. It was a very comprehensive review of all the regulations applying both to credit cards and to other revolving credit. The comment period is open until October. After that we will move as expeditiously as possible to issue a final rule that will apply to credit card issuers. We are also, as you know, doing a complete overhaul of Regulation Z as it applies to mortgage lending. We have had a series of hearings on that.

We are also, as we did with credit cards, going to do consumer testing to make sure that people can understand the disclosures. That is going to take a while. It will probably be next year in 2008, as we come to some conclusions on that. But in a nearer term, in order to address some of the current issues in the subprime mortgage market, we have taken off a few elements that we think we can move on more quickly relating to solicitation and advertising of mortgages and when you have to give information to consumers, how quickly you have to make those disclosures. So there is some element to that that we think we can move up. The full Regulation Z on mortgage lending, however, is going to still take a while because of the need to do consumer testing.

Mr. CASTLE. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Massachusetts.

Mr. LYNCH. Thank you, Mr. Chairman.

The CHAIRMAN. I very much appreciate the Chairman staying with us. After 2½ hours, you are entitled to call something a rehash when it is. We have, I think, four members left who haven't asked questions. That should take us about 20 or 25 minutes, and that will give us time to finish the hearing. So if you can accommodate that, we would appreciate it.

Mr. LYNCH. Thank you, Mr. Chairman. I will try to be brief. I do want to go back to an issue that Mr. Royce and others have talked about, the subprime mortgage problems that we have been having. In your own remarks, Mr. Chairman, you mentioned that the subprime mortgage sector has deteriorated significantly, the conditions there, and that reflecting mounting delinquency rates on adjustable rate loans continue to be a growing problem. You also note that one risk to the economic outcome is that the ongoing housing correction might indeed prove larger than originally anticipated with possible spillovers into the consumer spending area.

And in addition, you made remarks that the recent rabid expansion of the subprime market was clearly accompanied by deterioration underwriting standards, and in some cases, by abusive lending practices and outright fraud. And while we all agree that promoting access, as you have noted, to credit and to homeownership are important objectives, we do, in my opinion, need to do something more concrete, not only going forward. And I appreciate that I know you worked with some other Federal supervisory agencies to issue a principles-based guidance and nontraditional mortgage regulation, and that in June, you issued a supervisory guidance on subprime lending going forward.

But I do want to note that in Massachusetts, this is just one example that I throw out there, Governor Deval Patrick instituted a moratorium working with mortgage lenders in Massachusetts, instituted a moratorium on foreclosures and a coordinated workout process for some of those folks that were harmed because of the, as you have noted, abusive lending practices and in some cases outright fraud.

And I was wondering, is there anything—it is sort of a two-part question. One, are we doing anything going forward more significantly and more specific than described in your general guidance, and are we looking at all at possibilities working—I know you are working with the States—are we looking at any ways to maybe hold those people harmless or to mitigate the damage that might have been done because of abusive lending practices or that fraud?

Mr. BERNANKE. Well, in terms of workouts, our supervisory letter emphasized to the banks and other lenders that we encourage them to look for loan modifications. Foreclosure involves a considerable financial loss to the lender as well as to the borrower. In many cases, it is economically beneficial to both sides to try a loan modification, and we encourage firms to do that. We have also been looking at whether there have been some artificial barriers to doing modifications.

For example, we have looked at some of the accounting rules that may serve effectively to make it more difficult to do modifications. We have also looked at some of the legal agreements involved in the securitization of mortgages, the pooled service agreements. So I think there are ways to facilitate this modification process by looking at some of the legal and accounting barriers that stand in the way. I think one thing that we should be a little careful about is not rewarding lenders for making bad loans. We don't want to get into a bail-out where lenders who have made bad loans find themselves essentially getting paid off.

So, what we need to do is work with borrowers to try to get these loans changed. A couple of things that we have observed, in many conversations with the industry, with consumer groups, and the like, is, first, one of the most basic things that a borrower can do is to call their lender since lenders often find that the borrower will not get in touch with them until they are well into the delinquency situation. If you see your rate about to reset several hundred basis points in the next 6 months, and you think that is going to be a serious problem, then you probably should talk to your lender in advance to get more time to work that out. The other thing is that, unfortunately, lenders are very reluctant to do sort of mass restructuring. It is a very labor intensive, loan-by-loan kind of process, and we don't really see a way around that, except to try to provide support, encouragement, counseling and the like, to facilitate this process.

Mr. LYNCH. Lastly, turning to another issue. We talked a lot this morning about the deplorable savings rate here in the United States. And from our own example here in the Congress, we have a Thrift Savings Plan where there is a match. I know a lot of employers have incentivized savings among employees. Is there not some model out there that we could use to expand that across the Nation to incentivize people to save with that match maybe? Certainly it is doable. I think if we created incentives for employers in the Tax Code, treated them more favorably if they set up these matched savings plans within their companies, I think that we could do great things for the United States and reduce our reliance on foreign investment and reduce our foreign borrowing. We could do a lot more for our citizens if we just induced that behavior. I am wondering if you had any thoughts on that? I yield back.

Mr. BERNANKE. Just a couple. The pension bill that was passed by Congress recently had a provision that allows employers to create savings plans with an opt-out provision. That is, the employee is put into the savings plan unless they explicitly request to be let out. There is a lot of research which suggests that with that opt-out approach, most people will stay in the saving plan, and you actually get very significant effects that way. I have a couple of other thoughts. First, one might consider using the existing Social Security system. There was a big debate here in Congress about carveout accounts. Something that might be less controversial, possibly, would be an add-on account, whereby individuals had a chance through their payroll taxes to contribute to an independent account that would be in their name.

Finally, I think it is probably worth taking a look at the long list of savings programs and incentives that now exist in our Tax Code and in our government policy. They are quite confusing and sometimes somewhat contradictory, so there might be some benefits to simplifying our savings programs in a way that people can understand better and provide more explicit incentives for saving. While I think there are some things to do, the truth is, we have never found the magic bullet to induce the public to save a good deal more.

The CHAIRMAN. The gentleman from New York.

Mr. MEEKS. Thank you Mr. Chairman. Chairman Bernanke, thank you. I first want to make sure that I associate myself with many of the comments of my colleagues, a concern about the growing disparities that are taking place here between those who have and have not and the middle class and the pains that they are feeling. And as a result, folks are trying to figure out what is the best way to do it. Some have suggested that maybe we should take a pause in pursuing trade and investment legalization with some of our trading partners. So my first question, I am going to go in two areas, and this area is, would there be any economic benefits or losses to the United States if, in fact, we did take a short pause in pursuing trade legalization and investment with some of our trading partners?

Mr. BERNANKE. I think it would be very costly economically to do that, both because there are many benefits to expanding trade investment and because if you interfered with existing trade investment relationships, that could be very disruptive. The main concern about trade is that, even if it provides general benefits to the economy, there are some people who are worse off because their company or their plant shuts down because of foreign competition. I think a better approach, rather than blocking trade, would be to try to assist those who are displaced to find new work, to get retraining—and this could apply to communities as well as individuals—to help them overcome the problems created by this dynamic change in the economy. So that would be my preferred approach, rather than just shutting down what has been for the economy, as a whole, a very beneficial direction.

Mr. MEEKS. I heard the gentleman talk earlier about the trade assistance program currently; as we know, it doesn't work, and it hasn't been working. So I think that to the degree that we could use all of the mires as possible to come up with something that does, in fact, work. That is clearly what we have in place now. And it goes even bigger in trade, I think, because also people are losing jobs because of efficiency and technology.

In fact, we probably lose a lot of jobs in regards to the technology that is being created today, and so we need something for the displacement of all workers. And what we have today is not working, and we have to figure out something better. Otherwise the anxiety that individuals have will roll over to trying to do something that could be what you described, a disastrous situation. That is why I think we need to all focus on all levels in that regard. My other question in that particular area is foreign investment in the United States. It seems that it is growing. And my question to you is, do you think that it will continue to grow and how important is foreign direct investment for the United States economy?

Mr. BERNANKE. It will continue to grow. We have, as you know, a very large current account deficit, which means that our investment here in the United States greatly exceeds our own saving, so we are borrowing a great deal of money from foreigners. A lot of that borrowing is taking the form so far of selling treasury bills and other kinds of fixed income instruments. But in the future, I think it is quite likely that we will see more and more foreign direct investment coming from abroad. Generally speaking, I think foreign direct investment (FDI) is positive for the economy. We are already the major recipient, the largest recipient in FDI in the world. Transplants that come, like the automobile transplants, provide jobs, they bring new technologies, and they bring managerial talent. There are also investments that don't move quickly in a financial sense. There are permanent kinds of investments. So I think they are beneficial. The Congress has recently, of course, just revised the CFIUS program to address whatever issues there may be of national security. It is really up to Congress to make sure you are satisfied with the provisions to ensure that acquisition of U.S. assets by foreigners doesn't interfere in any way with national security.

But putting aside that issue, I think there is a substantial benefit to be had by having foreigners invest in our country, provide jobs here, provide capital, and provide technology for the United States.

Mr. MEEKS. Let me go into another area. I only have time for one question, although I have many. With what is now becoming known in issues of managed funds, hedge funds, private equity, my question is related to, for example, the collapse of the long-term capital management where there was this concern about how exposed the banking system was to LTCM. And so my question is, do you feel that currently we have adequate regulatory safeguards in place to make certain that say, for example, the collapse of a few major hedge funds won't create a systematic risk for all of the banking industry? Do we have enough in place currently?

Mr. BERNANKE. Well, you can never be too careful. We always have to keep alert and on top of the situation. But the President's Working Group on Financial Markets recently issued a set of principles which argues that the best way to discipline hedge funds and other pools of capital is through market discipline.

What that means is that it is incumbent on the investors and on the counterparties and the creditors who work with those hedge funds to assure themselves that the risks, the leverage associated with the funds, is not excessive. From the supervisor's or the regulator's point of view, it is our job to make sure that the investment banks who are dealing with the hedge funds are in fact managing their risks adequately and are getting sufficient information to protect themselves in case there are problems in a hedge fund. So, I think that is the right approach. It is not a laissez-faire approach. It does require that the supervisors and the regulators to look very carefully to make sure that the banks and investment banks are doing due diligence in their dealings with these pools of capital. But it seems to be the best approach that preserves financial stability while allowing these pools of capital to perform the positive functions that they perform in the economy.

The CHAIRMAN. Thank you. Let me just take 10 seconds. I appreciate the answer, Mr. Chairman. It just occurred to me—it is one of the questions that we ask. Are all the counterparties subject to some regulation? That would be the question.

Mr. BERNANKE. Not private investors.

The CHAIRMAN. And should there then be something—I mean, if the main protection is to ensure that the counterparties, etc., are under the supervision, is there a problem with unsupervised counterparties? Do they reach a level where that could be a problem?

Mr. BERNANKE. Well, it is less a question of making sure the hedge funds don't fail. I mean, some of them are going to fail and that is not necessarily a bad thing. It is a question of making sure that the major institutions are secure in case there are problems.

The CHAIRMAN. The gentlewoman from California.

Ms. WATERS. Thank you Mr. Chairman. I would like to thank you again for holding this hearing. And I would like to thank you for all of the work that you have put into getting the Chairman over here today to make sure that we honor the work of Gus Hawkins, my predecessor. He is responsible basically for, as was described, the 30th year of semiannual testimony on the economy and monetary policy by the Federal Reserve. The Humphrey-Hawkins Act was basically established by him. And the goals, as I understand it, that had been established a year before Humphrey-Hawkins is what Mr. Hawkins focused on and that should be a part of these semiannual hearings.

So thank you for recognizing that in your testimony. And let me just say that I have been very pleased about some of the speeches that you have made and the focus that you have placed on income equality. I would like to note that you certainly have been talking about this issue. I really want to cover several things today. I found myself feeling a little bit uncomfortable because as we talk about income equality, and we all know and feel that something is going on here, and that the gap is growing, what I don't find is any real steps or answers to deal with it. I was talking with my colleagues here a little bit earlier about the ways in which the income of the average person is just going out the window. We have all this new technology, as well as new products in our lives with incredible fees. What an average family is paying for telephone service now probably has been quadrupled based on the home had one telephone with an extension. Now everybody has a cell phone and you have to pay Internet charges. You have late fees; and you have to pay all these extraordinary banking fees if you don't use a teller; and on and on and on. But I hear no discussion of these issues. And someone brought up even the amount of money that we are paying for health care, etc. You continue to talk about it in a traditional way and you talk about the increased costs of energy and food. But what about all of the new expenditures that the average family is confronted with today? I want you to talk about that.

Second, on subprime mortgages, why is it that it has taken so long to know what was happening, and so many people have been hurt? Even the answers that you are giving us such as disclosure are not adequate. And then you are talking about going back and taking a look at prepayment penalties, the use of escrow accounts for taxes and insurance, stated income, and low documentation and no documentation loans. The advocacy groups have been talking about this for years now.

Why has it taken us so long to be of any real assistance to the average citizen out there? It is not enough, I think, to just talk about disclosure. First of all, why did it take us so long to find out what was going on in the subprime market? And why can't you just come forward and say that there really should never be any no documentation loans? Why not even take a look at interest only loans and the resetting of the loans? Those are some problems that it shouldn't take us another 2 years while people continue to be hurt. Why can't we speed up the process and know in advance about these trends and at the time that these practices are being put into play, why can't we know sooner than later? With that, I would just give you an opportunity to comment on it.

Mr. BERNANKE. Well, on the first part of your comments, there are many issues that affect a consumer's budget: energy; health care; a whole variety of items. Each one of these things is a big and complex problem. There is not a single solution. We are just going to have to address them piece by piece. So we talked about energy, we talked about health care, we talked about other aspects of the cost of living. Let me turn, though, to your very good question about subprime.

First, there always have been some concerns about these practices; you are correct about that. But there was a period that lasted perhaps less than a year—late 2005, early 2006—when there was just a tremendous sea change, a deterioration in underwriting and its standards. That came about because of the confluence of a number of different events, including this huge demand for high-yield mortgage securities from Wall Street, the expansion of lenders outside the banking system where they are closely regulated, financial innovation, new kinds of products. An important factor was the fact that with high house prices, people were stretching for affordability. All those things came together at the same time and underwriting standards really deteriorated pretty quickly.

And we have seen that of mortgages written in 2006, with many of them the first payment doesn't get made; they get returned within a few months. So, something seems to have changed in late 2005 and early 2006. We were very active early on in providing guidance on best practices, on doing disclosure work, on doing fair lending reviews and so on. But it is clear, having seen some of these recent developments and asking my staff to do a top-to-bottom review, it does seem clear we need to take additional steps, which I have talked about today, and they include not just disclosure, but the rules.

And among the rules we are considering are addressing low doc loans, escrow, some of these other prepayment penalties, and some of these other things you have mentioned. Some of these things have already appeared in our subprime mortgage guidance, which a lot of the States have adopted for their own, so a lot of these things are going to be put in place more quickly. But in terms of the rulemaking process, there are obviously some procedural steps that we have to take. We have to go through a full process of getting commentary and the like, and we can't go faster than that.

Ms. WATERS. Do you have any suggestions for legislation for us? We would move it a little bit faster if we understood it a little bit better and knew what to do.

Mr. BERNANKE. I would be happy to talk about you about it, Congresswoman. There are a number of different bills that have already been introduced, as you know, with many different aspects. I mentioned earlier the point about a national registration of mortgage lenders that are not bank lenders. You could, of course, if you wished, achieve some of the rules that we are trying to do through the rulemaking process more quickly, potentially through legislation. A very, very tough issue is the enforcement issue, because most of the lenders outside of the banking system are State-licensed. Some of the States are very good at enforcement, others have less resources. The question is what to do about that.

Our approach has been to work more closely with the States and hope that we can get everybody working effectively together. So that is another question that you might want to be thinking about.

The CHAIRMAN. Thank you. One of the things you just said was one of the causes of this phenomenon was we are only looking for a high yield. It was sort of an interesting thing where the need for the high yield created a product. I mean, it goes counter to being told, oh, we needed to do this to meet the housing need. There is almost a perversion of what ought to be the way the system works.

Mr. BERNANKE. That is how markets work. People look for profit opportunities.

The CHAIRMAN. Right. But when that leads to the creation of—it undercuts the justification. The argument has been, oh, no, this is just a response to the demand for housing. And you are now talking about a somewhat different approach, which doesn't mean you do away with it all together, but it affects how we deal with it if there is sort of an artificiality in the product driven by the demand. The gentleman from North Carolina.

Mr. MILLER OF NORTH CAROLINA. Thank you, Chairman Bernanke. There have been several members who have asked about income inequality. Mr. Hodes asked a series of questions that were very like the questions I have asked of you in your previous appearances before this committee. You said that in the last 5 years the middle quintile of American families, in answer to Mr. Hodes, had increased, I think, real income had increased by 5 percent, is that right?

Mr. BERNANKE. The data I have is, I believe, if I recollect it correctly is the middle quintile of families with children.

Mr. MILLER OF NORTH CAROLINA. Right. The middlest class.

Mr. BERNANKE. So of the five quintiles, the one in the middle.

Mr. MILLER OF NORTH CAROLINA. The middlest.

Mr. BERNANKE. Yes.

Mr. MILLER OF NORTH CAROLINA. Now, Mr. Castle asked you questions about core inflation versus total inflation. Are you backing out of income growth core inflation or total inflation?

Mr. BERNANKE. Total inflation.

Mr. MILLER OF NORTH CAROLINA. The information that I have is that from November of 2001 until May of 2007, the wages of production workers, which is about 80 percent all workers, had increased 17.28 percent and total inflation had increased 17.22 percent, which is barely treading water. Is that an incorrect number?

Mr. BERNANKE. That could be correct. I don't know the exact number. But the real wages have not grown very much in the last 5 or 6 years, that is true.

Mr. MILLER OF NORTH CAROLINA. Okay. That is total inflation?

Mr. BERNANKE. Yes.

Mr. MILLER OF NORTH CAROLINA. What are you backing out?

Mr. BERNANKE. If you have multiple family workers, for example, who change the number of hours they work, or if they have investment income of some kind.

Mr. MILLER OF NORTH CAROLINA. What are you backing out this inflation rate?

Mr. BERNANKE. I am totaling the CPI inflation rate.

Mr. MILLER OF NORTH CAROLINA. Then I am looking at very different numbers.

The CHAIRMAN. Will the gentleman yield? You are talking about wages?

Mr. BERNANKE. I am talking about income.

The CHAIRMAN. So if a second member of the family goes to work, it is going up. I think that is the explanation?

Mr. MILLER OF NORTH CAROLINA. That may be the explanation then. But income wages are not keeping up with inflation or barely keeping up.

Mr. BERNANKE. That is true.

Mr. MILLER OF NORTH CAROLINA. In your discussion with Mr. Castle, and in your testimony, you gave the explanation for why core inflation doesn't really include energy costs and food costs because traditionally those are the most volatile costs and that you would see more fluctuation than you would long-term trend. Is that generally the explanation for not including energy costs and food costs?

Mr. BERNANKE. Again, it is not that we don't care about it. We drive, we eat, we understand that inflation involves all prices, not just those that are not volatile. But the nature of monetary policy is, if we want to address inflation, there is nothing we can do today that is going to affect today's oil price. We have to affect inflation over a period of 1 to 2 years, and therefore we have to ask ourselves where is inflation going.

Mr. MILLER OF NORTH CAROLINA. But my question is, do you really believe the increases we have seen in energy costs is simply a fluctuation and not long-term? Aren't the pressures that have pushed gasoline prices to $3 a gallon or more at the pump a long-term here to stay, the permit, not a fluctuation? Don't you really believe—and in your testimony, you gave the reason for the increase in food costs as being the cost of grains because grains are now being used for fuel production. Isn't that permit, is that really a fluctuation?

Mr. BERNANKE. The best guess is that food and energy prices, or at least energy prices, will stay high. The question, though, is whether they will keep rising at the pace that they have been rising. As best we can tell, as best as futures markets suggest, while they may remain high, they will not continue to rise at the same pace. Now, that is a very uncertain judgment. I discussed in my testimony that this is one of the risks that we are examining. One of the things that could happen to make inflation more of a problem would be if energy prices in fact did continue to rise at the pace they have in recent years.

Mr. MILLER OF NORTH CAROLINA. I have more questions, but I want to move on to subprime lending. Many people have asked about subprime lending. When I have asked in the past about subprime lending, it has been a pretty lonely effort. The concerns about subprime lending are not new for many of us. I introduced a predatory mortgage lending bill 4 years ago, 4½ years ago, when I first came to Congress, and I dearly wish that Congress had enacted that legislation because we would not have seen the spike, the disastrous spike in foreclosure rates and the default rates that we have. There has been more discussion in the press about the spike in foreclosures in the subprime market has affected the stability, what it has done to hedge funds that hold portfolios than there has to how it affects the families who have lost their homes.

You have talked some about the importance of homeownership, equity in homes, to the wealth of no class families. The information I have: there were about 900,000 residential foreclosures in 2005; 1.2 million foreclosures last year; and there will be 1.5 million foreclosures this year. As you have said, based upon the change in underwriting last year, it is going to explode the year after that and the year after that. What is that doing to the wealth, to the life savings of families who are now facing foreclosure?

Mr. BERNANKE. We have numbers which are a bit lower than yours, but I agree that the number is high and rising. It depends very much on individual circumstances. Frankly there are a few cases of investors who just walked away from a condo which they no longer thought was worth holding onto. But there are cases also of families who have refinanced, taken equity out of their home and now, given the situation, they will lose their home and some of the accumulated equity.

Certainly, for some families, there is going to be an adverse financial impact. There is also a concern, which I am very aware of, that there are certain communities in neighborhoods where if you have a lot of foreclosures within a square mile, the values of the other homes go down and so there is kind of a neighborhood effect as well. So yes, there are implications of this for financial markets because there are significant financial losses. But there are obviously also very important implications for household wealth building and for communities.

Mr. MILLER OF NORTH CAROLINA. The adverse financial consequence you refer to for a middle-class family who loses their home to foreclosure, they fall out of the middle class and into poverty and probably will never climb out for the rest of their lives.

The CHAIRMAN. I thank the members and I thank the Chairman. This has been very useful for us. I appreciate the endurance of Chairman Bernanke, and we will continue all of these conversations at a later date.

[Whereupon, at 1:00 p.m., the hearing was adjourned.]

A P P E N D I X

July 18, 2007

Statement of Congressman Kenny Marchant
July 18, 2007
Financial Services Committee hearing to receive the testimony of the Chairman of the Federal Reserve Board of Governors on monetary policy and the state of the economy

Chairman Bernanke thank you for testifying before our Committee today. In my opening statement today I'd like to focus on two very different but very familiar topics that have caused a lot of problems for this country: illegal immigration and our economic relationship with China.

There is no country in the world that has the number of illegal immigrants that we have here in the United States. We currently have an estimated illegal immigrant population of between 12 and 20 million people in this country. Now I know there is no way that the labor statistics that the Federal government puts out can account for all these illegal immigrant workers. However I am curious as to your view on what effect an illegal immigrant population of this size has on "real" unemployment in this country.

In addition, I'd like to hear your views, Mr. Chairman, on the historical uniqueness of our current economic relationship with China. By this I mean that we currently have a communist foreign country that is manipulating the currency market to our detriment, buying up our debt and meanwhile doing IPOs in New York City to raise money for their nationalized companies. I am curious as to your views the impact these combination of factors have on our economy as a whole and what we can do about it.

Thank you for your time Chairman Bernanke and I look forward to your testimony.

Committee on Financial Services
Office of Rep. Tom Price
Full Committee Oversight Hearing: Monetary Policy
July 18, 2007

In this Committee we have often had the chance to talk about some of the factors negatively impacting our Nation's global competitiveness – excessive securities litigation and overly burdensome regulation – both of which are forcing capital and companies offshore. But there is another factor having negative consequences - exorbantly high corporate tax rates.

This directly affects our global competitiveness – a subject on which this Committee has been far too silent this year. While it has certainly demonstrated the majority's desire to put the government back in the housing business – passing 10 housing bills in the first six months; it has done little to nothing to reduce regulation or prevent frivolous securities lawsuits, both of which continue to force capital offshore – costing Americans jobs.

Recently, the German government moved to approve an 8.9 percentage point reduction in their corporate income tax rate. This follows a trend in which 25 industrialized nations have adopted pro-growth, Reagan-style corporate income tax rates since 2001. Unfortunately, the United States isn't one of those countries.

Vietnam has announced it will cut its corporate rate to 25% from 28%. Singapore has approved a corporate tax reduction to 18% from 20% so that they may better compete with Hong Kong with a rate of 17.5%. Even France's new President, Nicolas Sarkozy, has proposed reducing the corporate tax rate to 25% from its current level of 34.4%.

By way of contrast, the corporate income tax rate in the United States has been frozen at 39.3% (35% federal plus a state average of 4.3%) – which is the highest in the developed world according to the Tax Foundation. To engage in these policies that hinder our global competitiveness is to force us to compete with one arm tied behind our back. The American people deserve a fair and level playing field.

Democrats, since the election last November, have made so many spending promises that they are must continue to find creative new ways to increase the money flowing to the federal coffers by taxing the profits of private equity companies and hedge funds at a much higher rate. The cost of which will be innovation, risk taking and American prosperity. We should not be in the business of penalizing success.

Clearly other industrialized countries have learned a lesson that Former Fed Chairman Greenspan was fond of saying – if you tax something, you will get less of it. That is the case whether you're talking about increasing corporate income tax or completely changing the way you tax pools of private equity. The net effect will be the same – capital will flee our shores for Europe and Asia.

I would like to hear your thoughts on positive benefits that our economy might see if the Congress reduces the 35% U.S. federal corporate tax rate to the industrial nation average of 29%; additionally, you might get his thoughts on the negative consequences to our global competitiveness that would result from taxing the profits of private equity companies at the corporate tax rate rather then as it has been done traditionally the capital gains rate of 15%.

The second item I'd like to focus on is our national savings rate, which is very important because of what President Clinton called the "looming crisis" we're facing with Social Security. But since then we've seen little to no action to secure the future of our retirees.

We are quickly reaching the breaking point. Social Security costs will begin to sharply rise after 2008 – next year -- when the first baby boomers have turned 62 and begin to collect Social Security retirement benefits.

Social Security costs will nearly double from $652 billion in 2009 to over $1.1 trillion by 2017. Social Security cash surpluses will begin to decline beginning in 2010. Starting in 2017, Social Security tax revenues will fall short of benefits. It seems that the only thing greeting our retirees will be frustration and heartache rather then a secure retirement.

From 2009-2017 the number of retirees receiving Social Security will grow by 24.5 percent, the number of workers by only 4.8 percent. In other words, the number of retirees will grow more than five times faster than the worker population. A system created in 1935 with only minor changes over the years is not capable of keeping up with today's dynamic workforce and changing demographics.

Chairman Bernanke, I bring this up because I am concerned with our national savings rate. According to the Bureau of Economic Analysis at the U.S. Department of Commerce - in 2004, it was 2.0 percent, in 2005 it was -0.4 percent, and in 2006 it was -1.0.

So at a time when baby boomers, and younger Americans, need to be saving more and more money for their retirement – because clearly they can not rely solely of social security – they aren't. We must find ways to encourage Americans to save more then they earn then they consume.

A national consumption tax, or FairTax, would provide some common sense to the current mess. The FairTax would allow individuals to keep all of their hard earned pay check to use as they see fit. It would incentivize investment, spur economic growth, and provide tax prebates to those who need them.

What do you think that we can do to increase the national savings rate, including the possibility of transitioning to a consumption or retail tax system?

REMARKS OF THE HON. ADAM H. PUTNAM

FINANCIAL SERVICES COMMITTEE HEARING on
MONETARY POLICY AND THE STATE OF THE ECONOMY

WITNESS: Ben Bernanke, Chairman of the Federal Reserve Board

July 18, 2007

Mr. Chairman, Ranking Member Bachus, I am pleased to join both of you and my colleagues today to hear testimony regarding monetary policy and the state of our economy. I welcome back Chairman Bernanke, and look forward to his testimony.

We have a responsibility to provide a sound economy for future generations, and it is my belief that the state of the economy is well on its way to doing so. In June alone, 132,000 new jobs were created – bringing total new job creation to over 2 million in the past 12 months. The United States has added over 8 million jobs since August 2003 – more new jobs than all the other major industrialized countries combined. Our economy has now seen job gains for 46 straight months.

The unemployment rate is now 4.5 percent – close to its lowest reading in six years. Last week, we learned that the federal deficit will be nearly $40 billion lower than originally projected and reach its lowest level since 2002. And just yesterday, the Dow Jones Industrial Average rose above 14,000 and closed at another record high.

Whether it's more new jobs, a lower deficit, or a surging Dow, the benefits of pro-growth policies are clear as day and positive for our economy.

I feel confident about the strength of our economy and the leadership you provide Mr. Chairman. However, I do have concerns about the subprime industry and the rise of loose delinquencies in this segment of the market.

Whether it's to purchase a new home or to refinance an existing mortgage, the subprime market does afford an opportunity for many homebuyers who would not otherwise be able to finance a home. And, it is important to recognize that there are healthy relationships that currently exist between lenders and borrowers in ensuring sound and practical loans. But abusive lending by some irresponsible lenders has worked against the common goal that we share here today of providing more homeownership for hard working families across the nation.

While I do not support a government bail-out, I believe we should be vigilant in trying to prevent further subprime lender bankruptcy or mortgage foreclosures. In my home state of Florida, we posted one of the highest foreclosure rates in the nation in May and June. And in late June, the Mortgage Bankers Association reported that one of every 23 mortgages in Florida was delinquent by the end of the first quarter – clearly not good news for Florida's families, communities, or economy.

I applaud the Federal Reserve's recent efforts to create standards that encourage fair and affordable mortgages for those that need the extra assistance, while recognizing that such loans should only by made when it is clear that the borrower can afford to repay it. The effort by Federal bank regulators to set tougher standards for higher-cost adjustable rate subprime mortgages is definitely a giant step in the right direction.

Again, I welcome Chairman Bernanke and thank him for his commitment to keeping our economy strong. I look forward to hearing his comments.

OPENING REMARKS of the HONORABLE MAXINE WATERS D-CA 35th

COMMITTEE ON FINANCIAL SERVICES

HEARING TO RECEIVE TESTIMONY of CHAIRMAN, BEN BERNANKE,

OF THE FEDERAL RESERVE BOARD OF GOVERNORS

WEDNESDAY, JULY 18, 2007

Good morning. Ladies and gentlemen. I would like to join Chairman Frank and Ranking Member Bachus in welcoming Chairman Ben Bernanke of the Federal Reserve Board of Governors. Mr. Bernanke it has been more than a year since you joined the Fed and your willingness to work closely with the Members of the Committee on Financial Services is appreciated. As you know, I will host you in my

35^{th} Congressional District of CA as soon as our schedules permit.

The Committee held a hearing just yesterday on "Monetary Policy and the State of the U.S. Economy", which I found fascinating because of the discussion I had with you when you appeared before the Committee in February 2007. That is, the issue of income inequality was raised in our witnesses' testimony. You have raised the bar with you outspoken views on this subject. The witnesses testified that there is clearly a link between monetary policy and income inequality, and that the Fed, if it chooses, has the tools to meet the Humphrey-Hawkins goals of combating inflation and achieving full employment.

When you appeared before the Committee in February 2007 to present the Fed's Monetary Policy report to the Committee, you identified three "predominant" issues that you felt could influence the economy—inflation risks, a housing market correction, and oil prices. While there is not been a great deal of volatility in oil prices as some predicted, the U.S housing market has slowed considerably and the subprime crisis has led to bankruptcies among subprime lenders as well as a major default of Bear Stearns' hedge funds. The subprime crisis is far from over with many Adjustable Rate Mortgages (ARMs) scheduled to set this year and next year. I am not sure whether the subprime crisis will cause additional volatility in worldwide financial markets, but on more than one occasion subprime defaults have sent shock waves through these markets, and will likely affect U.S financial markets.

I also noticed just yesterday the Fed has joined other federal regulators and states to conduct targeted consumer protection compliance reviews of selected non-depository lenders with significant subprime mortgage operations, including their associated mortgage brokers. However, this activity will not begin until the fourth quarter of this year.

Chairman Bernanke, you were undoubtedly correct in identifying the issues that would impact the U.S. economy moving forward. And we are now entering what could be the beginning stages of a major slowdown in the U.S. economy because housing is no longer robust, oil prices are likely to increase, and the Fed continues to keep inflation at bay. Something has to give, and maybe it is the end of the ride for this economic growth cycle.

It has been nearly six years since the expansion began in November 2001, and working Americans are still waiting for their share of the incredible wealth being amassed through private equity and hedge funds. According to some reports, "the economy is showing remarkable parallels to the situation of a decade ago." The first five years of the expansion in the 1990s brought with it record corporate profits, a robust stock market, and increased wealth for the very few. That expansion would ultimately last for ten years. On the other hand wage increases have been flat for the American worker. Monetary policy has contributed to prosperity in the financial markets—private equity and hedge funds have shown incredible growth. So could it be time to alter the course of monetary policy to lead to a rise in wages for the American worker as well as increased employment consistent with the goal of Humphrey-Hawkins.

These trends related to wealth tell us a lot about why there is growing income inequality in the U.S. I am afraid that if the economy turns in the opposite direction from where it has been these last six years, income inequality will increase. As income inequality grows, we will see more people slip into poverty, while unemployment will add to the economic woes of the already strapped American working family. Unfortunately, the U.S. poverty rate already stands at approximately 12.6 percent, representing 37 million people who are counted as poor. In addition, unemployment is extremely high in many communities affected by the loss of manufacturing jobs. Some of the unemployment is intractable, and many of the unemployed will remain unemployed for years rather than for months.

As Chairman now for more than one year, what can you tell us about the role of the Federal Reserve in addressing these problems? Is it just a matter of monetary policy and the need to control inflation, or can the Fed in a meaningful step in to help fix the problems that we are facing in the US -- poverty and income inequality? What will we experience when the expansion ends and growth slows? Once again, I am pleased to be able to hear your views related to the Fed's Semi-Annual Monetary Policy report and our nation's economy, particularly as they relate to the neglected segments of the population --- those living in poverty, the unemployed and underemployed. Thank you.

