How Long Can the Business Expansion Continue?

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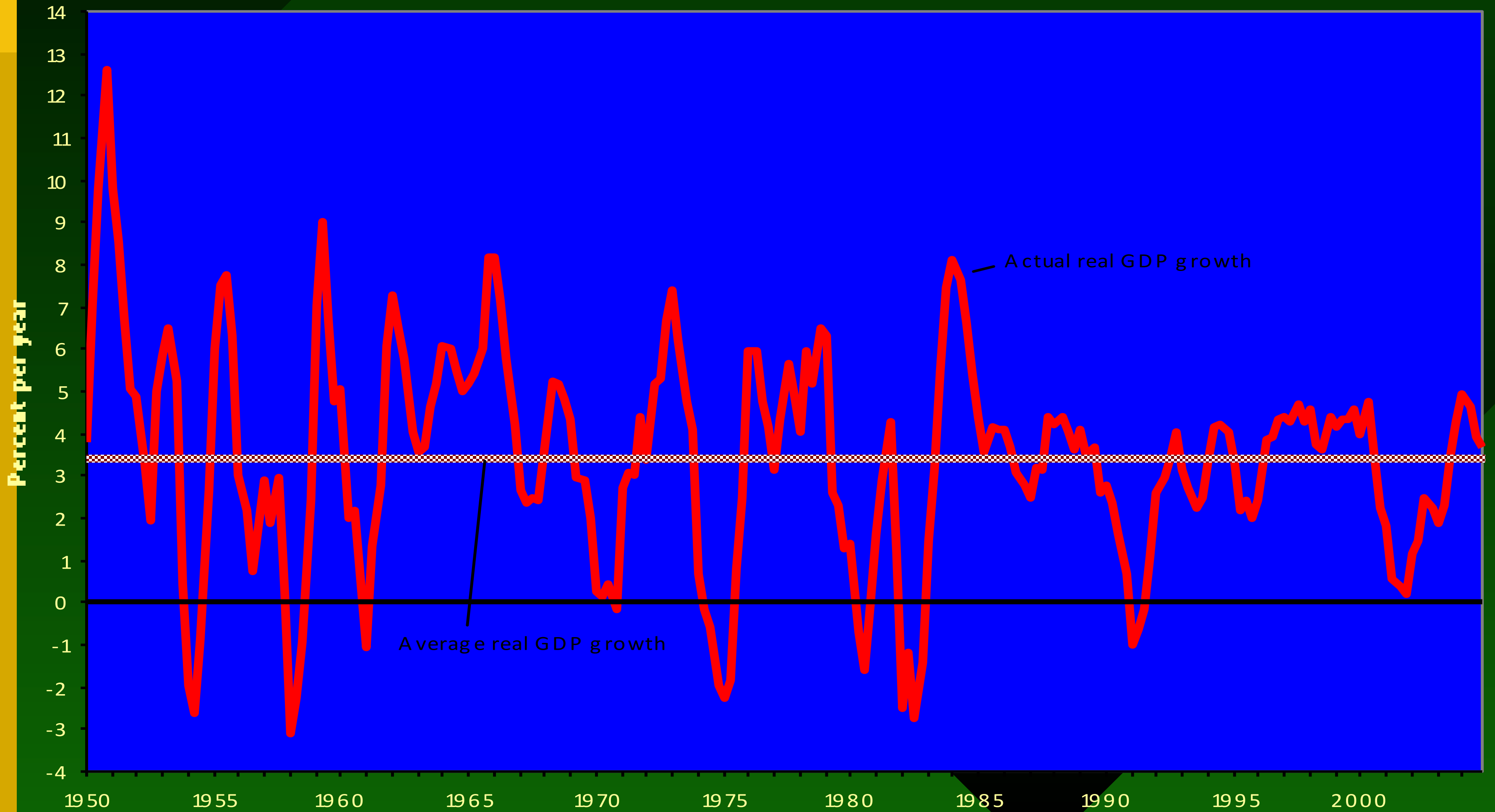
To Look Forward, We Need Two Components

