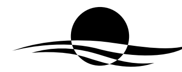
Growth STRATEGIES

Trend Analysis That Builds Business Decisions



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1 – AFFLUENT DEPRIVATION

It's fair to note that the US economy has a long record of defying pessimistic predictions. Our national culture, with its pervasive ambition and its proven capacity for innovation, favors expansion. These are powerful forces. But it's equally true that economic progress has periodically stalled.

Could the economy now be at one of these historic inflection points, when its past behavior is no longer a reliable guide to its future? That is the central question.

The great project of the next president is to improve the economy's stability without subverting its vitality. The good news is that even if the present slump deepens (an 8 percent peak jobless rate would make it the third-worst recession since World War II), the odds are that it won't approach the Great Depression in severity or suffering. Too much attention is being paid.

The bad news is that recovery, though boosting employment, may prove unsatisfying. Our new economic era may lapse into a state of "affluent deprivation." That's an unfamiliar term. It doesn't mean poverty. The United States will remain a wealthy society. Rather, "affluent deprivation" signifies a state of mind. People feel poorer, because their sluggish income gains get siphoned off into higher taxes, energy costs and health spending. Though these all involve benefits, they don't pay everyday bills or cover people's routine pleasures. There's an approaching collision between private and public wants – government spending for everything from retirement benefits to defense to the repair of roads and bridges.

Economic growth has anchored our national self-esteem; slower growth suggests a grumpier and more contentious America. Unfortunately, slower growth seems probable.

A dilemma for the new president is how to reconcile the needs of the present with those of the future. The immediate need is to revive confidence – to rev up demand and spending, thereby absorbing the jobless and increasing the production of underutilized businesses. But the long-term problem is different. It is to mediate between all the competing demands on the nation's income and to expand the economy's capacity to produce the output that satisfies those demands. The closer the economy comes to stagnation, the more Americans will succumb to distributional struggles – not just between the rich and the poor, but also between the young and the old and between immigrants and natives.

Down that path lies "affluent deprivation."

Whatever happens, the future of American affluence will be a state of mind as much as a state of production. So much of our national identity is wrapped up in economic progress that the failure to achieve it in palpable quantities would sap Americans' self-confidence. There have been other moments when the outlook seemed grim, but enduring American strengths – a widespread work ethic and strong entrepreneurial spirit – asserted themselves and disproved the conventional wisdom.

[Robert Samuelson, *The Great Inflation and Its Aftermath: The Past and Future of American Affluence* (2008)]

2 – THE END OF PROSPERITY

The tanking of the US economy in the 1930s and 1970s demostrates the dangers of the four killers of prosperity and bull markets. Those killers are:

- Trade protectionism.
- Tax increases and profligate government spending.
- New regulations and increased government intervention in the economy.
- Monetary policy mistakes.

In the 1980s and 1990s and early 2000s most of the obstacles to growth were cleared away. Taxes, tariffs, regulations, and inflation weren't eliminated, but they were tamed. The unmistakable trend over the period was toward stable prices, a dependable and strong currency, lower and flatter tax rates, a lighter hand of regulation in key industries ranging from financial services to transportation to telecommunications and energy, somewhat moderate levels of federal spending, welfare reforms that rewarded work over dependency, the elimination of most price controls, and so on.

Without these interferences the economy blossomed and US industries reawakened from the wicked spell of stagflation. The United States was unquestionably the global winner in the race for capital around the world. America soaked up some $5 trillion in net capital investment from around the world. These growth policies also attracted human capital. And the United States became the world's premier economic superpower.

Today, [however], there is a widespread consensus of opinion that tougher times lie ahead. Employment is down, income is down, housing values are down, family incomes are down, and consumer confidence is in the tank. If in this precarious financial environment a new Congress decides to impose tax increases, the effect on our economy could be devastating.

The danger is imminent and very real. Major tax increases will occur if Congress does nothing; the Bush tax cuts will expire after 2010 if nothing is done to extend them. The capital gains tax rate will go up; the dividend tax rate will go up; the death tax will jump from 0% to 55% in 2011.

In these automatic tax increases we have the makings of an economic calamity.

[Arthur Laffer, Stephen Moore, Peter Tanous, *The End of Prosperity: How Higher Taxes Will Doom the Economy – If We Let It Happen* (2008)]

3 – VELOCITY AND THE V-SHAPED RECOVERY

The US economy has weakened substantially in the past several weeks, and the National Bureau of Economic Research will eventually get around to declaring an official recession. Conventional wisdom believes that the current recession will be longer and deeper than any recession the US has experienced since the early 1980s, continuing through 2009 and perhaps into 2010.

When the NBER picks the start date of this recession, we suspect that they will reach back to the fourth quarter of 2007, when real gross domestic product fell by a slight 0.2%. We do not agree that the US was in recession then, or for that matter up through August 2008. Despite a horrible housing market, real GDP expanded at a 2.8% annual rate in Q2, while real GDP was basically flat in the third quarter.

But in September, the economy fell off a cliff, with real GDP likely contracting at a 3% annual rate in the fourth quarter, making it the worst quarter since 1982.

Rather than being the first of several negative quarters of economic growth, we expect this will be a temporary capitulation to the credit crunch, with almost all of the economic losses postponing economic activity into what will turn out to be a healthy period of growth in the second half of 2009. To be precise, we expect real GDP to be flat in Q1-2009 but then grow at an average annual rate of 3% in the final three quarters of next year.

