

2003 Economic Forecast:
Will the Economy Continue to be Weak?

Remarks Before the
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I am very pleased to take part in the 12th Annual Ohio Tax Conference. The Ohio Chamber of Commerce, Ohio Department of Taxation, and all of the sponsors are to be commended for their ongoing commitment to this educational forum. As so amply demonstrated by today's strong attendance, this is indeed a valuable use of time.

I will begin my remarks with an overview of the outlook for the economy and financial markets, and then discuss the potential effects of key uncertainties, including pending tax law changes. The economy and the tax code are inextricably intertwined. It is common to think about how the tax code affects the economy. What are the incentives or disincentives created toward saving, investing, and producing, for example? Or, how do differences in taxes across states and local jurisdictions affect the health, location, and expansion of businesses?

It is less common to consider how the economy affects tax policy, which is happening now as economic conditions are shaping tax law at both the federal and state levels. The main argument given for the president's tax plan is to stimulate the national economy. Likewise, the Ohio Legislature has been busy rethinking the Ohio code, and last week Governor Taft pointed out the necessity of updating Ohio's tax structure to both balance the state budget as Ohio works through this economic soft spot and provide for balanced growth in revenues with minimal cost to the economy. These reform efforts are among several factors that will shape the performance of the economy in 2003.

Before I turn to the outlook, you should know that I long ago uncovered the secret to successful forecasting: if you give a number, don't give a date, and if you give a date, be sure not to give a number. In all seriousness, what matters to business people like you and me is not knowing the future precisely – that is impossible. Our realistic goal is to recognize the trends and events that really matter and understand how they matter. Maybe equally important is knowing what not to worry about. I will use some numbers and even some dates, but only to help illustrate my thoughts on these points.

First, with respect to the outlook, the recession is over – at least technically, if not officially or in the hearts and minds of the American public. The recession started in March 2001 and ended late that year or in early 2002. Of this, I am certain, even if the recognized arbiter of the business cycle – the National Bureau of Economic Research – has not officially proclaimed the recession over.

The Bureau is withholding judgment, because of the weakness in industrial production and

employment in recent months. There is a chance that this dip could develop into what looks more like a continuation of the last recession than a new one. But the economy has expanded for five consecutive quarters at an annual pace approaching 3%, making that unlikely. In fact, during the last thirty years, growth has averaged only a few tenths of a percentage point faster. Yet it is true that the recent performance has been largely unsatisfying, and in many circles has gone unnoticed. The reason is twofold.

The historical experience derives, of course, from periods of below and above average growth, and it is times like now during which growth tends to exceed the average – often by a multiple of two or three. Moreover, trend growth is insufficient to bring down the unemployment rate, and in the recent climate, has been unable to generate net job growth. Add to this the many negative lagged effects of recession, such as weak federal and state tax revenues, and you are left with the feeling of an incomplete recovery. Throw in the worries over terrorism, war in Iraq, corporate governance, and the stock market and you get the impression that the economy is vulnerable, that the expansion is shaky. While understandable, these assessments are wrong.

Growth might continue to fall short of hopes and expectations this year, but it will continue. A major reason for the relatively slow growth so far is that the recession was – in very broad terms – the mildest on record. The bust in the stock market was quite spectacular, and the deterioration in the technology and communications sectors, and in corporate profits more generally, were extremely severe. Call the downturn uneven, but the overall loss in output relative to trend was the smallest on record.

We are witnessing what economist Milton Friedman calls the rubber band effect. The farther the economy sinks in recession, the faster it snaps back in recovery. The shallower the downturn, the more subdued the bounce-back. Two of the most cyclical sectors – housing and motor vehicles, for example – reached record high levels of activity in the depths of the recession, creating no room for a robust rebound.

Sources of Growth

Even so, a number of factors will keep the economy moving in the right direction, if only at a moderate pace. The main engine of growth will remain consumer spending. Consumers have been hurt by the decline in stock prices. They are burdened with debt and are worried about terrorism, Iraq, the stagnant job market, and so on. But they still spent 3% more in real terms last year than the year before. The reason is that spending depends most on real after-tax income, which increased about 5% last year. The low level of real interest rates is also supporting consumer spending.

In addition, the drop in stock prices has brought about a sense of reality, not a reality of poverty. On average, investors have lost just the gains from the bull market, not the original principal of their investments. When dealing with averages, we must remain mindful of the man who drowned in the river that was one foot deep ... on average. The unequal incidence of stock market losses is painful for many. In aggregate, though, these losses have been partly offset by gains in bonds and in the value of homes, which are a more significant and more widely-held asset than stocks.

