

Economic Outlook—2002

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I am very pleased to be here to give you my economic outlook for 2002. My employer requires that I say that the views expressed here are mine, and do not necessarily reflect the views of the Federal Reserve Bank of St. Louis or the Board of Governors of the Federal Reserve. Truthfulness requires me to say economic forecasts are just that, “forecasts”—*conjectures about future events*. While any single economic forecast might be reasonably accurate, on average, economic forecasts for the economy—real output growth, interest rates and inflation—tend to have very large forecast errors. For example, the *Blue Chip* consensus forecast for real GDP growth for 2001, made in December 2000, was 3.1 percent. It now looks like real economic growth for 2001 will be zero, perhaps even negative. This is an enormous forecast error.

Like weather forecasts, the quality of economic forecasts tends to deteriorate as the forecast horizon lengthens. A couple of weeks ago the National Bureau of Economic Research Business Cycle Dating Committee concluded that the current recession began in March of this year. However, a large number of economic forecasters did not forecast recession until after the horrific events of September 11. For example, the September *Blue Chip* consensus forecast of economic growth for the third and fourth quarters of 2001 were 1.6 and 2.6 percent, respectively—not a hint of a recession.

As you can tell, I really do not think economic forecasts are very accurate. Economic forecasters are very smart, hard working and sophisticated. That’s not the problem. The problem is that forecasting economic events is difficult. I believe that it is so difficult that I have decided not to do it. Hence, I will not reel off a list of forecasts for output growth, inflation, interest rates, the trade deficit, or the federal budget deficit [wasn’t it just recently that the government was forecasting a budget surplus]. If I did, I

would only worry that some of you would write my forecast down and call me later when, no doubt, history would prove me wrong. Rather, I will present my perspective on several issues that have received attention during the past year. In so doing, I will present my forecast for the direction of the economy in 2002 and for the next economic expansion.

I will focus on three issues: the economic effect of the September 11 terrorist attack, the effect of Federal Reserve actions in 2001 and the effects of fiscal policy actions—those already taken and the actions that are likely to be proposed.

The horrific events of 9/11 appear to have had a dramatic effect on the economy. The Dow Jones industrial average, which had already lost about 10 percent of its value from its mid-July high, dropped another 15 percent in the first week of trading after the stock market reopened nearly a week after the attacks. More importantly, forecasters, who had previously thought recession would be avoided, immediately changed their minds. Suddenly, recession was a certainty. For example, the October *Blue Chip* consensus forecast for the third and fourth quarters of 2001 were revised sharply down to -0.6 percent and -1.3 percent, respectively. This single event appears to have caused the Blue Chip forecasters to revise their outlook for economic growth in the last half of the year by more than 3 percentage points, from 2.1 percent to -1.0 percent.

How large was the effect of 9/11? I don't want you to think I am insensitive by asking such a question. Indeed, there is no true way to adequately measure the effect of such senseless acts. Nevertheless, it is instructive to estimate the direct economic effect of these actions in order to gauge their impact on the economy in 2002. One way to do this is to compare it with other disasters, such as Hurricane Andrew in 1992 or the

California earthquake in 1994. Analysts estimate that the direct effect of the terrorist attacks was about 1.5 times the direct effect of Andrew. The effect is substantial, but certainly manageable.

The events of 9/11 affected consumer psychology in a profoundly different way from either of these natural disasters. For this reason alone, the economic effects of 9/11 should be both larger and perhaps longer lasting. Nevertheless, theory suggests that the economic effects of such a one-time event should be relatively short-lived. Indeed, I believe the effects are largely over. This is evidenced by a number of economic indicators, but dramatically so by the behavior of stock prices. The Dow Jones industrial average regained its pre-9/11 level one month after the terrorist attacks.

The effect on some sectors of the economy, such as the travel industry, may be more sustained. It is important to note, however, that the recession began in March. Leisure activities are luxury goods, and as such, tend to suffer more during economic downturns. Because of this, it is very difficult to disentangle the effects of 9/11 on tourism from the normal effects of a significant slowing in economic activity. In any event, my point is that the economic impact of 9/11 is largely behind us and should have only a very small effect, if any, on the economic outlook for 2002 and beyond.

I will now turn to what some have called the extraordinary monetary policy actions of 2001. Beginning with the 50-basis-point reduction of its target for the federal funds rate on January 3, the Federal Open Market Committee [FOMC] reduced its target by a total of 450 basis points. Three percentage points of that amount occurred before 9/11. This is the most aggressive change in the funds rate target since the Fed began announcing its target rate in 1994.

These actions are often referred to as preemptive, meaning the Fed acted before there were signs that the economy was weakening. The dating of the onset of the recession, however, suggests that the actions were not taken too far in advance of the economy's weakening. Moreover, by the week before Christmas 2000, the rates on federal funds futures contracts for January and February indicated that market participants believed that the funds rate would decline by 50 basis points in late January or February. This is not surprising because there were several indications that the economy was weakening before the FOMC made the first reduction in the funds rate target. For example, the Fed's index of industrial production had peaked in June 2000 and declined significantly during the last three months of the year. The same is true of the capacity utilization rate. In addition, there were strong signs that the stock market *technology boom* was coming to an end. The Nasdaq composite index, which peaked in mid-March 2000, had given up 50 percent of its value by year's end, as investors reassessed the earning prospects of many of the dot-com companies.

