



**The Economic Outlook for the United States
and the European Community**

by Joel M. Stern
Managing Partner and Chief Executive Officer
Stern Stewart & Co.

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For the past 23 years, I have been a member of this three-man forecasting team. When the new dean was appointed a few years ago, I asked him, “how long should I continue to present this forecast?” He answered, “until you get it right.”

Well, this is the year I should say goodbye. At long last, it appears that almost all of the important variables are very close to the mark. Last year, virtually every business economist who offered a forecast suggested that a 2½% real growth rate for the United States in 2003 would be at the high end of possible outcomes. My forecast was 4%, but only after a highly probable war in the Middle East ended. Until then, I said that fear of war would cause Americans to have a 9/11 reaction, pulling in their horns, becoming more liquid, cutting back on spending until the dust settled, literally, in this case. We economists refer to this process of building liquidity in times of uncertainty as an increase in idle cash balances.

And all this has pretty much come to pass. Growth in the first quarter of this year was close to 1.4% at an annual rate, despite tax cuts that were just ahead and an explosive growth in the money supply by the Federal Reserve. The caution continued until the war was over and there was some easing of the ongoing tension between the Bush administration and the United Nations, stemming, of course, from our decision to go it alone in Iraq. As you know the leaders of France and Germany also sought to improve relations with Washington. And once this process appeared to be producing results, the U.S. economy began to respond. As if a slingshot had been stretched to its limit and then released, in mid-May the pent-up demand from the liquidity build up was released and the U.S. economy started to grow at an ever-increasing rate. Real growth for the entire second quarter was at a 3.4% annual rate. If we assume that the first quarter growth rate

continued for the first six or seven weeks of the second quarter, it means that the real growth rate for the remainder of the quarter was in excess of 4½% and possibly even above 5%.

At least as significant, the manufacturing recession that was in full force until May 15th also came to an end. The level of employment in manufacturing also began to increase.

To provide some perspective on the situation in the year 2003, it would be helpful to talk a little bit about the chronological sequence of the recent American experience. The National Bureau of Economic Research (NBER), the think tank that dates turning points of the business cycle, stated that the recession of 2001 began in March and ended in December of '01, despite the 9/11 shock that also increased idle cash balances. Thus, according to the NBER, the short, mild recession of 2001 has been over for almost two years for the economy as a whole. But, as I mentioned before, the manufacturing sector continued in recession until this past May. No double dip recession as was forecasted by others and certainly no growth rate at unacceptably low levels. In fact, until the war talk stoked by the Bush administration a year ago, the U.S. already had had four quarters of 2½% real growth, which is impressive considering how little the economy declined during the recession. I remember the rule Milton Friedman gave us in his monetary economics course: "Shallow-mild, deep-strong." When translated, this means that a mild recession is followed by slow growth, while a deep recession is followed by very strong growth.

Returning to the current situation, I believe that real growth is continuing to accelerate, so that the third quarter just ended showed an annualized growth rate of about

8.2% in real terms. And I believe the fourth quarter will grow at least at a 5% rate, so that growth for the year as a whole will be just above the 4% figure I offered in last year's forecast.

There are three reasons for this robust growth. The first I have already mentioned. It is the release of unwanted idle cash balances that are built up during periods of political and economic uncertainty, as people like you and me take a wait-and-see attitude. Second, the monetary aggregates have been racing along as if they were competing for a starting slot at the Kentucky Derby. Narrow money is up 8.1% from a year ago; broad money is up 7.2%. Please keep in mind that these numbers are the result of a slower growth in the first six months of around 6½-7% and 8½% over the last six months. You will not find a monetarist economist anywhere who's not concerned about the increasing likelihood of a huge increase in the inflation rate by late next year. Just last month producer prices jumped 8 tenths of one percent when forecasters expected only 2 tenths. We will have to watch the monthly CPI very, very carefully in coming months. We are simply experiencing too much money chasing too few goods. The increase in the gold price of more than \$100 an ounce in the past 15 months is a market statement that cannot be overlooked.

And, for good measure, such concerns about inflation are shared even by Keynesians, as the budget deficit hovers in the range of \$450-500 billion. According to most economists of this persuasion, the so-called "full employment deficit" is believed to be around \$200 billion.

As the distinguished late Minority Leader of the U.S. Senate, Everett McKinley Dirksen, used to say, "a billion here, a billion there and soon it adds up to real money."

