Money and Financial Markets

The sharp decline in interest rates over the past two years reduced the opportunity cost of holding monetary instruments nearly to zero. Consequently, the demand for money, as measured by M2, rose sharply in 2001. As short-term interest rates and opportunity cost stabilized in 2002, M2 growth slowed considerably but accelerated in the spring.

In the financial sector, stock market volatility remains a big story. Although economic fundamentals softened somewhat in the fall, earnings reports surprised investors, coming in slightly better than forecast for the third quarter. After hitting bottom in October, the S&P 500 turned around but remains well below its level at the beginning of the year. Earlier declines were consistent with the realization that the recovery was much weaker than had been expected when 2002 began, particularly for investment. Falling stock prices, combined with rising earnings, resulted in a precipitous decline in the price-to-earnings ratio.

Another factor contributing to the stock market decline is concern over the quality of financial reports. The issue has shifted from worry about potential corporate fraud to questions about legal but improper accounting practices. One practice now receiving closer scrutiny is public companies’ developing their own measures of earnings and reporting them in press releases. Such measures—called pro forma, street, or operating earnings—differ from the measures defined by generally accepted accounting

(continued on next page)
principles—GAAP—earnings in that they omit various nonrecurring, non-cash, and miscellaneous items. Full reports typically provide GAAP earnings somewhere but they feature company-defined measures far more prominently.

The discrepancy between company-defined (“operating”) earnings and GAAP (“as reported”) earnings has been increasing over time. Does the operating earnings measure exaggerate a firm’s performance? Excluding items such as nonrecurring costs may be appropriate if such charges are truly unrelated to a firm’s future earning power. The great question is whether the items excluded from alternative measures are truly non-recurring. If they are, one would expect the discrepancy to diminish, with GAAP earnings growing faster than the alternatives. Only time can resolve this question.

Two other issues are the treatment of employee stock options (ESOs) and pension fund gains and expenses. Under current GAAP rules, firms are not required to expense the value of the stock options they grant. Because ESOs are a form of compensation, critics argue that omitting them from expenses exaggerates earnings. During the past year, more than 100 firms in the S&P 500 announced their intention to expense earnings voluntarily.

Weakness in the stock market has reduced the value of pension fund portfolios, increasing the need for cash contributions. Critics note that current GAAP rules do not fully reflect increased pension expenses. Standard and Poor’s calculates a core

(continued on next page)
earnings measure for the S&P 500 that adjusts GAAP earnings for the value of ESOs and pension funds.

Despite the earnings quality issue, the stock market has firmed since its October low. The underlying fundamentals of continued strong productivity growth and steady consumer spending provide some support for optimism. Nevertheless, measures of consumer confidence remain tempered, even with the most recent increase in consumer expectations. Household spending during 2002 was supported by funds made available from mortgage refinancing. Because the holiday season is so critical, markets are likely to be sensitive to the strength of retail spending in December.

Housing prices have held up reasonably well despite limited employment growth. The housing price index, though decelerating, has continued to increase. A key factor in housing strength is that falling mortgage rates have made home ownership more affordable. Debt service burdens for mortgages are essentially unchanged from 1990. Worries about a housing price bubble do not seem justified by these facts.

The decline in mortgage rates is ultimately bounded. Thus, to the extent that consumer spending has been fueled by mortgage refinancing and housing by affordability, private spending by households could slow. Hopefully, investment spending by firms will continue to accelerate and pick up the slack.