Whether preemptive or not, the relatively large and aggressive cuts in the target for the funds rate appear to have had only a modest effect on economic activity. Despite reducing the funds rate target by 275 basis points by the end of June, 2001, the economy continued to slip deeper into the recession—and things appear to have gotten worse, not better. Just last week the estimate of real GDP growth in the third quarter was revised down from -0.3 percent to -1.1 percent. Moreover, most analysts believe that the fourth quarter growth will be slower still.

One reason for the apparent lack of success in monetary policy is that long-term rates have not followed the lead of the overnight federal funds rate. The 10-year

Treasury rate is now only about 50 basis points below its December 2000 level. Perhaps more telling for economic activity, the Aaa corporate bond rate has been hovering at or slightly above its December 2000 level. The successive and large cuts in the funds rate target have had virtually no effect on longer-term rates, and it is longer-term rates that influence corporate investment spending.

My second reason for the lack of success of the FOMC's actions is idiosyncratic. It is a view that is not shared by a majority of my professional colleagues. I believe that, despite the 450-basis-point cut in the funds rate target, the Fed has done relatively little to ease monetary policy this year. The Fed controls the federal funds rate by adding or draining reserves through "open market operations"—the act of selling or buying government securities in the market. If the Fed wants to push the funds rate down, it injects reserves into the banking system. If the Fed wants to push the funds rate up, it drains reserves from the banking system. If the Fed were responsible for the very large drop in short-term interest rates that has occurred this year, one would expect to find a large increase in reserves during the year.

This is not the case, however. With the exception of the period immediately surrounding the events of 9/11, which I will discuss in more detail shortly, the Fed has done little to increase the supply of reserves during the past 12 months. If the Fed has not significantly increased the supply of reserves, exactly how did it manage to push the federal funds rate down by 450 basis points? I believe a possible answer is that it didn't.

Let me explain. The yield curve is the relationship between short-term and long-term interest rates. The yield curve is normally positively sloped; that is, long-term rates are usually higher than short-term rates. The yield curve tends to invert before

recessions, because short-term rates tend to rise above long-term rates prior to the onset of recession. Indeed, the slope of the yield curve is one of the components of the index of leading economic indicators, and an inverted yield curve is an important recession indicator. The yield curve inverted during the second half of 2000, as short-term rates rose and long-term rates declined.

As economic activity slows during a recession, interest rates tend to fall. However, short-term rates tend to fall much faster and to a much greater degree than long-term rates. Interest rates would fall during a recession even if the Fed did nothing. Falling interest rates, however, force the Fed to take action. One possibility is that the Fed could resist market pressures to keep rates from falling. To do so, it would have to drain reserves from the banking system. The Fed seldom does this for very long; rather, it acquiesces to market pressures by reducing its target for the funds rate. For monetary policy to become easier in the face of slower economic growth and reduced credit demand, the Fed must reduce its target for the funds rate by an amount greater than is needed simply to accommodate market pressures. To do this, the Fed must increase the supply of reserves relative to demand. But this is not what has happened this year. With the exception of the temporary spike in reserves in the immediate aftermath of the terrorist attacks, reserve growth was essentially flat. Hence, rather than increasing reserves to push interest rates down, it appears that for the most part the Fed has simply adjusted its funds rate target by the amount dictated by the new economic circumstances.

Of course, the Fed increased reserves immediately in response to the terrorist attacks. The reaction was enormous and appropriate. During the first couple of weeks following 9/11, the Fed increased the supply of reserves by about 50 percent, or about

\$35 billion. These reserves were largely supplied by temporary measures that quickly and automatically reversed themselves. The reaction was appropriate because the market needed a temporary increase in liquidity to ensure that transactions that were directly affected by the terrorist attacks could be carried out, and to allay any concern that the events of 9/11 would adversely effect the functioning of our financial markets. Once this was accomplished, the liquidity that was supplied during this period was drained from the market.

If my analysis is correct and the Fed has merely reduced the funds rate by the amount dictated by changing market conditions, then one should expect such actions will have little effect on economic activity. Hence, the apparent lack of effectiveness of the Fed's actions may stem from the possibility that, in reality, the Fed has done very little to ease monetary policy. Moreover, if the Fed has done relatively little to easy policy, then one should not expect to see a significant response to monetary policy in 2002.

If monetary policy isn't going to pull us out of the recession, what will? Fiscal policy? The government already passed a tax cut this year. I don't know about you, but we have already spent our \$600, so whatever that was supposed to do for the economy has already been done. Of course, the government has dramatically increased spending in the wake of 9/11, and the President and Congress are now trying to work out the details of an "economic stimulus package."

