Economic Navigation in a Period of Great Uncertainty

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1997 was a very good year economically, but 1998 is expected to bring a lower growth rate and a slowdown across a number of industries. But rather than a period of doom-and-gloom, 1998 will in fact be best defined as a time of economic uncertainty. In light of this, this paper attempts to provide an economic outlook for the year ahead by answering three key questions: first, how will the East Asian financial deterioration affect us? Second, will politicians try to spend the projected federal surplus before it materializes? Lastly, will the Federal Reserve continue to stay on the policy sidelines?

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ECONOMIC NAVIGATION IN A PERIOD OF GREAT UNCERTAINTY

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The fundamental economic challenge facing Americans in 1998 is how to make commitments and decisions in a period of great uncertainty and the numbers becoming available are likely to confuse more than they help. The American public is about to be bombarded with an unusual array of favorable economic data. But, in this case, *caveat emptor* (buyer, or user, beware).

Yes, the reports of a high 3.7 percent rate of economic growth, a low 2.1 percent inflation, and a modest 5.0 percent unemployment rate will all be basically accurate (plus or minus the usual tenth of a percentage point or so of last minute technical changes). But these numbers are for the calendar year 1997; they will literally all be history.

As we experienced it, 1997 was a good year, in fact a very good year. It may have been as good as it gets. Of course, if you are out of work or your business is operating in the red, you won't believe that. But any appraisal of the economy has to deal with averages rather than exceptions.

So welcome to 1998. To put it mildly, I hope this new year will not set any records. I say that because, by every basic indication, 1998 is not going to be nearly as good a year as 1997. The rapid rise of the economy is visibly cooling off. For the year as

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a whole, we are likely to see a growth rate lower than 1996's 2.8 percent (see Table).

Major areas of expected slowdown in 1998 include exports, consumer services, automobile production, and commercial construction. However, my forecast — like that of most economists — is not a doom-and-gloom scenario. Rather, I see a so-so year. Yet, that will be a major change in outlook from the recent past.

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The dominant economic characteristic of 1998 is going to be uncertainty. Individual investors, business planners, and government officials will not be able to rely on "automatic pilot" mechanisms such as indexing to protect their interests. Each of us will have to stick our necks out and make some forecasts or assumptions, implicit or explicit. Central among them will be three key questions that will dog decision makers in both the public and private sectors all through the year:

- How will the unfolding East Asian troubles affect us?
- Will Congress and the President succeed in spending the budget surplus before it even arrives?
- Will the Federal Reserve continue to stay on the sidelines?

Let us take up each of these questions in order.
More Repercussions of the East Asian Financial Situation?

The dramatic financial impacts of the Asian currency "melt down" may have peaked, but the full effects are hardly over. The currency movements to date have been dramatic. The Korean won and the Thai baht lost over one-half of their value in terms of U.S. dollars since the middle of 1997. Indonesia's rupiah suffered an even greater loss — 70 percent, while the Philippine peso declined by 40 percent.

Those massive devaluations are just the start of the adjustment process. Many Asian financial as well as industrial companies are likely to default or at least "postpone" paying their obligations. An even greater number of firms can be expected to cut down on their purchases and production. The aggregate domestic effects may range from recession (Thailand) to substantial slowdown (Philippines).

One positive repercussion on the United States is that the declines in East Asian markets has enabled the Fed to avoid raising interest rates (which they likely would now be doing otherwise). The effects on U.S. business, in general, should be moderate, given the limited role of our trade with East Asia, accounting for about 3 percent of our GDP. Western Europe is even less oriented to Asian markets. All this, however, is of little solace to investors and businesses with major financial commitments in the Orient. Yet a Far East recession overall has a smaller adverse impact on the American economy than a recession here would have on East Asia.

In any event, there will be winners and losers, especially on this side of the Pacific. American consumers will be the obvious beneficiaries of lower prices for the clothing and other low-tech products that we customarily import from that part of the world. U.S. companies with operating subsidiaries in East Asia should benefit from substantially lower
costs (especially in terms of U.S. dollars) as will companies here that use components and raw materials produced in that part of the world. On the other hand, some domestic producers in the United States — in their roles as exporters and competitors — will face rougher price competition.

In assessing the future, Japan and China are two potential wild cards. International credit rating agencies estimate that between 15 percent and 30 percent of the loans held by China's banks are unrecoverable. With no foreign investors to pull out of its financial system, however, Beijing has the time to deal with the problem at its own pace. Vice premier Zhu Rongji, who is likely to be China's next prime minister, has been quoted as saying that its currency, the renminbi, will not be devalued, at least not to spur exports (that leaves a huge loophole, a competitive devaluation to avoid loss of existing market shares). Should China do so in the months ahead, that could trigger another round of regional devaluations.

Given its economic power, if Japan finally gets its act together and takes the needed tough financial and budget actions, all of East Asia could be out of the financial woods fairly soon. There is no guarantee on that score, however. A recent survey reported that a majority of the business leaders in Thailand, Korea, Malaysia, Indonesia, Taiwan, and the Philippines believe that Japan's financial situation has a "great" effect on their economy, while far fewer expect strong repercussions from the Korean crisis.

