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Remarks by

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One of the most complex economic calculations that most workers will ever undertake is, without doubt, deciding how much to save for retirement. At every stage of life, individuals ought to make judgments about their likely earnings before retirement and their desired lifestyle in retirement. Also implicit in such decisions are assumptions about prospective rates of return, life expectancy, and the possible accumulation of a nest egg for one's children. The difficulty that individuals face in making these projections and choices is compounded by the need to forecast personal and economic events many years into the future.

Insurance companies make some of the same judgments in calculating premiums for annuity contracts or life insurance. Defined-benefit pension plans make similar calculations for large groups of employees. The social security and medicare trustees replicate some of the same calculations in their annual assessments of the actuarial viability of those programs. Aside from these institutionalized forms of retirement saving, of course, is the discretionary saving that each of us does consciously by periodically setting aside portions of our income.

All of the above, and more, are required to assess the adequacy of retirement saving for an economy as a whole.

Most economic forecasts are subject to significant uncertainty. At least by comparison, one judgment looks to be a reasonably sure proposition: the ratio of retirees to those still working will rise precipitously starting at the end of this decade, and that ratio will continue to climb through the first third of this century and remain high thereafter. In part, this projected development owes to the retirement of the baby boomers. But the phenomenon is broader than that and reflects the aging of our society. Importantly, according to the social security trustees, the demographic challenge will not go away with the passing of the baby-boom generation.

This ever-larger retired population will have to be fed, clothed, housed, and serviced by a workforce growing far less rapidly. The retirees may have accumulated a large stock of retirement savings, but the goods and services needed to redeem those savings must be produced by an active workforce assisted by a stock of plant and equipment sufficiently productive to meet the needs both of retirees and of a workforce expecting an ever-increasing standard of living.

Though from the point of view of an individual household, saving reflects financial claims adequate to meet future needs, the focus for the economy as a whole, of necessity, must be on producing the real resources needed to redeem the financial assets.

The role of finance is to channel saving into investment of the physical capital assets that assist in the production of the gross domestic product, which, in turn, serves both retirees and active workers. Clearly, an efficient system of finance can more effectively deploy a given stock of capital and thus maximize its contribution to supporting the population.

Any analysis of the amount and type of saving required to finance the bulge in retirements that is just over the horizon needs to project (1) the number of retirees, (2) the size of our workforce, and (3) the productivity of that workforce. Of the three, productivity is most directly affected by the level of investment, which, of course, is financed by saving.

The size of the future workforce, excluding immigrants, and the size of the future retired population are relatively simple to project from today's existing age distribution. The level of immigration, both legal and illegal, will be dominated by public policy decisions and by economic forces, both in the United States and in the countries from which our immigrants are drawn. This forecast is more problematic, and its level matters: Over the past decade, for example, immigration accounted for approximately one-third of the increase in our workforce. The larger our workforce in 2010 and beyond, the easier producing goods and services for both retirees and active workers will be. Immigration policy will, therefore, be a key component of baby-boom retirement policy.

The rate of saving--for retirement and other purposes--may not directly affect either the number of retirees or the size of the workforce. But it surely affects capital investment, which it finances, and the productivity that it engenders.

Besides the total amount of saving and investment, changes in the allocation of those funds among different types of capital also appear to have some influence on the growth of labor productivity. A dollar of new saving flows through financial markets to firms that allocate it among different types of capital investment. Clearly, firms' choices about the types of investments to make matter crucially for how much labor productivity ultimately is boosted.

In the late 1990s, for example, businesses allocated much more of their investment dollars toward high-tech, higher-return capital than they did in earlier years. Businesses made this shift and are continuing to move further in that direction in response to the extremely rapid decline in the prices of high-tech assets and the new opportunities that these assets have afforded. According to one set of calculations, of the roughly 2-1/2 percent annual rate of increase in output per hour, or labor productivity, between 1995 and 2001, perhaps a quarter of that growth could be attributed to on-going shifts in the composition, as distinct from the dollar level, of capital.

Improvements in the quantity and quality of education of our workforce enhance workers' skills and contribute importantly to the growth of labor productivity. But far more important over the past six years are the gains in output attributable to technological innovation, especially information technology and improved managerial organization, and as I noted in testimony yesterday, the greater flexibility and resilience of our economy stemming from deregulation, primarily in finance.

