RECOVERY DELAYED

High gasoline prices and uncertainty over the Iraq war have delayed the economic recovery. While stronger growth had been expected to begin in the third quarter of the year, it now appears that the recovery will be delayed by at least a quarter.

The economy struggled through 2002, though growth was positive in each calendar quarter. This slow, stumbling performance had been expected to end by mid-2003. Now it appears that the sluggish performance will go on for an additional few quarters. The likely profile of the recovery would be clearer if the extent of the war were known.

In 2002, the economy grew largely because of the strong spending of households. Many households augmented their purchasing power by re-financing their houses at low interest rates. This source of strength can only be sustained if rates fall further in 2003. My view is that the Fed will lower rates further if the economy appears to be in danger of a second dip, and that the lower rates plus the fiscal stimulus we expect will be sufficient to avert a second recession. More likely, the economy will continue stumbling without strong growth until late in the year.

Growth at a rate of 2 percent or less can be expected through most of 2003, with growth at a rate of 3 percent plus being delayed until near the end of the year.

HOUSEHOLD SPENDING

Households were strong purchasers of autos and residences in 2002. This behavior has been the strong point of the recovery to date. A strong drop in consumer confidence in February, coinciding with a decline in the sales of large, energy-using vehicles, suggests that household spending may not continue to be strong throughout 2003. Higher gasoline prices will restrain consumer spending, especially of low-income cash-constrained households.
Household wealth remains high. The decline in the stock market has erased the growth of several years of boom, but stock prices remain substantially higher than they were a decade ago at the start of the last economic recovery. Many people are still able to retire with more purchasing power than they had expected they would have a decade ago.

Households have continued to invest in residential real estate. While house values have declined in some markets, like Silicon Valley, they have held their values or increased their values in most markets. Households have the financial resources to continue spending at 2002 levels even if income growth falls. The question is whether they will have the confidence to spend, not the wherewithal.

The effect of the war on consumer confidence is an unknown. It will have a strong influence on the direction of consumer spending in 2003. Certainly the decline in confidence reported in surveys in recent months has coincided with news of war. No one can be sure of the extent to which it is the war that has constrained consumer spending.

Finally, higher oil prices add uncertainty to the decision to buy autos. Sales of SUVs have fallen as gasoline prices rose recently. Certainty about the course of oil prices in the future will help car sales.

**BUSINESS SPENDING**

Inventories have not yet been fully replenished following the recession of 2001. Inventory replenishment had been expected to be a major source of strength in 2003, but the postponement of production decisions by firms will delay the inventory boom. The most recent statistics for durable goods orders and the decline in the purchasing managers index suggest a slowing of production in the near term for producers of intermediate goods.

Competition from China is also hindering the production of manufactured goods at all levels from simple components to finished machinery. The fear of Chinese competition is hindering investment decisions in the manufacturing sector. Managers may find it difficult to identify the source of weakness in their sales, and may mistakenly attribute to China the weakness caused by the sputtering economy. Long term investment is less likely in an environment where strong Chinese competition is expected.

Spending on Business Equipment and Software grew in the fourth quarter of 2002, reversing a long period of decline. The turnaround in this sector had been one of the sources of strength anticipated for 2003. The modest strength in business investment exhibited to date suggests that even sustained economic weakness in 2003 is unlikely to turn into a second full-blown recession.

**THE COST OF THE WAR**

There are no good estimates of the likely cost of the war in terms of the added production needed in 2003. First, the extent of the war is unknown. Second, there are many ways to count costs, some of which include the depletion of inventories of old weapons with limited future shelf life. To use weapons now in storage will not add to production in 2003.

Published estimates of the war’s cost have ranged from $50 billion to $200 billion, or from .5 percent to 2 percent of GDP. The injection of $200 billion purchasing power into the economy in 2003 would be sufficient by itself to return the economy to a path of strong growth. The likely injection will be much smaller than this,
however. Spending was increased substantially in 2002, so the increase of spending in 2003 will be much less than the war’s total cost. In a war estimated to cost $99 billion, for example, if $33 billion was injected in 2002 and $66 billion is injected in 2003, the increase in spending in each year would amount to $33 billion. Thus the amount added to growth in 2003 would be equal to the amount added in 2002. In this case spending for the war would not be a source of added growth in 2003.

