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A Perilous Path

The last quarter of 2009 saw a 5.7 percent annualized growth rate, driven in large part by slower inventory liquidation with support from consumption, business spending on equipment, software and trade. The pace of employment decline eased with a November increase and January showing a drop of 20,000. There were January gains in manufacturing, retail, education, health and business services. The headline unemployment dropped to 9.7 percent with an increase in employment in the household survey which includes self-employed, and agriculture. The upswing grinds on as observers anxiously await the upturn in wage and salary employment. This saga will continue as 2010 winds on. Gains in employment are the short-term policy focus, as the wage and salary job count is more than 8 million below the level it was when the economy peaked in December of 2007. There are "Jobs Bills" in Congress, and nearly every idea is couched in terms of job gains even though the ability to quickly impact employment is rather limited. Before one drifts off in the evening, ponder the question "Where do jobs come from?" Is it people trying to figure out products and services that other people are willing to pay for, covering all the costs of production including profit and hiring people in the process or successful lobbying? The poll question "How do you rate the x politician's handling of the economy?" implies a degree of control which is not the case in reality.

The Congressional Budget Office released its long term fiscal projections that anticipate a string of deficits to 2020 totaling $9.2 trillion. The $1.42 and $1.35 trillion deficits of 2009 and 2010 reflects the recession and efforts to mitigate the fall in private spending, as well as the collapse in revenues. The long term situation reflects a structural deficit, a built in difference between projected spending and revenues. The long term projections make assumptions that are not likely to come true-expiration of the Bush tax cuts and no correction to the Alternative Minimum Tax. Debt held by the public is projected to increase to $15 trillion in 2020 -67 percent of GDP up from 53 percent currently. The projections bring home the point that our fiscal policy is not sustainable. Who will buy the debt? In June 2009 there was $11.6 trillion in debt outstanding with $5.03 trillion held by the Fed or other Government agencies leaving $6.52 trillion held by the public with 52 percent of that held by-non residents. The interest costs are according to the CBO "poised to skyrocket." (CBO 1/28/2010) Will there be a collision in the credit markets when currently weak private borrowing increases with accompanying implications for interest rates? What happens if non-residents decide that they do not wish to hold as many dollar assets? Will a future Fed decide to monetize the debt with accompanying inflationary implications? The questions are serious. The spending trajectory is driven by entitlements which dominate the Budget. In the $3.83 trillion Budget submitted in February for Fiscal year 2011, Medicare, Medicaid, Social Security and net interest account for 63 percent of spending. On the tax side according to the CBO, people in the highest quintile with incomes averaging $248,000 in 2006 paid 69.3 percent of all Federal taxes. The bottom 60 percent of taxpayers paid 14 percent of all Federal taxes.

The long term questions have to be dealt with and the choices are difficult especially in an environment of biennial or quadrennial elections where unpleasant truths do not sell. Now we are on a perilous path. Tightening fiscal policy amidst an economy just emerging from "The Great Recession" risks stifling the upturn, but failure to begin dealing with the long term imbalances risks serious problems down the road. The excitement will continue in 2010 and beyond.