Policy Brief

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Economic Survey of the United States, 2000

Summary

The US economy now appears to be in a position to supply faster medium-term growth of living standards to households than has been achieved at any time since the 1960s. The upswing seems likely to continue this year, with growth of about 4½ per cent. The prolonged surge in activity, along with welfare reform, has increased employment of less-favoured groups, and reduced welfare rolls, while poverty rates have fallen. The movement to greater income inequality has been checked, though it remains high relative to other OECD countries. Higher investment in information technology has been the one of the keys to the step-up in productivity gains. At the same time, prudent economic policies have prolonged the expansion. Abstracting from energy price increases, inflation has been low and fairly stable. But demand continues to outstrip supply, generating a very tight labour market, a widening external deficit and the risk of higher underlying inflation, raising the economy's vulnerability to business cycle risks. To safeguard a continued, if slower, expansion, at just under 3 per cent in 2001, further increases in short-term interest rates are needed. Fiscal policy should focus on the longer term, using prospective budget surpluses to pay down debt, thereby securing future pension benefits as the population ages. Policy-makers also need to ensure that growth is ultimately sustainable. Here, improving the education and health of the least advantaged is crucial, as is maintaining the quality of the environment through a further expansion of economic incentives in this area. A far-sighted orientation to policy can only benefit the nation. ■

This Policy Brief presents the assessment and recommendations of the 2000 OECD Economic Survey of the United States. The Economic and Development Review Committee, which is made up of the 29 Member countries and the European Commission, reviewed this Survey. The starting point for the Survey is a draft prepared by the Economics Department which is then modified following the Committee's discussions, and issued under the responsibility of the Committee.

OECD Observer

Is the US economy on a higher growth path?

The US economy seems to have shifted to a higher potential growth path, having recovered a considerable amount of the dynamism lost in the 1970s and 1980s. It has now been expanding continuously for longer, albeit not more rapidly, than at any time in modern history. Such a durable increase in output is linked to a significant economic transformation. At the aggregate level, trend labour productivity growth has probably doubled from the rate seen in the 20 years prior to the mid-1990s, helped by a surge in the capital equipment and software available for each worker. Central to this development has been the extraordinarily robust technical progress in the computer and communications industries. Advances in information technology have resulted in a sharp fall in the price of investment goods, boosting the growth of the capital stock and thus of labour productivity in the high-technology parts of the economy. These gains appear to be spreading into other sectors, and, if the decline in price of investment goods continues, may offer the possibility of maintaining, or even further boosting, the higher overall growth of labour productivity and hence of average real incomes for some time to come. ■

What are the sources of tension in the economy?

While the economy's ability to supply goods and services has improved significantly, demand continues to increase even more quickly. Financial markets have anticipated future income gains and capitalised them to a very full extent. Consequently households, as well as benefiting from improved employment prospects and gains in real income, have seen a continuing substantial increase in their net worth. The personal sector has translated a part of this rise into higher consumption, which has accounted for a growing share of domestic demand in recent years. Investment, too, has been buoyant because of the prospects for persistently buoyant sales and ample availability of low-cost capital. Moreover, from the middle of 1999, exports too have been adding to demand, as the world expansion has become increasingly robust.