For release on delivery
10:00 a.m. EDT
July 18, 2007

Statement of

Ben S. Bernanke

Chairman

Board of Governors of the Federal Reserve System

before the

Committee on Financial Services

U.S. House of Representatives

July 18, 2007

Chairman Frank, Ranking Member Bachus, and members of the Committee, I am pleased to present the Federal Reserve's Monetary Policy Report to the Congress. As you know, this occasion marks the thirtieth year of semiannual testimony on the economy and monetary policy by the Federal Reserve. In establishing these hearings, the Congress proved prescient in anticipating the worldwide trend toward greater transparency and accountability of central banks in the making of monetary policy. Over the years, these testimonies and the associated reports have proved an invaluable vehicle for the Federal Reserve's communication with the public about monetary policy, even as they have served to enhance the Federal Reserve's accountability for achieving the dual objectives of maximum employment and price stability set for it by the Congress. I take this opportunity to reiterate the Federal Reserve's strong support of the dual mandate; in pursuing maximum employment and price stability, monetary policy makes its greatest possible contribution to the general economic welfare.

Let me now review the current economic situation and the outlook, beginning with developments in the real economy and the situation regarding inflation before turning to monetary policy. I will conclude with comments on issues related to lending to households and consumer protection--topics not normally addressed in monetary policy testimony but, in light of recent developments, deserving of our attention today.

After having run at an above-trend rate earlier in the current economic recovery, U.S. economic growth has proceeded during the past year at a pace more consistent with sustainable expansion. Despite the downshift in growth, the demand for labor has remained solid, with more than 850,000 jobs having been added to payrolls thus far in 2007 and the unemployment rate having remained at 4-1/2 percent. The combination of moderate gains in output and solid advances in employment implies that recent increases in labor productivity have been modest by the standards of the past decade. The cooling of productivity growth in recent quarters is likely the result of cyclical or other temporary factors, but the underlying pace of productivity gains may also have slowed somewhat.

To a considerable degree, the slower pace of economic growth in recent quarters reflects the ongoing adjustment in the housing sector. Over the past year, home sales and construction have slowed substantially and house prices have decelerated. Although a leveling-off of home sales in the second half of 2006 suggested some tentative stabilization of housing demand, sales have softened further this year, leading the number of unsold new homes in builders' inventories to rise further relative to the pace of new home sales. Accordingly, construction of new homes has sunk further, with starts of new single-family houses thus far this year running 10 percent below the pace in the second half of last year.

The pace of home sales seems likely to remain sluggish for a time, partly as a result of some tightening in lending standards and the recent increase in mortgage interest rates. Sales should ultimately be supported by growth in income and employment as well as by mortgage rates that--despite the recent increase--remain fairly low relative to historical norms. However, even if demand stabilizes as we expect, the pace of construction will probably fall somewhat further as builders work down stocks of unsold new homes. Thus, declines in residential construction will likely continue to weigh on economic growth over coming quarters, although the magnitude of the drag on growth should diminish over time.

Real consumption expenditures appear to have slowed last quarter, following two quarters of rapid expansion. Consumption outlays are likely to continue growing at a moderate pace, aided by a strong labor market. Employment should continue to expand, though possibly at a somewhat slower pace than in recent years as a result of the recent moderation in the growth of output and ongoing demographic shifts that are expected to lead to a gradual decline in labor force participation. Real compensation appears to have risen over the past year, and barring further sharp increases in consumer energy costs, it should rise further as labor demand remains strong and productivity increases.

In the business sector, investment in equipment and software showed a modest gain in the first quarter. A similar outcome is likely for the second quarter, as weakness in the volatile transportation equipment category appears to have been offset by solid gains in other categories. Investment in nonresidential structures, after slowing sharply late last year, seems to have grown fairly vigorously in the first half of 2007. Like consumption spending, business fixed investment overall seems poised to rise at a moderate pace, bolstered by gains in sales and generally favorable financial conditions. Late last year and early this year, motor vehicle manufacturers and firms in several other industries found themselves with elevated inventories, which led them to reduce production to better align inventories with sales. Excess inventories now appear to have been substantially eliminated and should not prove a further restraint on growth.

The global economy continues to be strong. Supported by solid economic growth abroad, U.S. exports should expand further in coming quarters. Nonetheless, our trade deficit--which was about 5-1/4 percent of nominal gross domestic product (GDP) in the first quarter--is likely to remain high.

For the most part, financial markets have remained supportive of economic growth. However, conditions in the subprime mortgage sector have deteriorated significantly, reflecting mounting delinquency rates on adjustable-rate loans. In recent weeks, we have also seen increased concerns among investors about credit risk on some other types of financial instruments. Credit spreads on lower-quality corporate debt have widened somewhat, and terms for some leveraged business loans have tightened. Even after their recent rise, however, credit spreads remain near the low end of their historical ranges, and financing activity in the bond and business loan markets has remained fairly brisk.

Overall, the U.S. economy appears likely to expand at a moderate pace over the second half of 2007, with growth then strengthening a bit in 2008 to a rate close to the economy's underlying trend. Such an assessment was made around the time of the June meeting of the Federal Open Market Committee (FOMC) by the members of the Board of Governors and the presidents of the Reserve Banks, all of whom participate in deliberations on monetary policy. The central tendency of the growth forecasts, which are conditioned on the assumption of appropriate monetary policy, is for real GDP to expand roughly 2-1/4 to 2-1/2 percent this year and 2-1/2 to 2-3/4 percent in 2008. The forecasted performance for this year is about 1/4 percentage point below that projected in February, the difference being largely the result of weaker-than-expected residential construction activity this year. The unemployment rate is anticipated to edge up to between 4-1/2 and 4-3/4 percent over the balance of this year and about 4-3/4 percent in 2008, a trajectory about the same as the one expected in February.

I turn now to the inflation situation. Sizable increases in food and energy prices have boosted overall inflation and eroded real incomes in recent months--both unwelcome developments. As measured by changes in the price index for personal consumption expenditures (PCE inflation), inflation ran at an annual rate of 4.4 percent over the first five months of this year, a rate that, if maintained, would clearly be inconsistent with the objective of price stability. [1] Because monetary policy works with a lag, however, policymakers must focus on the economic outlook. Food and energy prices tend to be quite volatile, so that, looking forward, core inflation (which excludes food and energy prices) may be a better gauge than overall inflation of underlying inflation trends. Core inflation has moderated slightly over the past few months, with core PCE inflation coming in at an annual rate of about 2 percent so far this year.

Although the most recent readings on core inflation have been favorable, month-to-month movements in inflation are subject to considerable noise, and some of the recent improvement could also be the result of transitory influences. However, with long-term inflation expectations contained, futures prices suggesting that investors expect energy and other commodity prices to flatten out, and pressures in both labor and product markets likely to ease modestly, core inflation should edge a bit lower, on net, over the remainder of this year and next year. The central tendency of FOMC participants' forecasts for core PCE inflation--2 to 2-1/4 percent for 2007 and 1-3/4 to 2 percent in 2008--is unchanged from February. If energy prices level off as currently anticipated, overall inflation should slow to a pace close to that of core inflation in coming quarters.

At each of its four meetings so far this year, the FOMC maintained its target for the federal funds rate at 5-1/4 percent, judging that the existing stance of policy was

[1] Despite the recent surge, total PCE inflation is 2.3 percent over the past twelve months.

likely to be consistent with growth running near trend and inflation staying on a moderating path. As always, in determining the appropriate stance of policy, we will be alert to the possibility that the economy is not evolving in the way we currently judge to be the most likely. One risk to the outlook is that the ongoing housing correction might prove larger than anticipated, with possible spillovers onto consumer spending. Alternatively, consumer spending, which has advanced relatively vigorously, on balance, in recent quarters, might expand more quickly than expected; in that case, economic growth could rebound to a pace above its trend. With the level of resource utilization already elevated, the resulting pressures in labor and product markets could lead to increased inflation over time. Yet another risk is that energy and commodity prices could continue to rise sharply, leading to further increases in headline inflation and, if those costs passed through to the prices of non-energy goods and services, to higher core inflation as well. Moreover, if inflation were to move higher for an extended period and that increase became embedded in longer-term inflation expectations, the re-establishment of price stability would become more difficult and costly to achieve. With the level of resource utilization relatively high and with a sustained moderation in inflation pressures yet to be convincingly demonstrated, the FOMC has consistently stated that upside risks to inflation are its predominant policy concern.

* * *

In addition to its dual mandate to promote maximum employment and price stability, the Federal Reserve has an important responsibility to help protect consumers in financial services transactions. For nearly forty years, the Federal Reserve has been active in implementing, interpreting, and enforcing consumer protection laws. I would like to discuss with you this morning some of our recent initiatives and actions, particularly those related to subprime mortgage lending.

Promoting access to credit and to homeownership are important objectives, and responsible subprime mortgage lending can help advance both goals. In designing regulations, policymakers should seek to preserve those benefits. That said, the recent rapid expansion of the subprime market was clearly accompanied by deterioration in underwriting standards and, in some cases, by abusive lending practices and outright fraud. In addition, some households took on mortgage obligations they could not meet, perhaps in some cases because they did not fully understand the terms. Financial losses have subsequently induced lenders to tighten their underwriting standards. Nevertheless, rising delinquencies and foreclosures are creating personal, economic, and social distress for many homeowners and communities--problems that likely will get worse before they get better.

The Federal Reserve is responding to these difficulties at both the national and the local levels. In coordination with the other federal supervisory agencies, we are encouraging the financial industry to work with borrowers to arrange prudent loan modifications to avoid unnecessary foreclosures. Federal Reserve Banks around the country are cooperating with community and industry groups that work directly with borrowers having trouble meeting their mortgage obligations. We continue to work with organizations that provide counseling about mortgage products to current and potential homeowners. We are also meeting with market participants--including lenders, investors, servicers, and community groups--to discuss their concerns and to gain information about market developments.

We are conducting a top-to-bottom review of possible actions we might take to help prevent recurrence of these problems. First, we are committed to providing more-effective disclosures to help consumers defend against improper lending. Three years ago, the Board began a comprehensive review of Regulation Z, which implements the Truth in Lending Act (TILA). The initial focus of our review was on disclosures related to credit cards and other revolving credit accounts. After conducting extensive consumer testing, we issued a proposal in May that would require credit card issuers to provide clearer and easier-to-understand disclosures to customers. In particular, the new disclosures would highlight applicable rates and fees, particularly penalties that might be imposed. The proposed rules would also require card issuers to provide forty-five days' advance notice of a rate increase or any other change in account terms so that consumers will not be surprised by unexpected charges and will have time to explore alternatives.

We are now engaged in a similar review of the TILA rules for mortgage loans. We began this review last year by holding four public hearings across the country, during which we gathered information on the adequacy of disclosures for mortgages, particularly for nontraditional and adjustable-rate products. As we did with credit card lending, we will conduct extensive consumer testing of proposed disclosures. Because the process of designing and testing disclosures involves many trial runs, especially given today's diverse and sometimes complex credit products, it may take some time to complete our review and propose new disclosures.

However, some other actions can be implemented more quickly. By the end of the year, we will propose changes to TILA rules to address concerns about mortgage loan advertisements and solicitations that may be incomplete or misleading and to require lenders to provide mortgage disclosures more quickly so that consumers can get the information they need when it is most useful to them. We already have improved a disclosure that creditors must provide to every applicant for an adjustable-rate mortgage product to explain better the features and risks of these products, such as "payment shock" and rising loan balances.

We are certainly aware, however, that disclosure alone may not be sufficient to protect consumers. Accordingly, we plan to exercise our authority under the Home Ownership and Equity Protection Act (HOEPA) to address specific practices that are unfair or deceptive. We held a public hearing on June 14 to discuss industry practices, including those pertaining to pre-payment penalties, the use of escrow accounts for taxes and insurance, stated-income and low-documentation lending, and the evaluation of a borrower's ability to repay. The discussion and ideas we heard were extremely useful, and we look forward to receiving additional public comments in coming weeks. Based on the information we are gathering, I expect that the Board will propose additional rules under HOEPA later this year.

In coordination with the other federal supervisory agencies, last year we issued principles-based guidance on nontraditional mortgages, and in June of this year we issued supervisory guidance on subprime lending. These statements emphasize the fundamental consumer protection principles of sound underwriting and effective disclosures. In addition, we reviewed our policies related to the examination of nonbank subsidiaries of bank and financial holding companies for compliance with consumer protection laws and guidance.

As a result of that review and following discussions with the Office of Thrift Supervision, the Federal Trade Commission, and state regulators, as represented by the Conference of State Bank Supervisors and the American Association of Residential Mortgage Regulators, we are launching a cooperative pilot project aimed at expanding consumer protection compliance reviews at selected nondepository lenders with significant subprime mortgage operations. The reviews will begin in the fourth quarter of this year and will include independent state-licensed mortgage lenders, nondepository mortgage lending subsidiaries of bank and thrift holding companies, and mortgage brokers doing business with or serving as agents of these entities. The agencies will collaborate in determining the lessons learned and in seeking ways to better cooperate in ensuring effective and consistent examinations of and improved enforcement for nondepository mortgage lenders. Working together to address jurisdictional issues and to improve information-sharing among agencies, we will seek to prevent abusive and fraudulent lending while ensuring that consumers retain access to beneficial credit.

I believe that the actions I have described today will help address the current problems. The Federal Reserve looks forward to working with the Congress on these important issues.

For use at 10:00 a.m., EDT
Wednesday
July 18, 2007

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

July 18, 2007

Board of Governors of the Federal Reserve System

Monetary Policy Report to the Congress

Submitted pursuant to section 2B of the Federal Reserve Act

July 18, 2007

Letter of Transmittal

BOARD OF GOVERNORS OF THE
FEDERAL RESERVE SYSTEM

Washington, D.C., July 18, 2007

THE PRESIDENT OF THE SENATE
THE SPEAKER OF THE HOUSE OF REPRESENTATIVES

The Board of Governors is pleased to submit its *Monetary Policy Report to the Congress* pursuant to section 2B of the Federal Reserve Act.

Sincerely,

Ben Bernanke, Chairman

Contents

Monetary Policy Report to the Congress

Report submitted to the Congress on July 18, 2007, pursuant to section 2B of the Federal Reserve Act

Monetary Policy and the Economic Outlook

The U.S. economy generally performed well in the first half of 2007. Activity continued to increase moderately, on average, over the period; businesses added jobs at a steady pace; and the unemployment rate remained at 4½ percent. Overall inflation, however, picked up as a result of sizable increases in energy and food prices. At the same time, core inflation (which excludes the direct effects of movements in energy and food prices) held at about the same rate as in 2006; this measure smoothes through some of the volatility in the high-frequency data and thus is generally a better gauge of underlying inflation trends.

Although real gross domestic product appears to have expanded at about the same average rate thus far this year as it did in the second half of 2006, the pace of expansion has been uneven. In the first quarter, consumer expenditures and business fixed investment, taken together, posted a solid gain. However, homebuilding continued to contract, and manufacturing firms adjusted production to address stock imbalances in that sector that had emerged over the course of 2006. In the second quarter, housing activity declined further in response to the continued softness in home sales and still-elevated inventories of unsold new homes; personal consumption expenditures (PCE) also slowed. Even so, the available data point to solid gains overall in other components of final sales, and with manufacturing inventory imbalances significantly reduced, growth in real GDP apparently sped up.

Job growth in the first half of 2007 was driven by sizable increases in service-producing industries. In the goods-producing sector, manufacturing employment contracted, especially at firms closely tied to the construction industry and at producers of motor vehicles and parts. Employment in residential construction, which had turned down in mid-2006, decreased only modestly further over the first half of 2007 despite the substantial decline in homebuilding.

Real hourly compensation increased over the year ending in the first quarter, the most recent period for which complete data are available. In the second quarter, however, gains in real compensation were probably curtailed by a steep, energy-driven rise in consumer prices. Employment continued to rise apace in the first half of 2007 in the face of moderate growth in output. As a consequence, growth in labor productivity—which had slowed in 2006 from the rapid rate observed earlier in the decade—appears to have remained modest. The cooling of productivity growth in recent quarters likely reflects cyclical or other temporary factors, but the underlying pace of productivity gains may also have slowed somewhat.

Financial market conditions have continued to be generally supportive of economic expansion thus far in 2007, though there was a notable repricing in the subprime-mortgage sector. In recent weeks, the deterioration in that sector has been particularly marked, and markets for lower-quality corporate credits have also experienced some strains. Nonetheless, spreads on such corporate credits have remained narrow on the whole, and business borrowing has continued to be fairly brisk. On balance, equity markets posted sizable gains through mid-July, in part because of continued robust corporate profits and an upward revision to investors' outlook for the economy. The improved outlook led market participants to mark up their anticipated path for the federal funds rate, and intermediate- and long-term interest rates rose significantly. The foreign exchange value of the dollar has declined moderately this year as the pace of economic activity abroad has strengthened.

Overall consumer price inflation, as measured by the PCE price index, picked up noticeably in the first half of 2007, largely because of a sharp increase in energy prices. After moving down over the second half of 2006, the prices households pay for energy subsequently turned up and by May were 14 percent (not at an annual rate) above their level at the end of last year. Food prices also contributed to the step-up in overall inflation this year. The faster rate of increase in overall prices has had only a modest effect on inflation expectations: Surveys suggest that near-term inflation expectations have risen somewhat in recent months, but measures of long-term inflation expectations have remained within the range of recent years.

The rate of increase in the core PCE price index ticked down from 2.1 percent over the twelve months of 2006 to an annual rate of 2.0 percent over the first five months of 2007, primarily accounted for by more-favorable readings between March and May. Although higher energy prices this year added to the cost of producing a wide variety of goods and services that are included in the core index, these effects were offset by other factors—most notably, a slowdown in the rate of increase in shelter costs from the very high rates seen in 2006.

The U.S. economy seems likely to continue to expand at a moderate pace in the second half of 2007 and in 2008. The current contraction in residential construction will likely restrain overall activity for a while longer, but as stocks of unsold new homes are brought down to more comfortable levels, that restraint should begin to abate. In addition, the inventory correction that damped activity in the manufacturing sector around the turn of the year appears largely to have run its course. Thus, stock adjustment is unlikely to be a drag on production in coming quarters. Consumer spending should also keep moving up. Employment and real wages are on track to rise further, and, although the difficulties in the subprime-mortgage market have created severe financial problems for some individuals and families, the household sector is in good financial shape overall. Businesses are also continuing to enjoy favorable financial conditions, which, along with a further expansion in business output, should support moderate increases in business investment. The positive outlook for economic activity abroad bodes well for U.S. exports.

Core inflation is expected to moderate a bit further over the next year and a half. Longer-run inflation expectations are contained, pressures on resource utilization should ease slightly in an environment of economic expansion at or just below the rate of increase in the nation's potential to produce, and some of the other factors that boosted inflation in recent years have already receded or seem likely to do so. As noted, increases in shelter costs, which helped push up core inflation in 2006, have slowed appreciably this year. In addition, the paths for the prices of energy and other commodities embedded in futures markets suggest that the impetus to core inflation from these influences should diminish. And although unit labor costs in the nonfarm business sector have been rising, the average markup of prices over unit labor costs is still high by historical standards, an indication that firms could potentially absorb higher costs, at least for a time, through a narrowing of profit margins.

Nonetheless, the possibility that the expected moderation in inflation will fail to materialize remains the predominant risk to the economic outlook. The more-favorable readings on core inflation in recent months partly reflect some factors that seem likely to prove transitory. Moreover, the economy appears to be operating at a high level of resource utilization, which has the potential to sustain inflation pressures. In addition, an upward impetus to costs could emanate from other sources, including higher prices for energy and other commodities or a slower rate of increase in structural productivity. Another concern is that high rates of headline inflation, if prolonged, could cause longer-run inflation expectations to rise and could thus become another factor sustaining inflation pressures.

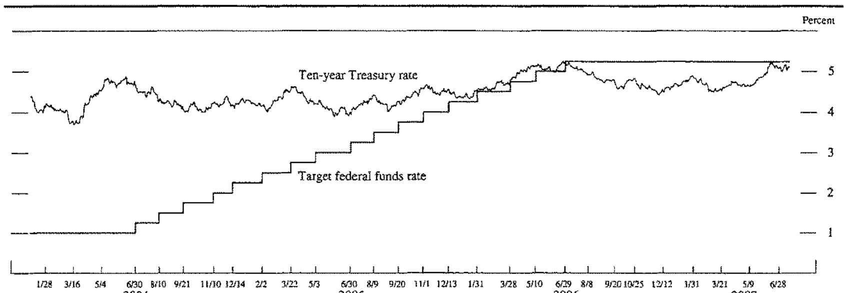
Significant risks also attend the outlook for real economic activity. On the downside, the fall in housing construction could intensify or last longer than expected. In addition, persistent weakness in the housing sector could spill over to other sectors, especially consumption. But upside risks also exist. For example, consumer spending appears to be rising less rapidly of late after a period of large increases that pushed the personal saving rate into negative territory; increases in consumption could return to their earlier pace. Exports could also boost aggregate demand more than anticipated, especially if economic conditions abroad continue to exceed expectations.

The Conduct of Monetary Policy over the First Half of 2007

The Federal Open Market Committee (FOMC) left the stance of monetary policy unchanged over the first half of 2007. At the time of the January meeting, available economic information pointed to a relatively favorable outlook for both economic growth and inflation. While manufacturing activity had softened, the housing sector had shown tentative signs of stabilizing, and consumer spending remained strong. Readings on core inflation had improved some from the elevated levels reached in 2006, and inflation expectations continued to be stable. Nevertheless, the prevailing level of inflation was uncomfortably high, and elevated resource utilization had the potential to sustain inflation pressures. Against this backdrop, the Committee decided to leave its target for the federal funds rate unchanged at 5¼ percent and reiterated in its policy statement that some inflation risks remained. The Committee also explained that the extent and timing of any additional firming would depend on the evolution of the outlook for both inflation and economic growth as implied by incoming information.

When the Committee met in March, data suggested that the ongoing weakness in the housing market had not spilled over to consumption spending, and the strains in the subprime-mortgage market did not appear to be affecting the availability of other types of household or business credit. Although investment spending had been soft, it was expected to pick up, primarily because of strong corporate balance sheets, continued high profitability, and generally favorable financial conditions. Nevertheless, sluggish business spending and the deterioration in the subprime-mortgage market suggested that downside risks to growth had increased. At the same time, readings on core inflation had stayed somewhat elevated, and increases

Selected interest rates, 2004–07



NOTE: The data are daily and extend through July 13, 2007. The ten-year Treasury rate is the constant-maturity yield based on the most actively traded securities. The dates on the horizontal axis are those of FOMC meetings.

SOURCE: Department of the Treasury and the Federal Reserve.

in the prices of energy and non-energy commodities had boosted the risk that the expected deceleration in inflation would fail to occur. The FOMC decided to leave its target for the federal funds rate unchanged at 5¼ percent and noted in the accompanying statement that its predominant policy concern remained the risk that inflation would fail to moderate as expected. In light of the increased uncertainty about the outlook for both inflation and growth, the statement indicated that future policy adjustments would depend on the evolution of the outlook for both inflation and economic growth as implied by incoming information—a characterization that has been repeated in the two postmeeting FOMC statements since then.

In May, the data in hand indicated that the adjustment in the housing sector was continuing and appeared likely to persist for longer than previously anticipated. Moreover, growth in consumer spending seemed to have slowed in the early spring. Nonetheless, because the problems in the subprime-mortgage market apparently were contained and business spending indicators suggested improving prospects for investment, the economy seemed likely to expand at a moderate pace over coming quarters. Despite more-favorable readings for March, core inflation remained somewhat elevated from a longer perspective. Inflation pressures were expected to moderate over time, but the high level of resource utilization had the potential to sustain those pressures. As a result, the FOMC decided to leave its target for the federal funds rate unchanged at 5¼ percent and repeated in the statement that its predominant policy concern remained the risk that inflation would fail to moderate as expected.

At the June meeting, data appeared to confirm that economic growth had strengthened in the second quarter of 2007 despite the ongoing adjustment in the housing sector. Business spending on capital equipment, which had faltered around the turn of the year, firmed somewhat in the spring, and nonresidential construction advanced briskly. In addition, the inventory correction that had held down economic activity late last year and early this year seemed to have mostly run its course. Moreover, defense spending and net exports appeared poised to rebound after sagging in the first quarter. These factors more than offset a slowdown in the growth of consumer spending. Readings on core inflation remained favorable in April and May. Nonetheless, a sustained moderation of inflation pressures had yet to be convincingly demonstrated, and the high level of resource utilization had the potential to sustain those pressures. Under these circumstances, the Committee decided to leave its target for the federal funds rate unchanged at 5¼ percent. In its policy statement, the Committee repeated that its predominant policy concern remained the risk that inflation would fail to moderate as expected.

At their meetings over the first half of 2007, FOMC meeting participants continued the discussions they had formally initiated last year regarding their communications with the public. The discussions included a review of the role of the economic projections that are made twice a year by the members of the Board of Governors and the Reserve Bank presidents and which are included in the Board's *Monetary Policy Report to the Congress*. In addition, participants exchanged views on the possible advantages and disadvantages of specifying a numerical price objective for monetary policy. They also discussed the appropriate role of meeting minutes and policy statements. These discussions remain ongoing, as participants continue to evaluate the best available means for improving communication with the public in furtherance of the Committee's dual mandate for both maximum employment and stable prices.

Economic Projections for 2007 and 2008

In conjunction with the FOMC meeting at the end of June, the members of the Board of Governors and the Reserve Bank presidents, all of whom participate in the deliberations of the FOMC, provided economic projections for 2007 and 2008 for this report. The central tendency of the FOMC participants' forecasts for the increase in real GDP is 2¼ percent to 2½ percent over the four quarters of 2007 and 2½ percent to 2¾ percent in 2008. The civilian unemployment rate is expected to lie between 4½ percent and 4¾ percent in the fourth quarter of 2007 and to be at about the top of that range in 2008. As for inflation, FOMC participants expect that the increase in the price index for personal consumption expenditures excluding food and energy (core PCE inflation) will total 2 percent to 2¼ percent over the four quarters of 2007 and will drift down to 1¾ percent to 2 percent in 2008.

Economic activity appears poised to expand at a moderate rate in the second half of 2007, and it should strengthen gradually into 2008. The ongoing correction in the housing market seems likely to continue to weigh on the rate of economic expansion over the near term. But as that process runs its course, the rate of growth of economic activity should move up somewhat. The pace of consumer spending may be restrained in the near term as households continue to adjust to the latest run-up in energy prices and to softer house prices; still, household balance sheets are generally in good shape, and increases in employment and real wages over the next year and a half should be sufficient to sustain further gains in spending. Regarding business investment, solid gains in real outlays on equipment and software seem likely in light of the anticipated expansion in business output, continuing strong profits, and generally favorable financial conditions. Opportunities to realize significant gains in efficiency by investing in high-tech equipment should provide ongoing support to equipment spending as well. Investment in nonresidential buildings also seems to be expanding briskly. In addition, prospects are favorable for continued increases in demand for exports of U.S. goods and services.

FOMC participants generally expect core inflation to edge down a bit further over the next year and a half. In assessing the apparent slowing of core inflation this spring, participants recognized that the monthly price data are volatile and that some of the recent improvement may prove to have been transitory. Nonetheless, they believe that the current environment will be conducive to some further moderation in underlying price pressures. The participants' forecasts for real activity imply a slight easing over the next several quarters of the tightness in labor and product markets. And although core inflation is expected to remain under some upward pressure in the near term from the pass-through of the increases to date in the prices of energy and other commodities, those cost pressures should subsequently wane. Accordingly, with long-run inflation expectations contained, diminished cost pressures should result in some moderation in core inflation.

Economic projections for 2007 and 2008

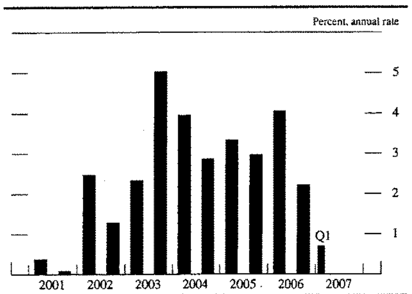
Percent

Indicator	Federal Reserve Governors and Reserve Bank presidents: Range	Federal Reserve Governors and Reserve Bank presidents: Central tendency
	2007	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4½–5½	4½–5
Real GDP	2–2¾	2¼–2½
PCE price index excluding food and energy	2–2¼	2–2¼
Average level, fourth quarter		
Civilian unemployment rate	4½–4¾	4½–4¾
	2008	
Change, fourth quarter to fourth quarter[1]		
Nominal GDP	4½–5½	4¾–5
Real GDP	2½–3	2½–2¾
PCE price index excluding food and energy	1¾–2	1¾–2
Average level, fourth quarter		
Civilian unemployment rate	4½–5	About 4¾

1. Change from average for fourth quarter of previous year to average for fourth quarter of year indicated.

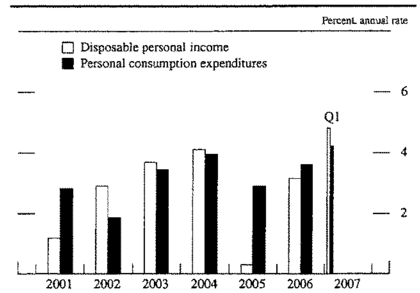
Economic and Financial Developments in 2007

Real GDP increased at an annual rate of 2¼ percent in the second half of 2006, and it appears to have risen at roughly that pace, on average, over the first half of 2007. Although consumer spending and business fixed investment posted moderate gains, on balance, during the first half, the contraction in residential construction exerted significant restraint on economic activity. The rise in real GDP in the first quarter was also damped by a downswing in inventory investment, a dip in defense spending, and an unusually sharp drop in net exports. The available information suggests that GDP growth rebounded in the second quarter as the drag from inventory investment waned and as defense expenditures and net exports snapped back after their first-quarter declines. In the labor market, hiring continued at a steady pace throughout the first half, Change in real GDP, 2001–07



NOTE: Here and in subsequent figures, except as noted, change for a given period is measured to its final quarter from the final quarter of the preceding period.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Change in real income and consumption, 2001–07



SOURCE: Department of Commerce, Bureau of Economic Analysis.

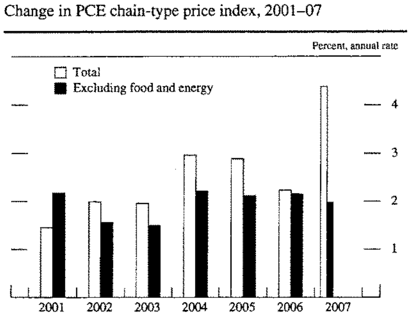
although job gains fell short of those recorded in 2006, and the unemployment rate remained at 4½ percent. Headline consumer price inflation was boosted by a reversal of the downturn in energy prices in late 2006 and a step-up in retail food prices, while core inflation was little changed. Real hourly labor compensation increased over the year ending in the first quarter, although gains in the second quarter were probably eroded by the energy-driven pickup in overall inflation. Conditions in financial markets have remained generally supportive of economic expansion thus far this year despite deteriorating conditions in the subprime-mortgage sector. Investors seemed to become more optimistic about the outlook for the economy: Interest rates rose, credit spreads on corporate bonds stayed narrow on the whole, and equity markets recorded sizable gains.

The Household Sector

Consumer Spending

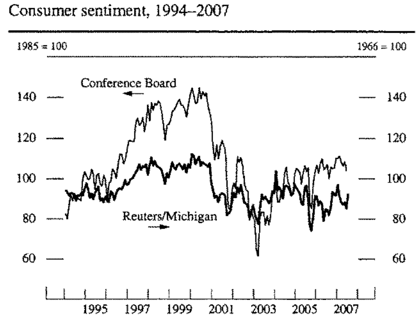
After exhibiting considerable vigor in late 2006, consumer spending slowed somewhat over the first half of 2007. Spending continued to be bolstered by the strong labor market and the lagged effects of earlier increases in household wealth. However, these positive influences were partly offset by the rise in energy prices this year, which drained consumers' purchasing power, and by reduced home-price appreciation, which limited recent gains in

Change in PCE chain-type price index, 2001–07



NOTE: The data are for personal consumption expenditures (PCE). Through 2006, change is from December to December; for 2007, change is from December to May.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Consumer sentiment, 1994–2007



NOTE: The Conference Board data are monthly and extend through June 2007. The Reuters/University of Michigan data are monthly and extend through a preliminary estimate for July 2007.
SOURCE: The Conference Board and Reuters/University of Michigan Surveys of Consumers.

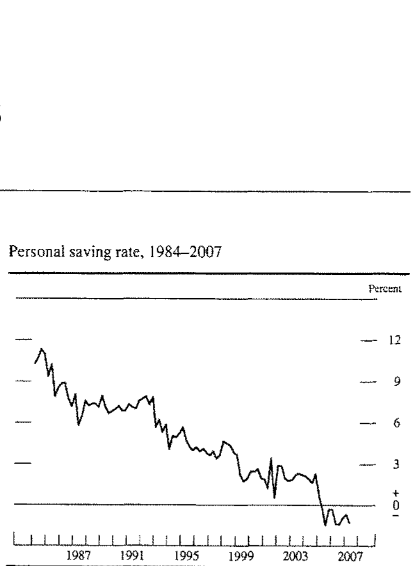
wealth for many households. Surveys of consumer sentiment have remained in a favorable range this year.

Real PCE rose at an annual rate of 4¼ percent in the first quarter. Spending on light motor vehicles (cars, sport-utility vehicles, and pickup trucks) got off to a fast start this year, expenditures on energy services were boosted by unusually cold weather in February, and outlays for other goods and services posted sizable gains after a steep run-up in the fourth quarter. The available data imply a much slower pace of spending growth in the second quarter, as sales of light motor vehicles softened and real spending on goods other than motor vehicles turned lackluster.

Real disposable personal income (DPI)—that is, after-tax income adjusted for inflation—also started the year on a strong note after a large increase in the fourth quarter.[1] Wages and salaries and some other major categories of personal income continued to rise appreciably in nominal terms throughout the first half. However, these gains were eroded in real terms by the energy-related jump in inflation in the spring, and, as a result, real DPI rose at an annual rate of just 1½ percent between the fourth quarter of 2006 and May 2007, compared with an increase of more than 3 percent over the four quarters of 2006.

