

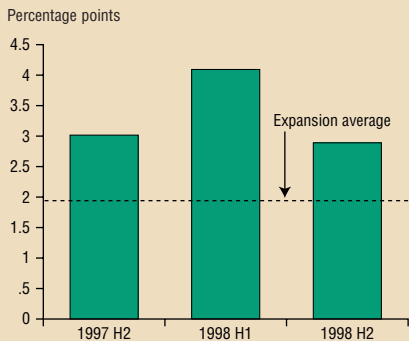
# A FRESH LOOK AT THE NATIONAL ECONOMY

The U.S. economy is in the position of the man who, while standing with one foot on hot coals and the other on a block of ice, said, "On average, I feel fine." We have seen the nation's traded-goods sector go cold while its nontraded sector has heated up. On net, growth has been robust. The divergence between the traded and nontraded sectors makes forecasting the economy unusually difficult. Financial market turbulence is also a concern, although the financial market squeeze that seemed to threaten the expansion during the fall of 1998 now appears more aptly described as a credit "pinch" than a credit "crunch." Our best guess is that we will see further solid output gains in 1999, with inflation rising only a little from 1998's low levels.

## A Review of the Economy's Recent Performance

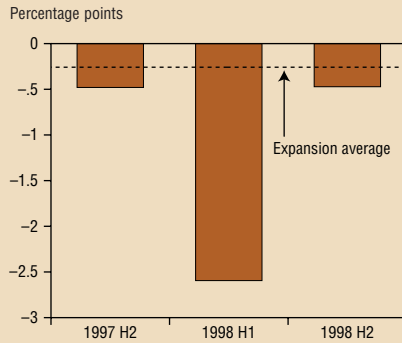
The current expansion is now nearly eight years old, and second in length only to the expansion of the 1960s. (To match the 1960s expansion, we'll have

**CHART 1**  
CONTRIBUTION OF CONSUMPTION TO GDP GROWTH



SOURCES: U.S. Department of Commerce (Bureau of Economic Analysis); authors' calculations.

**CHART 2**  
CONTRIBUTION OF NET EXPORTS TO GDP GROWTH



SOURCES: U.S. Department of Commerce (Bureau of Economic Analysis); authors' calculations.

to hold out through January of the year 2000.) More and more, the 1960s are the standard against which this economy must be compared. Both unemployment and inflation are at their lowest levels since the days of bell-bottoms, granny glasses and tie-dyed T-shirts. The big question is whether we can expect this performance to continue in the wake of the Asian crisis and its Russian and Brazilian aftershocks.

So far, the Asian crisis has been good news for U.S. consumers. The collapse of demand in Asia has meant that suddenly workers and equipment that were being used to satisfy the wants of households overseas have been freed up to produce goods for households here in the United States. Given an opportunity to purchase an abundance of goods at low prices, U.S. consumers have gone on a buying binge.

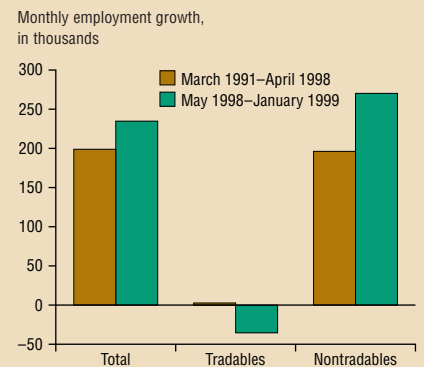
As Chart 1 shows, the contribution that real consumer spending makes to growth in U.S. gross domestic product (GDP) increased sharply as the Asian crisis unfolded, rising from an average of about 2 percentage points during the first six years of this expansion to about 3 percentage points during the second half of 1997 to more than 4 percentage points in the first half of 1998. However,

in recent quarters we have seen consumer spending growth begin to decelerate. This shift to slower growth is only natural: households have been given a chance to stock up at what is essentially a fire or going-out-of-business sale. The start of the sale brought a surge of spending, but now the pace of buying is leveling off.

Ordinarily, booming consumer spending would mean good times for U.S. manufacturers. But when domestic consumption is booming partly because of a collapse of overseas demand, U.S. exporters—and those U.S. manufacturers who compete against foreign exporters—face tough sledding. As shown in Chart 2, the trade drag on U.S. GDP growth rose from about 0.25 percentage point, on average, during the first six years of this expansion to about 0.5 percentage point in the second half of 1997 and then exploded to 2.5 percentage points in the first half of 1998. In the second half of 1998, the drag from trade showed signs of fading.

