

THE ECONOMIC OUTLOOK FOR 2003

by

Charles I. Plosser*

William E. Simon Graduate School of Business Administration
University of Rochester

*Delivered at the
Economic Outlook Seminar
Hyatt Regency Hotel
Rochester, New York
December 11, 2002*

As useful as it can be to us in our businesses and personal planning, forecasting is risky business, especially when it is about the future! There is an old saying about forecasting and it goes like this: “If you can’t forecast well, forecast often.”

The State of the Economy

Last year was a great illustration of the wisdom in that old adage. It seemed like every month there was a new story or revelation that had potential impact on the U.S. or world economy. The topics included war in Afghanistan; new terrorist attacks around the world including Bali, Russia, and now Kenya; risks of war between Pakistan and India; potential war with Iraq; nuclear weapons in North Korea; continued violence in the Mideast, and if that wasn’t enough turmoil around the world, we were further shocked by a sniper terrorizing our nation’s capital and surrounding areas.

Other topics of a more economic nature also attracted front page headlines, including the virtual collapse of the Argentine economy and the continued economic trials of Brazil, not to mention Japan and Germany; further revelations of fraud and abuse in corporate America, which last fall seemed largely confined to Enron, yet slowly grew to include companies such as WorldCom, Tyco, Adelphia, and Global Crossing. These experiences resulted in investigations and new regulations such the Sarbanes-Oxley Act and a new accounting oversight board. Whether the political and regulatory responses were appropriate or will be effective is an open question, but they have certainly increased the costs of doing business and generated their own brand of uncertainty in the marketplace.

Other economic-related events in 2002 included greater protectionism from the Bush Administration in the form of increased tariffs on steel and timber and the lavish agricultural subsidies that threaten trade relations with the rest of the world and reduce growth prospects in many developing countries. Also on the policy side, we had the creation of the Transportation Safety Authority at the cost of billions of dollars to buy new uniforms for airport screeners and train them how to politely take nail clippers from grandma as she tries to sneak them on to airplanes. Those of

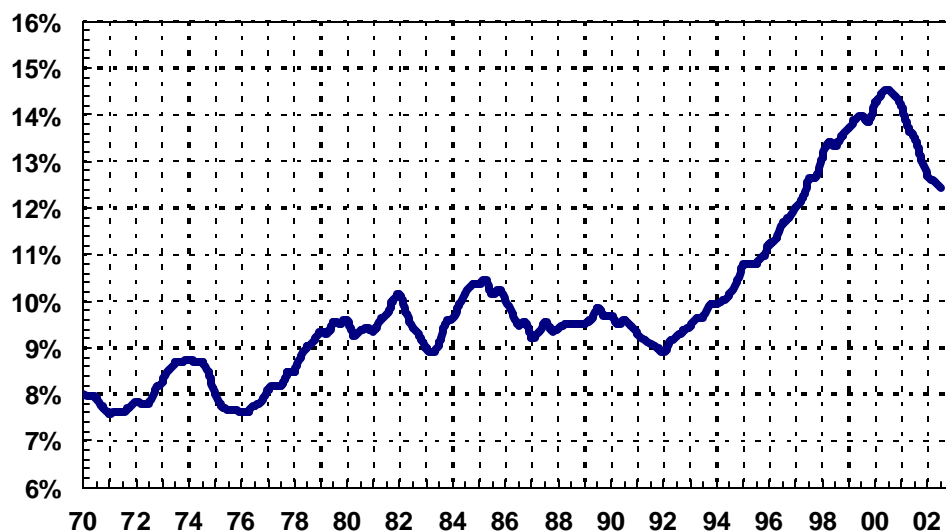
* The author is Dean and John M. Olin Distinguished Professor of Economics and Public Policy at the William E. Simon Graduate School of Business Administration, University of Rochester, Rochester, NY 14627.

you who fly regularly surely have seen dozens of these people standing around doing little as passengers stand in long lines, waiting because someone had too much metal on their belt or steel shanks in their dress shoes and had to be scanned and searched. It is no wonder airlines are having trouble attracting the frequent fliers back. The air carriers' costs are up and customers are frustrated. We now are lucky enough to have a new Department of Homeland Security which promises yet another avenue to ever higher government spending and a larger role for the federal government. To add insult to injury, we suffered through a longshoreman's strike/lockout in which 10,000 relatively highly paid workers imposed staggering losses on an already weak economy. Nowhere have these uncertainties been more acutely reflected than in the performance of the stock market.

