

National and District Overview

THE U.S. ECONOMY: Between Iraq and a Hard Place?

By Kevin L. Kliesen

U.S. economic growth, as measured by the percentage change in real GDP, improved modestly in 2002 after roughly no gain in 2001. The pace of activity, however, faltered in the fourth quarter, and forecasters do not expect robust growth to take hold until the second half of 2003. Despite the recent spike in energy prices, most forecasters expect continued low inflation to persist this year. According to some economists, “geopolitical risks”—specifically, a possible war with Iraq—have significantly raised the level of uncertainty among businesses, households and financial markets. These economists argue that when the risks cease, the economic climate will become much more vigorous.

A Review of 2002

After rising by 0.1 percent in 2001, real GDP rose by 2.9 percent in 2002. Despite the faster growth, business capital spending fell modestly, and firms remained reluctant to bid for new employees. The stock market declined for the third straight year, and the growth of real consumer spending weakened for the fourth straight year. Bolstered by faster economic growth in Canada and Mexico, U.S. exports were a bright spot, rising by 4.3 percent after falling by 11.4 percent in 2001. The economic news was even better in other respects. Real after-tax consumer income growth remained strong (the 5.9 percent rise in 2002 was the largest since 1984), while inflation and market interest rates stayed low. These sources of strength helped keep the housing sector growing robustly: Sales of new and existing single-family homes in 2002 reached an all-time high. Moreover, the banking sector reported only a minor rise in loan delinquencies.

As recoveries go, the 2002 version was one of the weakest in the post-World War II period. However, the weak recovery probably reflected the mildness of the 2001 recession:



Mild recoveries tend to follow mild recessions.

Hunkering Down?

The economy ended 2002 on a sour note, as real GDP grew by only 1.4 percent at an annual rate during the fourth quarter. Despite little forward momentum, the consensus among forecasters seems to be that real GDP growth will gradually strengthen this year, and that price pressures will remain contained. For example, according to the Federal Reserve’s Monetary Policy Report to the Congress issued on Feb. 11, 2003, Fed policy-makers expect: real GDP to increase by between 3 percent and 3.75 percent in 2003; the personal consumption expenditure price index to increase by between 1.25 percent and 1.75 percent (after rising 1.9 percent in 2002); and the unemployment rate to average between 5.75 percent and 6 percent during the fourth quarter of 2003 (it averaged 5.9 percent in the fourth quarter of 2002).

In making these projections, the FOMC noted the positive influence of recent expansionary monetary and fiscal policies and the expectations of an improved economic climate overseas, lower energy prices, some restocking of business inventories, and an upswing in capital investment. But are there other developments that could derail this forecast? To some economists, the transition to faster growth might be delayed until the conflict with Iraq is successfully resolved. In their view,

the weakness that developed during the fourth quarter of 2002, which has carried forward into the first quarter of 2003, reflected this heightened climate of risk and uncertainty, which impeded the normal risk-taking activities that a market economy depends on. They believe that the economy will continue to under-perform until the threat is removed.

Are these economists correct? Have the economic developments in early 2003, in fact, been affected by increasing geopolitical risks? To some extent, they have: Equity prices have declined year-to-date, consumer confidence in February fell to its lowest level in more than nine years, and gasoline and natural gas prices have risen sharply. At the same time, despite these setbacks, the economy appeared to be gaining steam in January: Payroll employment, non-auto retail sales, sales of existing homes, and new orders to factories for capital goods all posted healthy increases. Meanwhile, the unemployment rate fell back nearly a quarter of a percentage point.

Despite declines in payroll employment and retail sales in February, which may have been partially related to severe weather, the pace of economic growth in early 2003 seems consistent with the forecast of an economy steadily gathering steam in the face of perceived headwinds caused by increased risk and uncertainty.

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