

An Assessment of Economic Performance and Policymaking

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The economy is fundamentally sound but inhibiting factors have contributed to a substandard recovery. While sustained strong productivity gains have lifted profits and real wages, consumer spending has grown only modestly, businesses are maintaining low inventories and have been hesitant to invest, and employment remains below its recession trough level. Some negative factors are dissipating and the pace of real GDP growth is projected to accelerate modestly above 3 percent through 2004, and profits are expected to continue to rise at a healthy pace. Employment will rise, but the unemployment rate will remain close to current levels through year-end 2003 before receding modestly in 2004. Rising spending for defense and national security will add to near-term growth but will be partially offset by reduced purchases by the financially-strapped state and local governments. In the longer run, the rising government absorption of national resources will crowd out private consumption and investment, modestly constraining potential growth. The Bush Administration's tax reform proposal would contribute positively to economic growth, but tax hikes by states attempting to close their budget deficits would be damaging. Inflation is projected to remain low, but popular concerns about deflation are overstated as growth in aggregate demand is modestly exceeding productive capacity and should pick up. Real interest rates, which have fallen to unsustainably low levels, are projected to rise with stronger economic growth and higher expected rates of return on investment. The Federal Reserve eventually must raise short-term interest rates, but its stated desire to avoid further disinflation suggests hikes in its Federal funds rate target will be delayed.

Assessing the Economic Recovery

By most measures, the recovery from recession has been modest by historic standards. In part, this has reflected the mildness of the recession--the decline in GDP was very shallow, primarily because consumption continued to grow. But the soft rebound also reflects several inhibiting factors: the adjustment of business investment to the excess capital stock created in the 1990s, the dampening impact on consumption of the decline in wealth, the negative impact of global economic weakness on exports and the risk and uncertainty generated first by the accounting scandals of 2002 and recently by the Iraq war.

As a result of these inhibiting factors, the rebound of nominal GDP has been sluggish compared to prior recoveries, and particularly slow in light of the magnitude of monetary and fiscal stimulus (see Chart 1). Its year-over-year growth has picked up to 3.7 percent, after falling to a recession low of 2.0 percent growth. This weak rebound in nominal spending has generated significant adjustments in business behavior: they have lowered

desired levels of inventories, delayed business investment plans, and been reticent to hire. Concerns about accounting scandals and associated adjustments in corporate finances have contributed to these trends. The resulting efficiencies and sustained productivity gains have supported rising real wages, contributed significantly to rising profits and created a strong base for future expansion, but these benefits receive less attention than the relatively poor performance of other indicators of current economic conditions.

Adjustments in the capital stock. The investment boom in the 1990s resulted in excess capital stock relative to output. The adjustment since 2000 has involved a reduction in capital spending and obsolescence of the capital stock, and in financial markets, lower expected rates of return on investment, a sharp fall in stock valuations and dramatic declines in real interest rates (see Chart 2). While business fixed investment has begun to rebound sluggishly, it remains below its prior expansion peak and it continues to decline as a percent of GDP. At issue is when the adjustment process will end. The composition of business investment provides some clues, suggesting that in selected sectors the adjustment is near completion, but in other sectors, further declines are anticipated (see Chart 3).

Investment in information processing equipment and software, which includes telecommunications equipment, one of the leaders of the 1990's boom, has rebounded rapidly in the last year. Measured year-over-year, it has risen 10.0 percent (6.7 percent in nominal terms), driven by a 23 percent rise in computers. Investment in communications equipment, which was the primary source of the decline from mid-2000 through the recession, has risen 4.6 percent in the last year. This recent growth suggests the capital stock adjustment in information processing equipment and software is largely completed. In contrast, investment in transportation equipment continues to decline rapidly (-10.1 percent), reflecting in part the structural problems and excess capacity in that industry. Ditto investment in structures, including offices and industrial space: following its 10.6 percent decline from 2000Q4-2001Q4, it has continued to fall at a 13.5 percent annualized pace over the past five quarters, but the rate of decline has begun to dissipate. Adjustment in these sectors will continue to be a drag on economic performance. Investment in industrial equipment has stabilized close to its recession trough level.