Who could have predicted this series of extraordinary events, none of which can be viewed as positive for the economy as it struggled to recover from recession? Yet despite this pessimistic accounting of the turmoil that helped shape 2002, the economy did grow and grew more than most forecasters expected. During the first three quarters of 2002 the economy grew at a 3.4 percent rate. Thus despite all the bad news, the economy has begun its recovery, albeit not as rapidly as we would like.

It is useful in understanding the halting recovery to reflect on the underlying cause of the recession in the first place. The initial cause for the slowdown began way back in the spring of 2000 with a sharp deceleration in the rate of business investment. This was largely attributable to the reduction in spending on computers and information technology that had grown substantially in the late 1990s in anticipation of Y2K. This investment boom of the late 1990s and the subsequent decline are apparent in Figure 1.

Figure 1
Ratio of Real Business Investment to Real GDP

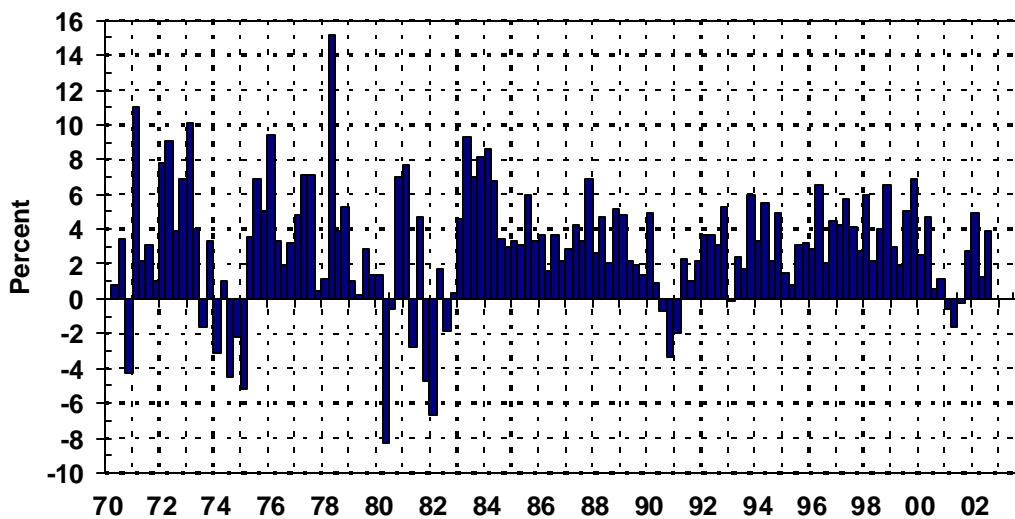


The cutback in total spending was exacerbated by the terrorist attacks in September 2001 which caused a temporary reduction in consumer spending. Adding to the woes in 2001 were the revelations concerning Enron and Arthur Andersen. Had the bad news merely stopped there, the economy would likely have rebounded nicely, but the bad news continued. The war on terror and new government edicts forced a reallocation of resources and investments for the public and private sectors; new accounting scandals erupted; bad policy choices and strikes all raised the general level of uncertainty in the economy. This increase in uncertainty has been reduced, but has not entirely gone away and business investment, which holds the key to a more robust recovery, is unlikely to make a significant turn around until more of it is resolved.

There is another kind of policy uncertainty that is currently at work restraining business investment. The phased-in nature of the tax cuts in 2001 actually has a detrimental effect on the economy in the short-run as they encourage businesses and individuals to defer earnings and investment into later periods when the tax consequences are more attractive. The tax reductions would have had a more beneficial impact had they come into effect earlier. Now, in the wake of the Republican victory in November, there seems to be a strong belief that more tax relief will be coming early next year. This anticipation causes firms to further withhold investment decisions until the tax breaks actually take effect.

