EconoFact Chats: The U.S. Economy: Still the "Envy of the World"?
Mark Zandi, Moody's Analytics
Published on 7th September 2025

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I'm Michael Klein, executive editor of EconoFact, a non-partisan web-based publication of The Fletcher School at Tufts University. At EconoFact, we bring key facts and incisive analysis to the national debate on economic and social policies, publishing work from leading economists across the country. You can learn more about us and see our work at www.econofact.org

Michael Klein
I have been having a discussion with Mark Zandi for EconoFact Chats about every four to six months since the end of 2023. In his role as Chief Economist of Moody's Analytics, Mark keeps his pulse on the economy. And the pulse has indicated very different levels of health over the past two years. In the early fall of 2024, The Economist magazine declared on its cover that the United States economy was, in their words, "the envy of the world." Now there is increasing discussion of a slowing economy and rising inflation, 'stagflation.' The British publication might call this an 'own goal,' the soccer term for when a team scores against itself. How likely is a recession? What is likely to happen to inflation? And are these outcomes, if they arise, in fact, an own goal? Given the evolution of events over the beginning of the year, indeed over the past couple months, I'm very pleased to welcome Mark back to EconoFact Chats today. He's the author of *Paying the Price: Ending the Great Recession and Beginning a New American Century* and *Financial Shock: A 360 Degree Look at the Subprime Mortgage Implosion*. Mark serves on the board of directors of MGIC, the nation's largest private mortgage insurance company, and is the lead director of the Reinvestment Fund, one of the nation's largest community development financial institutions. Mark, thanks for joining me once again, on EconoFact Chats.

Mark Zandi
Hey, Michael, it's good to be with you. Thanks for the opportunity.

Michael Klein
Well, it's always great to have you on Mark. So we're recording this on Friday, September 5, and this morning, the jobs report was released, and it was a disappointing report. The number of jobs added in August was only about 22,000. People were expecting something more like 80,000. In fact, in June, it turns out, with the revisions, there was a loss of 13,000 jobs. This was the first negative job report since COVID. What's going on with the economy now, Mark? Are we pivoting from a quite strong economy from a year ago to being vulnerable to a very poor outcome now?

Mark Zandi

Yeah, Michael, I think the economy is struggling. You can see it. Pick your statistic, GDP, growth in the first half of the year was just over 1%-ish, that's obviously well down from the almost 3% growth we experienced in calendar year 2024. It's fair to say that manufacturing is in recession. It's contracting. Construction is in recession. Even with the boom in data centers, we're seeing the construction sector pull back. Overall consumer spending, if you take all spending and account for inflation, that's basically gone sideways since the beginning of the year, no growth. And of course, in the job market, it's come to a standstill. Job growth has really throttled back. The underlying rate of job growth is pretty close to zero. Also disconcerting is that the job growth that is occurring is increasingly narrowly focused across industries. In fact, the Bureau of Labor Statistics constructs a so-called diffusion index across all the industries that it surveys and calculates the percent of those industries that are adding to payrolls, and that's been below 50% now for almost five, six months. And that has never, ever happened and a recession not ensued. So now, this time may be different, and I think there's still a reasonable shot we kind of navigate through without a full blown economic downturn, but it's already pretty uncomfortable, and it's going to be pretty close, and I'd say to close that we are already in a jobs recession. As soon as you get a negative jobs number, that's a recession, and we are seeing negative job growth.

Michael Klein

So I also mentioned my concerns about stagflation. I came of age, and I guess you did too, in terms of the understanding of the economy in the 1970s, a decade that was marked by stagflation. For those listeners younger than you and me, can you describe in a little bit more detail what stagflation means?