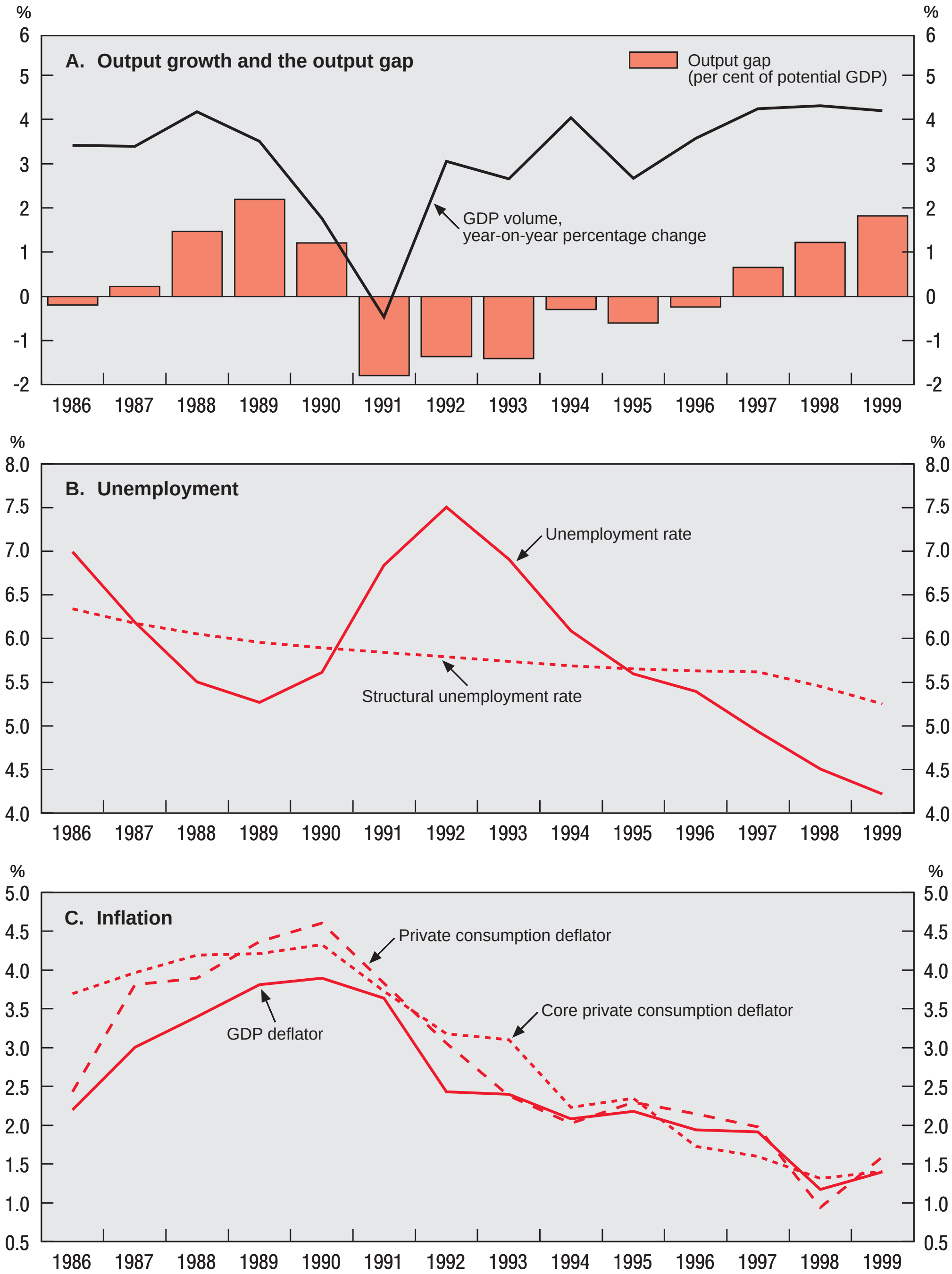
Such high demand has resulted in the intensification of a number of tensions over the past year. Household saving has fallen further, with personal indebtedness rising swiftly. Companies, too, have been borrowing heavily, and credit has risen rapidly. Investment capital has also been readily available to the booming Internet sector of the stock market – recently capitalised at around 12 per cent of GDP – although few of these companies make profits at the moment. However, as yet, the debt-service ratios for both households and companies have not returned to the levels seen at the end of the 1980s. Moreover, while these sectors no longer have financial surpluses, their identified net borrowing remains small. Nonetheless, their deterioration has helped to generate a large current-account deficit that, at 4.2 per cent of GDP in the fourth quarter of 1999, was the largest since the Second World War. This growing imbalance has led the nation's net foreign liabilities to rise to an estimated 20 per cent of GDP, up from an average of 5 per cent of GDP in the first half of the 1990s.

In addition to the external imbalance, the labour market has become more stretched. Indeed, at around 4 per cent of the labour force, the overall unemployment rate is the lowest in 30 years, and the corresponding rates for minorities have fallen to record lows. The economic expansion has brought with it a fall in the poverty rate, and, possibly in combination with welfare reform, has contributed to a shortening of the welfare rolls. It has also stemmed the long-standing trend to a more uneven distribution of income. At the same time, faster productivity gains and tight labour market conditions have pushed up real wages more generally.

