2 Outlook for the National Economy

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I want to discuss the background of our current economic situation because it has an enormous influence on the federal budget, on state and local government budgets, and on the private sector in terms of the funding that is available for research and development. One of the biggest lessons we are learning about our economy is that we presently operate in a global system rather than a national system. To understand what is happening in this country and the role it plays, we have to look at the United States within a global context.

We are in the midst of an extraordinarily strong economic recovery here in the United States, which has been going on for about a decade. I think it is almost insured that this will be the longest economic expansion that the United States has in its recorded history. It is a period of very strong growth driven primarily on the demand side.

There are two reasons that the U.S. economy is so strong. First of all, business investment has recovered from the startlingly low levels of the early 1990s, when it had collapsed in the recession of 1990 and 1991. In 1990, private investment in the United States was down to just a couple percent of GDP. Since that time there has been a steady, eight-year recovery—we are nearly back to some of the historical peaks. Much of the present expansion of the U.S. economy has been investment-led.

The second—and probably even more dramatic—aspect of the U.S. economy is that we are in the midst of another consumption binge. This country has an incredible desire to consume. In fact, the private savings rate in the United States collapsed during the 1990s. It has not, however, hurt anything for purposes of American investing. You might ask how investment can increase while savings—which you would think

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would be needed to finance investment—decrease. The answer is that there is another part of the story. The United States finances our investment by borrowing abroad, and we run a very large current account deficit with the rest of the world. At present, the United States is the major market for much of the global economy: it has been the primary engine of growth. Region after region in the 1990s has faltered seriously in growth prospects—most recently Asia—but the U.S. market continues to expand.

What keeps all of those economies going right now? It is the willingness of American consumers to go out and spend money. American spending gives these countries opportunities to sell goods here in the United States—and to our credit, we keep our borders open, despite complaints from some other countries about United States trade restrictions.

The U.S. is the cheapest place in the world to buy anything. We have the lowest barriers against imported goods and trade of any country in the world, which is reflected in the fact that prices are so low. Many Japanese goods are cheaper in the United States than they are in Japan, and the same is true for European products—because we have an extraordinarily open economy in the midst of a very strong economic boom and a willingness to let the rest of the world participate in that.

We benefit from that participation because we could not afford our consumption binge if we had to produce it all ourselves. The United States is basically at full employment; everybody is working. We do not have the capacity to produce all the goods and services that we are consuming at the present time, so the fact that there happens to be excess capacity in the rest of the world has been good for us.

There are a variety of reasons that demand is so strong here in the United States. Normally I would dismiss one that is frequently cited—the stock market. Historically, the stock market has gone up and down, and nothing happens to the economy. The stock market is just not that important—most people who invest in the stock market expect it to fluctuate, and fluctuations in stock market prices are discounted in terms of what it does to their wealth and what it does to their consumption.

I think that is still true. The impact of changes in stock market wealth on consumption is about half that of other types of wealth changes. But this stock market binge has been so huge that it has created enormous amounts of paper wealth—and many Americans are beginning to spend that wealth. That behavior can explain that the household savings rate in the United States is now zero, meaning that the average American household consumes everything earned in the form of money.

How could one possibly do that? It is financed by wealth—capital gains from the sale of stock wealth. There has not been a particularly large increase in debt in this expansion—we do not see people borrowing incredibly large amounts of money. But every time the interest rates go down, people rush out to refinance their mortgages. There is also an emerging tradition among Americans: When you refinance the mortgage, take out another ten percent and use it to pay off your credit cards so you can start over again. That has been important as interest rates and inflation have declined.

But the real key to a sustained expansion of the U.S. has been a continued low rate of inflation. We no longer have a regularity of business cycles in the United States, mainly because the production of goods is just not that important any more. The old durable good or inventory cycles are largely gone. We now have a primarily service-producing economy.

Instead, business cycles are largely a reflection of changes in government policy, which typically result from changes in inflation. The reason this expansion has been so long and drawn out is that despite an incredible decline in unemployment here in the United States, there has been absolutely no evidence of inflation. That is a major surprise to U.S. economists studying inflation behavior. We thought that a tightening of labor markets would give rise to pressures for nominal wage increases.

Unemployment is now down to 4.5 percent, where we once thought the level of full employment was six percent. And there is still no evidence of accelerating inflation. That is probably the biggest puzzle of the economic expansion. In such a tight labor market, why have American workers not pressed for wage increases?

One possible reason is that Americans feel more subject to global competition and are more uncertain about what is going on—therefore, they are reluctant to push for wage increases because they are more afraid of losing their jobs. There also has been a lot of deregulation in the sectors of the economy that were dominated by strong worker groups—the transportation industry and the communications industry often led the way in past inflation cycles. Those are very open, competitive sectors in which it is difficult for workers to push up wages.

In general, there has been a decline in unions, which used to play a role in the process. Most Americans seem to have decided that instead of joining a union, it is a much better to threaten to join a union. Then you get everything you want. So now union membership in the United

States is at an extremely low level, and therefore not an important force in wage determination.

