

## Smooth Sailing in 1996

Remarks Before Selected Guests  
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### **Introduction**

Good morning and welcome once again to the fifth annual Huntington Forecast Breakfast. A great deal has happened since many of us last met here in this room exactly one year ago tomorrow. Congressional Republicans have pressed forward with their agenda. Economic growth slowed abruptly in the first half, the dollar plunged on foreign exchange markets, and the interest rate cycle turned down. Although the balanced budget amendment failed by a single vote in the Senate, Congress is attempting to enact a blueprint for balance by 2002 – this time with a debt ceiling hanging over their heads. Support for major reform of the federal tax code is building, while legislative action probably remains a few years away.

Against this backdrop, I would like to discuss my views on the current situation and the outlook for the economy and financial markets.

### **Review of Last Year's Forecast**

First, we all deserve a big pat on the back for our forecasts from a year ago – mine from my forecasting models and yours in the form of responses to the pre-meeting survey conducted in October 1994.

My forecast was that economic growth had peaked at 4-1/2 percent in the third quarter of 1994, compared with a year earlier, and would fall to 2 percent in the first half of 1995. The slowdown materialized as expected, as the temporary stimulus from the extremely low interest rates in 1992-93 inevitably faded. The most interest-rate-sensitive sectors of the economy – autos, housing, and business equipment – contributed about 3/4 of overall growth in 1993 and 1994 and this is where the slowdown has been most pronounced.

A year ago, survey respondents and I both expected interest rates to rise further. The survey called for the prime rate and the government's 30-year bond yield to be at about 8.6 percent on September 30, 1995 – up from 7-3/4 percent and 8 percent, respectively, at the time.

My specific prediction was that the Fed would hike short term rates by a half point at their meeting the next week and by another half point to what would become a cyclical peak of 5-3/4 percent before the end of February, which would drive the prime to 8-3/4 percent. I parted company with the survey in that I expected long term interest rates to peak soon near then current levels and edge down very modestly during 1995.

Interest rates did continue rising into early 1995, and then turned down in the spring and summer. The Fed raised the federal funds rate 3/4 of a point at their meeting and by a final half point on February 1st, to 6 percent. They might wish they had listened to me, because they subsequently trimmed short rates by a quarter point in early July to 5-3/4 percent. The actual prime rate was 8-3/4 percent on September 30, which is as good as it *ever* gets in interest rate

forecasting. The yield on the government's 30-year bond peaked at 8.16 percent the week after our meeting and then fell more than one and a half percentage points to today's level of 6-1/4 to 6-1/2 percent. That is about as good as interest rate forecasting *usually* is.

In fact, forecasts of long term interest rates that were wide of the mark were far from rare for the second year in a row. The 30-year bond yield climbed two full percentage points from 6 percent on November 1, 1993 to an average of 8 percent in the fourth quarter of 1994, but only 3 out of 50 *Blue Chip Financial Forecasts* panelists predicted a yield above 7 percent. It was the same story this year in the other direction. The bond yield fell one and a half percentage points from 8 percent on November 1, 1994 to about 6.4 percent on average in the fourth quarter of 1995, yet only 2 out of 49 forecasters predicted one year ago that the bond yield would fall even to below 7 percent.

A major reason for the error in the long term rate forecasts was inflation. It turned up in 1995, as both you and I expected, but it didn't get up to 3-3/4 to 4 percent, as we thought, and it turned south again at mid-year.

Why didn't the inflation materialize? As I talked about last year, the Fed started tightening monetary conditions in advance, rather than waiting for inflation to rise before acting, as it always had in the past. The timely and swift moves doubled short term interest rates in about a year's time and prevented even the modest and temporary rise in inflation that was likely in light of the easy monetary policy of 1992-93. By all appearances, the Fed has pulled off a soft landing, that is, uninterrupted economic growth at a sustainable pace without a permanent rise in inflation.

### **Current Forecast**

Where does this leave us? In a nutshell, the outlook is for (1) continued economic expansion indefinitely, though not forever, (2) low inflation, (3) falling short term interest rates, and (4) flat long term rates – between 6 and 7 percent. In a broader sense, my forecast has been for some time and remains that we have entered a period in which inflation will be much lower than during the 1980s and therefore that interest rates will fluctuate around lower averages.

