

The Economy in Perspective

Collateral damage... At its early-November meeting, the Federal Open Market Committee reduced its federal funds rate target by 50 basis points, to 1.25%. Although it was the FOMC's first action since December 2001, the November decision was the twelfth consecutive rate reduction, cumulating to 525 basis points, since May 2000. Many observers interpret the November decision as the FOMC's acknowledgment that the economic expansion does not seem to be gaining momentum and that another monetary policy action would provide additional support. As recently as April, most analysts expected that the 2001 recession would have ended officially by now, but its presence—or aftermath—remains at the forefront this holiday season. Consumer sentiment about economic conditions has been wobbly, and business executives continue to complain about corporate profits and the poor environment for capital spending. For some of our important trading partners, economic conditions have been worse than our own; this means weak demand from abroad and downward price pressure. Firms are reluctant to hire new employees, and although overall employment levels have been holding fairly steady, the labor force continues to expand. Consequently, the unemployment rate has yet to show signs of cresting—the recent report that the national unemployment rate rose to 6.0% in November was a sharp disappointment. Disappointment seems to lurk at every turn, and patience is wearing thin.

On December 6, the White House announced the resignations of Treasury Secretary Paul O'Neill and National Economic Council head Lawrence Lindsey. A new team of economic policy leaders is expected to be named shortly as the Bush administration places renewed emphasis on communicating its programs and pushing for their enactment. The charged atmosphere makes it likely that economic stimulus will figure prominently in the administration's initiatives, although it has not officially announced the details of its plans.

Last year, Congress enacted legislation that created a wide range of tax reductions for individuals and corporations, some effective immediately and others to be phased in over a 10-year span. One might reasonably expect the administration to phase in some of the already agreed-upon tax measures more rapidly than last year's legislation specified. One might also expect the administration

and Congress to pay additional attention to incentives for bolstering capital spending, which has been so much weaker than household spending on housing and durable goods.

It is necessary to consider how tax policy might be adjusted to stimulate economic growth quickly, but there are risks worth considering as well. The first concerns the need for stimulus. During recessions and expansions alike, economic activity is volatile on a monthly and quarterly frequency, limiting the value of forecasts. If the U.S. economy is currently in a recession, it is a strange recession indeed, for real growth has been in the range of 3% all year. Orders for capital goods may strengthen gradually in the natural course of events next year as excess industrial capacity dissipates.

A second risk concerns the effectiveness of tax policy. To take the most obvious example, if capital goods orders are weak because so much current industrial productive capacity remains unused, would investment tax credits spur much demand?

A third risk concerns the interaction between short-term fiscal policy and the U.S. government's long-term fiscal position. In the fiscal year that just ended, the federal government's budget deficit amounted to \$159 billion, and total debt outstanding held by the public rose to roughly \$3 trillion. Yet the net present value of the government's commitments for the next 75 years to pay Social Security, Medicare, and federal retirement benefits is in the range of \$18 trillion to \$26 trillion, double the size of our current \$11 trillion GDP. As Undersecretary of the Treasury Peter Fisher concluded in a recent speech, the federal government needs to encourage more investment and saving to support faster economic growth, to control the health care costs affecting the budget, and to become more disciplined about the cost of its promised future benefits. Fitting short-term stimulus measures into this longer-term framework presents its own set of challenges.

Recessions do not merely inflict damage at their epicenter; they are also capable of casting long and unpredictable shadows. Fortunately, recessions in the United States have been infrequent during the last 20 years, and economic policymakers have become more adept in responding to them. Policymakers' recent actions show that they are paying close attention to this one.