The Risks to America’s Booming Economy

By Martin Feldstein *Wed, Mar 29, 2017*

'The danger is that overpriced assets and high-risk loans could lose value and cause an economic downturn,' writes our guest columnist, the well-known Harvard economist.

After a long and slow recovery from the recession that began a decade ago, the United States economy is now booming. The labor market is at full employment, the inflation rate is rising, and households are optimistic. Manufacturing firms and homebuilders are benefiting from increasing activity. The economy is poised for stronger growth in the year ahead. We no longer hear worries about secular stagnation.

The overall unemployment rate is just 4.7%, while unemployment among college graduates is only 2.4%. Average hourly earnings are 2.8% higher than they were a year ago. The tight labor market and rising wages are inducing some individuals who had stopped looking for work to return to the labor force, boosting the participation rate.

A clear indication that the economy is at full employment is that the rate of inflation is increasing. The “core” consumer price index (which omits volatile energy and food prices) has reached an annual rate of 2.2%, substantially higher than the 1.8% average during the previous three years. During the most recent three months, core inflation rose at a 2.8% annual rate.

Household wealth is also increasing. The price of homes, the most important asset for US households, rose by 5% during the most recent 12 months. The rising stock market has caused the broader measure of net worth to increase even faster.

Surveys of consumer attitudes point to strong positive feelings. The University of Michigan Consumer Sentiment Index recently reached a 17-year high. Likewise, the Conference Board Consumer Confidence Index hit a 15-year high in February.

Manufacturing firms have increased output in each of the last six months. Homebuilders are racing to keep up with demand, reflected in an increase of more than 6% in the number of new single-family houses in the past 12 months.

All of this suggests that real (inflation-adjusted) GDP will rise more quickly in 2017 than it did in the recent past. While volatile trade and inventory numbers have depressed the recent GDP figures, the more fundamental measure of final sales to private purchasers has been rising in real terms at an annual rate of about 2.5%. Overall GDP is likely to increase at a similar rate for 2017 as a whole.

But, although the economy currently is healthy, it is also fragile. The US has experienced a decade of excessively low interest rates, which have caused investors and lenders to seek higher yields by bidding up the prices of all types of assets and making risky loans. The danger is that overpriced assets and high-risk loans could lose value and cause an economic downturn.

The price-earnings ratio of the Standard & Poor’s 500 Index is now nearly 70% above its historic average. A return of the price-earnings ratio to its historic average would cause share prices to decline by 40%, implying a loss of more than $9 trillion, an amount equal to nearly half of total GDP.

Ten-year Treasury bonds now yield just 2.5%. With the current inflation rate of more than 2% and markets anticipating a similar inflation rate over the longer term (as measured by five-year five-year-forward inflation expectations), the yield on ten-year Treasury bonds should be above 4%. A rise of the ten-year yield to 4% would reduce the value of those bonds substantially. Other long-term bonds—both government bonds and corporate bonds—would suffer similar declines.

Reaching for yield has also narrowed credit spreads between high-grade bonds and riskier domestic and emerging-market bonds. And commercial real-estate prices have been bid up to levels that are probably not sustainable.

At the same time, banks and other lenders have extended loans bearing interest rates that do not reflect the riskiness of the borrowers. And, because these covenant-light loans impose fewer conditions on the borrowers, they are more susceptible to default if economic conditions deteriorate.

But a bad outcome is not inevitable. None of the risks I have described may materialize. Interest rates may return to normal levels, and asset prices may gradually correct. But there is a clear risk that a decade of excessively low interest rates will cause a collapse of asset prices and an economic downturn. This will be a major challenge to the US Federal Reserve and the Trump administration in the year ahead.

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