“RODNEY DANGERFIELD” REDUX: 
STILL NO RESPECT FOR THE ECONOMY

By Randall S. Kroszner 
Professor of Economics 
The University of Chicago 
Graduate School of Business 
Director, Stigler Center for the Study of the Economy and the State 
Former Member, President’s Council of Economic Advisers 

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When I addressed you last year, I characterized the economy as experiencing a “Rodney Dangerfield Recovery,” named for that profound scholar and comic who, no matter what he did or how well he did it, could get no respect. Rodney may have joined George Burns and Jack Benny in the great comedy club in the sky, but here on earth, alas, nothing has changed.

The economy continues to post a solid and consistent performance no matter what Mother Nature nor nattering nabobs of negativism may throw at it. The US economy has grown for 16 straight quarters. We have had growth above our long-run trend rate of roughly 3 ¼ percent for ten quarters in a row, a full two and a half years. Despite the terrible tragedies of Katrina and Rita in August and September – among the greatest natural disasters the US has ever experienced --, the GDP data released last week show that the economy grew at 4.3 percent during the third quarter. No major industrialized economy in the world has had such strong growth over the last couple of years.

We also now have experienced more than 2 years of solid employment growth, with roughly 4 million jobs added since the job market turned around in the summer of 2003. (As you may recall
from my previous BFL remarks, this was just when I had left Washington as a Member of the President's Council of Economics Advisers. As we always caution at the GSB, correlation does not imply causation! By the way, the stock market has added trillions since I left too!) The revised statistics reported on Friday show that there was no net loss of jobs even in September and October following Katrina and Rita.

Nonetheless, measures of consumer sentiment are at gloom and doom levels; survey and polls suggest the same. It is difficult to understand the “great disconnect” between the performance of the economy and the perception of it. (Perhaps the discussions of the long-run problems of Social Security somehow overshadowed information about the recent performance of the economy.) A series of newspaper articles in the last few weeks have even recognized this disconnect, but an full explanation remains elusive.

Let’s now turn to assessing my forecast from last year and my new forecast for 2006. In doing so, I would like to quote one of the founders of the Chicago School of Economics who wrote a famous book 80 years ago which is still appropriate for our times “Risk, Uncertainty, and Profit.” He said:
“I am reminded of a deep philosophical observation made by a high politico in a speech some years ago . . . “The time has come to take the bull by the tail and look the situation square in the face.” Frank H. Knight. The Role of Principles in Economics and Politics. Presidential Address delivered at the 62nd annual meeting of the American Economic Association, Chicago, 1950, published in American Economic Review 41(1), March 1951: 1-29; quote on p. 5.

The preponderance of pouting pundits of pessimism – who seem to focus only on the bull’s tail, however, have done little to undermine my bullish forecast from last year. As you can see on your scorecard, real GDP grew only slightly less rapidly than I had forecast, and inflation was only slightly higher than I had predicted. These differences are largely due to energy prices being sustained at a higher level than I had anticipated a year ago. Despite continuing strong corporate profits (growing close to what I had predicted), real business investment was lower than I had forecast, and consumption spending was a bit stronger.

Perhaps one of the benefits of spending time in Washington was that I was able to nail the growth of real government spending and come quite close on the fiscal deficit. Continuing strong tax revenues have kept the fiscal deficit to under 3 percent of GDP. In addition, continuing strength of the US relative to other countries led me to predict a widening of the gap between imports and exports to
$625 billion – the trade balance -- without dire consequences for the dollar or interest rates.

Going forward, you can see that my forecast for 2006 shares many elements in common with my 2005 forecast – if you have a winner, stick with it. I believe that real GDP growth will continue to be a bit above the US post-war average at the mid-3’s (percent) for 2006. My reasons for this forecast are as follows.

By far the largest component of GDP is consumption. Despite the endless reports of persistent pessimism among consumers, strong consumption spending has been a characteristic of this recovery, coming in even higher than I had forecast for last year. The tax reforms during the last four years that reduced the top marginal rate to 35 percent and created the 10 percent bracket for those less affluent have helped to boost real disposable income and keep the consumer buying. As some of the “froth” comes off of the housing market – thereby reducing the positive “wealth effect” of the strength in the housing sector -- and people fully adjust to higher energy prices, I see the growth in real consumer spending inching down to roughly 3 percent next year. The “alternative minimum tax” or AMT
will eventually start to have an impact but probably not in the next year.

