DOUBLE DIP AND MONETARY POLICY

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There are an increasing number of economists in the US who start to include the possibility of a double dip in their latest US economy forecasts. Their argument runs as follows: First, falling prices of equities lowers economic activity. Second, a weaker real exchange rate of the dollar, necessary to turn around a balance of payments deficit for current account of around 5% of GDP, is also a sign of weaker business prospects. Third, the increase in prices at the US housing market, that has allowed the household sector to maintain a reasonable consuming resilience when the equities have been falling, is leading to another bubble that also could burst. And fourth, productivity is also reducing its rate of growth. Lets have a closer look at the different parts of this argument.

There is no doubt that a fall in the real share prices tends to lower economic activity. Lower share prices obliges firms to reduce investments and cut costs in order to increase, in the short term, expected earnings growth in order to attract investors back to buy again their stock. The immediate result is less jobs and less sales by the providers of inputs to the public or quoted companies. Historically, there is a very stable relationship between the strength of the stock markets, adjusted for the price level and labour productivity, and the level of job creation and employment. The correlation between stock market capitalization as a ratio of GDP and employment as a ratio to labour force is very high in most OECD countries since 1960. For instance, in 1996, when the bubble started to build up the unemployment rate in the US was 5,5% and in 2000, at the peak of the bubble had come down to 4%.

It is not so clear that a weaker real exchange rate is a sign of lower economic activity. For monetarists, falling real share prices reduce economic activity but a weakening real exchange rate makes more competitive the tradable sector of the economy and, therefore, stimulates foreign demand of the national production and reduces the competitiveness of imported goods, increasing domestic activity as a result. For Keynesians the end result is not so clear since they consider that money wage rates will not adjust, at least in the short term, and nor the central bank will adjust either by creating more money, due to the fear of the impact in domestic prices of imported inflation. Other economists imply that a weaker real exchange rate hinders foreign competitors and, therefore, invites to higher mark-ups that can contract output and jobs available, in the same way as falling real equity prices. The main issue here is about the direction of causality. A strong real exchange rate is the result of stronger economic activity as well as a strong stock market is the result of higher expected earnings and therefore strong economic activity, this is the reason why long term correlations between both are usually so high, but it does not mean that the same is true in the short term. As a matter of fact, a weaker real exchange rate can worsen the trade deficit in the short term, as the famous “J curve” implies.

It is also true that some investors worry about the outlook for the housing market and think that another bubble is building up and could be the next one to burst provoking a double dip similar to what happened in Japan in the early 1990s. The strength of the housing market has been the main factor behind the maintenance or the very slow fall of the consumer demand, once the falling equity prices have made the corporate sector to undertake a major
adjustment. Reports of the ongoing strength of home sales and the increase of housing in the
balance sheets of most US households have intensified these fears. Nevertheless, there are
some reasons why these expectations could be misplaced. It is true that home price inflation
has far outpaced growth in household income in recent years, however, it does not seem
enough to trigger a strong drop in home prices. The household sector’s balance sheet is not yet
too over exposed to real estate and mortgage debt service is not so onerous after the reduction
of interest rates by the FED, especially in light of the surge in home ownership in recent years.
As for sales in the housing markets themselves, there is no sign of speculative excess in the
turnover of existing homes. Therefore, the high level of housing affordability associated with low
mortgages should support and incremental demand for owner occupied units. The current gap
between changes in home prices and household income does not point to a significant further
slowing in home price inflation, judging from two prior episodes. Both the gaps in the late 1970s
and in the mid-1980s that were 2.8 and 3.3 percentage points, respectively, did not trigger a
large drop in the housing prices. Although the current gap is larger, 5 points, there should not be
a fear of a burst for three reasons. First, the sharpest decelerations of home prices have
occurred during recessions, when both actual and prospective personal income growth were
exceedingly weak relative to previous averages. Although the outlook for household income is
hardly robust, the expected rise in personal income over the next year is still above 3% implying
a 2% growth in household income, therefore, there will be a slowing trend in home prices but
not a sharp drop. Second, the present prices of homes are not unusually high relative to income.
The median price of existing homes sold is about 85% higher than the average household
income, and this percentage is well below the peaks achieved in past home price surges. Third,
the present increase in real estate assets holdings in the total assets of households has
reached a share of only 28%, well below the 1980s plateau and the present European averages.

