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Will Falling Equity Prices Produce a Double Dip in the U.S. Economy?

By David Hale

The divergence between the performance of the U.S. economy and equity market is the greatest in living memory. The U.S. equity market appears likely to experience its third year of negative returns for the first time since the periods 1929-1933 and 1939-1941 despite the fact that there are clear signs of at least a moderate economic recovery.

Investor appetite for risk has fallen sharply for several reasons. The markets have been shocked by evidence of accounting fraud and other forms of corporate governance abuse at several large companies. There is concern that falling equity prices could depress household confidence as well as business sentiment and set the stage for a double dip in the economy. There is apprehension about the competence of the administration's economic policy team because of its surrender to protectionist forces during the first half of the year and seeming inability to regain the initiative in managing the corporate scandals. The markets fear that pollsters now control the White House and that Congress will play the decisive leadership role in shaping regulatory changes affecting corporate governance. There is growing recognition that the war on terrorism will be prolonged and that U.S. is moving towards a new foreign policy doctrine in favor of pre-emptive action against potentially dangerous countries such as Iraq. The prospect of war in the Persian Gulf could drive oil prices higher and increase the risk of political inability in neighboring countries such as Saudi Arabia.

The market has recently experienced a rally but it is unclear if the uptick will produce a sustained change in sentiment. The outlook for corporate profits is still mixed. The Federal Reserve does not want to be seen reducing interest rates in order to prop up the equity markets. There is little prospect of the administration and Congress agreeing on any major fiscal policy proposals to stimulate growth. The markets are also apprehensive about how the pending changes in corporate governance and accounting could affect corporate profitability and the economy.

There is a clear risk that the new regulatory mood will cause both accounting firms and corporate managements to become highly risk averse. They could now penalize the growth of corporate profitability by compelling firms to recognize the cost of stock options, reduce pension fund shortfalls, and expense other items which might have been capitalized in the past. Managers could also become more cautious about investment decisions because of the short-term impact on profitability at a time when investors are very frightened of any negative surprises. The tort lawyer community could also attempt to take advantage of new legislation by litigating against companies which are perceived to have problems with their accounting.

Investors clearly want policies which promote improved transparency and disclosure of information. But they also are concerned about regulatory overkill threatening the performance of successful companies and the valuation parameters of the equity market. One month ago the market appeared to be fairly priced at a P/E multiple of 20 with government bond yields of 4.75%. But there is now a significant possibility that profits will be revised down and thus boost P/E multiple to levels which investors could find less attractive. According to Prof. Jeremy Siegel, a new more conservative definition of core earnings proposed by S & P produces profits 17% below those in conventionally reported accounts. Options expenses accounted for most of the difference as the net effect of other adjustments (such as pension fund gains) offset each other. What remains unclear is how changes in the accounting treatment of items currently capitalized could affect reported earnings.

The U.S. is now moving towards its most aggressive reforms of corporate governance and financial markets since the 1930's. As during the early years of the 20th century and the 1930's, public outrage over corporate scandals and abuse of power is encouraging demands for reforms of corporate governance, disclosure, and the accounting profession. According to the Financial Times, executives responsible for the companies which suffered from accounting fraud and other abuses, collected \$3.3 billion on their stock option programs. Such revelations have greatly inflamed public opinion and thus profoundly altered Washington perception of the corporate sector.

The proposals moving through the Congress would create a new institution to regulate the accounting profession, increase the jail-time for corporate fraud, and attempt to strengthen audit committees. The SEC is also requiring all firms with over \$1.2 billion of sales to have their CEO's certify their accounts before August 14th. What remains unclear is how these reforms will affect the accounting practices which actually set the stage for the recent scandals. America is different from other industrial countries in having an accounting profession which depends upon rules rather than principles. The rules provide accountants with a wide range of options for how to address complex issues without requiring that the accounts actually reflect economic reality. Enron, for example, was able to hide billions of dollars of liabilities by exploiting accounting rules originally designed to regulate leasing activity. The quality of audits also has suffered from a change in the focus of accountants to corporate systems rather than substance. This change has helped to expose improper behavior by middle level employees but increased the freedom of senior executives to manipulate the accounts in other ways. The scandals will probably encourage organizations such as the FASB to re-examine the accounting rules for SPE's (special purpose entities), options, and other issues which have been highlighted by the recent scandals. But it's important to remember that the FASB is responsible for many of the rules which originally led to the problems while its attempts to reform option accounting were actually opposed by Congress during the mid-1990's. In fact, the Congress has declined to enact any new legislation to regulate options despite widespread public perceptions that they helped to create the preconditions for the recent upsurge of corporate fraud.

The issue of scandals is likely to fade during the late summer after the country's leading companies recertify their accounts and the President signs the new legislation. It will take analysts longer to determine the impact of accounting changes on corporate profits because there are divergent ways to account for the cost of options, pension fund outlays, and other items which are now controversial. Some brokerage firms, for example, estimate the cost of expensing options will reduce profits by only 3% while others project the cost could be 15-20% of profits. The poor performance of the equity market and low level of bond yields could also compel some firms to lower their estimates of pension fund returns from 9-10% recently to numbers in the 6-7% range. Such adjustments could also produce large earnings adjustments during late 2002 or 2003 at companies with large unfunded liabilities, such as General Motors. The government estimates that U.S. corporations would have an unfunded pension liability of \$111 billion, if firms could earn only 5% on their assets compared to widespread projections of gains in the 8-10% range. The prospect of firms using conservative forms of accounting could ultimately be positive for equity market values by enhancing investor confidence in the quality of profits. The problem in the short-term is that the market has to adjust to the unraveling of a bubble period in which valuations rose sharply on the basis of both faulty business models and fraudulent accounting.

There will be no simple way for the administration to restore confidence in its economic team. In the American system of government, the traditional center of economic policy is the U.S. Treasury with other agencies such as OMB, the USTR, and the State Department playing a supportive role. The problem is that the Treasury's role also depends heavily upon the personality of the Secretary. Mr. Paul O'Neill has failed to gain the confidence of the markets because of a personal style which has often caused him to appear as a cantankerous outlier in the conduct of policy rather than as someone playing a commanding role. He is not the first Treasury Secretary to suffer from such a problem, but he stands in sharp contrast to his immediate predecessors, Robert Rubin and Lawrence Summers. The Clinton administration did not offer any economic proposals without their consent. As Mr. O'Neill himself has publicly admitted, he did not support the administration's proposals for steel tariffs and corporate tax cuts earlier this year. He also has frequently made comments about international economic issues which have increased investor's risk perceptions of emerging market economies.

