

AN ECONOMIC PERSPECTIVE AMID UNCERTAINTY

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September 1998

International crises and uncertainty abound, yet the U.S. economy remains fundamentally sound after over 7 years of continuous expansion, and is well positioned and sufficiently flexible to absorb the recent external shocks from Asia and the stock market correction. Economic growth is expected to slow significantly from its robust 3.8 percent pace in the last 10 quarters, but the probability of recession is low. Inflation pressures remain muted, and the Federal Reserve's monetary policy is consistent with low inflation. Deflation is not in the cards. In the first half of 1998, the Asian crisis had a relatively minor impact on economic growth, as domestic demand accelerated while a widening trade deficit suppressed domestic production. However, weakening influences threaten to dominate in the near term, as consumption and investment slow in response to the stock market correction and the trade deficit widens further. Yet, monetary thrust points toward continued domestic demand growth, and interest rates and oil prices have declined, providing support for the economy. The biggest uncertainties facing the U.S. economy are the potential reverberations of a Japanese banking crisis, ongoing severe financial market contagion and/or the spreading use of capital and currency controls by emerging market nations. Amid turbulent global financial and economic conditions, the Fed's credible pursuit of price stability, and its avoidance of misguided policy shifts in response to foreign events and stock market corrections, is crucial for the sustainability of the economic expansion.

RECENT ECONOMIC CONDITIONS

Through the first half of 1998, the economy continued to grow, with few potentially disruptive imbalances. The only disturbing trend has been the recent flattening of corporate earnings. While the unemployment rate hovers near its lowest rate

in decades, the adjustment to tight labor markets and rising real wages has been a moderate narrowing of profit margins, but no inflation pressures.

The decline in interest rates, stronger U.S. dollar, and lower oil and other commodity prices in response to the Asian financial shock that began in late 1997 have mitigated the negative economic impact of the crisis by boosting purchasing power and domestic demand. Real consumption spurted nearly 6 percent annualized in the first half of 1998 and housing activity reached record levels, lifting residential investment 14.4 percent annualized. Business fixed investment remained robust, growing 16.7 percent annualized. These trends lifted domestic final sales nearly 6.5 percent annualized.

Domestic production was suppressed relative to domestic demand as exports declined 5.4 percent annualized in the first half of 1998 and import growth accelerated to 15.3 percent annualized. The dramatic widening of the trade deficit from 149 billion chain 92\$ in 1997Q4 to 246.3 billion chain 92\$ in 1998Q2 reduced real GDP growth by 1.3 percent. Businesses raised production faster than demand in 1998Q1, seemingly underestimating import penetration, and inventory building jumped to an unsustainable 91.4 billion chain 92\$ pace; but inventory building was cut dramatically to 39.1 billion in 1998Q2, in part due to the General Motors strike. Thus, while final sales growth has been strong and relatively stable—4.3 percent growth in Q1 and 4.4 percent in Q2—real GDP grew 5.5 percent in Q1 but only 1.6 percent in Q2.

Trends in unemployment and labor productivity have been consistent with these patterns of economic output and its mix. In 1996-1997, robust gains in nonfarm payrolls (2.6 percent annualized) and labor productivity (1.9 percent) contributed to the rapid economic growth. Employment in manufacturing, which began to experience renewed growth in 1994, continued to rise at a healthy 0.8 percent pace. Labor productivity in manufacturing was particularly robust: 4.5 percent annualized, even stronger than its healthy 3.5 percent annualized gain in 1991-1995. The suppressed demand for domestically produced goods in 1998 has had a marked impact: labor productivity in manufacturing slowed sharply to 2.0 percent annualized in the first half of 1998, and manufacturing employment has fallen 150,000 since April. Employment trends in the non-manufacturing sectors, including service-producing industries and construction, have remained healthy while gradually moderating.

The tight labor markets have pushed up wages—in the last year, average hourly earnings have risen 4.2 percent and the employment cost index 3.5 percent, but these modest accelerations represent an increase in real earnings associated with healthy gains in labor productivity, and have not exerted significant upward pressure on unit labor costs in the non-farm business sector, which have risen 2.3 percent in the last year.

The trajectory of corporate profits has flattened. Following 6 years of 11.2 percent annualized growth—the strongest sustained rise in recent history—NIPA profits, which include write-offs and extraordinary items, have fallen or been flat in each quarter since 1997Q3 and have recorded the first year-over-year decline since 1989. Earnings from continuing operations of S&P500 companies are still rising, but just barely, following years of robust growth. In the GDP accounts, the decline in profits has occurred primarily in domestic nonfinancial industries, while profits in domestic financial institutions continued to rise to record levels. Rest-of-world profits—the net profits repatriated from overseas affiliates and activities—have dipped modestly from peak 1997Q3 levels, suggesting only a minor negative impact from the stronger U.S. dollar. NIPA profits are expected to deteriorate in 1998Q3 due to significant write-offs, restructurings and the GM strike.

