

Views on the Economy and Financial Markets

Remarks Before
Selected Guests
Powell, Ohio
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By James W. Coons

Who wants me to start with a joke? Who wants me to start with an economic forecast? Who can tell the difference?

I wrote an eloquent and stirring speech on the economic outlook for this morning, but frankly - after all of the speeches we have endured during this political season - I figure you probably don't want to hear another. I know I don't. So, let's just open it up for questions ...

1. You have a widespread reputation as a first-class forecaster. How did your predictions from last year turn out.

That's an excellent question! Last year's forecast was a beautiful thing. Last November, I predicted: (1) Uninterrupted economic growth at a moderate pace. (2) Inflation of less than 3%. (3) A 75bp reduction in the short-term interest rate controlled by the Federal Reserve. (4) A yield on the government's 30-year bond between 6% and 7%. And (5) a generally favorable environment for the stock market.

Notice that I remembered to apply the cardinal rule of forecasting, which is: if you give a number, don't give a date, and if you give a date, don't give a number.

How did the numbers come out? (1) The economy will expand this year by only a bit more than the 2% it gained last year. (2) Inflation will almost exactly match the subdued 2.8% increase of a year ago. (3) The Federal Reserve reduced short-term interest rates further, but by 50bp rather than 75bp. (4) The bond yield did not stay as close to 6% as I thought most likely, but for the most part it stayed in the 6-7% range. Yesterday, it was only 30bp from where it was a year ago - about one-quarter of the average annual change during the last 10 years. And finally, (5) this environment has been so favorable for stocks that the S&P500 index has tacked another 16% onto its 34% gain in 1995.

2. Using your keen analytical insight, please tell us where you think the economy stands today.

It is true that the economic fundamentals are as sound today as in a generation or more. The percentage of the working age population employed is at a record high. Housing construction and sales and automobile purchases are at sustainably high levels. Business inventories are low, compared with sales. Investment in equipment is 63% higher than 5 years ago. Corporate balance sheets are stronger than at any time in recent memory. The ratio of credit upgrades to downgrades hit a record in the third quarter. Inflation has been about 3% or less for six straight years. Interest rates remain at moderate levels. And, of course, the stock

market keeps setting new highs, as the Dow did again yesterday.

Still, the current economic expansion has been much weaker than average. The economy has expanded for the last twenty-two quarters. (1) During this time, real economic growth per capita has increased by less than half as much as the average. (2) Employment growth has also been weaker, although that is because the number of jobs was unchanged in the first year and a half. Since then, job growth has been comparable. (3) The least favorable comparison is perhaps the most significant. Real income on a per capita basis is up about 7%, compared with the average of close to 18%.

Why? Two big tax rate increases in 1990 and then 1993. Fiscal policy that increasingly favors borrowing and spending over saving and investment. And a relentless increase in the cost of complying with federal regulations that is estimated at near \$600 billion annually.

Economic growth did pick up by 2 percentage points from 1995 to the the first half of 1996, but the improvement was artificial and transitory. Half of the gain was caused by the depressing effect of the government shutdown on federal spending in 1995 and the positive, one-time offset this year. The other half was from a temporary acceleration in consumer spending, much of which was driven by a wave of mortgage refinancing.

Activity slowed significantly in the third quarter, as these temporary factors faded. In fact, you can make the case that the apparent fluctuations in economic growth since the 1990-91 recession have been no more than random, temporary shifts around an unchanging slow growth trend.

3. What do your unparalleled skills as a forecaster tell you this means for the economy and financial markets in the year ahead?

My forecast is fivefold: (1) The economy will expand again in 1997, but by a smaller amount than this year. That should push the unemployment rate up from about 5.3% to close to 6%. Based on the historical lag between a change in monetary policy and its effects on the economy, the 1994-95 tightening is just now starting to exert its full force. Fiscal restraint is also undercutting growth. The primary federal budget, which excludes interest, is in surplus, indicating that federal spending is a drag on the economy.

(2) Inflation will stay low next year or go lower, because monetary policy has been disinflationary. Short-term interest rates are moderate-to-high in absolute terms, compared with inflation, and relative to economic growth. Short-term credit growth has been falling for more than a year. Commodity prices appear to still be trending down. Gold is below \$400 and falling and the dollar has been strengthening on foreign exchange markets. These are all signs that inflation remains subdued.

(3) The next move by the Federal Reserve will be to reduce short-term interest rates. This won't happen soon, but it could happen next year if growth fades on schedule, the unemployment rate rises, and inflation stays down.

(4) Bond yields are about where they belong, given this growth-inflation scenario, but have more room to fall than to rise. The market has swung from fear of an increase in inflation to about neutral. If the economic numbers deteriorate further, as I expect, sentiment might well swing temporarily toward fear of recession.