In the 1950s and 1960s, fiscal policy was thought to be the principal way that government could influence the economy. Many of you may not know it, but monetary policy was thought to be relatively ineffective. The large and persistent government deficits of the 1970s and 1980s changed that. No one believed that fiscal policy was

practical in an economy with large and persistent government deficits. For a while it seemed that the phrase “fiscal policy” would pass from the economic lexicon. The reappearance of government surpluses in 1998, the forecast of large and persistent surpluses, and now a recession have changed all of that. The government is now in the process of trying to fashion an “economic stimulus package” to pull the economy out of the recession.

What has not changed, however, is the overwhelming evidence that fiscal policy is relatively ineffective. There were several examples of this in the U.S. in the 1960s, but the most recent and perhaps most dramatic example is Japan’s fiscal policy experiment of the last decade. After decades of strong economic growth and only one relatively mild recession (in 1974), the Japanese economy has been in a period of sluggish growth since the early 1990s. From 1991 to 2000, Japan’s GDP grew at a compound average annual rate of 1.2 percent—3.0 percentage points below the rate of the previous decade.

In 1992, the Japanese government attempted to stimulate their economy by implementing a series of unprecedented tax cuts and expenditure increases. General government outlays rose from 30.9 percent of GDP in 1991 to 38.1 percent of GDP in 1999, while general government tax and non-tax receipts declined from 33.8 percent of GDP to 31.1 percent. Not surprisingly, the government budget went from a surplus of 2.9 percent of GDP in 1991 to a deficit of 7 percent of GDP in 1999. In contrast, the largest general (federal, state, and local) government deficit in the U.S. in the deficit-ridden 1980s was 5.3 percent of GDP in 1986. As a result of these efforts to stimulate the economy through fiscal policy, Japan now faces a serious debt problem. Japan’s debt-to-GDP ratio nearly doubled in the last decade, rising from 0.58 in 1991 to 1.1 in 2000.

Many of the reasons advanced for the apparent failure of the fiscal policy measures to stimulate the Japanese economy sound familiar: some of the measures were viewed as temporary and, consequently, had little impact on aggregate demand; the actual fiscal policy measures were not large enough—more aggressive action would have been successful; the actions were smaller than originally announced; the wrong set of expenditure programs were introduced—other programs would have been successful. Any or all of these criticisms may be valid, but they imply that implementing a successful fiscal policy is, at least, difficult. The evidence suggests, in fact, that either implementing a successful fiscal policy is difficult or fiscal policy is ineffective. Either way, the Japanese fiscal policy experiment suggests that the practical usefulness of fiscal policy may be limited.

Returning to the U.S., if monetary policy did not ease a great deal in 2001 and fiscal policy actions are likely to be rather ineffective, I must believe that the economic outlook for 2002 is rather bleak—right? Wrong! I believe that too much emphasis is placed on the role of government in stimulating the economy and much too little importance is given to the economy's self-equilibrating mechanisms. Adjustments of prices, wages, interest rates, exchange rates, the capital stock and (perhaps, most importantly) expectations create forces that prevent economic contractions from spiraling downward. The same forces, plus resource constraints, keep economic expansions in check. The economy's self-equilibrating mechanisms require markets that are free so the necessary adjustments can take place, a monetary policy that focuses on keeping inflation low and predictable, and a monetary authority dedicated to maintaining the efficient

functioning of financial markets. In short we need monetary policy and government regulations that foster, rather than impede, market adjustments.

It is my belief that we have such a system in place. I hope that neither the monetary authority nor the federal government takes actions that inadvertently slow these adjustment processes.

I also believe that the stimulus from technology, which contributed significantly to the exceptionally good economic performance of nearly the last decade, is not played out. Many of the same forces that drove the last expansion are still in place. Consequently, I believe that the economy will rebound in 2002.

Will we see a return of the 4+ percent economic growth that marked the last 7 or 8 years? I think it is unlikely. For one thing, the growth of the 1990s was partly driven by expectations that were out of line with long-run economic realities. These expectations gave rise to incredibly high stock market returns which, in turn, contributed to somewhat faster growth than was otherwise warranted by the circumstances. Expectations have been revised, and I believe that this process will continue.

In addition, I note that the price-earnings ratio for the S&P 500 is still close to 30—well above its historical average of about 16. Earnings are going to have to be very strong during the next decade or stock prices are going to have to adjust. I am betting on the latter. Prices can adjust quickly, as they did in the 1987 stock market crash. Alternatively, they could meander for a number of years, as they did over a decade from the late 1960s to the late 1970s. Either way, I expect very little extra stimulus from the stock market during the foreseeable future.

Overall, I believe the economic outlook is rather good. Spurred by technology, I anticipate that during the next economic expansion, which will likely begin in the first half of 2002, economic growth will average close to 3.5 percent. This is historically rapid growth, but much slower than the 4.25 percent output growth during the latter part of the 1990s. I expect the economy will get a boost from monetary and fiscal policy in 2002, but not beyond. However, the boost may be largely or completely offset by the fact that economic growth in the rest of the world appears to be slowing.

The key danger is that monetary policymakers will overreact and ignite inflation pressures that will require a subsequent tightening of policy that could work to shorten the length of the next economic expansion. It is my belief, however, that we have not pursued such a policy and that, barring any unforeseen Fed actions, inflation should remain relatively low and stable. As much as anything else, this is how monetary policy can contribute to sustained economic growth.