As the Recession Door Opens, Who Will Step Out -- the Lady or the Tiger?

At long last, economists agree – the United States economy entered recession in March 2001, according to the National Bureau of Economic Research Business Cycle Dating Committee. That agreement, however, diverges as to how severe a recession portends. Most prognosticators foresee a short, shallow recession with recovery beginning in the first half of 2002. Much fewer foresee no recovery until 2003. What shall it be – the lady or the tiger?

The stock markets – Dow Jones, NASDAQ, and Standard & Poors 500 -- each recently rose above their September 11th levels less than two months after that unprecedented terrorist shock and more recently, the Dow Jones for a time snuck above 10,000. The stock market provides a forecast, albeit imprecise, of the future performance of the economy. Thus, the markets currently support the view of the optimists – the lady will provide a short, shallow downturn and the economy will resume its 1990s-style upward momentum.

Let's examine the facts. The lady's case rests on solid ground. First, firms do not hold significant levels of inventories. Thus, no paring of excess inventories need occur before new production emerges. Second, unlike recent downturns, oil prices have weakened significantly. Lower energy costs provide much needed fuel for the economy's engine. Finally, and most importantly, monetary and fiscal policies already provide high-octane propellant for the economy's booster rockets.

On the monetary side of the ledger, Chairman Greenspan guided the Federal Reserve toward significant easing some time before the "R" word was even whispered. A record eleven cuts in the Federal funds rate over the last year places substantial growth potential in the economy. Or does it?

On the fiscal side of the books, President Bush prompted Congress to enact major fiscal reform prior to September 11th that addressed the recent projections of federal government fiscal surpluses as far as the eye could see. In May 2001, the Congressional Budget Office (CBO) forecasted a cumulative budget surplus between 2001and 2011 of over $5.5 trillion. After the enactment of Bush's plan, the CBO's forecast fell to $3.3 trillion. Then, immediately after September 11th, Congress quickly authorized additional spending of $55 billion -- $40 billion for disaster relief and enhanced security measures and another $15 billion toward grant and loan guarantees for the airline industry. Currently, Congress debates additional fiscal stimulus that may exceed an additional $100 billion.

The lady's case, however, is not open and shut; the tiger possesses several important arguments in his brief. First, both the household and business sectors succumbed to borrowing binges during the crazy, hazy, lazy days of the 1990s – the longest post-WWII expansion on record. Household and corporate indebtedness got seriously out of whack. Moreover, debt imbalances cannot correct themselves overnight, requiring some time to unwind and reach more sustainable levels. Consequently, the record eleven interest rate cuts may prove much less powerful than expected. As the old saying goes, "You can lead a horse to water, but you cannot make her drink." Lower interest rates may not stimulate demand, if the private sector remains leery of more debt. Moreover, long-term interest rates, which most directly affect spending decisions, have not fallen to the same degree as short rates.

Second, although fiscal stimulus of significant proportions will occur, the types of fiscal stimulus remain unsettled. And some fiscal stimuli provide more stimuli than others. Debate rages in the halls of Congress about the fiscal package currently wending its way toward adoption. Republicans offer primarily tax cuts. Democrats provide more support for spending increases. One clear fact exists: tax cuts only stimulate demand, if such cuts promote spending and not saving; government spending clearly increases demand.

Consider tax cuts, business spending responds more to temporary tax cuts than permanent ones. For example, an investment tax credit will move planned investment forward in time to take advantage of the tax benefits. Of course, with too much debt already on the books, corporations may be chary to increase investment, even with the tax incentive. Household spending, on the other hand, responds more to permanent tax cuts than temporary ones. The tax rebates already issued did not create the big change in spending that was hoped for, since much of it landed in increased household saving. Will the proposed new rebate, targeted at lower income folk, or a one-month elimination of the payroll tax provide more stimulus? Maybe yes; maybe no.

To complicate federal policy decisions further, the recession pushed the budgets of state and local governments into deficit. And most states require, either by law or constitution, a balanced budget. Thus, state governments will provide significantly less stimulus during the current recession. To forestall a weaker stimulus from state and local governments, Congress could forward moneys through revenue sharing to finance some state spending.

Finally, a confluence of world events may also toll the death knell to any nascent recovery. The world economies already, or soon will, taste recession. An unprecedented synchronization of business cycles around the world means that the U. S. economy will get little help from its friends. Japan has experienced on-again, off-again recessions since the early 1990s. Until the Japanese authorities address the structural crisis in their financial institutions, economic recovery remains only a hope, not a reality. Also, the European community stands at the brink of imminent recession. The European Central Bank adamantly refused to lower interest rates until an unanticipated 0.5 percent drop some weeks ago.

Optimists forecast a short, shallow recession. While everyone hopes for a mild recession, the economy must clear several important hurdles before that outcome can emerge. The U. S. economy needs a good dose of “old-time” Keynesian stimulus. That is, the debt burden of households and corporations prevents the monetary stimulus, already in the system, from achieving its desired end. Rather the fiscal arm needs to prime the pump. Moreover, of the two possible fiscal actions – tax cuts and spending increases, a strong argument supports spending increases. Policy makers need to implement temporary, not permanent, spending increases, however, so that they do not seriously disrupt the long-run fiscal balance that the U.S. has most recently achieved. We need not repeat the mistakes made during the last episode of “Keynesian” fiscal expansion when President Reagan and Congress implemented another significant fiscal reform, largely tax cuts.

In sum, will the U. S. economy experience a short, shallow recession or a longer, deeper downturn? Will it be the lady or the tiger? Unless we get our act together, the tiger looms in the door. As Chairman Greenspan demonstrated on several occasions, the Fed occasionally must fulfill its traditional role as “lender of last resort,” preventing a financial meltdown. The current economic situation requires the President and Congress to fulfill their duty as “spenders of last resort.” The short-term prosperity of the U.S., and the world, economy depends on it.

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Stephen M. Miller is Professor and Chair of the Department of Economics, College of Business at the University of Nevada, Las Vegas.

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