Consumer debt is at an all-time high by some measures, but it will not impede growth. The

debt-to-income ratio is a flawed measure of the debt burden, because it mixes a stock with a flow. What matters is the purposes for which debt was acquired and the cost of servicing it relative income.

To a very significant degree, consumers borrowed wisely to buy motor vehicles, houses and other durable goods. Those purchases will provide valuable services while the debt is being repaid. This is a wise and perfectly legitimate use of credit. Secondly, while the ratio of loan payments to income has reached a new high, it is only marginally above its previous peak. In part, the increase was driven by rising home ownership, because mortgage payments are counted as debt service, whereas rent payments are not.

Spending will probably continue to rise somewhat more slowly than income this year, as consumers elevate their rate of saving. This will not impair overall economic growth, though, and is actually a positive development for the longer term.

Most other major categories of the economy will be adding at least modestly to the forward momentum provided by consumer spending. One of the hallmarks of the 2001 recession was the severe drop in capital spending. Companies cut outlays for equipment and software by 13% from the peak to the trough. Since then, spending has stabilized. It has increased for two straight quarters and possibly three. Investment in computers is up 6% over three quarters after falling a total of 15%.

No one expects a speedy return to the double-digit growth rates of the 1990s, but outlays will rise more quickly as businesses gain confidence in the outlook. Already, a quarterly survey by the National Federation of Independent Business of its members indicates that small businesses are as positive on the outlook for the next six months as they have been since the early stage of the recovery from the 1990-91 recession.

A more immediate lift is coming from the replenishing of inventories. The paring-down of stockpiled goods subtracted about \$160 billion from growth in 2001. The economy would have expanded by 1.8% instead of 0.1%. This process reversed last summer, and inventory rebuilding will contribute to growth this year.

One dark cloud is that there is no realistic prospect of improvement in nonresidential construction until late in the year at the earliest, due to very high vacancy rates in most property types in many markets.

A final source of growth will be government spending, which has ramped up due to the recession and anti-terrorism efforts. Government spending is not an engine of long-term growth, but it contributes in the short-term. A substantial and lasting boost could come this year from tax law changes.

Taxes

The president's opening bid on taxes would be a positive for the economy. The main growth-oriented features are fourfold: (1) the elimination of double taxation of most corporate income, (2) the acceleration of all previously legislated marginal rate reductions retroactively to the beginning of this year, (3) increasing the depreciation of business capital expenditures, and possibly (4) reducing the marriage tax penalty. Whatever their other merits, the increase in the child tax credit and the extension of unemployment benefits are not economic stimulus.

First, the double taxation of corporate income under current law distorts decisions by businesses and investors. It reduces investment by inflating the cost of capital. And it makes corporations more prone to bankruptcy by inducing an over-reliance on debt compared with equity. It limits growth and destabilizes the economy.

A cleaner and more complete way of correcting these obstacles to growth would be to eliminate the tax on capital gains and make dividends tax deductible at the corporate level. Both, however, are political nonstarters. Credible analyses show that, as crafted, the proposal could lift stock prices by 10%, and possibly much more. The rise in the market immediately following the announcement and the decline after the proposal ran into opposition support that notion, although other factors were also at play.

Second, accelerating the reduction in marginal tax rates is a twofer. The marginal rate has a lot of leverage on economic growth. This has been the case across time and across political jurisdictions, apparently because of its effect on the decision about how much to work. Therefore, the proposed bracket and marginal rate changes would surely raise the rate of economic growth. The second benefit comes from the removal of disincentives arising from the phased-in reduction in rates, which has a delaying effect on economic activity.

Third and fourth, increasing or accelerating depreciation would probably encourage some additional business expansion. At the very least, it would help get things going sooner. And the marriage tax penalty is just a special case of the marginal rate story.

An important principle for evaluating the effects of tax policy on the economy is that it is not about money; it is about incentives and how they affect behaviors. Passing out checks does not spur the economy, as we learned in 2001, when the tax rebates were saved instead of spent. Incentives embodied in the tax base and in marginal rates are where tax policy really has a powerful effect on the economy.

Although the president's plan met with predictable opposition, the climate might be right for a bidding war in which the tax cuts actually get bigger during negotiation rather than smaller. After all, the latest economic numbers are weak. A key will be whether we can put deficit-phobia behind us.

Budget Deficit

Americans' thinking about the federal budget reminds me of the two elderly ladies dining at a restaurant. One says to the other, "This food is terrible." And the other replies, "Yes, and such small portions!"