The administration policy which most clearly alarmed the markets earlier this year was the decision to impose tariffs on steel and Canadian lumber as well as supporting the congressional farm legislation which could

undermine the Doha trade round by boosting agricultural subsidies. The markets perceive that such policies were driven by White House political advisors, such as Karl Rove, not the traditional institutions of economic policy, such as the Treasury or USTR.

The administration maintains that these protectionist concessions were unavoidable because they were the price of obtaining congressional support for the fast track trade bill. According to Karl Rove, the steel tariff helped to obtain the votes of twelve members from steel producing districts for the fast track bills which narrowly passed the Congress. The administration decided over one year ago that it would not be able to achieve any success in trade policy without the fast track legislation, so it has been prepared to offer protectionist compromises in order to obtain congressional support. The Clinton administration resisted all protectionist temptations but was not able to obtain any fast track legislation during its final years. The great unresolved question is whether the Bush administration could have persuaded Congress to enact any trade legislation without fast track authority. The Clinton administration did obtain congressional support for an African trade bill and Chinese membership of the WTO without fast track authority. Some contend that the Bush administration might also been able to obtain support for other bilateral trade agreements without fast track authority.

Both Chambers of Congress have now approved fast track bills and the Senate should complete work on the issue in the near future. If the Congress can complete the legislation, the administration will be able to claim that its trade concessions were an acceptable price to pay for having a more secure political foundation for pursuing new trade deals.

The administration has launched a new initiative to reduce agricultural subsidies despite the recently enacted bill to boost U.S. farm subsidies. The administration is attempting to rationalize the new U.S. subsidies on the grounds that they merely institutionalize what Congress already was doing through supplementary spending bills while pointing to the much higher level of subsidies prevailing in other industrial countries. The U.S. wants to create a rule which would cap farm subsidies at 5% of the value of farm output compared to current levels of 25% in Europe, 40% in Japan, and 8% in the U.S. Under the current rules, the U.S. is spending about \$19 billion on subsidies compared to \$60 billion in Europe and \$30 billion in Japan. The new initiative on farm trade is encouraging because the developing countries are demanding such reforms as quid pro quo for their own trade liberalization. But the subsidies are so deeply entrenched in the political systems of the industrial countries that it is far from clear that the Doha trade round will be able to achieve major breakthroughs. If the Doha talks stall, the Bush administration may attempt to justify its protectionist compromises on behalf of the fast track bill by pursuing more bilateral trade deals with countries such as Australia, Chile, Singapore, and Morocco.

Enactment of fast track legislation has boosted market confidence by lessening the risk that the administration will feel compelled to make other compromises with the forces of protectionism. The fast track news should also help to stabilize the dollar after a sharp decline which resulted in part from market perceptions that the administration might favor a soft dollar policy in order to bolster American manufacturing industry. In fact, the dollar's decline coincided very closely with the introduction of the steel tariffs.

The problem for the markets this autumn is that the risk of war with Iraq is likely to loom larger and larger as a possibility. Most pundits are confident that the U.S. military will be able to annihilate the forces of Saddam Hussein in a few days. But the prospect of war will still create numerous new risks. Will the oil price rise sharply because of the risk of supply interruptions in the Persian Gulf? Will an attack on Iraq produce an upsurge of anti-Americanism and revolutionary ferment in Saudi Arabia or other Arab countries? Will Iraq use weapons of mass destruction against Israel and compel her military to become directly involved in the war? Will the U.S. be able to produce a viable new political regime in Baghdad or will Iraq fragment into new ethnically defined territories creating a regional balance of power vacuum in favor of Iran?

It is possible to construct a variety of scenarios for how the war will play out. The most benign scenario would produce a rapid U.S. military victory at a modest cost and the introduction of a new pro-American government in Baghdad which would attempt to boost oil output in order to pay for economic reconstruction. The most negative scenario would produce a high cost military campaign accompanied by significant political instability in Saudi Arabia, Jordan, and other countries which were pro-American in the past. The U.S. military would

surely prevail on the field of battle in Iraq, but the markets might become concerned about the need for military intervention to prevent revolution in Saudi Arabia.

The Bush administration is still weighing all these risks as it formulates a policy for Iraq. But the administration has now invested so much political capital in the campaign against Saddam Hussein, it cannot easily back-down. As a result, the risk of war in the Persian Gulf is likely to emerge as a major constraint on the performance of the financial markets after the corporate governance scandals fade this autumn.

Since the war against terrorism has clearly boosted the president's popularity, he has a strong incentive to make military and foreign policy issues predominant in the public mind. The focus on military issues and the war against terrorism is always a problem for the financial markets because of what it implies for resource allocation. The U.S. defense budget will soon be \$100 billion larger than it was only twelve months ago. All federal discretionary spending is increasing at a 9% annual rate. After a long period in which the role of government had been shrinking, we have entered a new era in which security concerns will justify large increases in both public spending and the role of government.

Whereas the financial markets benefited from the peace dividend during the 1990's, they are facing the prospect of increased costs for security in both the public and private sector. The prospect of a long war also has implications for political and cultural values. In the 1990's, America celebrated individualism, the pursuit of wealth, and the development of technology for profits. In a time of war, there has to be a change of values in favor of sacrifice and promoting a larger public good.

Michael Prowse wrote an insightful column for the Financial Times last month on the role which values had played in setting the stage for the recent corporate scandals. After being a great enthusiast for American values during the mid-1990's, he expressed second thoughts about how far the culture changed in response to unrestrained individualism. He said, "Many people's behavior is now guided almost exclusively by prudential considerations. In other words they obey the law, help others and respect customs and mores only if they calculate that this will benefit them personally in some way. They do not accept the validity of 'oughts' or 'shoulds'. On this view, 'doing one's duty, regardless of the personal cost' is the philosophy to which only fools should subscribe...*The market economy...is an arena in which individual action is guided not by ethical values, but by personal preferences. The rational market participant is supposed to treat everyone and everything as a means to his ends...Today's excesses are not comparable with most previous episodes of financial depravity because they follow a quarter of a century in which policymakers have striven to enhance the authority of markets...But the total effect was to promote a virulent individualism*".