Mark Zandi

Sure, stagflation is weaker growth, higher unemployment and higher inflation. And it's a rare phenomenon we've suffered it…the last time was in the 70s and early 80s, and that was a virulent form of stagflation. Unemployment got into the double digits, inflation did as well. That's not what's happening now, at least not to that degree. We're a long way from that, but directionally, that's what's happening. We're seeing weaker economic growth, we just talked about that, and inflation has picked up. Just to give you a statistic, the inflation is measured by the Consumer Expenditure Deflator, the core PCE deflator, so that’s ex-food and energy, to abstract from the volatility in those parts of the index, is almost 3%. That's what the Fed targets, and the Fed deems 2% to be appropriate and comfortable. We're at 3%, or close to. I think here, the direction of travel is pretty disconcerting given the tariffs and immigration policy, and that's fundamentally why stagflation is a concern at this point. It's because of policy. It's because of the higher tariffs. Tariffs are like a tax on the economy, and that's slowing growth, and the tax works through higher prices for imported goods, and so that's inflation. And the other policy, of course, is a highly restrictive immigration policy, which is weakening growth because many of the immigrants work in key industries like construction, agriculture, manufacturing, transportation, distribution…go on and on and on, and you're limiting the supply of those workers, and that's causing costs to rise, and inflation in the parts of the economy that rely on immigrants is starting to pick up. So those two policies, higher tariffs and highly restrictive immigration policy, are working together to create this kind of stagflationary-ish/esque kind of environment.

Michael Klein
Mark, to give a little bit of historical context, what was, or what were, the sources of stagflation in the 1970s?

Mark Zandi
A few things. I think, and this is in no order of importance, one, the Federal Reserve lost its independence early on in the 1970s, and this is well documented in the Nixon tapes. President Nixon captured the Fed. His buddy was Arthur Burns, the chair of the Fed at the time, and they worked to keep interest rates low for a long period of time, to try to juice the economy, and to help win the '72 election, and that was right at the start of the inflationary pressures that were developing. The interest rates were just not set for economic reasons. They were set for political reasons. Of course, the '70s was a period of oil price embargoes, the Iranian hostage crisis that sent oil prices skyward to record highs at the time. And oil was a much bigger input into the economy's production process than it is today. And then three, I think there was not a clear understanding of the importance of inflation expectations. The idea that if people and business [and] investors think inflation is going to rise, then it's going to rise. Because workers demand higher wages, businesses think, oh I'll give the higher wages to the workers because I can pass that through to the former higher prices. And you get into this kind of wage, price spiral dynamic that's a feature of stagflation. So those are the three things that I would point to that were behind that period of stagflation.

Michael Klein
Yeah, we have a number of EconoFact memos that speak to those. We have one by Tom Drechsel of the University of Maryland, where he actually looked at the number of meetings between the President and Fed officials, and as you were suggesting, that spiked during Nixon's time. Then he estimated that inflation was higher because of those kinds of meetings. We also have some other original research by Ken Kuttner at Williams College, where he looked at the way in which changes in inflation fed into expectations of inflation, and that was much higher in the '70s and '80s and subsequently, and I guess a concern now, is that we might be returning to that kind of situation with the attacks on the Federal Reserve's independence. So you mentioned what the sources of concern about stagflation today would be…the tariffs and some other policies. In the 80s, the stagflation was ended by Paul Volcker when he generated a big recession that broke the back of inflation expectations. Do you think that today we would need something like that, but

it's becoming increasingly less likely to happen, both because oil prices reversed and that helped, but it's not clear the tariffs are going to be reversed, or some of these other policies, and it looks like the Fed is becoming less and less independent instead of more independent, meaning it's less likely it could undertake the kind of policies that Volcker put in place in ‘79 and ‘80?

