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By MARTIN FELDSTEIN

CAMBRIDGE – Although the strength of the US economy in 2010 remains uncertain, it is important to look ahead to its likely performance in the coming decade. The rise of GDP over the next ten years will reflect the very positive effect of the eventual recovery from the current deep downturn, combined with a below-trend rise in the economy's potential output at full employment. When I add up all the key components, I conclude that the coming decade's annual growth is likely to be about 1.9%, roughly the same as the average rate over the past ten years.

To understand why, let's start with the cyclical recovery. I'll make the optimistic but plausible assumption that the economy will fully recover over the next decade, lowering the unemployment rate from the current 10% to about 5%. That return to full employment will also reduce the number of people who, discouraged that no jobs exist for those with their skills, have stopped looking for work (and are therefore not counted as unemployed).

That cyclical recovery of employment will cause GDP to rise by about 13% over the next decade, or an average of 1.2% per year. That represents a substantial turnaround from the past decade, when the unemployment rate rose from 4% to 10% and the labor-force participation rate fell from 67% to 65%, reducing GDP by about 1.6% per year.

The full rise in GDP will combine the 1.2%-per-year cyclical rebound with the increase in potential full-employment GDP. The growth of potential GDP will reflect the structural rise of the labor force, the increase in the capital stock, and the improvement in multifactor productivity (i.e., the change in the output that results from improvements in technology rather than from increases in labor and capital.) Although there are uncertainties about each of these components of growth, their performance in the coming years is unlikely to be as good as it was in recent decades.

Slower population growth and a demographically driven decline in the labor-force participation rate will reduce employment growth. Indeed, the US Department of Labor recently predicted that the labor force will grow by only 8% between 2008 and 2018, down from 12% in the previous ten years. That growth of the labor force will raise potential GDP by only about 0.5% per year.

Although the capital stock will benefit from a higher household saving rate, the increase will be offset by more government "dissaving" as budget deficits remain high. A reluctance of foreign investors to keep accumulating dollar assets will cause a smaller capital inflow from the rest of the world.

Finally, the change in potential GDP will depend on what happens to the rate of change of multifactor productivity – that is, the change in output that results from changes in technology and production processes. According to the OECD, US multifactor productivity rose at a relatively stable annual rate of about 0.75% from 1985 to 2000, and then jumped to 1.4% per year from 2001 through 2008. There is no way to know whether the rate of growth of multifactor productivity will remain at its current level or will revert to the pre-2000 pace.

Assuming slower growth in the labor force than in the past decade, no rise in productivity due to capital accumulation, and a decline in multifactor productivity growth to its pre-2000 average implies that annual potential GDP growth will be only 1.4%. Combining these conservative assumptions about potential GDP with the effect of the cyclical rebound – an estimated 1.2% annual rise in real GDP – would produce real GDP growth at an average annual rate of 2.6%, which would be significantly higher than the 1.9% rate in the decade ending in 2009.

But not all of the extra output produced over the next decade will remain in the US. If the trade deficit is reduced by 3% of GDP between now and the end of the decade, the implied rise in exports and decline in imports would

reduce output available for US consumption and investment by about 0.3% per year.

The effect of a decline in the dollar over the coming decade could be equally important. If the real trade-weighted value of the dollar falls by 25% over the coming decade, and the full effect of that dollar decline is reflected in import prices, the increased cost of imports would reduce the growth of US real incomes by about 0.4% a year.

These two international effects would leave annual net growth of real goods and services available for US consumption and investment – both domestically produced and imported – at just 1.9%, implying no change compared to the past decade. During those years, the rise in the volume of net imports just balanced the effect of the dollar's fall on the total cost of imports. As a result, the rise in the real value of goods and services available for US consumption and investment was the same as the rise of real GDP.

There are, of course, serious downside risks to this forecast, especially if the fiscal deficit remains high or adverse tax policies depress the rise in productivity. The government should take the weak ten-year projection as a warning and a reason to devote policies to reducing fiscal deficits and strengthening incentives for growth.

Martin Feldstein, a professor of economics at Harvard, was formerly Chairman of President Ronald Reagan's Council of Economic Advisors and President of the National Bureau for Economic Research.