So, no matter what your preference – monetarist or Keynesian – we were going to have lots of real growth in 2003.

A third reason for the high growth came as something of a surprise to most economists, but it's one that I cited in last year's forecast -- and that is a continued rapid growth in productivity. I confess that I did not expect productivity to improve by 6% this year, and in the last quarter at an 8 percent annual rate. I predicted 4%. When the U.S. is doing well, productivity improves around 2-2½%. What do you think happens when productivity improves 6%? The answer is that Joel Stern gets his unemployment rate forecast wrong. I had forecast that unemployment would fall into the low 5% level. But with the push for productivity as strong as it was growing so rapidly, enough people lost their jobs that the economy was only able to absorb this same number when things were going well. And so the unemployment rate remained high. Of course, President Bush did not make my task any easier by twice extending unemployment benefits. Sit back, relax and take a more leisurely view of the topography and, you guessed it, the unemployment stays high as the average length of the job search is voluntarily extended.

We have been fortunate that thus far the explosion in the money supply and the huge budget deficit have not yet triggered a step-up in inflationary expectations. The evidence for this is found in the index-linked government bonds that yield only 2.4% when the nominal rate for identical 30-year maturities is just over 5%. The difference of 2.7% is the expected inflation rate and, although it is up over last year, it is up only 50 basis points.

So much for the past and present. What will we see between now and the end of the year 2004? In my opinion, the high rate of real growth by U.S. standards is going to

continue at an even higher rate, although somewhat below the real growth rate of the second half of 2003. The last six months of 2003 has seen a growth rate running at close to 6%. This is simply unsustainable. Very soon Alan Greenspan is going to recognize the potential increase in inflationary expectations, and I can assure you he will do something to slow down what will appear to be undesirable growth.

For the year 2004, I forecast a 4.9% rate of real growth, and I expect that after-tax corporate profits net of inflation will increase by 17%. This will encourage management to substantially increase capital spending as utilization rates come closer to full employment levels. We will see capex up at a 7% real rate, as CEO confidence continues to build through the year. An acceleration in the hiring rate will likewise result and the unemployment rate will begin to drop quite measurably, so that we will close out the year at 5% unemployment while averaging about 5.2% for the year.

Inflation measured by the Implicit Price Deflator will be 2.7%. You can see on the scorecard that I believe real consumer spending will continue to be decisive up 4.1%, and government spending likewise up 5%. But the budget deficit will drop to a minus \$180 billion as tax revenue starts to close the gap.

I should also add that I believe that all of what I have just forecast is almost assured because of the remarkable stimulus that the United States has experienced, whether intentionally through the tax cuts and increases in government spending or because of the unintended increase in the so-called monetary base, often called high-powered money, which is the starting point for increasing the money supply.

In my view, the recession of 2001 was caused in large measure by an over-reaction by the Federal Reserve to the so-called stock market bubble. I also feel that the

Fed has misread the seriousness of the recent recession and its aftermath. I believe that they have been spooked by the persistence in the unemployment rate at around 6%, when, in fact, the high rate has been the result principally of extensions in unemployment insurance and of the truly remarkable increase in productivity. Productivity gains are often accompanied by layoffs, but a strengthening economy increases employment. Up to now, the new hiring has continued to be offset by layoffs. But in the coming months, I expect the balance to shift, with the rate of new hirings overtaking the rate of layoffs.

I am also forecasting continued appreciation of the U.S stock market, which I had expected to increase by 15% this year--and which has in fact increased by almost 20% when measured by the Standard & Poor's 500, and 16% when measured by the Dow Jones Industrial Average. In part, these gains are the result of too large a collapse from admittedly excessive levels. That is, the market appears to have overshot the runway both at the top and at the bottom, again, in part because of the unfortunate misreading of the economy by both the media and the Federal Reserve.

I believe there is still plenty of room for the market to rise. In 2004, I forecast that the S&P 500 will increase by at least 15% and the Dow Jones Industrial Average will be up slightly less--unless Dow Jones decides to eliminate Eastman Kodak from its index. I am afraid that digital photography has caught up with Kodak and although they recognize the problem, film sales and film processing will disappear over time and they will not be able to make this up. Dow Jones has eliminated several firms that had been successful and represented an important part of the economy, and Kodak will likely be eliminated from the index soon.