Mark Zandi
Well, I think so far, at least, to date, the Fed is conducting policy consistent with the economics. It's not being politically driven, I don't think. They're in a difficult spot, the Fed. I mean, stagflation is pernicious. When thinking about monetary policy, what do you do? Do you lower rates because of the weaker growth, or do you raise rates because of the higher inflation? The answer is, I don't know, and that's what has been guiding the Fed up to this point, the Fed has been sitting on its hands, not changing policy, trying to figure out which direction it should move. I do think at this point, the Fed's more concerned about growth. You know, they got the job numbers, you got a negative number. I think they feel like they need to guard against that more than they need to guard against higher inflation, because the inflation, at least as a result of the tariffs, would be probably more one off, one time price increase, as opposed to a persistent increase in inflation, particularly if it doesn't get embedded into the wage price dynamics or affect inflation expectations, which it hasn't, at least to this point. So, so far so good. I think the Fed will cut rates here to preserve growth, but you know, you make a great point about Fed independence. You know, clearly the President has made clear that he wants lower interest rates. That's his view would be the appropriate policy. And I think there's increasing pressure on the Fed to follow through. And of course, the key here will be the next Fed chair. Chair Powell's term as Fed Chair expires in May of 2026. President Trump will nominate a new Fed chair, we’ll have to see who that person is. But if the Federal Reserve on the other side of all of this isn't actually independent, and is being guided by politics, say, keeping rates very low in the lead up to the midterm elections in an effort to juice up the economy, to help sway the election results, that would be a problem, and that would be the fodder for this stagflation that we're suffering, to become a more serious problem. Again, a long way from what happened in the 70s and 80s. But you know, directionally, we're moving in that direction, and it could get worse, if the Fed loses its independence, or Fed independence is impaired in any significant way. So something to watch very, very carefully here.

Michael Klein
I want to go back to what you said about tariffs. So there seems to be some evidence now, and we're going to publish a memo very soon, that tariffs are raising the prices of imported goods, but also domestic goods that compete with those imported goods. But you know, inflation is a persistent rate of change of prices, not a one time increase. How concerned are you that the combination of this one time increase, but then the concerns about the Fed's perhaps lack of independence going forward, could actually set off that wage-price spiral that you mentioned?

Mark Zandi
Yeah, that would be the issue. I mean, if the Fed is vigilant in conducting policy consistent with the economic factors that drive policy, they should be able to head off that wage-price spiral that higher inflation expectations, because inflation expectations are part of what they look at when setting policy. But if they lose that independence, and they're pressured to keep rates lower for political reasons, that's when this becomes potentially a real problem. I will say, though, that the prospects of inflation becoming more persistent may be more of an issue with regard to immigration policy than the tariffs. Because the immigration policy is restricting labor supply in key industries, and we are starting to see prices rise for different types of services that are provided by immigrant workers, and that could become more of an issue, more of a problem, in terms of the persistence of inflation going forward. We're all focused on the tariffs, because they're big and, you know, they're obvious, and they're coming on quickly, but when thinking about where inflation could become more of a persistent problem, maybe more around the immigration policy than the tariff policy. So we have to be vigilant and careful to watch both, very carefully.

Michael Klein
Again, news of the day today, a number of South Korean workers at a Hyundai plant in Georgia were arrested by immigration authorities, and so this is also, you know, sort of chilling the ability of non-native Americans to work, or their concerns about working in the United States. And that also leads to a reduction in the labor force, which, as you're suggesting, could raise wages. So pivoting a little bit now, another concern is the rising national debt. The Big Beautiful Bill, the Budget Bill, is projected to contribute to a burgeoning debt. What do you see as the evolving fiscal situation and also, what do you see as the consequences of that?

Mark Zandi
It's a problem. You know, the BBB, the Big Beautiful Bill, the tax spending bill, didn't make the fiscal outlook any worse compared to current policy, but [it] certainly didn't help. That's a problem, because the outlook is pretty dark by any measure. The nation's debt to GDP ratio is 100%-ish, and 10 years from now, it's going to be 120%-ish. And the direction of travel there is pretty disconcerting. If you look at the deficit to GDP, it's 6%. That's extraordinary. The primary deficit to GDP that excludes interest payments on the debt, is 3% and that's just hard to fathom when the economy is at full employment or close to. And of course, interest payments on the debt are rising very rapidly, and now we pay more on interest than we do on our own defense. And as a share of GDP, or federal government revenue, is pretty close to a record high, and certainly will be a record high in the not too distant future. So our fiscal situation and outlook is dark. It's definitely headed in the wrong direction. And you know that will at some point become a real problem for bond investors. A good rule of thumb is that for every percentage point increase in the debt to GDP ratio, that will raise the yield on the 10 year treasury bond by one,

