Election Year Economics

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Regardless of almost anything else that's happening, economic issues tend to dominate our presidential elections. If the electorate feels that the economy is healthy and if the voters feel that they personally are prospering, then the incumbent will win (see Johnson '64, Nixon'72, Reagan '84 and Clinton '96); if the electorate feel that the economy is going south, then the incumbent will lose (see Carter '80, Nixon '60, Bush '92 and, in the most extreme case, Hoover '32). So, heading into the fall of 2004, it's probably wise to take a look at whether economic issues will dominate this election, which ones they are and the forecast for the economy over the next four quarters.

Before we do this, however, a caveat is appropriate. The power of the president to determine the course of the economy is limited, and the public often ascribes far too much credit or blame for economic conditions on the White House. There are two reasons for this. First, the executive branch of government is not the sole—or in many cases even the most important—maker of economic policy. Both the Congress and the Federal Reserve, with their power to set monetary and fiscal policy, are key players in the shaping of the economy. While the executive has the power to initiate, and accept or reject, economic measures, it must rely on others to develop policy. Only on the regulatory front does the President have direct power over economic events.

The second reason that the President gets far more credit or blame than is warranted is that economic measures affect the economy only with long lags. The recent increase in interest rates by the Fed was intended to slow down the economy, but it will not be felt until well into 2005. Similarly, the tax cuts passed by the Congress in 2001 and 2003 did not get the economy going until well into 2004. The great expansion of the Nineties is credited to Bill Clinton, but started on the watch of George H. W. Bush; the recession of the early 2000s is blamed on George W. Bush, but started under Bill Clinton.

There are three factors shaping the economy in this election year: fiscal stimulus from two major tax cuts in three years, low interest rates, and fears of inflation. The environment in which the presidential election will be contested will be structured by these three factors. For the most part, none of the three plays as an obvious advantage to either side, since they are all the proverbial half full/half empty glass. Should we be happy because rates are so low, or unhappy because they are rising? Should we applaud the recent growth in jobs are decry the fact that there are now fewer jobs than there were in January 2001, and some of these are much less lucrative? Both sides will emphasize the slants that favor their causes and both will be right.

In the short term, however, the November election will be decided by what's on the minds of the voters at that very time. Our forecast for the economy over the next four quarters, or until the end of June 2005, suggests a slowly deteriorating economy, in which there is continued growth but at lower rates. Employment continues to grow, but the pattern of lower wage jobs with limited benefits continues. Inflation continues to creep up. As it does, interest rates rise as well, finally slowing down the housing boom.

There are some real dangers to this forecast. As interest rates have fallen over the past several years, households have increasingly tapped into their housing wealth. While this has fueled consumer spending, it leaves households exposed as interest rates rise and housing prices stall. This becomes a bigger problem for households who have opted for adjustable rate mortgages or the new interest only loans (often at 100 percent or more of the house's current market value.)

The second danger in the forecast is in the growth of real income. Consumers have held the line on spending in great measure because they could tap accumulated housing wealth. As housing wealth is depleted, real income must grow significantly to maintain household spending. One part of this puzzle is jobs, and employment has grown steadily since August 2003. However, the jobs that have been created in this economy over the past several years are service jobs which carry lower compensation than the manufacturing jobs that have been shipped abroad. They add less to real income than did the jobs which were lost in the recession. Adding to the hurdle here is rising prices, which reduce the real value of any increases in income, and have been particularly strong in energy and food, the areas of necessity for most Americans.