

The Economy in Perspective

History in the making... Although most economists think the recession that began in March 2001 concluded nearly a year ago, no official endpoint has yet been announced. Criteria for dating business cycles rely on widespread evidence of cumulative changes in income, employment, industrial production, and sales to pin down the timing of cyclical peaks and troughs. As the National Bureau of Economic Research's Business Cycle Dating Committee stated on November 5, "The behavior of the economy in the first eight months of 2002 indicates that the decline in activity that began last year may have come to an end. But recent data indicate that additional time is needed to be confident about the interpretation of the movements of the economy last year and this year."

Earlier this year, when economic momentum seemed to be building, many analysts thought that the recession trough soon would be dated at December 2001 or January 2002. However, in its recent announcement, the Business Cycle Dating Committee said it wants to be sure that it would regard "...a hypothetical subsequent downturn..." as "...a separate recession, not a continuation of the past one." The reason for the NBER's reluctance to date the cyclical trough might be that as the year has unfolded, economic growth has held up reasonably well overall, but performance among sectors has been highly uneven. And employment growth, an important factor in the NBER's dating process, has been unusually shallow.

Along with mixed signals about the economy's progress for the year to date, commercially available forecasts suggest some slippage in the fourth quarter. The same forecasts also indicate that the economy will deliver a more solid performance next year, but this fails to comfort some analysts, who have heard too many similar assurances over the past six months. Among the public, frustration with the pace and composition of the recovery seems to be growing.

But the economy, for its part, is hard at work repairing itself. Economic activity peaked in a range of industries throughout 2000 and early 2001, leaving excessive inventories in the supply chain. Firms curtailed production sharply, sending capacity utilization rates lower and unemployment rates higher. Business investment spending collapsed, especially in the high-tech sector. These abrupt adjustments put strong downward pressure on market interest rates when the supply of funds suddenly exceeded the demand. Lower interest rates promote

two kinds of adjustments: On the margin, they discourage saving and encourage both consumption and investment, which helps correct credit's supply-demand imbalance. But when credit demand for business investment remains relatively weak, even at lower interest rates, funds move to the household sector to support housing and automobile purchases, as well as mortgage refinancing. Consumers are taking advantage of lower interest rates to acquire more durable tangible assets at a time when the business sector's appetite for capital spending has diminished.

Healthy long-term economic performance eventually requires that spending shift back toward business capital; indeed, speculation about the timing and strength of a pickup in business spending has intensified in recent months. The prognosis is clouded by the forces that contributed to the investment spending collapse, augmented by the subsequent terrorist attacks and corporate accounting scandals. Once investors have changed their fundamental views about the future profitability of certain firms and entire industries, part of the labor and capital those enterprises attracted during the expansion must migrate elsewhere. The transition has been slowed by generalized excess capacity and firms' diminished risk tolerance. Terms and conditions of bank loans and capital market credit reflect these revised judgements about future profitability, and quality spreads have widened in recent months to the detriment of suspect firms. In these cautious times, both firms and households want very liquid financial assets; firms may have additional incentives to pay down debt. Adjustments will continue until balance sheets are aligned with risk preferences.

The Federal Reserve cannot dispel anxiety about Iraq, expunge bad credits from lenders' balance sheets, or remove excess-capacity manufacturing plants, but it can contribute to the regeneration process by reducing the federal funds rate when market-determined rates fall. The public's desire to hold more short-term and highly liquid financial assets allows the Fed to add reserves to the banking system with little concern about future inflation. In fact, as economic conditions press market-determined interest rates further down and the public realigns its portfolio, declines in the funds rate might prevent inadvertent liquidity squeezes and unexpected disinflation. Viewed this way, monetary policy doesn't so much stimulate spending as it does foster conditions conducive to spending. The rest is history.