



ISSUES IN BRIEF

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Politics and the Near-Term Economy

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Politics and the Near-Term Economy

At certain times in American history, such as the 1930s, political events and public policy decisions have more of an impact on the economy than during calm or “uneventful” periods. We are likely now experiencing a period when public policy is having a more pronounced impact on the domestic economy than at any time since the early 1980s. A quick look at the most probable course of events during the next six months suggests that we will need to keep a close eye on politics to chart the near-term course of the economy.

After the major recession associated with the collapse of housing finance, a series of major initiatives (TARP, stimulus program, quantitative easing by the Federal Reserve Board, nationalization of General Motors and Fannie Mae and Freddie Mac), has helped the economy to resume growth. Unfortunately, there does not appear to be enough momentum from the private sector, despite the massive stimulus and help from strong growth in Asia and other parts of the developing world, to sustain and strengthen the domestic growth trajectory. The Manufacturers Alliance/MAPI recently lowered its growth projections modestly, and the Bureau of Economic Analysis later this week will almost certainly lower the growth estimates for the second quarter of 2010 from an already tepid 2.4 percent to 1.5 percent or less.

The need to deleverage the economy after decades of stellar growth in credit is the principal explanation of the weak performance, but political uncertainty and missteps are not helping to get beyond the deleveraging process.

A quick look at a leading survey of small business confidence is key evidence of the problem. The July report from the National Federation of Independent Business (NFIB), *Small Business Economic Trends*, concludes: “The persistence of Index readings below 90 is unprecedented in survey history. The performance of the economy is mediocre at best Owners have no confidence that economic policies will ‘fix’ the economy.” Further, small business owners see weak profits and slower growth ahead, and their plans for capital investment are just two points (out of 100) above the record low in the history of the survey. Small businesses are not hiring as a result. “Bottom line, owners remain pessimistic and nothing is

happening in Washington to provide encouragement. Confidence is lost.”¹

Unlike larger firms and multinational corporations, most small businesses cannot as readily offset domestic weakness by going after faster growing international markets. Their confidence seems to be sapped by the prospect of higher taxes (most are pass-through organizations that would be hit hard by the expiration of the Bush tax reductions), more regulation on top of the complex new health care plan (such as new ozone or carbon emission rules), and little to no return on their investments. Federal stimulus programs are winding down and state governments are cutting personnel and programs. As small businesses cut back capital expenditures and hold the line on hiring, two major sources of domestic demand are weakened, which dampens the manufacturing recovery for all firms.

The brighter side of the picture is that American consumers and businesses are deleveraging at a rapid pace and rebuilding their balance sheets. The global economy is stronger than that in the United States, and U.S. exports are growing. Productivity remains buoyant in a sign that American firms are finding ways to remain competitive. Sooner or later autos and the housing stock will have to be replenished, and equipment investment is already showing signs of life as companies replace older stock. A key missing ingredient is confidence, which clearly is being dampened by the doubts and uncertainties stemming from public policy.

The November elections could change the political dynamic as well. A likely scenario of divided government could, if nothing else, prevent damaging new regulations or taxes from coming into effect in the next few years. In and of itself this “gridlock” could enhance confidence by limiting new political shocks to the economy. Sixteen years ago, when faced with divided government, President Clinton accepted the new reality, set out on a more fiscally responsible path and opened foreign markets, and the economy responded with excellent results. A major question is whether the current Administration would follow that lead should the elections result in divided government. The debate at the end of this year over whether to extend the Bush tax policies, even for a few years, will be an important leading indicator of its response.

¹ William C. Dunkelberg and Holly Wade, *NFIB Small Business Economic Trends*, National Federation of Independent Business, August 2010, pp. 1-3.