What I think we can really say is that inflation and, therefore, interest rates are likely to fluctuate around lower averages for the foreseeable future than they did during the last ten years, or so.

(5) This moderate-growth-low-inflation outlook could mean another good year for stocks. My forecasting equation translates my growth, inflation, and interest rate assumptions into an increase in stock prices that about matches this year's increase.

4. In February, you wrote, in an Op-Ed piece for the Columbus Dispatch, that the economy would be a negative for the President's reelection bid. What do you have to say, in light of the election outcome?

I do not recall that article.

5. As unlikely as this may be, what developments could cause your economic growth forecast to be too high?

I have already mentioned a couple of them. Monetary and fiscal policies might have larger effects on growth than I estimate. There are a number of others:

(1) The two-part increase in the minimum wage might create thousands of unemployed teenagers in the next two years, just as the 1990 and 1991 increases appear to have done.

(2) Further attempts to eliminate the federal budget deficit by raising tax rates or by other means that (a) reduce the quantity of labor supplied or (b) that discourage saving and investment would undermine growth.

(3) Economic activity overseas seems to be picking up, but could falter again. After booming ahead early this year in Japan, for example, real GDP decreased in the second quarter. In Mexico, the peso has plunged again in response to a lack of confidence in the new economic plan.

(4) An oil price spike would be a real blow. Each of the last three recessionary periods were triggered in part by a spike in oil prices. So far this year, the cost of West Texas intermediate has increased by one-third. That's not a spike ... yet.

(5) Far less likely, but potentially much more potent, is a military clash. The Heritage Foundation recently identified several threats: (1) North Korea invades the South, (2) China invades Taiwan, (3) Afghanistan explodes into another Yugoslavia, (4) Saddam stirs the pot in the Middle East again, or Syria or Iran strike out.

(6) In my view, the most serious threat to growth - taking into account both probability and impact - is the alarming deterioration in consumer finances here at home.

The ratio of loan payments to income has risen quickly in the past year, and including car leases, matches the all-time high. This might not be as serious as it looks, because (1) credit seems to have been extended mainly to those who have the experience and cashflows to handle it and (2) consumer financial leverage has actually improved in recent quarters, falling back to its low of the last ten years in the second quarter.

But consumers are clearly experiencing financial stress. Late payments on credit cards have increased for seven straight quarters to an all-time high. And delinquencies are up across all types of credit, including even home equity loans and mortgages. Personal bankruptcies are rising, too. They were 40 percent higher in the second quarter than two years ago and will top 1 million this year for the first time. In response, the willingness of banks to make consumer loans has fallen to a recessionary level.

In large part, I think these developments are a normal part of the business cycle. The tighter lending standards are more of a prudent reaction to events than a catalyst for trouble. Yet there is no mistaking that these developments make the economy vulnerable to disturbances of the types that I have mentioned. In that sense, the deterioration in consumer finances is the beginning of the end.

6. You said in your latest newsletter that the current economic expansion has lasted much longer than average. How does this affect the chances for a recession?

Age appears to have nothing to do with it. Researchers have decided that the probability that an expansion is about to end does not increase with the length of the expansion.

But the longevity of an expansion is very highly correlated with the length of time during which short-term interest rates decrease at the outset. This chart shows the correspondence - for the twenty expansions this century - between the number of months until the prime rate turns up (horizontal axis) and the length of the expansion (vertical axis). It is the best long-term recession indicator that I have come across. (Watch closely: this is the high-tech part of the slide presentation.)

For what it is worth, the prime rate reached its low point 35 months into this expansion. If the historical relationship had held exactly this time, the expansion would have ended in June. Given the past degree of imprecision, there is a 67% chance the expansion will end by next June and a 95% probability that it will not make it past June 1998.

(I hasten to add, however, a lesson that my non-mathematician brother taught me: Even if the odds are 95-5, you still have about a 50-50 chance of being in the 5% group.)

Now, in all honesty, I don't entirely know what to make of this analysis. It is a little short on both theory and data. But it is based on the work of two very prominent researchers - one of whom pioneered the measurement and analysis of the business cycle. And it seems to work! What it says to me is that - for the first time in years - the economy faces some real business cycle risks.

To sum up, the party is over. The music is still playing, but only softly. The Fed has not taken the punchbowl away, but it has been a long time since the last refill. The partygoers are still mingling - most of them unaware that they have already engaged in enough revelry to cause a hangover, whenever morning arrives.

7. Your comments have been fascinating again this year. Will you come back next November to present your updated forecast?

Yes. Thank you for asking.

Now, are there any real questions?