Despite these ongoing adjustments, several factors point toward rising investment spending: the modest pick up in product demand, the need to replace short-lived equipment and software, rising corporate profits and lower costs of capital reflecting rising stock valuations and declining yields on corporate bonds. Interestingly, year-to-date, yields on corporate bonds in the telecommunications industry have fallen an average of _ percentage points, or _ percent. Through year-end 2003, business investment is expected to rise approximately 1.5 percent, as a 1.8 percent increase in investment in equipment and software is partially offset by stabilizing investment in structures. In 2004, capital spending will rise approximately 7 percent, as stronger growth in equipment and software spending is accompanied by modest increases in investment in structures.

Consumer spending. On the one hand, consumption rose during the 2001 recession, softening the severity of economic downturn, and it has continued to increase in recovery, defying the skeptics. On the other hand, its growth pace has been well below prior recoveries, and it has been particularly weak recently, rising only 1.7 percent in 2002Q4 and 1.4 percent in 2003Q1 (see Chart 4).

Consumption has been supported by sustained increases in real disposable income, monetary easing and low interest rates, but the propensity to spend has been dampened by the significant declines in household wealth. Real disposable income still benefits from rising real compensation (up a mere 0.4 percent year-over-year) reflecting sustained gains in labor productivity and receding inflation, but its year-over-year growth has recently decelerated to 2.3 percent as a consequence of declining employment and hours worked and the dissipating impact of the 2001 tax cuts (see Chart 5). Despite the offset provided by rising values of real estate and bonds, a 5-year moving average of household wealth (including stocks, bonds and real estate) has declined from a peak 9.5 percent growth in 2000Q2 to a meager 1.3 percent increase, and it may fall into the negative territory. While the short-run elasticity of consumption with respect to a change in wealth is relatively low, as the cumulative declines in wealth have gained a sense of permanence, they have been a drag on consumer spending.

Both retail sales and consumption of services, which constitute over 55 percent of total consumer spending, have registered only moderate growth. While large swings in motor vehicle sales have contributed to an erratic monthly pattern of retail sales, consumption of durable and nondurable goods has grown 2.8 percent in the last year, roughly half its robust late-1990's pace. Growth of consumption of services, including health and education services, household maintenance and operations, and business and personal services, has also moderated significantly. The anemic 0.5 percent growth in consumption of services in 2003Q1--the weakest since the Gulf War in 1991Q1--presumably was due to severe winter weather and the so-called "CNN effect" and likely was temporary, but the trend clearly shows deceleration. Year-over-year services spending growth is 1.9 percent, also about half its late-1990s pace.

Consumption is expected to receive a boost from the recent sharp decline in oil and energy prices, that have more than reversed their pre-Iraq war run-up, and grow approximately 2.75 percent through year-end 2004. Amid weak global demand for energy, prices may recede further. Consumption will benefit from pending tax cuts; selected provisions of the tax package, including an acceleration of the increase in the child credit, reduction of the marriage penalty and lowering of marginal tax rates, would add immediately to after-tax disposable income. Moreover, we expect that much of the household adjustment to the larger declines in net worth has been accomplished.

Global economic weakness and net exports. Weak global economic conditions have constrained demand for U.S. exports, partially offsetting the positive impact of the lower U.S. dollar. In particular, the recent deceleration of growth in core Europe and the temporary negative effect of SARS on economic activity in non-Japan Asia have constrained trade. Following an 11.4 percent decline in U.S. exports from 2000Q4-

2001Q4--the largest fall since the 1982 recession--exports have risen 2.4 percent annualized, well below their typical recovery pace (see Chart 6). While real exports of services have rebounded 8.0 percent annualized, exports of goods have risen at a scant 0.1 percent pace in the past five quarters. Most notably, exports of non-auto capital goods, which constitute 42 percent of all exported goods, have declined 1.8 percent annualized, and exports of foods, feeds and beverages have fallen at a 1.3 percent pace. The geographic distribution of U.S. goods actually has supported exports: approximately 24 percent of exports of goods go to Canada, which has enjoyed strong economic growth, while 18 percent go to non-Japan Asia, whose GDP-weighted growth has nearly trebled the global average.