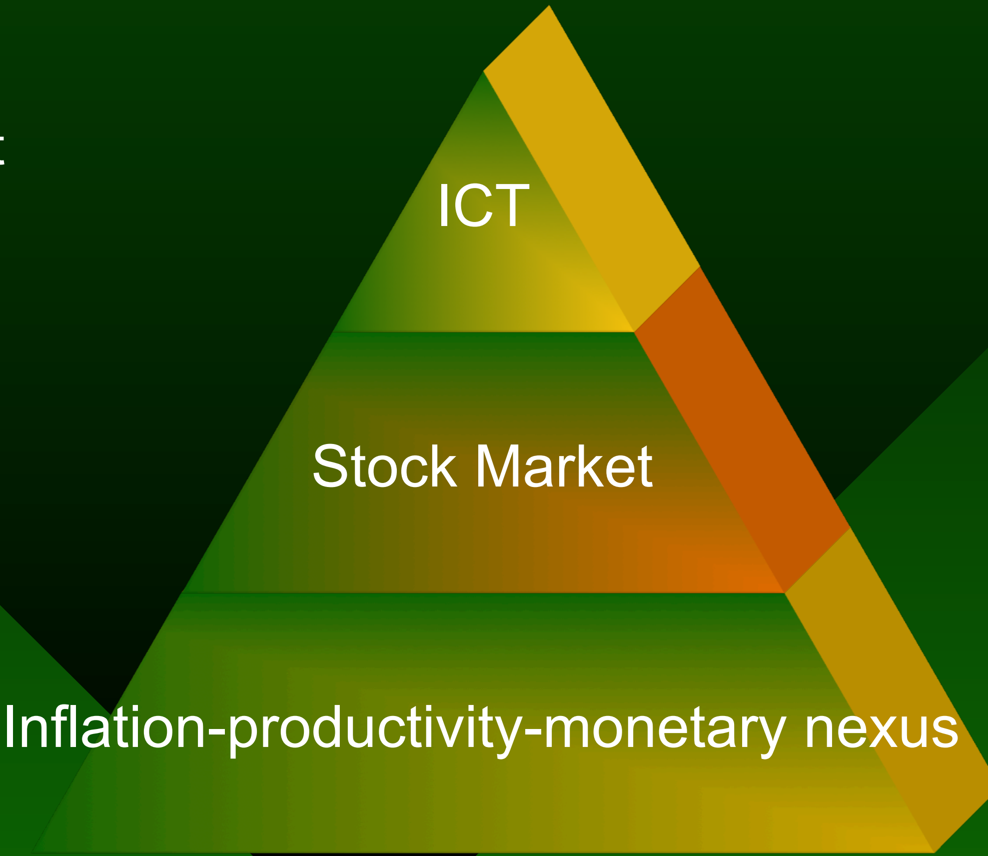
- First, to understand late 1990s boom and subsequent 2001-2004 U. S. slowdown, recession, and subsequent slow recovery
- Second, to decompose the conflicting elements in today’s U. S. economy and predict out over the next two years.

Real GDP Growth: A New Era of Stability since 1985?