Even so, nominal increases in salaries and benefits were quiescent for much of 1999, little changed from previous years. This raises the question of whether there has been an underlying improvement in the functioning of the labour market. Certainly, the changing demographic composition of the labour force – with fewer young people and more middle-aged workers – would account for some fall in structural unemployment, though much of this effect occurred in the 1980s. More recently, however, improved job matching from temporary help agencies and the Internet job market may have resulted in a further fall. Nevertheless, for the time being, there is little empirical evidence to indicate an equilibrium unemployment rate below 5 per cent, suggesting an eventual pickup in inflation.

Some signs of inflationary pressure have emerged elsewhere in the economy. World oil prices have more than doubled. Indeed, higher petroleum prices have helped push the increase in the consumer price index above3 per cent over the past twelve months. Moreover, other commodity prices have been increasing, notably in the area of metals and other primary materials. Such moves have led to some increase in prices at the early stages of production. Furthermore, with the dollar no longer strengthening, overall non-oil import prices have stopped falling for the first time in four years.

Aggregate economic indicators



Source: Bureau of Economic Analysis and OECD.

Considerable momentum now exists in final demand, suggesting that there may be no slowdown in the pace of the expansion this year. The reduction in real incomes stemming from the substantial increase in oil prices over the past year has not left an appreciable mark on consumer spending. Moreover, the increase in personal wealth is sufficiently large that a further fall in the saving ratio can be expected. At the same time, outlays on information technology equipment continue to be driven by falling relative prices and seem likely to recover from their Y2K-induced slowdown at the end of 1999. Although part of the increase in demand is projected to be met by another widening of the current-account deficit, output seems set to grow faster than potential for the year as a whole, with GDP probably expanding by some 4½ per cent against an increase of just over 3½ per cent in estimated potential output. The resulting enlargement in the output gap points to the likelihood of a modest rise in core inflation and some upward creep in wage increases.

With the considerable changes that have occurred in the economy in the past few years, uncertainties surround the projections of both inflation and output. Faster demand growth than is currently projected risks higher inflation, particularly if the recent moderation in wage growth turns out to have been driven by temporary factors, rather than a further fall in the structural unemployment rate. In a pessimistic scenario there could be a falling-off in the foreign demand for US assets that would lower the dollar exchange rate and reinforce the pressures on inflation. This could end the "exuberance" in equity markets. In such a case, recent levels of borrowing could be seen as excessive and so generate a pervasive slowdown in demand as private-sector balance sheets are restructured. A similar outcome could occur if there were a spontaneous fall in the stock market generated by investors returning to earlier more conservative valuation rules that might adversely affect the technology sector, just as occurred at the end of the 1960s bull market. ■

What monetary policy stance is called for?

Over the past year policy makers have sought to ensure that inflation remains low and stable. In 1998, when international instability led to adverse movements in financial markets, short-term interest rates were lowered. These cuts were gradually unwound during 1999. By November, three quarter-point increases had restored the level of nominal interest rates to that of the summer of 1998. However, even after the latest increase in March, some measures of real short-term rates are still below their pre-crisis levels. Overall credit growth remains rapid, though the surge in money and bank credit seen at the end of 1999 may be unwound as the liquidity injected to deal with potential Y2K problems is progressively withdrawn. Thus, with little change in the effective exchange rate and continuing equity-price gains, overall financial conditions do not yet seem tight.

Increases in the inflation trend, however slow and apparently innocuous, will eventually become entrenched in expectations, making its ultimate reversal that much more difficult. With output increasing by 6½ per cent annual rate in the last two quarters of 1999, inflation expectations were, once again, moving towards 2½ per cent per year at the beginning of 2000. Such conditions warrant a further progressive increase in interest rates this year. The full extent of the increase that will be necessary is as yet uncertain, as underlying equilibrium real interest rates may have risen with the improvement in returns to capital. If the projected further 1 percentage point increase in the Federal funds rate, to 7 per cent by the end of this summer, proves to be sufficient to slow growth to less than 3 per cent in 2001, as projected by the OECD, that should not cause undue problems in financial markets, as such an increase in rates has now been largely discounted. In any case, a modest decline in stock prices would help to restore the balance between supply and demand in the economy as a whole by lowering private consumption more quickly than could be achieved by movements in short-term interest rates alone.

