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How to forecast the economy

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Knowing that I am an economist, friends and acquaintances frequently ask me, "What is going to happen with the economy?" If I say with great assurance, "Inflation will rise 0.3 percent, unemployment will fall 0.6 percent, and economic growth will increase by 3.2 percent," they will walk away happy, believing they know something others do not. Or, I can be honest and say, "I don't know with certainty, but the actions of the Federal Reserve and the Congress are likely to do X." (Asking an economist what the economy is going to do is a bit like asking your stockbroker which stocks are going to go up. If he knew, he would be living like Warren Buffet rather than pushing stocks to you.)

A major reason people are so confused about the future of the economy is that they are confronted with a huge amount of misinformation on a daily basis by all too many in the press, as well as an endless babble of ignorance and deliberate distortion oozing from the political class.

To clear up the confusion, the following is all you really need to know to make reasonable judgments about the future course of the economy.

Inflation — a rise in the general price level — is caused when the central bank (the Federal Reserve in the U.S.) produces too much money in relation to the volume of goods and services, and deflation — a fall in the general price level — is caused by too little money. The problem for the central bankers (e.g., Alan Greenspan) is that it is very difficult to know beforehand how much money to produce, because changes in tax and regulatory policies, government spending rates, technological innovations, terrorists' acts, and actions of other countries all affect the real growth rate of our economy.

Recently, the Fed has been producing a lot more money, but that has not, so far, resulted in inflation because the velocity of money (i.e., the number of times the same dollar is spent in a year) has fallen. Velocity is down because people are holding more of their money due to the rise of uncertainty resulting from terrorists' threats and concerns about the real financial health of many large companies.

Common price indices, such as the consumer price index, are not very helpful in guiding the Fed, because the indices only tell if too much or too little money was produced in the past. The best indication of future inflation or deflation is analysis of sensitive commodity prices, particularly "futures" prices. These indices can be found in the Wall Street Journal and other papers. Commodity prices are now slightly lower than they were both a decade ago and a year ago. Six months ago, they were quite depressed, but they rose steeply in late winter, primarily due to the increase in oil prices. In recent weeks, they have been slowly drifting downward, which means there is no immediate inflation threat.

Government regulations can cause the economy to slow when the costs of the regulation exceed the benefits. The Bush administration has been making a commendable effort to stop new regulations that do not meet a reasonable cost-benefit standard. However, the irresponsible attacks of the trial lawyers on many industries, have reduced

investment, resulting in slower economic growth. If nothing is done to rein in the excesses of the trial lawyers, future economic growth will be greatly diminished.

Taxes are a major depressant on economic growth since they discourage work, saving and investment. When forecasting the effect of tax changes on economic growth, one needs to look not only at the overall tax burden but also where the tax falls. An increase in the gasoline tax where the entire additional tax revenue is used to improve roads could have more benefits than costs. However, an increased tax on labor (payroll and income taxes) or capital (capital gains, interest, dividends, etc.) is always harmful if the prevailing tax rates are above the growth maximizing rates — which is the situation today — because of the extent to which it reduces the supply of labor and productive investment. A tariff is a destructive tax, as every good economist from Adam Smith in 1776 and on has known. As a result of the Bush tax cuts, the tax burden will be slightly reduced, which means faster growth, but this reduction is being partially offset by some state and local tax increases, and the increase in steel and lumber tariffs.

Despite the myth, increased government spending harms rather than benefits the economy. This myth began with the Keynesian economists, who were totally discredited by Friedrich von Hayek, Milton Friedman, and others. Yet, it is so embedded that the Economist magazine, in a recent silly critique of President Bush's economic advisers, got it totally backward. Remember that any money the government spends must come from taxation, borrowing or inflating the currency. For an increase in government spending to have a positive effect, the benefits from such spending must exceed the total coercive costs of extracting that money from the private sector. The empirical evidence is overwhelming that very few government programs ever meet that test. (It is true that politically favored individuals can benefit from specific increases in government spending, but at the expense of the majority.)

If governments could spend their way to prosperity, the socialist and high tax and spend countries would be rich, and the U.S., Ireland, and Switzerland would be poor. Thus, if you see government spending rising as a percentage of GDP, as it is now, you should forecast slower growth.

Now, you know what makes the economy grow faster or slower. You just do not know by how much — but then again, neither does anyone else.

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