Fasten Your Seat Belts—It's Going to be a Bumpy Economic Ride

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The one good thing that economists can say about our current economic situation is that it looks so grim, things can only look up from here. While dismal scientists rarely speak optimistically, I'm going to try: Overall, if we persist with current policy settings, the economy will eventually start to show signs of recovery. Indeed, income and output numbers are showing positive growth.

The problem is that so far this has been a jobless recovery. Employment is still falling and unemployment is still rising. By simple arithmetic, this implies that productivity growth is also quite strong, which is a good thing. But fast productivity growth also means we need robust output growth to keep the same number of people in a job this year as last. And it looks like we are going to fall below this rate of growth—often called growth in potential output. The result? We are seeing moderate growth in output, but a slow loss of jobs. Hopefully, by the end of the year, output growth will pull ahead of potential growth and unemployment will at least stabilize.

In terms of policy settings, the levers are all set to go. Federal Reserve Chairman Alan Greenspan has interest rates at an historical low (and almost as low as they can go), and has signaled that he is willing to keep them there for as long as it takes. This should give us all confidence. The weak U.S. dollar—which seems to attract misinformed commentary—presents good news for exporters: selling our goods at the same prices in US dollars translates to a price cut in foreign currency, which should stimulate export demand.

The real optimists among us will also point out that tax cuts are appearing in our paychecks, which should stimulate spending. Unfortunately this is where the good news ends. For all the talk of this being a stimulatory package, President Bush's tax cut program probably isn't. Most of the tax cuts are going to turn up in your paychecks in several years, not the next few weeks. And unless you are rich, you aren't going to see much of a tax cut anyway.

My bet is that more of the tax cut will end up as larger bequests to the children of the rich, than as stimulatory spending. Worse, even as these ill-targeted cuts fail to provide much of a pick-me-up, government borrowing will cause interest rates to rise, crowding out productive private section investment.

The stakes for getting the policy settings right couldn't be higher. Unfortunately the world economy is fairly weak at the moment, and the traditional engines just aren't firing. Not only is the U.S. in a slowdown, but Japan is in a prolonged decade-long slump, Germany is in recession, and the rest of Europe is only just getting by.

Two serious clouds further darken the horizon. One is deflation. The real fear there is not that people will stop spending in the face of falling prices, but rather that interest rates cannot fall below zero percent. What really matters to business investment is the real interest rate—that is, the announced interest rate less the expected rate of inflation. If nominal interest rates are zero, and prices are falling, then real interest rates remain high, which could choke off a recovery. Monetary policy at that point becomes impotent—or even worse—a destructive force.

Also looming is the possibility that we are in the midst of a residential real estate bubble, much as we were in an Internet bubble a while ago. If this is the case, then we might see property prices fall dramatically, and as we all feel less wealthy, spending will collapse. Some even argue that this might be a global phenomenon, which would be a horrifying prospect. While a sharp fall in home prices seems unlikely, it would probably set in motion similar forces to those seen during the tech wreck, and at this fragile stage, another shock would probably lead to a much more persistent recession.

Want to do something to really help this economy along? Don't just sit on that tax cut, and don't just go out and spend it. If you received a big tax cut, it's probably safe to say that there are others who are suffering more from this recession. Don't just blow the money. Send it along to a non-profit that can help those currently out of work. And you can bet that these folks will help boost spending. Perhaps enough concerned citizens can help redirect those tax cuts to where they are desperately needed.

-- Justin Wolfers is Assistant Professor of Political Economy at the Stanford Graduate School of Business