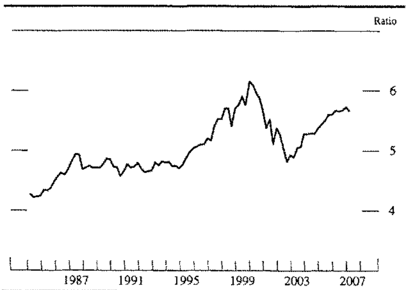
Even given the sharp deceleration in residential real estate values, household wealth has remained supportive of spending growth. One reason is that the surge in equity values in recent quarters has allowed overall household wealth to keep pace with nominal income despite the softness in home prices. In addition, because changes in net worth tend to influence consumption with a lag of several quarters, the increases in wealth during 2005 and 2006 are likely still providing a good deal of impetus to spending. These increases in wealth, which have provided many households with the resources and inclination to raise their spending at a rate that exceeds income growth, have been a factor pushing down the personal saving rate over the past couple of years even as interest rates have moved up. After fluctuating in the vicinity of 2 percent from 1999 to 2004, the saving rate subsequently dropped sharply, and it stood at negative 1¼ percent, on average, in April and May of 2007.

Personal saving rate, 1984–2007



NOTE: The data are quarterly and extend through 2007:Q2; the reading for 2007:Q2 is the average for April and May.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Wealth-to-income ratio, 1984–2007



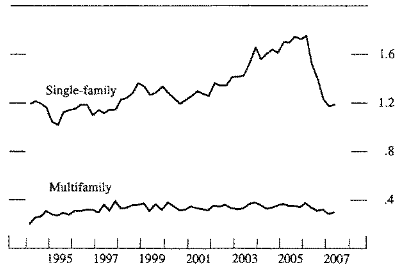
NOTE: The data are quarterly and extend through 2007:Q1. The wealth-to-income ratio is the ratio of household net worth to disposable personal income.
SOURCE: For net worth, Federal Reserve Board, flow of funds data; for income, Department of Commerce, Bureau of Economic Analysis.

Residential Investment

Residential construction activity remained soft in the first half of 2007, as builders continued to confront weak demand and an elevated inventory of unsold new homes. In the single-family sector, new units were started at an average annual rate of 1.18 million between January and May—more than 30 percent below the quarterly high reached in the first quarter of 2006. Starts in the multifamily sector averaged a little less than 300,000 units during the first five months of 2007, an amount at the lower end of the range of the past nine years. All told, the contraction in housing activity subtracted nearly 1 percentage point from the change in real GDP in the first quarter of 2007—almost as much as in the second half of 2006—and the drag likely remained substantial in the second quarter.

1. According to the published data, real DPI rose at an annual rate of 4¾ percent in the first quarter. However, a substantial part of the increase occurred because the Bureau of Economic Analysis (BEA) added $50 billion (annual rate) to its estimate of first-quarter wages and salaries in response to information that bonus payments and stock option exercises around the turn of the year were unusually large. Because the BEA did not assume that these payments carried forward into April, real DPI fell sharply in that month.

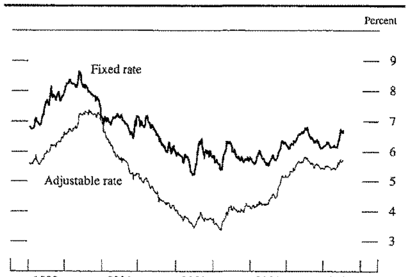
Private housing starts, 1994–2007



NOTE: The data are quarterly and extend through 2007:Q2; the readings for 2007:Q2 are the averages for April and May.
SOURCE: Department of Commerce, Bureau of the Census.

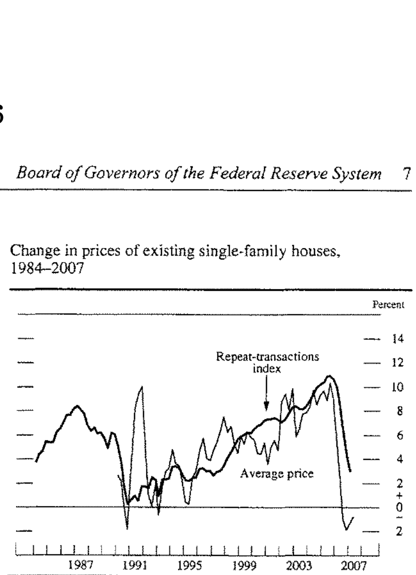
The monthly data on home sales have been erratic this year. But after smoothing through the ups and downs, the data suggest that demand has softened further after falling at a double-digit rate between mid-2005 and mid-2006 and then holding reasonably steady in the second half of last year. On average, sales of existing homes over the three months ending in May 2007 were 4½ percent below their average level in the second half of last year, while sales of new homes were down 10 percent over that period. The further weakening of housing demand this year likely reflects, in part, tighter lending standards for mortgages, and it occurred despite mortgage rates that were relatively low by longer-run standards. The ongoing slippage in sales has made it more difficult for homebuilders to make much of a dent in their inventories of new homes for sale. When evaluated relative to the three-month average pace of sales,

Mortgage rates, 1999–2007



NOTE: The data, which are weekly and extend through July 11, 2007, are contract rates on thirty-year mortgages.
SOURCE: Federal Home Loan Mortgage Corporation.

Change in prices of existing single-family houses, 1984–2007



NOTE: The data are quarterly, and changes are from one year earlier. The repeat-transactions index extends through 2007:Q1. For the years preceding 1991, that index includes appraisals associated with mortgage refinancings; beginning in 1991, it includes purchase transactions only. The data for average price extend through 2007:Q2, and the reading for Q2 is the average for April and May compared with the same period one year earlier.
SOURCE: For repeat transactions, Office of Federal Housing Enterprise Oversight; for average price, National Association of Realtors.

the months' supply of unsold new homes in May was more than 60 percent above the high end of the relatively narrow range it occupied from 1997 to 2005. Moreover, these published figures probably understate the true inventory overhang in this sector to the extent that they do not account for the surge in canceled sales in the past year; such cancellations return homes to unsold inventory but are not incorporated in the official statistics.

The rate of house-price appreciation slowed dramatically in 2006 after nearly a decade of rapid increases, and prices appear to have moved roughly sideways in the first half of 2007. The purchase-only version of the repeat-transactions price index for existing single-family homes published by the Office of Federal Housing Enterprise Oversight, which tracks sales prices of the same houses over time, rose at an annual rate of just 2 percent in the first quarter of 2007 (the latest available data) and was up just 3 percent over the year ending in the first quarter, compared with an increase of 10 percent over the preceding year. For April and May combined, the average price of existing single-family homes sold—which does not control for changes in the mix of houses sold but is available on a more timely basis—was about 1 percent below that of a year earlier.

Household Finance

Household debt expanded at an annual rate of 6 percent in the first quarter of 2007, somewhat below the pace of

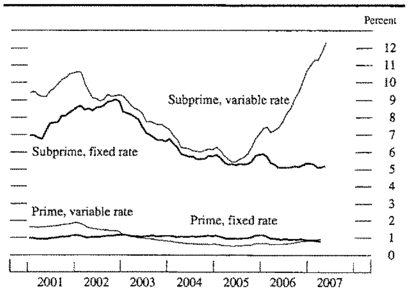
8¾ percent posted in 2006. The deceleration was primarily the result of a significant step-down in the rise of mortgage debt, which reflected the sharp slowing of house-price appreciation and the slower pace of home sales. Consumer (nonmortgage) debt has remained on a moderate uptrend this year.

Debt rose a little more slowly than personal income in the first quarter, so the financial obligations ratio for the household sector inched down, though it remained only a bit below its historical high. Most households were able to meet their debt service obligations, and measures of household credit quality were generally little changed. For example, delinquency rates on consumer loans and prime mortgages—the two main components of total household debt—stayed low through the spring of 2007, as did those on subprime fixed-rate mortgages. In addition, household bankruptcy filings continued to be subdued in the first half of the year: They ran near the average pace seen since early 2006, after the bulge that accompanied the implementation of the new bankruptcy law in October 2005.

Some households, however, have experienced growing financial strains. Delinquency rates on subprime mortgages with variable interest rates, which account for about 9 percent of all first-lien mortgages outstanding, continued to climb in the first five months of 2007 and reached a level more than double the recent low for this series, which was recorded in mid-2005. The rise in delinquencies has begun to show through to new foreclosures. In the first quarter of 2007, an estimated 325,000 foreclosure proceedings were initiated, up from an average quarterly rate of 230,000 over the preceding two years; about half of the foreclosures this year were on subprime mortgages. The decline in credit quality in the subprime sector has likely stemmed from a combination of several factors, including the moderation in overall economic growth and some regional economic weakness. In addition, a substantial number of subprime borrowers with variable-rate mortgages have faced an upward adjustment of the rates from their initial levels. When house prices were rising rapidly and rates on new loans were lower, many of these borrowers qualified to refinance into another loan with more-favorable terms. With house prices having decelerated and rates having moved higher, however, the scope for refinancing has been reduced. Moreover, investor owners may have been tempted to walk away from properties with little or no equity. Subprime mortgages originated in late 2005 and 2006 have shown unusually high rates of early delinquency, suggesting that some lenders unduly loosened underwriting standards during that period.

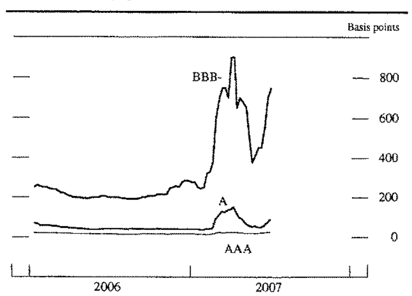
In recent months, credit has become less easily available in the subprime-mortgage market, as investors in subprime-mortgage-backed securities reportedly have scrutinized the underlying subprime loans more carefully and lenders have tightened underwriting standards. For example, more than half of the respondents to the questions on subprime residential mortgages in the Federal Reserve's April 2007 Senior Loan Officer Opinion Survey on Bank Lending Practices indicated that they had tightened credit standards on such loans over the previous three months. In June, the federal financial regulatory agencies issued a final Statement on Subprime Mortgage Lending to address issues relating to certain adjustable-rate mortgage products. Credit spreads on the lower-rated tranches of new subprime securitizations have increased sharply, on balance, this year, and issuance of subprime-mortgage-backed securities has moderated from its vigorous pace of the past couple of years. However, despite the ongoing

Mortgage delinquency rates, 2001–07



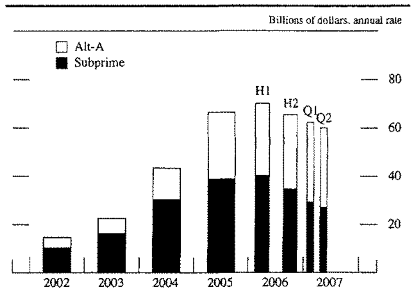
NOTE: The data are monthly. Prime-mortgage data extend through April 2007, and subprime-mortgage data extend through May 2007. Delinquency rate is the percent of loans ninety days or more past due or in foreclosure. Prime mortgages include near-prime mortgages.
SOURCE: First American LoanPerformance.

Spreads over libor of securities backed by subprime residential mortgages, 2006–07



NOTE: The data are weekly and extend through July 6, 2007.
SOURCE: Merrill Lynch.

Gross issuance of alt-A and subprime-mortgage-backed securities, 2002–07



NOTE: Alt-A includes such products as mortgages with limited income verification and mortgages secured by non-owner-occupied properties.
SOURCE: *Inside MBS & ABS.*

problems, the subprime market has continued to function, and new loans are being made.

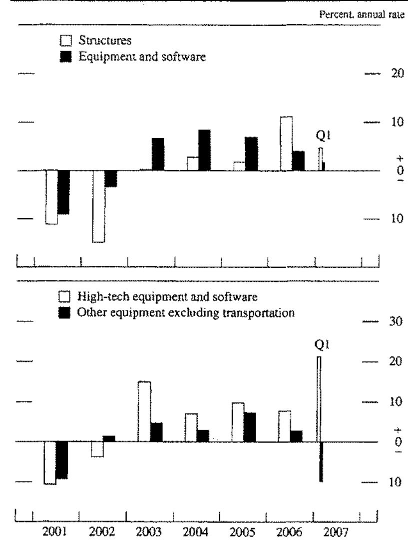
The Business Sector

Fixed Investment

After having risen sharply over much of 2006, real business fixed investment (BFI) lost some steam in the fourth quarter and posted a relatively meager gain in the first quarter of 2007. The slower rise in business output in recent quarters has likely been a moderating influence on business investment expenditures. But on the whole, economic and financial conditions still appear to be favorable for capital spending: Corporate profits remain robust, businesses have ample liquid assets at their disposal, and conditions in financial markets remain supportive.

Much of the recent softness in BFI was in spending on equipment and software (E&S), which rose at an annual rate of less than 2 percent in real terms in the first quarter after having fallen nearly 5 percent in the fourth quarter of 2006. Within the major components of E&S, real spending on high-tech equipment expanded at an annual rate of more than 20 percent in the first quarter of 2007 because of both a surge in outlays on computers after the release of a major new operating system and a spurt in investment in communications gear. Aircraft purchases also posted a sizable increase. However, spending on motor vehicles tumbled, as many firms had accelerated their purchases of medium and heavy trucks into 2005 and 2006 so that they could take delivery before the Environmental Protection Agency's new emissions standards for engines went into effect this year. Elsewhere, real investment in equipment

Change in real business fixed investment, 2001–07



NOTE: High-tech equipment consists of computers and peripheral equipment and communications equipment.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

other than high-tech and transportation goods dropped at an annual rate of 10 percent in the first quarter after a fall of nearly 5 percent in the previous quarter. The weakness in this category, which accounts for roughly 40 percent of investment in E&S when measured in nominal terms, appears to have reflected, in part, appreciable declines in spending on equipment disproportionately used by the construction and motor vehicle industries and was most pronounced around the turn of the year.

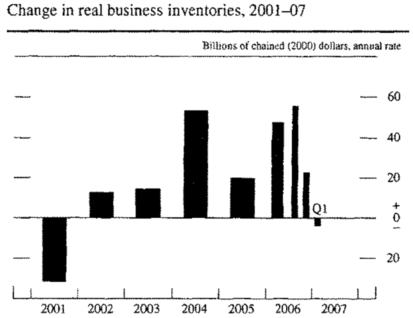
Although the weakness in truck sales apparently extended through midyear, real E&S outlays apart from transportation equipment appear to have posted a solid increase in the second quarter. Incoming information suggests that high-tech spending continued to move up in real terms—albeit not as fast as it did in the first quarter. Moreover, shipments and orders for equipment other than high-tech and transportation items regained some lost ground.

Nonresidential construction activity turned up steeply in 2006 after having been stagnant for several years, and it continued to exhibit considerable strength in early 2007. Outlays for office, retail, and industrial buildings are all running well above year-earlier levels, and—given that vacancy rates have moved down over the past couple of years—prospects for further gains in coming quarters are good. One exception to the recent strength in this sector is the drilling and mining category, in which real outlays fell in the first quarter after three years of sizable gains. The recent softening in this category of investment may reflect, in part, reported shortages of specialty equipment and skilled labor.

Inventory Investment

Inventory investment slowed markedly in the fourth quarter of 2006 as firms acted to stem rising inventory imbalances, and it turned negative in the first quarter of 2007. The downswing in inventory investment shaved about 1 percentage point from the change in real GDP in both the fourth and first quarters, and it appears to have brought stocks into better alignment with sales. Some of the inventory correction was in the motor vehicle sector, in which high gasoline prices have been causing demand to shift to more-fuel-efficient models—a trend that, by the middle of 2006, had left dealers with bloated inventories of light trucks and sport-utility vehicles. Facing little prospect of significantly stronger sales of those vehicles in the near term, the manufacturers instituted sharp cuts in production starting in the second half of last year. The production cuts, which in the first quarter of 2007 brought assemblies of light vehicles to their lowest level in more than a decade, helped clear out dealers' lots and thus set the stage for a step-up in assemblies in the second quarter. The automakers have scheduled a further rise in assemblies in the third quarter, in part to get a good start on producing the new, more-fuel-efficient models that will be introduced to the public in coming months.

Change in real business inventories, 2001–07



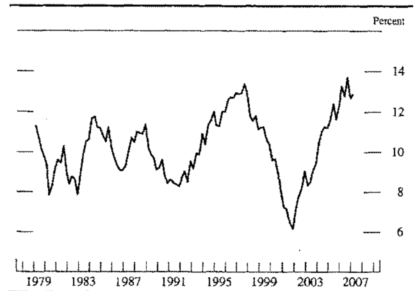
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Excluding motor vehicles, inventories appeared to be well aligned with sales through much of 2006, but they too started to look excessive as the growth of aggregate demand slowed in the latter part of the year. The emerging imbalances, some—though not all—of which appear to have been at firms that supply the construction and motor vehicle industries, prompted production adjustments that reduced non-auto inventory investment to a very modest rate in the first quarter. According to the limited available information, the pace of real stockbuilding appears to have remained low in April and May, and, for the most part, inventories seem to have moved back into rough alignment with sales. In fact, businesses surveyed in June by the Institute for Supply Management reported that their customers were mostly comfortable with their current stock levels, whereas earlier in the year an elevated number of respondents had characterized these inventory positions as too high.

Corporate Profits and Business Finance

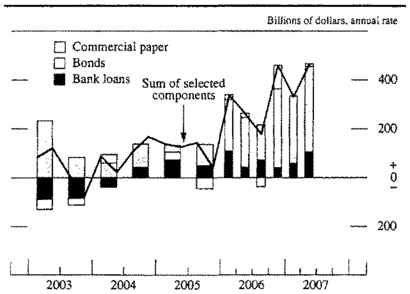
In the first quarter of 2007, growth in corporate profitability slowed from last year's pace, but the level of profitability remained high. Earnings per share for S&P 500 firms decelerated but still came in nearly 10 percent above their year-earlier level. In the national income accounts, profits of nonfinancial corporations in the first quarter were little changed from year-earlier levels after double-digit gains in 2006; nonetheless, before-tax profits measured as a share of sector GDP were nearly 13 percent, close to the high levels posted last year.

Before-tax profits of nonfinancial corporations
as a percent of sector GDP, 1979–2007



NOTE: The data are quarterly and extend through 2007:Q1. Profits are from domestic operations of nonfinancial corporations, with inventory valuation and capital consumption adjustments.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

Selected components of net financing for nonfinancial corporate businesses, 2003–07

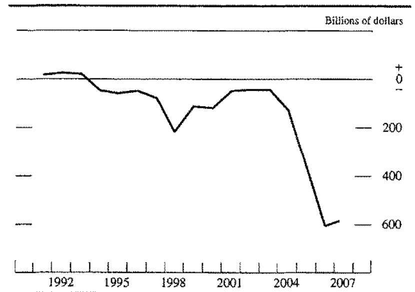


NOTE: The data for the components except bonds are seasonally adjusted. The data for the sum of selected components are quarterly. The data for 2007:Q2 are estimated.
SOURCE: Federal Reserve Board; Securities Data Company; and Federal Financial Institutions Examination Council, Consolidated Reports of Condition and Income (Call Report).

Fueled in part by continued heavy merger and acquisition activity, nonfinancial business debt expanded at an annual rate of 9 percent in the first quarter of this year, only a bit slower than in 2006, and data in hand suggest a robust pace of expansion again in the second quarter. Net bond issuance has been solid so far in 2007, and commercial and industrial lending by banks has remained strong. Although lower-quality corporate credit markets experienced some strains, generally narrow credit spreads have encouraged corporate bond issuance, and the growth of business loans has been spurred by banks' accommodative lending posture. Considerable net fractions of respondents to the April 2007 Senior Loan Officer Opinion Survey indicated that they had eased some terms—especially spreads of loan rates over their costs of funds, costs of credit lines, and loan covenants—on commercial and industrial loans over the previous three months. Banks pointed to more-aggressive competition from other banks or nonbank lenders and to increased liquidity in the secondary market for these loans as the most important reasons for having eased business lending terms. Commercial paper outstanding was flat in the first quarter but increased somewhat in the second quarter.

Gross public issuance of equity by nonfinancial corporations has continued to be moderate so far this year, but private equity issuance has apparently remained strong, as leveraged buyout activity has continued to climb. However, given the elevated levels of share repurchases and equity retirements from cash-financed mergers and acquisitions in the first quarter, net equity issuance continued to be deeply negative.

Net equity issuance at nonfinancial corporations, 1991–2007

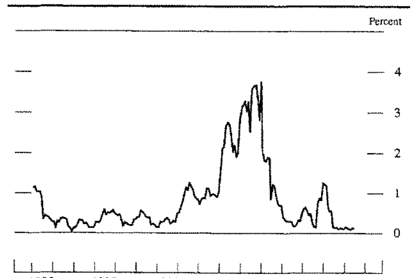


NOTE: The data are annual through 2006; for 2007, they are as of Q1. Data for 2006:Q4 and 2007:Q1 are estimated. Equity issuance includes funds invested by private equity partnerships and stock option proceeds.
SOURCE: Federal Reserve Board, flow of funds data.

Despite some deceleration in profits, the credit quality of nonfinancial firms has generally continued to be robust. The six-month trailing bond default rate has stayed near zero this year, and the delinquency rate on commercial and industrial loans at banks remained extremely low in the first quarter. For public firms, balance sheet liquidity was still high in the first quarter, whereas corporate leverage stayed near historical lows despite the large net retirement of equity. In addition, net interest payments relative to cash flow continued to be near the low end of the range seen over the past two decades.

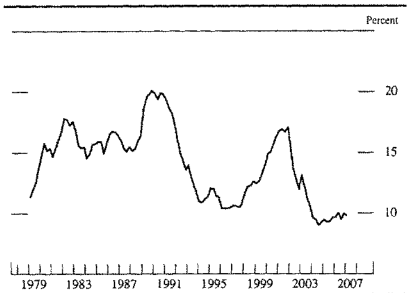
Commercial real estate debt expanded briskly in the first quarter of 2007, albeit not quite so rapidly as

Default rate on outstanding corporate bonds, 1992–2007



NOTE: The data are monthly and extend through June 2007. The rate for a given month is the face value of bonds that defaulted in the six months ending in that month, multiplied by two to annualize the defaults and then divided by the face value of all bonds outstanding at the end of the calendar quarter immediately preceding the six-month period.
SOURCE: Moody's Investors Service.

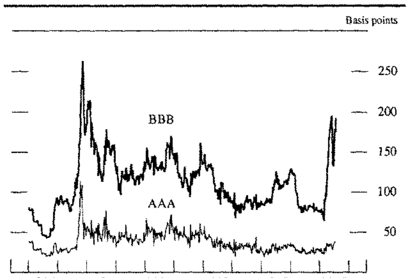
Net interest payments of nonfinancial corporations as a percent of cash flow, 1979–2007



NOTE: The data are quarterly and extend through 2007:Q1.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

in 2006, a pattern consistent with the net tightening of credit standards on commercial real estate loans reported in the Senior Loan Officer Opinion Survey. Spreads on BBB-rated commercial-mortgage-backed securities (CMBS) soared in late February and have varied within an elevated range since then. The increase reportedly came in response to a reduction in investor interest in collateralized debt obligations, sponsors of which traditionally have purchased many of these securities, and to plans by the rating agencies to increase the level of credit support required for such securities. However, because rents on commercial properties have been increasing and vacancy rates have remained moderate, credit quality has generally continued to be good. Delinquency rates on commercial mortgages held by life insurance companies and on those backing CMBS have stayed near the bottom of their recent ranges this year. The delinquency rate on commercial mortgages held by banks edged up further in the first quarter in response to a deterioration in the performance of loans for multifamily properties and for construction and land development; nevertheless, this delinquency rate remained low by historical standards.

Spreads of ten-year investment-grade commercial-mortgage-backed securities over swaps, 1997–2007



NOTE: The data are weekly and extend through July 11, 2007.
SOURCE: Bloomberg.

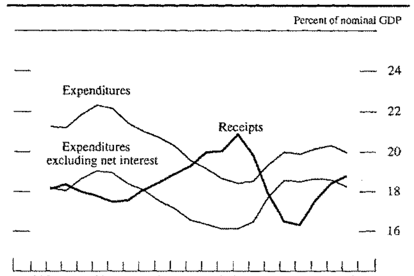
The Government Sector

Federal Government

The deficit in the federal unified budget narrowed further during the past year: Receipts continued to rise at a fairly rapid rate, while growth in outlays was relatively subdued. Over the twelve months ending in June, the unified budget recorded a deficit of $163 billion, $113 billion less than during the comparable period ending in June 2006. When measured relative to nominal GDP, the deficit has decreased steadily from a recent fiscal year high of 3.6 percent in 2004 to a little more than 1 percent during the past twelve months.

Nominal federal receipts during the twelve months ending in June were 8 percent higher than during the same period a year earlier. This increase was considerably smaller than the double-digit advances recorded in fiscal 2005 and fiscal 2006. Nonetheless, it was faster than the increase in income and pushed up the ratio of receipts to GDP to nearly 19 percent. Individual income tax receipts continued to outpace the rise in taxable personal income as measured in the national income and product accounts (NIPA), likely a result, at least in part, of larger

Federal receipts and expenditures, 1987–2007



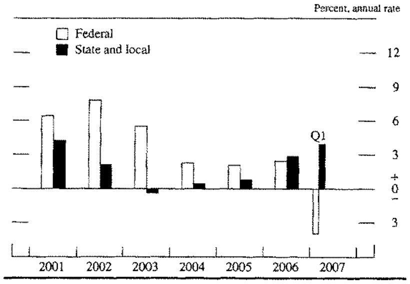
NOTE: Through 2006, receipts and expenditures are on a unified-budget basis and are for fiscal years (October through September); GDP is for the four quarters ending in Q3. For 2007, receipts and expenditures are for the twelve months ending in June, and GDP is the average of 2006:Q4 and 2007:Q1.
SOURCE: Office of Management and Budget.

capital gains realizations (which are excluded from NIPA income), the effect of some taxpayers moving into higher tax brackets as their real incomes increased, and perhaps a further shift in the distribution of income toward high-income households, which typically face higher tax rates. Corporate receipts, after rising at an annual rate of nearly 40 percent, on average, over the three years ending in fiscal 2006, rose 15 percent during the year ending in June, a rate more in line with the increase in corporate profits.

Nominal federal outlays increased less than 3 percent during the twelve months ending in June and edged down to 20 percent of nominal GDP, around the lower end of the narrow range that has prevailed since 2003. In large part, the deceleration in outlays reflected the tapering off of the temporary bulge in expenditures for flood insurance and disaster relief associated with the 2005 hurricanes. Meanwhile, spending on health programs continued to rise briskly, only in part because of the net increment to spending from the Medicare Part D prescription drug program, which started in January 2006. Defense spending was up 5 percent over the period, an increase somewhat below those recorded in fiscal years 2005 and 2006. Total federal outlays were also boosted by a sizable rise in net interest payments as interest rates moved higher, although the increase in debt service costs was significantly smaller than that of a year earlier.

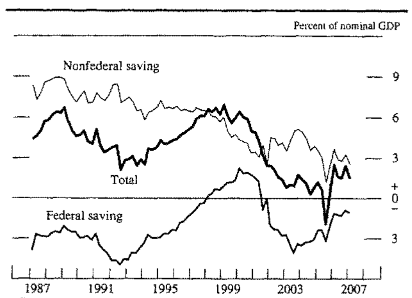
As measured in the NIPA, real federal expenditures on consumption and gross investment—the part of federal spending that is a direct component of GDP—fell at an annual rate of nearly 4 percent in the first quarter, as a drop in defense spending more than offset a moderate increase in nondefense purchases. Defense expenditures tend to be erratic from quarter to quarter, and the first-quarter dip followed a large increase in the fourth quarter. Defense spending appears to have turned back up in the second quarter, and, given currently enacted appropriations, it is likely to increase further in coming quarters.

Change in real government expenditures on consumption and investment, 2001–07



SOURCE: Department of Commerce, Bureau of Economic Analysis.

Net saving, 1987–2007



NOTE: The data are quarterly and extend through 2007:Q1. Nonfederal saving is the sum of personal and net business saving and the net saving of state and local governments.
SOURCE: Department of Commerce, Bureau of Economic Analysis.

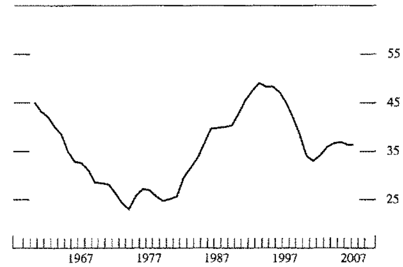
All else being equal, the significant narrowing of the unified budget deficit over the past few years raises national saving. However, the positive effect on national saving of the smaller federal deficit has been largely offset by a downward drift in nonfederal saving. Although business saving has increased substantially over this period, personal saving has dropped sharply. Accordingly, total national saving (that is, federal plus nonfederal) has recovered only a little from the exceptionally low levels reached between 2003 and 2005; measured net of estimated depreciation, it has fluctuated between 1½ percent and 2½ percent of GDP since the start of 2006. If not boosted over the longer run, persistent low levels of saving will be associated with either slower capital formation or continued heavy borrowing from abroad, either of which would retard the rise in the standard of living of U.S. residents over time and hamper the ability of the nation to meet the retirement needs of an aging population.

Federal Borrowing

Federal debt rose at an annual rate of 6¾ percent in the first quarter of 2007, a bit slower than in the corresponding quarter of last year. As of the end of the first quarter, the ratio of federal debt held by the public to nominal GDP was about 36 percent, a level little changed from that in recent quarters.

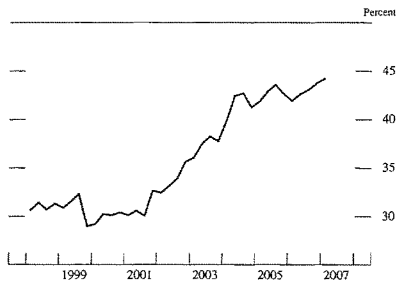
The improvement in the budget position of the federal government has led the Treasury to scale back issuance of marketable coupon securities. As part of its reduction

Federal government debt held by the public, 1960–2007



NOTE: The final observation is for 2007:Q1. For previous years, the data for debt are as of year-end, and the corresponding values for GDP are for Q4 at an annual rate. Excludes securities held as investments of federal government accounts.
SOURCE: Federal Reserve Board, flow of funds data.

Treasury securities held by foreign investors as a share of total outstanding, 1998–2007



NOTE: The data are quarterly and extend through 2007:Q1.
SOURCE: Federal Reserve Board, flow of funds data.

in issuance, the Treasury announced in May that it was discontinuing auctions of three-year nominal notes. This move had been widely anticipated and elicited little reaction in financial markets.

Overall, foreign purchases of Treasury securities appear to have increased further this year, thereby bringing the share of these securities held by foreign investors to a new high of almost 45 percent at the end of the first quarter. The proportion of nominal coupon securities purchased at auctions by foreign investors moved up in late 2006 and has stayed elevated thus far this year, albeit well off the peak reached in 2004. Balance of payments data point to sizable net purchases by foreign private investors between January and March, whereas such investors sold Treasury securities, on net, in 2006. In contrast, net purchases by foreign official investors have declined somewhat this year. Custody holdings at the Federal Reserve Bank of New York on behalf of foreign official and international accounts have only edged up since the end of 2006.

State and Local Government

On the whole, state and local governments continue to enjoy strong fiscal positions as a consequence of several years of robust revenue inflows and a period of appreciable restraint on spending after these governments' fiscal difficulties earlier in the decade. Accordingly, over the past year or so, states and localities in the aggregate have been able both to raise expenditures and to maintain healthy balances in their reserve funds. However, revenue flows in many states appear to have slowed a bit of late, a pattern similar to the one that has emerged at the federal level. For local governments, property tax receipts are still being bolstered by the earlier run-up in real estate values, but the deceleration in house prices over the past year will likely slow the rise in local revenues down the road. Moreover, many state and local governments expect to face significant structural imbalances in their budgets in coming years as a result of the ongoing pressures from Medicaid and the need to provide pensions and health care to an increasing number of retired state and local government employees.

According to the NIPA, real expenditures on consumption and gross investment by state and local governments rose at an annual rate of nearly 4 percent in the first quarter, and they apparently posted a further increase in the second quarter. Much of the strength in the first half of 2007 was in construction spending, which has been climbing since the start of 2006, in part because of very rapid increases in outlays on highways. Hiring by states and localities also exhibited considerable vigor during the first half of 2007, both in the education sector and elsewhere; on average, state and local government employment rose 30,000 per month over the six months ending in June, compared with an average monthly increase of 22,000 over the preceding ten years.

State and Local Government Borrowing

Borrowing by state and local governments has been strong thus far in 2007, largely because refundings in advance of retirements have been elevated as interest rates have remained relatively low. In contrast, issuance of short-term debt has been moderate—a development consistent with the strong budgets of state and local governments. The credit quality of municipal bonds has remained solid on the whole, as the number of bond-rating upgrades has outpaced the number of downgrades thus far this year. The ratio of yields on municipal bonds to those on comparable-maturity Treasury securities has stayed at the low end of its range of the past decade.

The External Sector

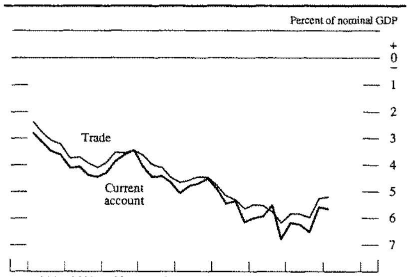
In 2006, U.S. real net exports made a positive contribution to the full year's economic growth for the first time since 1995. The contribution of net exports moved into negative territory again, however, in the first quarter of this year, as imports rebounded and exports slowed from their exceptional pace late last year. Data for April and May point to a resurgence of exports and a moderation of imports in the second quarter.

The U.S. nominal current account deficit widened a bit in the first quarter of 2007 to $770 billion at an annual rate, or about 5¾ percent of nominal GDP, from $752 billion in the fourth quarter of 2006. The larger deficit was due to an increase in net unilateral transfers abroad. Although the first-quarter trade balance deteriorated in real terms, increases in export prices outpaced those in import prices, thereby leaving the nominal trade balance unchanged. Despite the large negative U.S. net international investment position, the U.S. balance on investment income remained positive and also was about unchanged in the first quarter.

