

THE UNEVEN ECONOMIC SLUMP

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The current economic slump has resulted from the 1999-2000 monetary tightening that generated slower demand, the negative supply shocks imposed by higher energy costs and the dramatically higher costs of capital that have constrained production and investment. The sharp reversal of these cyclical and structural factors that drove the earlier robust economic performance and soaring NASDAQ have produced an uneven economic deceleration: while consumer spending has slowed to a moderate growth pace and housing activity has remained firm, businesses are aggressively cutting production and capital spending, and profits are falling sharply, a reversal from their earlier double-digit gains. Slowing imports and a narrowing trade deficit will provide a partial offset to weaker domestic demand. This pattern is expected to generate modest real GDP growth in the first half of 2001, with moderate downside risks posed by slower consumption growth. In lagged response, the unemployment rate is projected to rise to 5 percent by year-end. Recent and expected further monetary easing are projected to stimulate demand later this year, but lingering weakness in capital spending may inhibit the pace of recovery. Meanwhile, core inflation has drifted up, and is well above the Federal Reserve's long-run objective.

Insofar as the negative supply shocks constrain production and capacity growth while monetary policy influences aggregate demand, the Fed's job is difficult. Monetary policy is not capable of short-run smoothing of the negative implications of the supply constraints. Nevertheless, the Fed is pressured to ease dramatically; effectively it is being asked to address short-run issues beyond its control. In this environment, the Fed must avoid over-managing the economy (or the stock market) and return to the pursuit of its long-run objective of price stability.

The Boom: Its Sources and Characteristics

The capital market and monetary policy adjustments to the Asian crisis and the subsequent financial turmoil--lower interest rates, sharply falling energy and commodity prices and an appreciating U.S. dollar, and aggressive monetary easing in Fall 1998--generated robust but unsustainable economic and financial market performance. The sharp fall in interest rates, declining energy prices, surge in net capital inflows, and monetary easing provided traditional demand stimulus--in many ways, characteristic of traditional early cyclical rebounds from recession--while falling energy and commodity prices and sharply falling costs of capital associated with surging stock valuations provided positive supply shocks.

While the Asian crisis changed the composition of nominal spending growth--stronger domestic demand and a sharply widening trade deficit, and higher real output and lower

inflation--the Fed's aggressive easing in Fall 1998 generated the first marked acceleration of nominal spending growth of the decade. Nominal GDP growth jumped to 8.2 percent year-over-year in 2000Q2 from its 5-year average pace of 5.6 percent. Real consumption growth accelerated with the Asian crisis to 5.0 percent year-over-year by 1998Q2 and 6 percent in 2002Q1, a year following the initial Fed tightening. At the same time, investment and profits soared in absolute terms and relative to GDP.

The sky-high valuations in the NASDAQ and the boom in high technology investment went hand-in-hand: from mid-1997 through mid-2000, when business fixed investment rose 12.5 percent annualized, almost 80 percent of the growth occurred in information processing equipment and software. Some of the strongest increases occurred in industries that enjoyed the lowest costs of capital. By year-end 2000, business fixed investment had risen to 15.3 percent of GDP, up from 9.6 percent in 1990, and information processing equipment and software had risen to 49.5 percent of total business fixed investment, up from 21.3 percent in 1990.

Although nominal spending growth accelerated to a dangerously high rate relative to long-run productive capacity, core inflation remained low and stable while productivity and real output surged. The booming spending on capital characterized by declining prices and low labor intensity of production contributed to these highly favorable conditions. The robust labor productivity growth flattened unit labor costs and widened profit margins.

Even though the full force of the monetary stimulus and positive supply shocks were temporary, the surges in productivity-driven economic and financial performance buoyed expectations, and longer-run forecasts became extrapolations of recent trends. Based on robust growth and labor productivity gains, estimates of sustainable potential growth were adjusted up dramatically, in some cases well above 4 percent, while unrealistic expected rates of return on capital investment fueled bloated stock valuations relative to earnings potential. The downward adjustment of these expectations has highlighted the slumping economic and financial conditions.

