Economic Challenges:
What Have We Learned,
What Do We Face?

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Economic Challenges: An Overview

- The economic challenge is a high and growing standard of living, properly measured.
- For decades, the American economy—and the American consumer—has been the center of the global economy.
- It has been buffeted by a number of shocks and done surprisingly well.
- But perhaps more important are the longer term trends that shape its ability to perform in the future.
- Tonight’s discussion will set the stage by presenting those trends and considering their implications for future growth and standards of living.
Challenge #1: Low Saving Rates

- The personal saving rate is low and declining. This includes net pension plan contributions.
- The federal government runs persistent deficits. This includes the Social Security surplus.
- The nation as a whole runs trade deficits with other countries.
Low and Declining Personal Saving
Trade Deficits with the Rest of the World

Percent of GDP

Exports

Imports

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What Are the Consequences?

- Lower saving has historically led to lower domestic investment, but that link has weakened over (surprise) the last 25 years.
- Even with healthy investment, lower saving means lower ownership of capital—and claims to its returns—in the future.
- That means low growth in consumption or lower leisure in the future.
- This is not necessarily “suboptimal,” but reconciling ourselves to it may pose something of a challenge.
Challenge #2: Declining Labor Force

- The labor market, as measured by the unemployment rate, peaked in Spring 2000 and bottomed out in Summer 2003, well after the end of the recession.
- Since then, labor force participation has not rebounded, even as employment has increased and unemployment has decreased.
- People are leaving the labor force, generally with reasonably high levels of education, and seemingly voluntarily.
- Like saving, this may not be “suboptimal,” but it does suggest a different future than the past.
The Rise and Fall of Unemployment

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Continued Declines in Participation

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Challenge #3: An Eroding Tax Base

- An implication of lower employment, but more importantly, higher health costs, is a declining tax base.

- Over the past five years:
  - Total employee costs of compensation have increased at a 1.4 percent rate.
  - However, wages and salaries are growing at just 0.75 percent, with benefits (mostly health insurance) growing at a 3 percent rate.
  - This has not put a damper on corporate profits, but wages and salaries are the most highly taxed form of income.
Declining Wage and Salary Share

Percent of Gross Domestic Income


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How Have We Managed?

Two Principal Reasons

- Financial markets have allowed us to convert previously illiquid assets, like housing, into consumption. This is likely to be a temporary phenomenon.

- There has been a resurgence in productivity growth in the last decade, which may or may not be permanent.
Using Your House as an ATM

Percent of Disposable Income

Billions

1993 1995 1997 1999 2001 2003 2005 2007
The Productivity Miracle?

![Graph showing percentage points from 1960 to 2005]
Challenges on the Horizon

- Further threats to economic performance come from two areas in the future:
  - An aging population, with its pressure on federal entitlement programs like Social Security and Medicare.
  - Persistently rising health care costs—projected at 1 percent per year greater than GDP growth—particularly as they interact with federal entitlement programs.
Social Security’s Financial Gap
Medicare's Long-Term Costs

Percent of GDP

- Payroll Taxes
- Tax on Benefits
- Premiums
- State Transfers
- General Revenue
- HI Deficit
What Has the Government Done?

- On Fiscal Policy, Very Little That’s Constructive
  - Tax policy has focused on “making tax cuts permanent” and a generally weak budget target.
  - Social Security reform stalled in the legislature—for the President’s unwillingness to use new revenues to close the fiscal gap.
  - Medicare’s finances were made much worse, with the addition of Part D without a dedicated funding source.
So What Will Happen?

- We may get some improvement in saving from better design of institutions (e.g., pensions).

- However, financial market innovation lately has supported consumption, not saving.

- Absent more prudent behavior, prices—exchange rates and interest rates—will simply change to equilibrate imbalances.
The Dollar Has Started to Depreciate
But Long Term Bond Rates Remain Low
Summing Up

- To me, the biggest mystery in the economy is how the U.S. long-term interest rate can stay so low.
- I cannot see it remaining that way for long, and its rise will take the stock market and housing market with it.
- But I’ve been saying this for a while.
  - As an economist, I’m happy to be right, but usually even happier to be wrong.