When we faced an outlook of unrelenting surpluses, people worried that the central bank could not conduct monetary policy once all the debt was repaid and that Social Security would ultimately have to buy equities and wind up nationalizing a great chunk of the American economy. Well, we dodged that one. But now we are back to worrying about a rising budget deficit forcing up interest rates. Interest rates will rise from today's unsustainably low levels, but not because of deficits.

The link between government borrowing and interest rates is so loose that econometricians can't find it. Too many other factors come into play. What really matters for the economy's long-term health is not so much how government spending is financed – the mix

of taxing and borrowing – but rather how large government spending is relative to the economy that supports it. The news on that front is not sanguine, but if anything, rising budget deficits will restrain growth in spending, which could have positive long-term effects on economic growth.

Monetary Policy

Turning to monetary policy, the Fed has made it quite clear that it will do everything it can to promote economic growth. As you know, short-term interest rates are at forty-year lows. The Fed stands ready to cut them again and again if the economy falters. Already, the overnight borrowing rate for banks is zero, after accounting for inflation – a condition that has always been followed closely by a revival in the economy. Current money and credit conditions are conducive to economic growth, and the spread between short-term and long-term rates – perhaps the best single leading indicator of the economy – is very wide by historical standards.

The Fed meets today and tomorrow, and tomorrow afternoon will announce any interest rate change and which way the committee might be leaning between then and the next meeting in mid-March. Markets have priced in about a 60% chance of another quarter-point reduction by spring. If economic reports are weak between now and then, the Fed will move. My forecast is that they won't need to, and that by late summer they will be on the prowl to raise rates.

A widespread concern has been that rates are already so low that the Fed could soon run out of ammunition. A related worry is that the U.S. will follow Japan into an extended deflationary recession. I haven't been sleeping well lately for reasons I'll get to in a minute, but neither of these has cost me a wink.

First, interest rates are only one of many channels through which monetary policy affects the economy. A more-powerful connection, which would remain completely effective, is money creation. Even if nominal rates hit zero, as in Japan, the Fed could produce a growing supply of money through any number of means, including open market purchases of foreign exchange. In other words, monetary policy will not lose its effectiveness, even if interest rates fall to zero.

Second, deflation in Japan is a symptom of problems in the Japanese economy that do not exist and will not take hold in America. Chief among them is an over-reliance on a severely undercapitalized banking system. The far greater role played by capital markets relative to banks in the United States, and the very strong health of both, inoculates us from Japan-style deflation.

War

The real key to the near-term outlook will be what happens in Iraq. The conventional thinking is that a short and successful war would be good for the economy and that a long, drawn out quagmire would be bad. This is overly simplistic and off-the-mark. There is no serious question as to the outcome of military engagement in Iraq. And even if there were, the \$10 trillion U.S. economy could support a far more costly venture for far longer than it could plausibly last. The significant question for the U.S. economy is the effect on the price of oil.

Each of the five recessions during the past thirty years was preceded – and in no small measure caused – by a large increase in the price of oil. In fact, of the five other post-war

recessions that occurred before 1973, all but the 1960 episode were preceded by what at the time were substantial increases in the price of oil. The war question is really an oil price question. Already, the price of West Texas Intermediate has roughly doubled from its low in late 2001, imposing a new tax of \$50 billion or more annually.

If Hussein spoils the oil fields, or if a backlash leads to an embargo, or if some other scenario produces a sustainably higher price of oil, the U.S. economy will probably experience another recession. It is the uncertainty of the event, coupled with the severity and certainty of the result, that is holding the economy back right now. Not until the confrontation with Iraq is resolved will growth reach its potential.

The logical assumption, seemingly shared by most analysts, is that the price of oil will be back down to a manageable level by spring, and I agree. The catch is that the consequences of the alternative would be terribly costly, and no assurances can change that. Therein lies the primary obstacle to faster economic growth.

Conclusion

In closing, the subtitle of my talk today is “Will the Economy Continue to be Weak?” In the long-run, of course, the answer is no. The so-called New Economy is alive and well in the form of flexible labor, capital, and product markets and a free society with solid economic fundamentals. The enduring result will be strong productivity growth that will lift living standards appreciably over time.

In the short-run, the answer is that it mostly depends on the price of oil. All is not sweetness and light. More time is necessary for completion of the typical cyclical adjustments, but those adjustments are underway. My forecast is that current conditions will give way to stronger-than-expected economic growth over the course of the year. If we are surprised this year, it will be by how quickly the economy gears up and attitudes improve. By this time next year, interest rates will be rising in response to higher inflation expectations and a strengthening economy.

