

ECONOMIC GROWTH ROBUST AS IMBALANCES EMERGE

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The U.S. economy has exhibited remarkable flexibility and resilience to international and financial turmoil. In 1998, amid violent fluctuations in financial markets and foreign exchange, decelerating economic growth in Europe, ongoing recession in Japan and selected Asian nations, and sharp devaluation and recession in Brazil, the U.S. continued to defy forecasts of sharp slowdown, registering its fastest growth since the expansion began in 1991Q2. So far, momentum has carried into 1999. But concerns have emerged. In 1998, profits declined for the first time since 1991. Economic growth has been very uneven, as robust domestic demand growth has been offset by a soaring trade deficit that has suppressed domestic production. The sharp rise in the trade and current account deficits highlights growing imbalances in international trade and capital markets. While falling oil and commodity prices have lowered reported inflation and inflationary expectations, the underlying rate of inflation has been stable. The Federal Reserve's sharp reduction in the federal funds rate in response to the international financial crisis has generated accelerating money growth and supported price appreciation of financial assets (including the stock market). If sustained, the rapid money growth would generate rising excess demand and inflation pressures.

Looking forward, economic growth is expected to moderate from its recent blistering pace but remain healthy, and the probability of recession is low. Inflation risks are emerging. Ditto for interest rates. The Fed must be prepared to tighten monetary policy in order to maintain the soundest foundation for sustained economic expansion. Continuing to generate excess demand to offset international weakness and to absorb pockets of foreign excess capacity is not a viable long-run strategy and only generated more imbalances and rates the risk of domestic inflation.

Strong Growth but Uneven Economic Conditions

Real GDP grew 3.9 percent in 1998, far in excess of estimates of sustainable growth for the third consecutive year. The Asian turmoil that unfolded in the late 1997 did not materially alter the rate of economic growth, but significantly changed its mix. In response to the crisis, U.S. interest rates fell and the dollar appreciated, and oil and commodity prices plummeted, which boosted domestic demand. This more than offset the sharp widening of the trade deficit that suppressed domestic production relative to demand. The result has been very uneven economic performance, with a divergence between indicators of domestic demand and manufacturing production, particularly those with international exposure.

Consumption which rose 3.3 percent annually in 1996-1997, accelerated to 4.8 percent growth in 1998. Housing activity also benefited: new and existing home sales spurred 11 and 13 percent respectively, and residential investment rose 10.4 percent in inflation-adjusted terms. The patterns of business fixed investment and inventory building suggest that businesses remain relatively confident. Business fixed investment growth slowed temporarily in 1998Q3 but ended the year strong, and increased 11.9 percent over 1997. Businesses maintained inventory building at a reasonable pace through year-end 1998, but cut back modestly in the second half, particularly in manufacturing.

At the same time, the dramatic widening of the trade deficit, from \$136 billion in 1997 to \$238 billion in 1998, subtracted 1.4 percent from GDP growth, and has been clearly evident in manufacturing and the tradable goods sector. Industrial production slowed to a scant 1.7 percent gain (December 1998/December 1997), following 6.1 percent average annual increases in 1996-1997, and the NAPM survey remained below 50 for eight consecutive months, signaling declining manufacturing activity. From December 1997 to December 1998, manufacturing employment fell 234,000, or 1.2 percent, while jobs rose 2.9 percent in all other sectors.

The widening trade deficit was attributable to slump in exports, which shifted from a strong 10.2 percent rise in 1997 to 0.7 percent drop in 1998, while imports have continued to grow rapidly, reflecting strong domestic demand. The weakness in exports has been very uneven: exports to Europe, Canada, and Mexico have continued to grow,

albeit at decelerating rates, while exports to Japan are declining at an accelerating rate (11.7 percent in 1998), and exports to Asia excluding Japan and to South America have shifted from healthy gains in previous years to sharp declines in 1998.

The international financial crisis of August-October 1998, which temporarily paralyzed markets, had a surprisingly small and temporary impact on the economy: in 1998Q3, consumption and housing activity remained strong, and the trend in business inventory building changed little; only business fixed investment stopped growing for a quarter in part due to labor problems in the auto industry, but it re-accelerated in 1998Q4. The sustained strong economic growth reflects lower interest rates, rapid money growth generated by Federal Reserve easing which lubricated financial markets and renewed confidence, and lower oil prices.

