

# Stagnation Zone

By Robert J. Samuelson

Wednesday, December 18, 2002; Page A35

One of the year's remarkable stories was the ease with which George Bush insulated himself from a faltering economy. Perhaps Americans were preoccupied by terrorism and Iraq. Perhaps they felt he shouldn't be blamed for the flameout of the 1990s boom. Either way, Bush must fear that his good fortune can't last. Hence, he fired economic advisers Paul O'Neill and Lawrence Lindsey. The trouble is that what ails the economy can't be quickly fixed by a change in faces or even policies. Call it the New Stagnation.

It defies normal labels. Statistically, we may have a "recovery" -- or a stubborn "recession." In 2002, the economy's output (gross domestic product) grew slightly more than 2 percent. This suggests recovery. But the growth wasn't fast enough to increase either jobs or profits. Employment is still about 1.6 million below the peak reached in early 2001. Corporate profits are about 10 percent below their record, which occurred (get this!) in 1997. This suggests recession.

Economically, we're trading water. In our prosperous society, stagnation is no tragedy. It doesn't signify mass starvation or poverty. The homeownership rate is a record 68 percent of households. Most people have jobs -- 134 million of us. But psychologically and politically, stagnation alters us.

During the boom, the dominant emotion was envy; people worried they weren't getting richer as fast as everyone else. Now that's superseded by fear. Among the obvious losers: recent high school and college graduates struggling to find jobs; manufacturing workers suffering huge employment losses (2 million since mid-2000); middle-aged workers nudged unwillingly into early retirement.

For others, expectations have been downsized. Less can be afforded; choices have to be made. In 2002, the stock market lost 20 percent or \$2.6 trillion (through yesterday), says Wilshire Associates. It's the third consecutive year of losses. Charities receive less. So do governments. In 2000, federal capital gains taxes (mainly on stock profits) totaled \$131 billion. This year, they may be half that.

The economy's doldrums can be blamed on any of the following: corporate corruption (Enron, WorldCom, etc.); uncertainty over a war with Iraq; the threat of terrorism; high oil prices. All are said to corrode confidence. Probably they do. But all are convenient scapegoats, minimizing stagnation's deeper causes. These lie in the collapse of the 1990s boom.

In the boom, consumers spent more and saved less, because their stock portfolios (a repository of savings) grew spectacularly. In 1992, Americans saved \$414 billion from their incomes; by 2001, annual saving had fallen to \$170 billion. Now, stock portfolios have shrunk. People are replenishing their

savings to pay for college tuition or retirement. Consumer spending will suffer.

The same thing happened to businesses. As the stock market rose, so did their pension funds. Companies could reduce annual contributions without jeopardizing the funds' solvency. This boosted profits and left more money for investment in computers, buildings, factories -- whatever. Now, lower stock prices require raising pension contributions to \$120 billion annually, according to economists at Goldman Sachs. That's three times the present level (\$40 billion). This will hurt investment spending, which is already suffering from overcapacity.

Or consider state governments. During the boom, surging tax revenue allowed spending increases and tax cuts. From 1999 through 2001, spending from states' general funds rose almost 8 percent annually. No more. Slipping revenue is forcing tax increases and spending cuts. In 2002, spending rose 1.3 percent.

The final element in the New Stagnation is a weak global economy. Ideally, the United States would export its way out of trouble. But Japan and Europe are floundering. Latin America is chaotic: Brazil strains to avoid default. Outside Japan, Asia is stronger. But that's little help because these countries run trade surpluses and (especially China) attract investment from elsewhere. Indeed, the danger of deflation -- a decline in prices -- arises from too much worldwide industrial capacity chasing too little demand.

What can Bush do? Not much. He can propose tax cuts. In principle, these might help, especially if focused on middle-class consumers. But benefits could be offset by the boom's destructive aftershocks.

For all the criticism, it's worth recalling that the Federal Reserve is the government's chief instrument for influencing the business cycle. Since January 2001, it has sharply cut short-term interest rates. The overnight fed funds rate is at its lowest level in 44 years, says economist Jack Lavery. If Al Gore were president, the economy would be in roughly the same spot.

No matter. Sooner or later, Bush may be held responsible. He must hope that the normal mechanics of recovery (people and companies repaying debts; surplus factories being shut) prevail. Against that is the possibility that the housing boom, which invigorated consumer spirits and spending, may falter.

In the past year, home prices have risen about 7 percent. They're up 18 percent in Los Angeles, 17 percent in Washington and 16 percent in Miami. Millions of mortgages were refinanced at lower interest rates. Homeowners have taken out \$260 billion of higher real estate values in new loans, says Mark Zandi of Economy.com. A lot of that money was spent at the mall. But Zandi doubts that either home prices or refinancings will repeat this year's performances. Mortgage delinquencies have already risen dramatically.

Economic forecasts for 2003 envision sluggish growth or a "double dip" recession. Either may feel like a third year of stagnation, which is almost un-American. We've entered a new economic, political and psychological zone. People don't want to fight over pieces of the same pie. They want a larger pie. Someone is supposed to provide it. No one can abide the idea that the economic bust, like the preceding boom, is not well understood or easily controlled. But the evidence suggests just that.