Economist Murray Weidenbaum presents his outlook on the U.S. economy as it transitions from the longest peacetime expansion in its history to an economic recession.

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THE CHANGING U.S. ECONOMIC OUTLOOK

by Murray Weidenbaum

The American economy is at a turning point. After enjoying the longest peacetime expansion in American history, we are now sliding into recession. Some perspective is necessary.

It is easy, perhaps too easy, to blame the recession in the American economy on the sharp run-up in oil prices brought about by the Iraqi invasion of Kuwait. True, the rise in oil prices from $18 a barrel to approximately $40 is the equivalent of a large OPEC tax on the American economy. That is so because we now import about one-half of our total oil supply.

This "tax increase" is clearly an economic depressant, pulling billions of dollars of purchasing power out of the national economy. But it could only tip us into recession because we were already so close to that condition just before the invasion of Kuwait in early August.

Sliding Into Recession

Let us recall the business outlook during late July 1990. The expansion was rapidly losing steam. Three major capital-intensive sectors—automobiles, construction, and defense—were turning down simultaneously. Large inventories of unsold automobiles had resulted in cutbacks in production in the bellwether motor vehicle industry.

The delayed impact of tighter monetary policy in 1989 and early 1990 reinforced the lingering effects of the 1986 tax reforms which reduced or eliminated many special incentives or "shelters" to real estate investment. The result was to bring down housing and office construction to very low levels. Housing starts in July fell for the sixth consecutive month; they fell again in August.

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On top of the declines in these two key capital-intensive civilian industries, major defense contractors had begun to lay off substantial numbers of employees in response to reductions in the military budget. Many of the large and medium-size firms in the military market were also announcing future reductions in their work forces.

As a result of these three negative forces—the unusual coincidence of simultaneous declines in autos, housing, and defense—veteran forecasters in July were reevaluating their projections. Several of them had already concluded that the recovery phase of the business cycle was drawing to a close.

The uncertainties in the Middle East, generally, and in the world oil market, specifically, reenforced the negative outlook in the domestic economy in the weeks that followed the invasion of Kuwait. The University of Michigan's index of consumer expectations fell from 77 in July to 63 in August.

In other times, we might have expected the Federal Reserve (Fed) to offset the negative developments in the economy by shifting to an easier monetary policy. However, the large increases in oil prices had a double whammy on the U.S. economy, simultaneously depressing demand and raising costs. While these price increases work their way through the industrial system, the Fed is understandably reluctant to expand the money supply to any significant degree. Alan Greenspan and his colleagues are sitting on the fence.

The sharp upward spurt in the estimated federal budget deficit for the next several years, brought about in part by the ever more costly bailout of the S&Ls, immobilizes fiscal policy as a potential source of additional stimulus. Thus, the recessionary forces have been allowed to build up steam.

The Federal Reserve can follow its current course of action (you may call it inaction) because the likelihood is that the recession will not last much beyond a very limited period of 6-9 months. Nor do we face the escalating double-digit inflation of the early 1980s. The prospect is for inflation to be contained in the 5-6 percent price range. That gives the Fed the confidence that they could responsibly increase the growth of the money supply should the
economy weaken more than is now anticipated.

Should the embargo of Iraq continue without military hostilities, the pace of inflation in the United States likely would decline after the initial run-up in oil prices was fully reflected in the chain of production. If Iraq abandons its capture of Kuwait (either with or without external military intervention), the change will be more dramatic.

In either event, the Fed could shift to a more expansive posture and the basis for the next upturn in the American economy would be set in place. If the embargo continues, the upturn likely will be moderate. In contrast, a successful conclusion to the Middle East crisis would bolster business and consumer confidence substantially and thus contribute to a stronger economic expansion. An extended shooting war would force forecasters (including this intrepid economist) back to the drawing board!

The Political Economy

It has become fashionable in the last few weeks to berate both Congress and the White House for the budget fiasco. Few profiles in courage will be etched by the historians of fiscal policy. Indeed, there is enough blame to go around, covering both ends of Pennsylvania Avenue and both sides of the political aisle.

But we should not overlook the accomplishments of American economic policy over the past decade—and there are enough kudos to go around also. Since the beginning of 1981:

1. Escalating double digit inflation has been eliminated.

2. More new jobs have been created (17 million) than in Western Europe and Japan put together.

3. We have enjoyed a greater degree of labor peace—fewer strikes and fewer people on strike—than at any other time since the Department of Labor started collecting the data.

4. Income tax rates have been cut across the board. The indefensible 70 percent top rate has been eliminated. We now realize that, albeit indirectly, those punitive rates only led to numerous tax loopholes.

5. Burdensome government regulation has been streamlined with the introduction of benefit/cost reviews.
Perhaps the most significant result did not occur in the United States at all. I am referring to the positive "demonstration effect" overseas that resulted from our efforts to reduce the heavy hand of government. Witness the simultaneous spread of free-market economies in various parts of the globe, in both Western and Eastern Europe.

Here at home, a new sense of realism is evident in business and personal decision making. Labor and management have both become more cost conscious. They are even aware of the awesome term "productivity" in a society in which government does not come so readily to rescue the losers in the marketplace.

Congress hasn't outlawed recessions. It couldn't do so even if that volatile body could reach agreement on such a benign objective. Nevertheless, short-term problems should not cloud our bright long-term future. The newly liberated nations of Eastern Europe do not look to Japan or Western Europe as their ideal. According to their own testimony, their role model is the United States. We must be doing something right.