The corporate scandals would have forced America to re-examine its values irrespective of other background factors. But the fact that the nation is now effectively at war will require an even more far-reaching adjustment in attitudes. Future historians may note that there was a sharp decline in equity prices during 2002 because of the country coming to terms with the full consequences of its new challenges. In the 1990's, the major ambition of America was promoting wealth creation in a world seemingly at peace except in a few peripheral regions of the third world. In the first decade of the new century, the great goal of America is to re-establish global peace and security through a war against terrorism and rogue states with weapons of mass destruction. Other ambitions, including the pursuit of profit, will have to play a secondary role until this struggle is concluded.

Will the Stock Market Slump Depress Consumption?

The U.S. government has published revised estimates of GDP growth which indicate that the economy experienced a more classical recession last year than was first thought. On the basis of the new data, real GDP contracted for three quarters last year, rather than just one. The decline was only 0.6% of GDP or the smallest of any modern downturn. The downturn was also unusual in that it was led by a slump in business fixed investment rather than homebuilding and consumption. The Federal Reserve did not produce the downturn by pushing interest rates to levels which provoked a downturn in traditional cyclical sectors, such as housing and consumption. Investment declined because of the unraveling of the speculative excesses which had caused capital spending to rise sharply during the late 1990's. It was apparent by late 2000 that many of the companies

which had led the spending boom on telecom and information technology capital goods did not have viable business strategies. As a result, both their share prices and capital investment experienced a large correction.

The U.S. economy slowed sharply during the second quarter after a robust 5.0% growth rate during the first quarter. As inventory demand had accounted for over half the first quarter growth rate, it was not surprising that output growth slowed to a 1.1% annual rate. The American forecasting community is still confident that growth will resume at a healthy rate during the second half of the year. The mid-July Blue Chip forecasting consensus projected 2.8% output growth this year and 3.6% during the third quarter, 3.7% during the fourth quarter, and 3.7% during the first half of 2003. There is also less dispersion among the forecasts than in the past. The ten most optimistic project 4.2% output growth next year while the ten most pessimistic project 3.0% output growth. There is more variation in profit forecasts. In 2002, the consensus projects 5.7% profit growth with the optimists at 13.1% and the pessimists expecting a 4.0% decline. In 2003, the consensus is projecting a profit gain of 9.2% with the optimists at 15.8% and the pessimists at 3.5%.

The great question now looming over forecasts is how much will recent stock market weakness depress consumption and investment. The consumer sector withstood large stock market wealth losses during 2000 and 2001 because monetary policy helped to produce a very robust housing market. But there are signs that the housing market has reached a peak while wealth losses in the equity market have been increasing. As a result, the Michigan survey of consumer confidence fell sharply during early July. It noted, "Although interviews conducted in late July were not as negative as earlier in the month, the loss in confidence for the month as a whole was still substantial. The July decline reversed all the gains recorded during the past six months, with widespread concerns among consumers about the potential economic impact from the accounting scandals and declines in stock prices. While slower economic growth and higher unemployment were anticipated by all consumers, these concerns were especially acute among consumers that mentioned stock price declines when asked to identify important recent economic developments. Importantly, consumers that cited the accounting scandals and stock price declines were also more likely to expect declines in interest rates. The data indicate a slowdown in consumer spending but not outright declines in overall expenditures, with a disproportionate share of the burden falling on purchases other than homes, vehicles, and other interest sensitive purchases.

The stock market capitalization of the U.S. has declined from a peak of 181% of GDP in March 2000 to 110% at the end of July. The only comparable decline was the one from 1929 to 1932, when market cap fell from 81% of GDP to about 20%. The major consolation is that the current market cap is still far above the post war average of 50% of GDP and the July 1982 trough of 33% of GDP.

The stock market decline has reduced household wealth from a level equal to 4.2 times personal income over two years ago to 3.4 recently or a level equal to where it was during the mid-1990's. The value of household equity peaked at \$9.4 trillion during the first quarter of 2001 and has declined to a level of about \$5 trillion today. The Bianco research group also estimates that households now have only \$222 billion of unrealized mutual fund profits compared to \$500 billion in May and a previous peak of \$751 billion in December 1999.

As a result of the stock market decline, housing has once again become the most important asset on household balance sheets. In the first quarter of 2002, housing was worth \$6.7 trillion compared to \$5.6 trillion two years ago. The housing sector has helped to sustain consumer spending through three channels. First, rising house prices have boosted consumer net worth. Secondly, increased turnover of homes encourages spending on appliances and home repair. Thirdly, low interest rates have encouraged unprecedented level of mortgage refinancing activity. It shot up to \$1.1 trillion last year from only \$250 billion during 2000 and is continuing at an annual rate of \$960 billion this year. Since homeowners typically increase the value of new mortgages by about 7%, they have reaped about \$90-100 billion of capital gains for consumption or other forms of savings. In 2001, households probably spent about \$70 billion of these proceeds.

The massive expansion of mortgage borrowing has pushed household debt up to a level equal to 75% of nominal GDP compared to 65% ten years ago, but low interest rates have held debt servicing costs at 14.1% of disposable personal income. As Alan Greenspan explained in his recent congressional testimony, the housing market has played a major supporting role for the economy in the face of falling equity prices and declining capital investment. The risk is that housing will not be able to offset these negative factors if the corporate scandals and falling equity prices further depress business confidence and investment while also eroding

household balance sheets. In fact, Fannie Mae estimates that mortgage refinancing could decline to \$600 billion next year, if short-term interest rates simply go sideways.

The other factor which has been supporting consumption is low inflation. The growth rate of nominal retail sales has been running at the very modest level of only 2.5-3.5%, but real growth has been stronger because of falling prices for autos, gasoline, and other goods. There is unlikely to be any major resurgence of inflation during the near term if the growth rate of demand remains modest, but oil prices could spike this autumn because of war risk while firms are experiencing cost pressure from industrial raw material prices which could encourage more attempts to raise finished good prices later this year. The increase in the price component of the purchasing agent index during the past six months has been greater than at any time during the past thirty years except for the 1976 recovery. The resilience of this index indicates that there are cost pressures in the economy despite the good performance of the CPI and the GDP deflator.

