

ECONOMIC OUTLOOK:

MODERATING GROWTH WITH MODEST INFLATION PRESSURES

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Economic growth continues to exceed reasonable estimates of sustainable growth, as last year's monetary easing is stimulating domestic demand. In 1999, real GDP will grow nearly 4 percent for the fourth consecutive year, despite the negative impact of trade. While the Federal Reserve's recent monetary tightening, along with higher interest rates and oil prices, is expected to slow domestic demand, this dampening trend will be mitigated partially by exports that are rebounding with improving international economic conditions. Real GDP growth is expected to average approximately 3 percent in the next year. Inflation pressures should remain modest, however, as nominal spending growth slows and productivity gains are expected to remain healthy. Short-term interest rates may rise modestly further as the Fed constrains demand growth, while bond yields already have risen sharply and likely are close to a peak. Improving economic conditions in Europe and Japan have contributed to higher worldwide real interest rates. Improved expected rates of return on Euro- and Yen-denominated assets may weaken the U.S. dollar.

Trends in Economic Growth

The spurt in consumption and domestic demand in response to the Asian crisis-related declines in interest rates and oil (and commodity) prices has been sustained by the Fed's monetary easing in Fall 1998. From 1997Q4 to 1999Q2, domestic final sales rose 5.6 percent annualized. Through 1999Q1, consumption advanced at an astounding 5.6 percent annualized pace and housing activity surged, with new and existing home sales reaching all-time highs; since then, their growth rates have simmered. Business fixed investment continues to grow at a double-digit pace, despite the financial market turmoil, with the vast majority of investment in short-lived equipment. During 1997Q4 to

1999Q2, the trade deficit soared from \$113 billion to \$260 billion, subtracting 2.0 percent (1.3 percent annualized) from real GDP growth, as exports flattened with weak international conditions, while imports grew rapidly with the boost in domestic demand.

Annualized real GDP growth may exceed 4 percent in 1999Q3. Fueled by strong vehicle and durable goods sales, real consumption will grow approximately 4 percent annualized, and business investment is expected to show continued expansion. While housing activity remains at a very high level, residential investment may decline modestly. Business inventory building is expected to increase from 1999Q2, adding to output, while the net export deficit, though near its peak, will remain a drag on GDP growth in 1999Q3.

The wealth effect is adding to economic growth, but several comments are appropriate. The stock market is up largely due to excellent economic and inflation fundamentals, so the *independent* impact of the rise in financial wealth on consumption is less than commonly advertised. Secondly, the impact of the strong stock market on capital spending may be as large if not larger than the impact on consumption. The high stock valuations reduce the cost of capital and generate business investment; it is no coincidence that business fixed investment has averaged 9.1 percent annualized growth since 1991.

However, several factors now point to a moderation in domestic demand growth. Since early 1999, interest rates have risen over one percentage point (a 20%+ rise) while core inflation has remained stable, and oil prices have doubled, retracing their two-year decline from early 1997. Monetary policy has moved from accommodative toward neutral: growth of the narrow and broad monetary aggregates has slowed markedly, the Fed has raised the funds rate from 4.75 percent to 5.25 percent, and the yield curve has flattened. The gradual shift toward restrictive monetary policy and sharply higher oil prices and interest rates should slow consumption and domestic demand growth. Historically, initial signs of slowdown show up first in housing and durable goods consumption. To date, housing activity seems to be peaking at very high levels, and residential investment may decline gently in 1999Q3, while consumption of durable goods retains substantial momentum. Overall consumer spending appears to be slowing

gradually from a 5 percent growth pace toward a more sustainable 3-3.5 percent annualized.

The impact of moderating domestic demand on GDP will be tempered, as exports rebound with improved economic performance overseas. After growing 10.3 percent in 1997, merchandise exports fell 1 percent in 1998 while imports remained robust, suppressing domestic production. Merchandise exports to Asia have already picked up sharply with the “V-shaped” recovery in Korea and other Asian nations. Exports to Europe remain soft, and they continue to decline sharply to South America. Imports should moderate with slowing domestic demand and a gradual decline in the trade-weighted value of the dollar. As a result, the trade deficit is projected to stabilize in late 1999 and narrow in 2000, thereby adding to domestic production.