International Trade

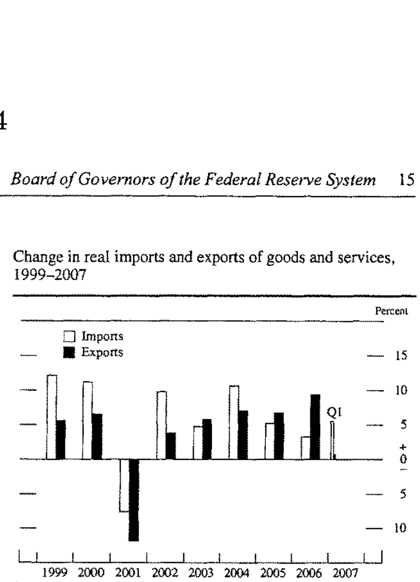
Despite continued solid foreign economic expansion and persisting stimulus from earlier declines in the dollar, the growth of real exports of goods and services slowed to an annual rate of less than 1 percent in the first quarter

U.S. trade and current account balances, 1999–2007



NOTE: The data are quarterly and extend through 2007:Q1.
SOURCE: Department of Commerce.

Change in real imports and exports of goods and services, 1999–2007



SOURCE: Department of Commerce.

from its exceptionally strong pace of more than 10 percent in the fourth quarter. The slowdown was particularly evident in sales of capital goods—especially aircraft and computers—and industrial supplies, which fell in the first quarter after rising robustly in late 2006. Also contributing to the slowdown, real exports of services rose only 2 percent in the first quarter after increasing more than 16 percent in the fourth quarter. Available data for nominal exports in April and May suggest that real export growth moved up in the second quarter, as increases in exports of services, automobiles, industrial supplies, and consumer goods more than offset a further contraction in exports of capital goods.

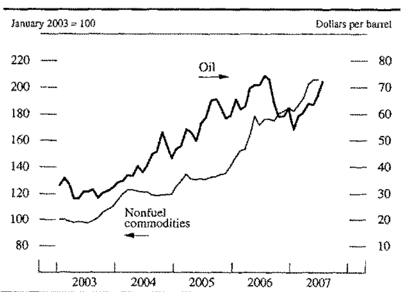
Prices of exported goods rose at an annual rate of 4 percent in the first quarter of 2007, up from the pace of about 2½ percent seen in the second half of 2006. Prices of non-agricultural industrial supplies, which had been reduced in the fourth quarter by lower oil prices, were pushed up in the first quarter by higher prices for metals and renewed increases in oil prices. In addition, agricultural prices—especially those of corn, soybeans, and wheat—have risen briskly over the past several quarters, in part because of the direct and indirect effects of the increased demand for ethanol. Monthly data on trade prices in the second quarter point to further increases in export prices on the strength of additional run-ups in the prices of non-agricultural industrial supplies, most notably metals.

After falling at an annual rate of 2½ percent in the fourth quarter, real imports of goods and services rose at a 5½ percent rate in the first quarter. A sharp increase in oil imports, after a fourth-quarter decline, was the most important contributor to the swing, but imports of computers, semiconductors, and natural gas also accelerated. Imports of other goods continued to be weak, likely a result, in part, of slower U.S. growth; imports of autos and industrial supplies, in particular, contracted sharply. The growth of real imports of services dropped from 6¼ percent in the fourth quarter to 2¾ percent in the first quarter. Data for April and May imply some slowing of overall real imports in the second quarter. In particular, imports of oil and computers displayed noteworthy decelerations.

Prices of imported goods excluding oil and natural gas rose at an annual rate of about 1½ percent in the first quarter of 2007, as prices of both finished and material-intensive goods recorded higher rates of increase. Monthly trade price data suggest that import prices accelerated in the second quarter, partly because of higher metals prices, which have fluctuated widely in recent months but are up substantially, on balance, so far in 2007. More generally, prices of industrial supplies have been rising briskly, a movement that may reflect, in part, a response to the depreciation of the dollar in recent months. No such effect of the dollar's decline is readily apparent in the prices of finished goods.

Oil prices fell at the beginning of 2007, as unusually mild temperatures reduced oil demand and OPEC members appeared less likely to implement fully production cuts agreed to at the end of 2006. The spot price of West Texas intermediate (WTI) crude oil, the U.S. benchmark, fell from an average of $62 per barrel in December to $54 per barrel in January. Oil prices then rose gradually as it became apparent that OPEC, led by Saudi Arabia, indeed would restrain oil production further. Oil prices also have been supported by solid growth in demand, particularly in developing countries, and by long-running concerns about supply disruptions. Ongoing violence has depressed oil production in Iraq and Nigeria; the Nigerian outage recently worsened to about one-fourth of the country's estimated capacity. Since the start of the year, concerns have also intensified about a possible future disruption of oil exports from Iran. The spot price of WTI averaged $72 per barrel in the first half of July.

Prices of oil and of nonfuel commodities, 2003–07



NOTE: The data are monthly. The price of nonfuel commodities extends through June 2007. The last observation for the oil price is the average for July 1 through July 13, 2007. The oil price is the spot price of West Texas intermediate crude oil. The price of nonfuel commodities is an index of forty-five primary-commodity prices.
SOURCE: For oil, the Commodity Research Bureau; for nonfuel commodities, International Monetary Fund.

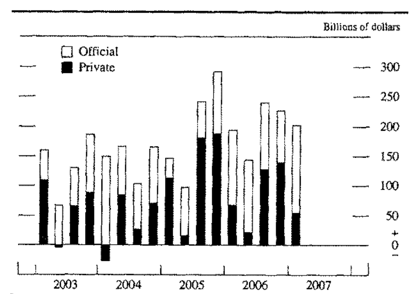
Despite its elevated level by historical standards, the spot price of WTI has not increased as much in recent months as have the prices of other grades of crude oil because of high inventories of WTI in the central United States arising from interruptions for maintenance and unplanned outages at refineries. Since early March, the spot price of Brent crude oil, the European benchmark, has risen about $5 per barrel more than has the spot price of WTI; the price of Brent averaged $76 per barrel in the first half of July.

The Financial Account

The U.S. nominal current account deficit continued to be financed primarily by foreign purchases of U.S. debt securities. Driven by purchases of U.S. government securities by Asian central banks, foreign official inflows moved up noticeably in the first quarter. Although demand for U.S. Treasury securities by foreign official investors eased, it was more than offset by increased official purchases of bonds and mortgage-backed securities issued by government-sponsored enterprises (GSEs). Preliminary data indicate that official inflows remained strong through April.

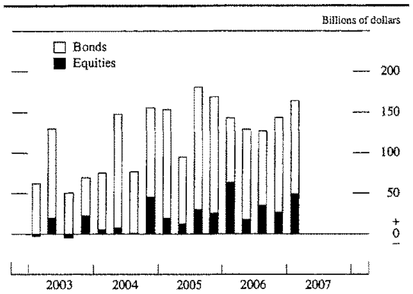
Foreign private purchases of U.S. securities maintained the extraordinary pace set in 2006. Demand for U.S. Treasury bonds extended its fourth-quarter strength, while demand for equities picked up from an already robust level; purchases of corporate bonds moderated slightly,

U.S. net financial inflows, 2003–07



NOTE: The data are quarterly and extend through 2007:Q1.
SOURCE: Department of Commerce.

Net private foreign purchases of long-term U.S. securities, 2003–07



NOTE: The data are quarterly and extend through 2007:Q1.
SOURCE: Department of Commerce.

and, on net, private foreigners sold debt issued by GSEs. Foreign direct investment flows into the United States weakened significantly; the rate of inflows in the first quarter was roughly half that in 2006.

Net purchases of foreign securities by U.S. residents, which represent a financial outflow, remained strong in the first quarter of this year. Net acquisitions of bonds continued at the brisk pace recorded in the second half of 2006, while purchases of foreign stocks, although slowing slightly, remained elevated. Outflows associated with U.S. direct investment abroad strengthened to a near-record rate.

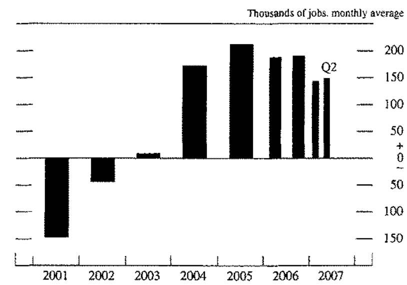
The Labor Market

Employment and Unemployment

The demand for labor has been increasing at a moderate rate this year, somewhat less quickly than in 2006. After having averaged 190,000 per month in 2006, gains in payroll employment averaged 145,000 per month in the first half of 2007. The civilian unemployment rate has changed little since last fall and stood at 4.5 percent in June.

As was the case in 2006, job growth in the first half of 2007 was driven by solid gains in service-producing industries. In particular, hiring at health, education, and eating and drinking establishments remained on strong uptrends, and job gains at businesses providing professional and technical services were sizable. However, employment in the financial activities and administrative support sectors softened after two years of strong advances. In the goods-producing sector, manufacturing employment, which has been on a secular downtrend for more than a quarter-century, declined again over the first half of 2007. The decline this year reflected cutbacks at firms closely tied to the construction industry and at producers of motor vehicles and parts, as well as the ongoing downtrend in payrolls at manufacturers of apparel and textiles. Employment in residential construction, which had fallen in 2006 after two years of substantial increases, declined just modestly, on net, over the first half of 2007 despite the substantial contraction in housing activity.

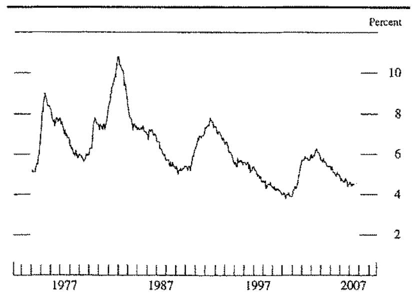
Net change in payroll employment, 2001–07



NOTE: Nonfarm business sector.
SOURCE: Department of Labor, Bureau of Labor Statistics.

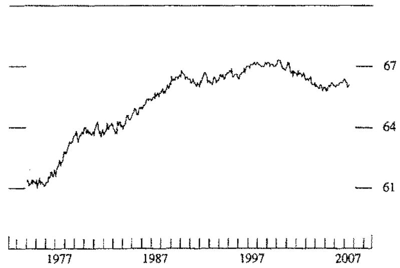
Other labor market indicators have mostly remained positive. Initial claims for unemployment insurance have stayed relatively low in recent months. In addition, readings from private surveys of hiring plans have remained in a favorable range despite recent declines, and the job openings rate has held at a high level. According to the Conference Board, households' assessments of job availability cooled a bit in the spring after having improved somewhat earlier in the year; even so, the June value for this indicator was still relatively positive.

Civilian unemployment rate, 1974–2007



NOTE: The data are monthly and extend through June 2007.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Labor force participation rate, 1974–2007



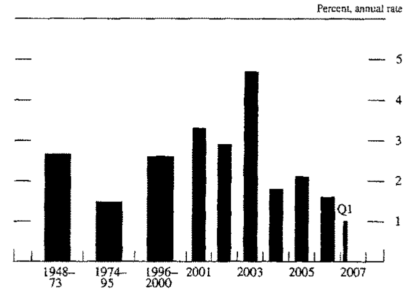
NOTE: The data are monthly and extend through June 2007.
SOURCE: Department of Labor, Bureau of Labor Statistics.

After hovering around 4¾ percent during the first three quarters of 2006, the unemployment rate fell to 4½ percent in the fourth quarter, and it remained in that neighborhood through June. The labor force participation rate has continued to be buoyed by the favorable job market, and it stood at 66.1 percent in June, within the narrow range that has prevailed since 2005. Despite the recent flatness, the participation rate has fallen appreciably since the start of the decade; the downtrend has largely reflected longer-run demographic forces that include a leveling off in the participation rate of women and an increase in the proportion of the workforce in older age groups, which have lower average participation rates than do younger age groups.

Productivity and Labor Compensation

Gains in labor productivity have slowed lately. According to currently published data, output per hour in the nonfarm business sector rose just 1 percent over the year ending in the first quarter of 2007, down from the pace of 2 percent per year recorded over the preceding two years (and down from much larger increases in the first half of the decade). The slowing in productivity was associated with the deceleration in output and thus was probably, at least in part, a temporary cyclical phenomenon. Indeed, the fundamental forces that in recent years have supported a solid uptrend in underlying productivity—the driver of real wage gains over time—remain in place. They include the rapid pace of technological change and firms' ongoing efforts to use information technology to improve the efficiency of their operations. Increases in the amount of capital, especially high-tech capital, available to each worker also appear to be providing considerable impetus to productivity growth.

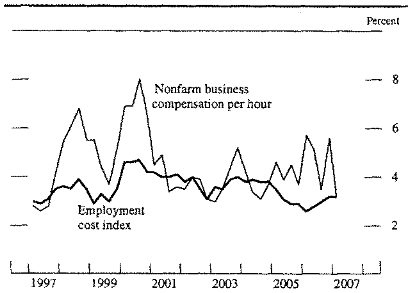
Change in output per hour, 1948–2007



NOTE: Nonfarm business sector. Change for each multiyear period is measured from the fourth quarter of the year immediately preceding the period to the fourth quarter of the final year of the period.
SOURCE: Department of Labor, Bureau of Labor Statistics.

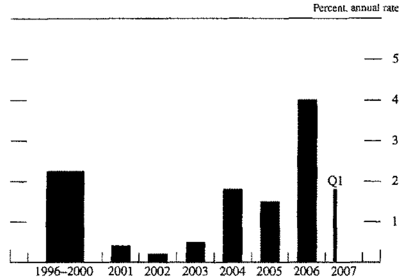
Broad measures of hourly compensation have been bounced around in recent years by the lumpiness of bonus payments, stock option exercises, and sharp swings in employer benefit costs. However, on balance, the evidence points to some pickup recently in the underlying pace of compensation gains, a development consistent with the tight labor market. The employment cost index (ECI) for private industry workers, which measures both wages and the cost of benefits, increased 3¼ percent in nominal terms between March 2006 and March 2007, compared with an

Measures of change in hourly compensation, 1997–2007



NOTE: The data are quarterly and extend through 2007:Q1. For nonfarm business compensation, change is over four quarters; for the employment cost index (ECI), change is over the twelve months ending in the last month of each quarter. The nonfarm business sector excludes farms, government, nonprofit institutions, and households. The sector covered by the ECI used here is the same as the nonfarm business sector plus nonprofit institutions. A new ECI series was introduced for data as of 2001, but the new series is continuous with the old.
SOURCE: Department of Labor, Bureau of Labor Statistics.

Change in unit labor costs, 1996–2007



NOTE: Nonfarm business sector. The change for 1996 to 2000 is measured from 1995:Q4 to 2000:Q4.
SOURCE: Department of Labor, Bureau of Labor Statistics.

increase of 2½ percent over the preceding twelve months. Adjusted for inflation, as measured by the increase in the overall PCE price index, the ECI rose nearly 1 percent over the year ending in March after having fallen nearly ½ percent over the preceding year. Data on hourly compensation in the second quarter are not yet available, but a sharp rise in overall consumer prices during that period probably offset much—if not all—of the nominal gains that were realized.

The step-up in the rate of increase in the ECI over the past year was concentrated in its wage and salary component, which rose 3½ percent over the year ending in March, 1¼ percentage points more than the increase over the year-earlier period. Meanwhile, increases in the cost of providing benefits have slowed dramatically of late, in part because premiums for health insurance have stopped rising at double-digit rates. The increase in benefit costs over the year ending in March, which amounted to just 2¼ percent, was also held down by a sharp drop in employer contributions to retirement plans. The lower contributions appear to have reflected several factors, including the strong performance of the stock market in 2006 and a high level of employer contributions over the past several years; taken together, these factors significantly boosted the funding levels of defined-benefit plans.

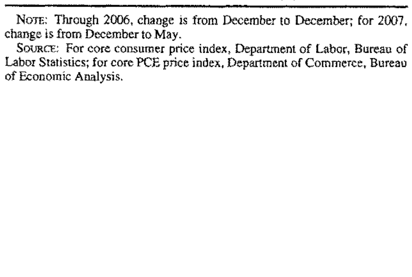
According to preliminary data, compensation per hour in the nonfarm business (NFB) sector—an alternative measure of hourly compensation derived from the data in the NIPA—rose 3¼ percent over the year ending in the first quarter of 2007, the same rise as in the ECI. Over the year ending in the first quarter of 2006, NFB hourly compensation had risen 5¾ percent, in part because of an apparent surge in the value of stock option exercises (which are excluded from the ECI) early last year. Largely reflecting the slower growth in NFB hourly compensation, unit labor costs rose 2¼ percent over the year ending in the first quarter of 2007 after increasing 3½ percent over the preceding four quarters.

Prices

Headline inflation picked up again in the first half of 2007, as energy prices surged after having eased late last year and increases in food prices quickened. The PCE chain-type price index increased at an annual rate of 4.4 percent between December 2006 and May 2007 after rising 2.2 percent over the twelve months of 2006. Core PCE prices—which exclude the direct effects of movements in food and energy prices—rose at an annual rate of 2.0 percent over the first five months of the year, 0.1 percentage point less than the increase over the twelve months of 2006.

Energy prices, which had fallen substantially in the fourth quarter of 2006, decreased further in January in response to declines in the price of crude oil, unseasonably mild temperatures in North America and Europe, and historically high inventories of petroleum products and natural gas. However, energy prices shot up from February to May, and the rise brought the net increase in the PCE price index for energy over the first five months of the year to 14 percent (not at an annual rate). The increase was especially large for gasoline, the price of which was boosted not only by higher prices for crude oil beginning in late winter but also by numerous refinery shutdowns, reflecting both planned maintenance and unplanned disruptions. Retail gasoline prices have fallen some since May as refiners have made some progress in bringing

Change in core consumer prices, 2001–07



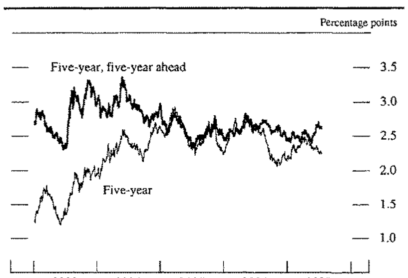
NOTE: Through 2006, change is from December to December; for 2007, change is from December to May.
SOURCE: For core consumer price index, Department of Labor, Bureau of Labor Statistics; for core PCE price index, Department of Commerce, Bureau of Economic Analysis.

output closer to seasonal norms, but they are still about $0.70 per gallon above the levels of late December.

Food prices have also picked up this year, in part because of the jump in the price of corn, which is now in demand not only as a feedstuff and food but also as an input to the production of ethanol. Between December 2006 and May 2007, the PCE price index for food and beverages increased at an annual rate of nearly 6 percent. The higher cost of corn was partly responsible for a 10½ percent rise over the period in prices for meats, poultry, fish, and eggs. The index for fruits and vegetables also posted a double-digit increase, mainly because a severe freeze in California in January destroyed a substantial portion of the citrus crop and set back the harvest of many other fruits and vegetables. Prices for food consumed away from home, which typically are influenced more by labor and other business costs than by farm prices, rose at an annual rate of 4 percent over the first five months of the year.

The edging down of core PCE inflation this year largely reflected some waning of the sizable increases in shelter costs that were recorded in 2006. Core PCE inflation in the most recent few months was also held down significantly by transitory factors—most notably, a sharp drop in the price of apparel. In addition, the retail price of tobacco, which, like apparel, tends to be volatile from month to month, flattened out after a steep increase earlier in the year. Meanwhile, the rate of increase in the core consumer price index (CPI) has dropped from 2.6 percent in 2006 to an annual rate of 2.1 percent so far this year; the main reason for the sharper deceleration in the core CPI than in core PCE prices is that housing costs receive a much greater weight in this index than they do in the core PCE measure.

TIPS-based inflation compensation, 2003–07



NOTE: The data are daily and extend through July 13, 2007. Based on a comparison of the yield curve for Treasury inflation-protected securities (TIPS) with the nominal off-the-run Treasury yield curve.

SOURCE: Federal Reserve Board calculations based on data provided by the Federal Reserve Bank of New York and Barclays.

Alternative measures of price change, 2006–07

Percent

Price measure	2006	2007
Chain-type (Q1 to Q1)		
Gross domestic product (GDP)	3.1	2.8
Excluding food and energy	2.9	2.7
Gross domestic purchases	3.5	2.5
Personal consumption expenditures (PCE)	3.0	2.2
Excluding food and energy	2.0	2.3
Market-based PCE excluding food and energy	1.6	2.1
Fixed-weight (Q2 to Q2)		
Consumer price index	4.0	2.6
Excluding food and energy	2.4	2.3

NOTE: Changes are based on quarterly averages of seasonally adjusted data. For the consumer price index, the 2007:Q2 value is calculated as the average for April and May compared with the average for the second quarter of 2006 and is expressed at an annual rate.

SOURCE: For chain-type measures, Department of Commerce, Bureau of Economic Analysis; for fixed-weight measures, Department of Labor, Bureau of Labor Statistics.

More fundamentally, the behavior of core inflation so far this year has been shaped by many of the same forces that were at work in 2006. Resource utilization in labor and product markets remains fairly high. And although last autumn's drop in energy prices may have offered some temporary relief, the resurgence in prices for energy and other commodities is likely putting some upward pressure on core inflation. Regarding inflation expectations, the Reuters/University of Michigan Surveys of Consumers (Reuters/Michigan) suggest that the median expectation for year-ahead inflation has moved up in response to the energy-driven pickup in headline inflation: It rose from 3.0 percent in the first three months of the year to 3.3 percent in April and remained at about this level through early July. However, longer-run inflation expectations appear to have remained contained. In fact, according to the Reuters/Michigan surveys, the median five- to ten-year expectation, at 3.1 percent in early July, has stayed within the narrow range that has prevailed for the past two years. According to the Survey of Professional Forecasters, conducted by the Federal Reserve Bank of Philadelphia, expectations of inflation over the next ten years remained around 2½ percent in the first half of 2007, a level that has been essentially unchanged since 1998. Inflation compensation as measured by the spreads of yields on nominal Treasury securities over those on their inflation-protected counterparts has also stayed within its range of recent years.

Broader, NIPA-based measures of inflation, which are available only through the first quarter of this year, slowed relative to the pace of the past couple of years. The latest data show a rise in the price index for GDP less food and energy of 2¾ percent over the year ending in the first quarter, down ¼ percentage point from the year-earlier figure. Although core PCE inflation picked up slightly during the past four quarters, prices for some other components of final demand, especially construction, decelerated.

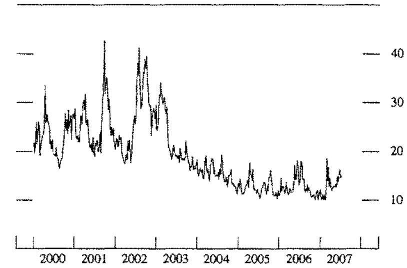
U.S. Financial Markets

U.S. financial markets have functioned well thus far in 2007 despite episodes of heightened volatility. As the year opened, financial market quotes put considerable weight on the expectation of an easing of monetary policy sometime soon. By the spring, however, investors apparently had become more optimistic about the economic outlook and, as a result, had concluded that less Federal Reserve easing would be forthcoming than they had anticipated earlier. In line with the upward shift in policy expectations, two-year Treasury yields rose about 10 basis points, on balance, through mid-July; ten-year yields increased 40 basis points. Supported by solid corporate profits and the more upbeat economic outlook, equity prices advanced roughly 10 percent on net. Despite some widening in recent weeks, risk spreads on corporate credits generally remained narrow, reflecting strong and liquid corporate balance sheets. Measures of investors' uncertainty about prospects for a number of financial asset prices widened somewhat, on balance, from low levels.

Market Functioning and Financial Stability

In late February and early March, financial market volatility increased sharply amid a pullback from riskier assets that was reportedly spurred by a variety of factors, including a sharp dip in the Chinese equity market, mounting concerns about conditions in the subprime-mortgage sector, and some softer-than-expected U.S. economic data. During the period, spreads on indexes of subprime-mortgage credit default swaps (CDS) spiked; equity markets in the United States and abroad declined; Treasury yields dropped across maturities; spreads of riskier fixed-income instruments over comparable Treasuries widened somewhat; and measures of market uncertainty, including implied volatilities derived from options prices, moved up sharply. Despite some capacity-related technical difficulties in equity markets on February 27, financial markets generally handled the volatility well. Liquidity in the Treasury market continued to be good, as record-high trading volumes were accompanied by bid–ask spreads within ranges of the past few years. Market sentiment subsequently improved—apparently a result, in part, of reduced anxiety about spillovers to broader markets of the problems in the subprime-mortgage sector—and financial markets gradually stabilized. Many asset prices reversed their

Implied S&P 500 volatility, 2000–07

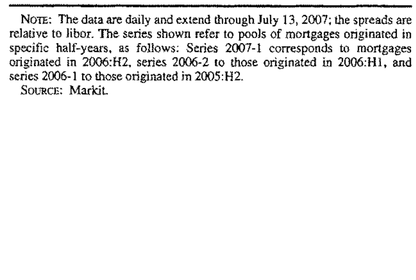


Note: The data are weekly and extend through July 13, 2007. The series shown–the VIX–is the implied thirty-day volatility of the S&P 500 stock price index as calculated from a weighted average of options prices.
Source: Chicago Board Options Exchange.

earlier declines, and measures of uncertainty moved lower.

Strains in financial markets increased again late in the spring, prompted largely by renewed concerns about the subprime-mortgage sector. A considerable widening in spreads on indexes of subprime-mortgage CDS contributed to, and was likely reinforced by, troubles at a few small and medium-sized hedge funds that had taken positions designed to profit from an improvement in subprime credit quality. These pressures intensified as a result of actual and anticipated downgrades of some securities backed by subprime mortgages. Investors' uncertainty

Spreads on BBB- indexes of credit default swaps on subprime mortgages, 2006–07



Note: The data are daily and extend through July 13, 2007; the spreads are relative to libor. The series shown refer to pools of mortgages originated in specific half-years, as follows: Series 2007-1 corresponds to mortgages originated in 2006:H2, series 2006-2 to those originated in 2006:H1, and series 2006-1 to those originated in 2005:H2.
Source: Markit.

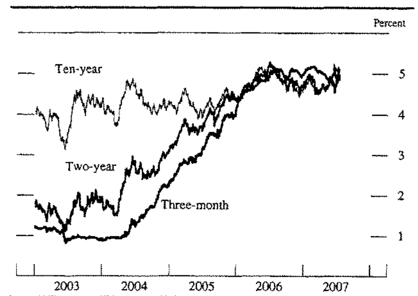
about a range of asset prices increased, and lower-quality corporate credit spreads widened, reportedly reflecting, in part, heightened uncertainty about the valuation of structured credit products, which are an important source of funding in the subprime-mortgage market and in other financing markets. These pressures have been contained, though: In spite of the recent rise, spreads on lower-quality corporate credits remain near the low end of their historical ranges, and, although investors recently have balked at some aggressively structured deals, financing activity in bond and other credit markets continues at a fairly brisk pace. Market participants do not appear to have pulled back from risk-taking more generally, in that equity prices have moved higher in recent weeks, and Treasury bid–ask spreads have stayed within normal ranges despite elevated trading volumes.

The effects on financial institutions of this year's difficulties in the subprime-mortgage sector have depended on the institutions' exposure to the sector. Several mortgage lenders—particularly monoline subprime lenders—experienced substantial losses, as they had to repurchase larger-than-expected volumes of previously securitized loans because of so-called early payment defaults. Consequently, a number of these lenders have gone out of business since the beginning of the year. Large investment banks active in the securitization of subprime mortgages suffered modest hits to their earnings, and their CDS spreads are considerably higher than at the beginning of the year. To date, most large depository institutions appear to have been less affected by the subprime difficulties, in part because of their greater diversification and generally limited subprime lending activity. CDS spreads for these institutions have moved up only a little, on the whole, thus far in 2007.

Interest Rates

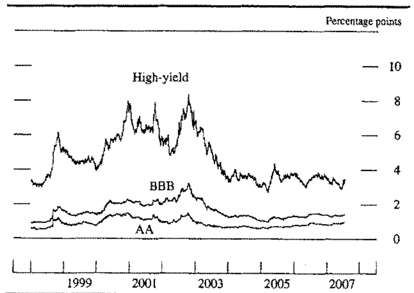
Since the beginning of the year, investors appear to have become more optimistic, on balance, about the outlook for economic activity and consequently have raised their expected path for the federal funds rate. Judging from futures markets, market participants currently anticipate that the rate will decline about 25 basis points through the end of 2008; at the end of last year, market participants had expected about 75 basis points of easing over the same period. Investors also have apparently become more certain about the path for the federal funds rate: Implied volatilities derived from options on Eurodollar futures over the next year have moved down, on net, this year and remain near historical lows. Estimated probability distributions for the target federal funds rate between six and twelve months ahead were somewhat skewed toward lower rates through mid-July.

Interest rates on selected Treasury securities, 2003–07



NOTE: The data are daily and extend through July 13, 2007.
SOURCE: Department of the Treasury.

Spreads of corporate bond yields over comparable off-the-run Treasury yields, by credit rating, 1998–2007

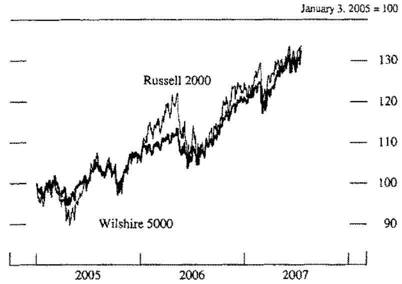


NOTE: The data are daily and extend through July 13, 2007. The spreads shown are the yields on ten-year bonds less the ten-year Treasury yield.
SOURCE: Derived from smoothed corporate yield curves using Merrill Lynch bond data.

Reflecting the reduced odds placed on policy easing, yields on two-year nominal Treasury securities increased about 10 basis points over the year through mid-July. Ten-year Treasury yields rose 40 basis points over the same period. A portion of the increase in longer-term yields appears to be attributable to a widening of term premiums, although estimated term premiums remain relatively low by historical standards. Yields on inflation-indexed Treasury securities moved nearly in line with those on their nominal counterparts, thereby leaving inflation compensation only a little higher.

In the corporate bond market, yields on investment- and speculative-grade securities rose about as much, on balance, as those on comparable-maturity Treasury securi-

Stock price indexes, 2005–07



NOTE: The data are daily and extend through July 13, 2007.
SOURCE: Frank Russell Company; Dow Jones Indexes.

ties through mid-July, and so risk spreads on such instruments are little changed on the year. The narrow spreads on corporate bonds appear to reflect investors' positive outlook for business credit quality over the medium term. The term structure of forward risk spreads for corporate bonds supports this view, as forward spreads for the next few years are low while spreads further out the curve are more in line with historical norms.

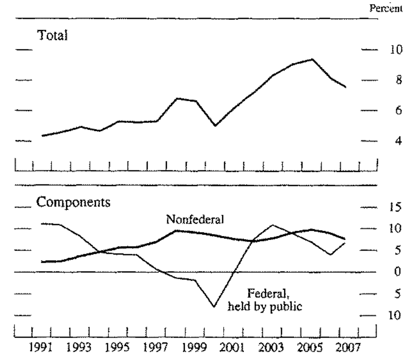
Equity Markets

Broad equity indexes increased between 8½ percent and 12 percent, on net, through mid-July. Stock prices were boosted by solid first-quarter earnings that generally met or exceeded investors' expectations and by the more upbeat economic outlook. Share prices rose for a wide range of industries, although basic materials and energy firms outperformed the broader market because of strong global demand for commodities. The spread between the twelve-month forward earnings–price ratio for the S&P 500 and a real long-run Treasury yield—a rough gauge of the equity risk premium—narrowed a bit and now stands close to the middle of its range of the past few years. After a spike in connection with the period of unsettled conditions in financial markets in late February and early March, the implied volatility of the S&P 500 calculated from options prices fell back, but it picked up again recently in response to renewed concerns about the subprime-mortgage market.

Debt and Financial Intermediation by Banks

The total debt of the domestic nonfinancial sectors expanded at an annual rate of 7¼ percent in the first

Change in domestic nonfinancial debt, 1991–2007



NOTE: For 2007, change is from 2006:Q4 to 2007:Q1 at an annual rate. For earlier years, the data are annual and are computed by dividing the annual flow for a given year by the level at the end of the preceding year. The total consists of components shown. Nonfederal debt consists of the outstanding credit market debt of state and local governments, households, nonprofit organizations, and nonfinancial businesses. Federal debt held by the public excludes securities held as investments of federal government accounts.
SOURCE: Federal Reserve Board, flow of funds data.

quarter of 2007, a somewhat slower pace than in 2006. The deceleration in borrowing was mainly accounted for by a slowdown in household debt, particularly mortgage debt. In contrast, borrowing by nonfinancial businesses remained robust in the first quarter. Preliminary data for the second quarter suggest slightly slower growth in total domestic nonfinancial sector debt. The step-down in growth is particularly noticeable in the federal government sector, in which strong receipts this tax season held down borrowing. However, the recent data suggest somewhat faster growth in nonfinancial business debt in the second quarter, a pickup fueled by heavy merger and acquisition activity.

Commercial bank credit increased at an annual rate of about 6½ percent in the first half of 2007. However, adjusted to remove the effects of a conversion of a bank to a thrift institution, bank credit expanded at an annual rate of about 8¼ percent over the same period, somewhat slower than in 2006.

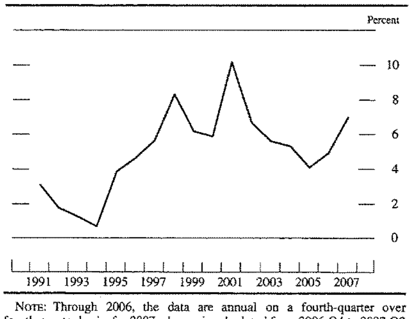
Excluding this bank-to-thrift conversion, total loans grew briskly in the first half of the year, with most bank loan types expanding vigorously. Rapid growth in commercial and industrial loans was supported by the continued robust merger and acquisition activity. Growth in commercial real estate loans was also strong even though construction and land development loans, a portion of which is used to fund residential development, decelerated sharply. Despite the ongoing adjustment in the housing market, residential real estate loans on banks' books (adjusted for the bank-to-thrift conversion noted earlier) expanded at a strong pace. But home equity loans grew only modestly. Because rates on these loans are generally tied to short-term market interest rates, the flattening of the yield curve last year made them a relatively more expensive source of credit. Consumer loans held by banks picked up in the first quarter, but they slowed in the second quarter.