The outlook for investment remains mixed because firms have experienced only a modest profit recovery while many firms are still suffering from balance sheet excesses left over from the previous boom. The corporate default rate has shot up to nearly 5.0% from 1% during 1998 or a level close to the previous post-war peak of over 5.0% during 1991-1992. The default rate on the value of speculative grade debt has risen to a new high of 17% compared to 2-3% during 1998 and a previous peak of over 12% during 1991-1992. The WorldCom bankruptcy will now push both ratios higher.

The increase in the default rate has begun to tighten lending conditions in the bond market after a long period in which firms were able to raise large sums for high-grade credits. In recent weeks, there has been a slump in bond issues of all quality. There have also been continued deadlines in bank lending and commercial paper issuance both because of firms liquidating inventories and increased caution by lenders. The situation does not yet resemble a full scale credit crunch but it is more stressful than at any time since 1998. It also is striking to note the increased correlation of many asset markets with the S & P 500. This increased correlation suggests that investors have few places to hide from the problems gripping the equity market. The Federal Reserve has not been alarmed about the upsurge of defaults because the bonds did not belong to highly leveraged institutions, such as hedge funds.

There are signs that the investment downturn in the high technology sector has begun to abate but the recovery is likely to be uneven because of the excesses which occurred during the late 1990's. There is no prospect of a recovery in telecom capital spending because the investment boom of 1997-2001 created far more capacity than can be profitably employed. Even at peak demand, capacity is more than twice as large as system traffic while during periods of average demand capacity is almost twenty times as large. There will not be a telecom recovery until more firms go bankrupt and consolidate their operations. But the telecom sector, alone accounts for only about 7% of capital spending in the U.S. economy. The major demand sectors for capital spending are consumer discretionary companies (25.7%), industrial companies (25.3%), financial service firms (22.1%), materials producing companies (5.3%), consumer staple companies (5.1%), utilities (3.3%) and information technology companies (3.1%).

If the economy can continue to achieve steady modest growth of output, there will be sufficient demand for capital goods from the non-telecom sectors to produce at least a modest upturn in capital spending.

There was a need for capital spending to decline during the recent slowdown because there is little doubt the U.S. economy experienced excessive investment during the late 1990's. This excess is apparent from the fact that profits peaked nearly five years ago while productivity growth remained robust. This divergence suggested that the U.S. was able to boost the productivity of labor but not capital because there was excessive growth occurring in the capital stock. The growth rate of capacity last year therefore fell to its lowest level in decades.

Investors are still confused about the profit outlook because of both the recent corporate scandals and the fact that reliable government estimates of profits are compiled with a long lag. The National Income measure of profits is determined on the basis of tax data in the long-term but during the short-term the government has to use published company data to make preliminary estimates. During the late 1990s, the government initially reported large profit gains but then had to revise the estimates when tax returns showed far less growth in

profits than was initially reported. The most recent GDP revisions indicate that profits peaked in mid 1999 and then fell sharply through mid-2001.

The recent stock market decline has been overwhelmingly concentrated in the sectors which led the boom of the late 1990's. Between March, 2000 and June, 2002 the market value of the Wilshire index had fallen by \$4.8 trillion. Only thirty companies accounted for \$3.5 trillion of the decline. The largest losers included Cisco (\$381 billion), Microsoft (\$265 billion), Intel (\$221 billion), Lucent (\$205 billion), Nortel (\$190 billion) and Oracle (\$186 billion). As a result of these losses in the telecom and technology sectors, the information technology share of the S & P 500 has fallen from a peak of 34.8% in March 2000 to 15% recently. The total market has declined by over one third since 2000 but the non-tech sectors have declined by only about 20%.

The critical factor which will determine the outlook for investment, growth, and the stock market is profitability. If firms can restore profit growth, there will be an upturn in both employment growth to boost consumption and business spending to revive investment. As the investment boom of the late 1990's was so dramatic in scope, it is useful to make long-term comparisons of growth and profits to get a sense of the economy's structural challenge in reviving profitability.

The table shows the growth rate of real GDP and real profits during the decades of the 20th century.

| | Real GDP | Real Profits |
|-----------|----------|--------------|
| 1900-1910 | 4.7 | 3.5 |
| 1910-1920 | 2.3 | -4.7 |
| 1920-1930 | 3.4 | 6.8 |
| 1930-1940 | 0.1 | -5.1 |
| 1940-1950 | 4.3 | 5.1 |
| 1950-1960 | 3.9 | 0.3 |
| 1960-1970 | 4.5 | 3.3 |
| 1970-1980 | 3.3 | 2.3 |
| 1980-1990 | 3.0 | 0.5 |
| 1990-2000 | 3.0 | 4.2 |

As the table indicates profit growth during the 1990's accelerated dramatically compared to the 1980's because of improved productivity. Profits fell during the second decade of the century because of war and during the 1930's because of the Great Depression. Before the 1990's, the greatest profit gains occurred during the boom of the 1920's, the Second World War, and the Vietnam War.

The stock market rose sharply during the 1990's because of the gains in profitability, but share prices became over-extended by 2000 because investors became excessively optimistic. There was little growth of profitability after 1997 because of excess capacity, constraints on corporate pricing power, and misallocation of capital by the telecom and information technology sectors. The correction in the market since March 2000 has resulted from investors lowering their expectations for profits, especially in the telecom and IT sectors which led the previous boom.

The dramatic Federal Reserve easing last year was unable to revive equity prices because valuation parameters were still exceptionally high for a corporate sector experiencing a profit slump. If the Fed had not reduced interest rates dramatically, the market might have fallen further, but interest rates, alone, could not stabilize prices in view of the profit disappointments which occurred.

The Fed is likely to keep interest rates steady unless there is evidence of the economy deteriorating significantly because of falling equity prices depressing consumption and investment, a stock market correction on the scale of 1987 (20% in a day), or another terrorist attack which depresses confidence. The Fed will probably not feel compelled to tighten monetary policy until the equity market experiences at a least a moderate recovery and there is further confirmation that the economy will be able to achieve the 3.0-4.0% growth target projected by both private and government analysts.