Core inflation has remained low and stable, but it has stopped falling: the year-over-year rise in the CPI excluding food and energy has been hovering around 2.2 percent, and the rise in the median CPI is 2.8 percent. A 5.9 percent decline in consumer energy prices has temporarily reduced the overall CPI increase to 1.7 percent. The rise in the GDP deflator has been even lower—1 percent—benefiting from the robust growth of business investment in information processing equipment, whose declining prices have suppressed inflation and raised real output. Producer prices have been equally well-behaved: in the last year, the PPI for finished goods has receded 0.8 percent, for intermediate goods, 2.1 percent, and for crude goods, 12.0 percent, reflecting falling energy and commodity prices and lower non-labor costs. Inflationary expectations have fallen well below core inflation; the inflation expectations implicit in the government's inflation-indexed bonds are not below 1.5 percent.

THE OUTLOOK

Economic growth has begun to moderate, and it will slow further in response to the recession and misguided economic policies in Japan and the associated crises in Asia and other emerging market nations, and the stock market correction, but the fundamentally sound structure of the economy and efficient capital markets responses point to a period of slow growth, not recession. However, recent events raise uncertainty, and increase near-term downside risks.

Importantly, the current situation is very different in character than the typical onset of recent recessions: money supply is growing at a healthy rate, which should sustain aggregate demand growth, interest rates are declining, and the recent fall in oil prices along the stronger U.S. dollar raise purchasing power. The negative shock to production and the economy was initiated from external sources, namely the Asian and emerging markets crisis and, more recently, the related stock market correction. The negative impact on production will feed back into weaker consumption and investment, and more trade deficit widening is likely, but there remains support for sustained growth in demand. *In contrast, recent recessions have been precipitated by the Fed's monetary tightening and rising interest rates that generated a sustained decline in aggregate demand and elicited a decline in production; demand (and production) continued to decline until the Fed eased.* That no recent recession has unfolded in the absence of monetary tightening (either independently or in response to a supply or external shock) does not guarantee smooth sailing; nevertheless, neither current monetary policy nor economic conditions point to recession.

Consumer confidence will be jarred by recent events, but the wealth impact on consumption should not be overstated. The stock market has declined 15 percent from its peak, representing an approximate \$1.4 trillion reduction in household wealth; applying a large elasticity of consumption with respect to wealth of .05 (and completely excluding the offsetting rise in wealth due to the appreciation of Treasury bond prices) generates a 1.2 percent hit to the rate of consumption, which would be large if bunched into several quarters. The negative impact on consumption will be larger as production cutbacks slow growth in employment and personal income. However, even if consumption growth were

interrupted temporarily, it would be quickly resumed in light of the Fed's monetary policy and low interest rates.

Housing activity will continue to receive support from the decline in mortgage rates, but likely will soften in response to a slower growth of employment and personal income, and the decline in household financial wealth. The largest impact of recent financial events will be to temper and perhaps reverse the sharp increases in real estate values.

Business investment plans also may be delayed, largely as a consequence of the flattening of corporate earnings and cash flows, and the heightened uncertainty about their future trends. The impact on the costs of capital vary widely by industry and company, as declining equity valuations may be offset by generally declining interest rates, although some companies face higher borrowing costs as corporate yield spreads have widened. Although businesses may adopt a more cautious posture in response to the heightened uncertainty about expected rates of return on investment, the demands for information processing equipment and other short-lived capital are expected to continue. Even if the pace of capital spending was cut by two-thirds, business fixed investment would grow 5 percent annualized.

A reasonable expectation is that real GDP growth will decelerate to an approximate 2 percent annualized rate in the second half of 1998, a significant slowdown from the recent pace. However, wide bands of uncertainty are appropriate, with potential downside risks in the short run. A flat GDP quarter should not be ruled out, but a sustained decline in demand does not seem likely. Inflation is expected to stay low, and perhaps temporarily recede further, but not fall as much as the market seems to be expecting. Deflation is not in the cards.

Nominal GDP growth is projected to be approximately 3.5 percent annualized in the second half of 1998 and 4-4.5 percent in 1999. This near-term dip from 4.6 percent growth in the last year is consistent with a decline in money velocity associated with the decline in interest rates. Money growth has been accommodative: the monetary base (sweep-adjusted) has grown 7.5 percent in the last year and 5.7 percent annualized in the last six months; M2's growth rates have been 7.3 percent and 6.9 percent.

A rise in the GDP deflation to 1.5 percent annualized would reflect slower growth of investment in information processing equipment, whose declining prices have raised real output and depressed the deflators, rather than representing any rise in core inflation. The decline in oil and commodity prices, and falling prices of non-petroleum imports (their 4.6 percent annualized decline so far in 1998 may accelerate) will temporarily reduce non-labor operating costs and relieve pressures on profit margins from higher labor costs. However, core inflation is unlikely to fall materially from its current rate, as domestic demand growth remains healthy. Although prices of certain goods, services and commodities are declining, deflation—a persistent decline in the general price level—which would unfold only if aggregate demand (nominal spending growth) falls persistently below aggregate supply (the growth of productive capacity) is not on the horizon.

