Originally published in **The Wall Street Journal**

February 21, 2016

The U.S. Economy Is in Good Shape

As we shake off the effects of past Fed policy, many signs are good. But the 2016 race has seen some alarming proposals floated.

By MARTIN FELDSTEIN

The American economy is in good shape, better than critics think and financial investors fear. Incomes are rising, unemployment is falling, and industrial production is up sharply. The recent steep declines in the prices of stocks and junk bonds are not the precursor of an economic downturn. Instead, they are part of the inevitable unwinding of mispriced financial assets caused by the Federal Reserve's unconventional monetary policy.

The Fed's monetary policy drove up equity prices to increase household wealth and stimulate economic recovery. But artificially high stock prices eventually have to come down. Even after the 9% fall in share prices from the recent peak in November, the price-earnings ratio of the S&P index is still more than 35% above its historical average.

Fortunately the necessary financial corrections are happening when the U.S. economy is strong. We are essentially at full employment, with an overall unemployment rate of 4.9% and 2.5% among college graduates. Tight labor markets are leading to increases in hourly earnings and in the producer prices of services. Total payroll employment is up more than 600,000 in the past three months, and the ratio of employment to population, which has been at very low rates for several years, is inching up.

Households are in good shape: Real disposable income is up at a 3.5% annual rate, and the total value of homes is 7% higher than a year earlier. The Congressional Budget Office and others predict that real GDP growth this year will be above 2.5%.

Although the money incomes of middle-class households have been rising very slowly for three decades, the focus on cash income is misleading. The CBO explains that once corporate and government transfers are added to market incomes, and federal taxes are subtracted, the real income after transfers and federal taxes is up 49% between 1979 and 2010 for households in the lowest income quintile (with average total incomes of $31,000 in 2010). Real income is up 40% between 1979 and 2010 for households in the middle three quintiles (with average total incomes of $60,000 in 2010).

Even that understates the true growth rates of real incomes, because government statistics don't fully capture improvements in the quality of goods and services.

The Fed and others express concern about the potential contagion effect on the U.S. economy of weak demand in other countries. GDP is slowing in China, growing at less than 2% in Europe and declining in Japan, Russia and Brazil. Still, the drag of lower exports on our GDP in the past six months has been less than 0.25%. The dependence of U.S. growth on exports and activity in the rest of the world is easily exaggerated.

The 70% decline in the price of oil since early 2015 will eventually turn out to have a positive impact on U.S. economic growth. Until now it has caused a dramatic decline of activity in the U.S. oil industry and in related manufacturing and construction firms. But the fall in gasoline prices alone has increased annual household spending power by about $129 billion or more than $1,000 per household. Although households have temporarily plowed much of this found money into savings, we are likely to see it lead to increased consumer spending in 2016 and 2017.

Those who worry that the U.S. faces another recession often refer to the danger of an inverted yield curve—with interest rates on long-term government bonds below short-term rates. The danger reflects that, in the past, an inverted yield curve was the result of a sharp increase of short rates by the Fed to reverse rising inflation. But such a sharp increase hasn't happened and isn't likely to happen—even after the Fed raises short-term rates again. The yield on the 10-year Treasury note is now 1.8% while the two-year rate is 0.7% and three-month rate is 0.3%.

It would be a mistake for the Fed to abandon its December forecast of four rate increases in 2016. Monetary policy would

still be very accommodative, and the federal-funds rate would still be less than the core consumer-price index inflation rate, which is now 2.2% since 12 months ago.

A decision not to raise rates in March would signal markets that the Fed fears falling share prices. The resulting sense that there is a Fed "put" could encourage financial investors to continue pouring money into equities, raising share prices again and increasing the danger of future financial instability.

The American economy does face long-term problems. High on my list is the large and growing national debt, rising from less than 40% of GDP before the recession to 75% now and heading to more than 85% in 10 years. That would require devoting 30% of personal income-tax revenue to pay interest on the national debt, with more than half of that going to foreign bondholders. The education system for most K-12 students falls short of global standards, and we fail to provide useful education and training for many high-school graduates. The country needs to address these problems in the coming decade.

But the big uncertainties that now hang over our economy are political, with presidential candidates threatening to raise taxes, increase fiscal deficits and pursue antibusiness policies. Removing those uncertainties could stimulate growth after this year's election.

Mr. Feldstein, chairman of the Council of Economic Advisers under President Ronald Reagan, is a professor at Harvard and a member of the Journal's board of contributors.