The sharp decline in oil prices—they have fallen to \$12/barrel from \$22/barrel in early 1997—has had significant positive impacts on economic performance. Just as the oil price shocks of the 1970s raised reported inflation and suppressed output, the recent sustained declines have lowered reported inflation and provided a positive shock to real output. Because the demand for energy products is relatively price inelastic in the short run, the lower oil prices have raised consumer purchasing power and lowered business operating costs by even more. Similar to the 1970's experience, the positive implications of the oil price declines may linger for at least several quarters, possibly raising the trendline rate of output growth for an extended period.

Following six consecutive years during which corporate profits rose sharply (12.1 percent average annualized), and rose as a share of GDP, profits flattened in 1998, and their pattern mirrored the uneven economic performance. Profits in the GDP accounts fell 1.7 percent in the year ending 1998Q3, while operating earnings on the S&P500 dropped 8.9 percent. In contrast to the mature stages of recent expansions, in which profits slumped as increases in unit labor costs accelerated and squeezed margins while product demand slowed (typically in response to Fed tightening), the flattening of profits since late 1997 has reflected the declining foreign demand for U.S. manufactured products due to international weakness, along with selective dramatic currency adjustments, commodity price declines, and the lack of producing power available to

businesses that are striving to constrain unit labor costs (ULCs) through productivity gains.

The sharp 10.9 percent decline in net profits from overseas operations was the largest source of the earnings weakness, while profits from domestic operations were virtually flat. The implications of the international turmoil on profits has varied widely; while import penetration has increased in selected industries and squeezed margins in others, costs of foreign inputs to production processes have fallen.

Since the expansion began in 1991Q2, the 3.1 percent average annualized growth in real GDP (3.7 percent annualized growth in nonfarm business output) has been attributable to healthy contributions of labor growth (employment and aggregate hours worked have grown 2.1 percent and 2.5 percent annually) and labor productivity gains (nonfarm labor productivity has risen 1.6 percent annually). As growth of employment has continued to outpace the labor force, the unemployment rate has declined and the employment ratio (total employment to working age population) has risen to an all-time high of 64.5. The tighter labor markets have pushed up wage compensation, but to date only modestly, and less than had been expected earlier. The employment cost index has risen 3.4 percent in the last year. Benefiting from the strong productivity growth and lower reported inflation, real wages have increased 1.6 percent annualized during the last three years.

The healthy productivity gains have mitigated the impact of higher wages on ULCs. In the nonfarm business sector, ULCs have risen only 1.5 percent in the last year, while they have actually declined in manufacturing, reflecting robust 3.9 percent productivity gains in that sector. The efficient adjustments in manufacturing that generated the productivity improvement amid turbulent international conditions and shifts in product demand are a key ingredient to strong economic performance.

Inflation has remained low and stable. Declining energy prices have temporarily pushed down consumer price inflation to 1.6 percent, while the CPI excluding food and energy has hovered around 2.3 percent since mid-1997. The GDP deflator has declined to 0.9 percent, reflecting the rapid increases in business investment in information processing equipment whose prices have been declining. With nominal GDP growing 4.9 percent, lower oil prices and sustained healthy productivity gains have boosted the

portion that is real output and reduced the portion that is inflation. As oil price stabilize, that favorable mix will shift back toward more reported inflation and less real output.

Money and Financial Conditions

Money supply, which grew at a healthy pace in the first half of 1998, accelerated in the second half to its fastest growth rate since 1993. Both narrow and broad monetary aggregates accelerated: in the last year, the monetary base (sweep-adjusted) and M2 have risen 7.9 percent and 9.1 percent; in the second half of 1998, their annualized growth rates were 9.2 percent and 10.5 percent. MZM growth of 15 percent in the last year has been even faster. So far in 1999, money growth has slowed modestly. The accelerating money growth can be attributable to several factors: the aggressive Federal Reserve easing of the funds rate to 4.75 percent from 5.5 percent in response to the financial crisis in Fall 1998, and an increase in money demand resulting from the decline in interest rates that reduced the opportunity costs of holding money and the international financial turmoil. Associated with the decline in interest rates, money velocity has declined, as nominal GDP rose 5.2 percent from 1997Q4 to 1998Q4.

Long-term Treasury bond yields have followed a dramatic “v-shaped” pattern associated with the flight-to-quality during the financial crisis and its recent unwinding and, presently, they are slightly above levels prior to the Russian default last July. The yield curve steepened as short rates fell with the Fed easings. The rapid money growth has fueled asset price appreciation and raised stock valuations despite weakness in profits. High grade corporate bond yields spread over Treasuries have receded back close to their pre-financial crisis levels, with most of the shifts in the spreads attributable to changes in Treasury bond yields, while spread on high yield corporate bonds remain very wide. The same is true for spreads of emerging market debt.

