

## Avoiding the Economic Pitfalls Ahead

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### Introduction

The economy is pulling out of recession. It will be a while before everyone really feels it, because people judge the state of the economy primarily by their experiences in the labor market. The surge in layoffs is behind us, but businesses have not ramped up hiring yet.

The 2001 recession was the least severe in the post-war period in most respects. In fact, recent data revisions indicate that it was milder than it appeared just a few months ago. Some analysts even question whether the downturn was correctly classified as a business cycle recession. More pertinent is what lies ahead and how policy makers react.

History shows that policy responses to economic shocks often have magnified the consequences. An obvious example is the Great Depression, which was deepened and lengthened by policies aimed at fixing the economy. The policy responses to the oil embargoes in the 1970s likewise turned unfortunate shocks into major crises.

Tempting reasons to tinker with the economy always exist. Those reasons seem to resonate better during troubled times, so we need to be especially vigilant today. The future level of prosperity will depend on our ability to temper reaction to the economic pitfalls at hand.

### The Economy

Make no mistake, the U.S. economy is on the mend.

- The number of people filing initial claims for jobless benefits has fallen by a quarter from its October peak, all the way back down to its pre-recession level.
- Correspondingly, the unemployment rate declined in both January and February - the first back-to-back improvement since September and October 2000.
- Total employment increased in February - the first increase since July - by the largest amount in a year.
- Consumer confidence has rebounded in five of the six months since September.
- Factory output increased for two consecutive months in January and February for the first time since May and June of 2000.

- The monthly survey of purchasing managers further indicates that the downward trend in production has been reversed. In February, the new orders index was the highest since August 1994, when the economy was last in a business cycle recovery.
- Finally, the stock market rebound since September signals recovery.

In short, the 2001 recession is over. The National Bureau of Economic Research designated March 2001 as the beginning. Sometime after mid-year, the NBER is likely to declare that January 2002 marked the end. Employment and industrial production, which are the two main coincident indicators, bottomed out in January and December, respectively.

The stock market, which has the most reliable lead time at troughs, also points to January, according to Anirvan Banerji, the Director of the New York-based Economic Cycle Research Institute.<sup>i</sup> If January was the end, then the 2001 recession was ten months long - one month shorter than the historical average.

It is important to recognize that the recession was not caused by the attacks in September. More than a year ago, I said that the coming slowdown would be pronounced, but would not deteriorate into recession.

The first part was correct. I would like to say that the second part would have been correct if not for the attacks, but there were too many signs before September 11 that the downturn already qualified.

- The S&P 500 stock price index was down 29% as of September 7. There had never been a larger decline that was not accompanied by recession.
- Industrial production had declined 5% from its peak by August – about the same as the total decline during the 1990-91 recession.
- The probability that the economy was in recession was 50% in July and 75% in August, based on a Markov-Switching model of the unemployment rate.<sup>ii</sup>
- And consumer confidence fell to its cyclical low in the first 10 days of September – more than 25% below its peak.

Going forward, the inventory swing will add significantly to the near term lift in economic activity. Massive liquidation of inventories in the fourth quarter, which will not be repeated, subtracted 2-1/4 percentage points from overall economic growth. Surprised by the success of 0% sales incentives, the auto industry let inventories dwindle too far. Producers have elevated first half production schedules accordingly. The auto sector could add a half percentage point to growth in each of the first two quarters.

Overall, the economy is on track to grow by about 4% this year on a fourth-quarter to fourth-quarter basis, with a little less than half that coming from inventory rebuilding. The remaining 2-2.5 percentage points will arise from final sales – up moderately from last year.

Growth at a 4% pace would be a considerable improvement from the 0.4% growth rate in 2001. Yet even a ten-fold increase in growth would fall well short of the performance during the typical recovery. Growth during economic recoveries has averaged about twice the trend rate, historically. Twice today's trend is about 6-7%.

The mildness of the downturn is one reason for expecting a subdued recovery. This was the only recession out of the last ten during which real output fell in only one quarter. It also included the smallest peak-to-trough drop in real output. The best measure of severity is total foregone output. On this score, the 2001 episode ranks as slightly more severe than the 1967 downturn, which was not labeled a recession, and somewhat less severe than the 1990-91 recession.

The factors that cushioned the economy last year include:

- the 50% reduction in the price of oil during 2001, which acted like a tax cut because we import more oil than we consume,
- the 50% reduction in short-term interest rates engineered by the Federal Reserve during the fourth quarter, which brought the 12-month decline to nearly 5 percentage points,
- the 0% auto financing, which was made possible by the Fed, and
- the largest-ever mortgage refinancing boom, which created billions in discretionary spending power.