There was a wave of speculation in the run-up to the recent F.O.M.C. meeting that the Fed might ease during mid-August. It appears that some officials in New York made comments to stockbrokers which were allowed to spin out of control and excite the stock market for a few days. It was never likely that the Fed would ease during August because recent economic data has not yet shown clear evidence of a double dip. Retail sales were strong during July. Some district presidents also perceive that easing in the current environment would only further fuel asset inflation in the property market but do little to rekindle capital spending. They will not want to ease unless it is clear that output growth will remain below 2.0% during the next few quarters.

| Equities have performed badly despite lower interest rates: performance of S & P 500 during periods of aggressive Fed rate cutting | | | |
|---|----------|-----------|-----------|
| Date of first cut | 6 months | 12 months | 18 months |
| Jan-70 | -20.7 | 0.1 | 8.4 |
| Aug-74 | -1.2 | 11.7 | 28.1 |
| Apr-80 | 24.4 | 33.7 | 14.6 |
| Jul-81 | -5.6 | -16.2 | 6.6 |
| June-89 | 8.9 | 12.8 | 0.7 |
| Jan-01 | -6.3 | -13.0 | -21.2 |

Source: HSBC, Thomson Financial Datastream

The great constraint on Fed tightening when the cyclical outlook improves will be concern about the housing market. If the Fed were to return to a neutral monetary policy with short-term interest rates of 4.0-5.0%, the risk is high that the housing sector would slump. Mortgage refinancing activity would probably contract by 80% or more. The cost of increased debt servicing would strain household incomes. The rate of gain in home prices would probably slow to 0-1% from numbers as high as 7-9% recently. Some analysts warn that the U.S. has been experiencing a housing bubble which could crack. Macroeconomic data does not suggest there has been a housing bubble. The ratio of median home prices to disposable per capita income is only 5.6 compared to a peak of 7.0 during the early 1980's and the late 1960's. But there have been regional bubbles which could crack while the growth of mortgage debt would probably slow very sharply. Such a slowdown in home financing activity could reduce discretionary income and set the stage for much slower growth of consumption in 2004. As a result of these risks, one of the great policy questions looming over the three year outlook is whether Alan Greenspan will want to remain chairman of the Federal Reserve long enough to crush the housing boom. If there is a hard landing in the housing sector late next year, he could be blamed for George Bush losing the election of 2004, just as he was once blamed for easing too slowly to save the president's father during 1992.

Buckingham Palace recently conferred a knighthood upon Mr. Alan Greenspan because of his role in promoting global financial stability. It also should be noted that he is the de facto central bank governor of one fifth of the British Commonwealth as well as the former British territory of Hong Kong because of currency board links to the U.S. dollar. As all of these commonwealth countries currently have depressed economies, they provide further encouragement for Mr. Greenspan to pursue an accommodative policy. What remains unknown is whether the Queen conferred her honors upon Mr. Greenspan at this time because of a perception that he may soon retire. In Britain, imperial honors are often conferred upon senior government officials as they approach retirement.

While monetary policy is on hold, fiscal policy is becoming steadily more expansionary. The federal budget deficit will be \$165 billion this year compared to a surplus of over \$220 billion in fiscal 2000. The deficit is also likely to expand to nearly \$200 billion next year and it is difficult to imagine large declines before 2005. The events of September 11, 2001 produced a dramatic transformation in congressional attitudes towards spending for many programs, not just defense. As a result, the federal outlay share of GDP will rise to 19.3% this year from 18.4% last year and could reach 19.6% next year. While spending is growing at double-digit rates, tax receipts have slumped because of the stock market decline and economic slowdown. The stock market boom drove the tax share of GDP from 18.1% in 1994 to a peak of 20.8% in 2000. The tax share of GDP fell to 19.6% last year and could easily drop back to 18.0% next year.

The risk of deficits remaining large is high because the budget rules designed by the U.S. Senate to restrain tax cuts and spending in the past will soon expire. These rules required a 60 vote margin to overturn caps on potential tax cuts and spending increases. If the rules are allowed to expire, the White House may become more aggressive at promoting tax cuts while the Democrats will attempt to boost spending. There is still a chance that fiscal conservatives will secure legislation to sustain the 60 vote rule for the caps, but on the basis of recent political trends the risk is high that the Congress will lose a major barrier to expanding fiscal deficits on a sustained basis.

The Federal Reserve and the foreign exchange markets are concerned about the deterioration in the government's fiscal position because it will promote the persistence of large current account deficits even as private savings improve. But it is difficult to imagine political scenarios which could set the stage for a restoration of budget surpluses unless there is a dramatic stock market recovery. The president's personal approval rating is still at 65% but in recent surveys only 44% of the people approve of how he is handling the economy. There has also been a large decline in people's perception of the country's long-term direction. The weakness of the president will make it difficult for him to resist popular spending programs while creating the risk that the Democrats could regain control of Congress this autumn. As a result, pressure will continue for highly expansionary fiscal policy through 2003 and 2004.

While federal fiscal policy will be expansionary, state and local governments are suffering from large revenue declines which will compel them to reduce spending. According to data compiled by the Rockefeller Institute, state tax revenues declined during the first quarter by 7.9% compared to the same period last year. This was the largest decline since the institute began collecting data ten years ago. Personal income taxes fell by 7.1%. Corporate income taxes fell by 24.4%. Sales taxes were flat. State and local government spending typically lags the business cycle nearly a year because of the impact of tax receipts on public policy. The downturn in revenues suggests the growth rate of spending will probably slow to only 1.0-2.0% by 2003 from 4.6% in 2001.

Will Foreign Central Banks Support the Dollar?

The U.S. dollar plunged to new lows during June and July as a result of concern about the equity market, the economy, corporate scandals, and other factors detrimental to investor confidence. But despite the superior performance of the Euro and the yen, both European and Japanese equities fell in sympathy with Wall Street. The remarkable convergence in equity market performance is a further confirmation of how integrated global capital markets have become during recent years.

