The drop in short-term interest rates over the past 18 months sharply reduced the opportunity cost of holding monetary assets. Consequently, the demand for money, as measured by M2, rose sharply in 2001. As short-term rates have stabilized at lower levels, M2 growth has slowed considerably.

In the financial sector, the stock market remains the big story. Despite reasonably strong economic fundamentals and quickly rising second-quarter earnings, stock prices plunged to five-year lows in July. Although price-to-earnings (P/E) ratios receded, they still exceed recent historical averages. If earnings projections for 2002 and 2003 come to pass, P/E ratios will continue to fall.

A series of revelations about corporate violations of accepted accounting standards has damaged investor confidence. With no way to assess how widespread such accounting abuses are, investors have become skittish, questioning the accuracy of all earnings reports and, more importantly, analysts’ projections of future earnings.

By August 14, markets will have some benchmark for assessing the magnitude of the accounting problem. On that date, the largest corporations’ chief executive officers and chief financial officers will be required to personally attest to the accuracy of their financial reports. Moreover, Congress has acted swiftly to provide clear guidelines for reducing the conflicts of interest that permitted the kinds of accounting shenanigans that have become visible in recent months.

(continued on next page)
One key fundamental for earnings is productivity’s pronounced acceleration in recent quarters. Productivity jumped 5.5% in 2001:IVQ and 8.5% in 2002:IQ, reaching a level more than 4% higher than in 2001:IQ. The late 1990s’ increase in trend productivity shows no sign of slackening. With higher trend productivity and relatively stable employment costs, profit margins are expected to keep increasing.

The unrelenting bear market of early summer aroused concerns that falling stock market wealth would be associated with another dip in economic activity. It is unusual for equity prices to drop in the six months after a cyclical trough. The question is whether the price plunge reflects an underlying deterioration in economic fundamentals or simply a transitory crisis of confidence. Although the wealth-to-income ratio has fallen, it still exceeds its average for the 1980s and early 1990s.

Investment has been slow to turn around in the face of excess capacity, but consumers have not been shaken by stock market volatility. Consumer expectations have held up well, slipping only modestly from recent levels. One important element in consumer resilience appears to be the continued, albeit slower, appreciation in housing prices.

A substantial share of household spending in the past 20 years was made possible by falling interest rates. Lower rates allowed consumers to assume a higher level of debt for a given level of debt burden (continued on next page)
(as measured by their monthly payments). So lower interest rates not only made home ownership accessible to greater numbers of households, but also allowed those who already owned homes to tap equity values through mortgage refinancing. It is important to remember that falling interest rates were largely the result of lower inflation expectations, the ultimate product of disinflation. With inflation currently near historical lows, it is doubtful that interest rates will continue to trend downward, which suggests that this source of consumer finance will diminish in the years ahead.

Some market analysts fear a housing price bubble. To a large extent, the rise in housing prices has encouraged greater consumer spending because liquidity-constrained households have been able to use increased housing values as a source of finance. If higher housing prices were not based on fundamentals, a persistent adjustment in consumer spending could result, precipitating another dip in aggregate economic activity. But the fundamentals for continued strong housing demand in the years ahead appear to be sound. Demographics reveal that “echo boomers”—the children of baby boomers—are just beginning to reach home-buying age. Moreover, a greater number of households are buying second homes. Although real estate as a share of wealth has risen sharply in recent years, this is largely a reflection of the sharp decline in stock prices. Real estate is still below its share in the 1980s.