The reason: This sharp drop in growth is due to a temporary drop in velocity, due to a true credit crunch, with some panic thrown in for good measure. It is not a typical recession caused by fundamental, economy-changing events such as higher tax rates, tighter money, protectionism or other public policies that stifle innovation or entrepreneurship.

If there is a slowdown in the turnover of money – say a 5% decline – the impact on nominal GDP growth is no different than if the money supply itself shrinks by 5%.

But there is good news. After ham-handing the rescue operation for months, the cavalry has finally arrived. The Fed has injected massive amounts of liquidity, driving the federal funds rate to roughly 1% – where it traded last week.

Moreover, the Treasury Department has drawn a line in the sand. It has decided that no more banks will fail due to a lack of liquidity. Despite the downside for free markets, these actions by the Fed and Treasury will help unlock the credit markets and turn velocity upward. With velocity and the money supply both heading up, a "V" shaped recovery is likely.

While the conventional wisdom is betting on an "L" shaped economy, and the equity market is pricing in the risk of a prolonged slump in earnings, we think the odds favor a "V" shaped recovery, with only a temporary hit to earnings and a Dow Jones industrials average that recovers to 11,000 by the end of this year, with another 20% climb in 2009 all the way up to 13,250. The economy has succumbed to a panicky credit crisis, not a typical policy-induced recession. As a result, the downturn is unlikely to last long.

[Brian Wesbury and Robert Stein (Forbes.com, 10/21/08)]

4 – HOW CAPITALISM WILL SAVE US

We are experiencing the devastating consequences of a chain of major economic policy errors, which, to use a current cliché, created the perfect storm. These government blunders temporarily paralyzed the global credit system and are now sending the US and Europe into recession, while sharply cutting back Asia's growth rates.

Left to its own devices, the credit crisis, which began in August 2007, would have crushed economies as severely as did the Great Depression.

Belatedly, but thankfully, governments recognized that the only way to get credit flowing again was for them to make quick and direct massive infusions of new equity into beleaguered banks, as well as commit to other emergency measures hitherto unimaginable.

If sensible rescue efforts continue – and they will – the immediate crisis will quickly pass. Shell-shocked businesses and consumers won't recover rapidly from the trauma of recent months, especially as we now cope with recession. But the downturn shouldn't be prolonged: The economy here and those overseas should start to pick up no later than next spring.

Despite the crisis, the global economy still retains enormous strengths. Between the early 1980s and 2007 we lived in an economic Golden Age. Never before have so many people advanced so far eco-

nomically in so short a period of time as they have during the last 25 years. Until the credit crisis, 70 million people a year were joining the middle class. The US kicked off this long boom with the economic reforms of Ronald Reagan, particularly his enormous income tax cuts. We burst from the economic stagnation of the 1970s into a dynamic, innovative, high-tech-oriented economy. Even in recent years the much-maligned US did well. Between year-end 2002 and year-end 2007 US growth exceeded the entire size of China's economy. Obviously China's growth rates were higher, but China was coming off a much smaller base.

The world is flush with cash. It's frozen because of fear, but the cash is there. Productivity gains are burgeoning.

So, will this global boom resume next year, slowly at first and then with increasing momentum? It should. Whether that happens, however, depends on the next, highly dangerous phase: the political aftermath.

Will we and other countries pursue policies that hinder growth and retard or abort a full-blown recovery, e.g., regulations that stifle innovation and taxes that harm the creation and deployment of capital?

Another chilling result of the crisis will be furthering the deadly process of criminalizing business failures. One of the significant advances of civilization and economic progress was the idea of limited liability, which took hold in the 19th century: Investors would be liable only for the money they actually put into a corporation; their other assets would be safe. If an enterprise failed, they lost only what they had invested. Limited liability thereby set off a positive explosion of risk taking. Our standard of living today would be where it was in the 1850s were it not for the wide use of limited liability.

But in recent years, particularly after the Enron/WorldCom corporate scandals, federal and local prosecutors began actively pursuing evidence of fraud whenever a big business went bust. Yes, there has been corporate wrongdoing, and miscreants have been tried and jailed. But many noncriminal individuals have been pursued. [And] the itch to indict remains.

[Steve Forbes (11/10/08)]

5 – INNOVATION ECONOMICS

Pessimism about America's future is growing. People worry about the long-term impact of the housing crisis, global competition, and expensive energy. And the policy solutions offered by Republicans and Democrats – mainly tax cuts and government spending programs – seem insufficient.

Yet beneath the gloom, economists and business leaders across the political spectrum are slowly coming to an agreement: Innovation is the best – and maybe the only – way the US can get out of its economic hole. New products, services, and ways of doing business can create enough growth to enable Americans to prosper over the long run.

The new field of innovation economics addresses this gap between spending and results. Economists are increasingly studying what drives successful innovation to learn how companies can get more bang from the bucks spent on R&D and higher education.

It's possible the longstanding partisan debate over tax rates and budget deficits may soon become a sideshow. "The main purpose of economic policy should be to spur innovation and growth," argues economist Robert Atkinson, head of the Information Technology & Innovation Foundation (ITIF), a nonpartisan think tank in Washington. "This is not an issue either party owns."

[Michael Mandel (BusinessWeek, 9/11/08)]