For the Winner, a U.S. Economy With Some Stubborn Problems

On the To-Do List: Deficits, Health Care and Oil Prices; A Twin Threat From China and Staving Off a Dollar Dive

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By David Wessel and Bob Davis

For months, the presidential candidates have been boasting about their grand plans to stoke the American economy. The end of the campaign means it's time to confront longer-term problems that defy the sound-bite solutions of stump speeches.

Among the most stubborn: persistent budget deficits, heavy dependence on imported oil, rising health-care costs, the growing U.S. reliance on borrowing from China and the imminent retirement of the baby-boom generation, whose oldest members are now 58.

The U.S. economy appears headed in a better direction than it was in January 2001 when President Bush took office. Even before the Sept. 11 attacks, the economy was sliding into recession as the stock-market bubble burst. Today, most economic arrows point up. The economy has grown at an annual rate higher than 3% for six consecutive quarters. The unemployment rate has dropped to 5.4% from its June 2003 peak of 6.3%. But high oil prices and the business community's reluctance to buy more machinery, buildings, computers and software are acting as a damper.

Because of the deficit's size, the winner will have only limited ability to stimulate the economy, if it falters, with tax cuts or spending increases. As a result, the president's most potent strategy may be to bolster confidence by actually tackling some of the long-term problems that politicians typically like to defer.

Here are some of the biggest:

The Budget

No matter how much attention the president devotes to Iraq and terrorism, he's forced to send a budget to Congress early in February. The choices aren't easy. How should the tax code be changed? What's the right balance between spending on defense and homeland security and spending on education, health and highways? Which campaign promises should be kept now, which ones deferred?

As long as the economy grows at the 3.5% annual pace expected by private forecasters, the White House should have little trouble devising a budget that projects a smaller deficit for next year than this year. That would be accomplished with a budget that simply extends this year's efforts, estimate Brookings Institution economists William Gale and Peter Orszag. Cutting the deficit in half, as both candidates pledged, is harder.

And the next four years aren't the problem. The real dilemma will come later as baby boomers begin to claim Social Security and Medicare.

The president will have an opportunity to engage the country in a broad debate about taxes with the imminent expiration of a fix to the alternative minimum tax, or AMT. Invented in 1970 to make sure the rich didn't use tax breaks to avoid paying income taxes altogether, the AMT isn't automatically adjusted for inflation. That means it's being levied on an increasing number of taxpayers, especially those with lots of exemptions, such as large families.

The latest fix expires at the end of 2005. The next year, according to Leonard Burman of the Urban Institute think tank, 18.6 million Americans will be hit by the AMT's higher tax rates, up from 3.4 million in 2005. On the other hand, a permanent fix would cost more than $500 billion over 10 years, Mr. Burman estimates, roughly equivalent to the 10-year price of the new Medicare prescription drug benefit. With neither option palatable, the president could seek a more sweeping reform of the tax code.

Another budget issue the president probably can't duck is the fragility of the federal fund that backs up private employers' defined-benefit pensions, the sort that promise a monthly check based on years of service and the level of wages. The federal Pension Benefit Guaranty Corp. has already absorbed the cost of paying pensions for many steel workers. It could inherit much of the airline industry's pension promises, too. So far, the premiums paid to PBGC by employers have covered the pension checks it mails each month, but that won't last. The PBGC ended last year with $11.2 billion more in promises than assets to meet them; it says this year's deficit will be bigger still.

Any solution would probably involve changing pension rules and putting gobs of taxpayer money into the system. And that's just the private pension system. Although neither Social Security nor Medicare faces such an imminent crisis, neither is on a firm footing. Social Security is regarded as the easier fix. The politics are tricky, but there are options on the table -- various combinations of payroll tax increases, reductions in promised benefits, private accounts and raising the retirement age.

Health

Restraining the rising cost of Medicare -- the government health-insurance program for the elderly and disabled -- while coping with new health-care technologies and an aging population, is more complicated than fixing Social Security. Medicare's problems are intertwined with the broader health-care system. Even before the new Medicare prescription benefit takes effect in 2006, there are calls to rethink it. The left says it isn't generous enough and wants the government to muscle drug companies into charging less. The right says it exacerbates Medicare's already rising costs.

Independent budget watchdogs say both sides aren't paying enough attention to the long term.

"Do you know how much money you'd have to have today invested in Treasury bills to deliver on the prescription-drug promise over the next 75 years?" asks David Walker, head of the nonpartisan congressional auditing body, the Government Accountability Office. His answer: $8.1 trillion. That's almost twice the $4.3 trillion in U.S. Treasury debt currently held by the public.

Consumers of the private health-care system are also increasingly dissatisfied. Despite the growth in government health-care spending, about 55% of the nation's health-care tab is paid by employers and families. The ranks of Americans without health insurance are growing, the costs to those with insurance are rising and the quality of care is uneven.