The Fed's inadvertently procyclical role in the robust growth of 1998 through mid-2000, which set the stage for the slump, should not be overlooked. In short, in response to a variety of conditions, the Fed remained too easy too long and then tightened too much in 2000. The Fed would have tightened monetary policy in early 1998 if not for concerns about the negative impact of the Asian crisis; it eased aggressively amid continued healthy economic growth in the second half of 1998 in response to concerns about the fragile state of financial markets and financial institutions; and it left in place an expansionary policy during most of 1999, well after the financial crisis had dissipated, growth accelerated and stock valuations rose strongly. Concerns about Y2K likely deterred the Fed from tightening more rapidly in late 1999. For whatever reasons, the Fed's accommodative monetary policy facilitated the booming economic and financial market performance.

By year-end 1999, the Fed had raised the funds rate back to 5.5 percent, its level prior to the Asian crisis, and while money growth had slowed, the earlier bulge in money associated with the 1998 easing had not been drained. Instead, it was generating accelerating demand. In the first half of 2000, the Fed raised the funds rate 100 basis points, the last 50 at its May meeting, after evidence of economic slowdown already had appeared.

The Uneven Slump

By May 2000, the Fed's monetary thrust was restrictive, with sharply slower money growth and an inverted Treasury yield curve. Bond yields had risen, and energy prices had soared dramatically above pre-Asian crisis levels. The higher energy prices adversely affected demand and also are a negative supply shock; they effectively operate like a tax hike, reducing real demand for goods and services while simultaneously raising business costs. Since then, the NASDAQ has fallen over 60 percent from its peak, and broader stock indexes also have declined. While monetary tightening and higher energy prices slowed aggregate demand, the higher energy prices and dramatic rise in the costs of capital associated with falling stock valuations constrained production, investment and productive capacity.

The fall in the stock market has had a larger impact on business investment than on consumer spending. While real consumption has slowed by half to an estimated 3 percent annualized in 2000Q4-2001Q1, capital spending has incurred a sharp reversal from its earlier 14 percent growth rate. It declined 0.1 percent in 2000Q4 and is forecast to decline 10 percent annualized in the first half of 2001.

The wealth effect on consumption tends to be over-emphasized. Even generous estimates of the elasticity of consumption with respect to wealth of .04 imply that a \$2.5 trillion reduction in wealth is associated with a 1 percent decline in consumption (0.7 percent decline in GDP). From its peak, the market capitalization of the Wilshire 5000, a broad stock index, has fallen approximately \$3.4 trillion (22.8 percent). While consumer spending has been dampened by falling stock values, it has been supported by continued healthy growth of disposable personal income and falling interest rates. Motor vehicle sales are lower than their all-time peak, but their 17.1 million annual sales rate in 2001Q1 remains high. Financial incentives have supported sales at the expense of narrower manufacturer margins. Chain store sales have weakened. But consumption of services, which include health and education services, and business and personal services, and constitute almost 60 percent of total consumption, continues to grow at a moderating pace.

In contrast, the tailspin in the NASDAQ and the more moderate declines in the broader stock indexes have had a significant impact on business investment. Although a relatively small share of GDP, business fixed investment now is a major negative contributor to the economic slump, following its strong positive contribution to the earlier boom in productivity-driven growth (from 1996 through 2000Q2, considered separately,

its growth constituted 32 percent of the 4.6 percent annualized real GDP growth). Business investment and inventory adjustment to slower demand traditionally are large swing factors during economic slumps.