Commercial bank profitability declined somewhat in the first quarter of 2007 but remained solid. The net interest margin of the industry continued to narrow, a likely result of ongoing competitive pressures and the flat yield curve. Bank profitability was also restrained by growth in non-interest expenses and a modest increase in provisions for loan losses. Credit quality stayed strong overall: Delinquency and charge-off rates remained generally low, although delinquency rates on residential and commercial real estate loans moved up further from last year's levels.

The M2 Monetary Aggregate

M2 expanded at an annual rate of about 7½ percent over the first half of 2007. The increase evidently outstripped growth in nominal GDP by a substantial margin and exceeded the rate that would have been expected on the basis of the aggregate's previous relationship with income and interest rates. M2 rose at an annual rate of 8 percent in the first quarter before slowing to a pace of 6¾ percent in the second quarter. Liquid deposits, by far the largest component of M2, have followed a similar pattern this year. Small time deposits and retail money market funds both grew rapidly last year, as the rates paid on them moved up with short-term market interest rates. However, these components have decelerated this year because market rates have changed relatively little. Currency growth has remained modest in 2007, apparently a result of weak demand for U.S. dollars overseas.

M2 growth rate, 1991–2007



NOTE: Through 2006, the data are annual on a fourth-quarter over fourth-quarter basis; for 2007, change is calculated from 2006:Q4 to 2007:Q2 and annualized. M2 consists of currency, traveler's checks, demand deposits, other checkable deposits, savings deposits (including money market deposit accounts), small-denomination time deposits, and balances in retail money market funds.

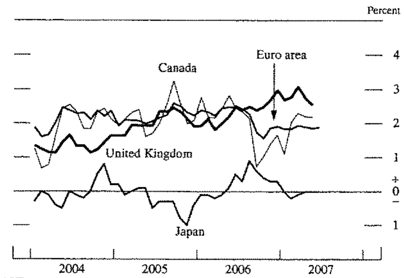
SOURCE: Federal Reserve Board, Statistical Release H.6, "Money Stock Measures."

International Developments

Foreign economic growth remained strong in the first quarter of 2007, supported by increased domestic demand in many key countries. Most recent indicators point to continued strength in foreign economies in the second quarter as well. Canada, the euro area, Japan, and the United Kingdom all posted above-trend growth rates in the first quarter. Although the expansion of the Japanese economy moderated somewhat in the first quarter, growth remained brisk relative to the average pace seen in recent years. Output accelerated in emerging Asia, led by China, and growth in Mexico appears to be picking up again after a lull in the first quarter.

Rising energy prices boosted consumer prices in many regions of the world last year, and, in some cases, substantial increases in food prices also contributed to inflation pressures. Broad measures of price inflation have continued to rise in many foreign economies this year, as economic growth has remained strong, and core inflation has moved up noticeably in a number of these economies. In response, monetary policy has been tightened in many

Consumer prices for major foreign economies, 2004–07

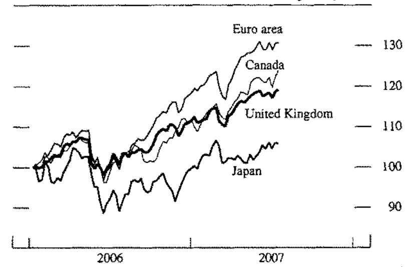


NOTE: The data are monthly; they extend through May for Canada, Japan, and the United Kingdom and through June for the euro area. Change is from one year earlier.

SOURCE: Haver.

Equity indexes in selected foreign industrial economies, 2006–07

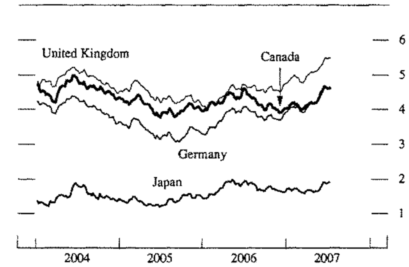
Week ending January 6, 2006 = 100



NOTE: The data are weekly. The last observation for each series is the week ending July 13, 2007.
SOURCE: Bloomberg.

Yields on benchmark government bonds in selected foreign industrial economies, 2004–07

Percent



NOTE: The data are for ten-year bonds and are weekly. The last observation for each series is the week ending July 13, 2007.
SOURCE: Bloomberg.

major industrial countries as well as in some emerging-market economies. Longer-term foreign interest rates have also risen.

Global financial markets were calm at the beginning of 2007, and volatilities for many asset prices were at, or close to, record lows. Toward the end of February, conditions changed, as international investors scaled back their exposure to risky positions—particularly those funded in yen—in response to a sharp drop in Chinese stock prices and concerns about the U.S. economy. As a result, equity prices in most industrial and emerging economies fell over the course of several days, while the yen appreciated sharply against most other currencies.

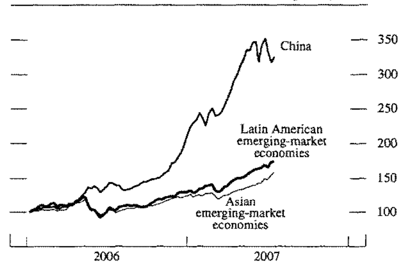
More-placid conditions returned in early March, and by early June share prices around the world had posted solid gains, reaching multiyear highs or even record highs in many countries. In particular, Chinese stock prices resumed their steep climb, although the rise was interrupted by occasional additional periods of heightened volatility. These episodes had no apparent disruptive effects on other global financial markets.

Most major global equity indexes experienced another increase in volatility during June and July amid concerns about the U.S. subprime-mortgage market, but they were little changed, on net, over this period. On balance, equity indexes in the major foreign industrial countries have increased between 5 percent and 12 percent in local-currency terms since the beginning of 2007. The Shanghai composite index is up more than 45 percent this year after a remarkable increase of about 130 percent last year. Leading equity indexes in other emerging Asian economies and in Latin America have also posted sizable gains in the range of 10 percent to 35 percent so far this year.

As in the United States, long-term bond yields in Canada, the euro area, and Japan rose significantly, on balance, in the first half of 2007; increases on ten-year nominal sovereign debt ranged from 25 to 70 basis points. Starting in early February, yields declined in global markets for several weeks amid growing concerns about the outlook for the U.S. economy. Since then, market participants seem to have become more optimistic about prospects for both U.S. and foreign economic growth, and yields have more than reversed the declines. Yields on

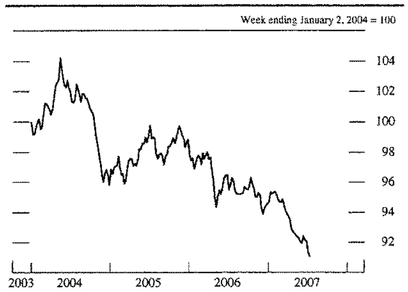
Equity indexes in selected emerging-market economies, 2006–07

Week ending January 6, 2006 = 100



NOTE: The data are weekly. The last observation for each series is the week ending July 13, 2007. For the Latin American and Asian groups, each economy's index weight is its market capitalization as a share of the group's total. The Latin American economies are Argentina, Brazil, Chile, Colombia, Mexico, Peru, and Venezuela. The Asian economies are China, India, Indonesia, Malaysia, Pakistan, the Philippines, South Korea, Taiwan, and Thailand. The series for China is the Shanghai Composite Index.
SOURCE: For Latin America and Asia, Morgan Stanley Capital International (MSCI) index; for China, Bloomberg.

U.S. dollar nominal exchange rate, broad index, 2004–07

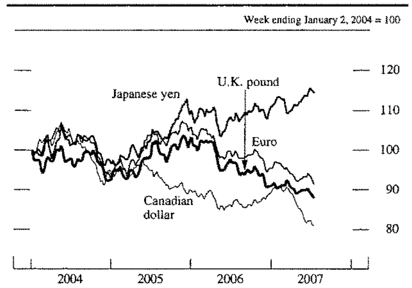


NOTE: The data are weekly and are in foreign currency units per dollar. The last observation is the week ending July 13, 2007. The broad index is a weighted average of the foreign exchange values of the U.S. dollar against the currencies of a large group of the most important U.S. trading partners. The index weights, which change over time, are derived from U.S. export shares and from U.S. and foreign import shares.
SOURCE: Federal Reserve Board.

inflation-protected long-term securities also rose during the first half of 2007 in the major industrial countries, but, with the exception of those in the euro area, they did not rise quite as much as nominal yields did, implying some modest increases in inflation compensation.

Our broadest measure of the nominal trade-weighted foreign exchange value of the dollar has declined about 3½ percent, on net, since the beginning of 2007. Over the same period, the major currencies index of the dollar has moved down more, about 4½ percent. On a bilateral basis, the dollar has depreciated 10 percent against the Canadian dollar and roughly 3½ percent against the euro and sterling; in contrast, it has appreciated about 2½ percent against the yen. The bulk of the change against the Canadian dollar occurred in the second quarter after better-than-expected news about economic activity and expectations of monetary policy tightening in Canada. The U.S. dollar has depreciated 3 percent, on net, against the Chinese renminbi since the beginning of 2007; the pace of change in the renminbi–dollar rate has accelerated somewhat over the past two and a half months.

U.S. dollar exchange rate against
selected major currencies, 2004–07

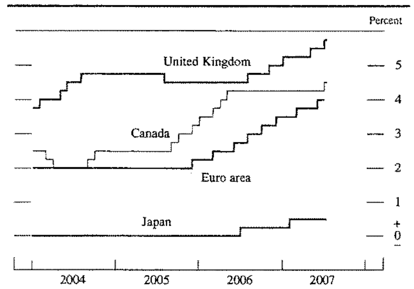


NOTE: The data are weekly and are in foreign currency units per dollar. The last observation for each series is the week ending July 13, 2007.
SOURCE: Bloomberg.

Industrial Economies

The major foreign industrial economies experienced above-trend growth in the first quarter of this year. In Canada, real GDP grew at an annual rate of 3¾ percent after rising nearly 2 percent during 2006; inventory accumulation figured prominently in the faster growth. In the United Kingdom, real GDP increased at an annual rate of 2¾ percent in the first quarter. Robust expansions in both countries have been accompanied by increases in inflation rates, which in recent months have hovered at or above those countries' inflation targets of 2 percent. Although the pickup in headline inflation partly reflected higher energy prices, core inflation has also trended up in recent months in both Canada and the United Kingdom. In the midst of elevated inflation and increasing rates of resource utilization, monetary policy was tightened three times this year in the United Kingdom (by 25 basis points each time) after two increases in the policy rate last year. The Bank of Canada also recently raised its policy rate 25 basis points. Market participants expect that both countries' central banks will raise their policy rates further.

Official or targeted interest rates in selected
foreign industrial economies, 2004–07



NOTE: The data are daily. The last observation for each series is through July 13, 2007. The data shown are the overnight rate for Canada, the refinancing rate for the euro area, the call money rate for Japan, and the repurchase rate for the United Kingdom.
SOURCE: The central bank of each area or country shown.

Growth of real GDP in the euro area moved down to 2¾ percent in the first quarter after posting growth of 3¼ percent over the four quarters of 2006. Although export growth moderated from its strong performance of 2006, recovery of domestic demand appears to have taken firmer hold, as investment accelerated in the first quarter. Private consumption in Germany had been muted earlier this year, partly because of a hike in the value-added tax at the start of the year, but lately retail sales in Germany and the euro area more broadly have picked up, on balance, from their January lows. Survey indicators of consumer and business sentiment also point to relatively strong growth in the euro area during the second quarter. Overall consumer price inflation has remained just below the European Central Bank's 2 percent ceiling since the fall of last year, while core inflation has risen to about 2 percent from around 1½ percent last year. To combat potential inflation pressures, the Bank continued to tighten monetary policy during the first half of this year, implementing two more increases of 25 basis points in its policy rates.

Japanese economic growth moderated in the first quarter of this year to a still-brisk annual rate of 3¼ percent. Household consumption rose at a robust rate of about 3 percent, and real exports increased almost 14 percent. Investment growth slowed, although recent surveys report that businesses are optimistic about the outlook. The labor market in Japan improved further in the first five months of the year: The unemployment rate fell below 4 percent, and the ratio of job offers to applicants remained elevated. Despite the strong growth of output and improved labor markets, consumer prices were about unchanged on a twelve-month basis in May; the GDP deflator has continued to fall, though, during the period. Core consumer prices have shown small twelve-month declines over the past several months, and wages have declined relative to their year-earlier levels.

Emerging-Market Economies

Economic activity in China accelerated in the first quarter of 2007 and appears to have remained robust in the second quarter. Growth was supported by a surge in exports and a pickup in fixed investment, which had slowed somewhat in the second half of 2006. The strength of exports has resulted in a ballooning of the Chinese trade surplus. Since late 2006, inflation in China has increased—reaching a rate of 3½ percent over the twelve months ending in May—largely because of higher food prices. Continuing rapid growth of aggregate demand and liquidity pressures from the accumulation of foreign exchange reserves have raised concerns about broader, more-sustained upward pressures on inflation. Chinese authorities have tightened monetary policy through several increases in banks' reserve requirements and two increases in interest rates so far this year; they have also continued to use sterilization operations to partially offset the effect of the reserve accumulation on the money supply.

Elsewhere in emerging Asia, real GDP surged in India and the Philippines in the first quarter and remained strong in Malaysia and Singapore. Growth was generally supported by domestic demand in all four economies. Growth held steady in South Korea, as stronger domestic demand was partially offset by a drag from net exports. Incoming data point to strength in the region in the second quarter. Outside of China, inflationary pressures in several emerging Asian economies have eased somewhat this year because of the unwinding of previous increases in food prices and, in some cases, the effect of currency appreciations. During the past year, political tensions in Thailand and uncertainty about the government's policy on capital controls have periodically disrupted markets and economic activity.

In a continuation of the deceleration that started about the middle of last year, Mexican output rose a scant ½ percent in the first quarter; manufacturing (particularly in the automobile sector) was restrained by the moderation in the U.S. economic expansion, and construction slowed sharply. Recent data on industrial production, however, suggest that growth may have rebounded in the second quarter. Mexican headline consumer price inflation continues to hover at the upper limit of the Bank of Mexico's target range of 2 percent to 4 percent. Monetary policy was tightened in Mexico in April for the first time since March 2005.

In Brazil, the growth of real GDP moderated to about 3 percent in the first quarter, as the appreciation of the Brazilian *real* weighed on the external sector. The strong *real* has also helped keep inflation in check despite fairly strong economic growth and a lowering of the policy interest rate. Economic growth in Argentina moved down in the first quarter, in part because of a contraction in exports, and reported data suggest that inflation has continued to decline. Growth in Venezuela appears to have slowed sharply so far in 2007 after three years of double-digit performances, driven by expansionary fiscal policy funded by high petroleum revenues. Venezuelan twelve-month inflation picked up to nearly 20 percent in June.

The Financial Services Forum
Policy Research

Succeeding in the Global Economy
A New Policy Agenda for the American Worker

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June 26, 2007

THE FINANCIAL SERVICES
FORUM

www.financialservicesforum.org

About The Financial Services Forum

The Financial Services Forum is a non-partisan financial and economic policy organization comprised of the chief executive officers of 20 of the largest and most diversified financial institutions. The Forum works to promote policies that enhance savings and investment in the United States and that ensure an open, competitive and sound global financial services marketplace.

The Forum's three primary missions are to:

- Educate the public about the importance of robust capital markets;
- Encourage a competitive global marketplace; and
- Shape the national and international regulatory dialogue.

As a group, the Forum's member institutions employ more than 2 million people in 175 countries and hold combined assets of more than $16 trillion -- an amount greater than the annual economic output of the United States, United Kingdom, and France combined.

Charles Prince, chief executive officer of Citigroup, is the chairman of the Forum. G. Kennedy Thompson, chief executive officer of Wachovia, is the Vice Chairman. Prince succeeds Treasury Secretary Henry M. Paulson, Jr., who served as the Forum's chairman before being nominated as secretary of the Treasury. Other past Forum chairmen include Philip J. Purcell, former chairman and CEO of Morgan Stanley, and William B. Harrison, Jr., chairman and former CEO of JP Morgan Chase.

Former United States Commerce Secretary Donald L. Evans is the Forum's chief executive officer and Robert S. Nichols, former assistant secretary for public affairs at the U.S. Treasury Department, serves as the Forum's president and chief operating officer.

The Forum was founded in 2000 and has been called "perhaps the country's most powerful trade association," by *Time*.

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Executive Summary

POLITICAL PRESSURE for a more protectionist tilt to U.S. economic policy has risen significantly in the past year. This policy drift reflects a drop in support for more open borders. Critics of U.S. trade policy (and globalization generally) argue that neither government nor private firms fully comprehend the forces at work in the global economy or appreciate the impact of these forces on individual workers and their communities. Public support for engagement in the global economy has been eroding rapidly in recent years. Left unaddressed, this erosion will gather momentum and will shape the economic-policy debate into the 2008 presidential elections and beyond.

This protectionist drift reflects a public increasingly skeptical about whether globalization benefits them. Today many American workers feel anxious—about change, and about weak or nonexistent income growth. These concerns are real, widespread, and legitimate. What role the forces of global engagement have played in this recent poor labor-market performance of most Americans remains an open question. But whatever the answer, in the current political discourse on this question globalization is front and center. There is a substantial risk that, absent an effort to clarify and address the real economic challenges at hand, policies will be implemented that isolate the United States from world markets and thereby undermine the ability of U.S. firms and workers to remain competitive in the global economy.

The goal of this report is to discuss the economic forces driving this policy drift away from global engagement, and then to offer a set of innovative policies for both the government and private sector aimed at arresting this drift. Our report explicates three key messages.

1. The Aggregate Benefits of Global Engagement

GLOBAL ENGAGEMENT has generated, and has the potential to continue generating, large gains for the United States overall and for the rest of the world as well. Living standards in the United States today are upwards of $1 trillion higher per year in total than they would have been absent decades of trade, investment, and immigration liberalization.

The average U.S. household could gain as much as $15,000 per year as a result of continued global engagement.

Looking ahead, annual U.S. income could be upwards of $500 billion higher with a move to global free trade and investment in both merchandise and services. This translates into average gain of at least $10,000 per U.S. household per year thanks to past liberalizations, $5,000 per household per year still to be realized.

These gains arise through many important channels. Globalization matches savings pools and investment opportunities around the world; it transfers ideas and technology to firms and people everywhere; and it frees countries from needing to produce what they consume. A number of forces—technological change, policy liberalization at home, and policy liberalization abroad—have fostered ever-greater flows across borders of goods and services, capital, ideas, and people. The net result has been higher aggregate productivity and living standards for the United States.

2. The Distributional Challenges of Global Engagement

THE AGGREGATE GAINS from global engagement, large though they are, are not evenly shared and do not directly benefit every worker, firm, and community. The many constituent forces of global engagement have also fostered economic changes that have pressured the well-being of many workers. These pressures are both short-term and long-term, and they often are concentrated in particular groups of workers, firms, and communities.

One very prominent cost is worker dislocation from increased product-market competition. International trade and investment are continually forcing U.S. firms to seek new ways of making profits; absent such innovations, these firms tend to scale down or even go out of business altogether. Global engagement is by no means the only source of job destruction in the American economy, but like dislocations from all sources, it often does create real costs in terms of unemployment spells and lower re-employment earnings.

Labor-market pressures are not limited to those directly dislocated and forced to move. Thanks to domestic competition among workers in the very dynamic U.S. labor market, over time the pressures of global engagement spread economy-wide to alter the earnings of even those not directly exposed to international competition.

From the mid-to-late 1970s to the mid-to-late 1990s, the real and relative earnings of less-skilled Americans was poor relative to both economy-wide average productivity gains and also the earnings of their more-skilled counterparts. And since around 2000, the large majority of American workers has seen poor income growth. Only a small share of workers at the very high end has enjoyed strong growth in incomes. The strong U.S. productivity growth of the past several years has not been reflected in broad growth in wage and salary earnings.

Economic openness has also pressured particular companies and communities. Global engagement fosters high productivity in American industries, but typically with substantial churn at the level of individual firms, with pervasive shut-down of inefficient plants and even entire companies. And because economic activity tends to be concentrated across American communities, this uneven distribution of globalization's pressures across workers and firms also means uneven pressures across communities as well. Hardship has befallen towns whose employment—and often tax revenues—are predominantly in firms and/or industries struggling against international competition.

The bottom line is that today, many American workers feel anxious—about change and about their paychecks. Their concerns are real, widespread, and legitimate. What role the forces of global engagement have played in this recent poor labor-market performance of most Americans remains an open question. But whatever the answer, in the current political discourse on this question globalization is often front and center.

"Economic policy should aim to produce a growing American economy in which every American can find opportunity to use their skills to craft their own economic future."

3. A New Policy Agenda

ECONOMIC POLICY should aim to produce a growing American economy in which every American can find opportunity to use their skills to craft their own economic future. That is the only way to meet the current challenge of guaranteeing that America overall continues to benefit from global engagement while also delivering on the idea of an equal-opportunity society and thereby addressing the legitimate distributional concerns about the pressures of economic openness. Our policy proposals draw on what are commonly considered domestic economic policy tools, rather than the tools of trade policy that are the focus of much of the current political debate. Globalization has largely erased distinction between domestic and international economic policy.

First, we explain how to address the current skewness in U.S. income growth. We start here because the protectionist drift reflects a public increasingly skeptical about whether globalization benefits them in the face of weak or nonexistent income growth. As such, we consider this poor earnings performance to be the most pressing policy issue to address. Our main proposal here is to reform the Federal Insurance Contributions Act tax to make it more progressive, either by fully integrating FICA into the income tax or by adding greater progressivity into FICA itself.

Second, we propose a menu of policy innovations designed to better facilitate adjustment by workers, communities, and firms. More can be done to smooth adjustment to the continual change in the dynamic U.S. economy in terms of hirings, firings, start-ups, and shut-downs.

One important proposal here is to combine Unemployment Insurance and the current Trade Adjustment Assistance program into a single integrated Adjustment Assistance program that offers a menu of features to all displaced workers. A second is to create a federal insurance facility that permits communities to insure their tax base against sudden economic dislocation. And a third is to identify certain communities facing significant pressures from international competition as Global Economic Development Platforms eligible for various supports aimed at attracting new investment to build new linkages to the global economy.

Third, we discuss why turning away from open borders—either a pause from liberalization or an actual move towards protectionism—is neither a viable nor desirable option.

Fourth, we propose a menu of recommendations to ensure that the United States remains fully engaged in the global economy. These proposals aim to move the discussion beyond the platitude "remain open" to a set of concrete ways to maximize America's gains from global engagement.

One important proposal here is for Congress to renew Trade Promotion Authority on a permanent basis. U.S. policymakers should aim to achieve meaningful liberalization in the Doha Development Round not just in agriculture, but more importantly in manufacturing and services. If Doha fails, the United States should call for the negotiation of a free-trade agreement covering both goods and services that would be open to all WTO members that choose to participate. Protection of inward foreign direct investment (FDI) needs to be strengthened, and the United States should remove outdated restrictions on inward foreign investment in areas including airlines, shipping, and telecommunications. And sensible immigration reform is needed, in particular to expand the supply of visas essential to attract top talent prospects by eliminating the cap on H1-B visas.

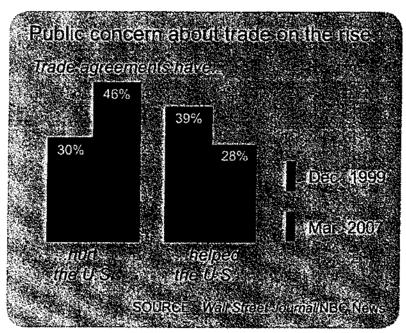
"One important proposal here is for Congress to **renew Trade Promotion Authority** on a permanent basis."

Introduction:
The Problem of Protectionist Drift

Political pressure for a more protectionist tilt to U.S. trade policy has risen significantly in the past year. Prospects are grim for Congressional renewal of President Bush's Trade Promotion Authority. The 109th Congress introduced 27 pieces of anti-China trade legislation. In just its first three months, the 110th Congress introduced over a dozen such bills.

Congress has also seen proposals to erect higher barriers to inward foreign direct investment (FDI). The Committee on Foreign Investment in the United States (CFIUS), which is legally required to review certain foreign acquisitions of U.S. businesses to determine whether they raise national security concerns, has lengthened the duration and raised complexity of many reviews. Both chambers of the 109th Congress passed bills to tighten CFIUS scrutiny even further, and similar legislation has already passed in the current House.

Trade negotiations have generated little forward movement that might forestall the protectionist drift. The Doha Development Round, the centerpiece of global trade liberalization, is years behind schedule and in real danger of collapse. Free-trade agreements with Panama, Peru, Colombia, and South Korea have run into stiff Congressional opposition. Little progress has been made in bilateral negotiations with Thailand or Malaysia.



This policy drift reflects a drop in support for more open borders. Critics of U.S. trade policy (and globalization generally) argue that neither government nor private firms fully comprehend the forces at work in the global economy or appreciate the impact of these forces on individual workers and their communities. Public support for engagement in the global economy has been eroding rapidly in recent years.

For example, An NBC/*Wall Street Journal* poll found that from December 1999 to March 2007 the share of respondents stating that trade agreements have hurt the United States increased by 16 percentage points (to 46%) while the "helped" share fell by 11 percentage points (to just 28%). A 2000 Gallup poll found that 56% of respondents saw trade as an opportunity and 36% saw it as a threat—but by 2005, the respective percentages shifted to 44% and 49%.

The March 2007 NBC/*Wall Street Journal* poll also found negative assessments even among highly skilled citizens: only 35% of respondents with at least a college degree said they directly benefit from globalization (versus just 20% for those at or below a high-school degree).

Left unaddressed, the trends in public opinion will gather momentum and will shape the economic-policy debate into the 2008 presidential elections and beyond. There is a substantial risk that, absent an effort to clarify and address the real economic challenges at hand, policies will be implemented that isolate the United States from world markets and thereby undermine the ability of U.S. firms and workers to remain competitive in the global economy.

The goal of this report is to discuss the economic forces driving this policy drift away from global engagement, and then to offer a set of innovative policies for both the government and private sector aimed at arresting this drift. Our report explicates three key messages.

1 Global engagement has generated, and has the potential to continue generating, large gains for the United States overall and for the rest of the world as well. A number of forces—technological change, policy liberalization at home, and policy liberalization abroad—have fostered ever-greater flows across borders of goods and services, capital, ideas, and people. The net result has been higher aggregate productivity and living standards for the United States.

2 These aggregate gains, however, are not evenly shared and do not directly benefit every worker, firm, and community. Even as global engagement has generated large gains for the United States, its many constituent forces have also fostered economic changes that have pressured the well-being of many workers. These pressures are both short-term and long-term, and they often are concentrated in particular groups of workers, firms, and communities.

3 Efforts to address these legitimate and large pressures on American workers by closing American borders is likely to be both infeasible and ineffective. Instead, both the public and private sectors must develop and implement more-creative policies both to broaden the set of stakeholders that directly benefit from international trade and investment and to assist those affected by economic change in general. We chart out a set of policy changes that aim to achieve this goal, with a focus on workers, firms, and communities.

The challenge posed by the drift toward protectionism is not just a question of perception. Real and relative income performance of many Americans—and in recent years, a widening group of Americans—has been poor. Job insecurity is high and rising for many. These concerns of American workers are the primary focus of our report. Workers are the key stakeholder on which we focus, with an ultimate goal of the mix of business and government policies that can maximize their ability to gain directly from the forces of global engagement.

Many point the finger for these labor-market pressures at international trade, and advocate policies to limit trade. We will argue that while global forces have played some role, the full set of forces at play are much broader, in ways still not fully understood. We will argue that regardless of the relative role of these different forces, the set of polices to address the legitimate concerns of American workers are not policies of isolationism. Instead, businesses and government need to consider a much broader range of policy options.

This need for fresh thinking is driven by the those broader forces of globalization which have accelerated the pace of economic change Americans have experienced in recent years relative to earlier decades. One especially notable innovation is the spread of globalization to activities in previously non-traded service sectors (such as finance, medical care, and a variety of business processes), a development that seems to be expanding yet the ultimate breadth and impact of which remain open to lively debate.[1]

The essence of the challenge we face is how best to reap the benefits of participating in the global economy and succeed in maintaining America's competitiveness while reducing the human cost of adapting to the economic changes that globalization fosters. In our view, one of the key elements missing from the policy discussions is a "competitiveness agenda" for the American worker – one that ensures every American has the tools to participate productively in the global economy and benefit from the opportunities it creates.

We will set out a broad set of ideas that need to be considered by all stakeholders: workers, the business community, and elected officials. We offer a pragmatic approach of trying to ask the right questions about the challenges we face to propose policy responses that do, in fact, address those challenges. We aim to reframe the issues, to accurately identify the challenges globalization poses, and to offer business leadership in addressing them.

Our policy proposals to help ensure that American workers benefit more broadly from our participation in a global economy will largely draw on what are commonly considered domestic economic policy tools, rather than the tools of trade policy that

1 An important early work here is: Blinder, Alan S. 2006. "Offshoring: The Next Industrial Revolution?" *Foreign Affairs* 85, March/April, pp. 113-128.

are the focus of much of the current political debate. The reality is that globalization has largely erased distinction between domestic and international economic policy, and that traditional trade tools are inappropriate and/or ineffective for the challenges facing many American workers, firms, and communities.

Instead, we focus our proposals on fostering for the United States an open economy that attracts globally engaged companies whose nexus of productivity-enhancing activities yield high-quality, good-paying jobs. A critical part of this environment will be expanding the ways in which the public and private sectors equip American workers with the tools to compete for those jobs in a global market. What that means in very real terms is that America cannot afford to leave individuals on the margin. Wholly apart from the moral arguments in favor of raising living standards for all, we must recognize that there can be a significant economic cost from failing to address legitimate distributional concerns in terms of lower living standards for all.

Our proposals aim to strike a balance between the need to ensure that American firms (and the American-based operations of foreign investors) can continue to generate large gains from global engagement for America overall—fostered by further trade and investment liberalization—and the need for well-constructed, well-targeted policies to spread these gains more widely across American workers, firms, and communities.

But, where appropriate, we will also try to identify policies that firms can pursue as well. If government's role is to ensure an economic environment that is conducive to new investment in productive activities that generate high-quality employment opportunities and to maximize the ability of every American citizen to participate in those opportunities, business' role is to respond to those incentives by making the investments and generating the jobs, and contributing to the process of developing a talented workforce.

Section 1:
The Aggregate Benefits of Global Engagement

Economists disagree on a lot. What is the proper way for central banks to conduct monetary policy? What is the best design of a fiscal system in terms of activities to tax and at what rates? How large a share of economic activity should be accounted for by government spending?

But there are two important economic-policy issues on which economists are nearly unanimous. One is that *productivity* is the single best indicator of the average standard of living of a country. The other is that *economic openness*—to cross-border flows of goods and services, of capital, and of people and ideas—raises the productivity and thus average living standards of a country. In this opening Section 1 of this report, we discuss and document the large gains that the United States has enjoyed in the past—and could enjoy in the future—from the forces of globalization.

I. Why Productivity Matters

To gauge the average standard of living of a country's citizens, the single most important indicator of well-being is *productivity*: the average value of output of goods and services a country produces per worker.[1] The following quotation from noted economist and *New York Times* columnist Paul Krugman makes this point concisely.[2]

> *Productivity isn't everything, but in the long run it is almost everything. A country's ability to improve its standard of living over time depends almost entirely on its ability to raise its output per worker ... the essential arithmetic says that long-term growth in living standards ... depends almost entirely on productivity growth ... Compared with the problem of slow productivity growth, all our other long-term economic concerns—foreign competition, the industrial base, lagging technology, deteriorating infrastructure, and so on—are minor issues. Or more accurately, they matter only to the extent that they have an impact on our productivity growth.*

1 It is important to stress that this report defines productivity as the productivity of labor. Economists use other productivity measures as well. For example, capital productivity is a measure of the average value of output produced per unit of capital. "Total factor" productivity is a measure of the average value of output produced per bundle of inputs such as labor and capital.

2 Krugman, 1990, pp. 9-13.

The economics of this "essential arithmetic" for why productivity matters is very simple. Broadly defined, a country's standard of living rises with the quantity and quality of goods and services its citizens can consume. People achieve economic well-being by consuming goods and services such as food, clothing, and medical care. Consuming these items requires some means to pay for them. For almost all people, their income is the primary — if not the only — means they have to pay for consumption.[3] In turn, people's income comes from producing goods and services, usually by working with others in firms.

Thus, the more people produce —that is, the more productive they are— the more income they receive and the more they can consume. Higher productivity means a higher standard of living.

So how can a country raise its productivity? There are only three basic ways to raise a country's overall labor productivity: (1) save and invest in other inputs like physical capital; (2) improve the technological know-how and techniques for transforming inputs into outputs; and (3) improve its allocation of workers and inputs across different industries to high-productivity uses.

One way to boost productivity is to accumulate the other inputs people work with to produce things. The most important other input people need is capital, broadly defined as goods and services that help people make other goods and services—e.g., buildings, machinery, software. All standard theories of economic growth agree on this point. The more capital workers have at their disposal, the more output each worker can produce with these tools. One of the earliest formulations of how capital accumulation raises output per worker was by Nobel Laureate Robert Solow.[4] More recently, Paul Krugman summarizes the theory this way.

> *What can we do to speed [productivity growth] up? There is a standard economic answer ... If you want more output, say the economists, provide more inputs. Give your workers more capital to work with, and better education, and they will be more productive.*

A second way to raise productivity is to improve the technological know-how for transforming inputs into outputs. Economists generally conceive of production technology as the methods by which inputs are combined to produce output. Numerous empirical studies have documented that technology advances were an important force behind overall U.S. output growth in the 20th century. For example,

3 Other options include selling assets or borrowing, but these are not sustainable indefinitely.

4 The link from higher investment to higher productivity assumes that an economy has not reached its "steady state" at which capital investment just offsets capital depreciation (i.e., the inevitable wear and tear on capital goods from their use). In the steady state (with constant technology and no population growth), output per worker is constant. Most economists think, however, that countries in the real world tend not to be in steady states.