I wish you all the best in the year ahead.

Figure 1a
Price of Oil
Dollars Per Barrel

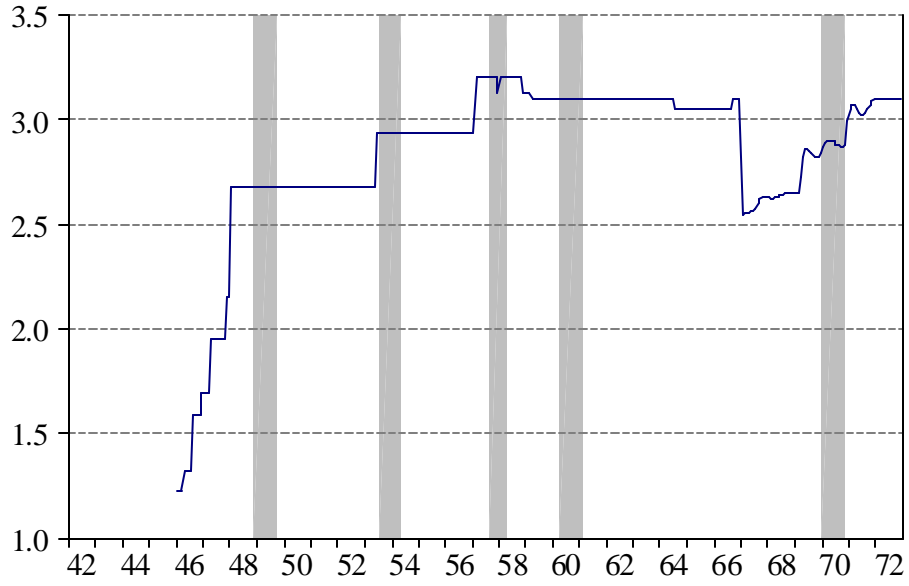


Figure 1b
Price of Oil
Dollars Per Barrel

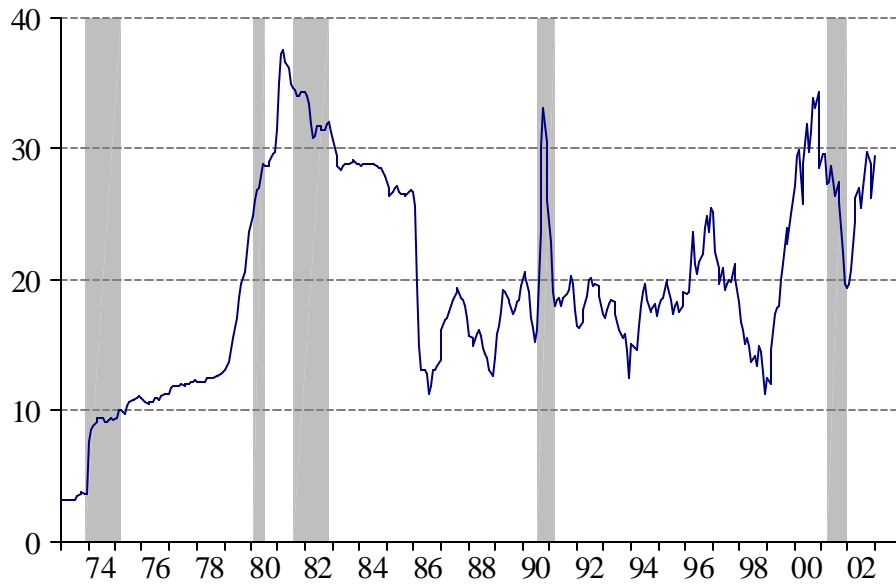


Figure 2a
Price of Oil
12-Month Percent Change

