

# ECOMENTARYÔ

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## Economics, Politics & Rhetoric: Greenspan HH 2001SH

Front-loaded Fed policy coupled with tax cut should improve economic activity as the year progresses, yet weakness could arrive from abroad or from further domestic developments

Considerable uncertainty to the current economic situation until inventory adjustment and is complete and capital spending resumes. Risk to the downside still prevails and the Fed could do more

Views of BoG and Reserve Bank Presidents reflect this assessment. It is implied in the “Central Tendency” of their individual projections.

**BoG and Reserve Bank Presidents “Central Tendency”**

	2001	2002
Real GDP (Q4 over Q4)	1¼ - 2	3 - 3 ¼
Unemployment (% avg. Q4)	4 ¾-5	5 - 5 ¼
Inflation (PCE)	2 - 2 ¾	1 ¾/2 ½

The Chairman mixed an unusual cocktail of economics, politics and rhetoric for the House Committee as the markets watched closely. After only a 25 basis point move by the FOMC on June 27<sup>th</sup>, today’s statement sent an alert to the markets that the **Fed could move again**. Many commentators had ruled out further Fed action, but Greenspan gave a sobering assessment of the task that monetary policy faced as the economy **“slowed sharply late last year and [has] remained weak this year, following an extraordinary period of buoyant expansion.”** There is a puzzling ‘dualism’ contained in his speech. He tries to first explain what went wrong in the U.S. economy as the Long Boom ended while justifying the extraordinary measures the Fed has used so far to “fix” the problem. But if the fix was lower interest rates, why did the Fed put out a stop sign on June 27<sup>th</sup> and then turn the red light back to yellow today? Are they also confused?

**What is the problem** Despite 275 points of ease (January through June), economic deterioration is still apparent, even if the Fed wishes to argue that the decline has lately slowed. **“But the uncertainties surrounding the current economic situation are considerable, and until we see more concrete evidence that the adjustments of inventories and capital spending are well along, the risks would seem to remain mostly tilted toward weakness in the economy.”** What was claimed to be essentially an inventory adjustment process is now seen to have risky implications largely because the heavy capital stock buildup during the previous boom. New investment has come to a halt, particularly in equipment and software. The centerpiece of that buildup was the New Economy--the home of the much-vaunted change in productivity that powered the boom. The economy needs that productivity growth and so does Greenspan!

**A litany of risks** The boom produced and was produced by an unprecedented surge in capital spending, much of which failed to achieve its projected rate of return. In the process, however, equity prices were bid up and the resulting wealth effect created even more consumer spending. Both capital stocks and consumer durables grew at unsustainable rates. **“Overall, capacity in high-tech manufacturing industries, for**

**example, rose nearly 50 percent last year, well in excess of its already rapid rate of increase over the previous three years.”** The key piece of the down turn was the collapse in the demand for many of these products creating an adjustment that “occurred much faster than most businesses anticipated” and was amplified by deteriorating purchasing power and corporate profits during 2000 that resulted from the energy shock. Finally, a more globally integrated world economy seems to have created a synchronous economic slowdown of our trading partners. The result was an “unanticipated” shock, which was compressed in time precisely because the new information technology quickly produced data that signaled the need for businesses to adjust quickly. Even if the new flexible technology and supply chain management allows firms to adjust more quickly, projecting forward demand correctly is still a “thornier problem.” In short, sales collapsed faster than production could be cut and inventories ballooned. The adjustment started late in 2000, but not all of the adjustment is yet completed in spite the Fed’s record-setting pace of rate reduction. With such a heavy capital stock overhang, the growth of new investment, particularly in equipment and software, has turned negative. Three months ago, the consensus was a rapid second half recovery? What now?

**The V is gone** The change in the “Central Tendency” for real GDP growth, unemployment and prices clearly shows that only modest growth is forecast for 2000. Real GDP in Q12001 was 1.2%. It is likely that Q2 will be lower, perhaps barely positive. The Central Tendency for GDP growth for the entire year of 2001 suggests a very small chance of a rapid rebound in QIII-QIV. The Chairman is clearly focusing on QIV and 2002 with a Central Tendency for real growth in 2001 of 3- 3 ¼ That would be quite respectable, even if not close to the 4-5% achieved during the boom times. The risks are still to the downside. But, if the case for an upturn is shaky, why did the Fed slow the pace of rate cutting to 25 basis points at the last FOMC meeting?