The largest risks to this forecast are external: a severe crisis in Japan's banking system, further severe financial market contagion, and/or any spread of capital or currency controls by key emerging market nations. A significant unraveling of Japan's banks could send shock waves through worldwide financial markets, raising uncertainties about economic outcomes, with higher risks to the downside. However, the flexibility and strength of U.S. financial institutions suggest that a Japanese banking crisis could be absorbed without severely damaging the U.S. economy: U.S. banks are well-capitalized, there is sufficient liquidity, and domestic loan losses are very low; the various capital markets remain orderly and efficient, with few signs of debilitating strain. Moreover, the recent BoJ cut in the discount rate to 0.25 percent and its stated willingness to increase liquidity as needed to avoid financial crisis or deflationary spiral in Japan, reduces the risks of collapse.

The continued efficient operation and flexibility of worldwide capital markets to facilitate international capital flows are crucial, particularly in light of selected large current account imbalances and financial strain in emerging markets. Capital or currency controls impose their largest economic costs on the nation that erects the inhibitions, but they may be damaging to other economies. Malaysia's capital and currency controls are wrong-headed, and any spread of their use by other key emerging market nations would be economically damaging and jarring financially.

FINANCIAL MARKET OUTCOMES

The increased political and economic risk and uncertainty generated by the recent Asian and emerging market crises, and heightened concerns about Japan's economy and financial system, have initiated a significant asset reallocation and flight to quality. The outlook for U.S. corporate earnings, which have flattened, is now more uncertain, and perceived creditworthiness of corporate debt has deteriorated. Assets have been reallocated from emerging markets to the U.S. (and to an extent, European) assets, and more recently, from higher risk investments such as equities and corporate bonds, particularly high yield bonds, into government bonds. U.S. Treasury yields have fallen to their lowest levels since the early 1970s (ditto the yields of most European government bonds), while the yield spreads of corporate bonds over Treasury yields have widened dramatically, values of emerging market investments have plummeted (in their own currencies, and even further in dollar terms). These trends have been accentuated by the deleveraging of investment funds. The stock market has corrected significantly (at this writing, the DJIA is down more than 15 percent from its peak, the S&P, down about 16 percent, and the Russell 2000 is off 30 percent; the S&P 500 trading P/E, which peaked at 29, is now below 25).

Despite the recent sharp declines in U.S. interest rates, *ex ante* real rates remain high. Those real rates should recede with a sharp deceleration of economic growth, and pave the way to still lower market interest rates if inflationary expectations remain low. In light of the sharp declines in inflationary expectations, short-term rates would decline the most with deteriorating economic conditions; a Fed easing would accentuate the steepening of the yield curve.

The U.S. dollar is expected to remain flat-to-modestly weaker versus the DM, and appreciate significantly further versus the Japanese yen. The German economy has rebounded, while U.S. economic performance should weaken and the political liabilities of the President add uncertainty. The yen should fall as a result of Japan's dismal economic performance, its policymakers' lack of credibility, and relatively low expected rates of return on yen-denominated assets. A falling yen is a natural—and necessary—

price adjustment to enable its economic recovery, and is a direct and necessary result of the BoJ's program to increase money supply and reliquify Japan's banking system.

FED POLICY

The Fed must continue to pursue its objective of price stability as a foundation for healthy economic expansion, and avoid misguided policy shifts in response to international events that are beyond its control or by overestimating international impacts on domestic conditions. It must remain cognizant of the limitations of its monetary policy. At the same time, the Fed must be aware of the rapidly evolving capital market and economic conditions, and anticipate the lags between monetary policy changes and economic impacts.

The Fed is now being pressured to ease monetary policy in response to a variety of worldwide woes, including the collapse of Russia, Japan's recession, the Asian crisis and its possible contagion to Latin America, as well as the potential impacts of foreign events and the stock market correction on the U.S. economy. But the rationale for an immediate and dramatic Fed easing is suspect. The Fed is incapable of aiding Russia. Now would a Fed easing help Japan; its problems stem directly from its own misguided economic policies, which the Fed cannot and should not offset. Emerging market nations face their own unique issues; with the U.S. dollar strong and short-term interest rates already low, the primary risk is the spread of currency or capital controls, and a Fed easing is unnecessary. The same arguments apply to a coordinated monetary easing by major industrialized nations (excluding Japan).

The U.S., demand growth remains firm and money growth points toward sustained growth in domestic demand, supported by sharp declines in interest rates and falling oil and commodity prices. The banking system is sufficiently liquid and well-capitalized, capital markets are functioning efficiently, without apparent strains that would be potentially disruptive. Moreover, the wealth effect on consumption should not be overestimated. Based on large estimated responses, the slowdown in GDP growth from its recent trend would leave growth not far from the Fed's central tendency forecast.

As economic growth moderates, the high real federal funds rate may be associated with a slowdown in money growth. Such a trend would require a Fed ease, but an immediate move would be premature.

The psychological impact on fragile and uncertain international financial markets of an expected or actual Fed ease is double-edged: while it may provide an initial positive announcement affect, it runs the risk of backfiring and generating a loss of credibility as financial market participants come to realize the sources of the problems are not monetary in nature and require other remedies.