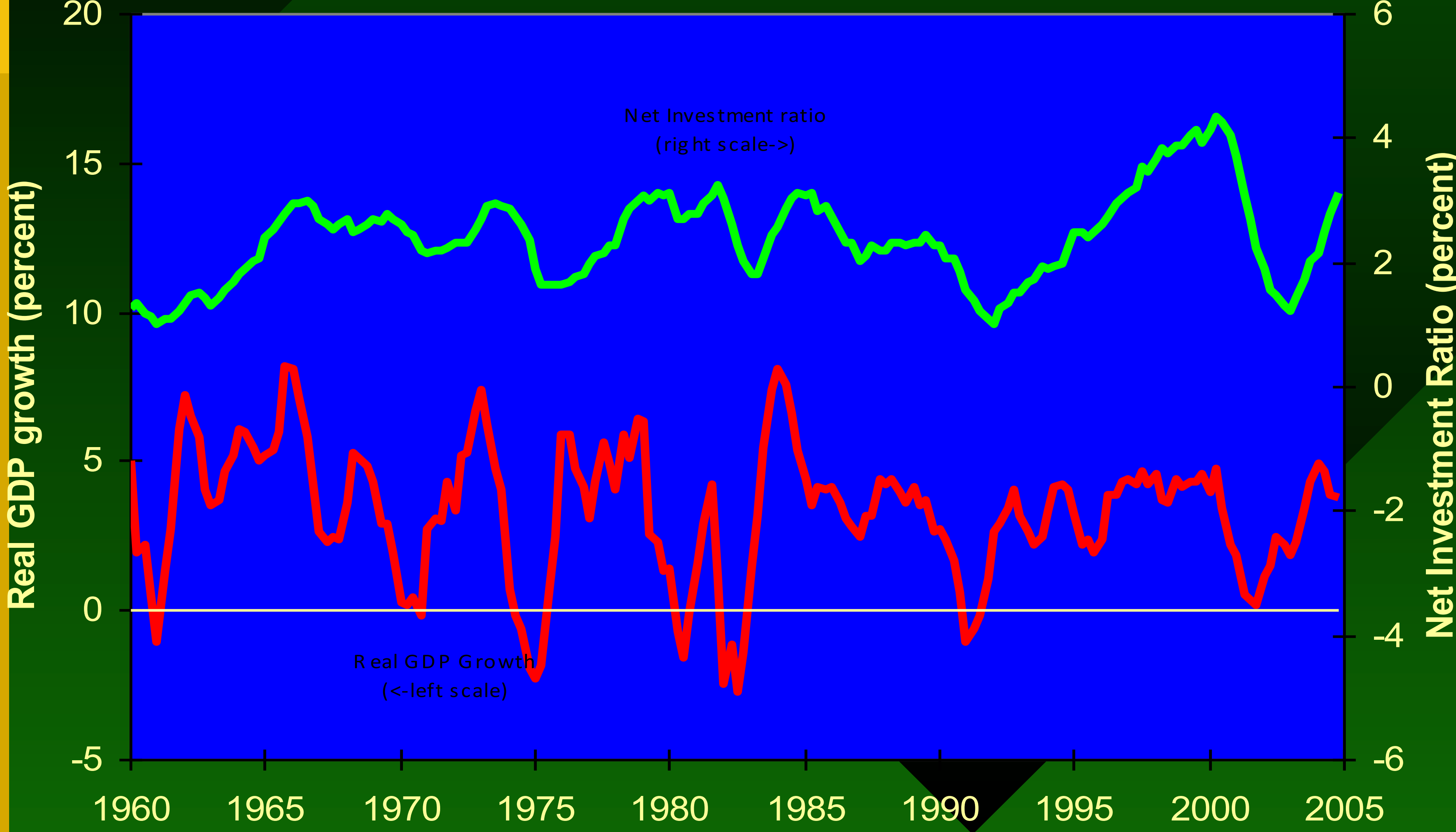


Understanding the 1996-2000 Boom: The Virtuous Triangle

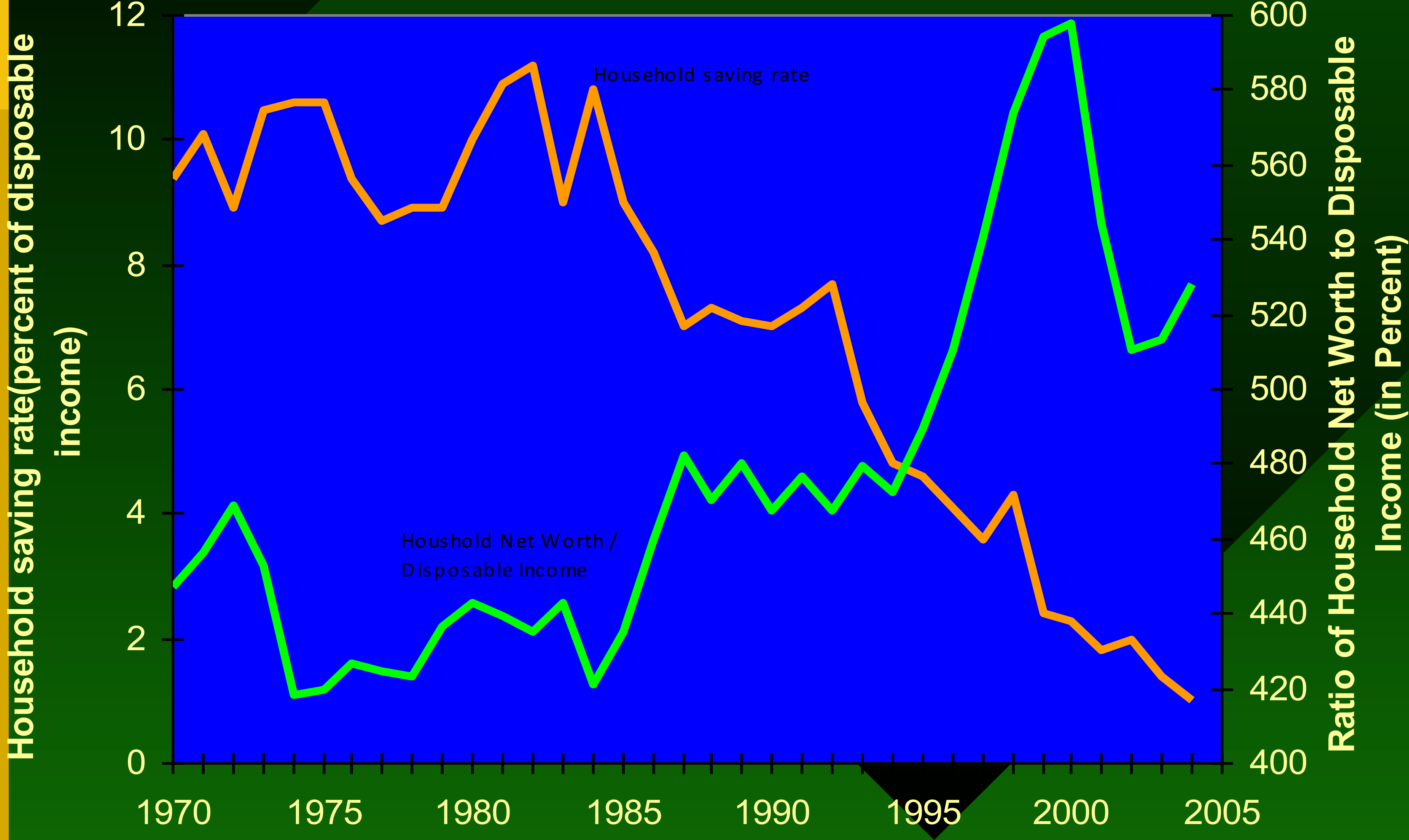
- The "triangle approach"
  - Why the ICT investment boom and bust?
  - Stock market: causes and effects
  - Economy-wide factors: productivity growth, inflation, monetary policy



