A bumpy landing for the US economy

Mickey Levy and Pete Kretzmer argue that the current US economic slump will continue for several months, before a spending rebound emerges.

With the Federal Reserve's third significant easing of the year on 20 March, a decisive move toward monetary ease is well underway. The Federal Open Market Committee (FOMC) has lowered the federal funds rate (the overnight cost of reserves lent within the banking system) from 6.5% at the start of the year to 5%. The current economic slump, however, will persist as monetary policy affects the economy with a substantial lag, and the negative supply shocks imposed by higher energy prices and the plummeting Nasdaq will continue to constrain investment and consumption.

Despite market frustration that the Fed has not moved more decisively, monetary policy is now substantially more accommodative than at the start of the year as the 150bp reduction in the federal funds rate has been accompanied by a dramatically steeper yield curve and accelerating pace of money growth.

We expect an eventual stimulative impact on aggregate demand, with consumer spending picking up speed during the third quarter. Until then, the FOMC will continue to lower its federal funds rate target. It may reach 4%, as the Fed tends to get caught up with current conditions and forget about the lagged impact of its policy changes.

An investment-led slump

The economic slump is investment-led, in that capital spending growth, which had provided an outsized contribution to the earlier economic boom, has weakened more than any other component of the US economy. Capital spending has slowed abruptly from 14.1% year-on-year growth in the second quarter of 2000 to an annualised decline of 0.6% in the fourth quarter of the same year.

> The unprecedented decline in the Nasdaq from record heights in early 2000 has contributed to the dramatic shift in capital spending, which remains the major wildcard in the economy

Business investment in equipment and software, comprising nearly 80% of capital spending, has fallen in response to weaker sales and profits due to both demand and supply-side factors and also much higher costs of capital as a consequence of sharp declines in stock valuations.

We project that equipment and software spending will decline by about 10% a year in the first and second quarters of this year and we expect capital spending to remain weak (flat-to-slightly declining), at least through the second half of 2001.

The unprecedented decline in the Nasdaq from record heights in early 2000 has contributed to the dramatic shift in capital spending, which remains the major wildcard in the economy. While capital spending has been a key element of the long expansion and remains crucial to the depth and duration of the slump, it was the pronounced deceleration of consumer spending from sustained torrid rates of growth that helped launch the downward spiral in capital spending.

Consumption has continued to advance, but its growth has slowed from a peak of 6% year-on-year in the first quarter of 2000 to about 2.75% annualised in both the fourth quarter of 2000 and the first quarter of 2001. The three years of rapid 5.4% real growth in household spending, from mid-1997 through early-2000, were driven by a combination of stimulative demand and supply factors, stemming mainly from the Asian financial crisis. The crisis led to large scale capital flight to the US and resulted in sharply lower market interest rates and a rapidly strengthening dollar. In addition, low energy prices, as worldwide demand faltered, acted as a tax cut to consumers while boosting business profit margins.

In response to these stimuli, consumer spending accelerated in late 1997 and through 1998. Then, even while the economy remained strong, the Fed undertook an aggressive monetary policy easing in late 1998 in order to combat illiquid financial markets. The result was a continued acceleration in US domestic demand growth, accompanied and reinforced by booming profits and surging equity valuations.

Start of slower economic growth

The end of the 1997/98 international financial crisis and subsequent emerging market recovery was accompanied by rising US interest rates, a stabilising dollar and rapidly increasing energy prices. The Fed, after maintaining a low 4.75% federal funds rate through the first half of 1999, reversed course in the second half of the year, reversing the earlier funds rate declines, and then

tightened an additional 100bp in the first half of 2000. As the Fed tightened and the stock market fell in Spring 2000, an economic slowdown became inevitable. It was this deceleration to a more sustainable long-run trend rate of spending growth that initiated the current adjustments.

Following the rapid growth in US demand, the transition to a more moderate pace of expansion has not been entirely smooth. First, businesses viewed the slower sales pace of mid-2000 as temporary, and while beginning to adjust workweeks and even new hiring strategies, generally maintained strong growth in production. Nine months of excessive and unintended inventory building last year has given way to a sharp decline in manufacturing production in recent months. Second, the abrupt and sizable shift to outright decline in business capital spending caught manufacturers of information-processing equipment by surprise. Inventory levels in these industries have risen dramatically, necessitating particularly large production cuts.

