21. Doomsday for the Doomsayers?

EXEMPLIFYING THE SOMETIMES APT description of economics as the "dismal science," several well-known practitioners have been busily purveying bleak assessments of the American economy's prospects. The doomsayers include two Nobel Prize–winning economists, two prolific columnists of the *New York Times,* one of Wall Street's top financial economists, and several alarmist writers of the London *Economist.*

Their pessimistic forecasts include a double-dip recession, economic "flat-lining," or a U.S. reprise of Japan's protracted twelve-year stagnation. The pessimists are reputable folk, and they occasionally mobilize evidence in support of their gloomy prognoses. But to accept these forecasts would be a big mistake. Benign scenarios for the American economy are more plausible. As another Nobelist pointed out several decades ago, economists "have correctly predicted nine of the last five recessions"!

The difference between the dismal and the benign forecasts is important. It is a difference between annual U.S. economic

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growth rates of 1 percent or less and 3.0 percent or more—amounting to more than $200 billion in the annual U.S. gross domestic product and more than 0.5 percent in the U.S. unemployment rate. This difference would have major significance both for the United States and the rest of the world.

Forecasting is inevitably a hazardous business—to paraphrase Yogi Berra, "It's dangerous to make predictions, especially about the future." Economic forecasts are also hazardous because of something in the economic realm akin to the uncertainty that Heisenberg discovered in the physical realm: economists' forecasts may affect what they purport to be forecasting.

The elements of a more benign, even optimistic, scenario for the American economy are numerous and powerful. They have been neglected by the media compared to the emphasis and attention accorded to the gloomier possibilities. The favorable and neglected elements include the following:

- The cumulative positive effects on corporate and investor behavior of continued and perhaps accelerated implementation of reductions in marginal tax rates, abetted in the forthcoming 108th Congress by reduction if not elimination of the anomalous double taxation of dividends. The current practice—taxing net income of corporations and then also taxing dividends paid to shareholders—impairs the efficiency of capital markets by encouraging corporations to acquire debt (because their carrying charges are tax deductible) and discouraging equity financing.
- A moderate weakening of the dollar resulting from "natural" market forces, rather than from inappropriate and ineffectual government intervention. A mild weakening of perhaps 5–10 percent in the foreign exchange value of the dollar may occur as a result of the continued large U.S. current account deficit (about 4 percent of U.S. GDP), along with some slackening

of autonomous capital inflows into the United States that have hitherto boosted the dollar's value. A decline of this magnitude in the dollar's value would have a doubly stimulative effect: encouraging U.S. exports and strengthening the ability of American producers to compete with imports in U.S. domestic markets.

- A further economic stimulus can be expected from the combined and cumulative effects of monetary and fiscal policy. The short-term Fed funds rate, at 1.25 percent, is already at its lowest level in forty-four years. Also, federal deficits, at a level of perhaps 2–3 percent of GDP principally due to increased outlays for defense and homeland security, are likely to have a mildly stimulative effect without entailing the consequential risk of inflation.
- Improvements in the efficiency and reliability of equity markets and the ensured gradual resumption of investor confidence should result from enhancement of "sell-side" regulation in wake of the Sarbanes-Oxley legislation; enforcement of higher standards of corporate governance by the SEC; imposition of appropriate penalties on the perpetrators of past corporate malfeasances; implementation of several "buy-side" improvements, including increased as well as quicker access to more reliable corporate information; enhanced investor sophistication; and, finally, a burgeoning of new investment in mutual funds because of their tax efficiency in offsetting prospective capital gains against capital losses incurred in the past two years.

These elements of a more benign, even buoyant, economic outlook are numerous and formidable. There are others, as well. One of these is the continuing and dramatic rise in nonfarm labor productivity (more than 4 percent for the year), enabling continued wage growth without inflation and potentially contributing to increased corporate profits and new business investment. Another is the pervasive resilience of the American economy, including the flexibility of its labor markets and the important, if ill-defined, "animal spirits" of American entrepreneurs.

To be sure, none of this assures that these positive elements will overwhelm such negative ones as the erosion of $6 trillion in household and institutional wealth as a result of the punctured asset bubble since 2001, the accumulation of large quantities of household and corporate debt in the United States, and the laggard performance of the EU and Japanese economies. Moreover, besides these familiar downside influences, other imponderables may have depressing effects, at least in the short term—for example, war against Iraq, further terrorist attacks against the United States, or a possible meltdown of the Japanese economy.

Nevertheless, a bottom-line assessment is that the ingredients of a benign trajectory for the American economy are numerous and strong and have been largely ignored or underweighted by the media relative to the hyping of the gloomier forecasts.

Although the "dismal scientists" have been given more prominence than they deserve, rebalancing this distortion doesn't thereby eliminate the grounds for their concern. The remaining uncertainty lies between those who believe the economic glass is half empty and those who believe it is three-quarters full!

POSTAUDIT

The bottom-line forecast described here—that the U.S. economy was (from the vantage point of 2002) more likely to grow at an annual rate of 3 percent or more, rather than the forecasts of 1 percent or less suggested by the gloomy punditry of the time—has been strongly validated in the intervening years.