The tax rebates appear to have been saved rather than spent, but the burst in government purchases during the fourth quarter added significantly to aggregate demand. Indeed, if not for government purchases, the economy would have contracted for 3 quarters instead of one. A compelling case can even be made that the September attacks actually shortened the recession through the effects on economic policy. Circumstantial evidence also suggests that the absence of additional attacks and the quick military successes in Afghanistan helped the economy by bolstering consumer confidence

The reason that a mild recession makes for a subdued recovery is simply that there is less lost output to be recovered. This is Milton Friedman's "plucking theory." The farther activity recedes from potential, he said, the faster it snaps back.

Auto sales, for example, fell by about one-third of the average decline during the last 5 recessions. Housing starts fell by about one-quarter of the typical decline. Since these sectors did not contract by the usual 30-40%, they don't have room to expand by the usual amount.

The economy is also being held back by the first synchronized global downturn in more than 20 years. The Japanese economy has spiraled into what could become its most severe recession on record. The German economy has contracted for two straight quarters, making this the first time since the mid-1970s that the world's three largest

economies have been in recession at the same time. Measured in terms of total lost output, that was the worst post-war recession in the U.S.

Nonetheless, the U.S. economy seems to have turned up, and leading indicators say it is likely to continue expanding. One remaining risk is policy missteps.

### Avoiding the Economic Pitfalls

The economy faces at least four pitfalls in this regard.

#### *Enron*

First, Enron has the potential to do great damage to the economy over time. Not because of the event itself, but because of policy responses that it might elicit. The primary danger is that election-year politics in a weak economy will spawn new laws and regulations to prevent future Enrons. They will be as inadequate as the existing restrictions that inspired the extracurricular innovation at Enron. And they will impose costs on all companies with prudent and law-abiding management.

Mother Market makes new rules unnecessary. When my siblings and I were children, the instantaneous wrath of my mother was far more effective at influencing our behavior than policies imposed by my father when he got home. Likewise, as soon as Enron's troubles surfaced, the market summarily executed the next likely suspects while Congressional hearings were just warming up. Tyco International, Williams Companies, General Electric, and many others were brutally punished for the fact or appearance of questionable finances.

A greater danger is that Enron-inspired rules will renew the complacency that made the Enron debacle possible. There is no substitute for the watchful eye of Mother Market. When my children were little, my wife wanted to add a drive-way gate to the fence around our backyard. I objected, I said, because the false sense of security would result in a sub-optimal amount of market-based supervision. Tightening the regulatory screws further will stimulate the creativity of financial engineers and breed complacency among investors – the precise recipe for more Enron's.

#### *Trade War*

The second pitfall to avoid is a trade war. On March 5th, the president imposed tariffs ranging from 8% to 30% on imports of certain steel products for three years. The result, of course, will be a higher price for steel and a shift in the mix of consumption away from foreign product to domestic.<sup>iii</sup>

As economics, of course, this was not a good idea. While receiving billions of dollars in subsidies,<sup>iv</sup> the U.S. steel industry has earned negligible after-tax profits during the last 20 years. If we are going to engage in industrial policy or try to protect a domestic industry, there are more likely winners.

Surely, the move was motivated by domestic politics. What should concern us is the effect on international politics and the broader implications for trade. One can easily envision escalating disputes at the World Trade Organization that will prevent growth-enhancing reductions in foreign trade barriers. The Doha trade round could stall and fast-track negotiating authority could be useless if it is ever re-authorized.

The stakes are large. During the fifteen years ending in 2000, U.S. exports grew three times faster than the rest of the economy. Approximately one-eighth of U.S. output is now sold overseas, linking the country's present standard of living and growth prospects to foreign trade.

Even if the tariffs somehow don't sour the mood to trade, they undercut the economy just as it is starting to recover. Studies claiming that more jobs will be lost than saved ring true. After all, the price of steel will be higher than it otherwise would be and the United States consumes more steel than it produces.

In any event, the tariffs are another example of an unfortunate event (in this case, foreign steel beating domestic steel) precipitating a reaction that on balance will harm the economy.

### *Economic Stimulus*

The third pitfall is that the stimulus bill signed by the president on March 9th will not offset the effects of the steel tariffs. The bill is too late. It is not stimulus. And it creates damage of its own.

It has been widely recognized for years that fiscal policy makers can't move fast enough to fine-tune the economy. Never has there been more poetic evidence than the passage of the so-called stimulus bill two days after Alan Greenspan told Congress that "an economic expansion is already well underway."<sup>v</sup>

Late might be better than never, but this bill will not stimulate. True and lasting economic stimulus derives from:

- the relentless enforcement of property rights,
- a transparent tax structure that makes it possible to know the implications of decisions ahead of time,
- low marginal tax rates that limit the deadweight loss from taxes, and
- regulatory policy grounded firmly in cost-benefit analysis.