Imports have rebounded with U.S. economic recovery, generating a significant widening of the net export deficit. In the past five quarters of expansion, real imports have risen 6.3 percent annualized, driven most prominently by a very strong 13.4 percent growth pace in imports of consumer goods excluding automobiles. The real trade deficit has risen to \$508.2 billion, or 5.3 percent of GDP, from \$425.3 billion, or 4.6 percent of GDP a year ago, suppressing domestic production relative to domestic demand (see Chart 7).

U.S. exports are expected to accelerate, benefiting from the declining U.S. dollar, but the net export deficit is expected to modestly widen, as U.S. economic growth outpaces global trends and growth of imports exceed exports. The magnitude of the widening will be tempered by a pickup in exports to the strong growth regions in the Americas and non-Japan Asia and the mounting impact of the weaker U.S. dollar.

Risk and Uncertainty. The accounting scandals of 2002 sharply drove up the costs of capital, cast a gray cloud of uncertainty, and adversely affected business operations and planning. Risk and uncertainty about war and renewed worries about international terrorism also likely restrained economic and financial market performance in 2002Q4-2003Q1. While it is difficult to quantify, household and business purchases and international trade activity have been suppressed by these factors, particularly since Fall 2002. As risks and uncertainties dissipate, economic conditions are expected to improve.

Employment Trends. Even as the economy has rebounded, employment and aggregate hours worked have fallen below their 2001Q4 recession trough levels, and their trends are tracking behind the anemic pattern of the so-called "jobless recovery" of 1991-1992 (see Chart 8). The unemployment rate has drifted up, but not nearly as much as during 1991-1992. Aggregate hours worked have been receding fairly consistently since Spring 2001 and have declined at a 2.0 percent annualized rate in the last six months.

The pattern of employment is particularly disturbing for selected sectors (see Table 1). Employment in manufacturing has declined for 33 consecutive months. In the last year, payrolls in durable goods manufacturers have declined 4.4 percent, a modestly slower pace of job loss than its 3-year average. Nondurable goods manufacturing jobs, which have eroded continuously since 1995, have declined 1.6 percent in the past year. Particularly large job losses have occurred in the textiles and apparel industries, presumably reflecting heightened import penetration. The pattern of employment in the

service-producing industries has been very uneven, with year-over-year declines in retail and wholesale trade, and transportation and public utilities offset by increasing employment in finance, insurance and real estate, general services, especially health-related services, and government.

Employment, which typically lags trends in demand and production, is expected to gradually recover and then rise during the remainder of 2003. Following the 1991 recession, during which employment fell about the same percentage as during the recent contraction, jobs did not start to grow on a sustained basis until a year into the recovery. In this cycle, the labor market began to rebound modestly in 2002, before renewed payroll declines began in November amid weakening demand and heightened war-related uncertainty. Now that these gray clouds have lifted and businesses have cut payrolls and operating costs further, net job hiring is likely to resume as demand growth solidifies. However the unemployment rate is not expected to recede in 2003, as monthly job increases of approximately 110,000 are required just to keep pace with estimated growth in the labor force.

Productivity and Profits. Increased business efficiencies and cutbacks in hours worked have generated a continuous string of productivity gains: labor productivity slowed but still rose during the recession, spurted during early recovery (5.7 percent in the year ending 2002Q3), and has increased 0.7 percent and 1.6 percent annualized during the last two quarters of sluggish private output growth (see Chart 9). With wage compensation up 3.3 percent year-over-year, unit labor costs have risen 0.9 percent in the past year, and following their sharp decline in 2002, they are just above early-2000 levels. Productivity gains in manufacturing have been even stronger, where unit labor costs are presently at 1990 levels.

