

The Economy in Perspective

by Mark Sniderman

Time to take a load off... Conventional wisdom—in other words, the central tendency of professional forecasters—holds that 2006 and 2007 will be decent years for the U.S. economy. Many economists expect real GDP to increase by about 3½% this year and next, keeping the economy on a path of nearly full resource utilization. The January employment report from the Bureau of Labor Statistics supports this comforting view: Net employment expanded at a solid rate in January; in fact, the revised figures for November and December show that job creation has been improving for some time now. And consumer confidence has been rebounding from its Katrina-induced lows.

Inflation, which has been elevated by energy price shocks, seems poised to gradually drift down to its longer-term trend. Considering the magnitude of the energy price shocks that have hit the economy, core inflation rates have been exceptionally stable. Moreover, inflation expectations five to ten years out have hardly budged in the face of these shocks, signaling a high degree of confidence in the future conduct of monetary policy.

On the surface, there are many reasons to have confidence in the U.S. economy's ability to continue providing its people with one of the highest living standards in the world. Beneath the surface, however, lie disquieting possibilities. The nation faces challenges that have the potential to slow the pace of economic growth if they are not managed effectively.

Fiscal policy is one of these challenges. The federal budget deficit looms large in proportion to the scale of the economy and shows no signs of shrinking. In fact, unless Congress can reign in expenditures for numerous entitlement programs, or demonstrate a greater willingness to pay for them from current taxes rather than with debt, the fiscal obesity that is our national debt will swell even further.

Marketing the national debt at an attractive price has been surprisingly easy for the past several years, primarily because of foreign buyers' powerful appetites for highly liquid, dollar-denominated assets. Some analysts contend that these appetites spring from certain foreign governments' desire to manage their exchange rates; other analysts argue

that the motive is to accumulate a stock of dollar reserves that a government could use to defend its exchange rate when it begins to float more freely. In either case, should these foreign appetites for U.S. Treasury obligations diminish, rolling over the national debt would probably become more expensive and take a bigger bite out of the budget.

There are those who say that the large and growing national debt is little more than an annoyance. After all, their argument goes, the nation has endured deficits and debts that were larger than this one, in proportion to the size of the economy. History shows that when the national waistline expands to the point where the pants no longer button, Congress will either let out some fabric, go on a diet, or devise a combination of the two. Consequently, the deficits will shrink and their potential for damaging the nation's health will dwindle.

But successful dieting requires a fundamental change in behavior, not reliance on quick fixes. No one likes to pay taxes, and everyone enjoys the benefits that come from federal spending. Politicians get re-elected by making people happy, and they know that the bigger the tax hike or expenditure cut they enact, the less happy their constituents will be. Yet, ironically, the longer we put off this adjustment, the more wrenching the changes could be.

Most obvious, U.S. businesses, households, and governments would likely have to pay more to borrow funds in world capital markets. As a result, capital equipment, housing, and durable goods would all become more expensive to acquire. Less obvious are the consequences that individuals and businesses might have to face in adjusting to higher tax rates or the loss of benefits that could accompany a fiscal rebalancing—or both. Decisions that made sense in the past, predicated on a certain set of beliefs about fiscal policy, could turn out badly.

The problem with the ballooning national debt is not that it will necessarily strangle national commerce. Like obesity, it is a risk factor, and many people at risk live long and productive lives. But its bulky presence could make it all the more difficult for us at some future date to respond to circumstances that vitally affect our national welfare.