The most widely cited estimate of the war’s cost is $100 billion. Some of this has already been spent in 2002. Some represents the cost of weapons to be withdrawn from inventory. Hence the impact on the economy in 2003 of a $100 billion war may not be large.

Even if the cost of the war were known, its economic repercussions would be hard to compute. The National Guard includes many soldiers who will leave jobs temporarily in the United States. The replacement of these soldiers with part-time help will affect domestic production in unknown ways. The disruption of normal family life and the uncertainty of when these worker-soldiers will return complicates the spending decisions of their families.

A decade ago during Desert Storm, consumer spending was restrained in a display of solidarity with the troops. Similar restraint could tip the economy into a brief decline in 2003.

STATE AND LOCAL GOVERNMENTS

All state governments are facing a financial pinch. The need to increase revenues or cut spending in the next fiscal year will be about $100 billion for the states as a whole. This drain is likely to be larger than the added spending for war.

Why the effect on state budgets of this modest recession was so large is not completely understood. The culprits include a) optimistic forecasts of revenue based on optimistic forecasts of economic growth that were based in turn on the mistaken view that the economy had entered a new era of higher growth; b) a misunderstanding on the part of the whole economics profession of the extent to which stock market profits had led to higher personal and corporate incomes, and hence to higher tax payments; and c) continued high rates of growth on spending for prisons and medical care.

EXPORTS

Continued weakness in foreign economies has constrained export growth. The high value of the dollar between 2000 and 2002 further restrained exports. The outlook for exports in 2003 remains weak. The recent decline in the value of the dollar will help exports but foreign economies have grown weaker, not stronger over the year. No improvement in the trade balance is expected in 2003.

INTEREST RATES

Interest rates will follow the economy in 2003, not lead it. If the economy appears to be weakening, the Federal Reserve will lower interest rates. If the economy appears to be strengthening, the Fed will raise rates. At this date, interest rates continue to fall.

Long rates are market determined and follow short rates with a long and variable lag. Long rates are strongly affected by investor expectations, which in turn are based on history. It is hard for investors to accept that today’s long-term rates are not low by historical standards. But I believe that if the economy weakens
substantially, long rates can fall another percentage point. Even if the economy behaves as I expect – sputtering through early 2003 – long rates are likely to decline.

**DEFLATION**

The fear of deflation is misplaced.

Deflation is a continuing decrease in the general price level. Temporary fluctuations in the price level, up and down, are not referred to as inflation and deflation, and a one-time decline in the average price level caused by a one-time decline in the price of food, for example, is not generally referred to as deflation. Deflation is a falling price level that continues to fall for an extended period of time. We have not experienced deflation since the Great Depression. I see no signs that a deflation is imminent.

In a sustained deflation, costs would have to decline along with prices. The cost of labor is unlikely to decline. Labor cost inflation increases during booms and decreases during recessions. In recent years, a decline in labor compensation of a full percentage point has taken place only when the unemployment rate has been increased by two percentage points and held at that level for a year. Labor compensation is now increasing at a rate of 3 percent to 4 percent per year. It would take a major prolonged recession to bring labor compensation down. In my view, labor compensation, which is a necessary ingredient of true deflation, would not decline in the absence of a major recession, hence deflation itself cannot be viewed as a possible cause of a recession.

Admittedly, several kinds of prices have fallen recently. Others, such as medical care have continued to increase. But the prices of products made largely out of labor cannot decline for very long unless the cost of labor declines. Products made largely from other resources can and do fluctuate up and down, and it is useful to remember which kinds of products have this feature.