But the president will find little consensus about workable, affordable and politically acceptable solutions to these problems. "First we have to answer: Why do health costs grow on a sustained basis more rapidly than the economy? Is it worth it? Are we getting our money's worth?" says Douglas Holtz-Eakin, director of the nonpartisan Congressional Budget Office. "After that, there is the financing issue: How to distribute those costs in a way that doesn't disrupt the economy and still provides a catastrophic backstop?"

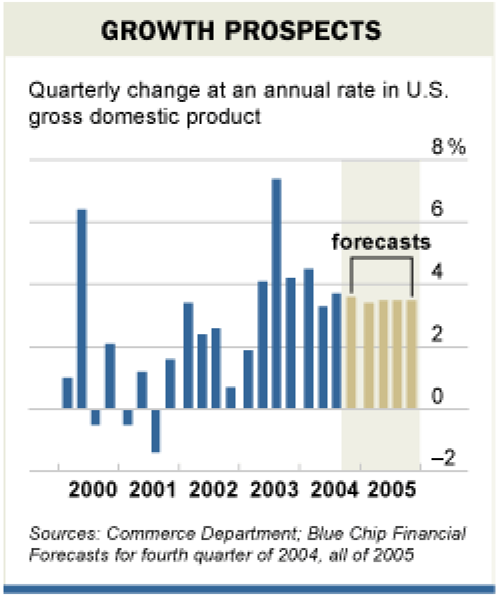
"There is no clean solution," he says.

Energy

The big run-up in the price of oil and natural gas raises a fundamental question: Is the U.S. in for a long period of high oil prices or is this a temporary spike that will soon be forgotten? The latter is possible. Only five years ago the domestic oil industry was seeking tariffs to protect it from $11-a-barrel oil, which it considered dangerously low. Now, odds favor a prolonged period of higher prices, partly because of unstinting demand from China and India.

The specter of $2-a-gallon gasoline and $50-a-barrel oil are near the top of White House and Federal Reserve worry lists. "Getting through the winter may well be the first energy challenge that the president faces," says Daniel Yergin, chairman of consultant Cambridge Energy Research Associates of Cambridge, Mass.

These aren't problems the president can do much to directly tackle. Nonetheless, the political and economic pain will put pressure on the president to intervene.



Price controls aren't likely, but there's already talk on Capitol Hill of using the 670-million barrel Strategic Petroleum Reserve more aggressively to nudge prices down. The Bush administration released about five million barrels to compensate for hurricane damage to oil rigs and pipes in the Gulf of Mexico, but has been reluctant to do more, arguing that the reserve should be kept for emergency use only.

Larry Goldstein, president of the Petroleum Industry Research Foundation, advocates swapping 25 million barrels of low-sulfur crude in the reserve -- about the amount he estimates was lost to Hurricane Ivan -- for 25 million barrels of higher sulfur crude from Saudi Arabia. Refiners could use the low-sulfur stock for heating oil, which could moderate price rises this winter, while leaving the oil reserve at the same overall level.

Higher oil prices could also help the administration find a way to address global-warming concerns that have divided the U.S. from Europe. By installing energy-efficient equipment to reduce energy costs, U.S. companies will also be able to reduce emissions of carbon dioxide and other gasses blamed for the rise in atmospheric temperatures globally. That will help U.S.-based multinational companies meet new regulatory regimes outside the U.S.

In January, the European Union plans to cap industrial emissions of carbon dioxide. Companies that can't meet the targets will have to buy the emissions rights from other companies. The Kyoto treaty on global warming, which is expected to take effect in January without U.S. participation, proposes a similar mechanism.

U.S. companies that have cut emissions in their European operations may support something similar at home, if only to make sure their domestic competitors don't reap a cost advantage. Even Glenn Hubbard, who was chief White House economist when the Bush administration walked away from the Kyoto treaty, says a mandatory emission-trading regime is becoming more likely in the U.S.

China

While the issue of outsourcing business to China received lots of attention during the presidential campaign, there was little focus on more significant changes in the international economy: the Dec. 31, 2004, expiration of the 30-year-old Multi-Fiber Arrangement, a deal that regulates world-wide trade in textiles and apparel, and the stubbornly low value of China's currency.

China wasn't even at the negotiating table when quotas on textile and apparel imports were ended a decade ago, but it has since joined the global trading system. China's combination of low wages and efficient production makes it possible for Beijing to take business -- and hundreds of thousands of jobs -- from competitors around the world.

Fearing a flood of cheap Chinese exports, a coalition of U.S. trade associations is asking the U.S. to invoke trade-law provisions that are designed specifically to limit the growth in imports of Chinese trousers, shirts, and yarn. Other petitions are expected. Similar efforts to block Chinese imports may follow in Latin America and in Europe.

