



The Recovery: Three Years On

By John H. Makin

The U.S. post-bubble economic recovery, which officially began in November 2001 after a recession of just six months, will be three years old by election day. The prior recession had lasted a mere eight months—from July 1990 to March 1991—and was followed by an expansion of ten years, the longest on record. The expansion before that one lasted ninety-two months—from November 1982 through July 1990—following a recession of just sixteen months. The period following November 1982 until the stock market crash of March 2000 witnessed one of the longest and most powerful stock market rallies in U.S. history, accompanied by falling inflation and falling interest rates. The remarkable performance of the last twenty or so years will be difficult to match over the next decade. Indeed, merely sustaining the growth in the current expansion will require some changes to current policy.

Presumption of Growth

Economic expansion has become the norm in the minds of most market participants and policymakers thanks, in no small part, to the fact that, since the early 1980s, recessions have been relatively rare. By election day, twenty-two years (264 months) will have passed since November 1982, and during that time the U.S. economy has been in recession just fourteen months—a mere 5 percent of the time. From the end of World War II through 1982, the U.S. economy was in recession more than four times as frequently (22.4 percent of the time). In view of the sharp reduction

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in the incidence and severity of recession over the past twenty-two years, it is little wonder that a recession is viewed as an unlikely event, one that occurs perhaps every eight to ten years and only for a short time when it does occur.

Little wonder, too, that markets have developed great confidence in the Federal Reserve under the guidance of Alan Greenspan since August 1987. Over that time, the Greenspan Fed has overseen the majority of the post-1982 period of brief recessions, long expansions, and falling inflation. Beyond that, it has managed to maintain that positive environment in the face of numerous shocks, including the stock market collapse of October 1987, two wars in the Middle East, the Mexican financial collapse in 1994–95, an Asian collapse in 1997–98 followed by the collapse of Long-Term Capital Management, the trauma of September 11, 2001, and its aftermath, extraordinary corporate bankruptcies, and a doubling in the price of oil over the past year.

Substantial event risk and elevated volatility in financial markets have coexisted with an extended period of economic growth and reduced volatility in the real economy. The steady fall in inflation since the early 1980s has freed the Fed to ease sharply when necessary to combat “systemic risk,” as it did most notably after the Long-Term Capital Management crisis in 1998 and after the 9/11 disaster.

Stocks Still Struggle

The shock that the Fed and global financial markets are still wrestling with is the March 2000 collapse of the Nasdaq bubble and associated turmoil

in other equity markets worldwide. The Nasdaq Composite Index collapsed from its March 2000 high of 5,100 to 1,700 by February 2001 and to a low of about 1,100 by August 2002. After recovering to 2,150 at the beginning of this year, it stands at about 1,900—just about 37 percent of its peak level three and a half years ago. The broader Standard and Poor's 500 Index has fared better, standing at about 1,120, or 72 percent of its March 2000 high, having dropped to a low of 50 percent of that high during the summer of 2002.

These subdued levels for U.S. equities have persisted even as earnings have grown at or above the rates of growth that produced the extraordinary prices of the late 1990s until March 2000. Allowing for extraordinarily low interest rates today, stock prices are even lower relative to their pre-March 2000 high. Based on standard—if controversial—equity valuation models, like that used by the Federal Reserve, U.S. stocks are more than two standard deviations below fair value, while just prior to March 2000 they were nearly three standard deviations above “fair value” as measured by the same yardstick. Not surprisingly, such extraordinary valuations have prompted some questioning of the validity of standard models. Alternatively, those who adhere to such models have made liberal use of the degree of freedom in the models—the “risk premium”—on stocks over bonds. That risk premium is said by some to have risen sharply, so that the expected return on stocks, either through dividends or price appreciation, has to be substantially higher than the interest rate on government (riskless) bonds to induce investors to prefer stocks over bonds. Such a risk premium was substantially lower prior to March 2000 when stocks were widely seen as an asset whose value went only up, with the only question being: how fast?

Whatever one believes about stock-valuation models, it is clear that equity markets are still far more cautious than they were in their pre-bubble period when it comes to translating higher projected earnings into higher share prices. Economic performance both in aggregate and at the company level no longer translates into elevated pre-bubble stock prices. Risk premiums (required higher expected returns) assigned to equity valuations have risen sharply and have not come down despite three years of economic expansion. The rise in stock prices over the past year is due to substantially higher earnings growth

and lower interest rates, not to more generous valuations of existing earnings that would suggest a lower risk premium.