Yet despite all of these concerns, the outlook is not as bad as it would appear. To begin with, the recession has been remarkably mild. In fact it will probably go down as the mildest recession in the post-war era. Figure 2 shows the growth rates of real GDP since 1970. The recessions of 1970, 1975, 1980, 1982, 1991 and now 2001 are apparent from the periods of negative growth rates. As the picture suggests, the declines in GDP in 2001 are much smaller than in any other recession. The decline in GDP during the 2001 recession was just 0.5 percent compared to an average decline of 2.4 percent.

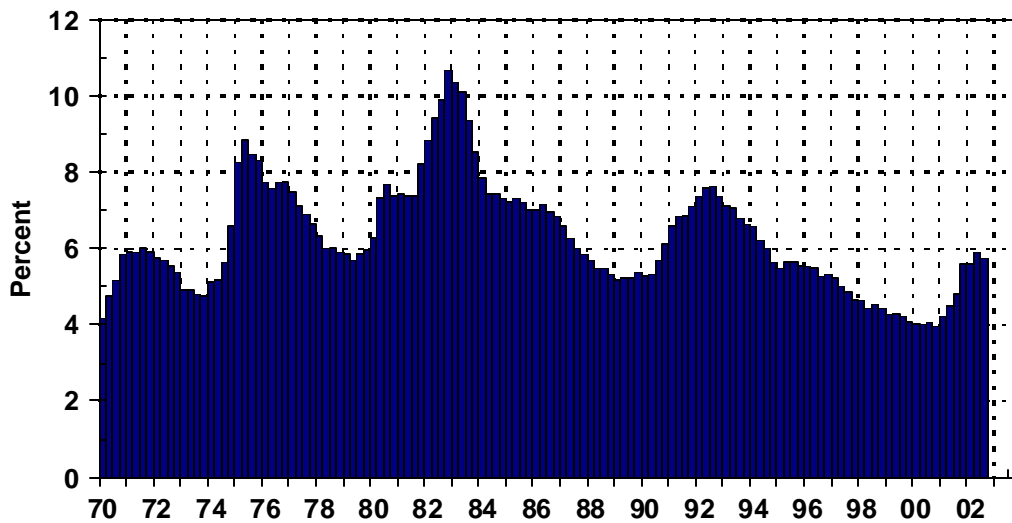
Figure 2
Real GDP Growth



The recession has been mild from the unemployment rate perspective as well. Figure 3 shows the unemployment rate back to 1970. The peaks in the unemployment rate represent recessions. The recession of 2001 resulted in the second smallest increase in the unemployment rate of any post-war recession except for the very brief and controversial recession of 1980. That recession was controversial because many economists thought that the 1980 and 1982 recessions should have been characterized as one recession, not two. Nevertheless, the 2001 recession has seen an increase of 2.1 percentage points while the average increase is 3.1 percentage points.

I find it interesting that the headlines reporting the recent increase in the unemployment rate to 6 percent, prominently noted that it was tied for the highest rate in eight years. They didn't point out that the rate hit 6 percent just last April and that the previous time was August 1994—three and one-half years into the recovery from the 1991 recession! Today we are barely a year into recovery. Clearly this reporting was intended to use the facts to alarm rather than truly inform.

Figure 3
Unemployment Rate



Despite the mildness of the recession, or perhaps because of it, the major concern has been that with the continued negative shocks to the economy, the recovery has not gathered any momentum. The major factor holding the economy back has been the unwillingness of businesses to invest.