With relatively slow revenue growth in average businesses, productivity gains have been the major contributor to the rebound in corporate profits. Pre-tax profits, which fell a dramatic 25.2 percent from their 2000Q2 peak to the 2001Q4 recession trough, have rebounded 16.0 percent (see Chart 10). Although the pace of rebound has been modestly below the average of prior recoveries, it has been strong relative to nominal and real GDP growth. Moreover, these gains have been achieved despite the continued declines in selected industries, including motor vehicles, transportation and communications, and net profits from overseas activities. Corporate cash flows are above their previous expansion peak, reflecting the rise in pre-tax profits and the boost from accelerated tax depreciation provided by the tax cut legislation enacted March 2002.

The Government Sector and Its Impact on Economic Performance

Current trends in federal and state and local government purchases--that portion of government spending that involve income-generating activity and are directly counted in GDP--will have a material impact on economic performance (transfer payment programs like social security that redistribute income and wealth are not counted in GDP) . Presently, real government purchases of \$1.7 trillion constitute 18.2 percent of GDP; federal government purchases are \$636 billion (\$412 billion for defense and \$224 billion

for nondefense), and state and local purchases are \$1.1 trillion. Nearly all defense outlays are counted as government consumption and purchases; like other government purchases, they are included in GDP on a cash basis.

Federal government purchases fell through much of the 1990s, reflecting declining defense spending as part of the post-Cold War peace dividend. The reduced federal absorption of national resources contributed to above-trend growth in private consumption and investment but was largely offset or "absorbed" by rising purchases by state and local governments late in the decade. Federal policymakers generally held the line on spending as tax receipts soared (at least through Fiscal 2000), generating a dramatic shift from large deficits to cash flow surpluses. In contrast, many state and local government officials used the rapid growth in tax receipts for short-run political gain, and put in place significant new spending programs. Associated with the sharp increases in spending from 1996-2001, state and local government purchases rose at a 6.6 percent average annualized rate, 3.8 percent in real terms (see Chart 11).

The tide has turned: defense spending is now rising rapidly, and the growth pace of nondefense purchases has doubled as well, while state and local governments are beginning to close their budget imbalances; by law, 49 of 50 states must have balanced operating budgets. Following 9/11/01, Congress authorized an additional \$40 billion in spending for defense and national security, the federal budget for Fiscal Years 2003 included sharp increases, as will 2004, and Congress recently authorized an additional \$80 billion for the Iraq war, follow up and related national security. The 9/11-related expenses and military buildup in preparation for the Iraq war--including personnel compensation and munitions--generated an 11.0 percent rise in federal government purchases from 2001Q3-2002Q4. Government defense purchases actually fell slightly in 2003Q1, but as the additional authorization is spent and utilized munitions are replaced, it will show up in government purchases and GDP.

State and local purchases have flattened as legal budget constraints have limited spending and delayed investment projects; however, some states and municipalities have instead attempted to balance budgets by raising state and local taxes. This stable-to-declining trend is expected to continue; however, during the next year, increases in federal defense spending are expected to exceed cutbacks in state and local government purchases.

With nominal GDP growth rising in response to monetary and fiscal stimulus, increased government purchases will add to GDP and will not crowd out private activity. In the longer run, however, the rising share of national resources absorbed by the government will crowd out private consumption and investment. Private productivity and potential growth will be constrained, perhaps by several tenths of a percent annually.

The impetus toward state and local government tax hikes to close their budget deficits is a major concern. While rebuilding national defense and security following a decade of reduction seems in the public interest, the large state budget deficits are due as much to fiscal mismanagement and political opportunism as they are to declines in tax receipts resulting from weak economic conditions. Rolling back inappropriate and expensive

spending programs is highly preferable to tax increases, which would damage economic performance and in many cases, prove unsuccessful in raising desired revenues.

Budget Deficits, Debt and Tax Policy

The federal government's budget has shifted dramatically to large deficit from cash flow surplus in fiscal year 2000. The deficit was \$158 billion in FY 2002 and may be \$400 billion in FY 2003 and 2004. At 3.7 percent of GDP, this would be high, but well below the 6.0 percent in 1983. This deterioration has been attributable to declining tax receipts associated with economic weakness and falling capital gains, legislated tax cuts, and sharp increases in federal outlays for national defense and workers compensation and other recession-related income support programs. The publicly-held debt/GDP ratio, benefiting from the improved cash flows in the 1990s, had receded to 33.1 percent in FY2001 from its recent high of 49.5 percent in FY1993. Even if deficits remain very high in the next several years, the debt/GDP ratio would remain below 40 percent, low by recent standards, and among the lowest of industrialized nations.