My final topic is a focus on the situation in Europe. The Euro bloc countries have a big problem because they have given up sovereignty over their currency in exchange for the Euro, and this has created a most unusual situation.

Prior to the Euro, if an economy such as Germany experienced a slowdown in growth or an outright recession, automatic stabilizers, or what economists call “self-correcting mechanisms,” normally spring into action. Interest rates fall as the demand for credit declines, and because inflationary expectations are reduced. Furthermore, the Central Bank increases bank reserves and the money supply to stimulate growth which also causes interest rates to fall, at least in the short run.

A second stabilizer that works in tandem with the decline in interest rates is a decline in the currency against the currencies of its major trading partners. This second stabilizer is much more important in Europe, Asia, and South America, where trade represents a much larger percent of the GDP as compared to the United States. Thus, the slowdown causes a decline in both interest rates and the value of the currency, which stimulates not only domestic production, but exports as well. And the good news is that this process does not take very long, only three to six months. It is truly ironic that Germany and France have experienced difficulty with their economies just after the Euro was created. Their problems remained manageable by the initial and unexpected decline in the value of the Euro. What might have become a truly serious recession was cushioned by the fall of the Euro, and thus growth was small. There was no period of a precipitous decline in real growth. And, as I expected, Germany and France returned to a period of decent growth in 2003. But when the Euro unexpectedly rebounded from about \$.90 to \$1.19, that 30% change caused a second dip to occur, especially in Germany. The

irony of all this is that it would not have happened had Germany retained the mark, because its value would have declined against its trading partners' currencies and remained down until the fundamentals in the economy warranted a higher rate of exchange to the dollar.

And this is the problem in trying to forecast the year 2004 in France and Germany. These countries need a temporary period of a lower value for their currency in order to get the export industries back on track. Of course, some recovery will be likely simply because the U.S. economy will be growing at truly remarkable rates. But if the Euro remains strong--say, above \$1.18--then all bets are off because imports from France and Germany may well be priced out of the U.S. market. This is the price a country pays for giving up sovereignty over its own currency. We all must remember that a bloc currency can work from an economic standpoint if, and only if, capital and labor are permitted to move quickly across national boundaries. This requires an elimination of trade barriers, including tariffs, import quotas and tax-induced price differentials, including those that arise from differences in the depreciation of assets when calculating corporate income tax. This is where politics displaces economic sense and well-being. France and Germany have experienced growth patterns that differ markedly from those experienced by other members of the Euro block. Their situation reminds me of a firm where the strategic business units recognize problems that require quick response but where the global choices made at head office appear to be inconsistent with the information that is possessed by managers of the SBUs that is conveyed to the top management of the consolidated firm. We don't run corporations this way because we feel that, as conditions change, new global choices are necessary.

But in nations where rural inhabitants, especially farmers, have a disproportionate vote, a bloc currency is not likely to work very well. And, by that, of course, I mean that the volatility in real growth will be unnecessarily large as the economics of the individual countries are overwhelmed by political interest groups. The result is that well-meaning people in France and Germany must end up violating the very rules they set in order to join and maintain membership in good standing in the European community. And that is why such countries are now running budget deficits that are much too large as a percentage of GDP, as well as the rescuing of ailing corporations by the state.

These kinds of problems are exacerbated by a bloc currency system that cannot work easily where preferences and cultures differ and where citizens want their governments to respond to regional and local problems. In sum, I believe that the recovery in Germany and France depends in large measure on what happens to the Euro--because its creation has essentially taken one of the two most important automatic stabilizers out of commission. Not only is it failing to work as planned, but it is working in the opposite of the desired direction. If the Euro spends most of 2004 between \$1 and \$1.10, the European community will perform quite well, in part due to the very strong U.S. economy. But if the Euro is, say, at an average of \$1.30 or more in 2004, it could well be a year of stagnation.

I can only hope that the European Central Bank will recognize the seriousness of the situation and take corrective action. In the long run, however, I do not believe that the Euro can survive, because as more countries enter the bloc, substantive conflicts will become more frequent and pronounced, ultimately undermining the very foundation upon

which the Euro was created. As a believer in individual liberty and a member in good-standing in the Mont Pelerin Society, I have always felt that nations should focus on their core strengths just as corporations have been reminded time and again to do the same. This is one of those rare instances where what is good for the corporation is good for the state.

Thank you.