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Structural Challenges for the U.S. Economy: The Good, the Bad and the Ugly

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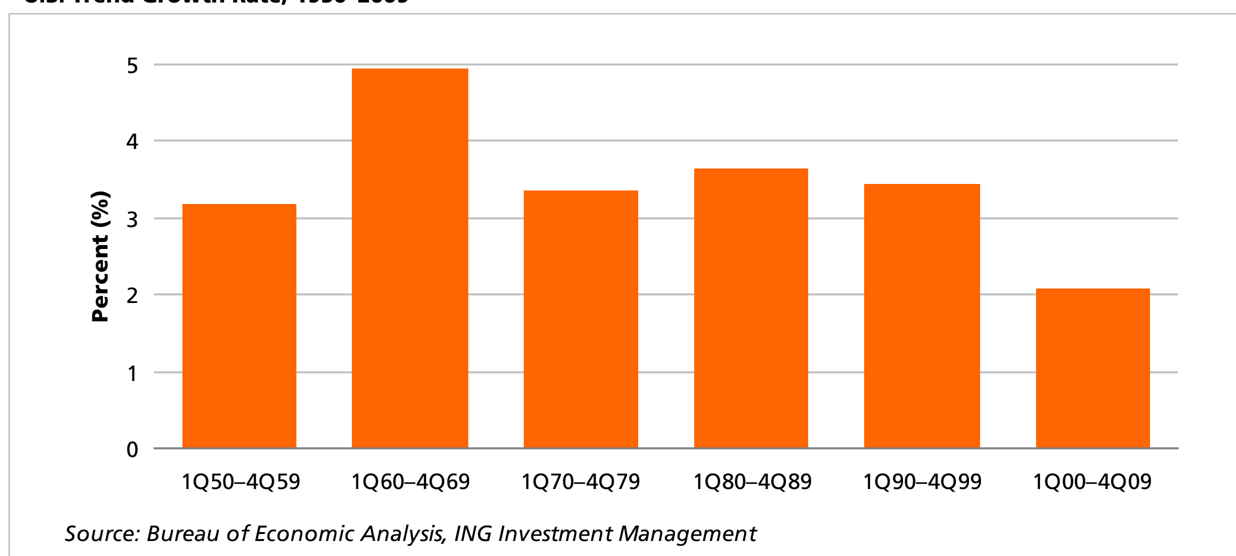
In the midst of the recovery from the Great Recession, it is crucial not to lose sight of the structural challenges and the strengths of the U.S. economy. Both the private sector and the U.S. government will have to work together to revitalize growth and address the challenges that loom ahead.

The post-World War II trend growth rate of the U.S. economy, at about 3.3%, is quite good for a mature, advanced economy. Since 2000, the U.S. leads G-7 countries in labor productivity growth. Labor force growth and labor productivity growth are the key drivers of economic growth. Labor productivity growth is not merely the result of accumulation of capital and technology but also an outcome of social organizations and social capital that include markets, private property, good management, incentive regimes and complex networks of production relations and knowledge sharing. It requires sustained investment in equipment and software, policies to support accumulation of human capital, quality education, skill formation, on-the-job training and technological progress.

The Federal Open Market Committee's (FOMC) most recent central tendency projections show the U.S. economy expanding at a pace of about 3.5% in 2010, followed by two years of growth well above that rate. However, the FOMC's long-run growth rate projection — which can be thought of as an estimation of the nation's potential growth rate — is 2.5–2.8%. The FOMC expects the unemployment rate to remain high for several years, hovering between 9.1% and 9.5% in 2010 before declining gradually by a percentage point in 2011. It forecasts core personal consumption expenditures (PCE) inflation in the range of 0.9% to 1.2% for 2010.

