

The Economy in Perspective

Taking stock ... Although some people worried that the U.S. economy would stumble at the end of this year and limp into the next, it appears to be running in fine form. Income and output actually accelerated last quarter, despite soaring energy prices and storm damage along the Gulf Coast. In November, energy prices receded, and employers impressively stepped up the pace of hiring. Retail store traffic is encouraging, with consumers seemingly throwing off their worries as easily as Katrina uprooted trees. Business confidence has stabilized as well: Stock prices have risen, and market volatility and credit quality spreads remain low. Many private-sector economic forecasters expect the U.S. economy to grow at a moderate pace next year, with headline inflation numbers falling back toward the 2% range.

What can we look forward to? The most interesting characteristic of the 2006 economy may prove to be its maturity. We are now into the fifth year of an economic expansion, far enough along for many of the imbalances that accumulated in the last expansion and recession to have been corrected. Capacity utilization rates have recovered considerably in most industries, and business spending for capital equipment has finally strengthened again. Surveys of business executives indicate that they are optimistic about orders, sales, and equipment spending. Employment growth was strong enough in 2005 to push the unemployment rate down to 5%, which is roughly equal to its long-term average.

As business conditions have matured, so have financial conditions. Many companies and investors took significant financial losses when the 1990s dot-com industry collapsed, but the macro economy has finally worked out the losses and moved on. Corporate profits, cash flow, and balance sheets now look healthy, for the most part, providing a firm foundation for further growth. And, allaying concerns about housing bubbles in some parts of the country, rising interest rates have helped to cool off housing price appreciation. At the macro level, the pricing of corporate bonds and equities is not a red flag as far as investors

are concerned. Banking companies, which often extend credit to those who cannot borrow in the capital markets, report stellar loan quality.

The inflation picture also is brightening. Declining energy prices are relieving the pressure on headline inflation, and thus far core inflation rates have not edged up from past energy price increases being passed through to consumers.* And if productivity growth continues at a healthy pace, inflation rates are likely to continue their pattern of moderation. Monetary policy has apparently succeeded in anchoring longer-term expectations, an important factor in holding down long-term nominal interest rates.

Although maturity connotes a successful evolution from an uncertain beginning, aging brings its own problems and sows the seeds of potential future disruptions. Yes, the dot-com wreckage has been hauled away, but yellow flags are out for the motor vehicle industry. How serious will their problems prove to be? What combination of sacrifices will ultimately be agreed upon by current and retired employees, investors, and taxpayers through the obligations of the Pension Benefit Guarantee Corporation? How will these adjustments affect communities that rely heavily on the most affected industries? What are the implications of the adjustments for the future of corporate pensions and health care policies?

Hurricane Katrina demonstrated more than the fact that low-probability events eventually will come to pass; the devastation of New Orleans was a product of both the storm and inadequate preparedness. Similarly, what some people call institutional legacy costs, others describe as the consequences of a failure to prepare prudently. Private-sector companies are not alone in grappling with the burden of past assurances that are no longer viable. Federal, state, and municipal governments are all confronting problems that were created in the past when decisionmakers shuttled the costs of their actions into the future. Increasingly, that future is now.

Taking stock of the U.S. economy requires us to acknowledge that while maturity has its privileges, it also entails significant responsibilities.

*This sentence was revised after this issue of *Economic Trends* was printed and before it was posted online.