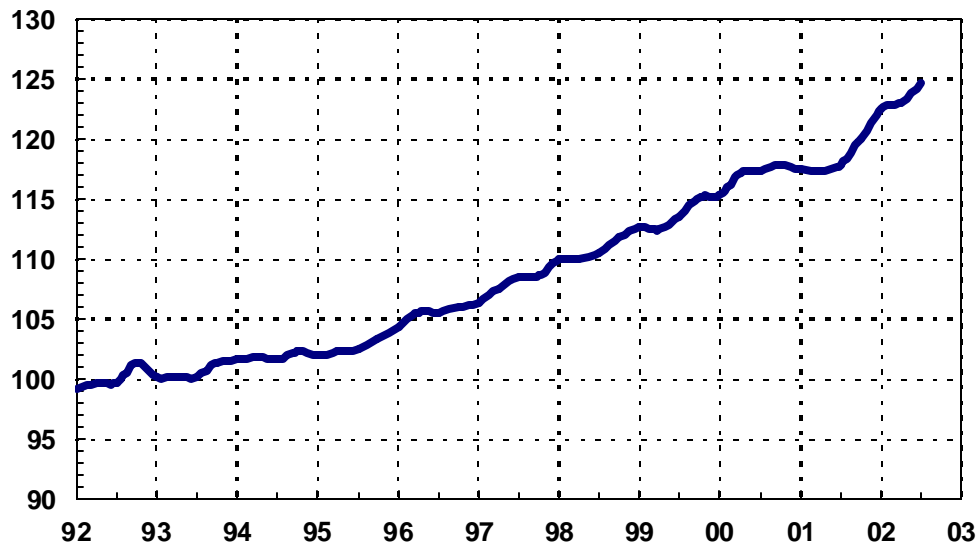
There are, however, many reasons to feel optimistic about the future. You often hear it claimed that the consumer has been the one bright spot in this recession, and that is true. Of course, that is true in almost every recession. Consumption never declines as much or as dramatically as investment during a downturn and never expands as rapidly during the expansion. This recession was not an exception to that rule. During the last three quarters, real consumption has grown at an

average annual rate of 3 percent while business investment has declined at an average annual rate of about 3 percent. More importantly, consumption growth was a robust 4.1 percent in the third quarter of this year.

There is more good news. Productivity growth (see Figure 4) has accelerated during the last year—increasing at an amazing 5 percent annual rate so far in 2002. At the same time real compensation in the business sector has also increased. This bodes well for the sustainability of consumption spending into next year. Of course the flip side of the rapid productivity growth is the slower growth in employment, but even that is improving (see Figure 5), notwithstanding the small drop that occurred in November.

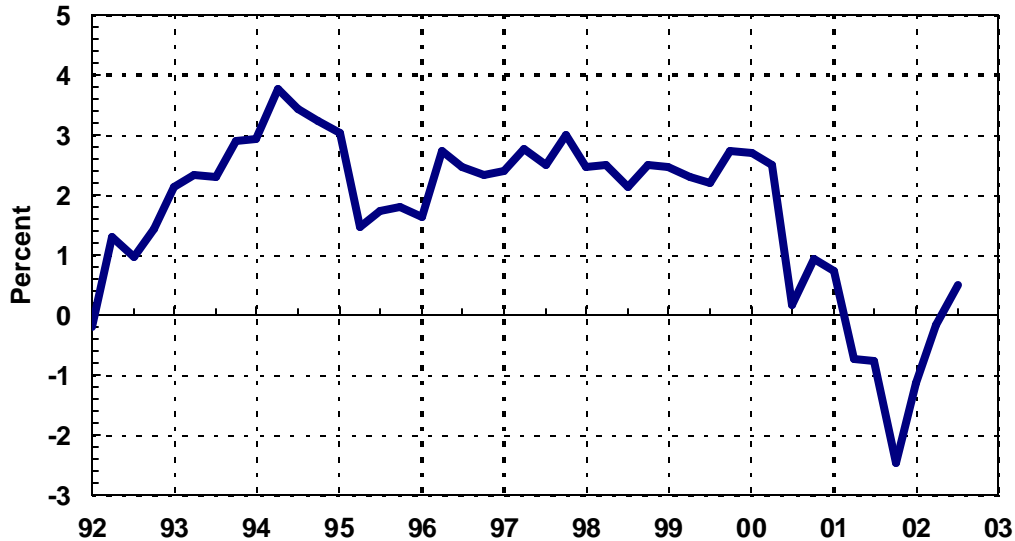
Even the profit picture shows some signs of improving. Corporate profits have improved every quarter this year. They have been growing at almost a 7 percent annual rate since they bottomed out in the 4th quarter of 2001. It is true that they have yet to return to pre-9/11 levels but the trend is still positive. The higher productivity is also the result of U.S. companies becoming significantly more efficient and hence competitive during the last year. This is good news for the profit outlook in the coming year.

