ECONOMIC OUTLOOK FOR 2001

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A SCARY SOFT LANDING

The U.S. economy suffered a sharp and unforeseen slowdown in sales in December. But preliminary data for January and February suggest that the slowdown has not gained momentum, and there is no evidence of an imminent collapse in consumer spending. On the basis of the strong rebound in sales in January, I think it is unlikely that spending will decline to recessionary levels.

What is happening is that the economy is making the awkward transition from a period of unsustainably high growth to a period of lower, but sustainable, growth. Such transitions are called "soft landings" though the bumpiness during the transition belies the metaphor. It is important to remember that there is always turbulence when the economic growth rate falls. Six months ago, I noted that we would be in for a choppy period during the transition, and that fears of an even greater decline typically arise when the economy switches from fast growth to slow growth. I quote from my report of September 22, 2000.

> "Economic growth is slowing down. My hope and forecast is that we will have a 'soft landing.' The slowdown has already begun and the soft landing that is anticipated for 2000-01 is one in which economic growth would continue, but at the reduced rate of three and a half percent per year. Even though a decline in growth to that level from its current five percent rate is a modest deceleration, transitions of this magnitude have rarely been smooth, and fears of recession are likely to be raised when weak data are reported...
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> If growth nationally does slow to a three and a half percent rate, I would expect growth in Wisconsin to fall to a rate of two and a quarter to two and a half percent. This would correspond to a growth in employment of a bit less than

three quarters of a percent in 2001, which would be down from a rate of almost one and a half percent today."

The choppiness of the transition from a high to a low growth rate has been greater than I had expected and some sectors have been damaged more severely than I had expected. As a result, I am trimming my forecast of growth by a percentage point. But in my view the generic implications of the term "soft landing" still apply to the overall economic outlook for 2001/2. By soft landing, I mean that **the rate of real economic growth in the national economy will decline from a rate over five percent to a rate between two and three percent, without first having gone through a recession.** While this growth forecast is lower than the three and a half growth rate I forecast six months ago, the economy's qualitative performance since that forecast has roughly followed the pattern that I identified at that time.

Corresponding to the slower growth anticipated at the national level, I anticipate a reduction in Wisconsin's growth of about the same magnitude. This means that **real output in Wisconsin is likely to grow at a rate of one and a quarter to two and a quarter percent, which would imply a growth in employment close to zero.**

A TALE OF TWO ECONOMIES:

THE PRODUCTION ECONOMY AND THE CONSUMPTION ECONOMY

The production side of the economy seems to be in more trouble than the consumption side. This often happens during a transition from high growth to low growth, though the difference between the two performances may be a bit wider this time than is typical. As a result, economists who follow the production numbers closely are much more pessimistic than the economists who follow final sales.

In interpreting the news and the differing views that are being offered (and that will continue to be offered,) it is useful to step back and remember how the consumption and production sides are related and where their performances might be expected to diverge.

Clearly production and consumption are strongly related. Higher levels of production lead to higher incomes – more employment and profits – which give households the wherewithal to spend. And higher levels of spending lead to new orders at the plant, and ultimately to increases in production. Keynes made a whole theory out of the stability of these two links, but whether one is a Keynesian or not, the two sides of the economy – supply and demand – cannot diverge for long.

In the short run, however, there is enough slack in the linkages between the two sides of the economy that they can diverge substantially. One source of slack involves inventories. If production grows faster than consumption, inventories rise. If consumption grows faster than production, inventories fall. Part of the problem during the current transition is that late last year inventories got temporarily too high. That is, production outpaced sales for a while and now it must underperform while inventories are worked down.

Another source of slack is the foreign sector where changes in export demand can generate new production even if households are not increasing their spending. And yet another way that production can temporarily sustain itself without new consumer orders is if producers increase their purchases from each other by investing in structures, equipment or research. Ultimately, however, the end product of such producer investment, at least from an economy wide perspective, is to make sales to consumers, government or the foreign sector. Thus ultimately, the production side has to adjust itself to the sales side.