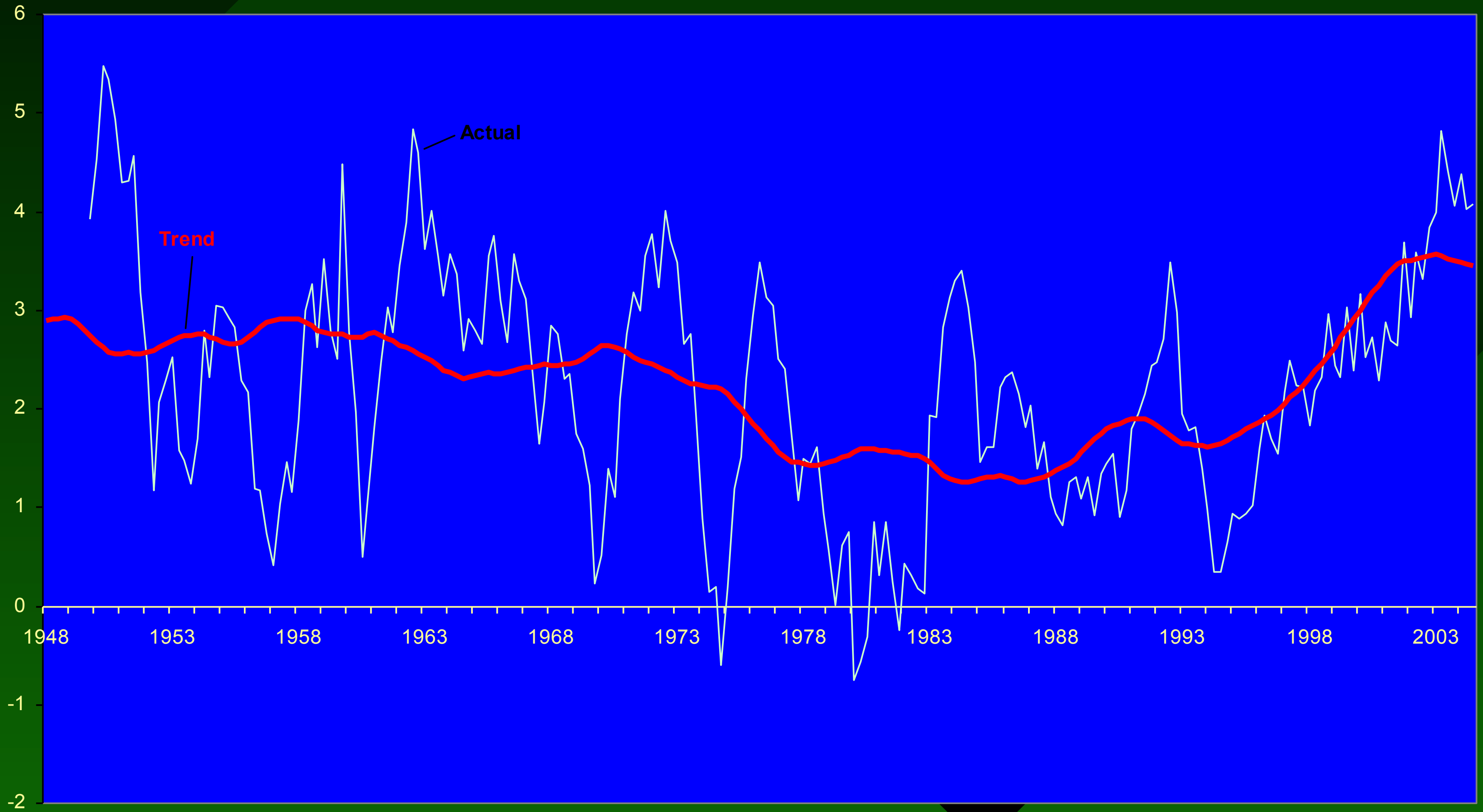
Part 1. The Investment Boom, Collapse, and Recovery



