AUGUST 25, 2003

ECONOMIC VIEWPOINT
By Robert J. Barro

Why the Second Half Looks More Solid Every Day

Bigger defense outlays, improved global security, and economic stimulus should keep fueling a U.S. recovery

Economic growth, at an annual 2.4% rate in the second quarter, came in stronger than many expected. Looking ahead, I concur with the consensus forecasts of even better growth for the rest of the year and into 2004. A number of factors are contributing to the improved economic environment.

One is the defense buildup. As a consequence of the conflicts in Afghanistan and Iraq, defense spending is $76 billion higher in 2003 than it would otherwise have been before September 11. It is up 25% over 2001. U.S. history indicates that each real dollar of this kind of military spending raises real gross domestic product by about 75 cents. That yields a contribution to 2003's real GDP of $57 billion, or 0.6% of GDP. In standard economic jargon, the 75 cents number means that the "multiplier" on defense spending is 0.75. I arrived at that number by studying large U.S. wars and isolating the economic effects of defense spending -- a relatively straightforward exercise. At the peak of World War II in 1943-44, the extra real defense spending was an astounding $540 billion, and this raised real GDP by $430 billion. For every defense dollar spent, real GDP rose by 80 cents. So the multiplier was 0.8. About the same proportionate effect on GDP arose during the Korean War, but a smaller multiplier showed up in World War I. If I average these three wartime experiences, I get the 75 cents number that I used for my estimate. Some other past conflicts did not yield reliable information for my study, such as Vietnam, Gulf War I, and the Spanish-American War. (The results would be different for wars that destroyed productive capacity, such as in Europe in World War II or in the U.S. in the Civil War.)

Prospects for higher economic growth may also be enhanced by the improved international security derived from the overall success of military operations in Afghanistan and, especially, Iraq. The mostly favorable resolution of the war in Iraq contributed to the strong performance of the U.S. stock market over the past several months. And stock market returns are a pretty good predictor of economic growth.

Of course, the stock market and the economy are also benefiting from the recently enacted tax-cut package. Unlike the tax cuts of 2001, this one provides significant incentives for investment, productivity, and employment. The pickup in private fixed investment in the second-quarter GDP numbers may already reflect these tax changes.

Growth will also benefit from a monetary policy that remains highly stimulative, with short-term nominal interest rates barely above zero. More relevant for the economy, however, are longer-term interest rates. To think about the long-term rate, it is useful to distinguish the real interest rate from the nominal interest rate. Fortunately, with the existence of indexed U.S. Treasury bonds, called TIPS

(Treasury Inflation-Protected Securities), it is easy to do this.

TIPS adjusts the return for inflation. It gives you an insight into what the market thinks is the expected inflation rate. For example, at the end of July, the 10-year U.S. Treasury bond was yielding 4.4%. That is the nominal interest rate. At the same time, the 10-year TIPS was yielding 2.4%. That tells us the real interest rate. Looking back, this real interest rate peaked at 4.3% at the end of 1999, pretty much along with the economy, and then went into a precipitous fall, reaching its low of 1.5% in mid-June of 2003. The main thing we should read from such a low real rate is that investment prospects were so weak that they justified a prospective real rate of return over 10 years of only 1.5%. From the same perspective, the 4.3% real rate at the end of 1999 was a sign of good times -- because the prospects for investment and growth were strong enough to warrant such a high prospective real rate of return.

The rise in the real interest rate from 1.5% in mid-June of 2003 to 2.4% at the end of July is thus a very positive development. It indicates that investment prospects are improving. No doubt, if investment picks up and the economy grows briskly, real interest rates will advance further, and no one should be upset about this.

The other part of the interest-rate picture is the expected inflation rate, which we can calculate as the difference between the nominal interest rate and the real interest rate. When computed this way, the expected inflation rate has remained in the vicinity of 2% over the period since 10-year Treasury indexed bonds were first issued in early 1997. The expected inflation rate did rise at the end of July from 1.7% in mid-June. But this small change should have little consequence for the economy. In fact, the small rise in expected inflation is welcome in the face of all the worry over deflation.

In the end, it is up the Federal Reserve to ensure that expected inflation does not rise much above 2%. Sound monetary policy, combined with higher defense spending and big tax cuts, should ensure America's return to strong economic growth.

Robert J. Barro is a professor of economics at Harvard University and a senior fellow of the Hoover Institution (rjbweek@harvard.edu).