

The Economy in Perspective

Caveat forecaster... The most remarkable aspect of current economic conditions is that they are so unremarkable. Real GDP expanded at a 3.7 percent rate during the last four quarters, the unemployment rate stands at 5.2 percent, and core CPI inflation registered 2.2 percent during the last 12 months. In other words, the economy is expanding somewhat faster than its long-term average, unemployment is at its long-term average, and the inflation rate is low and stable. Many forecasters expect real GDP to expand at a slightly slower rate in 2005 than in 2004, but still at a solid pace. Inflation is also thought to be well anchored although inflation measures were slightly elevated during the past year.

Most analysts' relatively sanguine picture of 2005 does not necessarily mean that it will turn out to be a ho-hum year. First, any forecast is just that, a forecast subject to various risk factors. Some, like energy prices, seem obvious. Others, like the pace of productivity growth, are more subtle. If productivity growth slows significantly from its pace of the last decade, might pressure on wages and inflation going forward be stronger than what is built into the average forecast? What about household consumption? If consumers decide to increase their personal saving rates after a long period of decline, might that not come at the expense of some of the consumption spending already built into the projections? Professional forecasters, who know more about these risks than the public does, use projections to evaluate exposure to various possible scenarios—they do not simply plan for the most likely one.

Another reason to be skeptical about forecasts for 2005 is that economists have more talent for describing the future than putting a date on it. The U.S. current account deficit and the dollar provide a good example: Several years ago, a number of economists pointed out that if our current account continued on its (then) present course, one might reasonably expect the U.S. dollar to depreciate against its trading partners' currencies. The logic of this prediction rested on the much-quoted observation that unsustainable events have a way of stopping. If the current account deficit ever stopped growing in proportion to our GDP, economic

theory and historical precedent suggested that dollar depreciation would probably be part of the adjustment process.

Some forecasters called for a little depreciation, others for a lot. Some expected a sharp adjustment, others a prolonged rebalancing. Whatever their views, they all looked foolish as long as the current account deficit continued to deepen without consequence for the dollar. Eventually, these forecasters' main point proved correct—the dollar did depreciate on a trade-weighted basis against foreign currencies. Whether the amount has been large or small, and the pace fast or slow, lies in the eyes of the beholder. Moreover, the current account deficit itself has not yet begun its predicted reversal, creating yet another opportunity for differences of opinion regarding the timing and magnitude of its doing so.; it is also plausible that it will not occur at all.

Forecasters tackle even longer-term issues than the current account, such as the solvency of the Social Security system. In that debate, the Social Security trustees and the Congressional Budget Office, respectively, estimate that the system will be unable to pay its obligations in about 40 or 50 years. Of course, some scenarios telescope that date forward and others push it back even further, but the indisputable fact is that something's got to give. Some people argue that 40 to 50 years is a long time, and since anything can happen—including a favorable economic future—why bother to press for reforms now. Others contend that since anything can happen—including a less favorable financial future—it is prudent to plan for insolvency now.

One reason to plan ahead for insolvency arises from another set of projections: Medicare and Medicaid deficits will increase rapidly as a share of GDP at the same time that Social Security is headed toward insolvency. Although many potential solutions could put these programs back on sustainable financial paths, predicting when and how a solution will be reached seems as useless today as forecasting when and how much the dollar would depreciate seemed a few years ago. But we are enriched by the exercise.