The Match That Can Ignite the Economy

Economic forecasters have stared into their crystal balls for most of this young century, hoping to see clearly the near-term future of the economy. The crystal ball, however, has proved smoky and difficult to read at best. Early on, the question was, When did the recession begin? And now, the question is, Will the recession end, and when, or will it double-dip?

Two facts clearly rise above the waves in the sea of uncertainty. First, both monetary and fiscal policy levers were pushed into highly expansionary gears some time ago. And President Bush, along with Congress, just levered the fiscal stimulus into an even higher gear. Second, given the stimuli injected into the economy over the past three years, little evidence yet exists that the stimuli moved the economy off its duff. Of course, that observation ignores the path the economy would have followed absent that stimuli.

This piece offers an analysis of the current and future states of the U. S. economy.

Current Situation

The National Bureau of Economic Research (NBER) Business Cycle Dating Committee put the peak of the last expansion at March 2001, ending a 10-year expansion of unprecedented length. Note, however, that the NBER Committee did not make its call until November 2001, 8 months after the peak. To date, the NBER Committee has not called the end of the recession.

Real Gross Domestic Product (GDP), our best measure of the economy's output, grew by only 1.9 percent in the first quarter of 2003. That was up from 1.4 percent growth in the fourth quarter of 2002, but down from 2.4 percent growth over 2002. The year the recession began, 2001, real GDP eked out a 0.3 percent increase, but that small increase resulted from the fourth quarter increase of 2.7 percent, since the first three quarters all fell. As a benchmark, real GDP grew at an average rate of 3.6 percent throughout the 1990s expansion. Clearly, the economy still exhibits a growth recession.

The recession that began in 2001 reflected a dramatic fall in investment, especially information technology (IT), spending. Consumer spending kept the recession on the positive side of zero growth, making up 90 percent of overall growth in 2001 and 75 percent of growth in the first quarter of 2003. Although investment grew in 2002, it started from a low base and contributed only a bit over 5 percent to total growth. And investment spending subtracted just over 25 percent from growth in the first quarter of 2003. In addition, the use of the existing capital stock, the economy's capacity utilization, averaged just over 80 percent during the most recent 10-year expansion. Capacity utilization fell through 2001 to around 73 percent where it stayed in 2002 and the first quarter of 2003.

A lack of confidence due to a host of uncertainties plays a major role in extending the current recession. Both the Conference Board and the University of Michigan Survey Research Center recently announced improvements in consumer confidence. But, the improvement reflected how consumers perceive the future economy; the assessment of the current economy worsened. Factors contributing to consumers' uncertainty include the progress in nation building in Iraq, terrorist threats, and SARS. The latter two may prove especially troubling to the Las Vegas economy, since it relies so heavily on tourism. But, if consumers substitute domestic for foreign travel this summer, then those uncertainties could actually boost the Las Vegas economy.

In sum, improving confidence may light the match that ignites the economy, since so much fuel is available to fire up the economy's engine. Let's look more closely at the fuel in the gas tank.

Monetary Stimulus in the Tank

Chairman Greenspan and company at the Federal Reserve began pumping fuel into the economy in early 2001, anticipating a slowdown or recession. Since then, the economy absorbed 11 interest rate cuts in 2001 and one more cut in late 2002. Interest rates now test all-time lows, uncharted territory for most participants in the economy. At some point, such low interest rates should spark investment spending.

The Federal Reserve's actions explain why consumer spending, especially on housing and autos, continued to bolster economic growth. The downside is that consumer indebtedness remains at all time highs. But at the same time, the debt's carrying cost has fallen along with interest rates. In sum, the consumer continues to resemble the "little engine that could." But, when will business investment spending jump on the train?

Fiscal Stimulus in the Tank

While monetary policy pushed the expansionary level into high gear, fiscal policy also pursued an expansionary course. President Bush first engineered 10 years of tax cuts in 2001. Most recently, the President again persuaded Congress to enact another large package of tax cuts, moving forward some of the tax cuts enacted in 2001, as well as adopting new tax cuts. While events at the state and local level move in the opposite direction to the federal stimulus, that offset is small.

Relying on tax cuts to grow the economy requires that consumers and businesses provide the stimuli to demand and supply, rather than to rely on the government as the spender of last resort. Consumers may take the additional money and pay down existing debt and/or add to household saving. Neither event will stimulate consumer spending. But, increased household saving flows into the financial markets and allows businesses to increase investment. Business confidence, however, must rise sufficiently to encourage investment, something that is not yet seen in the data. As just noted, low interest rates will fuel investment spending, when confidence recovers sufficiently.

Exchange Rate Stimulus?

The falling dollar makes our goods more competitive internationally, tending to increase our exports and reduce our imports. While the foreign sector contributed negatively to economic growth in 2000, 2001, and 2002, the first quarter of 2003 saw the foreign sector contribute nearly 50 percent of the growth of real GDP. Whether that reflects the start of a trend, only time will tell. The rest of the world, however, exhibits much less strength than the U.S. economy (e.g., Germany and Japan). So little hope exists for domestic stimulus emanating from the rest of the world. And the European Central Bank recently lowered its target interest rate by 0.5 percent, trying to stem the rise in the Euro and attempting to stimulate the Euro-zone countries.

The Forecast

Consumer and business confidence provides the key. Their recovery will start the economy's engine humming once again. The signs of improving confidence in the future suggest that 2004 could be a very good year. Moreover, the amount of fuel in the engine portends an extraordinary fast acceleration in the economy, so fast that Chairman Greenspan and company may turn their attention to worrying about inflation. Most recently, Mr. Greenspan has turned a bit more optimistic about the future of the U.S. economy, but he still downplays the risk of too much inflation when the recovery gets underway.

Risks to the Forecast

As with any forecast, certain risks exist. Events such as a significant terrorist attack in the U.S., a more dramatic outbreak of SARS, deteriorating conditions in the nation building in Iraq, and so on could prevent consumer and business confidence from recovering. In that case, the economy could remain mired in a growth recession.

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