The clear transmission of the intentions of the monetary authorities can aid the smooth functioning of financial markets. The Federal Reserve has signalled its intentions to markets in a number of ways: the announcement of biases to policy, together with speeches and testimony before the Congress. But confusion over the appropriate interpretation of such biases led it rightly to reconsider its procedures. As from the beginning of 2000, all interest rate decisions have been accompanied by a set of standard phrases to describe the risks facing the economy over a period that extends beyond the next meeting of the Federal Open Market Committee (FOMC). It remains to be seen whether such a step is a sufficient increase in transparency. Earlier publication of the minutes of the FOMC meetings might also be considered in order to provide a fuller appreciation of the future stance of policy. ■

Are budget surpluses at risk?

The need for a tighter monetary policy has, in any case, become more pronounced with the recent change in the underlying thrust of fiscal policy. After a seven-year period when the general-government sector improved its balance by an average of 1 percentage point of GDP per year, the structural surplus appears to have stabilised. The saving in expenditure brought about by the end of the Cold War has ceased, and federal discretionary spending is expected to rise in real terms in 2000, exceeding agreed, albeit unrealistic, budgetary caps. Moreover, the extent to which federal tax revenues are rising faster than GDP has diminished. State and local governments have also used unexpected revenue increases to lower tax rates. Nonetheless, the general government sector is projected to have a surplus of 1¼ per cent of GDP in 2000, and gross general government debt may fall to 61 per cent of GDP, a decline of almost 15 percentage points in the past seven years.

Medium-term budget projections point to increasing surpluses. Already questions are being raised as to whether these should be used to raise expenditure or lower taxes. However, these projections are very sensitive to the assumptions used. For instance, just a modest increase in the pace of government spending would be sufficient to eliminate all projected on-budget surpluses. Moreover, there is not as much room for manoeuvre as the surpluses for the next decade would suggest, given the ageing of the population that is likely to boost spending on Social Security and Medicare thereafter. Accordingly, from a longer-term perspective, it would be wise to use the surpluses to continue to pay down debt. On the other hand, official projections are based on what may eventually be conservative estimates about the potential growth rate of the economy. Nevertheless, unless it becomes clear that the economy is on a faster growth trajectory, it would be unwise to jeopardise future surpluses by new spending and taxation plans. In any case, some further reform of the old-age pension system, will be necessary to ensure the sustainability of social security.

Securing growth over the longer-term will require more than just continuing to follow sound fiscal, monetary and regulatory policies. Social and environmental policies, in particular, need to be reviewed in the light of achieving sustainable development. At the same time, there are markets where economic efficiency could be improved further. ■

What about the social agenda?

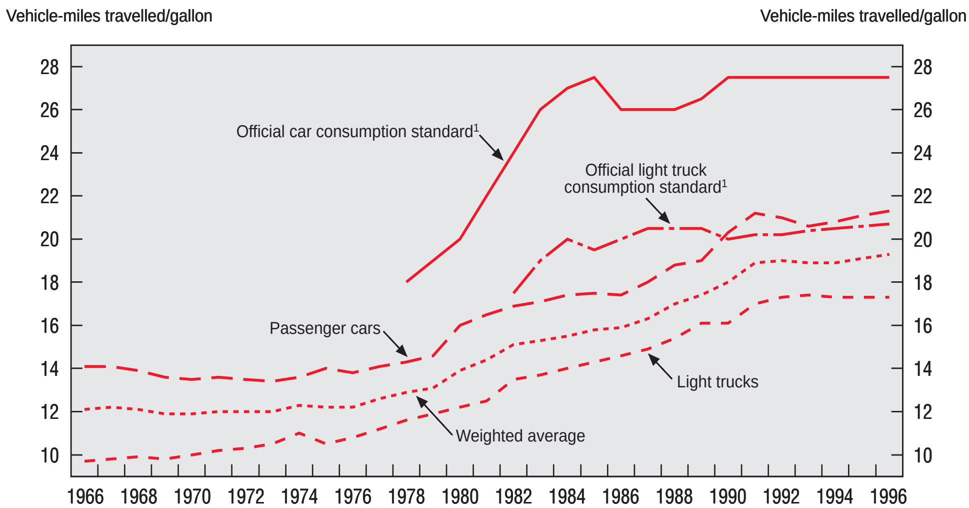
In the social area, better long-term economic prospects could be achieved through government policies with respect to education and health. Increasing the quality of the nation's schools is essential to maintaining the supply of highly skilled workers, so vital to the continued surge in high-technology sectors. Progress has been made in recent years in setting output standards for schools. By 1999, nearly all states had adopted standards for basic subjects, and most now assess school performance, revealing some improvement. Yet much still needs to be done to meet the agreed standards. The growing number of charter schools reflects efforts to improve performance; more funding could be made available to them. Federal subsidies for the hiring of additional public school teachers create opportunities for higher overall educational achievement and allow for a more equitable distribution of resources. Nonetheless, some youths are bound not to obtain highly valued skills. It is important to avoid pricing them out of jobs through too-rapid increases in minimum wages. It would be preferable to aid low-wage workers through raising the earned income tax credit. Health outcomes remain poor in the United States, given the scale of expenditures, perhaps reflecting imperfect access to medical care. Although the State Children's Health Insurance Program has improved coverage for children in poor families, the share of poor with health insurance coverage has declined slightly in recent years. More complete coverage for poorer people in general should remain a priority. ■