The negative influences of slumping demand and profits on business investment are being accentuated by the sharply higher costs of capital and its lessened availability, particularly in industries that fueled the earlier investment boom in information technology and electronics. One would expect diminishing returns on rapid growth in investment. In fact, the unrealistic expectations associated with the technology boom and NASDAQ bubble generated many uneconomic investments with negative returns. The reversal of the NASDAQ bubble and bloated expectations are particularly damaging. For the average company, the steep fall in the NASDAQ has tripled the cost of capital from equity issuance. Others have been less fortunate: dramatic declines in valuations in public and private markets have impaired some companies. The moribund high yield bond market for telecommunications has severely hampered debt capital raising. And the flow of venture capital into startup companies has dried, postponing investment.

We project a 10 percent annualized decline in capital spending in the first half of 2001Q1, and lingering weakness in the second half of the year, with a flat-to-slightly-down trend. Such a decline would not be extreme relative to previous downturns. This would dampen the pace of the economic rebound. The costs of capital and distinct shifts in expectations and investor risk preferences raise uncertainty.

Corporate profits and capital spending go hand-in-hand: in typical cyclical fashion, profits are declining, and the inventory adjustment process, including aggressive discounting and writeoffs, accentuates those declines. Slower product demand is accompanied by squeezed margins, as slower productivity gains push up operating costs while pricing flexibility is constrained. Profits, which always fluctuate significantly more widely than economic output, are projected to decline approximately 10 percent in the first half of 2001 and not rebound in the second half.

Inflation: Ignored but too High

Over the last year, headline consumer price inflation has been pushed up to 3.0 percent, while the core CPI (excluding food and energy) has drifted up modestly to 2.7 percent. The personal consumption deflator has also moved up above 2 percent year-over-year for the first time since 1995. These are above the Fed's long-run objectives. Wage compensation has accelerated (the employment cost index has picked up to 4.1 percent year-over-year) and the cyclical slowdown in labor productivity gains is putting upward pressure on unit labor costs. ULCs rose 4.3 percent annualized in 2000Q4, lifting their year-over-year rise to 2.3 percent; further increases are projected in the first half of 2001. The sharp slowdown in nominal spending growth since 2000Q3 is expected to dampen inflation temporarily, but the anticipated reacceleration of nominal GDP growth in response to the aggressive monetary easing, coming at a time when high energy prices and lower capital spending may limit trend growth of real output, may exert inflation pressures. The sharp steepening of the yield curve as the Fed has eased suggests that

while the Fed's primary focus is on the economic slump, market participants remain concerned about the long-run inflation outlook and the sustainability of low short-term interest rates.

Adjusting Toward Economic Rebound

The duration of the economic slump and the shape of the rebound hinge on several key issues: 1) how rapidly are the adjustments necessary to stabilize the economy and generate a rebound unfolding? and 2) what are the ongoing impacts of the higher energy prices and higher costs of capital? A related issue concerns whether consumer spending will hold up following the decline in stock valuations and falling production and investment.

In general, the adjustments in the goods, labor and capital markets have been rapid, and the Fed has eased very aggressively. A sizeable portion of the slowdown has been an inventory adjustment to a moderation in demand. The accompanying contraction in basic manufacturing is still ongoing but nearing its completion; it has much further to go in electronics and IT, but those sectors comprise a relatively small portion of total manufacturing. In the absence of the negative supply shocks, factors in place point toward a rebound in demand and output in the second half of 2001.

The near-term risk is that consumption weakens further. Although continued healthy growth in disposable income and falling interest rates support consumption, job layoffs are mounting and the unemployment rate is edging up. The 4-week moving average of initial unemployment claims has risen to 395,000, a 30+ percent jump from last Spring's low, nonfarm payrolls are flattening, and the unemployment rate is expected to rise to 5 percent. Weak retail sales in March (down 0.2 percent) establish a poor start for 2001Q2. Real consumption is projected to grow approximately 2-2.5 percent in the middle quarters of 2001. However, consumption is not expected to fall: its deceleration to date has been a key feature of the economic adjustment, and has been in line with the falling stock market, which has begun to level off; surveys of consumer confidence also have begun to stabilize; and interest rates have fallen sharply. Moreover, the sustained strength of housing activity is consistent with continued spending on household durable goods.