Slack also exists in the relation linking production to consumer sales because income from production is not the only source of household purchasing power. Households can spend not only their paychecks, but also their accumulated savings, and they can be influenced in this decision by the capital gains they are earning on their houses and retirement savings.

The two sides of the economy seem to be sending us divergent messages, with the consumer side performing a lot better than the producer side at this time. After looking at these diverging performances, I note why some amount of divergence is to be expected during a soft landing.

THE CONSUMPTION ECONOMY PERFORMED TERRIBLY IN DECEMBER, BUT SEEMS TO BE OK NOW.

Households did not spend in December. No one knows why. But after an absolutely terrible December, both auto sales and housing have bounced back to non-recessionary levels. These are the two most volatile consumer sectors, and both auto and housing spending are strongly influenced by changes in consumer confidence and interest rates. The robust performance of housing and autos in the past two months is heartening and suggests that households remain willing to spend, which will be necessary if recession is to be avoided.

Admittedly, consumer confidence is always a wild card because it has a self-fulfilling component. On the fundamental side, however, there has been no change in the underlying outlook to justify a sharp decline in consumer confidence. Interest rates, which also influence consumer spending, are not high by historical standards, and they have been coming down. Moreover, the Federal Reserve has shown a willingness to reduce rates further if hard data suggest that fears of recession are well-grounded. But such hard data are missing at this time. (Certainly a stock market decline is not the same thing as hard data that a recession is imminent. The current stock price decline in particular is more a recognition of past blunders or denial on the part of investors, than it is the revelation of a new discovery that the sky is falling.)

And consumer confidence remains a wild card because it is in part influenced by the media, and there has been a steady drumbeat of bad news in the headlines. Bad news is always news. Good news is rarely news. When the economy is choppy, the bad events make the news and the good events do not. Certainly the December decline was TV news and the January bounceback was not. In fact, households have had their noses rubbed in the bad news in the last few weeks but consumer spending, though weakening a bit, has not collapsed. The economists who look at consumer spending – which includes the majority of the economists at this time – are not anticipating a collapse, and do not predict recession.

A PROFITS RECESSION IN THE PRODUCTION ECONOMY

On the production side of the economy, it is clear that profits are in trouble, though reliable data on profits are very hard to find on a current basis. And profits, of course, have an important bearing on both stock prices and investment demand. But the decline in profits we are now seeing, and its anticipated effect on investment, need not restrict the expansion. Lower levels of investment are normal along a slower growth path.

Equity financing is in trouble, and we don't really know what this will do to the expansion, because equity financing is much more important today than it was in the past. To the extent we have a new economy, it runs on equity finance, and sectors that need equity finance will have hard going for a while.

The last threat to the expansion was in late 1998 and early 1999. This threat involved a sharp restriction in debt finance following the collapse of the Russian Ruble, and the associated collapse of a highly regarded hedge fund. The collapse of the hedge fund and its copycats hurt bank capital and caused a quick pessimistic collapse in expectations in some of the major financial institutions. As a result, large lenders tightened substantially the terms at which they would lend to risky ventures. The restriction of finance led to difficulties in many interest-sensitive sectors in late 1998 but no recession followed. In my view the collapse of debt finance in mid 1998 posed a greater threat to the expansion than does the collapse of equity finance today.

Equity financing is being restricted and this is curtailing capital investment, especially in new or risky ventures. Some sectors of the economy are already in recession as a result, and in 2001, the profit sensitive sectors will continue to suffer.

MANUFACTURING REMAINS IN THE DOLDRUMS

The manufacturing sector as a whole has been in decline for almost a year. The difficulties in manufacturing are well known and were addressed in my presentation 6 months ago. The difficulties then evident in traditional manufacturing have now spread to what is called "technology," which today means computers and communications, including both equipment and services, which is the sector most heavily dependent on equity finance.