Fed Risk

It is not very satisfying just to assign lower stock prices to a higher “risk premium.” More revealing is to ask why investors are unwilling to pay more for strongly rising income streams from stocks in an environment of low and falling interest rates. The question becomes especially compelling if, as some commentators suggest, the next recession will not come until 2010, since the last two decades seem to indicate that we only have a recession once every ten years or so.

The explanation for the failure of stock prices to rise may be quite simple. First, compelling reasons suggest that economic growth in the coming year will be substantially below the average growth rate for the past several years. Second, underscoring this risk is the Fed's apparent determination to continue raising short-term interest rates while espousing a conviction that economic growth will be substantially higher than market participants expect it to be. The Fed is in the awkward position of having run out of room to cut interest rates in the face of event risk and seems anxious to reload the rate-cutting machine. This it must do by risking rate increases just as, contrary to its assumptions, the economy is slowing as stimulus is withdrawn and, while the equivalent of an energy tax has been imposed by higher oil prices.

Over the two and a half years from the first quarter of 2002 through the second quarter of 2004, the economy grew at an average rate of about 3.5 percent. This is very close to what is perceived to be the economy's long-run sustainable trend growth rate. One percent labor force growth and 2.5 percent productivity growth provide the basis for suggesting that U.S. long-term trend growth is about 3.5 percent. In most of its public statements, Fed officials appear to agree with this assessment.

While the U.S. economy has appeared to be traveling along a path of normal trend growth over the past several years, it is important to remember that that growth was achieved with the help of extraordinary policy stimulus. Tax cuts and transfers added about a percentage point to growth during the twelve months following the summer

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of 2001 and during the twelve months following the spring of 2003. Added to that stimulus was considerable help from rate cuts by the Fed. The Fed funds rate was cut from a mid-2000 high of 6.5 percent to 3.5 percent in mid-2001 with the onset of recession. Subsequently, after 9/11, the Fed funds rate was cut in half to 1.75 percent at the end of 2001 and cut further to 1 percent by mid-2003. The Fed's rate cuts provided extraordinary stimulus through the U.S. mortgage market, where sharply falling rates enabled households to undertake refinancings of their mortgages that yielded cash. Cash-out refinancings injected an estimated \$100 billion a year into household disposable incomes during the 2002 and 2003 calendar years.

Cash-out refinancings by households enabled spending growth to run consistently ahead of tax-cut- and transfer-enhanced household income growth. During the year ending in July, real disposable income grew at a 1.8 percent rate while real consumer spending grew at a 3.5 percent rate. The difference (about \$130 billion) was probably tied to cash-out refinancings, since the growth of real disposable income included the benefit of tax cuts during that year. The gap between the growth in real disposable income and real consumption has recently increased. During the three months ending in July, real consumption rose at a 4.2 percent annual rate while real disposable income rose at only a 0.8 percent annual rate. The implied sharp drop in the saving rate is unlikely to continue and is likely to be reversed. The American consumer cannot carry the world economy forever, spending at levels well in excess of income growth.

With the extraordinary stimulus coming from tax cuts and interest rate cuts, during the two and a half years ending this summer the economy managed to grow at a 3.5 percent annual rate. Excluding the stimulus, the growth rate would have been closer to 2 percent.

The outlook for sustained trend growth rates of the U.S. economy is problematic. The stimulus from lower taxes and transfers along with the stimulus from lower interest rates was largely removed by the middle of this year. Along with that, a \$15 increase in the price of oil since the end of last year placed an additional drag on the economy, probably subtracting about a percentage point from growth for the year following the spring of 2004.

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Removal of the special stimulus from monetary and fiscal policy, coupled with the imposition of a higher tax from increased oil prices, could conservatively subtract two percentage points from U.S. trend growth of 3.5 percent—even without rate increases from the Fed. The slowdown might be mitigated if the period of extraordinary stimulus built up demand growth sufficiently to induce consistently elevated hiring. That appeared to be the case during March, April, and May, when employment growth averaged close to 300,000 per month. However, during the three months since May, employment growth has averaged just 104,000 per month, leaving open the question of the sustainability of employment growth as a means to generate sufficient growth of income to support spending.