**Growth Prospects.** I expect 2-2.5 percent economic growth next year, continuing indefinitely. Economic expansions do not die of old age, something has to kill them – usually one or more shocks, such as an oil supply disruption or economic policy errors, in combination with economic imbalances, such as high debt or inventory levels or inflation. The fact that this expansion, which officially began 4-1/2 years ago, is middle aged is largely irrelevant. Right now, shocks and imbalances that could interrupt growth are conspicuously absent.

The rise in interest rates last year was enough to slow growth but not preempt it. The economy appears to have weathered the 1990 and 1993 tax rate increases. Debt levels are rising, but remain relatively low. The inventory correction this year was a minor adjustment that will prolong the expansion by preventing what could have become a truly threatening inventory overhang. And, inflation is so low that economists are arguing over whether there is any, rather than what to do about it.

Consumer price inflation has been 3 percent or less in each of the last four years. It was 2.5 percent during the year ending in September, and this may overstate actual inflation by a full percentage point. 1995 will be the fifth year in a row of sub-3 percent inflation, and the prospects are good for a sixth straight year in 1996. I will return to that.

The prospect for low inflation is important to the growth outlook, because a stable price level is a prerequisite for the best possible rate of economic growth:

- people incur costs to protect against inflation,
- inflation interacts with the tax code to transfer resources away from the private sector, where they are used most productively,
- inflation obscures critical information about supply and demand that is transmitted by fluctuations in individual prices,
- and inflation can lead to recession by inducing the Federal Reserve to tighten monetary conditions; the Fed is implicated in this way in just about every post-war downturn.

So, the absence of an inflation problem raises the economy's potential and reduces the risk of recession.

None of this is to say, however, that the economy will grow forever. It won't. Something will cause a recession at some point. That something has not yet occurred and is not on the radar screen, and the economy is not especially vulnerable right now. The stock market keeps hitting new highs, which is a good leading indicator of continued expansion. Corporate profits are also at an all-time high and investment is surging. Purchases of equipment in the third quarter were 16 percent higher than a year ago, 36 percent higher than two years ago, and 71 percent higher than four years ago. Strong investment is a response to the sound economic fundamentals and is laying the foundation for solid growth in the future.

The consumer sector is also in reasonably good shape, albeit the big burst of activity is behind us for this cycle and some cracks are beginning to show. Total employment is at its highest-ever level and the unemployment rate is as low as it gets. Auto sales are likely to remain near 15 million units next year and housing starts should be in the 1.3 to 1.4 million unit range.

Entirely aside from the business cycle, these and other economic measures are showing the effects of the changing age composition of the population. The arrival of the Baby Bust and other social factors will keep the increase in the driving age population and the rate of household formation in the 1990s well below their paces in the 1980s. Current levels of auto sales and housing activity are sustainable based on these factors.

However, some seeds of the next downturn are sprouting. Consumer installment debt is at a new high relative to income and loan payments have been rising faster than income. Of greater concern is that credit problems are starting to brew. Installment loan delinquency has increased in each of the last three quarters. A tripling in serious delinquency among new mortgage loans in just the last year also waves a red flag. In part, this deterioration reflects relaxed standards by lenders, who mailed out five credit card solicitations per capita during the first quarter!

At this point, the slow deterioration in credit quality will not prevent continued overall economic growth, but could combine with other developments beyond 1996 to bring the expansion to an end.

**The Columbus Economy.** The Columbus economy has done quite well in this environment. Employment growth in Columbus has out-paced the national rate in two of the last three years. So far this year, it has fallen short. That might be due to estimation errors, as was the case last year, or it might show the effects of the tight local labor market. The unemployment rate in Columbus declined for the third straight year and at 3-1/2 percent remains

two full percentage points below the national level. Not surprisingly, a leading concern of businesses in Columbus and throughout the Great Lakes region is the limited availability of qualified labor. A growing number of companies pay signing bonuses to new recruits and bounties to employees who refer successful job candidates.

