American Enterprise Institute for Public Policy Research

Economic Outlook

November 2004

# Listen to the Markets

## By John H. Makin

Market behavior in 2004 has defied most predictions. Interest rates and stock prices have dropped—the reverse of most forecasts at the start of the year. The dollar has been broadly trendless despite a rising and "unsustainable" current account deficit that was supposed to have pushed it down. And, of course, the price of oil, which was widely expected in January—not to mention February, March, April, May, and June—to drop back below $30 per barrel has risen relentlessly to well above $50 per barrel.

Accompanying all of this supposedly bizarre market behavior has been a path of the U.S. and global economies that has not followed the script at the beginning of the year. Last year's deflation scare turned into a brief *inflation* scare during the second quarter, and by July the Federal Reserve was predicting second-half 2004 growth of well over 5 percent. As expectations for inflation and growth have drifted lower since mid-year, the Fed has boosted its interest rate (the federal funds rate) by 75 basis points and appears ready to adopt another 25-basis-point increase on November 10.

Outside of the United States, Japan's highly touted growth surge ended in the spring, while China has applied selective measures to cool off its economy and met with mixed results. Europe, especially Germany, continues to languish at low growth levels while monetary tightening by the Bank of England has cooled the housing bubble in the United Kingdom and slowed the economy. Forecasts of 2005 global growth, already set below 2004 levels, are contingent upon an oil price of $30 to $35 per barrel. Even though oil is above $50 per barrel and the effects of U.S. policy stimulus have largely run their course by now, few analysts have been discussing the likelihood of a global recession, but such an outcome is looming. Acknowledging that possibility instead of denying it is a necessary condition to avoid a recession next year.

John H. Makin (jmakin@aei.org) is a resident scholar at AEI.

### Unusual Behavior Reflects Unusual Conditions

The unconventional market behavior observed this year and over the past several years needs to be understood rather than simply characterized as irrational, unsustainable, or resulting from measurement flaws such as allegedly faulty inflation data. If we do not understand what is driving markets and the economy now, we shall be ill prepared to anticipate and to deal with future behavior. Policy mistakes could occur that destabilize rather than stabilize the U.S. and global economies.

The basic distinguishing factor of the unusual global economy and attendant market behavior we have witnessed over the last several years is the existence of excess capacity—especially in global markets for traded goods. Starting in 1996, the U.S. stock market bubble drove down the cost of capital, especially in the tech sector, so that over-investment in turn drove down the return on new and existing capital. The spillover into broadly higher stock prices also artificially depressed the cost of capital and created excess capacity.

Excess capacity in global goods markets has been severely exacerbated by the emergence of China's production platform, which has attracted capital from domestic and foreign investors to combine with huge reserves of cheap domestic labor. This is not a criticism of China. It is simply a fact with which policymakers and the global economy and financial markets must reckon. It is important to remember that a world where demand is scarce, rather than supply, does not fit underlying assumptions of most economic models, which are driven by assumptions of the need to allocate scarce resources in a supply-constrained world.

It is hard to overemphasize the extraordinary combination of U.S. policy stimulus, price stability, and falling interest rates over the past several years.

The persistent excess-supply problem has evolved over several phases since the mid-1990s. First, both the U.S. tech bubble and accommodative Fed policy since Alan Greenspan's famous December 1996 "irrational exuberance" address to the American Enterprise Institute drove an investment boom in the United States and Asia. The Asian investment bubble almost collapsed in 1997 and 1998 but was reinflated by the Fed's rescue of Long-Term Capital Management in the fall of 1998 under the banner of avoiding "systemic risk." That event solidified the view that the Fed would indemnify financial risks attached to aggressive lending and investing. U.S. stocks soared until the bubble burst in March 2000 after the Fed started to withdraw some stimulus during the last half of 1999.

## U.S. Policy Boosts China's Capacity

U.S. investment spending collapsed after mid-2000 and did not turn positive until the second quarter of 2003. To deal with an extreme excess-capacity problem in the United States, massive monetary and fiscal stimulus was employed. Much of this stimulus (especially the monetary stimulus) spilled over into China by virtue of its currency peg to the dollar, which effectively makes the Fed China's central bank.

During the ten quarters following the end of 2001, after sharp rate cuts by the Fed in response to fears that households would stop spending after the September 11 attacks, the U.S. economy has grown at an average rate of 3.5 percent. Over that same period, consumption growth has been somewhat lower, averaging 3 percent, suggesting that a substantial portion of the U.S. stimulus spilled over into foreign markets. Indeed, U.S. imports rose at an 8.3 percent annual rate during the same ten-quarter period since the end of 2001 after having contracted sharply for a year and a half prior to that.

The U.S. effort to alleviate excess capacity by boosting demand ironically contributed to a global capacity problem by creating a rush of lending to Asia that helped to boost global supply. This combination, of course, contributed to a surge in America's external deficit that has widely been associated with the expectation of a weaker dollar. The spillover of U.S. demand-boosting fiscal and monetary policy into Asia, awash with a swelling supply of traded goods, was accommodated and recycled by Asia's central banks. Aggressive purchase of dollars and recycling of those dollars back into U.S financial markets via purchases of U.S. government and agency securities helped to sustain U.S. demand growth at stable interest rates and prices.