Traditional manufacturing has a classic inventory problem that accompanies every unforeseen soft landing. Of course this soft landing was foreseen by many economists, including myself, but we were not believed when we made our forecast, perhaps because we had forecast it wrongly too many times in the past! I, for example, have been predicting soft landings since 1999.

So on the production side, manufacturing is down and profits in all sectors are disappointing. How will this bad performance on the production side be resolved with the not so bad news on the sales side?

To answer this, I first turn to an old classroom standby called the INVENTORY ACCELERATOR, which suggests that production should always do worse, at least for a short period, during soft landings.

INVENTORY ARITHMETIC

Why do unforeseen soft landings lead to inventory problems? (The arithmetic is pretty basic, but if you don't like math, you should skip this section, because the reasoning is complicated.)

The level of inventories of all kinds in the U.S. economy is equal in value to about one-fourth of a year's production. Put differently, inventories represent accumulated production that equals about three months of anticipated sales. Because services are about half of GDP, and because services have no inventories, the level of accumulated production of tangible products is about one half of a year's sales of those products. This means that, on average, tangible products are produced six months before they are sold. If sales are growing, production must exceed sales, because today's production must equal future sales, which are larger than today's sales.

Last year, the economy was growing at an annual rate of five percent. This means that on average production would have exceeded sales by two and a half percent, (because sales would have grown by two and a half percent by the time the products were ready to be sold.) But if we now anticipate that the economy will grow at a rate of only two and half percent per year, then production should exceed sales by only one and a quarter percent. This means that on the dramatic day when producers change their forecast from five percent growth to two and a half percent growth, not only must they reduce their plans for future growth, but they must also knock down the current level of production. Moreover, they suddenly realize that for the past six months, they have been producing at a rate that is too high and hence have excess inventories in the pipeline that must be worked down.

By this reasoning, even if consumption spending never declines, but simply proceeds to grow at a slower rate, production may decline in response. Thus a soft landing in consumption can be accompanied by a recession in manufacturing even though manufacturers are simply responding to the reduced rate of growth of consumer spending.

CAN THE NEW ECONOMY SAVE US?

Where is the New Economy when we need it? Actually, there is a New Economy in the sense that some important macroeconomic relationships have changed for the good in recent years. But in my view, recessions are still possible in the New Economy.

Two features of the New Economy may make this slowdown different from past slowdowns. One is the tremendously improved communication between retailers and producers, which has changed the pattern of inventory adjustment. The second is the greater use of knowledge as an input into production, which implies that fixed costs are a larger fraction of the cost of production and variable costs are a smaller fraction than they were in the old economy.

BETTER INVENTORY MANAGEMENT

Because of better information, the response of manufacturers to changes in consumer sales is much more immediate than ever before. In the old days, if sales growth were to decline, production would continue to grow at its unjustified higher rate for a much longer period of time. Simply put it would overshoot its target by a lot. Because the necessary decline in production would be delayed, it would be much larger than today and would often lead to a recession. With today’s more rapid response, such an overshooting is likely to be small.

Hence the layoffs we read about today are an immediate response to weakening sales and do not signify the beginning of a cascade of bad news as they did in years past. Layoff notices are likely to be bunched much more closely to the disappointing sales news than they were in days when information moved more slowly, and a burst of announced layoffs today are not the signal they once were of more bad news to come.

THE RECESSION IN NEW ECONOMY PROFITS

A second feature of the new economy that will make this adjustment different from past adjustments is the much greater reliance on information as an input, and in particular, on information as a fixed cost. And one of the strongest drivers of the productivity growth of the past few years has been the fact that variable costs are low. This means that in the New Economy, production could be expanded without a great expansion in employment. Hence as production grew, productivity and profits soared.

Now this magic is being run in reverse and it as nasty implications for profits on the downside. In the New Economy, when sales fall, employment falls by only a little and profits take most of the hit.