Figure 4
Business Sector Productivity



Another positive sign from the corporate sector is that the rapid inventory contraction has ended and businesses have started rebuilding inventories. There is also evidence that new orders for durable goods are rising, which is encouraging for the future of business investment.

Figure 5
Growth in Nonfarm Employment



The Outlook for 2003

There is little doubt that the economy is recovering. Yet uncertainty about the future remains a drag on business investment thus preventing a more robust rebound. Nevertheless, it seems reasonable to predict that these uncertainties will continue to wane as the New Year progresses and businesses will gradually begin to undertake new investment. Despite a more upbeat outlook for 2003, however, be prepared for what appears to be a weak fourth quarter of this year. Do not be dismayed—the fundamentals remain in good shape.

Table 1 provides a quick overview of the key economic indicators and the predictions for 2003 (Table A1 provides a more detailed report of the forecasts). Real GDP growth will accelerate somewhat from the 2002 rate; consumption spending will continue to grow in the 3.5 to 4.0 percent range; the unemployment rate will decline slowly, perhaps reach 5 percent by the end next year; inflation will remain in check, and interest rates will gradually begin to rise above their lows.

While this is not an extremely bullish forecast, it is upbeat and one that stresses the underlying strengths of the economy. While there is always room for error, this is one occasion where I believe there is more upside potential than downside. The downside could occur if a war with Iraq goes terribly awry or there is another serious terrorist attack on U.S. soil. The upside potential could be considerable if war and policy-related uncertainties are quickly put aside and businesses resume investment spending.

Table 1
FORECAST SUMMARY

	Actual 2000Q4-2001Q4	Forecast (12/2001) 2001Q4-2002Q4	Forecast (12/2002) 2002Q4-2003Q4
Real Gross Domestic Product (2002Q4-2003Q)	0.1%	3.0%	3.2%
Real GDP (Annualized Year over Year)	0.3	1.2	2.5
Real Consumption	2.8	3.9	3.6
Unemployment Rate	4.8	5.4	5.2
GDP Price Deflator	2.0	2.3	1.3
3-Month T-Bill Rate	3.4	2.7	2.1
10 Year T-Bond Rate	5.0	4.5	4.2

Do We Need More Monetary or Fiscal Stimulus?

Given the state of affairs, is it time for Washington to entertain initiatives to “jump start” the economy in 2003? With Republicans retaining control of the House and gaining control in the Senate, the political likelihood for an economic stimulus package from Congress has gone up significantly.

There are basically two schools of thought regarding the role of policy. One view is that fiscal policy initiatives are required to stimulate the economy during a time of weakness. The rationale is to stimulate demand in the short-run through temporary tax breaks or rebates of one kind or another. The key element here is that the policies are temporary. When economic strength returns the temporary incentives disappear. Examples include temporary tax rebates or tax “holidays” and temporary investment tax credits.

The main problem with this approach to stabilization is that the evidence shows that it is not very effective. Individuals typically respond to a temporary tax rebate by saving it or, equivalently, using it to pay down debt rather than spending it on increased consumption. As a result, the policy does not achieve its objective of stimulating consumption demand.

Moreover, in the current environment, where the problem is sluggish business investment due to widespread uncertainty, a policy targeted at increasing consumption demand doesn’t really get at the heart of the problem. After all, consumption spending has remained reasonably robust and yet business investment has yet to recover. On the other hand, it would seem that a temporary investment tax credit or temporarily permitting faster write-offs on equipment might be just the ticket to stimulate business investment. This is, perhaps, more appealing on the surface, but again experience suggests caution.