It is hard to overemphasize the extraordinary combination of U.S. policy stimulus, price stability, and falling interest rates over the past several years. The U.S. federal budget deficit swung from a surplus of 2.4 percent of gross domestic product in fiscal 2000 to a deficit of about 4 percent of GDP in fiscal 2004, a swing of 6.4 percentage points, far larger than the swing of 2.5 percentage points during the first four fiscal years of the Reagan administration (1981–85).

On the monetary policy front, since the end of 2001, after a sharp Fed response to fears of a post–September 11 slowdown, the real (inflation-adjusted) federal funds rate averaged minus one half of one percent, the lowest level seen in a period of falling inflation since the Great Depression.

All of this stimulus held growth at an average level of 3.5 percent (which is about the Fed's estimate of the trend rate of U.S. growth) during the ten quarters following the end of 2001. Three-percent consumption growth, coupled with strong growth of imports and a surge of government dissaving (rising budget deficits), boosted the U.S. current account deficit (the amount of external borrowing necessary) from 3.5 percent of GDP, just before the March 2000 stock market crash, to 5.7 percent of GDP by mid-2004.

## No Inflation and Falling Interest Rates

The powerful demand boost from a combination of extremely easy fiscal and monetary policies would have created inflation, high real and nominal interest rates, and a surging current account deficit accompanied by a falling dollar if all this had occurred in a fully employed economy. Had foreign investors been unprepared to lend more to the United States to finance the rising current account deficit, either real interest rates would have had to rise or the dollar would have weakened sharply.

In fact, the activity of U.S. macroeconomic variables has been radically different from what standard analysis would have predicted. Interest rates, both real and nominal, have persistently oscillated downward to lower levels. Inflation has dropped sufficiently to have produced a deflation scare in the spring of 2003. At the time, the Fed was contemplating the purchase of long-term U.S. government bonds as traders drove yields on ten-year Treasury notes to a low of 3.1 percent while stock prices fell. The trade-weighted dollar actually rose until early 2002 and then fell irregularly, declining by about 15 percent by late 2003. Since then it has moved slightly higher, while trading in a narrow range.

This year has perhaps been the most surprising year for markets since the March 2000 stock market crash. After the spring 2003 deflation scare passed, the U.S. stock market rose strongly until year-end. Economic growth was well above trend during the second-half of 2003, averaging almost 6 percent at an annual rate. By then it appeared that concerted monetary and fiscal policy stimulus had put the U.S. economy on a sustainable growth path. After a sharp jump from 3.1 percent to 4.5 percent in the yield on ten-year notes following the mid-year economic pickup and stock market rally, U.S. interest rates stabilized and fell slightly by late 2003. Ominously, the price of oil began to rise during the second half of 2003.

During the first quarter of 2004, the long awaited employment rebound expected to accompany a sustainable recovery did not materialize. Stocks languished and interest rates fell. The dollar held up because Asian central banks financed virtually all of the U.S. current account deficit, with Japan alone purchasing $140 billion during the first quarter of 2004.

We learned in the first quarter of 2004 that the supply-oriented producer economies in Asia simply would not let the United States reduce its current account deficit or allow the dollar to fall. In effect, by supporting the dollar, Asia exported its excess capacity to the United States by helping to sustain U.S. demand growth at levels far above U.S. income growth. The Fed's easy-money dollars that spilled abroad were simply recycled back into financial assets to help sustain the growth of U.S. demand for Asia's huge supply of traded goods.

To complicate matters further, U.S. employment growth surged briefly during the second quarter of 2004, seeming to confirm the notion of a sustainable recovery. At that time, U.S. interest rates rose again, with yields on ten-year Treasury notes reaching 4.9 percent. Higher yields and the rising price of oil kept stocks from rising by much and, in fact, most stock indices drifted broadly lower.

The end of the first half of 2004 saw the U.S. economy shift from the tailwinds of policy stimulus and stable energy prices to the headwinds of stimulus removal (in the case of fiscal policy) and reversal (in the case of monetary policy), coupled with steadily rising energy prices. Fears of a resultant slowing in the U.S. and global economies caused interest rates to fall while fears of weaker earnings growth caused stocks to drift lower. The dollar held steady thanks to continued support by Asian central banks and recycling of petrodollars.

> Investors should bet on lower interest rates and lower equity prices. Policymakers should be very cautious about further interest rate increases.

## Classic Post-Bubble Scenario

The unusual landscape in global markets and the global economy is a broad manifestation of excess capacity in the traded-goods sector. It represents a classic post-investment bubble scenario. The effort to sustain U.S. growth in the face of symptoms of that global excess capacity (including weak U.S. employment growth) has spilled stimulus into Asia, where substantial excess capacity still exists. Prices of commodities, especially oil, have begun to constrain growth as China and other Asian producers are driving up those prices to sustain production of finished traded goods at extraordinarily low prices. The combination of those two trends puts producers in other industrial countries in a serious terms-of-trade squeeze.

The response to this scenario needs to reflect the reality behind it. Investors should bet on lower interest rates and lower equity prices. Producers should resist the temptation to add further to productive capacity, especially in the area of globally traded goods. Policymakers should be very cautious about further interest rate increases. Higher oil prices will slow growth without creating higher inflation, given the fact that substantial excess capacity produces a profit squeeze rather than higher consumer prices. If oil stays above $50 per barrel through year-end, a recession is likely to occur in 2005. The current tendency of policymakers and corporate planners simply to ignore that possible outcome is dangerous. Meanwhile, markets are flashing warning signs as interest rates and the stock market grind lower and the dollar has slipped to a six-month low.