None of this is in the bill. Instead, at least two provisions are counterproductive. First, extending unemployment benefits increases unemployment, as our friends Rich Vedder and Lowell Galloway have shown.<sup>vi</sup> One might argue the merits of unemployment benefits on other grounds, but they will not stimulate the economy. Secondly,

changes made to the federal corporate tax code by the bill will intensify pressure on already weakened state tax receipts.<sup>vii</sup>

Once again, the policy reaction to an event increases the damage.

### *Monetary Policy*

The fourth pitfall to avoid is disruptive monetary policy. We have benefited from an imperfect but adroitly conceived and implemented monetary policy for 15 years. Quite simply, no one has ever done it better than Alan Greenspan. In part, that is why we should be concerned. Policy depends too much on one man, the Michael Jordan of Finance. When Alan Greenspan retires, he'll leave a void in Washington as large as the one left by MJ in Chicago, but with far greater consequences.

One can hardly argue with the success of Greenspan's policy maneuvers. But as in golf and pool, where a good shot is one that sets one up well for the next shot, monetary policy depends on previous moves. And the one move Greenspan has failed to make is to institutionalize price stability.

What is missing is a framework that will guide Greenspan's successors toward policies that protect the purchasing power of the dollar. Quite simply, Congress should require the Federal Reserve to keep inflation within a specific range – ideally one that includes zero – and hold it accountable for doing so. Now is the time to enact such legislation. A leading argument against aiming for low inflation is that the economic costs of getting there would outweigh the benefits. If the argument ever had merit, it no longer does with inflation already at long-time lows.

Complicating matters, policy is currently in motion. If Greenspan retires anytime soon, his successor will take over as policy careens around the corner at ninety miles an hour. From the even keel in 1996-97, policy swung down with the Asia/Russia/LTCM crises in 1998, back up with unfounded fears of an overheating economy in 1999 and 2000, and then back down again with recession in 2001. Today, short-term interest rates stand at historic lows, while the economy is building strength.

Given that the Fed currently implements monetary policy by pegging short-term interest rates, it did the right thing to reduce its target swiftly last year as economic growth retreated. But change creates danger.

Interest rates are the temperature of the economy, naturally rising when activity picks up and falling when it declines. To avoid disturbing the economy, the Fed needs to move its target rate in sync with the natural rate. As indicated by recent economic reports, the natural rate is rising with the fortunes of the economy.

If the Fed does not adjust its rate target promptly at the appropriate time, it will fuel overly rapid creation of money and credit that will require costly actions later. Already, the adjusted monetary base is growing at a 10% clip. If sustained, that rate is consistent with a multiple of the current inflation rate.

Making monetary policy is too much like trying to steer a pontoon boat. It is easy to make small adjustments to stay on course. But big turns invariably cause overshooting in one direction and then the other until things finally get straightened out. With the huge drop in interest rates last year to a level that the Fed acknowledges is too low, policy makers will be challenged to get the timing and size of the necessary upward adjustment just right. This is one of the biggest risks to the coming economic expansion.

## Conclusion

Although these four pitfalls probably will not derail the recovery, the next expansion will be longer and stronger if they could be avoided. Trying to clamp down on high-finance, tinkering with trade policy, passing a hollow and harmful stimulus bill, and relying too heavily on the man calling the shots at the Fed are policies we can do better without.

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## End Notes

<sup>i</sup> Anirvan Banerji, interview by author, March 15, 2002.

<sup>ii</sup> See Michael Boldin, “Dating Turning Points in the Business Cycle, *Journal of Business* 67, no. 1 (1994).

<sup>iii</sup> A unique and enjoyable primer on trade for the layman is Russell D. Roberts, *The Choice: A Fable of Free Trade and Protectionism* (Englewood Cliffs, New Jersey: Prentice Hall, 1994).

<sup>iv</sup> William H. Barringer and Kenneth L. Pierce, *Paying the Price for Big Steel* (Washington: American Institute for International Steel, 2000), p. 112.

<sup>v</sup> Alan Greenspan, Semiannual Monetary Policy Report to the Congress Before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate March 7, 2002.

<sup>vi</sup> Richard K. Vedder and Lowell E. Galloway, *Out of Work: Unemployment and Government in Twentieth-Century America* (New York: Holmes & Meier, 1993).

<sup>vii</sup> David S. Broder. “Ill-timed, flawed stimulus bill penalizes states,” 13 March 2002, p. A19.