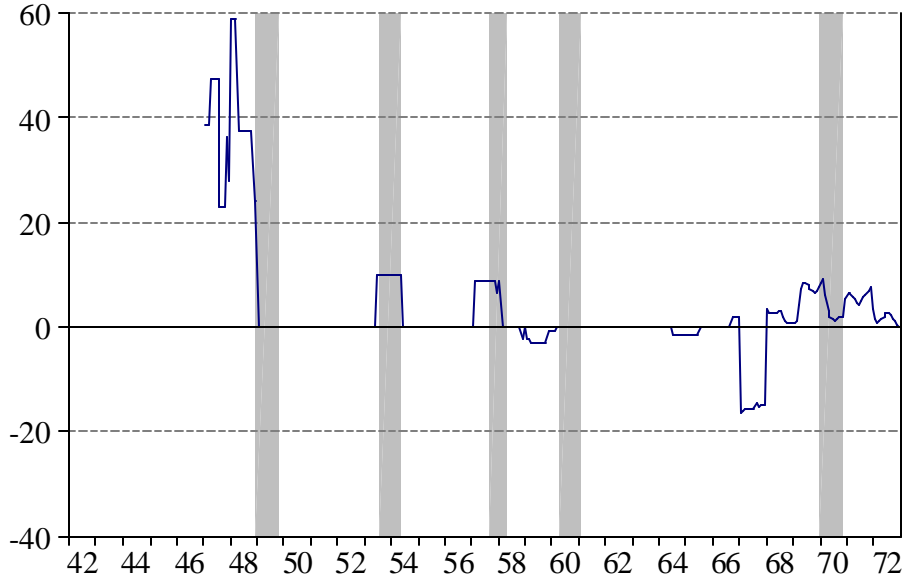


Figure 2b
Price of Oil
12-Month Percent Change

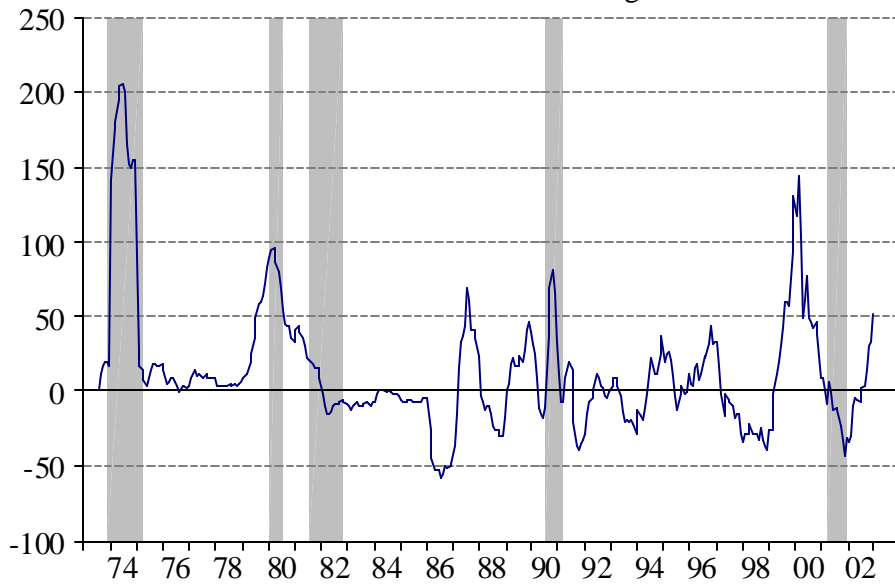


Figure 3a
Price of Oil
Percent Change From 24-Month Low

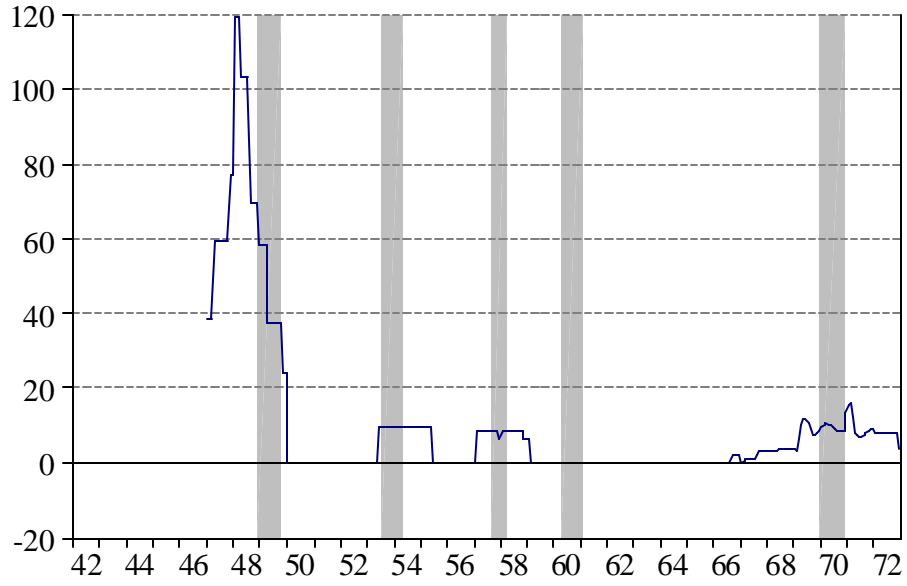


Figure 3b
Price of Oil
Percent Change From 24-Month Low