At the same time, the refusal of China to let its currency, the yuan, appreciate is worrying economic policy makers around the world. Holding the yuan stable makes China's exports more attractive, encourages the U.S. to import its goods, increases the size of the U.S. trade deficit and, as a result, forces the U.S. to increase its overseas borrowing, often from China itself. Economists worry that the U.S.'s insatiable demand for imports and its addiction to borrowing from abroad is creating a dangerous imbalance in the world economy.

A rise in the yuan's value could solve both problems by damping the U.S. trade deficit -- reducing its need to borrow overseas -- and forestall worries about a collapse in the dollar caused by a sudden loss of international investor confidence in the U.S. economy.

Policy makers in the U.S., Europe and Japan, backed by the International Monetary Fund, are pressing China to allow the yuan to rise in value, helping create a gentle decline in the dollar's value. China is signaling it sees reasons to let the yuan rise, mainly to thwart domestic inflation, but it refuses to be pinned down on timing.

A rise in the yuan "would unlock a series of moves throughout Asia that would be very helpful to dealing with the imbalances in the global economy," says Laura Tyson, a former top Clinton economic adviser. Only if China moves its currency against the dollar will Asian nations, who also export heavily to the U.S. and lend it lots of money, allow theirs to do the same.

The apparel and textile issue will force the White House to make a tough call, probably in late January. It's unlikely to reject the petitions flatly, and is likely to seek a deal with China to avoid a major trade fight.

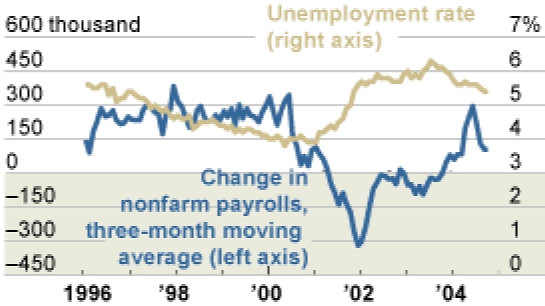
The U.S. might, as it did with auto imports from Japan in the 1970s, ask China to limit exports to the U.S. voluntarily. Or, if the White House is more ambitious, it could use the threat of more onerous restrictions on Chinese textile and apparel exports -- which would be politically popular -- as leverage to get Chinese government to unfetter its currency.

"Threats of action by the U.S. and China's other trading partners pose an opportunity for China to make a move," says Ms. Tyson, who is now dean of the London Business School.

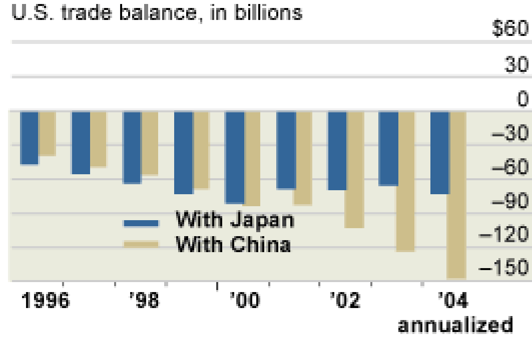
ON THE PRESIDENT'S PLATE

The winner of yesterday's voting confronts a growing economy, but an outlook clouded by trade deficits, budget deficits and rising spending on retirees.

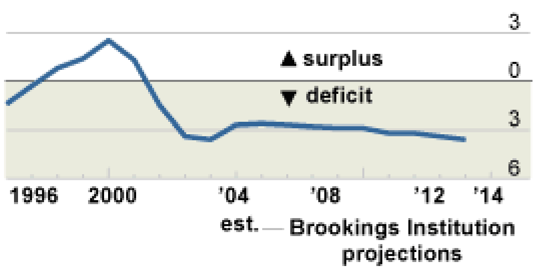
Mixed jobs picture



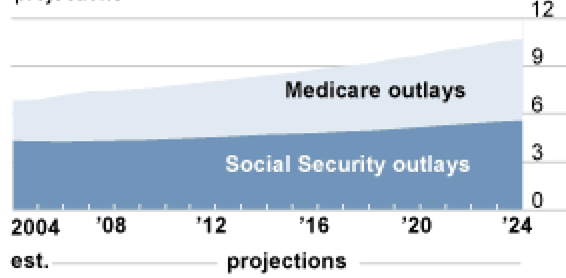
Trade deficits
U.S. trade balance, in billions



Persistent budget deficits
Actual and projected deficits, as percentage of GDP, assuming current spending trends, extension of expiring tax cuts and fix to alternative minimum tax.



Rising Social Security and Medicare spending
As a percentage of GDP, estimates and projections



Sources: Labor Department; Census Bureau; Congressional Budget Office; Department of the Treasury; Office of Management and Budget; Commerce Department; Brookings Institution