

The Economy in Perspective

Stormy weather... Recent developments, along with fresh data for 2001, are prompting forecasters to revise their expectations of economic activity downward for the rest of this year. Increasingly, analysts who had expected sunshine are calling for partly cloudy skies, and some are even predicting another thunderstorm. Economic meteorologists are paying particularly close attention to consumers, whose attitudes and spending are thought to signal upcoming weather patterns. Those who fear that a second economic thundershower will follow close behind the one that struck in March 2001, conjecture that consumer spending simply cannot hold up under the atmospheric low-pressure front brought on by sinking stock portfolios.

The newest data show that the U.S. economy was weaker in 2001 than originally reported, and total spending actually contracted in three of the four quarters. Sunshine for the year was virtually nonexistent. The decline in activity after the September terrorist attacks, as it turns out, occurred in the path of an already menacing hurricane. The data revisions show that although total personal income expanded more rapidly than previously estimated for 1999 and 2000, it fell more precipitously in 2001, largely because of weakening labor market conditions.

Consumers are caught up in several financial currents that are likely to affect their spending during the next few years. Households have been gradually building up wealth for the past two decades. Along the way, they have devoted an ever-increasing share of their assets to equities, while shrinking the portions claimed by other financial assets and real estate. Just a few years ago, equity holdings even surged past real estate in importance, inducing analysts to ponder the effects of stock market wealth on consumer spending decisions. Now that the equity-holding waters have receded because of the bear market, households hold roughly equal shares of their wealth in equities and real estate. Consumer sensitivity to the valuation of equity wealth is being tested again, this time in a downdraft.

Households have been overwhelmed by a two-pronged lightning attack. The first bolt came from the recession itself, which weakened employment and income growth. The second bolt was hurled from the stock market accounting cloud. Unlike the decline of the dot-com companies—which may go down in history as the most anticipated stock market collapse ever—recent accounting scandals electrified nearly everyone and burned many people who could

not carry the voltage. Caught in the storm, households lost billions of dollars in (illusory) wealth and confidence in the equity markets. It remains to be seen how much the stock market tempest will damage household spending during the next year or so, but it can only add to the strain.

Fortunately, there is a countervailing wind. Sales of new and existing homes were brisk during the last few years of the expansion, and the housing sector continues to be buoyed by interest rates' low-pressure front. In fact, sales have been so strong in some markets that talk of price bubbles is floating in the breeze. Ordinarily, one might wonder how much longer the lift could be sustained with interest rates now at 40-year lows. But if consumers reduce their exposure to stocks, we could see the climate change in favor of housing wealth again. Consumers have learned how to cash out the accumulating equity values in their homes through mortgage refinancing and home equity lines of credit, using the proceeds to supplement their incomes. So even if mortgage rates do not decline from current levels, appreciating house prices could still add gusts to consumer spending in the next several years.

Curiously, then, consumers have been pulled in opposite directions: Vilified for splurging during the go-go 90s, they are now being urged to hang on just a bit longer to prevent the recovery from petering out. Put another way, much was made of the fact that people's saving out of personal income had fallen so low in the latter period of the expansion. The weather report for June was unusual, showing both that the personal saving rate rose to 4 percent and that consumer spending expanded rapidly because of blistering automobile sales. But this pattern can continue only if there are sustained gains in personal income, which in turn require a better investment climate and a firming of labor market conditions.

With business fixed investment nearly stagnant, state and local governments awash in tidal waves of red ink, and export sales still falling short of imports, the outlook remains hazy. This uncertainty, however, is a familiar one. When the seasons change, weather patterns become uncertain for a time, until more stable conditions emerge. The U.S. economy is in the midst of shifting from a disruptive El Niño to a more temperate, traditional expansion. Instead of lamenting the stormy weather, let's weather the storm and look forward to a break in the clouds.