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Draining the Economy

SEVERAL UNDERLYING trends are emerging from the crossfire of confusing statistics and unprecedented policy challenges that faced the incoming Obama Administration in January. The period of what seemed to be a free-fall in the U.S. economy and in the financial system seems to be behind us. Surely, the declines now are at a much slower rate. The good news is that this is the usual prelude to an economic upturn. However, the long-term trend may be more powerful and much less favorable to business and thus to American economic performance.

The apparent disconnect between short-term changes and the longer term is due to a variety of actions. Most clearly, the Obama Administration is succeeding in shifting the balance between the public sector and the private sector in favor of the government. It is doing so in a great many ways. Despite some of the soothing rhetoric to the contrary, business is at the receiving end of a host of unfriendly policy and procedural developments. These changes range from a renewed emphasis in antitrust prosecutions, to increased taxation of those who do the saving and investment, to leaning on employers and investors in order to support union activism, to an impending expansion of government regulation, especially of financial institutions and labor relations. The rapidly rising deficit means that more of private savings will be taken by the government; less will be available for private investment—and there is much more in the offing, including costly new tax and regulatory policies on energy and the environment.

The cumulative effect will be felt over the years. American business will experience a much weaker trend in capital investment and thus in overall sales and earnings growth than in the previous decade. At the same time, rising protectionist sentiment will make it more difficult for U.S. firms to compete in the global economy. New protectionist policies will encourage investors to shift resources and decisionmaking to attractive overseas locations—markets with lower tax rates and less onerous regulation. Near the end of 2009, the American economy remains mired in the deepest and longest recession since World War II. While there have been a few weak signs of an upturn, it is unlikely that 2010 will be a year of rapid overall growth. It looks as though the unemployment rate will reach at least 10% before it starts to decline and that a mild recovery will remain the prevailing optimistic scenario. The pessimistic scenario shows the upturn postponed until 2010, hopefully no later than next spring. In either event, the global economy continues to experience a worldwide recession.

On the positive side, inflation remains unusually low and the availability of workers especially high. Politically, of course, that means increased pressure for government creation of jobs, be it by awarding production contracts or expanding the size of government agencies. At the same time, the U.S. is going to be hard pressed to sell all of the Treasury issues necessary to finance the rapidly rising budget deficit at anything like the current level of interest rates. The leaders of China have been repeatedly and publicly expressing their concerns over the U.S.'s weak

fiscal policy. The great danger is that the Federal Reserve and the Treasury will decide to inflate their way out of this situation. There are not many short-term alternatives to that fallback position.

For a variety of reasons, the longer-term prospects for resumption of rapid economic growth in the U.S. are not bright. First of all, to promote a more equal distribution of income, the increases in Federal income taxes proposed by the Obama Administration are focused on the segment of society that does the bulk of the saving and investment, and this is a key contributor to economic growth. This partial shift from tax cuts to tax increases would come on top of the devastating decline in financial markets (estimates range in the trillions of dollars), which has eroded the stock of private wealth available for investment in the American economy. That is the difficult macroeconomic environment facing the private sector.

Moreover, business recipients of generous government bailouts are finding out the hidden costs of such largesse. For instance, consequent to their new financial dependence on the Federal government, the major automobile companies abandoned their traditional opposition to stronger fuel economy standards. Likewise, financial institutions receiving governmental assistance tend to be more amenable than other industry investors to the weakening of traditional bondholder protections.

A year from now, Pres. Barack Obama will be wishing that election day for a second term was taking place right then. At that point in time, most economic variables are likely to be recording positive positions—inflation

contained (and deflation behind us), economic growth picking up, and unemployment finally turning down. Yet, it would be premature for the Obama Administration to rest on its laurels.

Two or three years hence, the economic outlook is likely to be far more grim. The longer-term results of the hastily adopted “stimulus” package will begin to be apparent: accelerating inflation; slowing economic growth; and sagging investment, all the result of a host of assaults by regulatory agencies and other government functionaries. A rise in interest rates, needed to help sell unprecedented amounts of Treasury securities, will be dampening down any ebullience in the business outlook.

Nevertheless, economic developments always are full of surprises—on the upside as well as on the downside.

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