In general, the Columbus economy continues to benefit from the many advantages of the area:

- the large pool of skilled labor,
- the vast transportation network,
- relatively low production costs, and
- proximity to much of the nation's manufacturing base.

Again, the major gains are behind us for this expansion, but the Columbus economy, like the national economy, can continue to perform well indefinitely . . . but not forever.

**Inflation and Interest Rates.** In this economic environment, inflation should remain low. I expect another year of approximately 3 percent inflation in 1996. Inflation is down and pressures are subsiding. Commodity prices have turned down. Labor costs remain subdued. And monetary policy has been tight for over a year.

In response to moderate economic growth and low inflation, I expect the Fed to lower short rates by another 3/4 point to 5 percent by next spring. The policy making committee meets next week and a move does not look likely, but I wouldn't rule out a quarter point drop before year end. Policy is restrictive, though, so the longer the Fed waits, the more it might eventually have to reduce rates.

### **Financial Market Implications**

What does this economic outlook hold for financial markets?

**Bonds.** My guess is that bonds return their coupon, with some upside potential over a multi-year period. The economic situation is consistent with a 30-year bond yield in the 6-7 percent range. In the moderate growth-continued low inflation scenario, bondholders would earn the coupon. A recession in 1996 or 1997 would wipe out inflation entirely, take long rates down to levels not seen in a generation, and produce capital gains. Alternatively, a resurgence in the economy would raise fears of inflation, drive up yields, and reduce bond prices. If the Fed then did its job, inflation would not materialize or it would retreat quickly. Bonds would take a wild ride, but return close to their coupons in the end. If the Fed did not do its job, bonds would be losers. I think that is a low-probability scenario.

**Stocks.** Stocks would also do well in a sustained growth-low inflation environment. A recent newsletter that is contained in the handout provides the figures. For more than a century, changes in stock prices have moved in the opposite direction of inflation. During years since Reconstruction in which inflation topped 3 percent, inflation-adjusted stock prices decreased 4 percent on average. In years of low inflation, real stock prices rose an average of 8 percent. The pattern is essentially the same by decade.

The business cycle has not been repealed and I don't know which way stock prices will zig or zag next. What this analysis says is that if inflation remains low, the increases in stocks will more than offset the periodic dips. The prospects for such a scenario are good. The Fed

has for some time publicly stated that its goal is to eliminate inflation and has behaved that way, and the Senate is considering legislation that would require it to do so.

## **Negative Risks**

Several developments could upset the apple cart.

**Monetary Policy.** I might be wrong about monetary policy. The Fed could be slower to ease monetary conditions than I expect or policy could be tighter than it appears. The abrupt slowdown in the monetary base to from double digits in 1993 and early 1994 to just 4 percent in the year ending September, raises the specter of recession next year.

**Fiscal Policy.** Fiscal policy might also be more restrictive than it appears. The budget deficit is still \$165 billion, which by conventional wisdom lifts economic activity. What really matters, though, is the primary budget balance, or government receipts minus outlays other than net interest. The primary budget balance reflects what the government is currently adding to or subtracting from the economy. Interest payments are result of past actions. Since last October, the primary federal government budget has been in surplus, meaning that the current stance of fiscal policy is restrictive, just as it has been beginning a year or so prior to every post-World War II recession.

**Japan.** There are risks abroad, as well. Political and economic uncertainties in Japan are potential sources of trouble for the U.S. economy. Japan is the largest market for U.S. exports, and Japanese investors supply billions of dollars annually to U.S. capital markets. The Japanese economy is flirting with a "liquidity trap," in which the outlook is so dim that no level of interest rates can spark a revival. And, the country is sitting on a banking problem that could dwarf our S&L fiasco as it undergoes a gradual debt-deflation. Producer prices have been falling since 1993 and consumer prices have been falling since last spring. The Japanese economy has not posted a healthy growth rate since 1990 and the prospects are bleak for the remainder of 1995 and 1996. The OECD expects some improvement. Private forecasters are less positive, looking for more of the same – growth below 1 percent through next year.