Although my 2.4% estimate for the U.S. potential growth rate is slightly below the central tendency forecast of the FOMC, it positions the U.S. well compared to my estimates for the other G-7 countries. At 2.2%, Canada comes closest to the U.S. in my estimation, while major western European nations such as Germany, France and the U.K. are in the range of 1.0% to 2.0%. I estimate Japan's potential growth rate at just below 1.0%.

U.S. Trend Growth Rate, 1950–2009



Source: Bureau of Economic Analysis, ING Investment Management

Employment Remains Slack

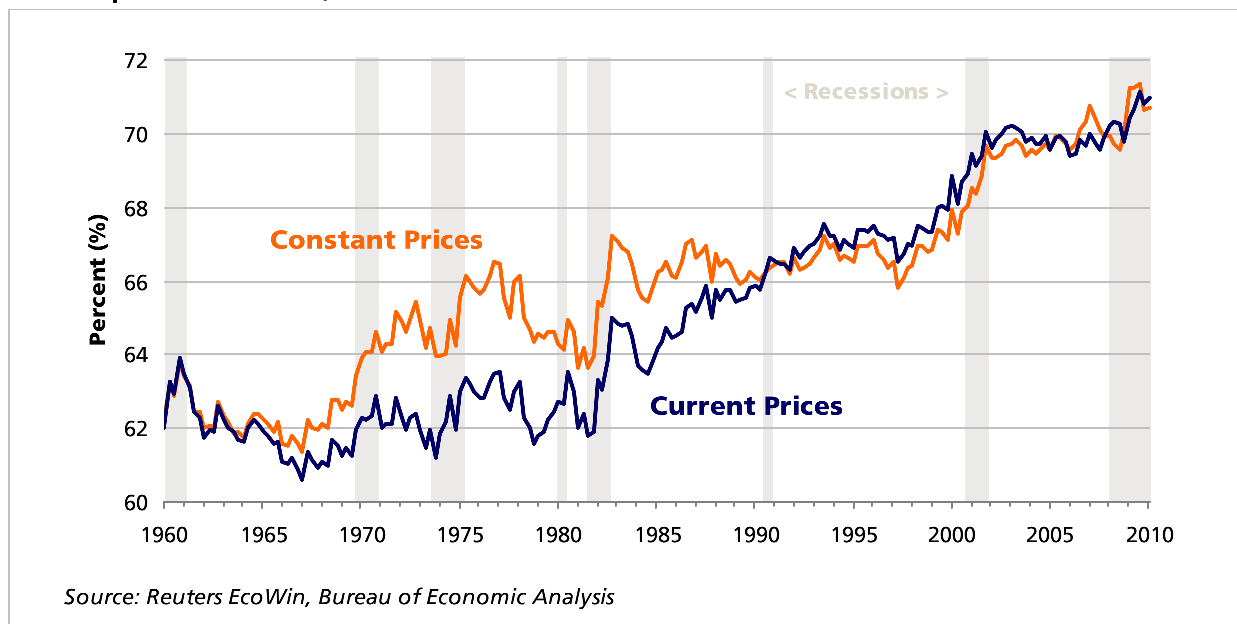
Though the trajectory of economic growth in the U.S. over the last 60 years has been good, growth has notably slowed since the turn of the century due to the recession of 2001 and the Great Recession of 2008–09. Using 2000 as the base year, real PCE is up nearly 30% through early 2010 while industrial production and total employment have been essentially flat. Thanks to the bursting of bubbles, the nominal value of house prices has declined 30% from its peak and nominal stock prices are approximately 20% less than where they were at the beginning of the century.

Creating not only sufficient employment but sufficient *well-paying* employment will be an important challenge. Since the 1970s, value added in manufacturing has declined sharply, from nearly 23% of nominal GDP to less than 12%. Likewise the share of employment in manufacturing has declined markedly, while the share of employment in services — such as the education and health care industries — have risen. According to the Bureau of Labor Statistics, gains in employment are projected to occur in home health aides and personal and home care aides, registered nurses, teachers, computer system administrators, computer software engineers and programmers, accountants and auditors, food/beverage servers, retail salespersons and so forth. Given the enormous slack in the labor market and stagnant wages and real income, policymakers will need to encourage policies that foster job creation in the United States.