It is also true that the long-term productivity growth outlook has become
less favourable over the last year, due, in part to September 11. Government expenditure on
defence is rising very quickly and this should have a negative impact for productivity growth by
diverting resources from the private to the public sector. Prior to September 11 the Federal
budget was running a surplus on a unified basis that was very close to the Social Security
surplus. Today a deficit of close to 3% of GDP is expected for 2002. Moreover, outlays for the
military procurement budget generate few gains for the remainder of the economy as military
weapons exhibit negligible complementarities with other good and services. The increase in
security costs following September 11 should have exerted a one time negative effect on
productivity. In addition, the terrorist attacks have slowed the pace of deregulation and trade
liberalization and both these factors were important in the surge in productivity in the late 1990s.
Nevertheless, the rates of productivity growth in the US continue to be larger than the European
ones and their drop is not large enough to point to the possibility of a double dip.

In conclusion, the two main internal factors that could create a double dip
in the US economy are, first, further drops in the value of financial assets, mainly in equities,
that could force another major adjustment in the corporate sector through less investment and
more layoffs and that could reduce further the net worth of households and affect very
negatively their rate of consumption. The end result of this new strong adjustment could be, on
the one side, a banking crisis, that could easily trigger a double dip, as it happened in Japan
in the early 1990s. But even in this negative scenario the present solvency situation of US banks is
much better than in previous crisis and the FED can always help by reducing interest rates
further to avoid a major crisis and can inject liquidity to help the banks improve their financial
conditions and give depositors more confidence. We should not forget that the main factor
behind the Great Depression was not so much the fall in the stock prices as the banking crisis
that was unavoidable given that the FED did not increase liquidity because it was under the
limits imposed by the Gold Standard and there was not a deposit insurance system available. Depositors provoked immediately a run on the banks deposits and a chain of bankruptcies. Now the situation in the banks balance sheets and in the depositors behaviour is much more favourable and the FED knows very well how to react injecting liquidity as it did in October 1998. On the other side, foreign investment could falter and induce a further drop in the dollar, but the US owes money to its lenders and investors in dollars and not in other currencies, therefore it will be easier to solve the problem without having to reduce internal demand and imports, as it has been the unavoidable case with other countries following the Asian or Latin-American recent crisis.

A second factor that could trigger a double dip could be a further sharp rise in the price of oil as a consequence of the most than probable US attack on Iraq. Another oil shock will produce a drop in growth in most countries together with an increase in inflation and could provoke another temporary recession. But even under this very negative scenario, the governments have learned from previous experiences. They still remember that the economic policy mix reaction to the first oil shock was not the optimal one, given that the fiscal authorities attempted to mitigate the decline of real GDP by expanding government expenditure while the central banks were very reluctant to stamp out the inflationary pressures by raising interest rates. As a consequence, the aggregate demand curve returned rapidly to its original position, exacerbating the inflationary effects of the oil shock but dampening temporarily its recessionary effects. In the second oil shock in the early 1980s, however, the authorities generally adopted a much less accommodating response, with fiscal policy remaining more neutral and monetary policy tightening to control inflation. As a result, after the initial downward shift, the aggregate demand curve was prevented from rebounding back upwards, which meant that inflation came down more rapidly than in the previous shock. A similar response occurred in 1990-91, with an even better result for inflation. As a result of these experiences, it became conventional wisdom that central banks should not attempt to accommodate the negative output effects on an oil price shock. Instead they should concentrate on maintaining inflation as close to target (either headline inflation or core inflation) as possible and should accept a temporary dip in output growth.