In the labor market, the effects of booming consumer demand have offset the effects of plunging net exports. The

**CHART 3**  
EMPLOYMENT GAINS IN NONTRADABLES SECTOR OFFSET LOSSES IN TRADABLES SECTOR



SOURCES: U.S. Department of Labor (Bureau of Labor Statistics); authors' calculations.

pair of bars on the left-hand side of Chart 3 shows that the rate of job growth over the past nine months has slightly exceeded the average pace of growth over the first seven years of the current expansion. But under this placid surface are strong crosscurrents. Employment in the traded-goods-producing sector has begun to decline, whereas employment growth in the nontraded sector (the construction and service-producing industries) has accelerated.

To get a feel for which of these trends will dominate during the remainder of 1999, we can look at the signals being sent by various leading economic indicators.

## The Outlook for Output Growth

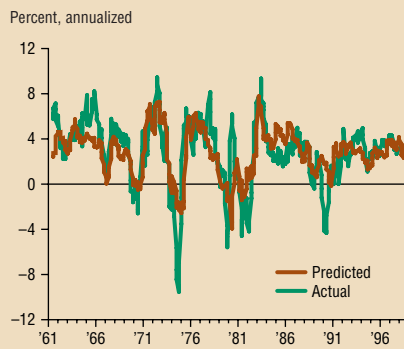
Studies have shown that real (inflation-adjusted) stock prices, the slope of the yield curve (the difference between long-term and short-term interest rates) and the real money supply each have useful information for the strength of the economy one to four quarters into the future. Other indicators are of little or no help at these horizons once stock prices, the slope of the yield curve and the money supply are taken into account.

Stock prices reflect the confidence people feel about the future health of the economy. However, stock prices are often volatile and sometimes signal recessions that don't actually materialize.

Banks find it difficult to make profitable loans when long-term interest rates are low relative to short-term rates. A flat yield curve can signal that policymakers have explicitly tightened credit by raising the federal funds rate, or have implicitly tightened credit by holding short-term rates constant in the face of declines in expected inflation or falling demand for credit.

The real money supply measures the amount of liquid, spendable wealth in people's hands. It also indicates how successful banks and money market mutual funds have been at attracting deposits that can be turned around and loaned to consumers and businesses. The "credit head winds" of the early 1990s were associated with unusually weak money supply growth. Sure

**CHART 4**  
**LONG-LEADING INDICATORS**  
**PREDICT MODERATE OUTPUT**  
**GROWTH IN 1999**



SOURCES: The Conference Board; authors' calculations.

enough, output and employment expanded sluggishly, despite rising stock prices and a steep yield curve.

The green line in Chart 4 plots output growth over six-month periods, measured by the Conference Board's composite Coincident Index. Growth in this index behaves a lot like GDP growth, but is available monthly. The brown line plots output growth predicted nine months before the fact using stock prices, money growth and the yield curve. The forecasting model misses a few big upward spikes in growth and underestimates the depth of recessions, but it gives several months' advance warning of every recent recession except that of 1990, which was arguably triggered by Iraq's sudden invasion of Kuwait.

Based on data through December 1998, the model predicts 3.6-percent growth in the Coincident Index during the second and third quarters of 1999—little changed from the 3.4-percent average growth during 1998 and substantially above the 2-percent real GDP growth predicted by the average private forecaster for those same two quarters. If the model's past performance is representative, the odds of negative growth during the spring and summer of 1999 are only about 1 in 20.

## The Outlook for Inflation

Output growth is only half the economic picture. The other half is infla-

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tion. Probably the most important factor affecting inflation is the inflation expectations that are built into labor contracts. Ideally, we would recognize that these expectations depend on past and anticipated future money growth. In practice, economists often approximate inflation expectations by taking an average of past inflation. Other factors affecting inflation include labor market slack (the unemployment rate), supply disruptions originating in the volatile food and energy sectors (as reflected in movements in the relative prices of food and energy) and global competition (as reflected in the price of imports relative to the price of domestically produced output).

Predicting movements in inflation has proven difficult because movements in food, energy and import prices are themselves difficult to predict. For example, much of the downward drift in inflation over the past several years—which has caught most economists by surprise—can be attributed to unexpected declines in the relative price of imports.

Chart 5 shows actual four-quarter changes in the GDP price index along with the forecasts generated by a model that factors in past inflation, labor market slack, food and energy shocks, and import prices. For the reasons just discussed, the model tends to overpredict inflation in recent years, but the errors are not generally large. Our forecast for inflation during 1999 is 1.3 percent—a

bit above the 0.9-percent rate of inflation we saw in 1998. Based on historical experience, chances are 50 percent that inflation will lie between 0.75 percent and 1.75 percent, and the odds that inflation will turn into outright deflation or that inflation will exceed 2.5 percent are each less than 1 in 20. Again, the average private forecaster is not quite so optimistic, expecting inflation to accelerate to a 1.7-percent annual rate.

## Risks to the Economic Outlook

Risks to our forecast are substantial. With other sectors already straining against capacity, further declines in manufacturing and mining may not be fully offset by growth elsewhere in the economy. Additional pressure on U.S. manufacturers might come from further deterioration in Asia, the spread of the Asian and Brazilian troubles to Mexico or a slowdown in Europe.