There are many misperceptions about the effects of deficits, and the comments of many pundits are either superficial or misleading. The bottom line in many deficit-related issues is that the impact of the government's budget (im)balance has less to do with its magnitude than with the allocative effects of the spending and tax structures that generate the budget outcomes.

Empirical studies suggest that the independent impact of deficits on interest rates is minor, and is particularly small relative to the dominant impacts of real economic performance and inflation. Witness the sharp drop in interest rates in recent years amid the dramatic shift from budget surpluses to deficits. Deficits have no direct impact on current inflation, but to the extent that high deficits are associated with rising government purchases that crowd out private investment and suppress potential, they may contribute to raising an economy's vulnerability to long-run inflation.

The correlation between deficits and exchange rates is complex and ambiguous, depending on how the tax and spending structures underlying the deficits affect economic performance and expected rates of return on U.S. dollar-denominated assets relative to assets denominated in other currencies. Exchange rates are influenced by an array of international factors; in the past, rising budget deficits at times have been associated with a strengthening dollar (early 1970s) and at times a weakening dollar (2001-present), while shrinking deficits or surpluses have been related to a strengthening dollar (late 1990s) and a weakening dollar (1985-1989).

The Bush Administration's tax package, currently debated in Congress, combines a proposed long-run reform, eliminating the double taxation of dividends, and more traditional short-run stimulus that would add immediately to disposable income and encourage investment (in the form of accelerating implementation of the rise in the child credit, reduction in the marriage penalty, lowering of marginal tax rates, and increasing the cap on small business expensing of capital spending). Traditional demand-driven

models of the economy project that this package would generate stronger economic growth and jobs, while supply-driven models predict the package's incentives would generate significant gains in efficiencies and improvements in corporate finances that would lift long-run growth and employment.

Concerns about the budget deficit dominate the tax policy debate, which is unfortunate, for several reasons: 1) the debate ignores the positive long-run economic responses to the proposal, and casts its budget implications in traditional Washington budget scorekeeping, which assumes no economic feedbacks; in reality, the positive economic responses would significantly reduce the deficit implications and improve the nation's allocation of resources, 2) the budget scorekeeping is based on 10 year projections which involve simple linear extrapolations that accentuate forecasting errors and distort perceptions about the size of the tax proposal; in reality, the tax package is small measured on a yearly basis or relative to the size of the economy or total tax receipts over the projection period, 3) the static differences between the current House and Senate versions of the tax package amount to a minor rounding error per year (about \$20 billion) in foregone revenues, 4) the fixation on limiting the total "size" of the package has led to gimmickry such as "offsets", "sunset provisions", etc, that only distort the likely impacts of otherwise positive tax proposals (for example, cutting taxes on dividends--a long-run reform--for several years, followed by their reinstatement), and 5) the debate is driven by political rhetoric that is based on many of the common misperceptions about the impacts of deficits that have proved incorrect time and time again. Instead, the debate should focus on economic growth and permanent job creation, and avoid politically-expedient and commonly-held but frequently wrong perceptions about the impact of deficits.

Inflation

Inflation is projected to remain low through 2004; the probability of deflation is remote (see Charts 12 and 13). In general, prices of goods (excluding food and energy) have fallen 1.4 percent, while the prices of services (excluding energy), which constitute roughly 59 percent of the CPI and 55 percent of the personal consumption deflator, have been rising at a fairly steady 3.0 percent rate. Insofar as inflation (deflation) results from persistent excess demand (insufficient demand) relative to productive capacity, the pickup in nominal GDP growth to 3.7 percent year-over-year establishes a low inflation environment, but not a deflationary one. Deflation, a persistent decline in the general price level, is not in the cards, unless nominal spending unexpectedly slumps and remains persistently below approximately 3 percent. Instructively, Japan's deflation has resulted from persistent insufficient demand: in the last 5 years, nominal GDP has been contracting nearly consistently. The weaker U.S. dollar--it has fallen 12 percent on a trade-weighted basis over the last year--is beginning to generate higher prices of imports.