**Mexico.** The crisis in Mexico – the second largest market for U.S. exports in 1994 – might also be far from over. The Mexican banking system is also on uncertain ground and the unprecedented \$50 billion bailout package has not arrested the crisis. The peso fell again yesterday; it was down to 7.8 to the dollar at noon. I believe that was a new all-time low. Short-term interest rates were 54 percent, up from 42 percent a week ago.

The size of the rescue package is itself a concern. The 1982 crisis drew assistance of \$1.2 billion and the 1988 crisis attracted aid of \$3.5 billion. It appears that the lesson Mexican officials and foreign investors learned from past mistakes is that irresponsible behavior has limited negative consequences – the U.S. and international agencies will come to the rescue. This behavior in response to assistance actually creates serious imbalances that the assistance is ostensibly intended to prevent.

The Mexican government did make an early payment on its U.S. loan a few weeks ago, but the money was borrowed from Europe. The crisis in Mexico is not over yet.

**Oil Shock.** Instability in the Middle East poses another threat. The region has been relatively quiet, but turmoil is never far below the surface. Saddam Hussein is still in power in Iraq and rival factions remain at odds across national boundaries. Real oil prices have declined sharply from the peak 14 years ago and pressures are building in Saudi Arabia, which sits on 25 percent of the world's proven oil reserves. Per capita GDP is down by half since 1981, the

water shortage is acute, and the Kingdom's international debt is \$60 billion and growing. Meanwhile, there is great potential for social, political, and military conflict that could disrupt oil supplies and drive prices sharply higher. Oil shocks played a role in each of the last three recessionary periods – the mid-1970s, early 1980s, and early 1990s – so renewed hostilities would certainly sour the economic outlook.

### **Positive Risks**

There is some upside potential, too. Tax law changes pose two positive risks to the outlook – one short term and one longer term.

**Capital Gains Tax Rate Reduction.** Capital gains tax reform is a good bet to pass this year. The House passed a Bill that cuts the rate to just under 20 percent and indexes gains for inflation. The Senate passed a Bill that cuts the rate, but does not index gains. The two Bills are in Conference now and the combined version must be ratified in both chambers and be signed by the President. Anything along these lines would give the economy a boost by reducing the multiple-taxation of corporate income and unlocking vast resources trapped by the tax code in under-performing investments.

Under existing law, corporate income is taxed twice directly by the tax code and a third time indirectly through the interaction of inflation with the tax code. Shareholders own pro-rata shares of corporate income, on which companies pay taxes on their behalf. The after-tax income is taxed a second time, at the personal level, either as dividends or capital gains. By taxing nominal capital gains, the code adds a punishing third levy on corporate income, even when there is a loss after inflation.

For example, shares in Borden appreciated 41 percent between the end of 1983 and the end of March 1995. A one thousand dollar investment would have produced federal tax liability of \$115 upon sale of the stock. During that same period, the general price level rose by almost 50 percent, turning the nominal 41 percent gain into a 6 percent loss after inflation. By ignoring inflation, though, the tax code magnified the loss to 35 percent.

The result is that much of the estimated unrealized gains of \$7.5 trillion is locked into low-performing investments. Cutting the rate and indexing for inflation would spur investment and raise productivity by easing the multiple tax on capital.

**Comprehensive Tax Reform.** The longer term positive risk to the forecast is the potential for far-reaching tax reform in 1997 or 1998. Integrating the corporate and personal tax systems to broaden the base and eliminate multiple taxation and lowering marginal rates would remove many of the costly distortions created by the current tax code and substantially raise the potential growth rate of the economy. Economists estimate that costs from compliance, tax planning, unlawful evasion, and distortions from pursuing unproductive tax-advantaged investments total almost \$400 billion annually. In 1993, total corporate and individual tax payments were \$625 billion.

### **Conclusion**

In closing, the economic outlook is for smooth sailing for the foreseeable future. The risks are more heavily weighted to the downside, led by the possibility that economic policies are more restrictive than generally acknowledged. Turbulence undoubtedly lies out there somewhere, but probably not in 1996.