In the eight years of expansion since 1991Q2, the 3.1 percent average annualized growth in real GDP (and the 3.8 percent annualized growth in the non-government component of GDP) has involved 2.5 percent average annualized growth of aggregate hours worked in the nonfarm private sector and 1.6 percent annualized gains in labor productivity. Since 1996, labor productivity gains have averaged over 2 percent (in the manufacturing sector, they have averaged approximately 4 percent throughout the expansion). With increases in employment outpacing the labor force, the unemployment rate has fallen to its lowest level in three decades. Labor markets are tight and presumably future employment increases will be constrained. Whether the recent rapid gains in labor productivity may be sustained is critical, but uncertain. Several factors suggest that labor productivity will remain strong and that trendline growth is close to 3 percent: technological innovations show no signs of abating; the low inflation thrust of the Fed and pricing pressures force production efficiencies; and business fixed investment in short-lived capital remains robust, expanding output, measured productivity, and capacity. In addition, changes in measurement of investment and output in the NIPA currently under consideration would raise (measured) investment, output, productivity, and profits. These changes include new measures of output and productivity in the financial services industry, as well as capitalizing rather than expensing business outlays on certain computer software and intangibles.

Inflation Trend: Sideways with Modest Upside Risks

Inflation has remained low in the strong growth/low unemployment environment due to strong productivity gains and the Fed's monetary policy through 1997 that constrained nominal spending growth and pricing power. The standard Phillips Curve/NAIRU frameworks failed to anticipate the favorable combination of strong growth and low inflation because they do not distinguish between supply and demand driven growth (or changes in the unemployment rate) and do not include a measure of monetary policy or demand growth, thereby failing to incorporate the degree of excess demand. For similar reasons, predictions of inflation based on the "GDP gap"—the measure of actual output relative to potential—have systematically overestimated inflation, and are unreliable guidelines for monetary policy.

Recently, inflation has been relatively stable. The CPI, which dipped to 1.5 percent increase year-over-year through early 1999 with the declining oil prices, has rebounded to 2.3 percent. The CPI excluding food and energy, which hovered slightly below 2.5 percent year-over-year increase through 1998, has decelerated to 1.9 percent. However, much of the deceleration is accounted for by BLS measurement changes that were not applied to historical data. As a result, to a reasonable approximation, the U.S. has enjoyed essentially stable inflation since 1994.

To date, inflation has not increased despite the acceleration of nominal spending growth associated with the Fed's monetary easing last year. The Fed's aggressive lowering of the federal funds rate in fall 1998 marked the third time in twelve years that the Fed eased monetary policy in response to a financial or banking crisis, and soon thereafter tightened. (The Fed eased in response to the 1987 stock market collapse and began tightening six months later. It pegged the funds rate at 3 percent for much of 1992 and 1993, generating double-digit money growth in an attempt to recapitalize the banking system, and then drained the excess liquidity through a series of tightenings beginning in early-1994). In response to the 1998 federal funds rate reduction from 5.5 percent to 4.75 percent, money growth and domestic demand growth spurted. Monetary base growth jumped to 10.9 percent annualized from 1998Q4 to 1999Q2, a sharp rise from its earlier 7.5 percent pace; MZM growth rose briefly to 20 percent annualized in late 1998 from 6.5 percent before the international crisis began in mid-1997; and M2 growth accelerated

to a peak of 12.2 percent from near 5 percent. Nominal GDP grew 6.4 percent annualized in 1998Q4-1999Q1, a marked pickup from its earlier 5.4 percent pace, partially offset by a decline in velocity associated with the temporary flight-to-quality and sharp decline in interest rates during the financial crisis. If sustained, such growth in nominal GDP would generate excess demand; even if trendline economic growth is now 3 percent annually, inflation necessarily would accelerate.

Since March 1999 money growth has decelerated from its earlier rapid growth: monetary base growth has remained rapid, but MZM and M2 growth have decelerated to 7 percent and 5 percent, respectively. At issue is whether the earlier bulge in money growth will continue to generate excessive nominal spending growth and begin to alter the mix of growth between real output and inflation. Money growth is expected to continue to moderate, nominal GDP growth to simmer to approximately 5 percent, and its mix remain favorable toward real output. Increases in inflation therefore are expected to be modest: we expect a small rise in CPI inflation but only to 2.5 to 2.75 percent, while the core CPI rises toward 2.5 percent.

