DON'T BLAME THE CONSUMER

JEREMY PEAT EXAMINES HOW OVERCAPACITY IN THE NEW ECONOMY NEEDS TO BE DEALT WITH BEFORE STABILITY CAN RETURN TO THE MARKETS.

One of the gravest errors that economists can make is to assume that the lessons of the past can be readily transferred to help resolve the problems of the present. New paradigms are by no means two a penny, but each twist and turn in the domestic and global cycle merits specific attention. This is both to ensure that the appropriate policy medicine is being prescribed and to understand developments in this complex macro-economic world.

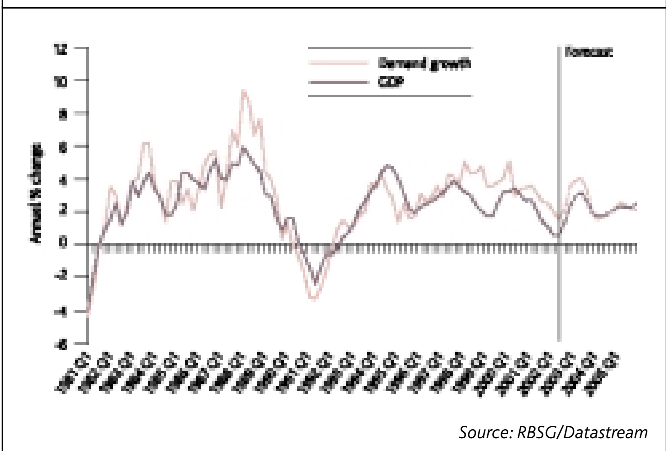
THIS IS A DIFFERENT SLOWDOWN. Even before the dreadful events of 11 September, it was evident that the present downturn had significant differences from other difficult periods over the past several decades. It so happens that the medicine applied previously may still be appropriate, but for different reasons. However, the effects may differ and we should not expect the same transition path from slowdown to sustained recovery.

Other recessions in the period since World War Two have tended to result from some disequilibrium causing consumer spend to slow sharply. In some instances the prime cause of that consumer slowdown has been policy tightening introduced to head off the risk of accelerating inflation. *Figure 1* shows how the return to positive GDP growth in the UK in the early 1980s and 1990s was associated with domestic demand growth turning from negative to positive. The UK's problems this time around have been closely linked to a sharp US deceleration. That US slowdown commenced in the second half of last year, and was led not by the consumer, but by a dramatic reduction in corporate investment and output.

THE CONSUMER IS NOT THE CAUSE. Disequilibrium led to the US slowdown. However, this was in the 'new economy' rather than the personal sector. Investment and output in telecoms, computing, etc. had run dramatically ahead of demand. A demand/supply gap emerged, partially because the Federal Reserve tightened monetary policy to reduce the risk of accelerating inflation, but primarily because expectations of the future pattern of demand for 'new economy' products proved dramatically over-optimistic.

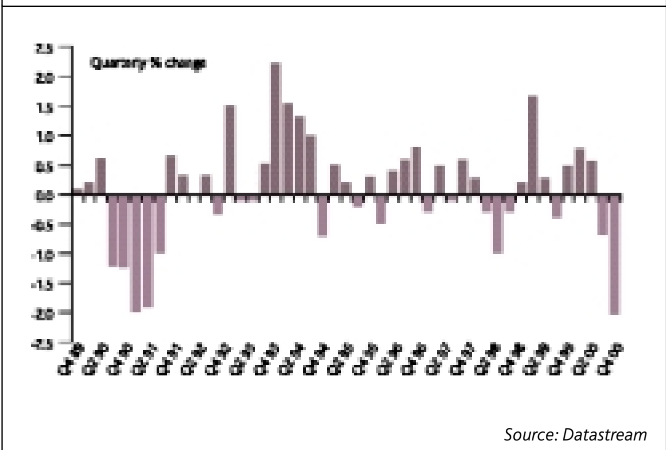
This excess capacity and inventory overhang is taking time to work through. The only reason that the US economy had not experienced an

FIGURE 1
GDP AND DOMESTIC DEMAND GROWTH.



Source: RBSG/Datastream

FIGURE 2
MANUFACTURING OUTPUT GROWTH.



Source: Datastream

‘THE ULTIMATE SOLUTION TO THIS ECONOMIC DOWNTURN LIES IN REMOVING EXCESS CAPACITY IN THE ‘NEW ECONOMY’ SECTORS AND A RETURN TO INVESTMENT’

overall contraction before the terrorist attacks was that the consumer had maintained a degree of momentum. That is not to say that the consumer had been unaffected. The ‘new economy’ trauma caused equity prices to tumble, reducing both consumers’ wealth and the rate of growth of consumer spend. The GDP data for the second quarter of this year provide a stark demonstration of these points. Inventories had declined at the most rapid rate for 25 years. But the process was not yet complete. Investment was still in decline and output expectations weak. Meantime, consumer spend continued on the up, at around 2.5% per year, well down on the rate of growth of the boom years but enough to achieve a marginal increase in overall GDP.

AND CANNOT PROVIDE THE ULTIMATE SOLUTION. The ultimate solution to this economic downturn still lies in removing excess capacity in the ‘new economy’ sectors and a return to investment. However, there should be no expectation of a return to growth rates experienced by these sectors in recent years. These were unsustainable. Cuts in interest rates provide some support to investment, but this was not the prime purpose of the Fed’s dramatic series of rate cuts during the course of 2001. The first objective has been to prop up consumer spend, in the face of equity decline and unemployment increases. Before the terrorists struck, differing economic forecasts regarding the US economic outlook related to different views as to (a) how long it would take for investment pick up and (b) whether consumption could stay the course until investment returns. Recent traumatic events have added markedly to these uncertainties and to the downside risks. Hence the co-ordinated moves to further ease policy globally.

Back home in the UK, we were already facing related problems. *Figure 2* shows manufacturing to be in recession – again. Domestic policies provide no simple solution on that front – lower interest rates may influence the exchange rate, but not in any predictable or controllable manner. As in the US we were bridging the gap until external demand recovers, by stimulating domestic consumer demand via lower interest rates. The Monetary Policy Committee at the Bank of England knew that the approach was by no means risk free, as they were exacerbating imbalances. There is a limit to how low rates can go and for how long. We may be testing that limit in the months ahead.

Even setting on one side for the moment the impact of recent events on confidence, the risks of global recession will not disappear until excess capacity and stocks have declined markedly. This process has been impacted globally, even though the basic root cause was concentrated in the US. Fortunately, there is strong policy credibility in the US, UK and the eurozone. This permits, for the time being, policy loosening to stimulate consumer demand while the ailing sectors sort themselves out. The enhanced uncertainties and risks make this task even more challenging.

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