Additionally, the negative impact on domestic production of slumping demand is partially mitigated by a narrowing trade deficit. Imports are falling with weaker domestic demand and declining capital spending, and despite slowing export growth, the net export deficit shrank in 2001Q1. From 1996-2000, the widening trade deficit subtracted arithmetically 0.8 percent annually from GDP; it is expected to narrow and contribute positively in 2001.

Since late 2000, business have been aggressively reducing production, and the undesired inventory overhang that emerged in the second half of 2000 has been cut significantly. Particularly in motor vehicles, sales in 2001Q1 (17.1 million annualized) far exceeded scaled-back production (10.6 million annualized), and inventories are quickly moving

toward manageable levels. The same is true of other durable goods manufacturing industries. Businesses have also cut labor inputs (employment and aggregate hours worked flattened), propping up productivity gains.

The notable exception is in the electronics and IT industries, where inventories have risen dramatically and new orders are falling sharply. Stabilization in these sectors, which requires a pickup in sales (and likely dramatic cuts in margins and corporate writeoffs), hinges on a turnaround in capital spending. Accordingly, the adjustment process may be prolonged and painful, imposing a drag on economic recovery as well as measured labor productivity. Again, this is the localized downside of the earlier boom.

Interest rates and the Fed have adjusted rapidly. Since the first signs of economic slowdown emerged in Spring 2000, bond yields and mortgage rates have fallen dramatically. This has provided support for real estate activity and consumption. This contrasts with prior slumps in which interest rates remained high amid weak economic activity.

The Fed's monetary policy is now stimulative, and eventually will generate a rebound in spending. Monetary thrust is not as stimulative as the sharp accelerations of MZM and M2 suggest: their growth picked up prior to the Fed's initial 50 basis point easing in early January 2000, reflecting asset reallocations from stocks into money market funds and bank CDs, and since early January their annualized growth rates have exploded to 26.5 percent and 13.5 percent, respectively, with no signs of slowing. Monetary base (reserves plus currency) growth has accelerated more modestly to 5.7 percent, reflecting weak loan demand. At the same time, the yield curve has steepened sharply due to lower short rates, corroborating the Fed's monetary easing: amid 200 basis points of federal funds rate reductions, 30-year Treasury bond yields have risen about 30 basis points to 5.8 percent while 2-year notes have fallen from 5.0 percent to 4.2 percent. The monetary stimulus is expected to generate a renewed acceleration in nominal spending growth in the second half of 2001, following a year of sub-4 percent growth (it grew 3.4 percent annualized in the second half of 2000 and is projected to grow less than 4 percent annualized in the first half of 2001).

While higher energy prices may prolong the lag between monetary ease and an acceleration of aggregate demand, sustained weakness in capital spending may skew the composition of the pickup, in part toward higher inflation. This would accentuate the unevenness of the rebound, following the uneven pattern of the slump, and exert more pressure on inflation and ULCs..

Comment on Fed Policy

The nature of the economic slump raises a point of caution for the Fed. Monetary policy is an aggregate demand tool that is incapable of short-term smoothing of the negative impacts of negative supply shocks. In particular, the sharp decline in capital spending due to the NASDAQ collapse is relatively localized; lower interest rates *per se* cannot stabilize IT capital spending, and attempts to prop up the NASDAQ (to reduce the cost of

capital) are misguided. Similarly, monetary attempts to offset the negative short-run impacts of wrong-headed energy policies in California are mistaken.

The Fed must avoid the temptation to over-manage the economy, instead pursuing its long-run objective of stable, low inflation. Well-intended but misguided wide swings in monetary policy recall past problems, when monetary policy was a source of instability, rather than the consistent policy tool that has gained substantial credibility in recent decades. In addition, except in emergencies, the Fed should avoid intermeeting policy changes and foster predictability rather than surprise.