1015 15th Street, NW, 6th Floor, Washington, DC 20005
Telephone: 202-777-3000 – Fax: 202-777-3010

Irwin Stelzer
21 July 2012

The Economy Is Slowing, But Perhaps Not For Long

Slow, slower, and maybe even stop. That's a quick summary of how Federal Reserve Board chairman Ben Bernanke sees the US economy. The economy grew at an annual rate of 2.5% last year, 1.9% in the first quarter of this year, "and available indicators point to a still-smaller gain in the second quarter" he advised congress last week. Household spending is slowing down because "confidence remains relatively low" (at its lowest level since December); numerous factors (a supply overhang, unavailability of credit) "impede growth" in the housing sector; manufacturing production has slowed; business investment has "decelerated"; there is "further weakness ahead" for investment demand; and "reduction in the unemployment rate seems likely to be frustratingly slow."

Now for the bad news. "US fiscal policies are on an unsustainable path." In the hope of forcing the politicians to do something to prevent the economy that is due to fall off a "massive fiscal cliff" at year end, when scheduled tax increases and spending cuts will, if implemented, cut 4% out of GDP and throw us into a sharp recession, Bernanke is holding fire -- there will be no QE3, at least not just yet, and probably not until the August meeting of central bankers in Jackson Hole, Wyoming, if then. Besides, some of Bernanke's colleagues feel the Fed has done enough, and that interest rates are already so low that a QE3 can't lower them any further. Former Democratic Treasury Secretary Bob Rubin has the same view about the fecklessness of a possible QE3. The International Monetary Fund disagrees, and would have the Fed do more to ease monetary policy.

But Bernanke's decision to hold fire is not likely to force the soak-the-rich Democrats and the no-tax-increases Republicans to compromise. We are in the midst of an election campaign in which President Obama has decided to replace argument with mudslinging, Chicago style -- the style that has brought his home state of Illinois to the brink of bankruptcy, but which has been effective in boosting his polling numbers in swing states. Meanwhile, Mitt Romney is so busy responding to Obama's charges -- including one that he has committed a felony by filing false information with the Securities and Exchange Commission -- that he has not had time to make clear how he would reverse the disastrous economic performance of the incumbent -- if, indeed, he has a fully thought-through plan to do just that.

In 108 days this campaign will end, leaving the winner to negotiate with a congress that includes we-know-not-how-many lame ducks, congressmen who have lost their seats but will hang around and vote until the new crowd is sworn in late in January. The Democrats are now inclined to let the Bush tax cuts expire on December 31, and then introduce legislation to re-institute them for all save those earning more than \$200,000 (\$250,000 for families). They are guessing that the Republicans would be loath to vote "no" to reduce taxes back to the Bush-tax-cut levels merely because it doesn't benefit "the rich". Never mind that Treasury Secretary Timothy Geithner says this Democratic strategy would be irresponsible, and that it is indeed a dangerous walk along the edge of the fiscal cliff. Or that many of those into whose wallets the President wants to dip are hardly the "millionaires and billionaires" he derides as greedy, or that soaring marginal income tax rates, added to the taxes lurking in Obamacare, are not likely to encourage small businessmen to expand or create jobs.

Small businessmen are among the gloomiest players in the economy. Over 80% think the economy is on the wrong track, according to a Harris Interactive poll of firms employing fewer than 500 employees. Because Obamacare imposes costs on firms that employ more than 50 full-time workers, and because of uncertainty about future tax rates, only one in five small businesses expects to add employees next year. Democrats have a different take on all of this. They believe that another stimulus package, proposed by Obama, will increase consumer demand and change small business gloom to cheer. They also claim that the notion that higher taxes on small businesses will reduce the incentive to hire ignores the fact that the cost of new hires is a deductible expense for tax purposes.

Nor is it likely that big businesses will dip into their cash reserves until the fog of uncertainty obscuring future fiscal policy lifts. Or that unconfident consumers will unzip their purses: retail sales declined in May for the third consecutive month. Even workers not among the 23-million-strong reserve army of workers seeking full time work or too discouraged to do so worry that they might be the next involuntary enlistee in that sad group, and prefer a crouch on the couch to a stroll in the mall.

Which brings us to the longer run outlook, life after the new or current president settles down to governing rather than campaigning. In part that will depend on the policies adopted. But some observers feel that the die is already cast. Bret Stephens, writing in The Wall Street Journal, fears Americans have already developed a European-style “habit of dependency”. About half of Americans live in a household that receives some sort of government assistance. That compares with 44.4% when the financial crisis broke in 2008 and 30% when Ronald Reagan lived in the White House. Meanwhile, about half of Americans pay no income tax (they do pay payroll taxes), up from 34.1% when George W. Bush took office in 2000.

Stephens foresees a “civilizational” rather than merely an economic crisis because this trend to dependency is irreversible -- it “will sooner drive a man to degradation than to reform.” Wrong, suggests Senator Bob Crocker, a Republican from Tennessee who has grown into a spokesman for his party on economic matters. Crocker believes we are “only a fiscal deal away” from resuming the sort of growth that has historically provided rising living standards and relatively full employment.

He might be right.

- American consumers have reduced debt from 133% of their income in 2007 to 114%, are seeing real wages rise for the first time in nearly two years, and are therefore in a better position to spend than in recent months.

- American banks are far better capitalized and in far better shape than those in almost any other country.

- One-third of manufacturing firms are considering “re-shoring” suggests an MIT survey.

- In June builders broke ground for more new houses than at any time in almost four years, so construction is set to add 0.3 percentage points to GDP, rather than subtract a full percentage point as last year.

- High-value exports are booming, led by our high-tech giants such as Apple, Google, Facebook and games-makers.

- Manufacturing jobs are returning to America, with Airbus joining overseas firms locating in the South.

- Energy costs are plummeting as “frac gas” hits the market.

Most of all, America remains the home of risk-taking entrepreneurs and venture capitalists. “There’s no way you can bet against America and win,” says Warren Buffett. Let’s hope he’s right.