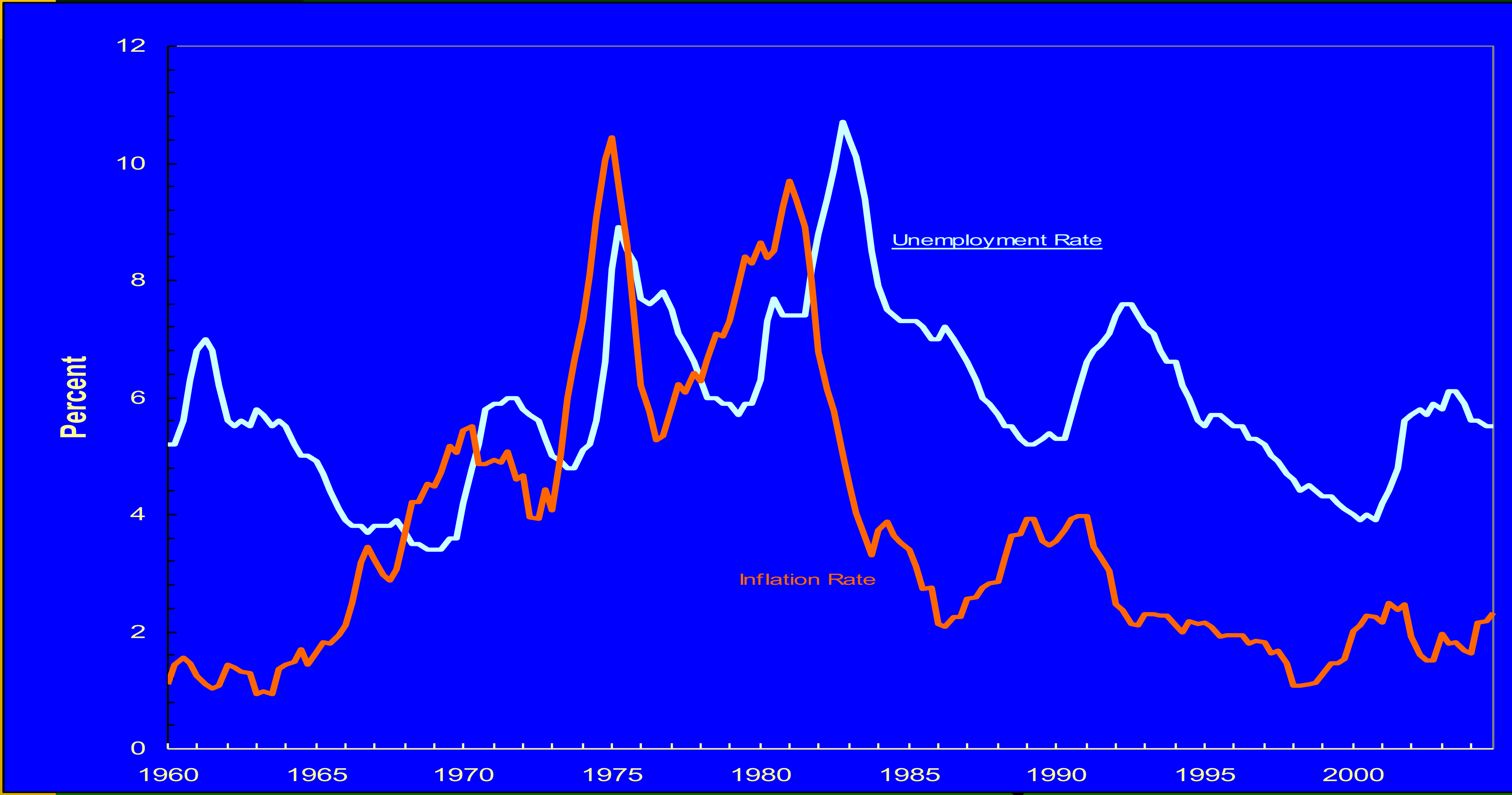
Part 2. The Consumer Keeps Buying and Stops Saving



Part 3. Productivity Growth Takes Off after 1995 and again after 2001



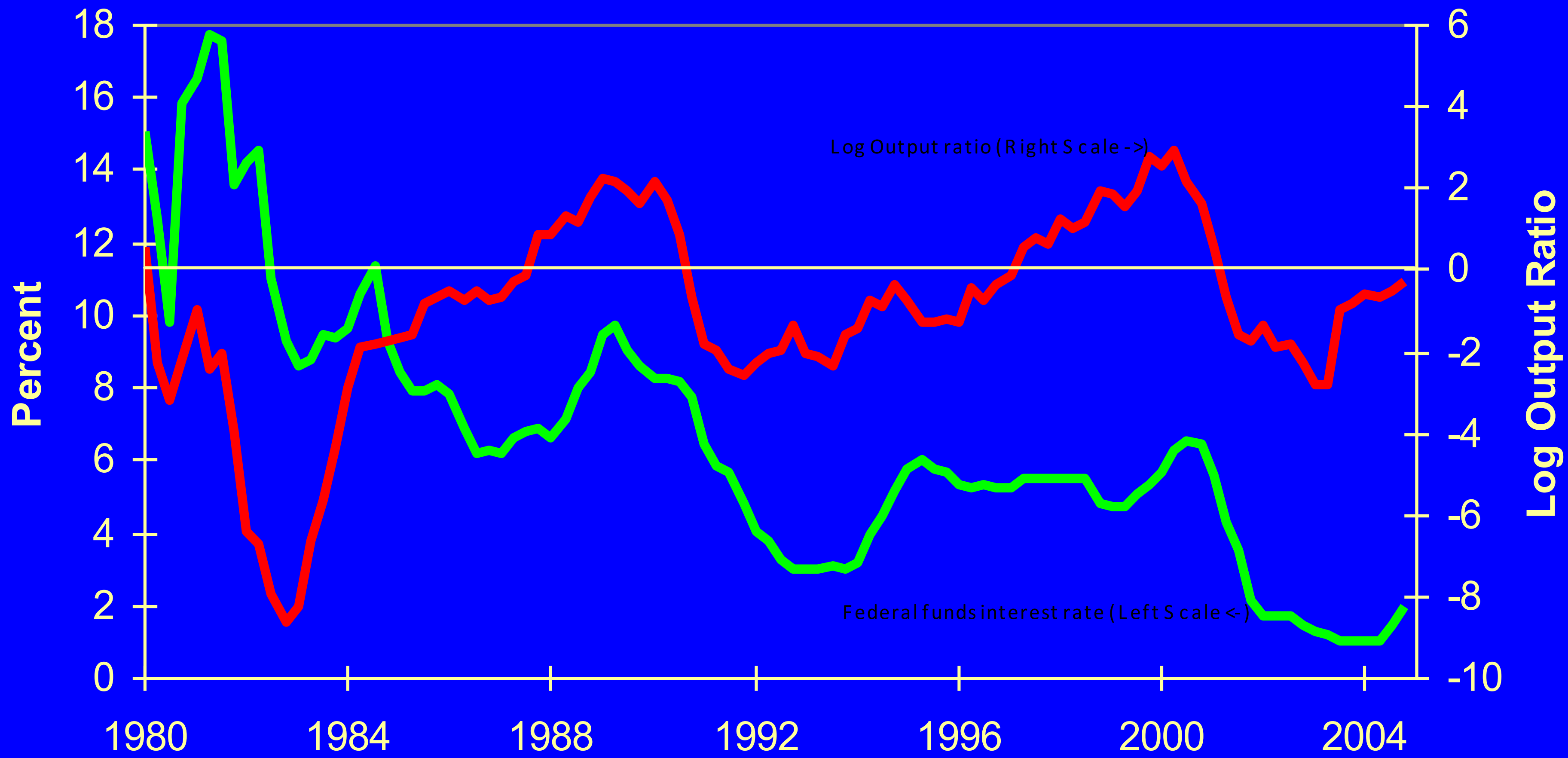
Part 3. The Biggest Event, A Non-event: Inflation did not Accelerate