The Outlook

Economic growth is projected to moderate from its recent torrid pace, but remain healthy. Low interest rates, monetary accommodation and the lagged impacts of lower oil prices will support domestic demand. It should grow approximately 4.0 percent in 1999, healthy but modestly slower than its 5.1 percent pace in 1998. The trade deficit will widen, suppressing production, but its deterioration will not be as severe in 1998. Real GDP growth is projected to exceed 3 percent in 1999.

Consumption, which began in 1999 with a running start as a consequence of December's 0.6 percent rise in inflation-adjusted terms, is expected to grow approximately 3.5 percent annualized in 1999Q1 and the underlying fundamentals point toward healthy growth through the year. Housing activity, which recently achieved record levels with existing home sales exceeding 5 million units annualized and new home sales 1 million annualized, should begin to recede from these levels in response to the recent rise in mortgage rates, and residential construction should slow.

In recent months, the manufacturing sector, which is most sensitive to international weakness, has shown signs of turnaround around. Industrial production has increased, business investment and inventory building have remained healthy, and the NAPM survey indicates improving production and that orders are up.

Business fixed investment experienced its strongest growth of the expansion in 1998, rising 11.9 percent, despite the profit squeeze and temporary financial crisis. The investment outlook for 1999 is a wildcard, with several contradictory factors. Strong product demand and low interest rates point toward sustained growth. Most investment growth in recent years has been for information processing equipment that is designated primarily as short-lived capital with rapid depreciation. Accordingly, rapid increases in gross investment are required to maintain a stable capital/labor ratio. Additionally, investment spending for Y2K compliance may provide a continued boost to 1999 (and perhaps take away from planned investment in 2000). This optimistic outlook for investment is tempered by the low capacity utilization, international uncertainties, and weaker profit growth.

The outlook for exports is clouded: while real exports rose rapidly in 1998Q4 and recent NAPM surveys indicate that export orders have risen, the positive results are

unlikely to be sustained in light to weak international conditions. Europe and Canada have been experiencing slower economic growth, Japan remains in recession, and Brazil is contracting, all trends that should subdue exports. On a favorable note, Latin America has not experienced contagion in response to Brazils problems; Mexico, the U.S.'s third largest trading partner, continues to grow, and regional recession should be avoided. Selected Asian nations are beginning to show sings to improvement, and Japan may begin to turn around in 2000 if it pursues stimulative monetary policy as part of its bank recapitalization plan, and allows the yen float. Also, toward year-end, European economies should be rebounding. Nevertheless, exports will remain weak in 1999, and deteriorating trade will suppress GDP.

The Fed's easy monetary policy, if sustained in 1999, would also generate inflation pressures. Core consumer price inflation has remained low because nominal spending growth has remained moderate, while healthy gains in productivity and employment have generated strong real growth and squeezed inflation. (Inflation has also benefited from declining prices of imports and energy and commodities.) The concern now is that the Fed's accommodative monetary policy stemming from its aggressive easing in response to the financial crisis will generate a pickup in nominal spending, and the excess demand would provide businesses some flexibility to raise prices. In terms of implications for inflation, note the crucial differences between the earlier productivity-driven economic growth and the current growth that has involved monetary accommodation and accelerating demand.

If rapid money growth persists in an environment of stable or rising interest rates, money velocity will stabilize and nominal spending growth will accelerate. With low unemployment and tight labor markets exerting upward pressure on wages, any sustained strong spending growth would result in higher inflation.

While any inflation pressures are expected to be relatively modest a renewal rise in inflation would threaten the sound foundations for healthy sustained economic expansion and would be viewed by financial markets as a key trend reversal. Stable, low inflation has been a key foundation for the sustained healthy economic and financial performance in the 1990s, and the Fed would have to adjust (tighten) monetary policy in response to inflation pressures. Whether it could do so and orchestrate a soft landing in

the current environment of high stock valuations, fragile international conditions, and narrower profit margins, as it did in 1994-1995, is uncertain. Financial markets are equally vulnerable to a shift in inflation psychology. Declining inflationary expectations throughout the 1990s have been a key factor lifting stock valuations and lowering bond yields. Presently, with inflationary expectations below core consumer price inflation, any rise in inflation pressures would be a potentially significant negative for financial markets.

