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As Good as It Gets

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Old habits die hard. Often, criticism leveled at policymakers is well founded. I certainly have offered up my share. But as 2003 ends and 2004 begins, we find ourselves at a point where the performance of the U.S. economy is about as good as it gets. The stock market is up 20 percent this year, inflation and interest rates are low, productivity growth is high, and U.S. exports are rising strongly. The biggest danger going forward arises from ill-founded criticism aimed at policy measures employed to achieve this excellent outcome and the (fortunately low) chance that policymakers will heed such criticism.

Deficit Obsession Dangers

The loudest cries of criticism have been reserved for the sharp transition from a U.S. budget surplus of over $200 billion in the 2000 fiscal year to a $380 billion deficit in 2003. Conservatives and liberals alike are already decrying an expected budget deficit of $500 billion in the current fiscal year. Criticism of rising budget deficits, an old habit among would-be policy wonks trying to sound profound and prudent, is just silly at this point. It would be like criticizing firefighters for pumping half the water out of a pond to put out a fire. Sure, there is less water in reserve for another fire, but why have the water there in the first place if you don't intend to use it to put out fires? Going from a budget surplus of 2 percent of GDP to a deficit, still below 4 percent of GDP, is appropriate in an economy with excess capacity, especially when much of the swing comes from two rounds of demand-boosting tax cuts that simultaneously improve resource allocation.

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U.S. budget deficits have risen because of two rounds of tax cuts that have added substantially to disposable income and helped to improve resource allocation in the United States. In this unusual business cycle, in which a large stock of excess capacity has prolonged the adjustment process, boosting demand with tax cuts is both prudent and effective. Government spending growth has also accelerated, and while spending growth is a less desirable form of stimulus than tax cuts, with capacity utilization at low levels and demand growth outside of the United States exceptionally weak, this is not the time to rein in spending growth. Domestic demand is languishing in Japan and Europe, and although it is strong in China, demand growth there is being largely satisfied by Chinese producers.

The deficits' decriers have been promising all year that rising U.S. budget deficits would push up interest rates and crowd out private borrowers. This has not happened. Interest rates on U.S. government ten-year notes, at about 4.25 percent, are exactly where they were a year ago. Adjusting for inflation, real interest rates on ten-year notes are just above 3 percent—very close to their long-term average.

One of the main reasons—beyond a steady fall in inflation—that higher budget deficits have not boosted interest rates is the need for higher budget deficits to sustain growth. Private borrowing by corporations and households has been particularly weak in recent months. As a result, money supply growth has slowed sharply.

Corporations have been able to finance their moderate investment spending (largely directed at maintaining capacity) out of internal cash flow. At the same time, household borrowing for mortgages and purchases of consumer durables has leveled off since the mid-year surge tied to record low interest rates.

Many market players have been betting on higher interest rates for the past several months only to be frustrated by a drop in interest rates that usually occurs after the appearance of economic data suggesting only moderate demand growth and stable-to-falling inflation. The modest 57,000 increase in November payroll employment reported early in December is the most recent example of weaker-than-expected activity.

Rather than complaining about large budget deficits, it would be more appropriate to view them as the byproduct of the extraordinary demand stimulus required to keep the U.S. economy from slipping back into recession and thereby throwing the world economy into a nasty recession. In fact, by next fall, after an election season filled with hand-wringing by Democratic candidates about rising budget deficits, we shall probably discover, again, that tax cuts stimulate enough economic activity to pay for themselves, at least in part. The budget deficit in this fiscal year will probably be closer to $400 billion than the currently touted $500 billion total, provided that no policy reversals interfere with sustained growth.

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Inflation Paranoia

Perhaps even more baffling than the complaints about rising budget deficits are the complaints from some quarters that the Federal Reserve is risking a return to high inflation by failing to raise interest rates. Even some Fed policymakers continue to flirt with the siren call of the need to move interest rates up to "neutral" levels lest inflation return with a vengeance. The fact is that inflation is still falling. The latest report on inflation—the November Consumer Price Index Report—recorded a year-over-year change in core CPI of 1.1 percent—down from the previous month's 1.3 percent and a low for the cycle. Disinflation is continuing. The three-month annualized core CPI inflation rate at 0.8 percent is well below the 1.1 percent year-over-year rate.

