IDEAS NATION

An Economic Checkup

Martin Feldstein | May 28, 2015

IDEAS **Economist Martin Feldstein on the state of the recovery**

The U.S. economy is at a critical juncture. The Federal Reserve's very easy monetary policy during the past few years has been the root of both good and ill: reduced unemployment on the one hand and increased financial risks on the other. The danger now is that the inevitable rise in interest rates over the next few years could cause substantial losses to banks and investors that, in turn, could weaken the economy's overall performance and lead to another economic downturn.

The Federal Reserve's unconventional monetary policy during the past five years–the combination of massive purchases of long-term bonds and its promise to keep short-term rates very low for a very long time–caused a sharp rise in the stock market and in the prices of owner-occupied homes. Together these raised household net worth by some $10 trillion in 2013. This large increase in wealth caused households to raise their spending and businesses to invest in new capacity. That increase in spending raised employment by enough to drive the unemployment rate down to just 5.4%. But the very easy monetary policy has also left us with dangerously low interest rates and overvalued assets.

With the overall unemployment rate down to 5.4% and the rate among college graduates at only 2.7%, there is little or no slack left in labor markets. As a result, labor costs are now rising at a faster rate. Compensation per hour in the nonfarm business sector rose at a 3.1% rate in the first quarter of this year, up from 2.5% in 2014 and 1.1% in 2013.

Rising labor costs usually lead to a higher rate of price inflation. This time inflation has temporarily been kept in check by the decline over the past year in the prices of gasoline and other forms of energy and by the rising dollar's impact on the cost of imported goods. But those offsetting forces are shifting into reverse. With oil prices recently up from their lows and the dollar no longer rising, inflation will be heading higher in the year ahead.

Although there have recently been some mixed signals about the strength of demand, the economy will remain on a solid growth path for the coming year unless it is upset by events in the financial markets. Real inflation-adjusted GDP grew at more than 4% in the second half of 2013, driven by the rise of household wealth. Bad weather weakened the economy in the first quarter of 2014, but after that consumer spending and business investment together continued to rise at an annual rate of more than 4%.

The first quarter of the current year was again very weak because of terrible weather and other temporary forces. But those things are behind us, and the economy is recovering. Since households' real after-tax incomes have increased at an annual rate of 4.5% in the most recent six months and employment prospects are strong, consumer spending is now likely to pick up. A rapid increase in housing starts–up more than 9% in April from a year earlier–will reinforce the stronger ordinary consumer spending. Because output can no longer be increased by significant reductions in unemployment, the potential pace of future GDP growth is likely to be limited to about 3%.

For the longer term, the economy faces a serious issue of preventing the projected explosion of the national debt. The ratio of the national debt to GDP has doubled in the past decade, from roughly 35% to about 75%. It is projected to start rising again in the near future, heading to 100% of GDP and higher unless legislative action is taken.

It is impossible to avoid the growth of the government debt by limiting increases in government spending on defense or on the budget items that are labeled as "nondefense discretionary," i.e., federal-government domestic spending other than Social Security and Medicare. The defense budget is already projected to decline by 2025 to only 2.6% of GDP, the lowest level in the past half-century. Similarly, the nondefense discretionary outlays are already projected to decline by 2025 to only 2.5% of GDP, also the lowest level in the past half-century.

Fortunately, the growth of the debt can be limited and the ratio of debt to GDP can be pushed back to earlier levels without cutting outlays for Social Security and Medicare and without raising tax rates. The key is to slow the growth of those outlays and to limit the spending that is built into the tax code by a wide range of tax subsidies to individuals and businesses. This should be the task of the current Congress and the current President, but I think it will have to wait until after the election in 2016. That, together with tax reforms designed to stimulate faster growth, should be the legislative priority in 2017.

Feldstein, the George F. Baker Professor of Economics at Harvard University, was chairman of the Council of Economic Advisers in the Reagan Administration

This appears in the June 08, 2015 issue of TIME.