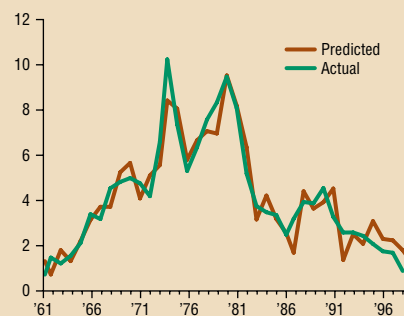
Even without further contagion, calls for the government to protect domestic firms from foreign competition can be expected to intensify. Moving away from free trade would certainly do the nation harm in the long run and might put upward pressure on inflation in the short run.

Finally, concerns about their own financial health and that of others have led some banks and investors to become more wary in lending and to put an increased premium on liquidity. Such concerns might have been triggered by a deepening economic slowdown overseas or by other signals of a less optimistic outlook for loan quality and profits. They could adversely affect the economic outlook in ways our forecasting models don't fully capture. Specifically, they give rise to two financial risks: a stock market plunge or a credit crunch. Indeed, the Federal Reserve eased monetary policy in late 1998 partly to counter mounting signs that these very risks could cause the economy to slow too much.

A stock market plunge can slow the economy in three ways. First, firms have more difficulty issuing new equity, and managers face pressure to bolster their stock prices by boosting near-term earnings through cutting payroll and in-

**CHART 5**  
**INFLATION TO REMAIN LOW IN 1999**

Fourth-quarter-over-fourth-quarter percent change, GDP price index



SOURCES: U.S. Department of Commerce (Bureau of Economic Analysis); authors' calculations.

**CHART 6**  
**NOT EVERY CORPORATE–TREASURY BOND SPREAD**  
**IS CLOSELY LINKED TO A RECESSION**



NOTE: Shaded bands indicate recessions.  
 SOURCES: Board of Governors of the Federal Reserve System; authors' calculations.

vestment costs. Second, an associated jump in uncertainty leads firms to postpone or cancel investment and hiring. Third, the decline in wealth and the associated fall in confidence lead people to cut spending. For every sustained dollar drop in equity wealth, annual consumption spending drops by about 4 cents. Indeed, if the stock price decline in the late summer of 1998 had not reversed, it appears that GDP growth would have slowed by 0.5 percentage point in 1999. Sustained stock price changes matter because households typically assess their equity wealth using a one- to three-year horizon to screen out stock price volatility. Looking ahead, the pace of stock market gains and their boost to consumption will likely slow. In addition, high stock price valuation suggests that stock prices are vulnerable and pose a downside risk to our forecast.

Another risk is that a credit crunch could emerge, in which more borrowers are denied loans or pay higher interest rates. To gauge the availability of bond and equity finance, three types of interest rate spreads are relevant: default, prepayment and liquidity risk indicators. Some analysts noted in late 1998 that spreads between interest rates on lower grade bonds and U.S. Treasuries widened to levels seen in recessions, as shown by the gap between yields on U.S. Treas-

uries and Baa-rated corporate bonds, the lowest risk category of investment-grade bonds (*Chart 6*). However, this spread has default- and prepayment-risk-premium components that behave differently, implying that the overall spread can give a false recession alarm.

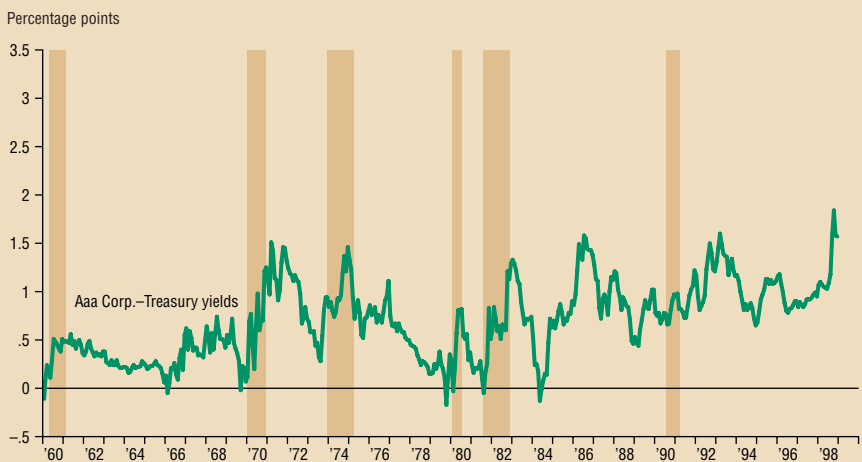
Default risk premiums, measured by the gap between yields on low- and high-grade bonds, compensate investors for the risk that borrowers may not repay. Rising default premiums often

imply higher borrowing costs and have been associated with credit crunches and recessions, as shown by the gap between yields on Baa- and Aaa-corporate bonds, the latter being the highest investment-grade bond category (see *Chart 6*). Recently this spread has risen to its post-1982 average, up from the exceptionally low levels of recent years. Spreads between Aaa-rated corporate and below-investment-grade bonds have widened to above-normal levels, implying that credit conditions have tightened more for less well-established bond-issuing firms.