In its recent policy statements, the Fed has essentially shifted away from hints that it fears an undue acceleration of disinflation to a message suggesting that inflation will remain low for a long time. After its December 9 meeting, the Fed said, "The probability of an unwelcome fall in inflation has diminished in recent months and now appears almost equal to that of a rise in inflation. However, with inflation quite low and resource use slack, the Committee believes that policy accommodation can be maintained for a considerable period."

As the Fed has downgraded the risk of an unwelcome fall in inflation, it remains vigilant. According to the October minutes of the Federal Open Market Committee meeting released on December 11, "members emphasized that the prospects for persisting slack in labor and other resources in combination with substantial further increases in productivity were likely to hold inflation to very low levels over the next year or two. Indeed, many saw modest further disinflation as likely, at least over the year ahead." Such comments accurately anticipated the tepid November employment increase.

Low and falling measures of inflation like the core Consumer Price Index or the Core Personal Consumption Deflator are the right guides to monetary policy, not higher oil and commodity prices. Policymakers look at core price indices, exclusive of volatile goods and energy prices, not so much because those components are volatile but because price increases for essentials like food and fuel are equivalent to tax increases and not appropriate signals for tighter monetary policy. The initial response to the first oil price surge in late 1973 was a surge in inflation. The first instinct of central banks was to tighten monetary policy, but they soon realized, to their horror, that tightening in response to a higher inflation signal based on higher energy prices amounts to responding to a backward shift in the aggregate supply schedule with a downward shift in the aggregate demand schedule. The resultant drop in output and employment is painful.

The truth is that, in sharp contradiction to the call for Fed tightening in anticipation of higher future inflation, actual inflation may fall over the coming six months. The jump in purchases of housing has freed up many rental properties and so the rental component of the core CPI index may actually show falling inflation in 2004. The same is probably true of insurance rates after the post-9/11 surge experienced in the year or two following that tragedy. Beyond that, cost-conscious employers are moving aggressively to cap the sharp increase in costs of medical coverage for their employees. All of these developments would depress core inflation further.

The Fed has indicated a desired range for inflation, without specifically setting an inflation target. Year-over-year core inflation between 1 and 2 percent, with more comfort at the higher end of that range, has been suggested as a goal. It is entirely possible that year-over-year core measures of inflation will slip below 1 percent, the lower end of the Fed's desired inflation range, during the first half of 2004. That would force the markets to rethink the current expectation priced into futures contracts that the Fed will begin to raise interest rates by May or June of 2004.

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The dangers of a premature response to calls for a balanced budget or to respond to imagined fears of future inflation are evident from the experience of Japan over the last decade. In April 1997, after a year of strong recovery, the Japanese government sharply increased taxes and threw the economy back into recession. Further unfounded fears of inflation in Japan between 1998 and 2001 resulted in a passive monetary policy and deflationary expectations in Japan that have yet to be overcome. Indeed, much of the Fed's current thinking about the dangers of deflation is based on an extensive study of Japan's experience with that dangerous phenomenon.

The Eminently Sustainable Current Account Deficit

A close cousin of the much-bemoaned U.S. budget deficit and attendant fears of a resurgence of inflation is the U.S. current account deficit accompanied by a weaker dollar. The U.S. current account deficit measures the total of American dissaving—its spending in excess of income. Such dissaving has become extraordinarily welcome in a world still plagued by inadequate demand and its counterpart excess capacity. Those decrying the U.S. current account deficit today are thinking of a world like that of the 1970s, where excess demand was an issue, unlike today's world of chronic excess capacity. Given U.S. overheating, dissaving would boost U.S. inflation and interest rates and weaken the dollar. But as we have already noted, today U.S. interest rates and inflation are actually falling, while the dollar is weakening—all a reflection of substantial U.S. excess capacity.