Clearly, in the current decline, employment has performed remarkably well. Indeed, one of the strongest indicators that we are not and will not be in recession is the high level of employment. Despite allegations that we are in an economic downturn, employment has failed to decline. This means that a larger share than usual of the decline in output is being borne by profits, not labor costs.

Of course, one possible explanation of the strong performance of employment in the face of weakening production derives from the recent labor shortage. According to this view, employers are holding on to key skilled employees even as production slows because they were understaffed during the peak of the boom. Then when sales slow down, workers are kept and the understaffing is resolved. Note that an implication of this pattern is that labor costs will not fall as quickly as they normally would in the face of a decline in sales. And because costs don't decline quickly when sales do, profits fall sharply.

But a second possibility is that the increased importance of knowledge-based inputs in the new economy has increased the fraction of costs that are fixed as opposed to variable. With low variable costs, costs will not fall by as much when sales fall as they would if variable. costs were high. This is a New Economy explanation of the sharp profit slump. Profits will absorb a disproportionate share of any decline in an economy in which knowledge based costs are important, because knowledge based costs tend to be fixed and not variable.

Note that the flip side of the low variable cost issue is that when the economy expands, profits will expand disproportionately. Productivity will expand enormously as well. This would mean that part of the extraordinary growth in productivity that was recorded in recent years was due to the growing importance of fixed as opposed to variable costs. Thus the increased importance of knowledge based costs, which was a widely trumpeted feature of the New Economy, and which can boost productivity growth on the upside, has the nasty effect of reducing productivity and profits on the downside.

In either case, the terrible performance of profits overstates the extent of the softness in sales we now see. Profits are taking a bigger hit than usual and the decline in profits overstates the decline in economic growth.

FINANCIAL VULNERABILITY IS LESS IN AN EQUITY-BASED ECONOMY

The outsized decline in profits can lead to difficulties in the stock market if these declines are viewed as permanent rather than cyclical. And while stock market declines have been associated with economic declines in the past, the association is not one for one. I am one who does not fear the effect on the economy of a stock market decline of the size we have had to date. (3/15/01) If the decline continues unabated, I will begin to worry about it.

Declines in the prices of stacks and real estate can have a crippling effect on a country's finances if its institutions are highly levered, as in Japan. But unlike Japan, U.S. firms, banks and other financial institutions are not heavily in debt to each other. Weakness or bankruptcy of one U.S. firm does not drag down others to the same extent as it would in Japan. Our firms are financed to a greater extent by equity, and though it is equity that is taking the hit, there is no reason in an equity driven economy for the hit to be magnified through a rash of bankruptcies.

SUMMARY OF NATIONAL OUTLOOK

I feel that by the second half of the year, the transition to a slower rate of growth will be completed, and I expect that by then the national economy will be growing at a rate above two percent per year.

I expect the Federal Reserve to respond quickly to news of weakness in demand, but I expect that demand will not enter a sharp decline.

WISCONSIN'S OUTLOOK

Wisconsin's growth will mirror that of the rest of the nation, but at a lower level. That is I anticipate that Wisconsin's performance will lag that of the national economy by about a half to three quarters of a percent. If the national economy grows at a two and half percent rate, Wisconsin's growth will be a bit below two percent. If the national economy does worse, so will Wisconsin, though the margin of difference will remain roughly the same, which is somewhere between one half and three quarters of a percent.

The reason Wisconsin will grow more slowly than the nation as a whole is its heavy dependence on manufacturing, a sector which is suffering the most at this time. Wisconsin's continuing labor shortage could work in either direction as far as the differential from the national rate of employment growth is concerned. Firms that had suffered the most from a lack of available workers will lay off the fewest when their sales weaken. Because the labor shortage has been more severe in Wisconsin than in the average state, we may see more workers retained during any decline in sales. On the other hand, if the national economy grows more strongly than anticipated, the labor shortage will continue to hold Wisconsin back.

On balance, my expectation is that employment in Wisconsin in 2001 will be no higher than in 2000.