Given the questionable outlook for U.S. economic growth, reflected in stagnant equity prices and falling interest rates, the Fed's determination to return the Fed funds rate to what it terms a "neutral" level seems odd. A neutral real Fed funds rate is a policy rate set by the Fed that is meant to be consistent with sustainable trend growth and stable prices. The real Fed funds rate has averaged around 2 percent for much of the past forty years and so if one expects inflation at a 1.5 to 2 percent level, the nominal Fed funds rate should be set at 3.5 to 4 percent if one believes a normal, "neutral" setting is appropriate.

During the two and a half years before the Fed's June 30 initiation of rate increases, the real Fed funds rate averaged zero. During that time, U.S. growth averaged 3.5 percent—the widely acknowledged sustainable trend rate of growth for the U.S. economy. The neutral real Fed funds rate during that period when tax cuts and substantial cash-out refinancings from mortgages were helping to support growth appears to have been zero or lower. If without the extra stimulus, growth would have been around 2 percent, a zero real Fed funds rate would have been considered too high to sustain trend growth. Stock markets may well be struggling with the prospect of higher short-term interest rates—and the Fed's apparent determination to provide them—in the absence of any evidence that the economy can sustain trend growth with a real Fed funds rate at zero, let alone at 2 percent.

The Fed has already increased the Fed funds rate by 75 basis points from 1 to 1.75 percent, returning the real Fed funds rate to about 0.25—at or slightly above its average

level for the past several years. Markets are currently expecting a further quarter percentage point rise in the Fed funds rate by the end of this year and another percentage point increase by the end of 2005. The only way to rationalize this path for interest rates would be to expect that, after the removal of the extraordinary stimulus applied to the economy over the past several years, autonomous growth would somehow just return to its trend level. For that to happen, the economy would have to simultaneously shake off the drag implicit in a \$15 per barrel increase in the price of oil as the Fed continues to raise short-term interest rates, so that the real Fed funds rate returns to about 1.5 percent by the end of next year. That set of events seems highly unlikely and probably has created considerable uncertainty about the outlook for earnings next year and therefore likely has put downward pressure on U.S. equity prices.

Sustaining Growth

In view of the challenging outlook for the U.S. economy, and with the prospect of Fed rate increases, what policy agenda might the next administration consider going forward? Three basic principles are paramount.

On fiscal policy, although the leeway for further tax cuts is limited, current tax cuts should be made permanent to give households and firms greater confidence about the future tax environment and to avoid adding tax increases to the substantial drags already hitting the economy from higher energy prices. Beyond that, marginal tax rates should be further reduced with any prospective revenue losses avoided by closing tax loopholes, particularly those connected to the overly generous tax expenditures that subsidize owner-occupied real estate. It is worth recalling

that lower marginal tax rates enacted in 1986 helped to encourage the extraordinary long expansion that was underway with revenue losses considerably smaller than those projected by static revenue estimation techniques that assume that lower marginal tax rates have no incentive effects on economic activity.

Second, the Fed needs to sharply re-examine its concept of the current neutral real Fed funds rate. The evidence of the past several years suggests that the neutral real Fed funds rate for the United States has been closer to 0 percent than 2 percent, and so increasing the Fed funds rate should be done with considerable care. The rationale that the Fed needs to raise the Fed funds rate in order to have the leeway to cut it in the future is essentially silly if such rate increases lead only to the need for future rate cuts.

Finally, if we are entering a period of slower growth, the United States should reassert its leadership in the trade arena and reduce restrictive trade practices both at home and abroad with renewed vigor. Simultaneously, it should continue to assert that markets should set exchange rates, and it should press hard to end exchange-rate manipulation by Asian central banks attempting to avoid the need to stimulate domestic demand while relying too heavily on exports to support growth.

Three years into this expansion, the U.S. economy faces a challenging year as it adjusts to the withdrawal of substantial stimulus (both monetary and fiscal), to higher oil prices, and to higher short-term interest rates. A combination of revenue-neutral reductions in marginal tax rates and a recognition by the Fed of the possibility of a lower neutral real Fed funds rate in a post-bubble environment will help to smooth the transition to a long-run, sustainable growth path above 3 percent.