two, maybe three basis points. So if you kind of do the arithmetic, and you go from 100 to 120% percentage points on the debt to GDP, that's going to add .2, .3, .4, maybe 0.5% to the 10 year yield. And that's real money that goes to the interest payments on the debt, that goes to fixed mortgage rates, that goes to corporate borrowing costs and investment. It's a very serious corrosive on the economy. And at some point, you could envisage bond investors beginning to question, not the ability, but really the willingness of the US government to pay in a timely way, and require a higher interest rate to compensate for that risk. And there could be some kind of a crisis event where bond investors lose faith all at once. And adding to that concern is the fact that increasingly, the owners of treasury bonds are hedge funds. You know, historically, at least in recent years, the Fed has been a big holder because of its quantitative easing. Foreign Institutional Investors, big US banks, all US banks have been big holders. They're less price sensitive. They're longer term investors. But hedge funds, they're here now, they're gone tomorrow, and they leave en mass. So you can easily envisage a scenario where at some point, and I don't know when that is, but at some point in the future, investors run for the door at the same time and you see a spike in long term interest rates. And obviously that would be a big problem for lots of different reasons.

Michael Klein
So what you're talking about is called a fiscal crisis. And then a fiscal crisis spills over into a macroeconomic crisis. And then when there's a macroeconomic crisis, because the government's bringing in less revenue, there's a deepening fiscal crisis. So you have this vicious circle, which is kind of a nightmare scenario. How likely do you think this is?

Mark Zandi
It's not my baseline. My baseline is my expectation in the middle of the distribution of possible outcomes, but it's certainly just that possibility of a spike in long term rates is in the distribution. I don't think we should discount it. Just to give you a sense of that, in my work, we do run lots of different macroeconomic scenarios for banks and regulators and a wide range of businesses. One of the scenarios we are running is what you labeled as a fiscal crisis, where interest rates spike. So it's on the radar screen, and people are thinking about it, trying to think about how they would manage through it, what it would mean for their own businesses, their balance sheets, their income statements, their profitability. So it's a real risk. Again, it's not my baseline, but it certainly should not be dismissed as a possibility.

Michael Klein
So this is like a bit of a downer.

Mark Zandi
Yeah.

Michael Klein
And yet, the stock market continues to make record gains. One measure of the stock market, the ratio of stock prices to corporate earnings, especially when you control it for the business cycle, its so-called CAPE Ratio, is near an all time high. Do you think stock market investors are being overly optimistic? Or do you think this is an example of what's called the Greater Fool Theory? As long as there are others willing to bet on rising equity prices. It makes sense to join that herd as long as you think you can get out in time.

Mark Zandi
Well, there's good fundamental reasons why stock prices are up, but there's also speculation to your point about the Greater Fool Theory as well. I mean, we've talked about some of the problems the economy faces, but there's some obviously good things that are going on. In artificial intelligence, and the build out of AI is a very powerful tailwind to economic growth. And I would go so far to say the US economy would likely be in recession today if not for the boom in AI, the build out in terms of construction activity, the data centers, utilities, all the equipment, all the software, all that is generating a lot of economic activity, a lot of GDP, a lot of income, a lot of wealth. And that's real. These companies that are leading the charge, that are publicly traded stocks, are real companies that are massively profitable, and their prospects are very, very good. Now just take a look at the so-called AI stocks, so the top 10 stocks that are kind of driven by AI, they're up 30% over the past year. Their stock price is up 30%. The market's up 10%. They're up 30%. If you exclude those top 10 AI stocks, you're at 5%. And then you have to consider, we had a corporate tax cut as part of the Big Beautiful Bill, the BBB… a corporate tax cut. So the arithmetic, assuming the constant price earnings multiple, would mean that's going to raise stock prices at least a few percentage points. So in my view, the stock market ex-AI, you should think about it that way, because AI is running on its own dynamic, and has nothing to do with this business cycle…is basically flat, and that's kind of how the economy is. It's basically flat. Now I do sense, and this goes back to your point about the Greater Fool, speculation is starting to creep in. You can kind of sort of feel it. You can feel it in the crypto market. You can feel it in what's going on with gold prices, silver commodity prices. And you can see meme stocks. I think, margin debt, you know, debt taken on to buy more equity…it's not at a record high, but it's pretty darn close. So those are all signs that the market is getting overdone…frothy. I'm stretching a little bit. So there may be some of that also embedded in the market, but most fundamentally, the stock market is not necessarily a real window into the broader economy, because it's being driven by this boom in artificial intelligence.