The trouble with such explanations is that they have been going on now for several decades, starting in the late 1970s and early 1980s. Yet in 1988–89, when unemployment in the United States declined about 5.5 percent, inflation took off. And the Federal Reserve, trying to curb that inflation, put the United States back into a recession. Why is it that when unemployment crossed six percent in 1995 and then stayed below that every year, it did not go down? What has happened since 1989? That is much harder to explain.

Part of the explanation may be that labor markets are not as tight as they seem. Years ago, women typically had relatively high rates of unemployment compared to men—with a relatively loose attachment to the workforce—and they tended to experience higher unemployment rates. That is no longer true. If they lose a job, women are just as aggressive as finding another one, and their unemployment rate is now actually below that of men in the same age groups. So there has been a shift in the composition of unemployment. However, if you focus on male unemployment rates rather than the overall unemployment rate, the market is not quite as tight as it would appear to be.

There also has been some improvement in productivity in the last few years, so we were able to offset some of those wage increases in the last three years by increasing American productivity. That is very encouraging for the future—maybe we are beginning to realize some benefits of all those computers we all bought.

Another reason that inflation remains low may be luck: a fortunate set of external circumstances. Take, for example, the 1970s. We had many shocks to the economy that tended to be inflationary, such as the driving up of oil and agricultural prices. In contrast, the shocks of the 1990s have had favorable effects on inflation.

In 1995, oil prices collapsed, providing real income gains to workers without the need for large wage increases. More recently, the Asian financial crisis contributed to low prices for other commodities and electronic parts.

Given this very strong economy, the United States is now forecasting a budget surplus, which we have not had since 1969. Most of the budget surplus is actually a surplus in the social security accounts, and it is occurring because all the baby boomers are working now and they are pumping a lot of tax revenues into the social security fund. That will continue for about another 15 years.

But there is also a large improvement in the other parts of the budget. How did that happen? The President and Congress did not agree to a tax increase and they did not agree to an expenditure cut. Part of the surprise is on the expenditure side—Medicare is increasing less than we expected it to. But the major surplus is on the revenue side. In effect, money has been pouring into the treasury, and we cannot fully figure out where it is coming from. One thing we do know is that it is in the personal income tax—not in social security tax payments or component taxes.

How can we possibly be getting that much money? One explanation is that the national income accounts of the Commerce Department are way off target, and the economy is growing a lot faster than we think it is. I believe we can largely discount that explanation, because if that were true, one would expect to see a surge in the employment taxes, as well as income taxes.

The other two explanations are that a large proportion of the income gains in the 1990s have gone to people at the very top of the income distribution, and they pay higher marginal tax rates than people at the bottom; and there has been a large increase in income from realized capital gains, which are not reported in the national accounts. That appears to be happening with consumption—people are spending some of their capital gains, so some part of the tax increase is coming from capital gains.

The reason we do not know for sure is because the information about individual returns comes from IRS records, and IRS is still processing 1996 tax returns. We know the total tax payment, but we cannot yet allocate it among individuals to figure out who paid. A little bit later this year we will begin to get information that will resolve some of the debate about the origins of the surplus. If you thought it was due to the redistribution of income, then I guess you would maybe argue that it might go on for some period of time yet, because I do not think the redistribution of income will reverse. But if it is due to capital gains, the budget surplus may turn out to be a little ephemeral.

In conclusion, I do not want to leave you with the impression that everything is great. There are problems in the changing income distribution: the failure of the expansion to benefit all groups throughout the income distribution. Between 1979 and 1996—in the midst of this long economic expansion and after adjusting for inflation—the income of men in the bottom 80 percent of the distribution declined. The only men who are experiencing income gains are at the top of that distribution.

For women, the picture is more positive—but that statement should be tempered with the fact that women started out earning only about 65 percent of what men did, and now they are up to about 75 percent. Even for women, the distribution of the gains is extremely skewed. They are much larger at the top of the distribution than they are at the bottom of the distribution. Finally, more than in the past, "likes" are marrying "likes" in the United States, meaning that men at the bottom of the distribution are marrying women at the bottom of the distribution, and men at the top of the distribution are marrying women at the top of the distribution. Thus, if you look at family incomes in the United States, there is a dramatic pulling apart of the income distribution.

I think the major reason for this is that because of technological changes, education is worth more in our society. There is a surplus of people with limited education, and there is a shortage of people with high levels of education. As a result, the price of unskilled labor is being driven down while the price of skilled labor is being driven up. That has some very serious social consequences for our country that we should be concerned about, and it is a big challenge to public policy.

The educational system plays a very important function in this whole process. We all should take pride, for example, in how well the American college and graduate system works—but no American should be proud of how well the American high school system works. We spend an amazing amount of money on people who go to college—but think about the 50 percent of Americans who stop at a high school diploma. We do not do anything for them, and the data are beginning to reflect some of the consequences of having ignored high schools for so long.