Notwithstanding these more intangible contributions, the level of saving remains a key ingredient of economic growth. But we need also to know whether the source of that saving is sustainable, and beyond that, whether the type of financial assets in which our saving overall is accumulated affects our productivity.

During the past six years, about 40 percent of the total increase in our capital stock in effect has been financed, on net, by saving from abroad. This situation is reflected in our ongoing current account deficit, which, by definition, is a measure of our net investment in domestic plant and equipment financed with foreign funds, both debt and equity. But this deficit is also a measure of the increase in the level of net claims, primarily debt claims, that foreigners have on our assets. As the stock of such claims grows, an ever larger flow of interest payments must be provided to the foreign suppliers of this capital. Countries that have gone down this path invariably have run into trouble, and so would we. Eventually, the current account deficit will have to be restrained. The nation's economic potential will be brighter if that comes about through an increase in domestic saving rather than a reduction in domestic investment.

Whether the mix of domestic private and government saving affects the rate of productivity growth is a more contentious issue. Another is whether the form of private saving, for example, whether in stocks or debt instruments including bank deposits, affects productivity growth.

Ultimately, the composition of real investment in our economy will reflect--among other influences--the attitudes toward risk of those who own the financial claims against the capital stock. If savers become more risk-tolerant, financial risk premiums will decline. In response to these reduced penalties on risk, firms will eventually adjust the mix of their endeavors toward more-speculative projects--but, importantly, presumably ones that also offer higher prospective rates of return on average, which more often than not translate into higher long-term average economic growth.

The nation's savers, daily in the marketplace, exhibit an obvious sensitivity to the association between expected return and risk. Indeed, many are clearly willing to forgo the higher long-term rates of return on equity for the greater tranquility of the lesser risk associated with most debt instruments--in effect forsaking more economic growth for a more stable, less stressful, economic environment. As a consequence, returns on common stocks over rolling twenty-year periods have almost always outpaced the returns on less risky securities.

The answer to whether government or private saving does more to foster productivity growth arguably thus comes down to the propensity to take risks by U.S. savers. The less the willingness on the part of the nation's savers to hold risky securities, the more that business enterprises must be induced to undertake less risky endeavors. That inducement will occur as relative preferences shift toward debt instruments and away from equity, thereby driving interest rates lower and earnings price ratios higher. Government saving is largely reflected in a retirement of debt. Having chosen to hold at least a portion of their savings in riskless securities, government debt holders when confronted with debt retirement presumably would chose less risky debt securities over common stocks to rebalance their portfolios. Thus an increased share of saving from the government is a markedly more conservative financial strategy than if the saving were undertaken in the private sector. Obviously, the federal government could invest in higher-risk assets, such as equities. But for reasons that I have expressed many times before the Congress, I do not believe that, other than in defined-contribution plans, such investment can be accomplished free of political pressures that would distort the efficient use of capital.

Presumably, most of those who maintain that greater risk-taking would likely produce faster long-term growth would also acknowledge that increased competition and economic growth would bring greater volatility and social stress. Because of the near certainty of a major rise in the retiree-to-worker ratio in the next few decades, we now face the major challenge of setting policies for enhanced economic growth. What level of personal stress, and some argue, increased inequality, which may be a byproduct of a highly competitive, high-octane economy, have we as a nation chosen? Is the level compatible with the level of domestic saving and possibly the risk-taking that is consonant with the elevated level of productivity growth necessary to meet the needs of an aging population? A national consensus on these questions is clearly missing. This is doubtless an area for useful debate.

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I cannot close a discussion about provisions for retirement without a few words on social security. Although the program replicates a private retirement annuity program in many ways, it is also quite different in several respects.

It requires contributions of workers, matched by those of employers. But unlike a privately funded annuity program, the tie between contributions and benefits deliberately is not tight at the individual level. If the Social Security Trust Fund is depleted, the law requires that benefits be paid only to the extent that they can be financed out of current payroll tax receipts. But I cannot imagine a viable political scenario in which full payment of benefits will not be forthcoming. Does anyone doubt that Congress would prevent benefits from being curtailed if the trust fund were depleted?

In addressing the impending retirement of those born just after World War II, we will need to consider whether social security should better align itself with the funding provisions of our private pension and annuity system. Policymakers need to consider these issues now if we are to ensure a comfortable retirement for the postwar generation, while at the same time according due consideration to the needs of the later generations that now make up our workforce.