Michael Klein
So I'd like to conclude by asking you a little bit about your view of the effects of AI on the economy, and I don't mean so much in terms of now the way it's driving construction and plant

and equipment and in utilities. But over a longer horizon, do you have a view of what AI is going to do to jobs and growth and distribution of income?

Mark Zandi
Yeah Michael, I opine about many things, as you can tell, some things I'm confident in. Some not so much. This would be the not so much. I mean, I'm a slave to history. I mean, that's how I do forecasts. I look at history and say, how does that inform how this next new thing is going to play out? And historically, if you look at big technological innovation, say, the internet, it takes a while for the technology to diffuse throughout the economy and lift kind of growth and productivity, and generally, I think the mechanism through which that happens is business formation. It's new businesses that optimize around a new technology. Now, when legacy companies are adopting new technology, it's hard. There's a lot of changes the legacy company has to implement in terms of the kind of people they have, the kind of equipment, software they have, the way they're organized, the products they have, so forth and so on. So it just takes time. If that's actually how this plays out with AI, and that's how I'm thinking about it, it's going to be meaningful. It's going to lift economic growth, GDP, wealth, stock prices. It's meaningful, but it's going to take some time. It's not a cliff event…it's not all of a sudden, boom. It's going to be over time. And when we look back over the next 5-10 years, we're going to see it very clearly in the data, the productivity data, the GDP data, the jobs data, but I don't think it's one of those things that changes the economy in one fell sweep overnight. It's going to take time for that to play out. But just to give you a number, I have GDP growth…average annual GDP growth over the next 10 years of 2.25% per annum. Pre-AI, if you go back to my forecast, pre AI, this is abstracting from the vagaries of the business cycle and policy, I had potential growth at 2%, so I'm adding a quarter point, not over a 10 year period, over really a five, seven year period. That kind of gives you a sense of magnitude. For someone who's listening, they'd say, that's not a big deal. That's a big deal in terms of dollars and cents. And so I that's but that's the kind of magnitude I built into my forecast.

Michael Klein
Yeah, it's the magic of compound growth.

Mark Zandi
Yeah, exactly.

Michael Klein
Well, saying that you're looking at history, I would just note that in the early 1990s the great economist Robert Solow said you can see the effect of the internet everywhere, except in economic data. But then, of course, by the end of that decade and into this century, we're starting to see that. So it sounds right to me the kind of projection that you're making.

Mark Zandi
Well, then we'll both be wrong. Michael, there you go, down together in flames.

Michael Klein
Well, you know, yesterday, we talked a little bit, and I sent you the poem, 'The Second Coming' by Yates and a famous line in that poem is 'the best lack all conviction, while the worst are full of passionate intensity.'

Mark Zandi
That's a beautiful poem.

Michael Klein
So a little bit of Irish poetry to close out this episode. And as always, it's great to talk with you, Mark, and I really appreciate your insights, and you taking the time to talk with me and do this podcast for EconoFact Chats. So thank you very much.

Mark Zandi
Yeah, thank you. You guys do great work, and I appreciate the opportunity. Anytime, Michael.

Michael Klein
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