

Economic and Financial Outlook—2002

**Daniel L. Thornton
Vice President and Economic Advisor
Federal Reserve Bank of St. Louis**

**Remarks made at the 38th Annual Meeting of the
Missouri Valley Economics Association**

February 28, 2002

I would like to thank Cletus Coughlin and Bob Rasche for helpful comments.

I am very pleased to be here to share my economic and financial 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. My employer also forbids me from making interest rate forecasts. I can, however, outline the factors that I believe will be most important for determining the path of interest rates.

These factors are the strength of the recovery and expectations for inflation. I will begin my analysis with a look at the behavior of long-term rates. The 10-year Treasury yield has declined by about 150 basis points from its January 2000 peak of 6.6 percent. Most of this decline is reflected in the improvement of inflation expectations. Measured by the spread between inflation adjusted and non-inflation adjusted Treasury rates, inflation expectations have declined by about 100 basis points. Hence, the decline in the long-term real rate over the course of the recession has been rather modest. Indeed, after declining significantly during the heart of the recession (when there appeared to be some “flight to safety”), the 10-year Treasury rate moved up substantially beginning in November (and risky rates fell), as evidence began to point to recovery.

Of course, short-term rates fell dramatically last year as a consequence of what some have called the extraordinary monetary policy easing of 2001. Beginning with the “surprise” 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 475 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 obvious signs that the economy was weakening. The dating of the onset of the recession, however, suggests that the actions were not taken that 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 Fed would adjust its funds rate target at its January 30/31 meeting. The market was only surprised that the Committee made an intermeeting target change. That the market anticipated the FOMC's action is not surprising. 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 dot-com companies.

The FOMC aggressively reduced its funds rate target in 2001, but did it ease monetary policy? Reducing the funds rate target and easing monetary policy are not necessarily the same. For example, assume that there is a 100-basis-point reduction in expected inflation. This will cause nominal rates to fall by 100 basis points. If the FOMC reduces the funds rate by less than 100 basis points, policy would become tighter because the Fed would have to drain reserves to keep the funds rate from falling. If the FOMC reduced the funds rate target by exactly 100 basis points, policy would be unchanged. Policy would be "easier" only if the FOMC reduced the funds rate target by more than 100 basis points. The same analysis applies to exogenous changes in real

rates—if there is a change in the equilibrium short-term real rate, the stance of policy changes unless the Fed changes its funds rate target by exactly the amount of the exogenous rate change.

If most of the 475-basis-point reduction in short-term rates in 2001 was the result of the Fed actively pushing the short-term real rate down, we should observe a large increase in monetary aggregates that are very closely associated with open market operations, such as total reserves and total checkable deposits. This did not occur. With the exception of the period immediately after the terrorist attacks on September 11, the Fed has done little to increase the supply of reserves during the past 12 months. During the weeks immediately 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 supplied during this period was drained from the market.

Some of you are probably asking: If the Fed did not push short-term rates down why did short-term interest rates decline by nearly 500 basis points? Just as I asked for additional evidence to support the claim that the Fed pushed interest rates down—and found little—you should ask, if not the Fed, what caused short-term rates to fall? First, I would note that periods of large and rapid changes in short-term rates are not uncommon and have occurred even during periods when the Fed was not explicitly targeting the

federal funds rate. Indeed, short-term interest rates are more volatile than long-term rates not only at high frequencies, but from peak-to-trough over their cycle as well. Some of the recent decline in short-term rates was undoubtedly due weakened credit demand associated with declining economic activity. The decline in short-term rates was likely exacerbated by an increase in the supply of short-term credit as equity investors decided to move to the sidelines until things get sorted out in the equity market—a process that, in my view, will be on-going for some time. If market pressures push short-term interest rates down, the Fed can either adjust its funds rate target accordingly or change policy. If it does not adjust its rate sufficiently, then policy will become tighter; if it adjusts the rate more than is required by changing market conditions, policy will become easier. I think it is safe to say that the Fed did not under adjust its target in 2001. Exactly how much easier policy has become, however, is another matter.

Some, perhaps many of you, will find parts or perhaps all of my analysis wanting. Since I am giving this talk, I will assume that my analysis is largely correct and ask what its implications are for the behavior of interest rates in 2002.

I do not believe that the Fed significantly eased monetary policy in 2001. Consequently, I don't expect a significant increase in inflation expectations over the next year or so. At most, I would expect to see a modest increase in long-term rates due to a readjustment of inflation expectations.

The real long-term interest rate appear to be at or slightly below its long-run level. Hence, I expect to see some modest increase in long-term rates as economic activity improves. Real long-term rates could move above their long-run level if output grows significantly faster than potential, which I am inclined to think that it will.

Short-term rates will rise faster and further than long-term rates. The speed of the readjustment will be faster if uncertainties in the equity markets resolve themselves faster than I anticipate. The federal funds futures market is not expecting a significant increase in the federal funds rate until July. My own expectation is that short-term rates will rise much faster than the federal funds futures rate is currently indicating.

I would like to conclude with a couple of comments on the economic outlook more generally and the roles of monetary and fiscal policy. I have already stated that I do not believe that monetary policy eased significantly in 2001, so you will not be surprised to hear that I believe that little of the current expansion can be attributed to monetary policy.

In the 1950s and 1960s, fiscal policy was thought to be the principal way that government could influence the economy—monetary policy was thought by many to be absolutely and relatively ineffective. Fiscal policy was all that was needed to stabilize the economy. I took principles of economics in the early 1960s and, like most of my classmates and much of the profession at the time, I was convinced that economists had solved the problem of the business cycle. The right combination of changes in tax and expenditure programs was all that was needed to stabilize economic activity. I remember telling this to my father during one of my visits home. He looked at me as if I were crazy—he was right, we were crazy. The large and persistent government deficits of the 1970s and 1980s removed fiscal policy as an option for politicians. No one believed that fiscal policy was practical in an economy with large and persistent government deficits. Alas, the hiatus from fiscal policy proved to be temporary. The reappearance of government surpluses in 1998, the forecast of large and persistent surpluses, and the

recession has shown that the phrase “we are all Keynesians” still applies. The effort to fashion an “economic stimulus package” to “pull the economy out of the recession” was undone by politics not by economics.

What has not changed in the last 30 years is the evidence that fiscal policy is either ineffective or difficult to implement. And the evidence is stronger than ever. The 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 (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 offered for the apparent failure of 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 for economic stabilization may be limited.

My point is that I believe that too much emphasis is placed on the role of government policy (monetary and fiscal policy) in stabilizing 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 (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 interfere with these mechanisms.

I also believe that the stimulus from technological change, 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 economy during the latter part of the last expansion are still in place and will help drive the current expansion. To the extent that growth in the latter part of the 1990s was driven by expectations that were out of line with long-run economic realities, growth will be moderated. Expectations have been revised, and I believe will continue to be revised.

The key danger during any recession 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 that we have not pursued such a policy. Barring any unforeseen Fed actions, inflation should remain relatively low and stable. As much as anything else, this is how monetary policy contributes to sustained economic growth.