Robert Solow calculated that about 75 percent of U.S. growth during the first half of the 20th century was driven by technological gains.

The third way to raise productivity is to improve the allocation of a country's workers (and other inputs) across different industries to high-productivity uses. Different industries can require different combinations of workers, capital, and ideas—for example, financial services require lots of highly educated talent and information technology equipment. A country can raise its productivity by being able to focus on those activities.

II. The Theory of How Economic Openness Can Raise Productivity and Living Standards

How can economic openness contribute to higher average productivity and thus higher average living standards? Perhaps the most vivid way to demonstrate this is to see how a country that is closed off from the rest of the world raises its living standards.

A closed economy must provide its own savings for investment in building its capital stock. It cannot finance investment in tomorrow's productive capacity by tapping into savings abroad. A closed economy must generate its own ideas, technologies, and techniques for product and process innovations. It cannot rely on the people and ideas of the rest of the world, either directly or indirectly as an innovative spur. And a closed economy must produce its own goods and services to consume today. It cannot reallocate resources to specialize in its particular strengths, because doing so might mean not making enough of everything to satisfy families' demands today.

Globalization and economic openness support productivity and living standards by relaxing all three of these constraints.

With globalization, savings by the world's households, firms, and governments can be deployed to productive investment opportunities literally around the globe, not just at home. Some private cross-border flows of capital that support investment and ultimately worker productivity happen inside multinational corporations through their FDI abroad. Other private cross-border flows of capital take the form of portfolio investment—in equities, bonds, and other assets—all mediated by commercial and investment banks. The net effect has been to bring investors and investment opportunities together on a global basis.

With globalization, ideas that improve technology can move across borders through many different channels. Ideas accompany people as they move via immigration—indeed, there becomes a global market not just for ideas, but for the talent that creates them. Ideas are deployed within multinational corporations as they spread their innovations among parent and affiliate operations. And ideas flow via the internet and countless other channels by which information technology connects workers, firms, and communities. We emphasize that all these linkages can matter, not just directly but also indirectly as a spur to firms everywhere to innovate new products and processes themselves.

And with globalization, a country can trade so that it no longer needs to produce what it consumes. It can concentrate people and capital in certain activities to which it is well suited compared to the rest of the world—activities in which a country holds a comparative-advantage, in the lexicon of economics. It can then export some of these activities to the rest of the world in exchange for imports of different bundles of goods and services—imports that can be enjoyed both in greater variety and at lower prices than would be the case without trade.

There are many channels, then, through which economic openness supports high and rising average livings standards. We emphasize, however, that openness per se is no panacea that automatically delivers higher average productivity. Rather, globalization provides expanded opportunities to a country's workers, firms, and communities. To be realized, these opportunities need to be complemented with an appropriate set of government and business policies. This is a very important point that will inform our policy discussions in Section 3.

III. What Forces Have Been Driving Global Engagement And How Do We See It?

In recent decades, two broad forces have driven the integration of world markets for goods and services, labor, capital and ideas. One is the decline of natural barriers. In the generation after World War II there were major innovations in the global movement of output and people: for example, containerized shipping, wide-body jets and commercial aviation. More recently there have been dramatic innovations in information and communication technologies—e.g., the creation of personal computers and the rise of the internet—that have supported international flows of ideas, capital, people, and output.

The other is the decline of *political* barriers. Governments in almost every country have chosen to liberalize their laws and regulations restricting cross-border flows. Political barriers have fallen in very dramatic fashion, perhaps the most vivid of which is the end of the Cold War and subsequent political revolution in the Soviet Union and most of its former communist satellites. For many decades after World War II, these countries were largely separate from the global economic system. Political barriers have also sometimes fallen unilaterally, i.e., as individual countries decide to engage with the world. Two of the most dramatic examples of this have been the ongoing acceleration of China and India's integration into the global economy. They have also fallen regionally and multilaterally, for example, with successive rounds of trade liberalization in the General Agreement on Tariffs and Trade and its successor, the World Trade Organization.

The impact of falling natural and political barriers to integration has been a dramatic rise in cross-border flows of people, ideas, goods and services, and capital. For the United States and many other countries, in recent decades the rate of growth of these cross-border flows has been much higher than the rate of growth of overall economic activity measured as gross domestic product (GDP). The size of these flows today is striking. In 2006, the United States exported to the rest of the world $1.47 trillion in goods and services, and imported from the rest of the world $2.23 trillion. As large as these amounts may seem, capital flows are an order of magnitude bigger. In 2006, foreigners purchased $21.1 trillion of U.S. long-term securities—while also selling $20.0 trillion worth of such securities. That same year, U.S. residents purchased $5.6 trillion in long-term securities—while also selling $5.8 trillion of such securities.[5]

"The impact of falling natural and political barriers to integration has been a dramatic rise in cross-border flows of people, ideas, goods and services, and capital."

IV. The Evidence on How Global Engagement Raises U.S. Productivity and Living Standards

The discussion above identified many channels through which global engagement can raise the productivity and average living standards of a country. But what do the data show? Has the United States benefited from integrating with the world economy? By how much? Can future liberalization deliver additional gains?

We turn now to what research by academic, policy, and private-sector economists says about these very important questions. It is important to emphasize at the outset, however, that because global engagement involves so many dimensions, different studies that use different methods to quantify different dimensions can and do yield different answers. The right question to ask is not, "What is the single dollar amount by which the United States has benefited from integration with the world?" It is instead, "What does the preponderance of evidence indicate has been the range of benefits the United States has realized from integration with the world?"

5 Data on trade flows come from the Bureau of Economic Analysis, National Income Accounts. Data on capital flows come from the U.S. Department of Treasury, Treasury International Capital data.

Evidence on Gains to the Overall U.S. Economy: Past

Recall there are three broad channels by which countries can benefit from greater economic openness brought about by lower natural and/or political barriers: better resource allocation; expanded knowledge of technology and techniques; and higher capital accumulation. How big have the gains through these three channels been for the United States?

Three channels by which countries can benefit from greater economic openness:

1. better resource allocation
2. expanded knowledge of technology and techniques
3. higher capital accumulation

Start with resource-reallocation gains. Here it is important to realize that gains can be measured for firms, in terms of being able to sell more exports by specializing in comparative-advantage activities, and for individuals and families as consumers, in terms of enjoying a wider variety of goods and services to consume at lower prices. Combined, these gains have been estimated to be large—especially once the value of broader variety is accounted for. For example, recent analyses suggest that reductions in U.S. tariffs since Smoot-Hawley in the U.S. and the rest of the world have increased real U.S. incomes by 4.5 percent of GDP, both by stimulating more capital formation and by improving resource allocation.[6] Increases in product variety in trade have added nearly three more percent of U.S. GDP.[7] In addition, a full accounting would yield additional gains from the impact of improved communications and transportation.

What about the gains from better technology and techniques? Many studies have tried to quantify economy-wide gains from the many linkages at play in these two channels. When considering both liberalization of trade and investment, the magnitudes here seem to be very large: something on the order of five to ten percent of U.S. GDP per year—above and beyond the 7.5 percent from the resource-reallocation gains of the previous paragraph![8]

Taking all these channels together yields a striking picture: the global engagement of recent decades means that today, annual U.S. income is conservatively ten percentage points of GDP higher than it would have been absent this integration. This translates into an immense aggregate gain of at least $1 trillion per year, or an

6 See the analysis in: Bradford, Scott C. and Robert Z. Lawrence. 2004. "Non-MFN CGE Simulations." Photocopy manuscript, Brigham Young University and Harvard University.

7 An excellent study on this topic is Christian Broda and David Weinstein, 2006, "Globalization and the Gains from Variety," *Quarterly Journal of Economics*, 121 (2).

8 A careful, comprehensive study in this area is Bradford, Scott C., Paul L. E. Grieco, and Gary Clyde Hufbauer. 2005. "The Payoff to America from Global Integration." In *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, edited by C. Fred Bergsten. Washington: Institute for International Economics.

average gain of at least $10,000 per U.S. household per year—21.6 percent of the 2005 median U.S. household income of $46,326.

To see all these channels at work, it can help to refine the focus from the overall U.S. economy down to particular industries, firms, and workers. To do this, let's start with the recent productivity performance of the U.S. economy.

Output per worker hour in the U.S. non-farm business sector has doubled in the past decade: from an annual average of 1.35% over 1973-1995 to an annual average of 2.70% since 1995. Thanks to the relentless math of compound interest, the importance of this productivity acceleration is difficult to overstate. At the previous generation's growth rate, average living standards required 52 years to double. At the current growth rate, average living standards need just 26 years to double. This difference of 26 years spans an entire generation, and so carries profound implications for the well-being of all Americans.

This productivity acceleration was not driven equally across all industries. Instead, much of the initial acceleration was related to information technology (IT)—and IT is one of America's most globally engaged industries. IT companies have been at the forefront of establishing and expanding production networks linked by trade and investment around the globe. Up until 1980, America was good relative to the rest of the world at making computers and related machinery. The earliest personal computers were produced largely in the United States in small manufacturing plants dotting Silicon Valley and elsewhere. But then IT firms, thanks to rising domestic competition and opening borders around the world, began to establish and expand global production networks.

Both falling natural and political barriers to trade and investment have driven the global engagement of the IT industry. Indeed, since the creation of the WTO the only industry to enact a free-trade agreement has been IT. Signed in 1996 by dozens of countries accounting for nearly 95 percent of world IT trade, the Information Technology Agreement eliminated over four years all world tariffs in hundreds of IT capital goods, intermediate inputs, and final products. This trade agreement facilitated the reconfiguration of global production, with U.S. IT firms moving to higher value-added activities such as core R&D, initial manufacturing, design, and marketing.[9]

The trade and investment data for the U.S. IT industry are striking. Imports and exports as a share of output have been high and rising in IT industries for decades. Imports and exports currently each equal over 100 percent of value-added of these products, far higher than in the broader economy. In the United States, parents of U.S.-headquartered multinationals account for about two-thirds of total U.S. sales

9 For a detailed discussion of the support that international trade and investment gave to productivity growth in the IT industry, see: Matthew J. Slaughter. 2002. *Technology, Trade, and Investment*. Washington, D.C.: Emergency Committee for American Trade.

in the central IT industries. Outside the United States, foreign affiliates of these U.S. companies now account for between 25 and 50 percent of worldwide firm value-added and employment, and around 15 percent of worldwide firm research and development—with nearly 60 percent of their output being exported rather than sold in host markets. These shares have been rising, and are generally higher than for other sectors.[10]

Integral to the productivity success of IT has also been cross-border flows of ideas and people. Research of the IT industry in Silicon Valley has documented that by 1998, 24 percent of the corporate executives in the region's technology companies were immigrants from China or India. This example of America's reliance on high-skilled immigrants for know-how is reflected in the overall economy: the share of U.S. Ph.D.s in hard sciences and engineering that were foreign born rose from 24 percent in 1990 to 38 percent in 2000.[11]

Information technology offers a very clear example of the dynamic benefits globalization has brought to many American producers.[12] But IT firms are by no means unique. International trade and investment are critical spurs to productivity growth in companies throughout the economy. There is now a large body of evidence for many countries that plants and/or firms exhibit substantial and persistent heterogeneity in total factor productivity and related performance. In recent years researchers have also documented a robust correlation between productivity and global engagement: plants and/or firms that export or, even more so, are part of a multinational enterprise tend to have higher productivity than their purely domestic counterparts.

Some of the most comprehensive research on this issue has been conducted by the McKinsey Global Institute (MGI), which has examined hundreds of firms and industries in countries ranging from the United States to India. A repeated finding is that exposure to "global best-practice firms" via trade and FDI stimulates firm productivity, and conversely that protection from global best practice retards it.

A clear statement of this globalization-to-productivity link appears in work by Nobel Laureate Robert Solow and former chairman of the Council of Economic Advisers Martin Baily:

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10 Matthew J. Slaughter. 2002. *Technology, Trade, and Investment.* Washington, D.C.: Emergency Committee for American Trade.

11 AnnaLee Saxenian. 1999. *Silicon Valley's New Immigrant Entrepreneurs.* San Francisco: Public Policy Institute of California. The economy-wide data come from the decennial population census of the U.S. Census Bureau.

12 See Catherine L. Mann and Jacob Funk Kirkegard. 2006. *Accelerating the Globalization of America: The Role for Information Technology.* Washington, D.C.: Institute for International Economics.

> *A main conclusion of the studies ... has been that when an industry is exposed to the world's best practice, it is forced to increase its own productivity. This finding emerged from a study that compared nine manufacturing industries in the United States, Germany and Japan. For each industry, the country that had the highest labor productivity in that industry was designated as "best practice," leaving 18 industries-country pairs that were below best practice. For each of these "follower" industries, a "globalization index" was calculated, reflecting the exposure of this industry to the best practice industry [via trade and FDI]. The relative productivity levels of the follower industries was then correlated with the globalization index, and there was a clear positive correlation. This positive correlation is consistent with the view that the more a given industry is exposed to the world's best practice high productivity industry, the higher is its relative productivity (the closer it is to the leader). Competition with the productivity leader encourages higher productivity.*[13]

The many channels through which integration into the world economy fosters high productivity show up clearly in the basic performance data of globally engaged companies. Start with firms that export or import. It is well documented that these trading companies tend to be larger, more capital and knowledge intensive, and pay higher compensation to observationally equivalent workers than do purely domestic companies.[14]

Even stronger performance is documented in the U.S. companies that are part of a multinational firm—either the U.S. parents of U.S.-headquartered multinationals or the U.S. affiliates of foreign-headquartered multinationals. The following tables document how these two sets of globally engaged companies perform substantial shares of the exporting, importing, capital investment, and research and development that help foster higher average living standards (all data here are for 2004, the most recent year currently available, where shares are shares of private-sector activity).

Companies in the United States that are part of a multinational firm account for barely one in four private-sector jobs. But these firms account for over 30% of GDP, a third of capital investment, half of all trade in goods, and a remarkable almost 80% of R&D. The bottom line of all these productivity-enhancing activities shows up

13 Baily, Martin Neil, and Robert M. Solow. 2001. "International Productivity Comparisons Built from the Firm Level." *Journal of Economic Perspectives*, Vol. 15, No. 3, Summer, pp. 151-172. For an additional comprehensive study on the links from economic openness to productivity, see: Robert Z. Lawrence. 2000. "Does a Kick in the Pants Get You Going or Does It Just Hurt? The Impact of International Competition on Technological Change in U.S. Manufacturing." In Robert C. Feenstra (ed.), *The Impact of International Trade on Wages*. Chicago: University of Chicago Press, pp. 197-224.

14 For a detailed discussion of the facts and interpretation of these performance differences, see: Howard Lewis III and J. David Richardson. 2001. *Why Global Commitment Really Matters!* Washington, D.C. Institute for International Economics. Also see the 2007 *Economic Report of the President*.

Table 1: Performance of U.S. Parents of U.S. Multinational Firms

Activity	Parent Share	Parent Value
Employment	19.0%	20.4 million
GDP	24.5%	$2.2 trillion
Capital Investment	26.7%	$308.7 billion
Imports of Goods	30.0%	$448.5 billion
Export of Goods	48.8%	$399.5 billion
Research and Development	66.1%	$145.0 billion

Table 2: Performance of U.S. Affiliates of Foreign Multinational Firms

Activity	Parent Share	Parent Value
Employment	4.5%	5.1 million
GDP	5.7%	$515.0 billion
Capital Investment	9.4%	$108.1 billion
Imports of Goods	25.3%	$378.1 billion
Exports of Goods	18.8%	$153.9 billion
Research and Development	13.6%	$29.9 billion

where one might hope: in paychecks. In recent years, workers at these firms earned an average annual compensation somewhere between a quarter to a third higher than the average annual compensation in the rest of the U.S. private sector. Much of this differential seems to stem from the nexus of productivity advantages enjoyed by these globally engaged firms.

Evidence on Gains to the Overall Economy: Prospective

The above discussion makes clear that in recent decades the U.S. economy has benefited tremendously from global engagement. But what does the future hold? Would additional declines in natural and/or political barriers yield much else?

At the time of our writing this report, the current Doha Development Round of the WTO remains focused—as it largely has been since the round's launch in late 2001—on agriculture and, to a lesser extent, manufacturing. Services, which make up the bulk of the U.S. economy have hardly figured in the talks to date. Economists have tried to gauge the basic resource-reallocation gains that a Doha merchandise liberalization could deliver to the United States. The consensus estimates here are quite small, even for global free trade in merchandise: something like $20 billion in additional annual U.S. income.[15]

Why does this number seem so small? One reason is that decades of trade and investment liberalization in merchandise have been quite successful in eliminating the majority of tariffs and non-tariff barriers in manufacturing. Another is that agriculture is such a small part of the U.S. economy today: just 0.9% of total U.S. GDP in 2005.

Studies agree that the major payoff from future liberalization is likely to come from liberalizing trade and investment in services. Through the three broad channels cited earlier—liberalization could deliver very large gains. Studies have estimated that global free trade and investment in not just merchandise but services as well could raise U.S. income by an additional $500 billion per year—over $5,000 for the average American family.[16]

The gains from services liberalization could be that large for three important reasons. One is that services account for such a large part of the U.S. economy today: 83.7 percent of payroll jobs, with more Americans working today in broad sectors such as retail trade, health care, and professional and business services than in all of manufacturing. A second is that the United States maintains a strong comparative advantage in many services activities. This is revealed in the aggregate trade statistics: the overall U.S. trade deficit of $763.6 billion in 2006 masked a sizable services-trade *surplus* of $72.5 billion that partly offset a goods-trade deficit of $836.1 billion. And a third reason is that today both political and natural barriers to cross-border transactions in services remain relatively high even though recent IT advances are making more services activities tradable, as discussed in the Introduction to this report.

It is important to point out that for many services activities, the main channel through which U.S. firms serve foreign markets—and thus the predominant political barriers to consider—is FDI, not exporting. This fact shows up clearly in the statistics on U.S. multinational firms: in 2004, sales abroad by majority-owned foreign affiliates of U.S. multinationals were $3.2 trillion, in contrast to just $400 billion in goods exports by these same parent companies. For America to realize the income gains from serving

15 See, for example: Bradford, Scott C., Paul L. E. Grieco, and Gary Clyde Hufbauer. 2005. "The Payoff to America from Global Integration." In *The United States and the World Economy: Foreign Economic Policy for the Next Decade*, edited by C. Fred Bergsten. Washington : Institute for International Economics. Similar results are obtained by the "Michigan Model" of University of Michigan economists Alan Deardorff and Robert Stern, as used, e.g., in: Kiyota, Kozo, and Robert M. Stern. 2007. Economic Effects of a Korea-U.S. Free Trade Agreement. Korea Economic Institute of America (KEI) Special Studies Series 4. Washington (April).

16 See note 15.

foreign markets in services, reducing barriers abroad to FDI will be of paramount importance.

V. The Evidence on How Global Engagement Raises Productivity and Living Standards Abroad

The large U.S. economic gains from globalization have been repeated around the world. In recent times India and—even more—China have achieved stupendous rates of productivity growth that have lifted out of poverty hundreds of millions of people. Output per worker in China is now growing at about 9 percent per year, an astonishing rate at which average Chinese living standards are taking just eight years to double.

Central to this success has been introducing market forces—in particular international market forces via trade and FDI. Think Chinese manufacturing, where today over half of all exports are accounted for by foreign multinational companies. Or think Indian IT software, where today two thirds of sales are accounted for by Indian or foreign multinational firms.

China and India offer important evidence against the widely articulated argument against global engagement for developing countries: that without protection, host-country firms cannot compete against their foreign counterparts. This "infant industry" logic contends that barriers to openness can insulate fledgling domestic firms from foreign competition. With this protection, firms can become more productive through channels such as learning by doing, facilitating local supplier networks, investing in physical capital, and undertaking research & development. Eventually, openness can be welcomed by a vigorous rather than vulnerable domestic industry.

Economic theory alone was never able to gauge the value of the infant-industry argument for developing countries. Instead, empirical evidence was required. The recent experiences of China and India in emphasizing export promotion, rather than import protection, are but two examples of the common outcome that infant-industry protection often fails because of at least three real-world complications.

One is that when protected, developing-country firms often do not achieve the best-practice productivity envisioned. Learning-by-doing for a largely domestic market can be insufficient; capital investments can be misdirected, and R&D can be unproductive. A second is that even if protected firms do gain efficiency, perverse political-economy incentives often arise that compel protected firms and other benefiting parties to seek more and/or longer trade protection than might be warranted. For protected firms, the highest-return activities can be political lobbying. And a third is that protection of certain industries often incurs opportunity costs of foregone comparative advantage. Even if a protected sector expands, aggregate national welfare can still be lowered because the resources used in expansion might have been more productively hired by other firms in other sectors.

Around the world, protection against trade and FDI tends to inhibit, rather than develop, the ability of developing-country firms to compete in international markets. Exposure to global best practice induces better firm performance via access to technology, access to capital, and competitive pressures. The investments in capital and technology that are needed for firm competitiveness are more likely the more engaged firms are in global product markets—and, especially, in the global production networks of multinationals and other globally engaged firms.

Of course, the fact that developing countries can benefit from global engagement through trade and FDI does not necessarily mean that they will. Openness may be necessary for stimulating developing-country industrial development, but by no means is it likely to be sufficient. It will be important to examine what constellation of policies governments can pursue to maximize the chances of success in their efforts to develop industries through global engagement. Some of these policies can be implemented and yield results quite quickly; others are longer-term endeavors whose payoff can take many years.

"Exposure to global best practice induces better firm performance via access to technology, access to capital, and competitive pressures."

VI. Summary: The Aggregate U.S. Gains from Global Engagement

Global engagement has generated, and has the potential to continue generating, large gains for the United States overall and for the rest of the world as well. Through the critical channels of capital investment, technological progress, and resource reallocation, American productivity is higher because of globalization.

Living standards in the United States today are upwards of $1 trillion higher per year in total than they would have been absent decades of trade, investment, and immigration liberalization. Looking ahead, annual U.S. income could be upwards of $500 billion higher with a move to global free trade and investment in both merchandise and services. These very large aggregate gains appear in particular industries, firms, and workers. Information technology was one vivid example we discussed. Through many channels of cause and effect, global engagement spurs higher productivity and, ultimately, higher average earnings.

All this discussion of aggregate gains is not to say that no costs are incurred in achieving them. The process of realizing these gains, through the many channels we discussed, is inherently dynamic. The adjustments of workers and capital being re-deployed across firms, industries, and communities may involve spells of unemployment and, over the longer run, the need to find jobs at wages lower than previously enjoyed. Indeed, as our discussion above of infant-industry protection demonstrated, for decades the economics literature has had theoretical models in which countries can, on net, suffer larger aggregate costs than gains from global engagement.

Has empirical research demonstrated that these aggregate real costs don't outweigh the aggregate real benefits? Yes. This has been a perennial question for decades, and the repeated empirical answer has been that total adjustment costs are far outweighed by total gains—sometimes by factors of 20 or even 100! Such studies can be inherently difficult, in part because of difficultly in quantifying costs such as the hardship of being forced to move geographically to regain employment. Nevertheless, there is widespread agreement that aggregate gains dominate aggregate costs.[17]

The evidence of this Section is, in itself, difficult to reconcile with the drift towards protectionist policies discussed in the Introduction. If globalization is so good for the U.S. economy overall, then why is protectionism on the rise? We argue that the explanation of this apparent puzzle hinges critically on distribution. Even as global engagement has generated large aggregate, on-average gains for the United States, its many constituent forces have also fostered economic changes that have pressured the well-being of many American workers, firms, and communities. Section 2 of this report examines these legitimate and widespread distributional concerns.

> "Through the critical channels of capital investment, technological progress, and resource reallocation, American productivity is higher because of globalization."

17 One early study estimated that the benefits from a five-year phase-out of all U.S. trade restrictions in 1971 would be 100 times greater than the wages that would be lost during the transitional unemployment required for displaced workers to find new jobs. See Magee, Stephen P. 1972. "The Welfare Effects of Restrictions on U.S. Trade." *Brookings Papers on Economic Activity* (3), pp. 645-701. A more-detailed follow-up study concluded that the overall gains from trade liberalization were 20 times the overall adjustment costs: see Baldwin, Robert E. John H. Mutti and J. David Richardson. 1980. "Welfare Effects on the United States of a Significant Multilateral Tariff Reduction." *Journal of International Economics* 10(3), pp. 405-423.

Section 2:
The Distributional Challenges of Global Engagement

In Section 1 we documented that the U.S. economy as a whole benefits greatly from global engagement. But the many forces of global engagement also impose real and often large and persistent costs on some American firms, workers, and communities.

One very prominent cost is worker dislocation from increased product-market competition. International trade and investment are continually forcing U.S. firms to seek new ways of making profits; absent such innovations, these firms tend to scale down or even go out of business altogether. And the labor-market pressures are not limited to those directly dislocated and forced to move. Thanks to domestic competition among workers in the very dynamic U.S. labor market, over time the pressures of global engagement spread economy-wide to alter the earnings of even those not directly exposed to international competition.

In this section we evaluate these distributional pressures of global engagement. We focus on three channels: worker dislocation, worker earnings, and a related angle of firms and communities. There is evidence that globalization has contributed to job loss, weak wage growth—particularly for less-skilled workers that still constitute the majority of the U.S. labor force—and increased worker anxiety.

However, a central message that emerges from our analysis is that because globalization is just one of many sources of structural change in the U.S. economy, isolating its particular contribution to these outcomes is very difficult. The U.S. economy is in a continuous state of flux, buffeted by technological and institutional innovations, demographic changes, cyclical fluctuations, government policy changes, and the many other powerful factors that shape the competitive struggles between firms. Because all these forces shape labor-market outcomes, the key policy challenge becomes not trying to isolate and limit the pressures of globalization but rather equipping American workers, firms, and communities to adapt to changes of all kinds.

"...the many forces of global engagement also impose real and often large and persistent costs on some American firms, workers, and communities."

I. Challenges to American Workers: Past Evidence on Employment Effects

Some people claim that trade destroys jobs. Others claim that trade creates jobs. The truth is that it does both. Trade—and the related forces of FDI, technological change, and so forth—is generally not about the numbers of jobs, but rather the kinds of jobs. Thanks to the dynamic flexibility of America's labor market, the real issue is the reallocation of jobs across firms, occupations, and pay scales.

This flexibility is reflected in America's generally low unemployment rate, which at the time of writing stood at 4.5 percent. But it is also reflected in the astonishing rates of churn that underlie this aggregate rate. The U.S. labor market is in a constant state of change, with a large number jobs continually being created and destroyed. In 2005, for example, the most recent full year for which for data are available, private-sector employment expanded by 2.1 million.

> "Some people claim that trade destroys jobs. Others claim that trade creates jobs. The truth is that it does **both**."

But, this *net* increase was achieved by gross employment changes that at the establishment level were an order of magnitude bigger: 31.4 million jobs created to offset 29.3 million jobs destroyed. At the more-detailed level of worker-establishment matches, these gross flows are even larger. In recent years, each month net job creation has been attained by about 4 million worker-establishment separations being offset by slightly more than 4 million worker-establishment matches. At an average of four 40-hour work weeks a month, this means that about 25,000 jobs are destroyed every hour that America is open for business—and slightly more than that amount are created.[18]

What accounts for all this churn? Most of these changes took place because existing establishments expanded or contracted, but beyond this 5.8 million jobs were destroyed due to establishments closing and 6.24 million were created due to establishments opening. The worker-establishment data shows that more than half of separations are voluntary "quits" rather than involuntary layoffs and discharges, nonetheless many workers still lose their jobs for reasons beyond their direct control.

So what is the economic impact of all this job displacement? There is considerable evidence that such involuntary job loss can be costly. Research on displacement from manufacturing in general and from import-competing industries in particular

18 The establishment-level data come from the Business Employment Dynamics database, and the worker-establishment data come from the Job Openings and Labor Turnover Survey, both of the Bureau of Labor Statistics.

has found that about two-thirds of displaced workers find new full-time jobs—but at an average wage loss of 13 percent (17 percent if one accounts for foregone wage growth during the unemployment transition). This average disguises a range of experiences: 36 percent gained re-employment at or above previous earnings, whereas 25 percent suffered earnings losses of 30 percent or more.[19]

What explains this range of re-employment outcomes is not the cause of dislocation. Indeed, the experiences of workers displaced from industries heavily impacted by trade are generally quite similar to those displaced from other manufacturing activities. One important influence on the costs of displacement is the business-cycle state of the overall economy. Adjustments tend to be more painful during recessions, when job losses are more common and more concentrated.

But beyond business cycles, a very important explanation of the range of re-employment outcomes is the characteristics of workers themselves. More-educated workers are less likely to lose their jobs; are more likely to change jobs with less cost; and are less likely to suffer declines in re-employment earnings. In contrast, the largest hits to re-employment earnings tend to be realized by workers who are older, less-skilled, and with established tenure. This central role for skills in understanding job transitions shows up in broader measures such as unemployment rates: at the time of writing this report, the U.S. unemployment rate for high-school dropouts was 7.2 percent—in contrast to just 1.8 percent for college graduates.

Given the magnitude of job transitions and the costs of involuntary displacement, workers are understandably concerned about employment security. Indeed, in the United States self-reports of worker insecurity have been rising: U.S. workers in the 1990s reported feeling more pessimistic about losing their jobs than in the 1980s, despite the long economic expansion of the 1990s.[20] And there is evidence that the expansion of international trade and investment may raise worker insecurity. Workers in the United Kingdom who work in high-FDI sectors are much more likely to report higher perceptions of economic insecurity.[21] And U.S. workers in service activities and occupations that are potentially tradable report both greater insecurity and a stronger desire for a strong government safety net.[22]

19 These data come from: Kletzer, Lori, G. 2001. *Job Loss from Imports: Measuring the Costs.* Washington D.C.: Institute for International Economics. The 17-percent figure comes from: Farber, Henry S. 2005. "What do we know about Job Loss in the United States? Evidence from the Displaced Workers Survey, 1984-2004." Industrial Relations Section, Princeton University Working Paper Number 498.

20 Schmidt, Stefanie R. 1999. "Long-Run Trends in Workers' Beliefs about Their Own Job Security: Evidence from the General Social Survey." *Journal of Labor Economics* 17 (4):S127-S141.

21 Kenneth F. Scheve and Matthew J. Slaughter. 2004. "Economic Insecurity and the Globalization of Production." *American Journal of Political Science*, 48 (4).

22 Richard G. Anderson and Charles S. Gascon. 2007. "The Perils of Globalization: Offshoring and Economic Insecurity of the American Worker," Federal Reserve Bank of St Louis Working Paper 2007-004A.

Are these concerns warranted? Are globally engaged firms and industries likely to be less stable than those that are not? Economic theory gives some reason to expect this. Just as globalization increases consumer choice, it also increases the options firms have in their production decisions. With the option of participating in global production networks, firms can be more responsive to costs of all kinds—wage costs included. This greater cost sensitivity can result in more-volatile employment outcomes for workers.

The empirical evidence on global engagement and employment volatility remains somewhat mixed. Early research on U.S. manufacturing plants, for example, found that most job creation and destruction was from idiosyncratic plant-specific shocks rather than broader forces such as regional or industry wages or trade flows.[23] Of course, the plant-specific shocks may themselves have been the result of global engagement: this speaks to an important limit of much of the data researchers use to try to disentangle the myriad influences of globalization and other forces. Recent work on services, in contrast, finds that jobs in occupations and industries in services that are potentially tradable (both domestically and internationally) have recently been less secure. For example, from 2001 to 2003 annual job-loss rates for displaced workers were 12.8 percent for those working in tradable services versus just 7.3 percent for those in non-tradable services.[24]

II. Challenges to American Workers: Recent Developments on Job Destruction and Dislocations

Beyond the long-standing issues about job destruction and dislocations discussed in the previous sub-section, the 2001 recession and subsequent recovery have added new concerns about the costs of global engagement. We turn now to address four of these.

One new feature has been the sharp and sustained drop in U.S. manufacturing employment. Total employment in U.S. manufacturing fell sharply around the 2001 recession, from 17.3 million in mid-2000 to just 14.3 million by the end of 2003. Since then employment has drifted down even further, to just 14.1 million at the time of writing. Domestic factors, in particular the combination of slow growth in demand and rapid growth in productivity, have been the dominant source of the job loss. But U.S. trade performance—in particular, very weak export growth, appears to have played some role as well. The share of manufacturing job loss that can be attributed to trade has been estimated at somewhere between 12 and 33 percent: a minority, yes, but one that few would deny has been both significant and persistent.[25]

23 Davis, Steven J., John C. Haltiwanger, and Scott Schuh. 1996. *Job Creation and Destruction.* Cambridge, MA: MIT Press.

24 J. Bradford Jensen and Lori Kletzer. 2005. "Tradable Services: Understanding the Scope and Impact of Services Outsourcing." Institute for International Economics Working Paper 05-09.

25 See: Martin N. Baily and Robert Z. Lawrence. 2004. "What Happened to the Great U.S. Job

Second, in the 2001 recession the share of more-educated workers rendered unemployed increased. Estimates show that in 2003, 9.9 percent of all workers with a college degree or higher had been displaced during the past three years: the highest such share ever recorded. This may have reflected the secular rise in educational attainment of the overall labor force, but may also have reflected features particular to this recession (such as the concentration of employment declines in manufacturing just discussed).

Third, following the 2001 recession a sizable share of the unemployed have found it difficult to secure re-employment. Long unemployment spells can be particularly painful for many reasons: e.g., after six months when unemployment benefits typically expire. Recent unemployment rates of 4.5 to 5 percent have historically been associated with average spells of about 12 weeks and long-term unemployment shares of 11 percent. In the current recovery, however, average spells have been 18 weeks and the long-term unemployment share has averaged over 18 percent.[26]

The fourth and perhaps most important new concern about the job dislocations of global engagement regards the spread of offshoring to services activities. Anecdotes now abound in the business media that thanks to the IT revolution in recent years—in particular, the spread around the globe of the internet—many workers across the skills spectrum now face competition from overseas outsourcing in traditionally non-traded activities such as business services and programming. When juxtaposed with the recent facts of persistent unemployment spells and relatively high dislocations of more skilled workers, these anecdotes have contributed to a widespread perception that global engagement in services is now destroying new swatches of American jobs.