Investors also demand a prepayment risk premium—measured by the interest rate gap between Aaa-rated corporate bonds that pose little default risk and Treasury bonds—for the possibility that borrowers will refinance their debt if interest rates fall. These bonds differ because when interest rates fall, Aaa bonds tend to be called and refinanced, whereas U.S. Treasuries are not. Prepayment risk premiums reflect interest rate and refinancing uncertainty but are not closely linked to recessions (*Chart 7*). Relative to default risk premiums, there has been a more pronounced rise in the gap between Aaa corporate and Treasury bond yields.

Sometimes this interest rate spread includes a higher liquidity premium to compensate investors for the fact that

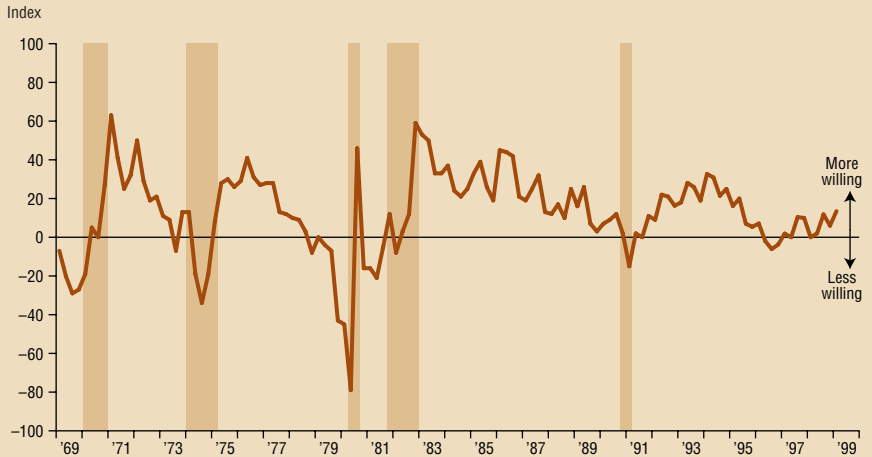
**CHART 7**  
**HIGHER PREPAYMENT–LIQUIDITY PREMIUMS**  
**ARE OFTEN NOT LINKED TO RECESSIONS**



NOTE: Shaded bands indicate recessions.  
 SOURCES: Board of Governors of the Federal Reserve System; authors' calculations.

*Overall, it appears  
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**CHART 8**  
**BANKS STILL SLIGHTLY MORE WILLING TO LEND TO CONSUMERS**



NOTE: Shaded bands indicate recessions.

SOURCE: Board of Governors of the Federal Reserve System.

private instruments are less desirable to hold than U.S. Treasuries when financial markets are turbulent and investors are very risk averse. Some have argued that the recent rises in prepayment spreads reflect a flight to quality in which investors shift from stocks into the most liquid bond instruments—Treasuries—thereby bidding down Treasury yields more than private bond yields and driving spreads up. This may have also widened the spread between interest rates on Treasury bills and prime commercial paper that pose virtually no prepayment or default risk. At one time, the paper–bill spread was correlated with recessions, but since the mid-1980s it has not been closely related to recessions and has given false alarms. Last fall, liquidity premiums surged and many firms could not issue commercial paper, bonds or stock. Partly to ease the liquidity squeeze, the Federal Reserve cut the federal funds rate several times. Since then, the paper–bill spread has returned to normal levels.

With respect to bank lending, Federal Reserve surveys in late 1998 found that after years of easing credit standards, banks slightly tightened credit standards for business loans to large and midsize firms, with smaller changes for loans to small firms. The patterns suggested that credit standards had been tightened more for firms with higher global exposure. Banks reported they

were, on net, more willing to make consumer loans than they had been in the earlier survey. Although willingness to lend is not rising as rapidly as in early 1997, it is not falling at a pace associated with previous recessions and credit crunches (*Chart 8*). This pattern continued in the most recent survey of January 1999 but with banks reporting little net change in credit standards for business loans. Overall, it appears the United States is in a credit pinch rather than a crunch. Lending practices are returning to more normal levels of risk-taking.

## Conclusion

The U.S. economy will likely grow at a robust pace in 1999, with a modest acceleration in inflation. However, the potential for further deterioration in economies overseas and financial market disruptions poses downside risks to this outlook.

—Evan F. Koenig  
John Duca