Effects of Low Inflation

- Normally low unemployment would create faster inflation, cause Fed to tighten monetary policy
- With low inflation, no need to tighten
- No change in interest rates, 6.0 percent in late 1994, 6.5 percent in mid-2000
- Compare to early 1980s, late 1980s

Low Inflation Prevented the Fed from Ending the Party



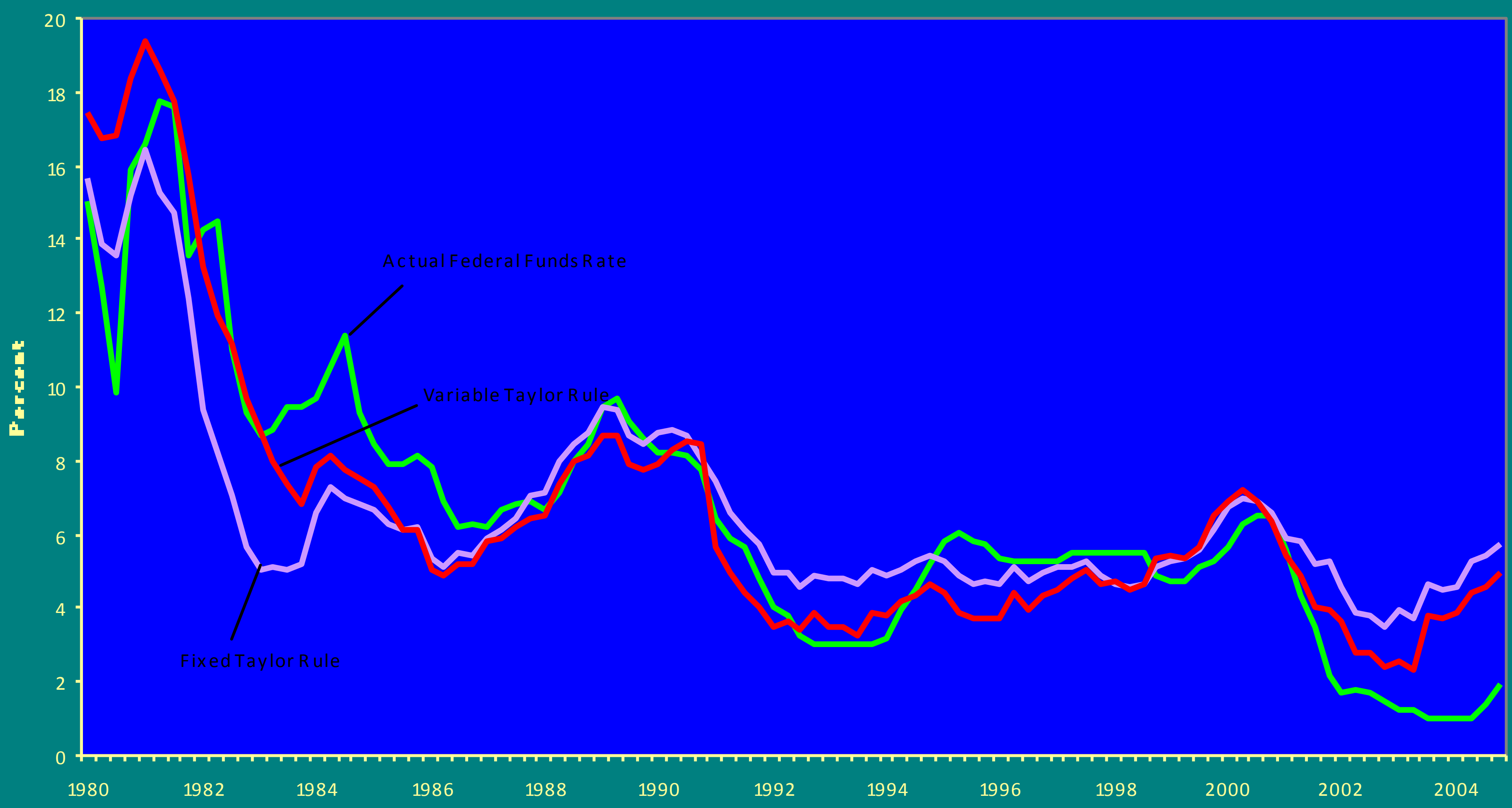
What Dragged Down the Economy?

