CHAPTER 5

THE STATE OF THE AMERICAN ECONOMY

Michael J. BOSKIN
Tully M. Friedman Professor of Economics and Senior Fellow, Hoover Institution, Stanford University, and Research Associate, National Bureau of Economic Research

Excutive Summary

The American economy is making a slow recovery compared to recoveries from other deep recessions in the country's history. Americans are pessimistic about the future of their economy and concerned that their children's standard of living may be lower than their own. They are asking whether slow growth is the new normal.

While economic growth is projected to show marginal signs of improvement in the short run, this could incur risks from a number of domestic and international factors, including fiscal policy, Europe's recession, China's impact and an increasing array of regulation.

The polity is divided on issues of fiscal consolidations versus short-run stimulus, adjustments in taxes versus spending, and generally on the size and scope of government. As the baby boom generation continues to retire, labor force growth is slowing, gradually raising the ratio of retirees to workers prospectively exploding entitlement costs.

However, the U.S. still compares favorably to other developed economies – with less demographic pressure than in the E.U. and Japan, lower taxes and a less burdened welfare state than Europe's most prominent economies. Moreover, its strengths in technology, productivity and higher education, combined with a more flexible market economy, should pull it through the worst, especially if sensible policy reforms are enacted. But it will not be an easy ride.

The State of the American Economy

The Short Run

The American economy remains in an historically slow recovery from the financial crisis and the deep recession. Recoveries from deep recessions are usually sharp and swift, as in the 1970s and 1980s. Sometimes recoveries from financial crises are slow, though not always. The economy remains well below its potential (see Figure 1). Economic growth has averaged roughly 2% per year since the recession ended.

The good news is that the Blue Chip private forecasters project a modest pick up to of 2% to 3% – still far too low – for this year and the next. The Congressional Budget Office (CBO) has the economy growing at 1.4% this year and 3.4% the next; thereafter, 3.5% for a few more years. The U.S. government administration forecasts a more solid recovery of 2.6% in 2013 and over 3.4% in 2014.

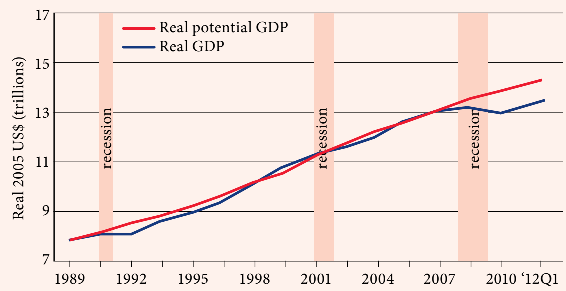
Of course, the U.S. economy, along with Canada's, is doing better than the other large advanced economies, some of which are contracting (see Figure 3).

While I am generally in agreement with the Blue Chip Consensus Forecast as a base case, I see considerable risk of economic growth getting worse over the next couple of years, along with some opportunities to do better.

The main risks in the short run stem from:

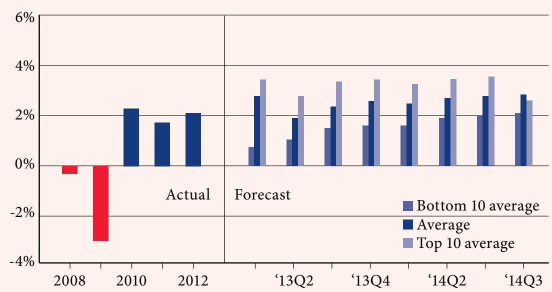
- Fiscal policy – especially any additional tax hikes – and the inability to agree on medium and long-run fiscal consolidation based primarily on slowing the growth of spending.
- Europe's deepening recession, which affects roughly 20% of U.S. exports. Its debt and banking crises remain a major problem, not just for Europe but for America and the global economy. Europe's banks are more thinly capitalized than American banks, but extend a larger share of credit in the economy as compared to credit markets.
- China – now the world's second largest economy and the first emerging market economy to be globally systemically important – is early in a political transition and must deal with a complex array of its own economic problems.
- Geopolitical issues – such as terrorism, nuclear proliferation confrontations (for instance, over Iranian oil) – a worst-case scenario could be severe enough to cause a recession.
- Continued deleveraging of the private sector is still in middle innings.
- There continues to be tight credit for small business.
- Additional regulation is continuing to raise the cost and uncertainty caused by the explosion of regulation in recent years. Wide swaths of the economy are being forced into non-commercial decisions by healthcare reform, the Dodd-Frank Act and Environmental Protection Agency regulation, whatever their non-economic benefits may be.
- Monetary-policy exit risk looms under current policy. The U.S. Federal Reserve (the Fed) is projected to have a balance sheet of US$4tr by 2014. Quantitative easing has hit the point of diminishing returns; still more excess reserves won't ease bank lending. Boosting asset prices risks bubbles that can burst and cause serious disruption. The Fed says it will raise interest on reserves to keep the banks from lending too rapidly, which would risk inflation. But especially given recent history, it is hard to imagine the public and the Congress sitting by while the Fed gives – not lends – tens of billions of dollars to the banks.