On-again, off-again tax policy often induces more volatility into business investment, not less. This is because businesses naturally try to anticipate these opportunities and will rush to undertake lots of investment when the tax credit is available and then shut down investment as much as possible when it is not in place. This fosters a kind of boom-bust cycle in investment. Even today, businesses are anticipating that Congress will pass some sort of stimulus package early next year and so are, quite rightly, attempting to withhold any investment in the latter part of 2002 until 2003 when the tax treatment is likely to be more favorable—thus dampening the economy in the current quarter.

As you can see I am not very positive regarding the efficacy of using temporary tax policy to fine tune or stabilize the economy. Having said that, there is a second school of thought that argues the most important role for tax policy is promoting long-term growth and efficiency. In that regard, there are some good things that the new Congress and the Administration could usefully do. First on my list is tax reform and simplification. The U.S. tax code is nothing short of an abomination. It is full of unnecessary complexity, it discourages saving and investment and distorts both individual and corporate behavior in dysfunctional ways.

I, along with most economists, favor a tax system that is more like a consumption tax rather than an income tax. There have been numerous proposals along these lines such as a value-added tax or a flat tax—either of which can be constructed to achieve the same objectives as a true consumption tax.

Since I realize that politically this is likely just a dream, I would encourage Congress and the Administration to abandon any efforts to create temporary tax breaks and focus on five initiatives that are already being debated:

- Move the already legislated tax cuts forward to take effect immediately. This will eliminate the negative impacts of the phase-in strategy.
- Make the tax cuts permanent. While nothing is permanent in Washington, the idea is to disabuse people of the idea the tax cuts are specifically temporary.
- Eliminate the corporate income tax or, at a minimum, the tax on dividends. I would marginally prefer to eliminate the tax on dividends at the corporate level rather than at the individual level because it is likely to have a greater direct impact on corporate behavior.
- Eliminate the Alternative Minimum Tax (AMT).
- If elimination of the corporate income tax is not feasible, then focus additional tax reductions that favor business investment.

These initiatives would go a long way toward promoting a more efficient tax code that would, in turn, promote long-term growth.

If fiscal policy is not a good tool for fine-tuning the economy, is monetary policy better equipped for the challenge? Here again, the track record is weak and timing is everything. Chairman Greenspan seemed to justify the latest reduction in rates on the grounds that the economy was in a “soft spot.” While none of us is quite sure what that means or how it can be used to guide

monetary policy, it utterly fails to address the fact that monetary policy works with a lag. If the economy is weak now, monetary stimulus now will not likely have an impact for many months to come. Thus, the case for cutting rates in November was not a compelling one in my mind. Moreover, if the Federal Reserve really believes that the economy is fundamentally sound but facing uncertainty due to “geopolitical risk,” then it is entirely unclear how or why temporarily lowering interest rates will reduce or offset that type of uncertainty. The danger of this strategy, of course, is that by the time the monetary stimulus begins to kick in, the economy will be growing and inflation rising and the Fed may be forced to raise rates more aggressively than they otherwise would to control inflation.

So for the near term, I believe that the appropriate stance of monetary policy is to stand pat. By the Fed’s own assessment the underlying economy is sound and recovery is underway.

Will the U.S. Catch the Japanese Disease?

Unfortunately, the Federal Reserve’s success in reducing inflation and its aggressive attempts to revive the economy by cutting interest rates have become yet another worry to the perpetual pessimists. The new villain is deflation and the fact that interest rates are now so low that monetary policy may soon become ineffective at stimulating the economy or preventing deflation. The fear is that the U.S. economy is in danger of mirroring that of Japan. Japan, of course, has been mired in a decade-long slump averaging just 1 percent real growth annually and since the mid 1990s has experienced a deflation rate of almost 2 percent per annum. Moreover, interest rates in Japan are close to zero with the Bank of Japan worried that they have done all they can do to combat deflation or boost the economy. This is not a record many countries would seek to emulate.

