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Economic and Financial Performance

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In response to the extraordinary 4.6 percent average annualized economic growth from 1996 through mid-2000 and the associated spike in labor productivity, most analysts and policymakers raised their estimates of sustained potential growth, in some cases to twice as fast as standard estimates of 2.25 percent of 10 years ago. Recently, several of the factors that contributed to the out-sized growth--monetary ease, lower interest rates, lower energy prices and a robust stock market--have reversed, and growth has begun to decelerate. As this soft-landing unfolds, economic growth will moderate further and corporate profits will continue to disappoint lofty expectations. While the spurt of technological innovations will continue, overly-optimistic estimates of potential economic growth likely will be revised down to very healthy but more realistic rates. Higher energy prices have raised headline inflation after several years in which declining energy prices suppressed inflation, but core inflation has remained low and is expected to remain stable. The recent declines in the stock market, higher energy prices and financial market turmoil have added uncertainty to the outlook for near-term economic activity. In this context, the Federal Reserve must avoid the temptation to over-manage the economy or financial markets, and continue to pursue its long-run objective of price stability.

Recent Economic Conditions

The healthy economic expansion shifted gears with the Asian crisis in late-1997, as declining interest rates, a surge in foreign capital inflows, a strengthening dollar and falling energy prices boosted real growth in domestic demand and productive capacity, while accelerating imports and sharply slower export growth widened the trade deficit and suppressed domestic production relative to demand. Prior to the crisis, high expected rates of return on investment in U.S. dollar-denominated assets relative to assets denominated in other currencies associated with the healthy U.S. economic performance attracted foreign capital and helped finance strong investment. As currencies of Asian nations collapsed and their economies temporarily contracted, raising fears about all emerging markets, net foreign capital flows surged into the U.S. The Federal Reserve's dramatic monetary easing in Fall 1998 in response to the financial turmoil triggered by the Russian default fueled a sharp acceleration in aggregate demand and output.

The resulting economic and financial trends were dramatic: from 1997Q3 through 2000Q2, domestic final purchases growth jumped to 5.6 percent annualized, compared to its 3.3 percent average since the expansion began in 1991Q1, and real GDP growth averaged 4.6 percent, compared to its earlier 3.3 percent average. During this period, real consumption growth averaged 5.2 percent annualized, while business fixed investment increased at a 10.6 percent pace. The trade deficit widened to $403 billion, or 4.3 percent of GDP from $120 billion and 1.5 percent of GDP in 1997Q3, and the current account deficit ballooned to $440 billion, or 4.4 percent of GDP, up from 1.6 percent in 1997Q3.

The key cyclical and structural factors that stimulated robust growth have reversed, and have begun to slow growth in consumption and investment, and likely will lead to a peak in the current account deficit. The Fed has raised its funds rate to 6.5 percent, growth in both the narrow and broad monetary aggregates has slowed significantly from earlier rapid rates, and the Treasury yield curve has inverted. As the Fed has slowed money growth, corporate bond issuance has ebbed, credit premiums have risen significantly, and banks have begun to tighten credit standards and slow lending. The fall in stock prices since Spring 2000, a natural response to the monetary tightening and the flattening trajectory of earnings relative to high expectations, reduces household financial wealth and raises business costs of capital and reduces its availability.

The sharp rise in oil prices above $30/barrel is a negative supply shock and operates effectively as a tax hike as the Fed's monetary tightening slows current dollar spending, and it constrains productive capacity. This reverses the positive cyclical and structural impacts provided by the fall in oil prices (from $22/barrel to $11/barrel) following the Asian crisis, which had temporarily boosted domestic demand and raised the share of nominal spending that was real output. Several factors suggest that the economic impact of the rise in energy prices will be about one-third as large as the two oil price shocks of the 1970s: the share of energy usage has diminished significantly as a share of consumption and output, the recent oil price increase is much more moderate when measured from a pre-Asian crisis level, and more effective uses of improved hedging instruments are available.

