

The Economy in Perspective

by Mark Sniderman

For reasons that have never been clear, economists are invariably asked to give outlook talks at the beginning of each year, as if a) that is the only time they actually think about the next 12 months, or b) that is the only time their audience pays attention. Neither of these explanations seems plausible. Perhaps the human mind has a compelling desire to organize and store information in compartments: Just file the economic outlook for 2006 in the appropriate folder and get on with making dinner.

The Federal Reserve Board's research staff has an excellent forecasting record (as such records go), and at this Bank we pay close attention to that and other forecasts. Like any business, we want to know what other people think about the things we spend so much time thinking about ourselves. That said, we like to believe that we are discriminating forecast consumers. We won't name names, but we do have our favorites. We are drawn to what might be called "the thinking man's forecaster"; not the one who tries to grab our attention with outrageous predictions of a depression or double-digit interest rates, but the one who tries to tell a comprehensive story about how our world is adjusting to the laws of economics and the forces of history.

History suggests that international economic conditions will play a major part in the evolution of the U.S. economy. First, developing economies account for increasing shares of global trade. These countries are likely to become still more important to the United States as trading partners and, in addition, as targets of U.S. direct investment destined to act as a base from which U.S. companies will serve these countries' growing internal markets. There are indirect effects as well. China, for example, has become important not only to the United States but also to Japan, Korea, and many other Asian countries. Strengthening ties within that region could affect ties between Asia and the West.

Second, capital flows from the rest of the world into the United States have become substantial and probably played an important role last year in sustaining sales in the interest-sensitive sectors of the U.S. economy. Many Asian nations now save more than they invest, but the gaps could close over time as their living standards rise and people choose to consume more than they do today. If saving rates in

Asian nations decline, the cost of capital to U.S. borrowers could rise.

The increasing globalization of trade and finance creates new markets and opportunities, but insofar as resources respond and adapt, U.S. companies and communities are forced to adjust as well. Our economy excels at reacting to change, but it is not immune to the vicissitudes of history. As a nation, we are being challenged to maintain a labor force that has the skills to sustain an economy with very high productivity levels. Maintaining our high standard of living will increasingly require that we find ways of increasing the skills of the disadvantaged among our population, who suffer from low rates of school completion and require high levels of social services. And, at a time when we must focus on building skills among our youth, we also face enormous fiscal obligations in supporting our elderly population.

So-called "long-term" issues, such as the globalization of commerce and finance, labor force skills, technology, and fiscal imbalances always seem to be just over the horizon, not materially affecting the ebb and flow of today's transactions. But they are present and, like the tides, their persistence has the power to reshape our shores. Most forecasters pay them little heed, since it is hard to detect their influence over year-long periods. By necessity, forecasts are constructed on the pilings of the past. People, however, look to the future and act today on their beliefs and aspirations.

Forecasters are already out on the stump with their estimates of consumption, investment, and government purchases for 2006. The odds of recession are low, as they almost always are in these forecasts, and—as a matter of fact—in reality. There have been only two recessions in the United States since 1982, and neither was severe. Yet who would deny that U.S. economic conditions have changed profoundly during the last 20 years?

*There's nothing constant in the world,
All ebb and flow, and every shape that's born
Bears in its womb the seeds of change.*

—Ovid (Publius Ovidius Naso),
Metamorphoses, 15:177–78