- End of Hi-Tech Investment Boom
- Stock Market Crash
- Strong Dollar
- “Multiplier” Effects

Why Was the Recession so Short and so Mild?

- The speed and extent of the Fed's cuts in interest rates
  - Housing refi boom
  - Zero percent auto loans
  - The impact continues to this day
- Less important, Bush tax cuts
  - Effect diluted by giving so much away to the top 1%
  - 90-90-90

By a Standard Monetary "Rule" the Fed has been Off the Charts



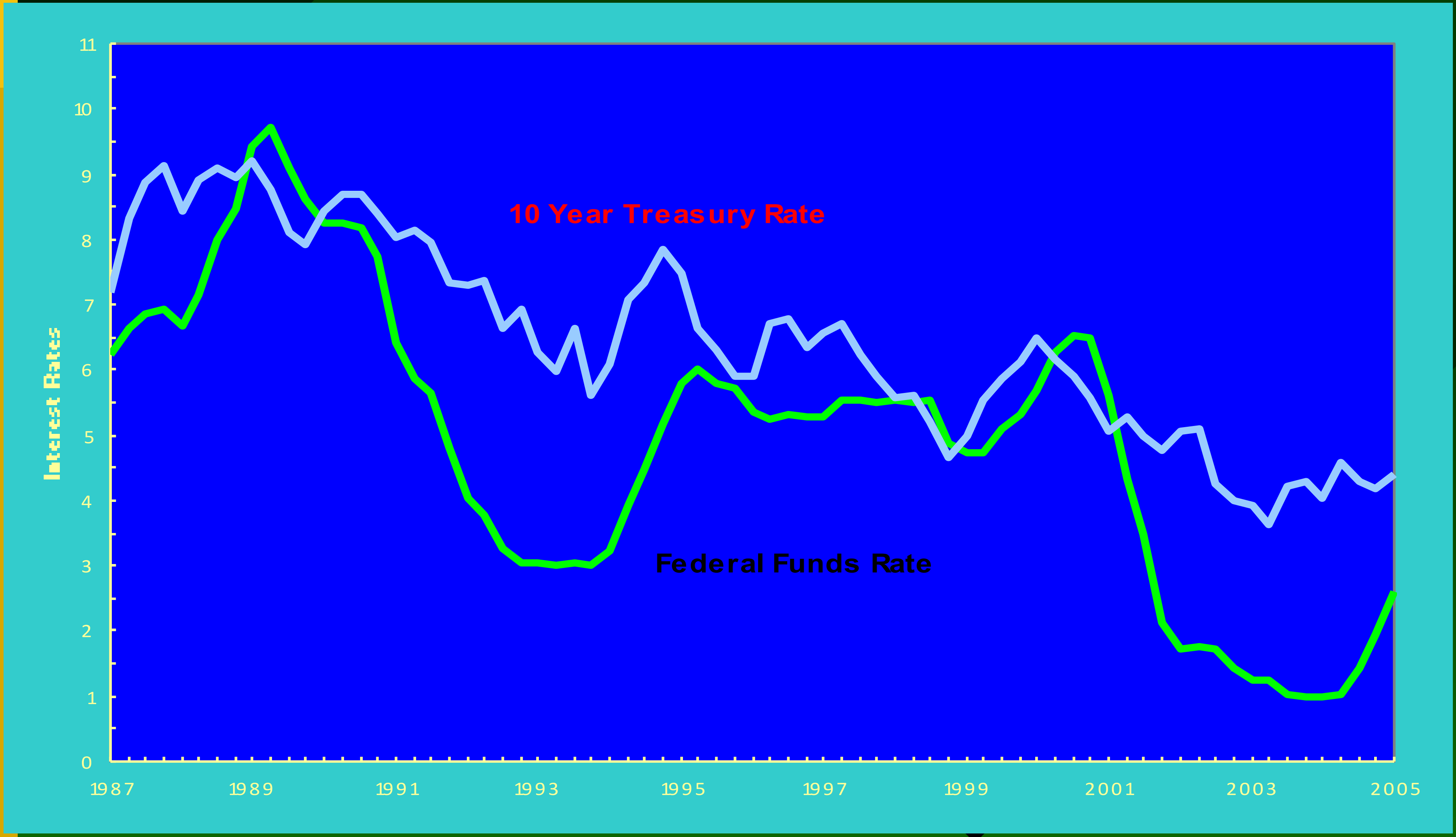
Why Did the Recovery Pause in late 2002, First Half 2003?

- Consumption
  - Auto Sale Payback
  - Overextended Consumer debt
- Investment Hangover Continued
- State and Local Government Spending
  - "Watching the S&L Finances Implode is like watching a multiple-car auto wreck happen in slow motion"
- Slow Growth in U. S. Export Markets

If Everything was So Dire, How Come the Recovery Continued? The Bond Market Gyroscope!