Consumption Rising as Investment Declines

Consumption share of GDP has witnessed a secular increase since the 1960s, when it was approximately 60%; since the turn of the century, it has risen to a bit above 70%. During the same period, investment as a share of GDP fell below 20%, noticeably less than that of other countries with similar GDP per capita. Various factors have contributed to the rise in consumption and the decline in investment, including asset bubbles, the availability of credit and loosening of credit standards, and changes in household preferences. While a rise in consumer spending contributes to aggregate demand, long-term growth requires efficient and effective public and private investment in infrastructure, equipment and software. Going forward, policymakers should focus on developing an updated and modern infrastructure for the country, particularly in transportation, energy, communication, education and the promotion of investment in productivity-enhancing capital goods and software.

Consumption Share of GDP, 1960–2010



Source: Reuters EcoWin, Bureau of Economic Analysis

Demographic Trends Favor U.S.

Demographics are favorable for the U.S. Average annual population growth in the U.S. is expected to be above 0.6% between 2010–50 — much higher than that of the other G-7 countries and also higher than that of some major emerging markets such as Brazil and China — due to both higher fertility rates/natural population growth and immigration. Germany and Japan, for example, are expected to experience a decline in their populations in the next 40 years as immigration will be insufficient to offset the decline in the native-born population. The U.K.'s population will grow, but immigration will be a more important driver than natural population growth. As a result of these trends, the U.S. will have a higher share of working-age population than many major economies by 2050.

Deficits, Rising Debt-to-GDP and Achieving the Right Balance

The large fiscal deficit in the U.S. is due to the significant fiscal stimulus measures in recent years and, more significantly, the decline of tax revenue and increased public spending owing to automatic stabilizers and transfers. These large deficits are expected to persist in the coming years and will result in an increase in the country's debt-to-GDP ratio. This situation is not unique to the U.S. — the U.K., for one, is in the same boat. And the U.S. is by no means an outlier in terms of the level of its debt-to-GDP ratio. Among the G-7 countries, only Canada, due to its prudent and conservative fiscal policy, is expected to maintain a low debt-to-GDP ratio by 2014. The U.S. debt-to-GDP ratio will be in the same range as that of U.K., France and Germany, but Japan and Italy are expected to have much higher ratios.

Although it is important that the U.S. prevents its general government debt-to-GDP ratio from rising to an unsustainable level, there is a strong case for using fiscal policy and fiscal stimulus to prevent a severe slide in output and a protracted, sharp rise in the unemployment. Fiscal deficits support economic activity by offsetting private-sector deleveraging, which in this cycle is proving to be a long multi-year process. The healing of private-sector balance sheets will take time; in the interim, public-sector borrowing and spending will have to support economic activity. Public investment fueled by deficit spending can foster growth and private fixed business investment. In addition, the federal government is better placed to borrow and transfer funds to states and local governments that are facing severe fiscal constraints.

It would be inappropriate to raise consumption tax and income tax before the economy is on a path of sustainable growth. Furthermore, the federal government's debt servicing costs, as measured by net interest payments as a share of GDP, remain low. The U.S. government has coped successfully with higher debt-to-GDP ratios in the past; high ratios following World War II fell primarily due to higher and sustained economic growth. Policymakers will have to achieve a right balance between supporting the economy through public spending and preventing an unsustainable increase in the debt-to-GDP ratio.

