

A photograph of a desert landscape with a rainbow in the sky. The image is split vertically: the left side shows a vast, flat desert floor with some tracks, and the right side shows a clear blue sky with a faint rainbow. The text is overlaid on the right side.

## THE ECONOMY

# The Case for Optimism

With war behind it, the U.S. will get back to growing. Not superfast, mind you. But we'll take it. **by Justin Fox**

A FOG OF FEAR AND UNCERTAINTY HAS SETTLED over the U.S. economy. Stocks have been tanking, consumers have stopped spending, businesses have put their plans on hold. High oil prices are pounding an already devastated airline industry and sure aren't helping SUV-addicted automakers. It is, of course, tough to see through fog, which is why much of what passes for economic forecasting these days amounts to guessing about how a war with Iraq will turn out. If all goes better than expected (Iraqis dance in the streets waving American flags; oil gushes from Iraqi wells; Jacques Chirac begs for forgiveness), the economy will come roaring back, we're told. If it goes far worse (the war is bloody and prolonged; Saudi oilfields are destroyed; Chirac starts outpolling George Bush in Texas), get ready for an ugly global slump.

All this may be true, but it's not helpful. We don't know exactly how things will shake out in the Middle East—that, along with the ever-present fear of new terrorist attacks on U.S. soil, is why everyone's so skittish. But what's not in doubt is that once the fighting starts, the U.S. and its allies will prevail. Then we'll be back to dealing with a few fundamental economic trends that, considered together, provide a basis for guarded optimism.

Before we go any further, let's define optimism. It

doesn't mean Cisco selling for \$80 a share by July—or even \$40. It doesn't mean \$100,000-a-year jobs for everybody who graduates from college this spring. It doesn't mean 4% or 5% economic growth—at least not yet. What it means is another year sort of like last year, when gross domestic product grew 2.4%. That means another year during which the job market doesn't get a whole lot better, but also doesn't collapse. It means another year during which promises of a strong economic rebound are postponed, but so are fears of a double-dip recession. Another year, that is, that will stump the doomsayers even while it fails to inspire us to party like it's 1999.

The greatest variable in this picture is the price of oil. As you'll read in the next article, it's probably headed down soon, which will give the economy a boost. That's not a sure bet, of course. But let's assume we avoid a recession-inducing oil price spike. Here's what we've got: Consumers who are getting tired but still have money to spend, businesses that have money to spend but are wary about spending it, and a federal government that's deep in debt but is spending like crazy.

First, let's consider America's consumers, whose activities account for 70% of GDP: That they will stop spending is a perennial worry that has perennially failed to come true. What kept it from coming true last year was ultra-low mortgage rates. Those rates aren't going much lower. In fact, they'll probably go up, regardless

of what happens in Iraq. And while a slight uptick in mortgage rates shouldn't kill the housing market, it will certainly halt the refinancing boom that put \$150 billion (1.4% of GDP) into American pockets last year. But here's the good news: The boom continued through the first quarter of 2003, generating another \$65 billion to \$70 billion in cash, estimates Henry Willmore, chief U.S. economist at Barclays Capital.

There's no guarantee consumers will spend all of that, though. These days they face a world in which wages are barely rising, household net worth has dropped for three years in a row (thank the stock market for that), and debt levels are at an all-time high relative to income. That last fact isn't quite as dire as it sounds: Because interest rates are so low, the share of income eaten up by debt payments has actually been declining slightly. But after relying on the booming stock market to take care of them in the 1990s, Americans do need to start saving again. Sure enough, the savings rate bottomed out in 2001 at 2.3% and had reached 4.3% by January. It may be headed back to the 7% to 10% range that prevailed before the 1990s. That's a healthy development for the long run, but right now it means consumers will be hard-pressed to match last year's 3.1% growth in spending.

But consumer spending won't plummet. Even in the oil-shock year of 1974, it dropped only 0.8%. People still need to buy food and gas and the occasional flat-screen TV. Then there's the tax factor. State and local levies are rising, but the President's tax plan—which should win new friends in Congress once Saddam is dispatched—would give Americans an extra \$100 billion to spend or save in the second half of the year.

Business spending, meanwhile, has been such a drag on the economy over the past two years that it can be counted as a positive for 2003 even if it just stays flat. Capital spending by business

## Contrary to popular belief, 2002 was one of the most profitable years ever for corporate America.

dropped 5.7% in 2002 and 5.2% the year before—the worst two-year decline since World War II. All the data were pointing to a capital-spending recovery until war-related uncertainty put spending plans on hold in February. Once that uncertainty is lifted, even if the war doesn't go all that well, spending should resume. Businesses have the money: For all the scandals and grumbling, 2002 was one of the most profitable years ever for corporate America—and that's based on what companies told the taxman, not investors. While households' net worth dropped last year, that of nonfinancial businesses actually went up. True, margins are slimmer and profits aren't rising, which is why Wall Street remains so grumpy. A return to the massive technology spending of the late 1990s is not in the cards. But neither is another 5% drop.

Which brings us to the Feds, who are spending like it's going out of style. After declining in real terms for much of the 1990s, federal outlays were up 7.5% in 2002. The Congressional Budget Office is forecasting a 5.5% rise this year, and given what you'll read in our third cover article, "Iraq: The Hidden Cost of Peace," that seems conservative. True, spending money that the government doesn't have isn't great long-term economic medicine, but for now it's certainly boosting GDP.

Put all that together, and what you get is a U.S. economy that won't exactly burn rubber but will grow a lot faster than Japan's or the European Union's. That's

because both labor productivity and population are growing much faster in the U.S. than in the world's other two major economies. This sounds like something to cheer about, but slow growth abroad is in fact the biggest negative in our economic scenario. If things don't start getting better soon in Japan, they might get disastrously worse. And Europe's sclerosis is making it extra hard for the U.S. to shake its own funk.

The European Union is the largest foreign market for the things U.S. companies sell. In the early 1990s, with Europe in relatively robust economic health, U.S. exports rose sharply right through a recession. This time around Europe's economy is at a near standstill (the EU's GDP grew just 0.8% in 2002). Largely as a result, U.S. exports were down 5.4% in 2001 and 1.5% in 2002. And while the dollar is down almost 25% against the euro since mid-2001, making U.S. products much cheaper in Europe, signs of an export rebound remain elusive.

So if exports aren't growing and U.S. consumers aren't spending much, it could be hard for corporate America to do more than tread water. As long as that's the case, the kind of aggressive hiring and business spending needed to get the economy really moving again will be postponed.

We're not saying that day will never come. At some point there has to be a payoff for the huge productivity gains corporate America has wrested from its workers (and its computers) over the past few years. In the meantime, we'll muddle through. That might not sound so great to you. But by the standards of the pre-bubble economy, it isn't bad. After all, most economists would have sworn on a stack of Bibles a decade ago that a 5.8% unemployment rate (what we've got today) signaled an economy in grave danger of overheating. **E**