Outlook for the Economy in 2004

Prof. Steven Kyle
Cornell Outlook Conference
December 9, 2003

I. How is My Crystal Ball This Year?

I was predicting growth of from 1 - 2% but it looks more like around 3%. I was wrong in thinking that consumers would stop accumulating debt - They have just kept right on going.

II. The Past Year

A. NBER reported March 2001 start to current recession and a November 2001 end to it.

Note that the determination of an end was delayed until July 2003. This was because GDP, personal income and retail sales surpassed previous peaks while unemployment remains stubbornly high and industrial production did not pick up until the third quarter. The mixed nature of the evidence led the NBER to wait before making a decision.

B. Signs of recovery

- Employment - Now maybe it's really bottomed out? The unemployment rate is down to 5.9% from 6.4, but this leaves out all of the discouraged workers. The absolute number of jobs is still more than 2 million lower than it was 3 years ago

- Industrial Production - looks like a turnaround but will it last?
- Wholesale/Retail Sales -The Real Question
    - Good 3rd Quarter News
    - Bad September/October News
    - Holiday Sales

- Personal Income - Unemployment may have turned around, but average hours worked are still pretty low

III. Current Policy Stance

A. Alan Greenspan keeps rates low -

He has said that he would lower them further if necessary but there really isn't much room below current rates. Best guesses now are that rates will remain where they are for at least a few months and then go up

- What will his next move be?
- The examples of England and Australia - already on the rise again

B. Fiscal Policy

- Short term outlook

  -The biggest stimulus I ever saw from the Feds

  Last fiscal year came in at 375 billion - Discretionary spending has grown at more than 12%

  - Aimed at high income earners, defense and paying the interest on the debt (more to rich than poor)

Note that the lowest 4 quintiles have received most of what they will get already - Lots still to go for the richest 20%. Interest on the debt is now almost a quarter of all spending. Lots of money gone to defense and the war - 79 plus 87 billion so far in supplementals.

- Offsetting state level fiscal situation or, So you thought you got a tax cut? Think again.

The Feds haven't helped the states as usually happens in recession. They also have added mandates for states - The result has been steep increases in state and local taxes, in many cases more than offsetting federal cuts. New York has suffered particularly from this. (Details and references can be found at http://www.kyle.aem.cornell.edu/NY_fiscalfacts_10_14_03.htm) California is another big one (though the outcome is still in flux there). These two together are a very large chunk of the total, but the picture isnt happy anywhere.

- Twisting the yield curve

The very low interest rates from the Fed together with the extremely bad long term fiscal outlook twist the yield curve to give low short term rates and high long term ones. Note that even though they look low in nominal terms, with inflation also low real interest rates are at higher than average historical levels..

- Long term outlook

- Fiscal train wreck

Latin American analogies are entirely appropriate. The world has never seen the country with the reserve currency behave in this manner before. It is reckless and irresponsible.

- Higher interest rates

These are inevitable whenever foreigners get tired of funding our excesses. These will also have to occur to offset any depreciation of the dollar.

- One sure thing - Something will change before 2010

IV. The Big Question - Where are We Going Now?

A. The Case for Happiness

Consumer sentiment is looking better - Both Conference Board and U. of Mich. indices are up

- At Last! A Good Growth Report Last Quarter!!!!

Any way you cut it, it was a great growth report. Even though the fourth quarter is unlikely to be as good, it seems clear that we have turned the corner

- At Last! Better Employment News!!

Jobless claims seem to be improving though there is as yet lots of slack in the labor market

- Statistically, It is High Time!!!

B. The Case for Caution

- If Consumers are Going to Spend, Where Will They Get the Money?

- Those puzzling productivity numbers

Though output has grown, hiring has stayed flat. This necessarily implies that productivity has gone up. (Note that productivity is never measured directly - it is always inferred from production and employment numbers - hence there is always the possibility that there is a measurement error somewhere). Either employers will have to start hiring soon or consumer spending will cool off - Current trends can't go on much longer. Recent research shows that much of the change in employment in this business cycle has not been cyclical in nature but has been the result of long term restructuring of the economy. That is, many of the jobs lost during the recession aren't coming back.

- Those troubling consumer debt numbers

They have just kept on going up and up. Lower interest rates mean that monthly payments don't have to go up even though debt does. But this can turn into an unhealthy backlash when rates eventually do go up. As Herbert Stein said, "Things that can't go on don't" (or something to that effect)

- Housing - Peaked out?

Housing usually peaks 1 - 3 years after the market - or around the time interest rates start back up again. We are due for this to turn around now. An added factor here is that housing is more directly connected to consumer spending than it ever was in the past through the home equity loan market.

- Those P/E numbers look more like the end of a cycle than the beginning of one

They are lower than at the height of the bubble a couple of years ago but with the P/E of the S&P 500 around 30 they are still very very high by historical standards

- Will Business Investment Drive the Recovery?

  - Capacity Utilization - Still in the Low 70's
  - If they were confident they'd be hiring more
  - Still, the latest business investment data is good

- Will the Foreigners Help Us Out?

  - Foreign Business Cycle News
  - The Exchange Rate - One way bet

V. Opinions from Where I Sit

A. Growth

After the third quarter results, it seems clear that we have turned the corner. I expect the rebound to continue into the next year, but at a more sedate pace. Expect the fourth quarter figures to come in with growth substantially lower than the third quarter but still healthy. Growth should continue next year, but will be constrained to some extent by the burden of consumer debt. Stimulus from the Federal government will continue though more heavily biased toward upper income brackets, thus muting its expenditure effects when compared to this year. The big question is whether interest rates will rebound substantially, creating a sharp retrenchment. So I have to pick a number? I pick 4%.

B. Inflation

CPI

There is no real inflationary pressure, especially given the slack in the labor market, and the low levels of capacity utilization. Nevertheless, the continued efforts of the Fed to fend off deflation by expanding the money supply will eventually have their effect. Another major question mark is the exchange rate. Should the dollar go down sharply, some degree of inflationary pressure will result.

Stocks

It's hard to see a huge boom in stocks given the current P/E levels. Nevertheless, if the recovery continues and interest rates remain low, stocks could rise above the 11,000 level. But it would be a mistake to believe anything I say on this point because I really don't understand how people can rationalize prices which would seem to require that the entire GDP consist of profits in ten years or so.

Housing Prices

It is likely that this bubble will pop over the coming year. Given the lack of inflation, we may see an actual decline in house prices. There are already signs of slowdown in the market in that both new and existing home sales were down in October.

C. Interest Rates

Alan Greenspan resists the idea of raising interest rates any time soon. The longer he can hold off, the better for fighting deflation as well as putting the brakes on spending. A possible fly in this ointment would be a precipitous dollar drop. While it would have to be a drastic situation for domestic monetary policy to move as a result, interest rate hikes to protect the dollar arent entirely out of the question.

D. The Rest of the World

Growth in Europe is projected to be somewhat anemic, on the order of 1-2%. Japan continues to stumble along. This means we are unlikely to get much help from major trading partners. However, a dollar slide would help our exporters.