Of great importance to economic and financial market performance is whether the sharp deceleration in consumer spending will proceed still further, including even an outright decline in consumption. Historical experience indicates that in response to the combination of the lagged effects of last year's higher interest rates, continuing high energy costs, and the collapse in Nasdaq valuations and moderate correction in broader stock indices, household spending will decelerate below its current 2.5% to 3% growth pace – perhaps significantly for a temporary period – but not decline.

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Even if retail sales fall, which may occur if sales of motor vehicles and other durable goods decline, a growing share of consumer spending, comprising almost 60% of the total, consists of spending on services, which historically has been resilient. We expect the weaker pace of consumption growth to unfold during the middle quarters of this year, with signs of a spending pickup visible by the end of the third quarter. With capital spending falling and uncertain in light of the sharp decline in the Nasdaq, a material further slump in consumer spending would be troublesome for economic performance and the Federal Reserve.

Fed easing to continue

With the inventory correction still underway, capital spending declining, and consumer spending likely to decelerate modestly further, additional Fed easing is on the cards.

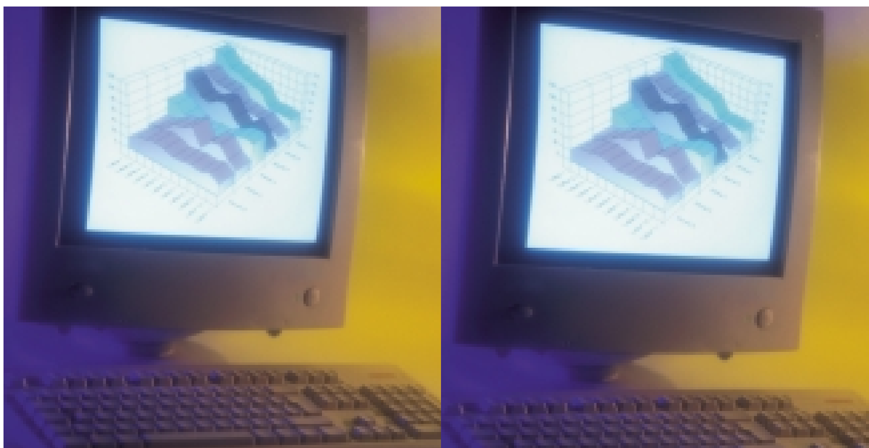
We expect the FOMC to lower the federal funds rate at least to 4.5% at its 15 May meeting and to 4.25% by the middle of the year. Repeatedly, in similar situations, the Fed has continued to ease until distinct signs of recovery are evident, sometimes well after the initial signs of a spending pickup have appeared. As in past slumps, labour market easing, including continued layoffs, corporate restructuring and a rising unemployment rate will continue well after the rate of spending growth has bottomed.

We expect the unemployment rate to rise to about 4.75% by early in the fourth quarter. With the FOMC showing few signs in recent years of abandoning its tendency to monetary policy overshooting, modest additional easing and a bottom near a 4% fed funds target may occur around this time.

After achieving a long-term decline in US inflation and impressive success in damping the swings in dollar spending growth during the past two decades, Federal Reserve policy is at a difficult juncture. By maintaining a low federal funds rate for an extended period of time in response to the financial market difficulties accompanying the Asian crisis, the Fed likely added to rapid US demand growth and even contributed to the development of the Nasdaq bubble in late 1999 and early 2000. Subsequent sharp Fed tightening and the collapse of the bubble have now made the adjustment to a slower pace of economic growth more difficult, by adding substantial uncertainty to the capital spending outlook.

Amid the bumpy US economic landing, the FOMC will be inclined to ease substantially. Yet, monetary indicators have already spiked higher in recent months, increasing the likelihood that after a lag, consumer spending will rebound sharply later this year, setting the stage for yet another policy reversal.

While economic conditions remain historically favourable, with both the inflation and unemployment rates low, the current experience may yet demonstrate once again the precariousness of conducting monetary policy and the ease with which Fed policy changes can become more a source of instability than the reverse. ■



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