Consumption growth decelerated to 3.1 percent annualized in 2000Q2, reaccelerated to a robust 4.5 percent pace in 2000Q3, and early indications point to a resumed slowdown in 2000Q4. Motor vehicle sales were weak in October despite aggressive pricing and financing incentives, and chain store sales have also been soft. Confidence surveys, while still high, have begun to erode, and point toward further slowdown. The short-run price inelastic demand for energy products will slow demand for non-energy products, and stock market declines may dampen the propensity to consume. Housing activity remains high, but both sales and new starts have receded from earlier levels. Insofar as the earlier strength in housing was stimulated in part by the booming stock market, softer activity and prices are likely.

The earlier robust pace of business fixed investment is projected to moderate, perhaps significantly, in coming quarters. Business fixed investment has risen 10.4 percent annualized since 1992; since 1996, its average growth has been an even faster 12.1 percent. The resulting rise in business fixed investment to 15.0 percent of GDP from 9.2 percent of GDP in 1992 has been heavily concentrated in information processing equipment and computer software, as old capital is replaced with new capital that embodies technological innovations. Information processing equipment and software now constitute almost 49 percent of total business fixed investment, a dramatic rise from 25 percent in 1992. The positive factors that stimulated robust capital spending, even beyond its already technology-elevated pace, have dissipated: since Spring 2000, product demand has slowed and the cost of capital has increased significantly. As corporate earnings have generally fallen shy of expectations, stock valuations have fallen dramatically for some companies, and the IPO market has soured as a source of cheap capital, particularly for small and-medium capitalized companies. The corporate bond market has deteriorated as credit risks have risen dramatically and new issuance has slowed sharply, particularly in the telecommunications industry. In addition, in response to heightened credit concerns, banks have tightened credit standards. While the long-run outlook for capital spending remains positive, growth may slow to less than half its recent rate through 2001.

As U.S. economic growth moderates, the trade deficit should stabilize. Import growth, which is particularly sensitive to capital spending, is projected to slow. Since 1990, imports of capital goods and industrial materials have constituted over 70 percent of total import growth; while weaker consumption would slow imports, a deceleration in capital spending would have a larger impact. Export growth, which has averaged 10.4 percent growth since 1999Q1, may moderate with slowing worldwide economic growth, but not dramatically. Since 1996, the widening net trade deficit has suppressed GDP relative to domestic demand by 0.9 percent average annually, so this economic soft-landing will change the composition of output.

Similarly, the bulge in the current account deficit should stabilize. Decelerating investment growth is projected to narrow the widening gap between national investment and saving, while diminished expected rates of return on U.S. dollar-denominated assets associated with the economic slowdown and stock market weakness will slow net foreign capital inflows into the U.S. A lower U.S. dollar is an expected adjustment to the high current account deficit.

Economic growth is projected to decelerate to 2.5-2.75 percent through mid-year 2002. Although the sharply higher energy prices, a falling stock market and tighter bank credit add downside risks and uncertainty to the outlook, the economic slowdown is measured from a strong growth base, and the probability of recession remains low.

A Comment on Potential Growth

The rate of potential growth is uncertain, and in reality estimates are only educated guesses. The spurt in technological innovation, robust growth in capital spending and heightened efficiency in production processes seemingly have lifted sustainable trendline growth well above early 1990's estimates of 2.25 percent but, in my assessment, to approximately 3-3.5 percent, not 4-5 percent, as many now assert. The Asian crisis-related factors that enhanced capital spending and economic growth from late-1997 to early-2000 also temporarily pushed up potential growth, and those factors have reversed.

Although labor supply has been more elastic than assumed previously--in part due to changes in immigration law and the Social Security earning test for elderly workers--the 3.9 percent unemployment rate suggests that sustainable growth of the labor force is approximately 1-1.25 percent. Accordingly, sustainable trendline growth hinges critically on sustainable productivity gains.

Virtually the entire bulge in nominal and real GDP growth from late 1997 to mid-2000 involved a sharp acceleration in labor productivity growth. In addition to the obvious productivity-driven growth of the computer industry, evidence now shows clearly that technological innovations are increasing productivity in a broadening array of industries. One example is the enhanced flexibility that the economy now displays as demand fluctuates, both due to improved production processes and better real-time information. Since demand began slowing in 2000Q2, businesses have quickly trimmed labor in order to maintain productivity and profit margins; aggregate hours worked have declined since late Spring. That suggests higher sustained growth. But the productivity bulge in recent years has reflected in part a dramatic pick up in business investment in information processing equipment and software, which may have been boosted temporarily by the positive thrusts following the Asian financial crisis and Y2K preparation. This spurt in capital investment presumably involved relatively low labor intensity of production. A deceleration of investment would slow both real output and labor productivity. Expectation of 3-3.5 percent sustainable growth--about 50 percent faster than earlier estimates and still consistent with the notion of a “new economy”--seems a more reasonable basis for conducting macroeconomic policy than 4+ percent assumptions.