The consumer price index increased 2.4 percent from December 2001 to December 2002; in recent months, headline inflation has been pushed up to 2.9 percent by the earlier energy price increases, but that bulge will reverse in 2003Q2-2003Q3. Other measures of inflation have been below the CPI: the GDP deflator has risen 1.6 percent and the PCE deflator has risen 2.3 percent (1.5 percent less food and energy), while the chain-

weighted CPI, which allows for changing patterns of consumption in response to changes in relative prices, has increased 2.5 percent, 1.4 percent excluding food and energy.

Inflation, Federal Reserve Policy and Financial Markets

The Federal funds rate and bond yields are at their lowest levels in 4 decades (see Charts 14 and 15). Their sharp declines since 2000 reflect falling real interest rates associated with weak economic performance and lower expected rates of return on investment, lower inflation expectations and monetary easing. While inflation has drifted lower, the fall in real rates has been the primary factor driving yields lower. This downward adjustment in expected rates of return is also reflected in the lower real U.S. dollar exchange rate and lower stock valuations.

Amid sustained economic weakness, the Federal Reserve has recently publicly expressed its overriding concern about further disinflation and strong desire to avoid deflation, which it perceives to be potentially destabilizing. In testimony before the U.S. House Financial Services Committee, Federal Reserve Chairman Greenspan stated "With price inflation already at a low level, substantial further disinflation would be an unwelcome development, especially to the extent it put pressure on profit margins and impeded the revival of business spending." In its announcement following the May 6, 2003 FOMC meeting, the Fed repeated this concern. Without explicitly referencing deflation, the Fed has made clear in these official statements and in speeches by members that it has abandoned its objective of zero inflation and would go to great lengths to avoid deflation.

At zero inflation--a stable general price level--prices of some goods and services are falling while some are rising, so that prices changes are changes in relative prices among goods and services based on real supply and demand conditions. As actual inflation has receded, prices of some goods and services (particularly goods) are falling. This is not necessarily bad nor destabilizing.

The presumption that deflation--a decline in the general price level--is destabilizing is based on the notion that it would result in a "downward spiral" in which monetary and fiscal policies would be unable to generate a pick up in demand. Many studies of deflation refer to the U.S. Depression of the 1930s and Japan's ongoing episode as recent bouts of deflation that have been associated with contracting economies. Japan's deflation stems in part from a seriously flawed economic structure and dysfunctional capital markets and banking system that have inhibited the ability of monetary stimulus to generate aggregate demand growth (meanwhile, Japan's high taxes are contractionary). The U.S. Depression was generated by misguided economic policies, including contractionary monetary and trade policy. The current structure and conditions facing the U.S. economy are far different than either of these reference points. The channels through which monetary policy normally function are operating properly, and tax policies are not severely inhibiting growth. Nominal GDP growth has been accelerating modestly and is above potential growth. The presumption that price stability or even mild deflation must be destabilizing seemingly is incorrect. Nonetheless, the current low-inflation and weak economy, and low interest rate environment raise concern. In considering the use

of monetary policy, the zero nominal interest rate bound does preclude a negative real Fed funds rate if expectations of deflation were to emerge. While this may *not* lead to a contracting economy nor eliminate other forms of monetary stimulus, it draws attention to a potentially uncomfortable situation.

In any event, a negative real Federal funds rate is unsustainable and eventually would be inflationary. Persistently stimulative monetary policy will generate stronger economic growth, rising credit demand, and increasing real interest rates. History suggests that when the real Federal funds rate becomes negative, it reverses itself over a reasonable amount of time. The Fed's current concern with low inflation points to a likely delay in any rate hikes until early 2004. Its message to financial markets has led to significant declines in bond yields as portfolios stretch for yield. Eventually, this trend will end and yields will rise with improving economic performance and dissipating worries about deflation.