**Inflation risks** “Certainly, should conditions warrant, we may need to ease further, but we must not lose sight of the prerequisite of longer-run price stability for realizing the economy’s full growth potential over time.” This nearly echoes a tightly reasoned speech on Fed goals and instruments given by Board Member Lawrence Meyer yesterday. It is apparent that there is a division of opinion at the Fed and one also among the FOMC.

**Politics of Money** The HH hearings are a political and social event, and there is no better politician in Washington than Alan Greenspan. He took on all comers who peppered him with questions about minimum wages, the benefits of liberalized trade, outlandish pay of corporate executives, conditions of entry in the home construction business, as well as appeals to the Chairman to support the varied social and political goals of the many committee members. All questions were answered in the polite but sparring manner for which the Chairman is known. The hard questions were avoided. For example, no one asked how it was that the Fed didn’t tighten further in 1999 when the boom was developing such a head of steam. And no one asked whether the acceleration of monetary growth around the Y2K day contributed to the excess of the boom. And, no one asked how it was that the Fed didn’t take action in October, 2000 when by its own admission it had seen the boom unwinding as early as late summer.

**Mea Culpa Time?** A close reading of this speech as well as prior FOMC minutes would clearly disclose that the Fed could be accused of being late to the party it had thrown. The investment growth statistics cited by the Chairman are not news! Buried on page four is a candid admission. **“The economic developments of the last couple of years have been a particular challenge for monetary policy.”** Then the recitation: Russian Default; Y2K; ‘growing optimism—if not euphoria about profit opportunities---all leading to a “surge in investment, particularly in high-tech equipment and software.” And, then, a most curious summation. **“The upswing outstripped what the nation could finance on a sustainable basis from domestic saving and funds attracted from abroad.”** But that can’t be the cause of the problem. The dollar got stronger, that’s true, and the boom caused long term corporate rates to rise---which told the Fed it was being too easy. The Fed raised rates 175 basis points through May 2000---just about the time that Old Economy’s stalwarts started slowing markedly. But, while the FOMC gave the Chairman the go-ahead for an intermeeting cut of 50 basis points, the Fed waited until it could see the whites of the eyes of failing businessmen. This is not a lag in the effect of monetary policy---it is a lag in the recognition that there is a problem for the Fed to treat. The problem is that the Fed cannot see into the fog any better than a corporation that makes a big investment only to find out when it is too late, that the market for the New New Thing is not a market---just a bad debt waiting to be declared!

The *sine qua non* of a monetary policy that is pre-emptive (as the Chairman used to call it) is that the Fed has to be able to make very good predictions about the future. Now, if a 1000 bullish analysts thought that

earnings were going to be just fine in 2001, and the Fed was loathe to take another view, what does that say about our ability to predict the future? In fact, this Chairman is quite modest. "While we are limited in our ability to anticipate and act on asset price bubbles, expectations about future economic developments nonetheless inevitably play a crucial role in our policymaking. If we react only to past or current developments, lags in the effects of monetary policy could end up destabilizing the economy, as history has amply demonstrated."

There are some observers who might question whether what we got in 1999-2000-2001 was stability, even if we got very rich growth rates? After the fact, the Fed now admits that 50% rates of investment growth in equipment and software were not sustainable...but that data was available right on through the Boom, while the Fed watched and waited.

There are clear benefits to making the economy grow very close to its potential growth path, but there are also sizeable risks in the variance of the economy's performance. If the Congresspeople who get to participate in the twice a year fun-fest called Humphrey Hawkins would focus on the rhetoric that surrounds the public presentation of monetary policy, we would really have a public good!

It may be that we are now 'bottoming out,' and the risks notwithstanding, it will be wine and roses soon again. If so, Bob Woodward will have to change Maestro to Magician!