Wages, Energy Prices and Inflation

Recently, wage compensation has accelerated and rising energy prices have pushed up headline inflation, but core inflation has stayed low and stable. These trends are not inconsistent. Real wages rose in the 1990s (1.1 percent annualized), but did not keep pace with gains in labor productivity (2.0 percent). The energy price-related rise in reported inflation has suppressed real wage gains, and amid tight labor markets, wages are rising as a catch up to productivity growth. In the last year, while wage compensation increased 5.1 percent in the nonfarm business sector, labor productivity rose 5.0 percent, so unit labor costs increased a scant 0.1 percent; in manufacturing, robust productivity gains exceeded wage increases, and ULCs declined. Real compensation for more productive workers is not inflationary. If wages begin rising faster than productivity and ULCs start rising--a likely possibility as wages continue to accelerate modestly and productivity gains decelerate--the inflation outcome depends on business pricing power, which hinges crucially on the trend of aggregate demand relative to productive capacity. If excess demand is squeezed, which constrains business pricing flexibility, margins will narrow and core inflation will remain low; accommodative aggregate demand would afford pricing flexibility and core inflation would rise. With nominal spending growth decelerating from 7.7 percent in the last year to an estimated 5.0 percent through mid-2001, any rise in core inflation from its year-over-year rise of 2.5 percent will be modest and temporary.

Similarly, the rise in energy prices will not push up core inflation as long as the Fed's monetary policy constrains nominal spending growth. Since demand for energy products is price inelastic in the short run, the rise in current dollar spending for energy constrains spending on non energy products. The resulting slowdown in real consumption will reinforce the trend toward domestic demand moderation, but is unlikely to produce a hard landing. Importantly, the energy spike represents a change in relative prices, not a permanent increase in core inflation. The energy price spike also squeezes business margins.

Monetary Policy and Financial Market Performance

In response to mounting signs of moderating growth, financial markets have responded in a predictable, traditional fashion: expectations of the Fed's monetary policy have changed from forecasts of more tightening to anticipating that the next move will be a reduction in the funds rate; stock prices have fallen and corporate bond spreads have widened as revenue and earnings shortfalls have jarred expectations and raised concerns about credit worthiness; and a flight to quality has lowered Treasury yields. The long-lasting inversion of the yield curve clearly has been a function of expected debt reduction as the Treasury has carried out its buyback operations. Based on the sustained inversion of the Treasury yield curve and the prices of the government's inflation-indexed bonds, neither the rise in wages nor energy prices have increased inflationary expectations. The adjustment of expectations in response to disappointing earnings has been jarring. Slower economic growth, a cyclical deceleration in productivity gains and the negative impact of higher energy prices on business margins suggests that earnings expectations may require further downward adjustment.

The projected slowdown in nominal spending growth is consistent with the Fed's low inflation objective. Since 1996, real GDP growth has persistently outpaced the Fed's expectations; since 1998, nominal GDP also has significantly exceeded the Fed's central tendency forecasts. Economic performance in 2000Q3 (nominal GDP growth, 4.8 percent; real growth, 2.7 percent, and personal consumption deflator, 2.1 percent, 1.5

percent excluding food and energy) fell slightly below the Fed's central tendency forecasts of 5.5-6.0 percent nominal GDP growth, 3.25-3.75 real growth, and 2.5-2.75 percent deflator, and 2000Q4 looks similar. Constraining inflation pressures in the face of higher energy prices and rising wages requires that nominal spending growth recede to 5.5 percent.

With decelerating demand, the Fed is expected to keep its federal funds target on hold in the foreseeable future. However, slowing growth and declining expected rates of return on investment point to a receding natural rate of interest. As a result, holding constant the federal funds rate eventually may involve slower money growth and effectively further monetary tightening. Accordingly, in the current environment, it is particularly important that the Fed rely on the monetary aggregates, rather than interest rates, as guidelines of monetary thrust.