The Europeans have expressed emotional satisfaction about their currency finally regaining parity with the dollar after two years of weakness. But neither Europe nor Japan is anxious to see further significant currency appreciation against the dollar because of concern about trade competitiveness. Japan is depending heavily upon exports to revive output growth. Europe's exports have performed poorly during recent years despite the weakness of the currency. If the yen and the Euro rise a further 10-15% against the dollar, both countries would suffer from weaker exports at a time when domestic demand is relatively weak.

As a result of concern about their trade competitiveness, both Europe and Japan are likely to intervene to restrain dollar depreciation. Japan intervened on a large scale during the second quarter to support the dollar. Europe has not yet intervened but it is likely to do so if the dollar approaches 1.10. The appreciation of the Euro has also dimmed talk about the European Central Bank raising interest rates this summer. Meanwhile, Switzerland has reduced interest rates because of concern about the franc's appreciation.

The dollar's decline is producing a major change in the composition of the capital inflows funding the U.S. current account deficit. Capital inflows from Europe plunged to only \$7.5 billion during the first four months of 2002 from \$40 billion during the January-April period of 2001. Capital flows from Japan declined during the first quarter but rose sharply during April and May. They are likely to remain at high levels because of currency intervention by the Ministry of Finance if private sector investors remain cautious. On several occasions during the past twenty years Japan has been prepared to spend large sums on dollar support operations and this pattern is likely to repeat itself during the next few quarters. The MOF has already spent over \$40 billion supporting the dollar this year compared to a previous peak of \$32 billion in 1999.

There is also evidence that some retail investors are withdrawing money from American banks and other financial intermediaries because of the pending introduction of new controls on foreign depositors resulting from the Patriot Act of 2001. This new law is designed to detect money laundering and terrorist funds by requiring banks to obtain more information about their clients than they had in the past. Some of their customers are reluctant to disclose information about their business activities and thus are shifting their money to offshore locations.

Dollar depreciation will not merely dampen European export competitiveness. It will also create great currency translation problems for European companies with significant American assets. Companies from the European Union have dollar sales of nearly \$1.1 trillion from subsidiaries active in the U.S. compared to exports of \$258 billion to the U.S. Japanese companies also have sales in the U.S. of \$453 billion from local affiliates compared to exports of \$146.5 billion. As a result of the great take-over boom for American assets during the 1990's, European companies now have a significant exposure to the American marketplace independent of their foreign trade. In addition to the depreciating dollar, European companies are also concerned about proposals from the Bush administration to increase their tax liabilities by reducing their ability to claim deductions for various expenses such as interest payments. If the administration is successful in enacting such legislation, it could cause the recent downturn in European bids for American firms to go further and thus add to the downward pressure on the dollar.

The major risk to the world economy posed by the falling dollar is that it will lose its consumer of last resort. The ease with which the U.S. was able to finance its current account deficit during recent years allowed America to play the role of global growth locomotive. As no other country appears capable of playing such a role, the G-7 central banks will have no choice but to resist the dollar's decline. The need to contain the dollar's decline will give a more accommodative bias to monetary policy in Europe, Japan, and other countries experiencing currency appreciation.

The Bush administration has not made any effort to resist the dollar's decline for four reasons. First, the administration believes that the markets should guide exchange rates. Secondly, there is a large pro-devaluation lobby in U.S. manufacturing industry which was quite vocal earlier this year. Thirdly, White House economists do not perceive any major inflation risk from dollar depreciation in the current economic environment. They perceive the global economy to have a somewhat deflationary bias and do not expect corporations to achieve significant pricing power even as the dollar declines. Finally, the dollar's decline has not had any adverse impact on the domestic bond market. If long-term interest rates were rising in response to the dollar's decline, the administration would be concerned about a potential negative spillover effects on the housing market and consumer spending. But instead bond yields have declined because of the weakness of the equity market, allowing the housing market to remain robust while export competitiveness improves. The administration's attitude towards the dollar will continue to be heavily influenced by the performance of the bond market and its linkages to the housing sector.

There is a broad consensus among forecasters that growth will improve in all the G-7 countries next year. In Japan, forecasters are projecting 1.1% output growth in 2003 compared to a contraction of 0.4% this year. In Germany, they are projecting output growth of 2.4% next year compared to 0.9% in 2002. In France, they are projecting a gain of 2.8% compared to 1.4% this year. In the United Kingdom, the consensus expects output growth to accelerate from 1.8% this year to 2.8%. In Italy, forecasters expect growth to rise to 2.5% from 1.1%. Among the G-7, only Canada is expected to have a growth rate exceeding 3.0% this year. As a result, its growth rate will rise only modestly to 3.7% in 2003 from 3.5% this year.

The European countries desperately need higher growth rates to contain the growth of their fiscal deficits. As a result of the recent slowdown, France, Germany, Italy, and Portugal are bumping up against the fiscal deficit targets set in the Growth and Stability Pact which accompanied the introduction of the monetary union. The newly elected French government is committed to reducing taxes despite the recent uptick in the country's fiscal deficit. The CDU/CSU*FDP coalition in Germany is committed to a tax reduction program if they win the September election. The Italian government also has been flirting with tax cut proposals.

The swing to the right which was apparent in European elections last year continued with the French parliamentary election in June. If the CDU-CSU coalition wins in Germany during September, Europe will be

dominated by center right governments for the first time since the 1960's. All the new center right governments have promised to pursue tax reduction and microeconomic reform. But it is still unclear exactly how far the reforms will go. The new French government is reluctant to repeat the conflicts that it had with the trade unions during the mid-1990's. The German conservatives recognize the need to liberalize labor markets in order to reduce unemployment but they have so far been careful to suggest that they would not tamper with laws which guarantee job security. All that can be said with certainty is that there will be more potential for reform during the next two or three years than at any other time during the past three decades. The prospect of reform should be a positive factor both European equity markets and the European currency. But if the new governments do not actually take advantage of their new opportunity, there could be a renewed wave of pessimism about Europe's growth prospect in 2005 and 2006 worse than during the late 1990's.

The strength of the Euro has increased the possibility that the British government will decide to hold a referendum next year on possible British entry into the European monetary union. Her Majesty's Treasury has long favored at least a 10-15% depreciation of the pound against the Euro before moving towards entry. As the pound tends to trade with the dollar, it has also slipped against the Euro during recent months. The major constraint on the Blair government could be the Prime Minister's support for American policy in the Middle East, especially a war against Iraq. There is great dissension in the Labour Party on this issue and some ministers could resign to protest a war unless it is supported by a United Nations resolution. In such a scenario, Blair would probably not dare to risk a referendum which could further undermine his authority.