The expiration of certain tax breaks for investment last year, such as “bonus” expensing, did not lead to the spike in real business investment I had anticipated. Nonetheless, we still have in place a number of pro-growth policies that will continue to provide a strong environment for investment. The reduction in dividend taxes in the Jobs & Growth package passed in 2003, just before I left the White House, has helped to reduce distortions in firm’s capital structure choices and has led to a significant increase in the number of firms initiating dividend payments and in the amount of dividends. (See Quarterly Journal of Economics, 2005). I forecast that real business investment will be roughly 6 percent in 2006 and corporate profits after taxes will maintain themselves at a healthy 12 percent growth rate.

Productivity growth in the US remains at astonishing levels. During the last four years, non-farm business productivity (output per hour worked) has grown at more than 3 percent per year. In manufacturing over this period, productivity has grown at more than 5 percent per year. Although it is difficult to see such trends being
sustained, the recent high growth rates suggest the high productivity of investment.

The pro-growth policy environment in the US contrasts sharply with that of many other countries around the world. Recall that the earlier this year, the leader of the ruling party in Germany had characterized foreign entrepreneurs and hedge fund managers as “locusts.” The very weak grand coalition government of Merkel in Germany is unlikely to undertake the reforms necessary to reignite growth, but I will leave it to Marvin to further analyze the political prospects for reform.

An important consequence of the pro-growth policies in the US is that people outside of the US continue to be willing to investment almost $2 billion per day into the US economy. Mike will focus more on the world economic outlook, but I maintain my optimism about the US relative to much of the rest of the world. Even though I am forecasting somewhat slower growth for the US in 2006 compared to 2005, the relative strength of domestic demand will lead imports to continue to outrun exports significantly. The trade balance is likely to be in the same ballpark as this year of negative $625 billion, continuing to hover around 6 percent of GDP.
Now on to another type of deficit, the fiscal deficit, which for reasons I can’t quite understand is often spoken of as the twin of the trade deficit since there is no necessary connection between the two. Given my prediction of economic growth and particularly strong profit growth, I see the Treasury continuing to experience solid increases in tax receipts. Real government spending is likely to rise slightly faster than last year, at least in part due to rebuilding efforts in the Gulf region, at just above 2 percent. This revenue and spending combination leads me to predict a federal fiscal deficit similar to what we experienced this year of approximately $320 billion.

While these numbers are substantial, they must be put in the context of the size of the US economy, which will be roughly $13 trillion in 2006. The 2005 deficit is approximately 2.6 percent of GDP, and my forecast implies that it will be even smaller as a percent of GDP in 2006. These are manageable numbers, particularly when we recall that the overall debt-to-GDP ratio in the US is below 40 percent, lower than most developed countries and dramatically lower than in Japan where the debt-to-GDP ratio exceeds 150 percent. There are some very important long-run fiscal challenges for the US,
including Social Security and Medicare/Medicaid, but, alas, it does not appear that they will be dealt with in the coming year.

Finally, the employment situation: Steady job growth has already resumed after the impact of Katrina and Rita on the September and October numbers. I do not see much of a reason for a substantial change in the unemployment rate so predict that the average for the year will be just above 5 percent, approximately where we are now.

To conclude, I want to come back to some long run considerations. My University of Chicago colleague, the Nobel laureate Robert Lucas, once said that when one contemplates the powerful impact of sustained economic growth on human welfare, it is hard to think about anything else.

When we consider policies of any type, we should always try to analyze what their growth impacts are. If we want to show respect to our fellow citizens, we should have great respect for incredible effect that economic growth can have on people’s lives and make that a key consideration in any policy debate. Rodney Dangerfield may still be throwing out one liners in heaven – or perhaps in a hotter place, given the character of some of those one liners – but let’s hope that
policies to promote economic growth both in the US and the world get the respect they deserve. Thank you.
<table>
<thead>
<tr>
<th>Economic Indicator</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Nominal GDP (% change)</td>
<td>6.0 %</td>
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<tr>
<td>Real GDP (% change)</td>
<td>3.5 %</td>
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<tr>
<td>Real Consumer Spending (% change)</td>
<td>3.0 %</td>
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<tr>
<td>Real Private Investment (% change)</td>
<td>6.0 %</td>
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<tr>
<td>Real Government Spending (% change)</td>
<td>2.2 %</td>
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<tr>
<td>Real Trade Balance (level, 2000 dollars)</td>
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<tr>
<td>Consumer Prices (% change)</td>
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<tr>
<td>Unemployment rate (year average)</td>
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<tr>
<td>Real Corporate Profits after Taxes (% change)</td>
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<tr>
<td>Federal Surplus or Deficit (fiscal year)</td>
<td>- $320 billion</td>
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