**Raw Materials.** Prices of raw materials always come down during recessions. The markets for raw materials operate in textbook fashion. When demand falls, prices of raw materials fall. When recovery comes, raw materials prices rise. Raw materials prices declined in recent years, but there is nothing unusual about the recent decline in those prices or in the relation of the decline to the business cycle to suggest that these price declines are harbingers of a general deflation. Indeed, in recent months, raw materials prices have started to recover.

**Imports.** Import prices depend on the exchange rate. Exchange rates fluctuate. The dollar strengthened substantially in recent years. This means that the dollar prices of imported goods were able to fall even though the prices of these goods may have been steady in the currencies of the home countries where the products originated. Recently, the dollar has been weakening. This will weaken the tendency for import prices to fall.

**Interest Costs.** Interest rates have fallen dramatically in recent years. Their decline may continue a bit longer, but cannot continue indefinitely. Interest is a cost of doing business. Some products, like residential rentals, depend importantly on interest rates. The prices of interest-intensive products have been able to decline recently, but cannot continue their decline indefinitely because interest rates cannot continue to decline indefinitely.

**Labor Costs.** Wages are not falling. No one expects wages to fall. Labor compensation is about two thirds of the cost of the typical product. It will be impossible to have true deflation without having labor costs decline.
At this time the percentage growth in labor compensation is in the 3 percent to 4 percent range. There is a chance that in an extended recession, labor compensation growth could fall to 2 percent or less, which would be about the same rate at which productivity growth might take place. In this case the growth in productivity would offset the growth in compensation, and labor costs would be flat. We are not at such a point at this time, nor do I anticipate that we would get to such a point soon.

**Price Declines Resulting From Over-Investment.** The recent boom led to excessive investment in some sectors, such as telecommunications. The working out of these excesses would normally lead to a downward re-pricing of the value of these assets. Prices of products made from these assets can fall without their decline being a symptom of a general deflation. These price declines are one-time affairs, and should be over soon.

**Fears of deflation** have become common recently, particularly among those close to manufacturing. Manufactured goods prices have been coming down. This is due in part to the growing importance of fixed costs, many of which are being re-priced during this recession. Furthermore, increased competition from China has led to price declines, and price declines have been enabled by large increases in productivity growth in many industries. But true deflation would include declines in the prices of products made of labor. We see none of that.

**WISCONSIN**

Wisconsin grew more strongly in 2002 than did the economy as a whole. But a substantial re-basing of the economic statistics for Wisconsin has taken away much of the growth we thought had existed in the last few years.

Our superior performance in the post-9/11 economy of 2002 was aided by our lack of strong participation in many of the industries that were most affected. Silicon Valley was decimated by the decline in the sales of products based on information technology. Wisconsin’s participation in these industries is less than average. We do not participate as strongly as the average state in financial services, especially of the high finance Wall Street variety. Hence we did not suffer from this decline as much as New York did. Finally, tourism that relies on air travel such as the large Disney parks in Florida were hit very hard by the decline in air travel in 2002. Wisconsin’s tourism industry is based on auto travel largely from the Chicago area. Many of our tourist firms saw increases in business in 2002.

The outlook for growth in Wisconsin is at a level below that for the rest of the nation, again because of Wisconsin’s heavy dependence on manufacturing, a sector that will not perform well in the first half of 2003. Paper has suffered from the strong dollar and continues to be threatened by a long-term restructuring of the industry, which is an industry dominated by firms with global strategies. Durable goods manufacturers are suffering from import competition and from the slow recovery of business spending on capital equipment. This weakness is shared with firms in these industries in neighboring states. Printing suffered from the large decline in spending on advertising, an industry that closely follows consumer spending, albeit with a magnified effect.

I expect that employment in Wisconsin will grow at less than 1 percent in 2003. The U.S. economy will grow at a rate of about 2-1/4 percent in 2003 with Wisconsin’s growth being about .5 percent less than that. Of that, productivity growth will support about 1-1/4 percent to 1-1/2 percent, leaving less than 1 percent for employment growth. In Wisconsin, employment growth will be even slower, possibly below .5 percent.