Coping with Growing Health Care Costs

The main problem with U.S. public expenditures and transfers in the social insurance programs (Medicare and Medicaid) is the rising health care bill due to both an increase in health care costs and an aging population. Health care costs in the U.S. have outpaced overall consumer price index (CPI) inflation rate measurably. While the recent health care reforms in the U.S. will eventually extend health care coverage to the current uninsured segment of the population, the main issue going forward in health care reform will be containing higher costs. The U.S. per capita health expenditure is much higher than that of the other Organisation of Economic Co-Operation and Development (OECD) members, as is its health care expenditures as a share of net national income, at 16%. The U.S. public-sector health care expenditure of about 8% of net national income is comparable to that of other OECD members. However, whereas other most OECD members have much lower private-sector health care expenditures, this spending amounts to another 8% of net national income in the U.S.

In spite of a large share of net national income devoted to health care expenditures, health outcomes — as measured by average life expectancy and infant mortality — are poor. Rising childhood obesity is an example of the entrenched health care problem in the U.S.; nearly one–third of all children aged two to 19 years in the U.S. are either overweight or obese. The U.S. will have to reform its health care system and promote healthier lifestyle choices among its population to check rising health care costs and improve the health outcomes of its population. Policymakers, meanwhile, will have to encourage more competition in the health care system to contain costs.

Increased Income Disparity Is Troubling

In the first two decades after World War II, income inequality in the U.S. fell. However, income dispersion among households has increased since the 1970s, as evidenced by a variety of measures. In 1970, the share of household income of the lowest quintile and the highest quintile was 4.1% and 43.3%, respectively; by 2008, those shares had changed to 3.4% and 50.0%. The household income ratio of the 90th percentile to the 10th percentile had increased from 9.2 times in 1970 to 11.4 times in 2008. Likewise the Theil Index, a summary measure of income inequality, rose from 0.27 in 1970 to 0.40 in 2008.

There are manifold causes of increased inequality in the U.S., including skills-biased technology changes, the decline of manufacturing, stagnant real wages, the steady decline of unions, welfare reforms and changes in public policy. Irrespective of the causes, higher and rising income inequality could lead to widespread opposition to free trade, globalization, cross-border financial flows, immigration and structural reforms, all to the detriment of the economy.

Conclusion

The U.S. faces formidable challenges in the years ahead, including sustained job creation, a rising debt-to-GDP ratio, high heath care bills and growing income inequality. But it also has many advantages compared to other G-7 countries, specifically better trends in labor force growth and productivity growth. The U.S. has a highly educated and talented population, a skilled workforce, excellent institutions of higher learning and scientific research, and favorable demographics. It is rich in both natural and capital resources. Its political and social institutions have proved to be resilient, stable and able to evolve with changing times. Hence, with appropriate and prudent policies, the U.S. economy can continue to expand and raise the living standards of its population. ■

Household Income Dispersion, 1970–2008

	Household Income Dispersion				
	1970	1980	1990	2000	2008
Shares of Household Income of Quintiles, %					
Lowest quintile	4.1	4.2	3.8	3.6	3.4
Second quintile	10.8	10.2	9.6	8.9	8.6
Third quintile	17.4	16.8	15.9	14.8	14.7
Fourth quintile	24.5	24.7	24.0	23.0	23.3
Fifth quintile	43.3	44.1	46.6	49.8	50.0
Mean Household Income of Quintiles, 2008 CPI-U-RS, adjusted $					
Lowest quintile	9,856	10,723	11,444	12,699	11,656
Second quintile	26,701	26,687	28,793	31,708	29,517
Third quintile	42,997	44,038	47,559	52,804	50,132
Fourth quintile	60,606	64,878	71,706	82,086	79,760
Fifth quintile	107,296	115,675	139,154	177,879	171,057
Household Income Ratios of Selected Percentiles					
90th/10th	9.2	9.1	10.1	10.6	11.4
95th/20th	6.3	6.8	7.6	8.1	8.7
80th/50th	1.7	1.8	1.8	2.0	2.0
Selected Summary Measures					
Gini index	0.39	0.40	0.43	0.46	0.47
Theil index	0.27	0.27	0.32	0.40	0.40

Source: U.S. Census Bureau

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