There have been more signs of recovery in the Japanese economy because of gains in both exports and consumer spending. The latest Tanken survey showed an uptick in business confidence after a long period of weakness. The manufacturing sector has been aggressively restructuring in order to maintain its international competitive position and the profit share of GDP was 6.8% during the first quarter compared to a previous trough of 5.8% during the fourth quarter of 1998. Firms have even trimmed spending on entertainment from 1.4% of GDP in 1992 (\$52 billion) to 0.8% in 1999 (\$35.2 billion). American firms, by contrast, spent a total of \$9.8 billion on all travel and entertainment last year. The great problems in Japan continue to center on the banking system and the need to recapitalize it. Some newly appointed officials raised the prospect of a government program to purchase troubled bank loans for par value during June but Mr. Hukuo Yanagisawa of the Financial Services Agency continues to argue against such rescue programs. He is also opposed to proposals for delaying the elimination of deposit insurance next April despite widespread concerns that retail savings flow could leave banks with credit quality problems. Prime Minister Kozumizu may not be able to achieve a consensus on the bank issue until he reshuffles his cabinet in September. In the meantime, he has been focusing his efforts on proposals to permit more competition with the post office. But it is unclear if private firms will want to compete with an organization as deeply entrenched and powerful as Japan's post office. It not only has 24,600 branches across the country. It operates the largest savings bank in the world with 240 trillion yen of deposits and has an insurance company with 79.6 million policyholders. Private companies have already warned that the new deregulation legislation is too restrictive for them to be able to compete effectively with the post office.

The Bank of Japan is continuing to purchase government debt in order to make monetary policy more expansionary. Its holding of government debt is now 87 trillion yen or 17% of the total. The debt purchases have been so large they now exceed the country's stock of currency (68 trillion yen) whereas ten years ago government debt holdings were 23 trillion yen compared to a currency stock of 39 trillion yen. The rating agencies are predicting that the BOJ will monetize about 40% of the government deficit during the year ahead. The Bank of Japan's decision to hold interest rates close to zero is also helping the government to contain the size of the deficit itself. As the table below indicates, Japan is unique in the world today in having debt servicing costs less than 2% of GDP despite a government debt stock now well above 100% of GDP. If interest rates were to rise to levels comparable to Europe, the budget deficit would quickly expand by 3-4% of GDP. The willingness of the Bank of Japan to monetize the debt is also encouraging Mr. Kozumizu to introduce new proposals for a tax cut next year.

| | Debt/GDP | Net Interest Payments/GDP |
|---------------|-----------------|----------------------------------|
| Japan | 119 | 1.3 |
| Italy | 113 | 6.0 |
| Belgium | 112 | 6.5 |
| Canada | 106 | 3.3 |
| Spain | 76 | 3.1 |
| France | 64 | 2.9 |
| United States | 62 | 2.7 |

The developing countries of East Asia have benefited from the upturn apparent in the U.S. economy as well as the continued steady growth of China. The growth rate of imports from Asia to China has shot up to 20% during recent months and China now accounts for 13% of Asia's total exports compared to only 11.5% for Japan. China's evolving role is to import parts and capital goods from other Asian countries and then re-export them to the rest of the world. Korea has enjoyed strong growth because of robust gains in domestic consumption. The Asean countries are showing signs of recovery in both domestic exports and domestic spending.

The weakest region of the world continues to be Latin America. Argentina's economy is shrinking because of the collapse of the financial system and the inability of the government to provide a convincing program for recovery. The country is also now heading for a presidential election next March which could produce an extended period of policy uncertainty. There is no clear front-runner for the presidency. Instead there will be a diverse mixture of candidates, ranging from populist-Marxist (Elisa Carrio) to orthodox-free market (Ricardo Lopez Muprhy). Former President Menem will also attempt to regain the office campaigning on a program calling for dollarization.

The IMF has not yet announced a program for Argentina because of concern about the government's failure to provide an effective policy for rescuing the banking system as well as concern about the influence of the provinces over fiscal policy. It is now clear that Argentina's decision to abandon currency convertibility has completely undermined the country's institutions and rule of law. The convertibility programs had become the foundation for all financial contracts and commercial agreements. As a result, its destruction has left the country without any effective framework for making business decisions and enforcing contracts. The banking system has lost over half of its deposits and been stripped of its capital, so it cannot play a growth supporting role even as the central bank attempts to inject liquidity in the system. There are precedents from many developing countries for reviving banking systems after devaluations and large increases in non-performing loans (Chile, Mexico, Korea, etc.) but the problem in Argentina is that there is no confidence in the capacity of the politicians to restore the rule of law and protect private property. As a result, there is likely to be continued capital flight and an investment strike until the presidential election provides more visibility for future policy.

| Debt indicators in 2000 | | | | | | |
|--------------------------------|---------------------------|-----------------|-----------------|-------------------------------|--------------------------------|--|
| | Public sector debt | | | Total Debt Service (1) | Public Debt Service (2) | Short-term external debt as a % of foreign reserves |
| | Total | External | Domestic | | | |
| | As a % of GDP | | | As a % of exports (3) | | |
| India | 60 | 9 | 51 | 13 | 11 | 9 |
| Indonesia | 99 | 59 | 40 | 25 | 10 | 80 |
| Philippines | 81 | 48 | 33 | 14 | 9 | 46 |
| Argentina | 52 | 34 | 18 | 71 | 43 | 116 |
| Brazil | 39 | 4 | 35 | 91 | 35 | 95 |
| Hungary | 55 | 8 | 47 | 24 | 11 | 38 |
| Russia | 67 | 52 | 15 | 10 | 4 | 64 |
| Turkey | 62 | 21 | 41 | 36 | 17 | 130 |

(1) Interest and principal payments on public and private long-term external debt (one year or longer).
(2) Interest and principal payments on public sector long-term external debt.
(3) Exports of goods and services.