Although such services outsourcing is indeed growing rapidly, to date it remains too small a scale to account for ongoing patterns of U.S. job destruction. For example, in the years of slow U.S. employment growth 2001 through 2004, total employment in India of business-processing outsourcing services grew by about 400,000—only some of which was devoted to servicing the U.S. market.[27]

The bigger and still-open question is the future breadth and impact of services offshoring. Former Vice Chairman of the U.S. Federal Reserve, Alan Blinder, has argued that IT-enabled services offshoring is likely to be a major source of job disruption in the future, particularly for relatively educated U.S. workers who have generally

Machine? The Role of Trade and Electronic Offshoring." *Brookings Papers on Economic Activity*. Also see: L. Josh Bivens. 2004. "Shifting Blame for Manufacturing Job Loss: Effect of Rising Trade Deficit Shouldn't Be Ignored." Economic Policy Institute Briefing Paper # 149. And see: L. Josh Bivens. 2006. "Trade Deficits and Manufacturing Job Loss: Correlation and Causality." Economic Policy Institute Briefing Paper # 171.

26 Lawrence Mishel, Jared Bernstein, and Sylvia Allegretto. 2007. *The State of Working America 2006/2007*. Economic Policy Institute: Cornell University Press.

27 Nasscom Data, quoted in Baily and Lawrence (see note 24).

believed their jobs to be insulated from international competition. Blinder has calculated a "mid-range" estimate that 26 percent of all U.S. jobs could be potentially offshored.[28]

How large a number is this estimate? Roughly 12 percent of Americans currently work in manufacturing, mining and agriculture, and about another three or four percent in services exports. This means that Blinder's estimates imply that an additional ten percent of the labor force could potentially face direct competition via global engagement. This is a large increase, but it would still mean that the majority of American jobs would not face such direct competition. It should also be stressed that this figure may be an overestimate since it is based on technological possibilities that do not directly account for the many other barriers (legal, cultural, regulatory) that could inhibit such movements even when the outsourcing technology might work. And however large the spread of services offshoring turns out to be, this transition is likely to unfold over many years if not decades. Juxtaposed against the current churn of 25,000 worker-establishment matches already being destroyed every hour, this transition does not seem as dramatic.

Nonetheless, we fully agree that declining natural barriers to global engagement, thanks to IT technology, is expanding the cross-border opportunities for many previously non-tradable services activities. And it is undoubtedly true that these expanding pressures of global engagement will reach many highly skilled Americans, not just their lower-skilled counterparts.

Of course, these new concerns about services offshoring speaks to the critical point that what matters is not just the numbers of jobs but also the kinds of jobs in terms of earnings. At the outset of this Section 2, we stressed that because of domestic labor-market competition, forces such as international trade and investment spread beyond those directly impacted via job destruction to all workers via pressures on earnings. And it is important to keep in mind that global engagement can pressure incomes by making it easier for firms to substitute foreign for domestic workers even if production does not move abroad.

"It is precisely on the issue of earnings where many American workers have had legitimate concerns for well over a generation—concerns that seem to have widened and deepened in recent years."

It is precisely on the issue of earnings where many American workers have had legitimate concerns for well over a generation—concerns that seem to have widened and deepened in recent years. We now turn to this issue.

28 Alan S. Blinder, see note 1.

III. Challenges to American Workers: Past Performance of Real and Relative Earnings

Perhaps the single most important development of the U.S. labor market in the past generation has been widening income inequality. It is now well established that income inequality across skills has been rising since (depending on the measure) the mid-to-late 1970s, and that productivity gains over this time accrued disproportionately to higher-end workers. This trend speaks to a critical message of this Section 2: the fact that the productivity gains the U.S. economy has enjoyed in recent times, which tend to lift *average* living standards as emphasized in Section 1, do not necessarily mean rising earnings and living standards for every particular American worker—and also every firm and community as well.

One can see the skewness of U.S. real-income growth in many measures. One is the overall earnings distribution itself. From 1966 to 2001, the median pre-tax inflation-adjusted wage and salary income grew just 11%--versus 58% at the 90th percentile and 121% at the 99th percentile. An alternative is earnings by educational groups. In 1975, workers with a bachelor's degree from college (but no advanced degree) earned an average of $14,200 more than workers with just a high-school degree: an education premium of 57 percent. By the year 2000 this premium for education had grown to almost $23,000 per year, or 93 percent.[29]

Different measures yield somewhat different numbers. And the trends just documented did not evolve smoothly year by year. For example, the period 1995-2000 saw strong growth in real earnings—on par or even faster than aggregate productivity growth—at all parts of the skills distribution, even for the less-skilled. This period featured ongoing economy-wide economic expansion and falling unemployment rates (down to 3.9 percent in early 2000), consistent with the state of the overall business cycle helping shape income performance.

But the overall trend has been clear: over the generation from the mid-to-late 1970s to the mid-to-late 1990s, the real and relative earnings of less-skilled Americans was poor relative to both economy-wide average productivity gains and also the earnings of their more-skilled counterparts. And this trend matters all the more because of the fact that by typical measures used by economists, the majority of American workers fall into this less-skilled category. In 2005 the median U.S. worker had a high-school diploma and about one year of post-high school education (but no associate's degree). Only about one in three workers had a college degree or higher.

What economic forces were driving this poor relative and real earnings performance for most American workers? A very large research literature by economists and other scholars has tried to answer this question. Many have looked for a possible

29 These statistics come from the 2006 and 2007 *Economic Report of the President*.

role of globalization through channels such as international trade, immigration and FDI. Freer trade with developing countries abundant in less-skilled labor; arriving immigrants who are predominantly less-skilled; and greater capital mobility that erodes the bargaining power of workers: global linkages like these were plausible candidates to examine. Other forces receiving much attention included "skill-biased" technological change (i.e., innovations such as the spread of IT hardware that induce firms to boost their demand for more-skilled workers) and institutional changes such as falling unionization rates, a declining real value of the minimum wage, and changing social norms.

Different studies, of course, reached different conclusions based on different data, methods, and exact questions being asked. That said, nearly all researchers agree with the consensus conclusion that the majority of earnings changes through the late 1990s were driven by skill-biased technological change, not global engagement. Trade's role in widening inequality overall was typically ascribed at only about 10 percent; the same for immigration, although many found immigration mattered more in pressuring earnings of high-school dropouts.[30]

So through the late 1990s, it appeared that global engagement was playing some (albeit a minor) role in pressuring the earnings of less-skilled Americans. Since that time U.S. earnings have grown quite differently, however, a critical issue to which we next turn.

IV. Challenges to American Workers: Recent Performance of Real and Relative Earnings

How have U.S. earnings evolved in recent years? Quite differently—and in ways that, we believe, are fostering even greater disenchantment with global engagement.

One change that might seem favorable is that most of the earlier trends of rising inequality across skills have stopped. For example, the college-high school earnings premium, which as documented above rose from 57 percent in 1975 to 93 percent in 2000, fell back to just 80 percent by 2004. Similarly, the relative wages of high-school dropouts have not declined since the early 1990s, and the wages at the 10th percentile of the overall distribution have increased slightly faster than those at the median.[31]

Switching attention from relative to real earnings, however, reveals a dramatic

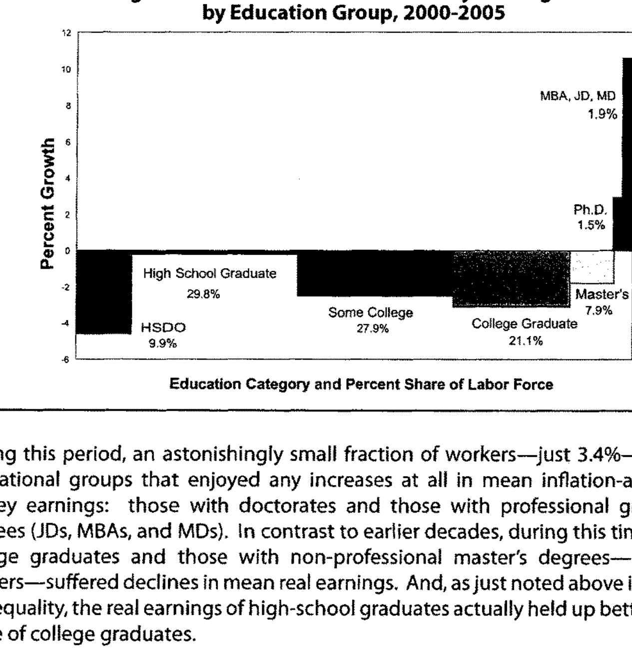
30 This research literature is vast. A useful overview is provided by the many studies in: Robert C. Feenstra (ed.), *The Impact of International Trade on Wages*. Chicago: University of Chicago Press. Another recent overview is: Frank Levy and Peter Temin. 2007. "Inequality and Institutions in 20th Century America." National Bureau of Economic Research Working Paper #13106.

31 The college-high school data come from the 2006 *Economic Report of the President*. The other data come from: David H. Autor, Lawrence F. Katz, and Melissa S. Kearney. 2006. "The Polarization of the U.S. Labor Market." National Bureau of Economic Research Working Paper 11986.

change in U.S. earnings in recent years. Growth in real income has been extremely skewed to very high earners, with little or no growth for most workers.

Figure 1 documents this new pattern in real-income growth in terms of educational attainment. For each of seven educational categories, the figure reports the share of the labor force in that educational category on the horizontal axis and percent growth in mean real money earnings from 2000 to 2005 on the vertical axis.

Figure1: Growth in Mean Real Money Earnings by Education Group, 2000-2005



During this period, an astonishingly small fraction of workers—just 3.4%—was in educational groups that enjoyed any increases at all in mean inflation-adjusted money earnings: those with doctorates and those with professional graduate degrees (JDs, MBAs, and MDs). In contrast to earlier decades, during this time even college graduates and those with non-professional master's degrees—29% of workers—suffered declines in mean real earnings. And, as just noted above in terms of inequality, the real earnings of high-school graduates actually held up better than those of college graduates.

The data in Figure 1 on total money earnings, while striking, do not capture total earnings overall because they do not capture payments of benefits —a category that can include health insurance, life insurance, and equity or stock-option grants. The recent earnings picture for all Americans improves somewhat when all compensation is considered: U.S. total real employment costs rose 5.3 percent from year-end 2000 to year-end 2006. This rise was partly accounted for by ongoing sharp increases in health-care costs—increases that do not increase well-being for workers of unchanged health benefits. Moreover, this still translates into an annual average of just 0.9 percent: far less than that period's 2.8 percent average annual increase in aggregate non-farm labor productivity, and far less than the rates of growth of the late 1990s. And like money earnings in Figure 1, this overall increase in total earnings was likely skewed to high earners (these total data are not available disaggregated by fine skill groups like that in Figure 1).

This astonishing skewness of U.S. income growth appears in other cuts at the data. Growth in total income reported on individual tax returns has been extremely concentrated in recent years, for example, the share of national income accounted for by the top 1 percent of earners reached 21.8 percent in 2005—a level not seen since 1928. From 2004 to 2005, the mean income change reported by the bottom 90 percent of tax filers was a decline of about 1 percent; in contrast, the mean change for the top 1 percent of filers was a rise of 14 percent.[32]

The second notable change in the recent pattern of U.S. income has been the sharp rise in corporate profitability. Since 2000 U.S. corporate profits have nearly doubled, from $817.9 billion in 2000 to $1.62 trillion in 2006. This rise has not been concentrated in one particular sector, but rather has been enjoyed quite widely across many industries. As a share of total national income, these corporate profits are today near 60-year highs at about 14 percent. The concentration of equity ownership in America means that higher corporate profitability may have contributed to the just-discussed skewness of total-income growth.[33]

To summarize: in recent years the large majority of American workers has seen poor income growth. Indeed, 96.6 percent of Americans are in educational groups whose mean total money earnings have been falling, not rising, since 2000. Only a small share of workers at the very high end has enjoyed strong growth in incomes. The strong U.S. productivity growth of the past several years has not been reflected in wage and salary earnings, and instead has accrued largely to the earnings of very high-end Americans and to corporate profits.

For the approximately two thirds of American workers without a college degree or higher, this poor earnings performance in recent years is largely a continuation of the long-run trend since the mid-to-late 1970s (with the exception of the late 1990s).

32 The data in Figure 1 come from the U.S. Bureau of Labor Statistics. Total money earnings each year includes all money wages, salary, bonuses, commissions, tips, etc. for employees in companies plus net income from any farm or self-employment activity as well (all before deductions for items such as taxes and union dues). These earnings are deflated by the Consumer Price Index-Urban. Each educational group's share of the labor force on the horizontal axis is the share of 2005 payroll jobs. Data on tax filers come from Thomas Piketty and Emmanuel Saez. For additional facts on the skewness of recent income growth, see the paper by Autor, et al (note 30).

33 These are corporate profits with inventory-valuation and capital-consumption allowances, as reported by the U.S. Bureau of Economic Analysis. Also, the median American household no longer owns any stocks (directly or indirectly): the share of households with any ownership fell from 51.9 percent in 2001 to 48.6 percent in 2004, the most recent year of data available. See Table 6 in: Brian K. Bucks, Arthur B. Kennickell, and Kevin B. Moore. 2006. "Recent Changes in U.S. Family Finances: Evidence from the 2001 and 2004 Survey of Consumer Finances." *Federal Reserve Bulletin*, Vol. 92, February, pp. A1-A38.

But for college graduates and those with non-professional master's degrees, this poor income performance is a new and presumably unwelcome development.

So what forces explain this recent poor income performance for so many American workers? At least some of it may reflect the business cycle. It is well established, for example, that corporate profits and thus profit's share of national income are pro-cyclical. Profits tend to fall during recessions (such as in 2001) and then rise rapidly with the onset of recovery for reasons such as higher capacity utilization. We note that the share of U.S. national income accounted for by total labor compensation was about the same in 2006 as it was in 1997. If the current economic expansion persists, then like in the late 1990s the overall U.S. labor market might tighten enough to accelerate growth in earnings.

It may also be the case that recent income trends have been driven by structural forces such as global engagement, skill-biased technological change, and evolving labor-market institutions. In much of the business-policy discussions of these possibilities, globalization tends to rise to the top of the list. For example, anecdotes abound that with the IT revolution, many workers with even college or non-professional master's degrees now face competition from overseas outsourcing in activities such as business services and programming. And the ongoing integration of world markets (especially capital markets) thanks to declining natural and political barriers (e.g., China's WTO accession in 2001) may have increased the scale over which very-skilled Americans in activities such as entertainment, finance, and management can operate.

We want to stress that, unlike for the period of the 1970s through the 1990s, this recent period of new trends in the U.S. labor market has *not* been comprehensively examined by economists and other scholars. Accordingly, there is *not* yet a research consensus on what explains these income trends. In particular, consensus on globalization's role has not yet been established. Because of the new development of falling mean earnings of college graduates and master's degrees, we suspect that any role for global engagement will be more complicated than just trade with low-income countries.

Indeed, we expect researchers will face more difficulty than in the past trying to separate different forces such as trade, FDI, and technological change. Suppose that a U.S. multinational company establishes a new affiliate in India to provide internet-enabled back office accounting support for its U.S. operations. Would this case be an example of trade, FDI, or technological change? The answer seems to us to be yes, yes, and yes.

V. Challenges to American Firms and Communities

Our discussion in this section has focused on the pressures that global engagement can place on American workers. We want to briefly point out that these same pressures also affect American firms and communities as well. Despite the large aggregate gains that America has realized from economic openness, these gains have not accrued directly to every single American firm and every single American community.

Start with companies. In Section 1 we emphasized that through many channels, global engagement fosters high productivity in American industries. It is important to stress that this productivity impact typically arises from substantial churn at the level of individual companies and their constituent plants and establishments. Research on many industries in the United States and abroad has documented that overall productivity gains induced by global engagement (and by other forces, too) typically entail the shutdown of inefficient plants and even entire companies. Rather than all companies and plants staying open and realizing proportionate gains, more-productive firms thrive and expand while less-productive competitors struggle.[34]

Because economic activity tends to be concentrated across American communities, this uneven distribution of globalization's pressures across workers and firms also means uneven pressures across communities as well. Some have thrived with the opportunities presented by global engagement, innovation, and related forces. Think of Silicon Valley, home to much of the IT revolution discussed in Section 1. At the same time, hardship has befallen other communities whose employment—and often tax revenues—are predominantly in firms and/or industries struggling against international competition. Think of many cities and towns in Georgia and South Carolina that have struggled to maintain activity in textiles and apparel after the elimination of the trade-limiting Agreement on Textiles and Clothing.

Communities like these can fall into a self-reinforcing cycle. Initial losses of jobs and taxes strain local public services like schools; struggling people and families eventually move away in the face of unemployment and stagnant property values, while struggling companies do the same or close altogether; and subsequent losses of jobs and taxes strain communities further. These downward cycles can play out over many years, if not decades.

The U.S. automobile industry offers a clear example of the challenges global engagement can present to American companies and communities. Through both international trade and investment, America's "Big Three" automobile firms have

34 See, for example, the following survey: Bartelsman, Eric J., and Mark Doms. 2000. "Understanding Productivity: Lessons from Longitudinal Microdata." *Journal of Economic Literature*, 38, pp. 569-594. These authors report, "Of the basic findings related to productivity and productivity growth uncovered by recent research using micro data, perhaps most significant is the degree of heterogeneity across establishments and firms in productivity in nearly all industries examined."

faced decades of widening competition against the likes of Toyota and Honda. These foreign-headquartered firms have innovated relentlessly, and the intensity of this competition has forced Chrysler, Ford, and GM to continually raise productivity and product quality—e.g., to reduce assembly times and quality defects. America as a whole has benefited greatly from this international competition: consumers, in particular, have enjoyed wider variety, restrained prices, and higher quality.

But this competition has affected different companies very differently. In recent years the Big Three have collectively lost tens of billions of dollars and reduced their U.S. payrolls by nearly 100,000 workers. In the past year Ford and GM have embarked on dramatic restructurings to stave off bankruptcy, and Chrysler has just been sold by Daimler to the private-equity firm Cerberus for far less than its acquisition price. Meanwhile, many foreign firms like Toyota have thrived: their profits and stock prices have soared, and they continue to build new U.S. plants even as the Big Three continue to close theirs.

This competition has also affected different communities very differently. Many cities and towns in the traditional Big Three footprint states like Michigan, Indiana, and Ohio have suffered. Today Michigan, where motor vehicles accounted for 11.6 percent of 2004 total labor compensation, has one of the country's highest unemployment rates and is suffering falling home prices in many places. At the same time, in other states including Alabama and Mississippi, communities have thrived with the construction of new production facilities of foreign-owned automobile firms. 328,100 Americans worked at U.S. affiliates of these multinationals in 2004, each earning an average annual compensation of $65,651.

VI. Summary: The Political Economy Challenge Presented By Distributional Pressures

Despite the aggregate gains that global engagement has brought to the United States overall, its constituent forces do not directly benefit all workers, communities, and firms. Achieving these overall benefits necessarily entails immense churning and change. Many workers, firms, and communities are hurt, not helped, by these forces. This has been true in the past; it is true today; and it will be true in the future.

America's integration into the world economy in recent decades has coincided with important changes in the U.S. labor market. From the mid-to-late 1970s to the mid-to-late 1990s, the real and relative earnings of less-skilled Americans was poor relative to both economy-wide average productivity gains and also the earnings of their more-skilled counterparts. And since around 2000, the large majority of American workers has seen poor income growth. Indeed, 96.6 percent of Americans are in educational groups whose mean total money earnings have been falling, not rising, since 2000. Only a small share of workers at the very high end has enjoyed strong growth in incomes. The strong U.S. productivity growth of the past several years has not been reflected in wage and salary earnings, and instead has accrued largely to the earnings of very high-end Americans and to corporate profits.

The bottom line is that today, many American workers feel anxious—about change and about their paychecks. Their concerns are real, widespread, and legitimate. What role the forces of global engagement have played in this recent poor labor-market performance of most Americans remains an open question. But whatever the answer, in the current political discourse on this question, globalization is often front and center.

Recall the dramatic drop in the support of American voters described in the Introduction. The evidence here in Section 2 explains this drop. Public support for engagement with the world economy is strongly linked to personal labor-market performance, and the protectionist drift reflects a public increasingly skeptical about whether globalization benefits them in the face of weak or nonexistent income growth. In short, policymakers face an increasingly skeptical public about whether globalization benefits them—a skepticism not without cause given the lack of recent real income growth for most Americans. This change in public opinion is the foundation of the protectionist drift in policy described in the Introduction.[35]

What can be done to address all this? The most commonly heard reply is, "more skills through more education." The idea behind investing in education is sound: higher-skilled workers generally earn more, experience less-costly transitions across jobs, and overall are more likely to directly benefit from economic openness as they provide a foundation for the American economy to attract and retain globally engaged companies. Upgrading the skills of American workers through education—and also striving to improve American education, from pre-school through college and beyond—we wholeheartedly support.

The limitation of this approach, however, is that upgrading skills is a process that takes *generations*. Any gains here will come far too late to address today's opposition to economic openness. It took 60 years for the United States to boost the share of college graduates in the labor force from six percent (where it was at the end of World War II) to about 33 percent (where it is today). And that required major government programs, such as the GI Bill, and profound socioeconomic changes, such as increased female labor-force participation. If the United States today undertook the goal of boosting its college-graduate share of the work force to 50 percent, then if past were prologue, graduation of that median American worker would not come until about 2047. And even this far-off date might be too optimistic: in the past generation, the rate of increase in the educational attainment of U.S. natives has slowed from its 1960s and 1970s pace, in part because college-completion rates have stalled.[36]

35 This argument of the critical links among labor-market performance, public opinion, and the protectionist drift is taken from: Kenneth F. Scheve and Matthew J. Slaughter. 2007. "A New Deal for Globalization." *Foreign Affairs*, July/August, pp. 34-47.

36 This argument of why education alone is not sufficient to halt the protectionist drift is taken

So the question remains. What policies can be implemented today to strike a delicate balance of allowing America to continue to realize the aggregate benefits of global engagement while also addressing the legitimate concerns across American workers, companies, and communities about the economic pressures generated amidst these aggregate gains? In Section 3, we offer our answer to this question.

from: Kenneth F. Scheve and Matthew J. Slaughter. 2007. "A New Deal for Globalization." *Foreign Affairs*, July/August, pp. 34-47.

Section 3:
A New Policy Agenda

In this Section we offer a package of policy ideas designed to stimulate debate and point toward a new synthesis on the goals of economic policy in today's global age.

We start from the premise that economic policy should aim to produce a growing American economy in which every American can find opportunity to use their skills to craft their own economic future. That seems to us to be the only way to meet the current challenge of guaranteeing that America overall continues to benefit from global engagement while also delivering on the idea of an equal-opportunity society and thereby addressing the legitimate distributional concerns about the pressures of economic openness.

Our prescriptions might, in some respects, seem radical. But we do not see them as such when viewed in the context of the very real economic pressures that global engagement is imparting to American workers, firms, and communities. We have articulated them in ways designed to stimulate discussion of alternatives and ways forward. The ultimate goal is a new policy agenda that works for all Americans. Many of our ideas present new choices and trade-offs, and we maintain great faith in the deliberative democratic process to find workable solutions.

That said, we are firm in two views. One is that this process cannot work if the debate is not well-informed by the relevant facts, however uncomfortable they may be. The second is that people at all points on the political spectrum cannot simply reiterate long-held positions aimed at key constituencies rather than at true progress to address our largely unprecedented challenges.

We present our menu of policy proposals in four sections. The first two speak to the legitimate anxiety about the economic pressures of global engagement. The second two speak to expanding American's integration into the world economy.

First, we explain how to address the current skewness in U.S. income growth. We start here because the protectionist drift discussed in the Introduction reflects a public increasingly skeptical about whether globalization benefits them in the face of weak or nonexistent income growth. As such, we consider this poor earnings performance to be the most pressing policy issue to address.

Second, we propose a menu of policy innovations designed to better facilitate adjustment by workers, communities, and firms. The dynamic forces of the U.S. economy foster widespread, continual change in terms of hirings, firings, start-ups, and shut-downs. More can be done to smooth adjustment to this churn.

Third, we discuss why turning away from open borders—either a pause from liberalization or an actual move towards protectionism—is neither viable nor desirable option. Any such turn would be a mistake on many dimensions.

Fourth, we propose a menu of proposals to ensure that the United States remains fully engaged in the global economy. These proposals aim to move the discussion beyond the platitude "remain open" to a set of concrete ways to maximize America's gains from global engagement.

I. Policies to Address Poor Real-Income Growth[37]

As we explained in Section 2, in recent years the large majority of American workers have seen poor income growth. The strong U.S. productivity growth of the past several years has not been reflected in wage and salary earnings, and instead has accrued largely to the earnings of very high-end Americans and to corporate profits.

There is not yet a research consensus on what explains these income trends. In particular, consensus on globalization's role has not yet been established. But for the critical policy question of whether America continues to integrate into the global economy, this current lack of consensus is largely irrelevant. The protectionist drift now underway in America reflects a public increasingly skeptical about whether globalization benefits them in the face of weak or nonexistent income growth.

Some of the recent poor income performance for so many American workers likely reflects forces of the business cycle. This means that if the current economic expansion persists, then like in the late 1990s the overall U.S. labor market might tighten enough to accelerate growth in earnings. This implies a broad goal for macroeconomic policy—both the fiscal policy of Congress and the monetary policy of the Federal Reserve—of sustaining this expansion.

But because much of the recent poor income performance seems structural, then to prevent an acceleration of the protectionist drift there is a strong case for greater income redistribution. Both to allow global engagement to generate large

37 The policy proposal in this section is taken from: Kenneth F. Scheve and Matthew J. Slaughter. 2007. "A New Deal for Globalization." *Foreign Affairs*, July/August, pp. 34-47.

overall gains for America, and to minimize the economic distortions that indirect redistribution can introduce, we favor the direct approach of using federal fiscal policy, our society's main tool for such efforts.

How do we propose to increase the progressivity of our current tax code? First, it is important to recognize that the personal income tax is already quite progressive. A sizable fraction of Americans pay no federal income tax, while those at the top of the scale pay a large share of this total tax.[38]

The personal income tax, however, is not the whole story. The U.S. revenue base is made up a number of different forms of taxation. One, in particular, is very large and very regressive. It is the Federal Insurance Contributions Act (FICA) tax, which is paid by every working American to support Social Security and Medicare.

FICA is large. In fiscal 2005, FICA taxes accounted for $760 billion in revenue, over 69 percent of the government's $1.1 trillion take from the progressive income tax. And while there are elements of progressivity in the benefits it provides, the funding of FICA is regressive, for two reasons: it is a flat rate on a (largely) capped base: 15.3 cents on every dollar a worker earns up to $97,500.[39] Moreover, FICA falls only on labor earnings, not other forms of income people might realize. This means that FICA exacerbates, rather than offsets, the pre-tax earnings trends we have discussed in this report.

In fiscal 2005, FICA taxes accounted for **$760 billion** in revenue, over **69 percent** of the government's **$1.1 trillion** take from the progressive income tax.

Many supporters of the FICA tax's current structure argue that the tax is akin to a contribution to a retirement plan, and that every American should be obliged to contribute to prevent erosion of political support for broad social programs like Medicare and Social Security. We do not find this argument sufficiently compelling. In practice these social programs are largely pay-as-you-go, not fully funded, which means FICA is simply another revenue source the federal government uses to make

38 Provisions like the Earned Income Tax Credit ensure that taxpayers on the low-end of the income scale pay no income tax. The burden of the income tax already falls heavily on upper-middle-income and high-income households. The Alternative Minimum Tax is presenting growing uncertainty about what effective income tax Americans face, as each year it takes a large bite out of the income of an ever-growing number of American taxpayers that typically view themselves in the middle class, broadly defined.

39 There are separate portions of the FICA tax for Social Security and Medicare. FICA imposes a flat tax of 15.3 percent on the first $97,500 of gross income for every worker (with an ongoing 2.9 percent flat tax for the Medicare portion beyond that). In statute, the worker and his/her employer each pays half of the total FICA tax. But in reality, the company's contribution ultimately comes out of it willing to pay the worker, with the net result being that FICA takes a full 15.3 percent of a worker's gross income before income taxes even come into play.

transfers and purchase goods and services. We think that the protectionist drift is a greater political danger than the intended but not practiced underpinnings of America's entitlement programs.

Without taking on the broader issue of needed reforms in Social Security and Medicare, we think there is real virtue in seeing FICA as simply a tax that is capable of being restructured to leave more of the average worker's hard-earned income in their pockets as a means directing the economy-wide benefits of globalization more to the average worker's kitchen table. In proposing FICA reform, in no way are we questioning the value of Social Security and Medicare as integral parts of America's social safety net. Indeed, our broad goal with FICA reform is to broaden this safety net to better address the pressures of global engagement.

Given all this, we propose the following change to the FICA tax.

Congress should either fully integrate FICA taxes into the income tax or introduce greater progressivity into the FICA tax itself through measures including raising the cap, in order to increase the progressivity of the overall tax system and to ensure broader sharing of the benefits of American's participation in the global economy.

Implementing this proposal would involve many important details. Determining the right scale and structure of redistribution would require thoughtful national discussion.[40]

II. Policies to Facilitate Adjustment by American Workers, Communities, and Firms

Section 2 of this report documented the enormous churn within the American economy. Every hour that America is open for business, 25,000 worker-establishment job matches are destroyed. Jobs appear and disappear, and companies start up and shut down, at amazing rates. Globalization is one among many forces that drive this dynamic reallocation of people, capital, and ideas to emerging business opportunities.

But all this adjustment can present very real costs to American workers, communities, and firms. What is to be done? We re-emphasize that without all this dynamic reallocation, average living standards would be harmed, not helped. Trying to

40 Kenneth F. Scheve and Matthew J. Slaughter (see note 38) analyze one particular option: to eliminate the full payroll tax for all workers earning below the national median. In 2005, the median total money income of all payroll workers was \$32,140, and there were about 67 million workers at or below this earnings level. Assuming that the mean labor income for this group was \$25,000, then these 67 million workers would receive a tax cut of about \$3,800 each. Because the economic incidence of this tax falls largely on workers, this tax cut would be a direct gain in after-tax real income for them, with a total price tag of about \$256 billion.

shield the economy from these changes is not an option. Rather, policy must strive to reduce the costs of these changes and thereby facilitate adjustment to help as many workers, communities, and firms respond to the challenges of globalization and ultimately directly benefit from its opportunities.

Before listing our policy proposals to better facilitate adjustment, it is important to point out that they share a common theme of rethinking much of what is taken as given about our current economic life of working and saving. Today there are about 138 million payroll jobs in the U.S. economy. Many think of the eight-hour shift for the typical payroll job as what a wage-earner owes the employer to take home a pay check.

But, thought of another way, those eight hours represent a daily investment by that worker in the success of his or her company's enterprise. This enterprise may or may not be fully engaged in and succeeding in the global economy. Indeed, as Section 2 discussed, globalization accelerates the need for and the pace of economic change. This means that American workers, firms, and communities are today increasingly exposed to the risks of international competition. Given this, standard investment theory suggests an increased need for insurance mechanisms to hedge and manage this risk. These risk-management tools can be best provided not just by the government but, where possible, by the private sector as well.

Adjustment Policies for Workers

For decades, high rates of job destruction and job creation have been a persistent feature of the American economy. In recent years anxiety about this churn has risen, in part because of spreading concern that declining natural barriers to global engagement thanks to IT technology is expanding the cross-border opportunities for many previously non-tradable service activities. Job turnover often imposes real costs, in terms of unemployment spells and lower re-employment earnings.

Economic openness is only one of the drivers of America's labor-market turnover, but it tends to predominate the discussions of how government policy can mitigate the costs of dislocations. The main U.S. government program here is Trade Adjustment Assistance, the program established in the Trade Act of 1974 that aids groups of workers in certain industries for whom increased imports have destroyed their jobs or have reduced their work hours and wages.

We regard TAA as well-intentioned but, because of its design, inadequate. The avenues by which globalization fosters economic change are many and, more important, both ever expanding beyond the scope of TAA and often intimately linked to other forces as well (such as technological change). We also point out that TAA's scale is insufficient relative to the size of these forces: fiscal 2005 TAA outlays by the Department of Labor were $845 million, about 0.03% of total federal spending.

Given the breadth of these forces and the need to cushion worker adjustments of all kinds, we suggest the following two proposals.

Congress should reform current adjustment assistance programs by combining Unemployment Insurance and the current Trade Adjustment Assistance ("TAA") program into a single integrated Adjustment Assistance program that offers a menu of features to all displaced workers including: (1) wage insurance, (2) the portability of health insurance, (3) assistance with geographic relocation or with establishing new businesses, and (4) retraining.

- Folding TAA into a unified program of adjustment assistance would reflect the reality of ever-changing, closely related sources of job churn.
- Appropriately designed wage insurance would cushion the cost of lower re-employment earnings. To mitigate likely moral-hazard problems here, the federal government should play a leading role here but private-sector provision of wage insurance (like auto and life protection) would be encouraged.
- Portability of health insurance would address the reality that the majority of Americans with health insurance receive it via their employer.
- Reform of existing supports such as retraining and relocation expenses would be encouraged—e.g., where feasible, to allow benefits uptake even after regaining employment rather than only when unemployed.

Congress should allow individuals to deduct from their gross income for tax purposes the full cost of education and training expenses, even when directed at preparation for an entirely new career.

- Rather than limit the tax deduction for training related to one's current job, it should be broadened to encourage individual workers to continue to invest in themselves and upgrade their skills throughout their lifetimes however they best see fit.
- In a global economy, the best adjustment policy is likely to be the one that a worker undertakes well in advance of his or her actual need to adjust; expanding deductibility of educational expenses would provide incentive to do just that.

Adjustment Policies for Communities

Today there already are many state and local programs designed to assist communities with economic development in the face of local shocks such as the downsizing or shutdown of a major employer. These programs speak to the critical point discussed in Section 2, that very different economics can be at work at the state and local level than at the national level. The churn essential to help grow our $13.7-trillion economy is often not the perspective facing communities. Rather than seeing many firms throughout the economy capable of absorbing workers and capital released from a downsizing firm, the community's perspective can be one of catastrophic loss of jobs, income, and tax revenue that can become self-reinforcing.