Having said all that, growth expectations in the US continue to be higher than in the Euro Zone. The US is expected to grow, according to the consensus of major experts, by around 2.4% in 2002 and by around 2.5% in 2003, while the Euro Zone is expected to grow only close to 1% or even a little less in 2002 and around 2% or a little more in 2003. Why? There is a wide consensus that the US economy continues to be a much more productive, innovative and flexible than the Euro Zone one. There are strong reasons to support this widespread belief. First, the Euro Zone is much more vulnerable to an oil shock even if it has the advantage on enjoining a stronger euro than in the past. Second, final domestic demand, in contrast to the US, has virtually stagnated since the spring 2001, leaving it more vulnerable to external shocks. In common with other economies, investment spending has been cut sharply in recent quarters but the real problem has been the reluctance of households to spend. Real income growth has been hit by a combination of higher than expected inflation, due, in part to the euro changeover and unusually large increases in food prices and, in part, by a sharp slowdown of employment growth. The savings ratio has been pushed up by declines in net wealth and higher unemployment. Third, monetary and fiscal policies have been more ineffective, in contrast to the US, in stimulating final domestic demand, in large part due to self-imposed constraints. As a consequence, there is very little room for manoeuvre in fiscal policy because of the straight jacket of the Stability and Growth Pact and the average high level of debt. Most countries have allowed their automatic fiscal stabilizers to operate, but these have not been powerful enough to give a strong bust to final domestic demand. The same narrow
room for manoeuvre affects monetary policy given that harmonized inflation continues, at least temporarily, to be above target. As a result, the economy has been reliant on the strength of the world economy to provide the catalyst for growth and, as a result, it is now very vulnerable to any renewed weakness in the US economy. This will continue to be the case until the Euro Zone governments take the necessary steps to override, not only the self-imposed constraints, in the short term, but also the strong rigidities that are still making the economy less flexible and productive than the US one, or, as a matter of fact, the UK one. It is very instructive to compare the performance of the Euro Zone with that of the UK and the role played by economic policy in both economies. While the UK GDP has slowed, growth has remained positive throughout 2001 and is likely to be around 1.5% in 2002. Consumer spending will rise by around 4% this year.

Two factors have helped to achieve this positive performance. First, because inflation has been below the government’s target, short-term interest rates were cut earlier and more aggressively during 2001 than in the Euro Zone. This has boosted house prices, encouraging households to borrow and spend. Second, because public finances were in healthy surplus, the government was in a position to ease fiscal policy. The fiscal stance eased by 1.3% of GDP in 2002, providing strong support to domestic demand. Besides being a more flexible country, in terms of product and factor markets, and even because of that fact, there is more flexibility in the use of economic policy and this one can have more powerful effects.

Coming back to the self-imposed constraints in the Euro Zone, there should be a wide debate about the need to achieve a budgetary position close to balance in 2004. There is a very high probability of this target being missed by most member countries and of the Stability and Growth Pact (SGP) simply falling in disrepute and losing totally its credibility both with the financial markets and with the citizens at large. Therefore, some reforms, that would be maintaining its sound principles and not imposing any change of the Treaty or the formal wording of the SGP, should be envisaged and debated. David Walton, chief European economist at Goldman Sachs, has advanced recently two of these potential reforms of the SGP. The first one is for the SGP to have a greater focus on the medium-term budgetary positions required for each country to achieved debt sustainability. An appropriated medium-term budgetary target would be a structural deficit of around 1,5% of GDP, close to its current level. This would secure a gradual decline in the debt ratio from 69.2% of GDP in 2001 and make some allowance for demographic trends on the future budgetary position. This would mean that Italy, Belgium and Greece, because of their high debt to GDP ratios, should maintain the target of budget balance for 2004, but that other countries such as Germany could go up to a deficit of 1.5% of GDP or such as France, Spain Ireland, Netherlands, Austria, Portugal and Finland could go up to a deficit of 2% of GDP. The second one will be to allow budget deficits to go above 3%, not only due exceptional and temporary circumstances, as the SPG recommends, but also due to cyclical factors. It should be recognized that it is inappropriate to force countries to tighten fiscal policies during economic downturns providing the structural deficit remains below 3%.

As monetary policy is concerned, the present policy of wait-and-see proposed by the ECB and its recent decision to maintain interest rates but giving a signalling bias of reducing them, if necessary, seems very rational and adequate to most financial market participants, given the present circumstances, where most member countries are growing much below potential growth and need monetary policy to be supportive to growth. This is why is so important for the governments of the Euro Zone in general and for the ECB in particular to do as much as they can to avoid another oil shock that could force the ECB to raise interest rates in the worst of the possible situations. In such a worst case, there should be a strong debate about the convenience to stick to a harmonized inflation target of 2% or switch to the alternative way
of using core inflation as the target, instead of headline inflation, if the present target of 2% does not want to be changed.