Figure 1: U.S. Real GDP, 1989-2012



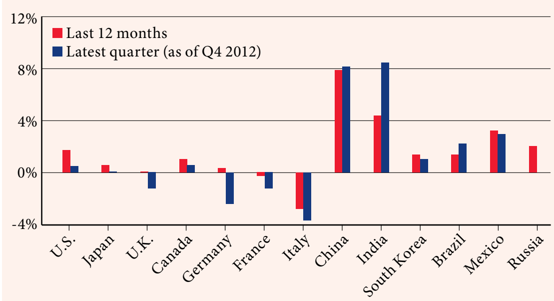
Source: BEA Web

Figure 2: Blue Chip Consensus U.S. Forecast, Quarterly 2013-14



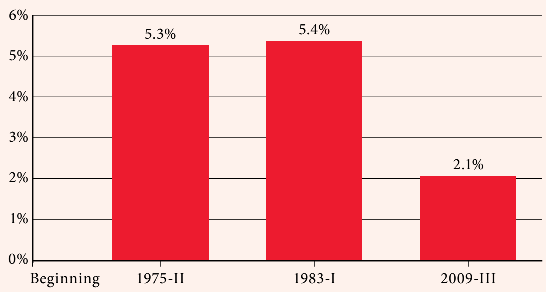
Source: Consensus forecast

Figure 3: GDP Growth Rates for Selected Countries (last 12 months and latest quarter, as of Q4 2012)



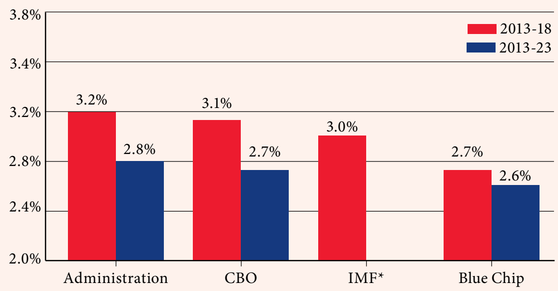
Source: The Economist

Figure 4: **Average U.S. Real GDP Growth, First 14 Full Quarters Since Severe Recession Trough**



Source: BEA Web

Figure 5: **Longer-Run Forecasts of U.S. Real GDP Growth, 2013-2023**



Source: White House, CBO, IMF, Consensus Forecast
** IMF's forecast only through 2018*

There is certainly lots of opportunity for the economy to do better than projected. Housing has finally begun to rebound. Although from a smaller base, it is now adding to – rather than subtracting from – growth. Fiscal drag from state and local tax hikes and spending cuts has likely peaked.

A technology revolution – 'fracking' – has created a boom in domestic oil and gas, which is generating jobs, incomes and government revenues. Combined with greater offshore drilling permits, Canadian oil and the once-unimaginable possible opening up of Mexico's oil industry to foreign investment – we have the opportunity to dramatically reduce the Organization of the Petroleum Exporting Countries' (OPEC's) strategic power. This is not just a potential economic revolution, at least, if policy or unsafe development doesn't kill it, but one of the most important geopolitical shifts in America's favor in decades.

Lots of cash is available on the sidelines, earning virtually nothing in relatively safe assets, on household and corporate balance sheets. Businesses are waiting for more favorable investment and hiring opportunities in a stronger economy and a more favorable expectation of the future tax and regulatory environment. In short, there is pent-up demand.

The recovery has been anemic compared to recoveries from the other two deep post-World War II (post-WW II) recessions. Those recoveries – in the mid-1970s and mid-1980s – were sharp and strong. As Figure 4 shows, gross domestic product (GDP) growth in the current recovery has been only 40% as strong. The jobs recovery has been running at only a 25% pace. In their first three and a half years, the earlier recoveries generated – adjusted for the growth in working age population – an average of 14.3 million jobs. The current recovery is 10 million jobs short. An unusually large number has left the labor force.