Sources: World Bank; Institute of International Finance (IIF); national data; BIS statistics. Table III.4

The Brazilian financial markets and currency slumped during July because of investor concern about opinion polls suggesting that left wing candidates could win the upcoming presidential election. The candidate in first place is Luiz Inacio Lula da Silva of the Workers' Party. Until recently, the candidate in second place was Jose Serra of the ruling coalition. But in recent weeks he has slipped to third place behind Ciro Gomes of the Labour Front. Mr. Gomes is a concern for the markets because he has promised to restructure the country's \$300 billion public debt in order to obtain extended payment periods and stimulate the economy. Mr. Gomes is also receiving economic advice from Roberto Mangabeira Under of Harvard, a philosopher who has been advocating policies of a strong state guiding the development of the private sector in a market economy. If Mr. Serra can regain second place, he has a reasonable chance of winning the presidency on the second round as he picks up the votes of both conservatives and moderates fearful of Lula's reputation for left wing populism. But if Mr. Serra falters, the run-off will be between two candidates perceived as likely to be more left of center and to be giving serious consideration to the option of debt restructuring.

The selling pressure on the Brazilian currency and financial markets encouraged the IMF to offer Brazil a large aid package in order to restore confidence. The package has a total potential value of \$30 billion, with \$6 billion provided this year and the remainder during 2003, if the new president pursues policies acceptable to the IMF. The decision to offer such a large package to Brazil represented a major U-turn for the Bush administration because until recently senior officials such as Paul O'Neill had tried to downplay the role of the IMF or warn that IMF money would vanish in capital flight to Switzerland. The administration appears to have recognized that a Brazilian default would have undermined all of its ambitions for a new Western Hemisphere free trade agreement as well as support for liberal economic policies in general. There is still a risk that a new left wing in President in Brazil could challenge American policy ambitions for the region, but if he is compelled to operate within the framework of an IMF program it is doubtful that policy would move in a highly destructive direction.

The Brazilian loan also represents a major break with America's tradition of supporting large aid programs only for countries with U.S. military bases (Korea, Turkey) or a common border (Mexico). Brazil may have qualified for special treatment because it attracted \$34 billion of U.S. foreign direct investment during the 1990's. In 1999, American firms had over \$70 billion of sales in Brazil. Many of the investors with Brazil exposure were major contributors to the Bush campaign two years ago and thus probably lobbied the White House to provide the country with assistance.

A Brazilian default would be a greater blow to the world financial markets than the Argentine default. Argentina had \$142 billion of public debt and \$52 billion of external private sector debt. It slumped in value all

through the final months of 2001 because investors perceived that the slump in the economy would make default a clear policy choice at some point. Brazil has \$371 billion of government debt and \$117 billion of private external debt. Its public sector external debt is \$93 billion or a sum equal to 9.5% of GDP. Argentina's external government debt, by contrast, was \$88 billion or 33% of GDP. A Brazilian default would also be a major blow to Spanish banks and American money center banks because both have large domestic lending operations within the country.

Mexico should be able to withstand the shocks from the southern cone of Latin America because of its high level of integration with the American economy. Mexico has suffered major job losses because of the U.S. slowdown. The Maquila sector near the border has lost 260,000 jobs since September, 2000 because of weak U.S. demand and competition from Asia for low skilled jobs. About 400 of the 550 companies which failed were in the textile and furniture business. The Maquila zone has been more vulnerable to recession because the current slowdown is the first in which Mexico did not experience a large currency devaluation bolstering export competitiveness.

The projected upturn in the G-7 countries should permit the growth rate of world trade to accelerate to 8% next year from 1-2% during 2001-2002. The great uncertainties center on whether the information technology sector will be able to play as dominant a role in encouraging trade as it did during the late 1990's. According to IMF research, the IT share of world trade rose from 7.5% in 1990 to 11.0% in 1999. The international sales of IT firms also rose from 33% of the total in 1990 to 43% in 1999, whereas non-IT firms had only about 32% of their sales in foreign markets. The major beneficiaries of this upsurge in the IT share of global trade were the countries of East Asia, especially Taiwan, Singapore, Malaysia, and Korea.

High tech products account for 40% of Asian export compared to 18% for Latin America, 17% for Eastern Europe and 6% for Africa and the Middle East. The economies of Latin America and Africa depend far more upon exports of fuel, metals, and food. The exports of industrial raw materials will tend to track the broad growth rate of global GDP and thus not provide the same locomotive for expanding trade as technology did during the late 1990's. There could be a dramatic expansion of trade in agricultural products if the Doha trade round reduces subsidies and trade barriers in the industrial countries but such a development is unlikely to be a significant factor for global trade until 2006, at the earliest.

| Major export markets and products (1) | | | | | |
|---|-----------------|--------------------------|---------------------------------------|-----------------------------------|--------------------------------------|
| | Asia (2) | Latin America (3) | Central and eastern Europe (4) | Africa and Middle East (5) | All emerging market countries |
| Export markets (6) | | | | | |
| United States | 21 | 39 | 4 | 16 | 20 |
| Japan | 13 | 4 | 1 | 4 | 6 |
| Euro area | 16 | 16 | 60 | 44 | 34 |
| Intraregional | 31 | 17 | 16 | 3 | 17 |
| Others | 19 | 24 | 19 | 33 | 24 |
| Products (7) | | | | | |
| Food | 8 | 24 | 8 | 14 | 14 |
| Agriculture | 2 | 4 | 3 | 3 | 3 |
| Fuels | 5 | 21 | 8 | 38 | 18 |
| Metals | 2 | 15 | 5 | 5 | 7 |
| Manufactures | 82 | 36 | 74 | 39 | 58 |
| High-tech | 40 | 18 | 17 | 6 | 20 |
| (1) As a percentage of total exports; for country groups, unweighted averages. (2) China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, the Philippines, Singapore, Taiwan (China) and Thailand. (3) Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela. (4) Bulgaria, Croatia, the Czech Republic, Hungary, Poland, Romania, Russia, Slovakia and Turkey. (5) Algeria, Egypt, Israel, Kenya, Morocco, Nigeria, Saudi Arabia, South Africa and Tunisia. (6) 2000. (7) 1999. | | | | | |
| Sources: IMF, Direction of Trade; World Bank | | | Table III.2 | | |