How has environmental policy evolved?

Despite the undeniable environmental progress made in recent years, many question whether high growth is sustainable, not only in conventional economic terms but also in terms of accompanying effects on our surroundings. The natural environment is difficult to manage efficiently because of the lack of price signals - there are few markets in environmental benefits, as they accrue to all. Furthermore, the full cost of any damage is generally not borne by the entity that caused it. As in other countries, the authorities' initial response to this problem was to introduce command and control regulations. Indeed, much of this approach remains, frequently in the form of rules that are complicated and expensive to administer. The government is aware of these costs and has been experimenting under Project XL with more flexible implementation of such command and control regulations, though the early results are disappointing.

There has accordingly been a move away from regulation towards market solutions. Trading in permits for sulphur dioxide emissions began in 1995, and their prices have been lower than expected. By limiting the overall quantity of such emissions and allowing a uniform price to be established, the overall costs of meeting the aggregate emissions ceiling have been minimised and incentives given to find efficient abatement techniques. Such pollution has fallen markedly. In 1999, permit trading was introduced for

Average fuel consumption of light vehicles



1. The official standard is the weighted average for the sales of vehicle producers, commonly known as "cafe" standards.

Source: Federal Highway Administration.

emissions of nitrogen oxides in a number of north-eastern states; further benefits should accrue to this programme following its extension to neighbouring states in 2004.

The tendency towards greater use of economic instruments has not, however, been uniform. One such area where little progress has been made is transport. Quite apart from its importance as a contributor to greenhouse gas emissions, the road transport sector has many other externalities. The costs of reducing some of these is borne by the sector itself (e.g. accident insurance and safety regulations, catalytic converters and emission regulation). Where the externality is closely related to fuel consumption, measures to increase fuel costs directly, whether through taxation or otherwise, would be both more effective and less costly than the imposition of average fuel economy standards on new car sales. Due to its high energy consumption, the United States is by far the largest per capita contributor to greenhouse gas emissions. Along with most other OECD countries, it seems unlikely to meet its original aim under the United Nations Framework Convention on Climate Change to keep greenhouse gas emissions in the year 2000 to no higher than their 1990 level. Meeting the more stringent emissions target for 2008-12 set out in the Kyoto Protocol using only domestic measures, would require considerable increases in carbon-based energy prices (either through taxation or through a cap-and-trade system). The introduction of a scheme involving international trading of emissions permits could substantially reduce the scale of the price increase necessary to reduce carbon emissions. The government is thus justified in seeking approval of such a scheme. But price increases should be adopted sooner rather than later, in order to allow adjustment to begin quickly, thereby lowering its ultimate cost.

The achievement of sustainable growth and economic incentives to avoid pollution are also notably absent in the area of agriculture and water use. The extensive use of nitrogenous fertilisers and intensive animal rearing have contributed to the continued growth of food production, but they have also caused deterioration in water quality and other kinds of environmental degradation in some regions. At the same time, agricultural subsidies generally contribute to higher output and intensive production methods that help create these problems, even if some of the subsidy programmes have significant environmental conditionality attached. A consistent application of the polluter pays principle in agriculture would imply, for example, taxing nutrient application in fertiliser and feeds in areas where water quality is compromised. Agriculture is also a major user of water for irrigation, often supplied at prices that are well below those paid by other users. It would appear that the structure of water use rights is frequently a barrier to its rational use. A way of either trading such rights or charging resource rents on water extraction needs to be found so as to try to enhance sustainability, even of agriculture itself, in areas where aquifers are being rapidly depleted.