To help communities better manage the risks of downsizing that can hit their local economies, we have two proposals. One is to create government-backed insurance of local tax bases, with payouts during periods of sudden economic hardship to prevent sudden drops in the provision of public services. The other is an innovation to attract new investment to struggling communities to allow them to build new links to the global economy.

Congress should create a federal insurance facility that permits communities to insure their tax base against sudden economic dislocation.

- This would allow communities to better manage economic risk, by allowing them to continue to provide essential public services during sudden economic hardship. The goal would not be to stop adjustment altogether, but rather to smooth its intensity over time. Towns with such insurance would become more attractive investment locations. [41]

Congress should enact legislation that would identify certain communities facing significant pressures from international competition as Global Economic Development Platforms ("GEDPs") eligible for trade preferences, tax benefits, and federal financing aimed at attracting new investment to build new linkages to the global economy.

- Trade preferences would eliminate any duty on goods produced in a GEDP when those goods finally enter the customs territory of the United States (akin to Foreign Trade Zones).
- Tax benefits currently available to Empowerment Zones and Enterprise Communities would be extended to GEDPs, with extensions such as reducing corporate tax rates applicable to income generated by operations in the GEDP.
- Investments in GEDPs would be eligible for private-sector financing that counts towards a financial institution's score under the Community Reinvestment Act, to foster the growth of ancillary businesses within GEDPs.
- GEDPs could receive additional benefits, such as access to a special GEDP visa to help staff their businesses and access to a new suite of services from the U.S. Department of Commerce to help their businesses deepen their global engagement (e.g., to identify both suppliers and export opportunities abroad).

41 This policy proposal is taken from: Robert Z. Lawrence and Robert E. Litan. 1986. *Saving Free Trade: A Pragmatic Approach.* Washington, D.C.: The Brookings Institution.

Adjustment Policies for Firms

Firms must continually adjust to stay profitable. In that sense, the best government policy is one that keeps U.S. markets open to maximize the competitive pressure on firms to innovate to become more productive. At the same time, however, not all firms succeed in these efforts. Given this reality, we propose three new government policies to give U.S. companies even more flexibility in their efforts to succeed at innovation. Our goal is not to slow or prevent downsizing and shut-downs. As discussed in Section 2, this dynamism is essential for realizing overall productivity gains. Rather, we aim either to encourage more of activities that have broader social benefits beyond the benefits to firms (education and information flows) or to resolve current policy uncertainty (trade safeguards) that, unchecked, will inhibit innovation.

Congress should allow firms a credit against income taxes for the marginal increase in expenses they might incur in extending their internal education and training facilities to workers outside the firm or to students in local community colleges.

- This would encourage firms to partner with their local community in building a workforce that is better matched to meet industry's needs in a complex, competitive, and ever-changing economic environment.

Congress should expand programs to help companies learn how to gain certification under international standards.

- Existing National Institute of Standards and Technology efforts to assist companies with international standards, including their implementation of lean management and quality assurance techniques, could be expanded—possibly by combining the current TAA program for firms with the existing Manufacturing Extension Partnership and outreach efforts by the USFCS.

USTR should place a high priority within the current rules negotiations under way as part of the Doha Development Agenda on reestablishing a workable safeguard mechanism within the WTO.

- This would allow the United States greater flexibility and certainty in providing American firms with both the time and incentive to adjust to international competition.
- This mechanism should be obtained even if it requires in exchange that the United States accept additional disciplines on its use of antidumping and countervailing duty measures.

III. Why Trade Protection is Not the Answer

The above discussion has laid out our policy proposals for addressing legitimate concerns about the disruptions and pressures generated by America's engagement with the global economy. But some might wonder, "Where are the new trade barriers? Where are the penalties against countries that don't play by the rules—especially those that manipulate their currencies? Where are the solutions to close America's yawning trade deficit?" Many in America's current business-policy debates about globalization say that trade barriers must be part of the, if not the, solution for addressing people's concerns.

We disagree completely. For at least seven reasons, trade protection would be an extremely poor instrument for dealing with the concerns and problems we have identified. We now briefly explain each reason in turn.

First, many—if not most—of the economic pressures on American workers, firms, and communities are different from the pressures of global engagement. They stem from domestic forces such as technological and institutional innovations, demographic shifts, cyclical fluctuations, and the competitive struggles between firms within our borders. All these forces would still be present even if the United States were completely closed to the rest of the world.

Second, America's integration into the world economy has been driven not just by falling barriers due to policy but also by falling natural barriers as well. Indeed (as discussed in Section 2), in the past decade arguably the most important change in globalization has been the revolution in information technology that has widened the range of service activities tradable across borders. Government trade policies would have almost no ability to thwart the flows that have been facilitated by IT advances and other forms of falling natural trade barriers. Accordingly, many of globalization's pressures on Americans today would persist regardless of U.S. trade policy.

Third, global integration has also been driven by policy liberalizations in other countries. Tariffs and quotas on specific U.S. products or services would do little or nothing to alter this course set by other countries that are emulating the success of the U.S. economy by opening themselves to world markets. China, India, and countless other countries will continue to integrate into the world regardless of U.S. trade policy. Accordingly, many of the pressures generated by their integration will continue to be felt here as well (e.g., via changes in world prices).

Fourth, even if trade barriers could improve certain labor-market outcomes for Americans, better targeted domestic policies could achieve the same goals at lower cost. It is well analyzed and demonstrated that the cost per American job saved by trade barriers (real or hypothetical) tend to be several times the wages earned in that job. Higher tariffs on steel, for example, might increase employment of steelworkers. But by making steel more expensive, they also reduce employment economy-wide in all the other industries—autos, machinery, etc.—that need steel as an input. Trade barriers impose large costs of resource allocation (discussed in Section 1). These costs are avoided by measures that redistribute income through transfers and taxes.

Fifth, trade barriers would incur the longer-run cost of inhibiting productivity growth. Through many channels (discussed in Section 1), economic openness fosters productivity growth and thus rising average living standards. Trade barriers would restrict these channels: e.g., by depriving U.S. firms of access to best-practice technologies and management techniques. Isolating the United States from the global economy would risk altering its culture of innovation and independent thinking that for generations has been a core source of comparative advantage—at a time when the world economy is offering greater rewards than ever to precisely that culture.

Sixth, new U.S. trade barriers could have damaging policy effects abroad. One would be reduced interest in further policy liberalization abroad. Today the biggest remaining barriers to trade and investment are abroad—especially in fast-growing low-income countries like China and India. If the United States stops liberalizing we will lose leverage in trying to negotiate market access abroad. Another would be outright retaliation. History offers clear precedents here: e.g., many countries have established expansive anti-dumping regimes by following closely U.S. practice. Either less liberalization or outright retaliation would hurt many American workers and firms trying to benefit from access to global markets.

Finally, beyond the various economic considerations just outlined, there are critical considerations of America's strategic and national-security interests. Freer trade and investment can enhance many foreign-policy goals. Indeed, the Doha Development Round was launched shortly after 9/11 because of the widespread view that global poverty is intimately linked to international security and stability. Time and again since the end of World War II, the United States has provided leadership in the world's shared efforts to foster peace through prosperity. With Doha on the brink of total collapse, new U.S. trade barriers could not be worse timed.

"Isolating the United States from the global economy would risk altering its culture of innovation and independent thinking that for generations has been a core source of comparative advantage—at a time when the world economy is offering greater rewards than ever to precisely that culture."

But what about the U.S. trade deficit? Wouldn't U.S. trade barriers level the playing field in a way that eliminates this problem? The answer is no.

The United States has been running large trade deficits because total U.S. savings by companies, the government, and households is far less than the capital investment undertaken by American companies. This gap is financed by tapping into savings abroad, an exchange which manifests in trade deficits. The U.S. trade deficit can be reduced only by raising national savings and/or lowering national investment. The most commonly heard proposals today for trade protection today are for barriers against particular countries. In today's complex global economy with many producers in many countries, such bilateral barriers would simply induce greater imports from other sources. Total U.S. spending, saving, and thus the trade deficit: all would be virtually unchanged.

In short, the trade barriers so commonly proposed as remedies to the pressures of global engagement are simply inapposite to the task. Indeed, for all the reasons just outlined they represent the single worst option policymakers could choose. We are not alone in this view. Here are the words of former Federal Reserve Chairman Alan Greenspan.[42]

> *Protectionism in all its guises, both domestic and international, does not contribute to the welfare of American workers. At best, it is a short-term fix at a cost of lower standards of living for the nation as a whole.*

The United States must continue to engage with the global economy. Our final sub-section proposes how best to do that.

IV. Sustaining America's Engagement with the Global Economy

Global engagement has generated, and has the potential to continue generating, large gains for the United States overall and for the rest of the world as well. Through critical channels such as of capital investment, technological progress, and resource reallocation, American productivity is higher because of cross-border flows of goods and services, capital, people, and ideas.

Today there are many difficult policy challenges in the areas of trade, investment, and immigration. For each of these areas, we now propose concrete steps policymakers should take to help further integrate America into the world economy.

42 "Economic Flexibility" speech, to the National Association of Business Economics Annual Meeting, Chicago, IL, September 27, 2005.

Trade Promotion Authority

Congress needs to send as clear signal as possible to U.S. trading partners that the United States will overcome the protectionist drift to remain fully engaged in the global economy. The swiftest way to communicate that message would be the prompt renewal of the President's Trade Promotion Authority. The Constitution grants Congress the power to regulate foreign commerce, but the President negotiates on the nation's behalf. To square these competing constitutional powers, Congress has for decades offered Presidents limited grants of negotiating authority—for many years known as "Fast Track" authority, now called TPA—that permits Presidents to submit trade agreements he has negotiated to Congress for an up-or-down vote without the possibility of amendment. The most recent grant of TPA will lapse at the end of June, 2007, which has led U.S. trading partners to question the United States' commitment to ongoing negotiations and to the world trading system generally.

- **Congress should renew TPA on a permanent basis,** to send the clearest possible signal that the United States does not intend to cede its leadership in shaping the global trading system.
- **This permanent TPA renewal should be conditioned on strict consultation requirements, with the opportunity to withdraw TPA if those requirements are not met,** to vindicate Congress' constitutional oversight of this critical facet of U.S. trade policy.

Trade Negotiations

Despite recurring calls for a hiatus in trade negotiations, the only way to break down political barriers U.S. exporters face or eliminate unfair trade practices that distort competition for U.S. firms is through negotiations with our trading partners. That said, both Congress and the Executive must refocus our strategy both to maximize the economic payoff and to address the underlying concerns that have eroded public support for further liberalization.

- **U.S. policymakers should prioritize the Doha Development Agenda as expeditiously as possible**, even at the expense of further bilateral agreements in the short run.
- DDA should achieve meaningful liberalization not just in agriculture, but more importantly in manufacturing and, especially, services in large emerging economies.
- **U.S. policymakers should reform our rural economic policy by delinking program payments from production**. This opportunity is presented both by current DDA difficulties and by the 2007 Farm Bill renewal.

- **U.S. policymakers should negotiate stronger multilateral disciplines on market-distorting practices** that injure U.S. economic interests and create the perception of unfair trade.
- **U.S. policymakers should prioritize trade liberalization in environmental goods and services such as biofuels and products that would contribute to energy efficiency and reduced carbon emissions.**

Whether Doha fails or succeeds, U.S. policymakers should promote within the WTO a system of "variable geometry" that addresses the diversity of its membership by allowing pluri-lateral agreements among those partners who are willing to engage in deeper economic integration in areas such as FDI and competition policy. *(Recall (from Section 1) the very large economic gains the United States realized from the Information Technology Agreement, which was this sort of liberalization among the willing.)*

- **U.S. policymakers should begin knitting individual FTAs into the basis for a wider agreements** that eliminate conflicting rules of origin and other requirements and thereby achieve truer market integration.
- **If Doha fails, the United States should call for the negotiation of a free-trade agreement covering both merchandise and services that would be open to all WTO members that choose to participate.**

Trade Enforcement

Aggressive enforcement of U.S. trade agreements is essential to ensure public support for further liberalization. The United States Trade Representative should significantly increase its enforcement efforts, both to ensure that U.S. exporters gain from negotiations to assure Congress and the American public that agreements are enforced once reached.

- **USTR should add a checklist to its annual National Trade Estimates report that clearly identifies the past year's efforts to reduce trade barriers identified there,** whether through negotiation or litigation.
- **USTR should begin to identify what foreign trade practices most inhibit U.S. exports and then develop strategies for eliminating them,** either through negotiation (where such practices are not currently subject to disciplines) or litigation (when international rules have been broken).
- **Congress should significantly expand the resources available for enforcement of U.S. trade agreements,** both to allow the Commerce Department to serve as the primary investigator and to allow USTR to function like a U.S. attorney in determining which cases to bring.

Addressing Labor and Environmental Issues

A consensus on how to generally approach issues such as labor and the environment in trade agreements is essential for progress. The recent agreement between the Bush Administration and Congressional leaders on the enforcement of core principles of the International Labor Organization labor standards in the free-trade agreements with Panama and Peru hopefully sets in motion a consensus on this set of issues. But simply signing trade agreements with these new provisions will not ensure that labor and environmental conditions in developing countries improve. They need to be reinforced with positive incentives and technical assistance to ensure implementation.

- **In future trade agreements, U.S. policymakers should offer additional incentives by accelerating liberalization in areas of particular interest to our trading partners conditioned explicitly on improvements in working conditions and the environment,** much as was done in the agreement with Cambodia over textiles market access in the late 1990s.
- **Congress should expand funding for, and the responsible Executive departments should increase the visibility of, efforts to implement and enforce labor and environmental agreements,** both through cooperative programs bilaterally and through existing international mechanisms (like the ILO) that already exist.

Investment

Continued U.S. openness to inward foreign direct investment is a critical indicator of maintaining American engagement with the global economy. The same holds true for opening markets abroad to U.S. investment. In May, President Bush issued an Open Economies and Investment Statement stating that the policy of the United States is to welcome foreign investment. This statement, America's first since 1991, was very welcome, as is the balanced approach that seems to be coming out of the current legislative process. But because international capital flows are so central to global engagement, and because part of America's current protectionist drift concerns inward FDI, we think it important to reinforce those points.

Congress should limit the scope of inward investment reviews by the Committee on Foreign Investment in the United States strictly to those national-security considerations raised by specific investments.

- Attempts to address broad security concerns would be better addressed by more direct means.
- CFIUS is not the proper forum to address broad security problems, such as the vulnerability of our telecommunications infrastructure, through individual investment reviews.

Congress should remove outdated restrictions on inward foreign investment in airlines, broadcast, shipping, and other areas.

- These restrictions were originally enacted for national-security concerns that do not exist today. These restrictions have led to substantial economic costs, and can be removed and replaced with the usual CFIUS process to address any concerns raised by specific transactions.

Both the Treasury Department and USTR should promote a multilateral agreement inside the WTO of rules on investment for both goods and services in the post-DDA global system.

- American multinational companies, especially those in services, serve foreign customers overwhelmingly through affiliate sales abroad rather than exports from the United States. This investment agreement would foster the global competitiveness of U.S. firms.

Immigration

Like the current Congressional debate on investment, the discussions on immigration will also send a powerful signal to our trading partners and foreign investors about the degree of U.S. commitment to the global economy. It is not, however, that portion of the current immigration discussion that receives the most attention—i.e., the treatment of currently undocumented workers—that will send that signal. Rather, it will be the treatment of highly skilled immigrants: both those working in America for many years if not permanently, and also those transiting in and out to support the flexibility of America's globally engaged companies.

- **U.S. policymakers should expand the opportunity our immigration policy offers to highly-skilled potential immigrants,** which need not conflict with the current laudable emphasis on family ties.
- **U.S. policymakers should expand the supply of visas that are essential to attract top prospects from the global talent pool to the United States. In particular, start by eliminating the cap on H1-B visas.**
- **U.S. policymakers should increase the flexibility with which globally-engaged firms with U.S. operations can move personnel within their operations internationally** (e.g., use of L-1 visas) in order to ensure potential investors that if they invest in the United States, immigration laws will not hamper their ability to staff their operations optimally.

Author Biographies

Grant D. Aldonas

Grant Aldonas holds the William M. Scholl Chair in International Business at the Center for Strategic and International Studies (CSIS). Previously, he had a distinguished career in law, business, and international economic policy, including service at senior levels in the U.S. government. Mr. Aldonas came to CSIS from Akin Gump Strauss Hauer & Feld, where his practice focused on international trade, investment, corporate governance, and corporate social responsibility. While at Akin Gump, he served as chairman of the U.S. arm of Transparency International. Before joining Akin Gump, he served in the Bush administration as the Commerce Department's under secretary for international trade from 2001 to 2005, where he was one of the president's principal advisers on international economic policy and managed a federal agency of 2,400 employees with offices in 80 countries and a budget of $350 million. In his role as under secretary, he also served as a member of the board of the Overseas Private Investment Corporation and as executive director of the President's Export Council.

Prior to his service in the administration, Mr. Aldonas was chief international trade counsel to the Senate Finance Committee. During his tenure, Congress passed a number of significant trade bills, including the Trade and Development Act of 2000, Permanent Normal Trade Relations for China, legislation replacing the Foreign Sales Corporation provisions of the Internal Revenue Code, and a series of tariff bills. Before entering public service, Mr. Aldonas was a partner with the Washington, D.C., law firm of Miller & Chevalier where his practice focused on international trade, tax, government procurement, and international litigation. He also served as counsel to the Bipartisan Commission on Entitlement and Tax Reform and as an adviser to the Commission on U.S.-Pacific Trade and Investment. He was appointed chair of the American Bar Association's Task Force on Multilateral Investment Agreements and served as vice chair of the ABA Section of International Law and Practice's Committees on Trade and Foreign Investment.

Mr. Aldonas began his career as a Foreign Service officer, serving tours in Mexico, the Department of State, and the Office of the U.S. Trade Representative. He continues to serve as an adjunct professor of law and member of the board at the Georgetown University Law Center. He also continues his role as principal managing director of Split Rock International, a Washington, D.C.–based consulting and investment advisory firm, and as a member of the board of the Center for International Private Enterprise and the Global Fairness Initiative. Mr. Aldonas received his B.A. in international relations in 1975 and his J.D. in 1979 from the University of Minnesota.

Robert Z. Lawrence

Robert Z. Lawrence is Albert L. Williams Professor of International Trade and Investment at the Kennedy School of Government, Harvard University, a Senior Fellow at the Peterson Institute for International Economics, and a Research Associate at the National Bureau of Economic Research. He served as a member of the President's Council of Economic Advisers from 1998 to 2000. Lawrence has also been a Senior Fellow at the Brookings Institution. He has taught at Yale University, where he received his PhD in economics. His research focuses on trade policy.

He is the author of *Can America Compete?*; *Crimes and Punishments? An Analysis of Retaliation under the WTO*; *Regionalism, Multilateralism and Deeper Integration*; *A US-Middle East Free Trade Agreement: A Circle of Opportunity?* and *Single World, Divided Nations?* He is coauthor of *Has Globalization Gone Far Enough? A Prism on Globalization*; *Globaphobia: Confronting Fears About Open Trade*; *A Vision for the World Economy*; *Anchoring Reform with a US-Egypt Free Trade Agreement* and *Saving Free Trade: A Pragmatic Approach*.

Lawrence has served on the advisory boards of the Congressional Budget Office, the Overseas Development Council, and the Presidential Commission on United States-Pacific Trade and Investment Policy.

Matthew J. Slaughter

Matthew J. Slaughter is Professor of International Economics at the Tuck School of Business at Dartmouth. He is also currently a Research Associate at the National Bureau of Economic Research and a Senior Fellow at the Council on Foreign Relations, and he currently serves on the academic advisory boards of the International Tax Policy Forum and the Tuck Center for Private Equity and Entrepreneurship.

From 2005 to 2007, Professor Slaughter served as a Member on the Council of Economic Advisers in the Executive Office of the President. In this Senate-confirmed position he held the international portfolio, advising the President, the Cabinet, and others on issues including international trade and investment, energy, and the competitiveness of the U.S. economy. In recent years he has also been affiliated with the Federal Reserve Board, the International Monetary Fund, the World Bank, the National Academy of Sciences, the Institute for International Economics, and the Department of Labor.

Professor Slaughter's area of expertise is the economics and politics of globalization. Much of his recent work has focused on the global operations of multinational firms, in particular how knowledge is created and shared within these firms and how their activities are structured across borders. He has also researched the labor-market impacts of international trade, investment, and immigration, and has studied the political-economy question of individual attitudes about globalization. This research has been supported by several grants from organizations including the National Science Foundation and the Russell Sage Foundation. Over forty articles by Professor Slaughter have been published as book chapters and in peer-reviewed academic journals. He also co-authored the book *Globalization and the Perceptions of American Workers.* He currently serves in various editorial positions for several academic journals.

In addition to numerous presentations at academic conferences and seminars, Professor Slaughter has spoken to many audiences in the business and policy communities and he has testified before both chambers of the U.S. Congress. His work has been widely featured in business media such as Business Week, The Economist, Financial Times, Newsweek, Time, Wall Street Journal, and the Washington Post. He has been interviewed on many TV and radio programs such as CNN's Lou Dobbs Tonight and NPR's Marketplace. In recent years he has also served as a consultant both to individual multinational firms and also to several industry organizations that support dialogue on issues of international trade, investment, and taxation.

Professor Slaughter joined the Tuck faculty in 2002. Prior to coming to Tuck, since 1994 he had been an Assistant and Associate Professor of Economics at Dartmouth, where in 2001 he received the school-wide John M. Manley Huntington Teaching Award. Professor Slaughter received his bachelor's degree summa cum laude and Phi Beta Kappa from the University of Notre Dame in 1990, and his doctorate from the Massachusetts Institute of Technology in 1994.

About the Authors

Grant D. Aldonas

Grant D. Aldonas is the William M. Scholl Chair in International Business at the Center for Strategic and International Studies. He has been directly involved in the debate over international trade and globalization for three decades as a diplomat, trade negotiator, a leading international attorney and a policymaker with the Commerce Department and Senate Finance Committee. Prior to joining CSIS, he served as Under Secretary of Commerce for International Trade from 2001 to 2005. He is also founder of Split Rock International, which provides strategic advice to firms operating in global markets and operates a microfinance fund making investments in the developing world.

Robert Z. Lawrence

Robert Z. Lawrence is Albert L. Williams Professor of International Trade and Investment at the Kennedy School of Government, Harvard University, a Senior Fellow at the Peterson Institute for International Economics, and a Research Associate at the National Bureau of Economic Research. He served as a member of the President's Council of Economic Advisers from 1998 to 2000. Lawrence has also been a Senior Fellow at the Brookings Institution. He has also taught at Yale University, where he received his PhD in economics. His research focuses on trade policy. He is the author of several books and numerous articles on the topic.

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THE FINANCIAL SERVICES FORUM

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

September 14, 2007

The Honorable Spencer Bachus
House of Representatives
Washington, D.C. 20515

Dear Congressman:

During the monetary policy hearing in July before the House Financial Services Committee, you asked me to comment on the provisions in Title I of H.R. 3012, the Licensing System of Residential Mortgage Loan Originators. Enclosed are my comments. I have also forwarded a copy to the Committee for inclusion in the hearing record.

Sincerely,

Enclosure

Insert page 45, line 1008 (July 18, 2007 hearing)

Chairman Bernanke subsequently submitted the following for the record:

The idea of a nationwide licensing and registration system for all mortgage loan originators, which is addressed in H.R. 3012, has considerable merit. It would help limit the ability of bad actors to move to a new state, and to continue engaging in irresponsible practices there, after having run afoul of regulators in their old states. I note that the Conference of State Bank Supervisors (CSBS) and the American Association of Residential Mortgage Regulators (AARMR) have an initiative of this sort, which appears to be promising. As the support and engagement of state regulators would be indispensable to the success of such a nationwide registry, federal legislation toward that end probably should take advantage of and incorporate the initiative by CSBS and AARMR. It may be appropriate for any new legislation to ensure that all individual originators are included in the same nationwide registry, although loan originators who are employed by depository institutions already are subject to significant oversight by the federal banking agencies--including the Federal Reserve System.

I note that H.R. 3012 also contains provisions to revise mortgage disclosure. The Board is currently reviewing its regulations in an effort to improve the effectiveness of mortgage disclosures under the Truth in Lending Act. We will be conducting extensive consumer testing of mortgage disclosures for this purpose. With respect to the technical aspects of H.R. 3012, the Board's staff would be glad to discuss these with Congressional staff.

BOARD OF GOVERNORS
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FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

August 22, 2007

The Honorable Randy Neugebauer
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am pleased to enclose my response to the questions you submitted concerning the taxation of carried interest following my appearance before the House Financial Services Committee on July 18, 2007. I have also forwarded a copy of my response to the Committee for inclusion in the hearing record.

I hope you find these comments helpful.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to written questions received from Congressman Randy Neugebauer in connection with the July 18, 2007, hearing before the Committee on Financial Services:

Recently, legislative proposals to increase the tax rate on fund managers at private equity firms have been the subject of much attention. Presently, the capital gains tax rate of 15 percent is applied to so-called "carried interest," or the share of profits awarded to fund managers at private equity firms and other investment partnerships. Legislative proposals would categorize these earnings as regular income, thus raising the tax rate on these profits to 35 percent. In your opinion, if the tax rate on carried interest is raised, what effect would this have on the amount of private equity available for investment in our economy?

Would this impact have a negative or positive effect on our economy?

Economists highlight at least three important issues when considering the taxation of carried interest. One issue is tax equity, which basically suggests that similar types of income should face the same tax rate. Thus, to the extent the carried interest received by the general managers of private equity funds, venture capital funds, hedge funds, and other types of investment partnerships reflects compensation for management services, carried interest should be taxed like other forms of compensation. However, to the extent that carried interest represents capital gains, they should be taxed as capital gains. Of course, determining in a particular case whether carried interest is compensation or capital gains is not always clear cut.

Another issue highlighted by economists relates to the cost of capital and capital formation in the United States. Increasing the tax on carried interest would tend to raise the cost of private equity--including buyout and venture capital--and reduce the after-tax return to these types of capital. In theory, the lower after-tax return to capital could reduce the rate of capital formation in the United States. However, this may be lessened to some extent as some funds may continue to invest in capital in the United States but do that investment through entities that are taxed outside of the United States.

A third issue is tax incidence. In particular, the general partners in these funds might, in effect, pass on the tax by restructuring or increasing the carried interest assessed on limited partners of the fund or by raising the cost of capital to portfolio firms in the funds, or both.

Ultimately determining the desired level of taxation for carried interest depends on concerns about the consistent treatment of similar types of income and of similar organizational structures under the tax code and about the effects of taxes on the level and allocation of capital. Making those determinations is not easy, and ultimately may have to involve difficult judgments by the Congress.

BOARD OF GOVERNORS
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WASHINGTON, D. C. 20551

BEN S. BERNANKE
CHAIRMAN

August 22, 2007

The Honorable Tom Price
House of Representatives
Washington, D.C. 20515

Dear Congressman:

I am writing in response to the questions you submitted following my appearance before the House Financial Services Committee on July 18. Your questions referred to the competitiveness of the U.S. corporate tax, taxing private equity companies as corporations, and measures to increase the national saving rate, which I answered in turn in the enclosure. I have also forwarded a copy to the Committee for inclusion in the hearing record.

I hope you find these comments helpful.

Sincerely,

Enclosure

Chairman Bernanke subsequently submitted the following in response to written questions received from Congressman Tom Price in connection with the July 18, 2007, hearing before the Committee on Financial Services:

Questions: **In this Committee we have often had the chance to talk about some of the factors negatively impacting our Nation's global competitiveness--excessive securities litigation and overly burdensome regulation--both of which are forcing capital and companies offshore. But there is another factor having negative consequences--exorbitantly high corporate tax rates.**

This directly affects our global competitiveness--a subject on which this Committee has been far too silent this year. While it has certainly demonstrated the majority's desire to put the government back in the housing business--passing 10 housing bills in the first six months; it has done little to nothing to reduce regulation or prevent frivolous securities lawsuits, both of which continue to force capital offshore--costing Americans jobs.

Recently, the German government moved to approve an 8.9 percentage point reduction in their corporate income tax rate. This follows a trend in which 25 industrialized nations have adopted pro-growth, Reagan-style corporate income tax rates since 2001. Unfortunately, the United States isn't one of those countries.

Vietnam has announced it will cut its corporate rate to 25% from 28%. Singapore has approved a corporate tax reduction to 18% from 20% so that they may better compete with Hong Kong with a rate of 17.5%. Even France's new President, Nicolas Sarkozy, has proposed reducing the corporate tax rate to 25% from its current level of 34.4%.

By way of contrast, the corporate income tax rate in the United States has been frozen at 39.3% (35% federal plus a state average of 4.3%)--which is the highest in the developed world according to the Tax Foundation. To engage in these policies that hinder our global competitiveness is to force us to compete with one arm tied behind our back. The American people deserve a fair and level playing field.

Democrats, since the election last November, have made so many spending promises that they must continue to find creative new ways to increase the money flowing to the federal coffers by taxing the profits of private equity companies and hedge funds at a much higher rate. The cost of which will be innovation, risk taking and American prosperity. We should not be in the business of penalizing success.

Clearly other industrialized countries have learned a lesson that Former Fed Chairman Greenspan was fond of saying--if you tax something, you will get less of it.

That is the case whether you're talking about increasing corporate income tax or completely changing the way you tax pools of private equity. The net effect will be the same--capital will flee our shores for Europe and Asia.

I would like to hear your thoughts on positive benefits that our economy might see if the Congress reduces the 35% U.S. federal corporate tax rate to the industrial nation average of 29%; additionally, you might get his thoughts on the negative consequences to our global competitiveness that would result from taxing the profits of private equity companies at the corporate tax rate rather than as it has been done traditionally at the capital gains rate of 15%.

The second item I'd like to focus on is our national savings rate, which is very important because of what President Clinton called the "looming crisis" we're facing with Social Security. But since then we've seen little to no action to secure the future of our retirees.

We are quickly reaching the breaking point. Social Security costs will begin to sharply rise after 2008--next year--when the first baby boomers have turned 62 and begin to collect Social Security retirement benefits.

Social Security costs will nearly double from $652 billion in 2009 to over $1.1 trillion by 2017. Social Security cash surpluses will begin to decline beginning in 2010. Starting in 2017, Social Security tax revenues will fall short of benefits. It seems that the only thing greeting our retirees will be frustration and heartache rather than a secure retirement.

From 2009-2017 the number of retirees receiving Social Security will grow by 24.5 percent, the number of workers by only 4.8 percent. In other words, the number of retirees will grow more than five times faster than the worker population. A system created in 1935 with only minor changes over the years is not capable of keeping up with today's dynamic workforce and changing demographics.

Chairman Bernanke, I bring this up because I am concerned with our national savings rate. According to the Bureau of Economic Analysis at the U.S. Department of Commerce--in 2004, it was 2.0 percent, in 2005 it was -0.4 percent, and in 2006 it was -1.0.

So at a time when baby boomers, and younger Americans, need to be saving more and more money for their retirement--because clearly they cannot rely solely on social security--they aren't. We must find ways to encourage Americans to save more than they earn than they consume.

A national consumption tax, or FairTax, would provide some common sense to the current mess. The FairTax would allow individuals to keep all of their hard earned pay check to use as they see fit. It would incentivize investment, spur economic growth, and provide tax prebates to those who need them.

What do you think that we can do to increase the national savings rate, including the possibility of transitioning to a consumption or retail tax system?

Answers: The structure of the U.S. corporate tax affects the economic and financial decisions of domestic firms, including affecting the total level of domestic investment, altering the allocation of capital between corporate and non-corporate businesses, and influencing whether corporate investment is financed with equity or debt. In addition, differences across countries in corporate tax structures can change the location of investments and provide opportunities for tax planning by multi-national corporations.

The full effect of the corporate income tax on domestic and international economic decisions is determined by not only the statutory corporate tax rate but also rules for the depreciation of capital, tax credits, and other features of the tax code. Recent reports by the Department of the Treasury and by the Congressional Budget Office have shown that while the United States has the second highest statutory corporate tax rate among the G7 or the OECD countries, this comparison is not quite as unfavorable when "effective" corporate tax rates are measured, which account for additional features of corporate tax structures--particularly depreciation allowances--along with statutory corporate tax rates. Even so, many economists have argued that the U.S. corporate tax structure could be improved.

One general economic principle of tax reform is that the economic efficiency of a tax system can often be enhanced if tax rates can be lowered while at the same time broadening the tax base in order to raise the same amount of revenue. However, reforming the corporate tax structure probably would not be easy as it would involve not only choosing to lower the corporate tax rate but also the difficult decisions of how to broaden the corporate tax base.

With regard to the taxation of publicly-traded private equity partnerships, an important issue is whether the income received by the general managers of these partnerships is determined to be derived predominantly from providing "active" business services--which would qualify the partnership to be taxed as a corporation--or derived mostly from "passive" capital gains--which would allow the returns to the general managers to be taxed at the capital gains rate at the level of the individual income tax. Once this determination is made, tax equity suggests that similar types of income and similar organizational structures should be treated consistently under the tax code. Nevertheless, treating publicly-traded private equity partnerships as corporations under the tax code might reduce--or even eliminate--the number of private equity partnerships that would choose to go public since doing so would increase their tax burden. However, an increase in taxes on publicly-traded partnerships may have little effect on the majority of private equity partnerships that plan to remain private and are currently taxed under the individual income tax.

Finally, I share your concern about the low rate of saving in the United States. Increasing our national saving rate would tend to lower interest rates, increase domestic investment, and reduce our reliance on borrowing from abroad. Unfortunately the U.S. private saving rate generally has trended down over the past two decades despite numerous policies implemented to try to increase saving. However, we should not stop trying to find policies that would help bolster the U.S. saving rate. Indeed, the pension legislation passed last year by the Congress that encourages firms to set up their 401k plans such that enrollment by employees is automatic may increase household saving as participation in these retirement saving plans rises. Another possibility to consider within the context of Social Security reform would be to create add-on accounts in which individuals could contribute payroll deductions in addition to the payroll taxes that already go to fund the Social Security program. Your question also suggests the possibility of shifting the income tax to a consumption-based tax, which in theory could increase private saving but also can raise difficult issues about the transition to the new tax structure and the distribution of the tax burden. As a final point, national saving also is bolstered by continued improvements in public saving that are achieved by fiscal discipline and by policies that do not increase private saving while reducing public saving.