Taiwan is an interesting special case that has received little attention. It is a strong economy with huge foreign exchange reserves (about $90 billion) and a steady trade surplus ($10 billion in 1996). Unlike South Korea (which followed the Japanese model), Taiwan is not dominated by a few huge corporate conglomerates. Rather, there is a large
array of competitive and mainly medium-size companies. It also has been benefiting from a reverse "brain drain." Scientists and other professionals trained in the United States have been returning to Taiwan and playing key roles in its economy.

For all of East Asia, the economic and financial outlook remains worrisome and difficult. Wrenching changes such as those the economies in that region are experiencing can be expected to generate very substantial political and social risks. However, for Americans with geographically diversified investments, the impacts, albeit negative, should be limited.

Thus, our main attention should shift to developments here at home. Most foreign nations would love to be facing our problems, such as dealing with limits to labor supply and how to handle a budget surplus.

**Backsliding on the Federal Budget?**

If nature abhors a vacuum, politicians equally try to avoid a budget surplus. The United States has not enjoyed one in forty years. Thus, we should not forget that the projected federal surplus is still only a future prospect. Yet, even while the Treasury's red ink continues to flow — albeit at a greatly diminished rate — legislators in both parties are rushing out with ideas to spend the "extra" money.

Sadly, they are ignoring the lessons of fiscal history. First of all, it is much easier to increase government spending than to cut it. The reason is fundamental: every dollar the Treasury disburses — be it for salaries, subsidies, procurements, or entitlements — is a dollar of income to somebody. Not many people want to see their incomes diminished.
The second lesson is that a permanent new spending program (temporary spending programs are rare) cannot be adequately financed by a temporary increase in revenues. The rapid rise in the stock market over the past year has provided the basis for many taxpayers achieving large capital gains and the Treasury is sharing the proceeds. But it would be irresponsible to base future budget policy on the optimistic assumption that those stock market gains will continue at the current rate — and that no recession will occur in the years ahead.

Cutting taxes is another way of responding to future budget surpluses. To maximize their effectiveness, tax decreases should be combined with future tax reform. Combining reform with tax cuts would increase the prospects for success in the effort to improve the tax structure. But it will take time before a majority develops in favor of any of the alternatives — a flat tax, a national sales tax, a savings-exempt income tax, or some combination. The case for patience is compelling.

Meanwhile, husbanding the surplus — by using it to reduce the federal debt — would be a sensible way of approaching the period in the not so distant future when the retiring “baby boomers” put great pressure on Social Security and Medicare. Making those two entitlement systems financially viable will require substantial transitional funding. Then those surpluses could be put to good use.

Meanwhile, dissipating the now widely anticipated budget surpluses (either by extra spending increases or standard tax cuts) would be far more than dumb fiscal policy. Such rash action could destabilize already skittish financial markets, where participants have been making their decisions on the expectation of budgetary soundness.
The Fed: A Sleeping Dragon?

I share the near universal belief that Federal Reserve policy has been exactly on track during the past year. Yet, we must ask, "What specifically has the Fed done?" The candid answer is nothing. By correctly staying on the sidelines, our central bank has permitted the private sector to demonstrate its continuing ability to generate prosperity. The time may come, of course, when Alan Greenspan and his colleagues should change course. Clearly that time is not now.

Meanwhile, market forces on their own have been lowering interest rates, most dramatically in the Treasury long-term bond market. New homeowners are among the key beneficiaries, as well as borrowers generally compared to savers.

It is conceivable, however, that later in the year, global investors may decide to lighten their holdings of U.S. securities when they consider the currency devaluation process to be relatively complete. At that point, financial markets in East Asia (even risk adjusted) may appear quite cheap in comparison to investments in the strong-dollar United States. It would be awkward if that shift coincided with the expected sharp rise in the U.S. current account deficit. All that would increase the likelihood of higher real interest rates on this side of the Pacific. That certainly would be an appropriate time for the Fed to ease.

Conclusion

Following one of the best years in a long time, 1998 is likely to be recorded in the history books as a so-so year. That's a big comedown, but in the wide sweep of economic history, an average year would not be too bad. That prospect certainly generates envy on
the part of people in East Asia who are seeing their hitherto vibrant economies slow to a walk or worse while their currencies and stock markets plummet.

Here at home, the talk these days is about deflation. The CPI rose at a modest 1.8 percent rate through the first eleven months of 1997 and the producer price index fell 0.2 percent in December. Nevertheless, anyone expecting to go to the supermarket to do the week's shopping and find that the total at the checkout counter is a lot lower than the week before is bound to be disappointed. Of course, produce prices will continue to fluctuate because of obvious seasonal factors but processed goods will be more stable. Moreover, the prices of many other items — ranging from car repairs to college bills and haircuts to home furnishings — will be steady at best and perhaps even rising a bit.

In contrast, some asset deflation is a real possibility, at least for a while. We tend to forget the obvious: stock market prices will continue to fluctuate — in both directions. We may be disappointed, but surely not surprised, if the long upward trend in the stock market is followed by a stable or even downward trend in stock prices. After all, we are very much part of the global economy — and modern communications reports bad news at least as quickly as good tidings. Economists have not yet developed a "shot" to inoculate us against the economic "Asian flu." Sad to say, we're not that kind of doctor.

All in all, 1998 is likely to be a period of continued and sustainable expansion in production, employment, income, and profits. This is no time to push the panic button.