The impact of regulation can also be made more favourable by the more widespread use of cost-benefit analysis. Rules and procedures governing the use of such analysis are inconsistent, with some legislation actually preventing its use in areas where it would obviously be beneficial. Such restrictions should be removed, and guidelines and quality control for its use should be strengthened, with similar requirements for its use in both regulatory impact assessments and environmental impact statements. Of course, many of the benefits and some of the costs of environmental regulation are uncertain and difficult to quantify. While the use of cost-benefit studies should be the norm, policy should not be rigidly constrained by their results, especially where non-quantifiable effects are important. Clear principles should be established under which non-quantifiable effects can influence the balance of net costs and benefits.

Heavy use of the courts is probably inevitable in the area of environmental law, where the use of market mechanisms to mediate conflicts - whether over environmental damage or protection of property rights against "takings" - is difficult. However, a recent OECD study, Regulatory Reform in the United States, concluded that the degree of litigation generally imposes considerable costs on society and the economy. Improved drafting of laws and regulations could probably reduce these costs. The tendency for legislation to provide only the broad targets of policy, with the details and some elements of strategy left to the executive branch of the government to interpret, increases the likelihood of costly litigation, however. Establishing the basic principle that the benefits of a measure must exceed its costs should at least focus attention on the essence of problems rather than procedures. ■

Where can economic efficiency be improved?

In the financial sector, the reduction of the Depression-era barriers between banking and other financial activities has been a long-standing concern. After many failed attempts at revision, these barriers have finally been abolished through the welcome enactment of the Gramm-Leach-Bliley Act. The legislation should prompt a further integration of capital markets and allow greater efficiency in the provision of banking and insurance services, though it also increases the demands on the regulatory structure. Financial modernisation needs to continue with a reduction in the relatively large number of regulatory authorities for deposit-taking institutions: the Office for Thrift Supervision could usefully be merged with the Office of the Comptroller of the Currency, for example. The market could also be given a greater role in applying discipline to financial institutions. Finally, the role of government-sponsored financial enterprises should also be reconsidered. Commercial markets no longer need implicit government guarantees provided to these enterprises, and policy should be oriented to reducing, or even severing, their links to government.

In the newer sectors of the economy, electronic commerce is already a powerful agent of growth, offering significant new business opportunities and greatly expanded consumer choice. It is also serving to transform many business models, by streamlining business processes. However, in terms of the fiscal regime, electronic commerce should be put on an equal footing with conventional commerce so as to avoid evident market distortions. There seems every reason to bring electronic commerce, and indeed the mail-order business, into the sales tax net, especially as emerging technology is making the attribution of such taxes that much easier. Such a move would also safeguard future state and local government revenues that depend heavily on such taxes.

There is also a need to maintain a constant vigil to ensure that product markets remain open. To that end, to the extent that official discretion is involved, it is crucial that recourse to contingency measures be kept to a minimum. But perhaps most important is the position of the United States in the ongoing efforts to initiate another round of global trade liberalisation. The world's largest economy, as well as its partners, stands to benefit handsomely from opening up trade in goods and services, especially in agriculture and textiles where intervention, which harms the interests of consumers and reduces efficiency, remains the order of the day. ■

For further information

More information about the *Survey* can be obtained from Richard Herd, e-mail: richard.herd@oecd.org, tel.: (33-1) 45.24.87.00. ■

For further reading

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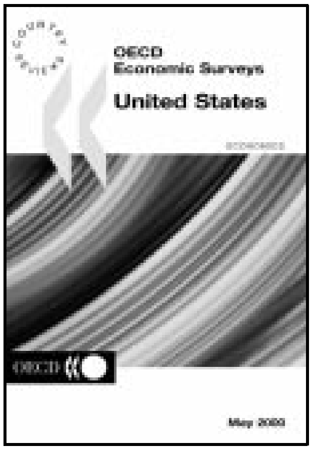

- **Additional Information**: More information about the work of the OECD Economics Department, including information about other publications, data products and Working Papers available for downloading, can be found on the Department's Web site at www.oecd.org/eco/eco/.
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