Yet the pessimists are off base again. Many of you recall that in the late 1980s there were many authors and self-proclaimed thought leaders who expressed the view that the U.S. was doomed to be overtaken economically by the much superior Japanese form of capitalism and that unless we learned important lessons about industrial policy, employment policy and trade policy, “Asia, Inc.” would one day rule the world.

Given Japan’s performance and the performance of the U.S. over the last decade it is apparent that these people could not have been more wrong. They had a fundamental misunderstanding of the relative strengths of the Japanese and U.S. economies. By like token, the current alarmists who identify Japan’s problems with deflation and zero interest rates and worry that the U.S. is headed for the same catastrophe also misunderstand the nature of the Japanese problem and the role that inflation or deflation play.

U.S. conditions differ substantially from Japan’s. Japan’s banking system is dysfunctional and nearly bankrupt, its capital markets are inefficient and its product and labor markets have severe structural problems. Perhaps most important, Japanese policy-makers lack credibility to make meaningful reform in any of these arenas. By contrast, the U.S. banking system is fundamentally strong and the capital markets remain the most efficient in the world.

Deflation is not the cause of Japan's stalled economy and moving to a positive rate of inflation alone will not revive it. Deflation has exacerbated the problems, particularly in the banking sector, but it is not the cause. Moreover, the Bank of Japan has steadfastly refused to do what is necessary to stop deflation even though it has the tools at its disposal. With approval from the Ministry of Finance, the Bank of Japan could undertake any number of initiatives that would raise liquidity and promote inflation yet it has refused to do so to any significant degree.

The U.S. has low inflation, not deflation, and interest rates are still above zero. Thus we are not in the same situation as Japan. Moreover, the Federal Reserve has openly discussed the fact that even at zero interest rates they are able to purchase longer term government bonds, foreign exchange and even stocks, if necessary, to raise liquidity and promote inflation if they so desired. Thus, the U.S. is in no danger of contracting the Japanese disease.

It would be nice to conclude from these musings that the storm clouds have passed and 2003 will be clear sailing. That, unfortunately, is a bit too optimistic. Nevertheless, I think it is fair to say that the skies are clearing and that partly cloudy weather will make for more sunshine in the coming year.

Table A1
U.S. ECONOMIC OUTLOOK

	Actual	Forecast ¹					2002Q4 - 2003Q4
	2002Q3	2002Q4	2003Q1	2003Q2	2003Q3	2003Q4	
National Income Accounts							
Real Gross Domestic Product	3.9	0.4	2.1	3.1	3.9	3.8	3.2 (± 1.2) ²
Real Consumption Expenditures	4.1	1.3	3.9	3.3	3.7	3.5	3.6 (± 1.0)
Real Nonresidential Fixed Investment	-0.7	3.7	3.5	4.6	4.9	5.0	4.5 (± 3.1)
Real Exports	3.3	13.0	12.4	12.3	12.8	12.8	12.5 (± 3.0)
Real Imports	2.3	10.5	2.6	8.7	8.8	10.0	7.5 (± 4.0)
Net Exports (Billions of 1996 \$)	-487	-493	-468	-468	-466	-469	-468 (± 21)
Employment, Prices and Money							
Civilian Unemployment Rate (%)	5.7	5.6	5.5	5.3	5.1	4.9	5.2 (± 0.6)
GDP Price Deflator	1.0	1.2	1.0	1.2	1.4	1.6	1.3 (± 1.0)
Trade Weighted Exchange Rate	-6.1	1.6	1.6	3.7	4.5	4.7	3.6 (± 5.8)
3-Month Treasury Bill Rate (%)	1.6	1.4	1.7	2.0	2.2	2.4	2.1 (± 1.5)
10-Year Treasury Bond (%)	4.3	3.9	3.9	4.1	4.3	4.5	4.2 (± 1.8)
Monetary Base	6.2	5.0	8.1	7.9	7.2	6.7	7.5 (± 0.8)

¹ Unless indicated, all forecasts are expressed as annual percentage rates of change.

² All statistical forecasts are subject to error. The numbers reported in parentheses indicate the approximate margin for error. Specifically, they show the band around the forecast in which the actual value will occur about 67 percent of the time.