In today's world of less than full employment, it is foreigners who will not allow the U.S. current account deficit to disappear, because they need the demand growth for their products that it implies. Indeed, the central banks of Japan and China have spent over $200 billion during the past year to prevent their currencies from appreciating. They have become the residual buyers of the rising supply of U.S. government securities used to finance demand-enhancing tax cuts and higher government spending. To suggest that Asian governments might suddenly decide to sell the U.S. government securities that they have been buying with abandon, in an effort to prevent deflationary appreciation of their currencies, is patently absurd.

Asian central banks have persisted in their dollar purchasing and the equivalent—their accommodation of rising U.S. twin deficits—despite a concerted effort led by President Bush for them to cease and desist. China is especially busy building up excess capacity with deflationary potential for the global economy. Perhaps, recognizing this, the president has even resorted to trade sanctions—actual and threatened—in an effort to extend to currency markets the free-market principles that are supposed to operate in markets for international trade in goods and services.

Easing Needed in Europe and Japan

The dangers of resorting to the policy orthodoxy that includes reducing budget deficits and fighting nonexistent

inflation in the United States are especially acute given the somewhat delicate condition of the world economy. A brief respite from acute global excess capacity during the second half of 2003 has been the byproduct of a surge of U.S. demand growth fueled by tax cuts, higher government spending, and easy-money refinancings that has boosted exports in Asia and Europe. Now, as policymakers are declaring a sustainable global economic expansion, U.S. demand growth is slowing. Meanwhile, Europe and Asia are drifting with tighter fiscal policy and neutral to passive monetary policy lulled by the third quarter surge in their exports. Rather than calling for tighter monetary and fiscal policy in the United States, those concerned with a sustained global economic expansion should be calling for easier fiscal and monetary policies in Europe and Japan.

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The calls for sharp reductions in the U.S. budget deficit and a Fed response to imagined inflation threats will probably not cease. Those making the calls have persistently failed to recognize that this is not a typical cycle, in which threats of excess demand growth and overheating are primary. This is a cycle that was not brought on by Fed tightening in response to overheating, but rather one that emerged as a response to a buildup of excess capacity and a sharp fall in stocks, whose prices reflected unrealistic expectations of earnings. The Fed has been reducing interest rates since January 2001, and we have had two rounds of major tax cuts. The upshot of all this is the somewhat disquieting fact that we have yet to see a sustained period of U.S. growth much above 3 percent in the absence of extraordinary policy stimulus. If productivity growth is 3.5 or 4 percent and population growth is 1 percent, then we need 4.5 to 5 percent demand growth to stabilize labor markets even if economic conditions in Europe and Japan stabilize or improve.

Inflation Targets Needed

Although most central banks including the Fed have declared the risks of an unwelcome, substantial further fall in inflation as behind us, those risks remain. It would be far better if the major central banks of the world set explicit inflation targets of 1 to 2 percent and jointly eschewed intervention in currency markets. In Japan, those steps would force the Bank of Japan aggressively to print money to finance purchases of long-term government bonds, commodities, and land until deflation was replaced by modest reflation. Likewise, the European Central Bank would be forced to cut interest rates if a U.S. growth slowdown and a falling dollar signaled a further deflationary appreciation of the euro. China could and should abandon its yuan peg and moderate or reverse the resulting currency appreciation by allowing its currently landlocked savers to venture into global capital markets.

As we move into 2004, 2003 may really start to look like it was as good as it gets. The big risks to a sustainable recovery are not large U.S. budget and current account deficits and higher inflation. Rather the risk is that fear of the byproducts of the right policies—larger budget and current account deficits—will lead to damaging tax increases and restraints on global trade. Fears of the inflation bogeyman ought to be kept in check by lower inflation numbers, but if the Fed behaves as markets currently expect and starts raising rates at mid-year, the U.S. economy could suffer a nasty relapse into subpar growth and rising unemployment.