Turning attention to the long run, polls show Americans are more pessimistic than at any time since the stagflation of 1978-82. Record numbers are doubting that their children's and grandchildren's standard of living will be higher than their own. They wonder whether the economy will ever return to normal, or is stuck in a new normal of much slower growth or even Japanese-style long-run stagnation; whether the lurch toward a European-style social welfare state will stop; and whether some combination of monetary policy and exploding government debt will lead eventually to high inflation. They wonder if the depressed job market is primarily a cyclical problem or a permanent change in labor markets; and if high and rising government debt, due to the explosion of entitlement costs –perhaps following a few years of lower deficits and relatively stable debt-GDP ratios – will seriously erode their children's future prosperity.

Figure 5 presents alternative five and ten-year forecasts of U.S. economic growth. For the next five years, the average annual growth rate projections range from a low of 2.7% (Blue Chip) to a high of 3.2% (Administration), with the International Monetary Fund and CBO forecasts in between. In all cases, the ten-year forecasts are somewhat lower, reflecting two factors: first, the five-year forecasts reflect expectations of some catching up to potential GDP as the recovery from deep recession continues. Second, the projected growth of the labor force is slowing due to demographic factors, primarily the continuing retirement of the abnormally large post-WWII baby boom generation. (Note that the labor force participation rate of the non-elderly has fallen substantially and the extent of any rebound will reflect both an improving economy and changes promoting work incentives in the several major income support programs that have greatly expanded in the last several years.) As a result of this, projected slowing of labor force growth, real GDP growth at the end of the ten-year period in 2023 and presumably thereafter, is projected to slow further to 2.3% (Administration), 2.2% (CBO) or 2.5% (Blue Chip). With reasonable policy reforms providing greater incentives to work in government programs and the tax system and/or greater economically based immigration – no sure thing politically – the U.S. should be able to reach or exceed the high end of these forecasts.

The prospect for successful fiscal consolidation is at best mixed. Recent research reveals that fiscal consolidations in OECD countries since WWII which stabilize the budget without recession averaged US$5-6 of *actual* spending cuts per U.S. dollar of tax hikes. Spending cuts, especially in entitlements and transfers, were far less likely to cause recessions than tax increases and, in some cases, increased growth. A dozen recent studies in peer-reviewed journals, including one by President Obama's first Council of Economic Advisers' Chair, unanimously document the negative effects on the economy of higher taxes. Since the American economy differs in some ways from these other cases – it comprises over one-fifth of the world economy, interest rates are already low, the US dollar is the global reserve currency and many countries are consolidating simultaneously – we should be cautious about claiming too much for the short-run benefits of fiscal consolidation.

One successful example of spending control occurred in the mid 1990s under President Clinton and a Republican Congress, but more commonly, as in Washington and many states in the 2000s – the opposite occurs: a boom brings a surge in revenues and politicians are anxious to spread the spending far and wide. Ideally, spending reductions would be phased in as the economy recovers, but it is difficult to make a convincing case that they will indeed occur, given the political economy of the budget, the history of most previous budget agreements and the inability of one Congress to bind the next.

The Long Run

But the long-run prospects for the American economy are not nearly as bleak as much commentary suggests – the stock market hitting new nominal highs notwithstanding. These pessimists claim that the U.S. and the other major advanced economies face inevitable decline, given their fiscal, banking, trade, employment and demographic problems.

A more balanced view admits that these are all (partially) valid concerns and will be difficult to work through, especially European banking and debt and America's fiscal problems. But at any time in history, a similar list of allegedly insurmountable problems could be compiled – i.e. automation/structural unemployment in the 1960s; stagflation in the late 1970s to early 1980s; competition from Japan in the late 1980s – yet the innate flexibility and dynamism of a primarily market-based economy surmounted them all with waves of technology innovation and productivity enhancement, especially in the U.S.

The U.S. compares favorably to the other advanced economies because demographic pressure is less severe than in the E.U. and Japan (China too, eventually); taxes are lower and the welfare state less bloated in the U.S. than Europe. But America is currently expanding its welfare state and borrowing on an unprecedented scale (other than during WWII). Historically, the U.S. political system has swung the pendulum back to the center. Will it be too late this time? Close to half the population is receiving government benefits and only half are paying income taxes. That is not a healthy political economy of the budget to control entitlement costs.

Most importantly, the U.S. still leads in technology, productivity and higher education, and this strength extends far beyond IT. Fortunately, there are successful examples in recent history of the welfare state being rolled back to levels consistent with solid growth, for example, the U.S. in the mid 1980s-1990s and Canada in the mid 1990s-2000s.

In conclusion, I am cautiously optimistic about a continued, but too slow, recovery and decent long-run growth. But lots could go wrong.