We are now 20 months into the economic recovery, what are some positive signs up to this point?

The economy has definitely improved. Real gross domestic product (GDP) grew 3 percent during the first year of the recovery and has shown continued growth since. The unemployment rate was down slightly in December, and since the trough of the business cycle in June of 2009, the stock market is up 40 percent.

Several recent events have reduced the perceived uncertainty about the future. First, the Congressional action to extend the current income tax code for another two years may presage the possibility that the tax code in existence for the past decade may become permanent. Second, the November elections have resulted in divided government which inhibits governmental activism. Third, many of the recommendations of the fiscal commission indicate that policy makers across the spectrum realize that tax and entitlement reforms are central to taming the federal budget.

What are some signs of continued concern?

Several measures suggest that we are not out of the woods just yet. The tremendous drop in the housing market will be remembered as the cause of the financial crisis that triggered the broader economic contraction. The last decade was characterized by personal consumption as a share of GDP well above the long-run average.

This “excess” consumption was financed by the consumption of housing equity as individuals refinanced to capture the increased value. As a result, housing equity as a share of housing value remained constant in spite of the boom in housing prices. Further, the excess housing supply fueled by the easy credit conditions of the last decade will continue to hamper price appreciation.

The Case-Shiller 20-city composite housing price index is up only 1.2 percent since June 2009, but of more concern is the fact that between June and October of 2010 house prices fell in all 20 cities that comprise the index. This is important as housing equity together with savings in retirement accounts constitute the majority of household wealth. Over the past three years, equities and housing prices, adjusted for inflation, are down 12 and 24 percent, respectively. These declines continue to impact consumption.

Other areas of concern are growth in government spending at all levels and continued deficit spending at the federal level and the associated growing debt burden. The international landscape is also troubling with the sovereign debt crisis the European Union is working through.

What are your economic projections for the coming year?

Figure 1 depicts our forecasts of real GDP growth, the unemployment rate, the inflation rate, and the ten-year Treasury note rate alongside forecasts from the Chicago Federal Reserve, the Congressional Budget Office (CBO) and Goldman Sachs. Our estimates of real GDP growth, inflation and the ten-year Treasury note rate are higher than the other forecasts, and our unemployment estimate is lower. We estimate that real GDP will grow 4.5 percent in 2011. Our projected real GDP growth rate is higher than the average growth rates at the same point for the nine prior business cycles. However, given the sluggish start of the present recovery, 4.5 percent growth for the next year is reasonable and would result in overall growth by the end of the year at about the median of past recoveries.

An unemployment rate of 8.9 percent is slightly lower than the CBO’s estimate of 9 percent. This unemployment rate coupled with slightly higher labor force participation...
and average per worker GDP growth is consistent with the real GDP growth assumption.

**Why are your inflation and interest rate forecasts higher than the others?**

A faster recovery combined with the Federal Reserve’s second round of monetary easing and the need to shed assets on its balance sheet points to higher inflation. Our estimate of a 3.6 percent inflation rate is 2 percentage points higher than the next closest estimate by the Chicago Fed. One way to infer the expected inflation rate is observing the spread between the nominal interest rate on government bonds and treasury inflation-protected securities (TIPS). Currently, the spread between the nominal return on a 5-year constant maturity government bond and a 5-year TIPS implies that a 2.0 percent inflation rate over the next 5 years would make the two investments equivalent. If one takes this spread as the market’s expectation of future inflation, then our 3.6 percent estimate is also quite a bit higher at 1.6 percentage points.

Does this large disparity between our forecast and the TIPS-Note spread put our forecast in doubt? To answer this query it is important to consider how well the implied inflation rate resulting from the five-year TIPS-Note spread compares to the actual one-year forward realized inflation rate.

Figure 2 presents this comparison. The realized inflation rate over the subsequent 12 month period from the date on the axis is presented alongside the implied inflation rate based on the five-year TIPS-Note spread. As the two series indicate, the implied inflation rate series is less volatile than the actual one-year forward series. The implied rate is also frequently lower than the realized inflation rate that it is intended to forecast. For the period over which the series overlap, the realized forward inflation rate averaged 2.5 percent and the implied rate averaged 2.0 percent, 0.5 percentage points lower. More specifically, the differential during 2007 between the one-year forward realized inflation rate and the implied rate was 1.6 percentage points which is the same as our forecast differential. Therefore, our relatively high inflation forecast is not without historical precedent.

The realized inflation rate may exceed the implied rate simply due to uncertainty in expectations, but for it to be persistently higher suggests that the risk-free nature of the government bonds may not completely identify inflation expectations.

**How does the federal debt held by the public that stands at $9.4 trillion or over...**
60 percent of GDP, weigh into your forecasts?

The debt held by the public as a percent of GDP is at its highest level since 1945. However, because of the low interest rates, net interest payments as a percent of GDP are below the levels of the 1980s and 1990s. Not until 2020 will the projected interest expenses as a percent of GDP rival the levels that existed during the early 1990s. Thus, the current interest burden is excessive when compared to the past.

While the interest expense is manageable today, the fiscal future for the US is definitely a puzzle given the expected growth in federal spending due to elderly entitlement spending on Medicare and Social Security. Based on the projections from the CBO, federal spending will rise to 26 percent of GDP by 2030 or 25 percent higher than the past 30-year average of 21 percent. However, these estimates assume that the Affordable Care Act’s (ACA) payment restrictions on Medicare spending are realized. The CBO offers alternative forecasts for Medicare based on the assumption that the ACA provisions will not be fully implemented, producing higher estimates. The alternative estimates result in federal spending in 2030 reaching 32 percent of GDP, or 53 percent higher than the 30-year average.

The message here is that without substantial tax increases or substantial reductions in the entitlement program spending, deficits and mounting debt levels are inevitable. These mounting debt levels have the potential for world financial markets to impose a default risk premium that could dramatically increase the debt service burden.

What policy alternatives can improve the long-term economic prospects in the United States?

The long-term economic prospects can be improved through tax and entitlement reform. Such reforms were central to the proposals of the fiscal commission. Tax reform based on a consumption tax that replaces income and payroll taxes is optimal. But absent that, the elimination or reduction of the tax preferences for health insurance and housing consumption coupled with lower marginal rates, so the change is revenue neutral, would be positive first steps.

On the entitlement side, we must come to grips with the expense of government-provided retirement consumption paid for by contemporaneous taxes. The open-ended Medicare obligation can be replaced with premium support payments that are indexed to per capita GDP growth. This would reduce the government’s share of elderly health care spending (Medicare) by the same magnitude as the ACA reforms, without resorting to what are essentially price ceilings on payments to doctors and providers. Granted, retirees would be responsible for a greater share of their health care spending, but their price consciousness will result in substantial supply side responses.

Reforming elderly entitlements so that they keep pace with, but do not exceed, per capita GDP growth, as they have in the past, is a reasonable goal. This can be accomplished while ensuring adequate provision for all retirees. Limiting the growth rate in entitlement spending in this way means that in the future, retirees will pay for a greater share of their consumption than retirees pay today. This will require workers to save more for retirement which could bring about increases in the capital stock and productive capacity.