Financial Conditions Outlook and Issues

Interest rates have risen significantly since early 1999 in response to several factors: reversal of the earlier flight-to-quality as the international crisis has subsided and international economic conditions have improved, sustained robust economic growth in the U.S., renewed fears of rising inflation, and the shift in financial markets from expecting that the Fed would ease to actual Fed tightening. Market expectations of inflation implicit in the government's inflation indexed bonds has increased from 1 percent in early 1999 to approximately 2 percent, presently similar to the year-over-year increase in the core CPI. Bond yields have remained relatively unchanged in response to the two Fed tightenings since early July; the flattening yield curve reflects the Fed's inflation-fighting credibility and the market's perception that only modest further increases in short-term rates will be necessary.

The Fed may need to tighten further, but only modestly. Money growth, particularly the monetary base, is still too rapid, but it is slowing; domestic demand remains strong, but is expected to moderate, while exports are picking up; and

productivity growth and capital spending seem to sustain growth in productive capacity. Further Fed tightening is expected to flatten the yield curve, as bond yields remain in their recent range in response to the Fed's inflation-fighting credibility and the perception that tightening will slow economic growth.

The pickup in global economic conditions and improved growth outlook has raised worldwide real interest rates: on average, bond yields in the Euro11 nations have increased approximately 1.1 percentage points since late 1998, while inflation has remained close to 1 percent; bond yield also have risen from 1.1 percent to 1.8 percent in Japan. Most emerging nation bond spreads over U.S. Treasury yields remain very wide, despite generally improving economic conditions, reflecting in part lower risk profiles among international portfolio managers and perhaps Y2K fears.

The significant appreciation of the yen/U.S.\$ in recent months reflects primarily improved economic conditions in Japan and associated higher expected rates of return on yen-denominated assets, rather than any problems in the U.S.; witness sustained strong U.S. economic growth, Fed tightening and high real interest rates. The U.S. dollar remains up on a trade-weighted basis so far in 1999, and the recent yen/\$ appreciation should have a negligible economic or inflation impact on the U.S. In contrast, the stronger yen clearly could inhibit Japan's economic recovery, particularly insofar as the strong yen reflects in part the political stubbornness of the Bank of Japan that prevents it from pursuing an appropriately stimulative monetary policy.

The U.S. current account deficit has increased significantly, reflecting the widening gap between national saving and investment. The current account has increased from \$122 billion, or about 2 percent of GDP in 1994, to \$274 billion, or 3.1 percent of GDP (on a 4-quarter rolling basis). Contrary to public opinion, national saving has risen about one percentage point as a share of GDP, to around 17 percent, but investment has risen about two percentage points, to 19 percent of GDP. (The approximate 1 percentage point difference between the current account deficit and the saving/investment gap is statistical discrepancy). Until recently, the increasing reliance on foreign capital has been associated with a firm U.S. dollar, reflecting the high expected rates of return on U.S. dollar denominated assets and weak economic performance overseas.

The improving economic conditions in Japan and Europe and the associated renewed attractiveness of overseas investment opportunities have increased concerns about the U.S. reliance on foreign capital. A weaker U.S. dollar and higher interest rates than would occur otherwise may be necessary adjustments. But those financial market adjustments will be tempered by several factors that suggest that current fears of a market-jarring flight of capital are unwarranted: U.S. economic performance is strong and expected rates of return on U.S. dollar-denominated assets remain high; international portfolio managers recognize the unique benefits provided by the liquidity and efficiency of U.S. capital markets; U.S. economic policymakers are significantly more credible and predictable than their foreign counterparts (particularly the Japanese); and the dollar remains the world's primary reserve currency. Importantly, the recent decline in the U.S. dollar is due to improving conditions abroad rather than any deterioration in U.S. fundamentals and, as such, economic and financial adjustments over time will reverse the recent widening trends in both the trade and current accounts. Accordingly, the recent declines in the dollar should not be of great concern to U.S. policymakers.