- Signs of Weakness? Bond Market yields tank
- A Housing Refinance Boom follows, money flows to consumer pockets, the economy is not weak after all
- Bond Market Reached low in June 2003, just before GDP growth took off
- Bond Market Gyroscope is a key Explanation of Greater Economic Stability since 1985

The Surprising Bond Market Fueled the Expansion in 2003-04



Reasons for Fast Growth after mid-2003 Continue

- Continued Effects of Low Interest Rates
  - On Consumption
  - On Residential Investment, now at record levels
- Recovery of Hi-tech Investment
  - Users can delay replacement only so long
  - Continuing innovation, albeit less revolutionary than late 1990s
- Federal Budget Deficits continue to pump spending into the economy
- Effect of Falling Dollar on Net Exports

Fiscal Policy

- Federal Government Deficit:
  - *Surplus* of $236 billion in FY2000
  - Projected *Deficit* of $426 billion in FY2005
  - Turnaround = $ -662 billion!
- Unprecedented shift from fiscal restraint to stimulus

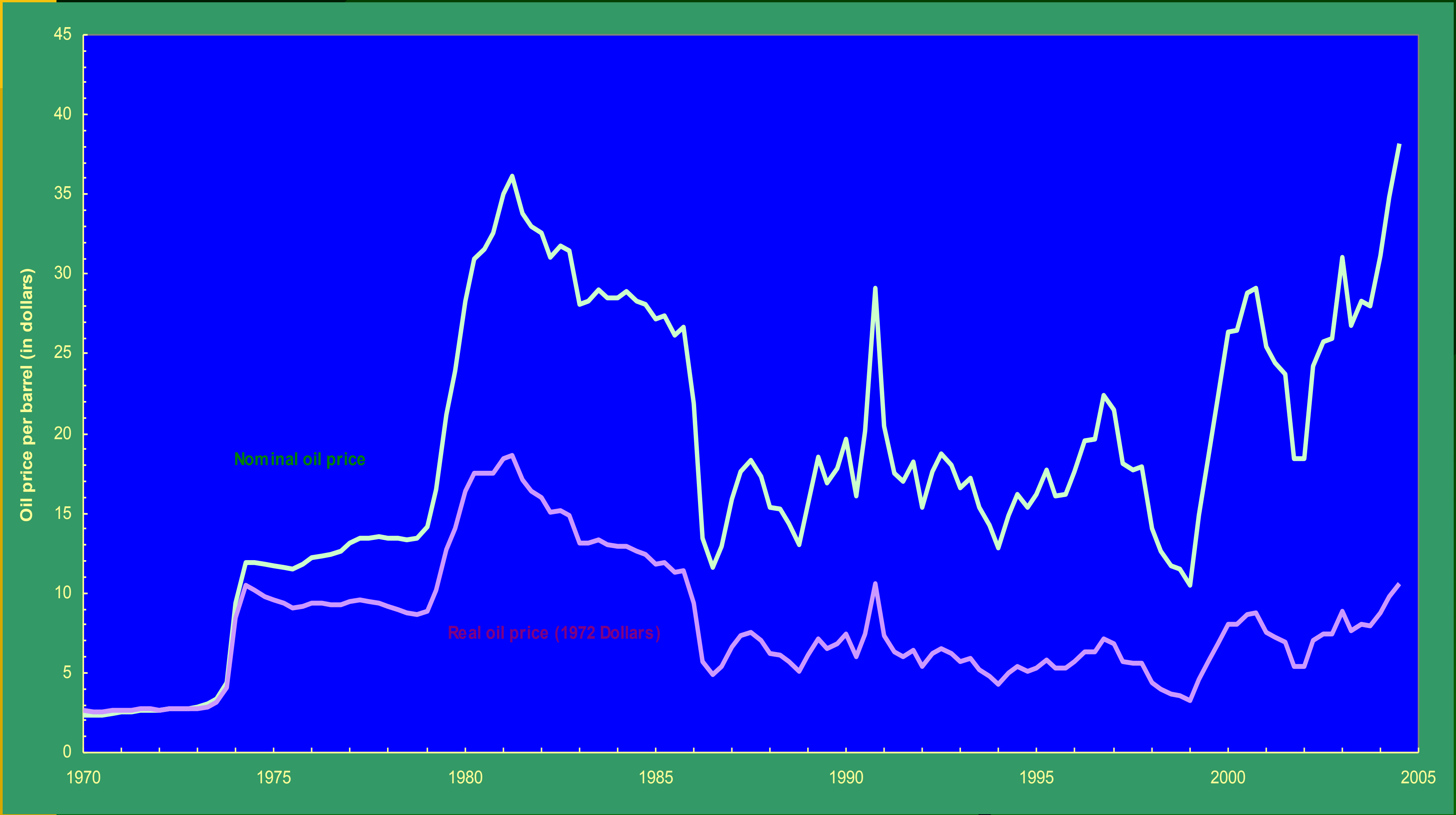
The Falling Dollar

- Dollar Appreciated 1995-2002
- Dollar has Weakened 2002-2005
- Dampened Effects, why?
  - Fixed Exchange Rate with China and Hong Kong
  - Managed Exchange Rate with rest of Asia (they manage it, not us!)
- Nevertheless a source of stimulus

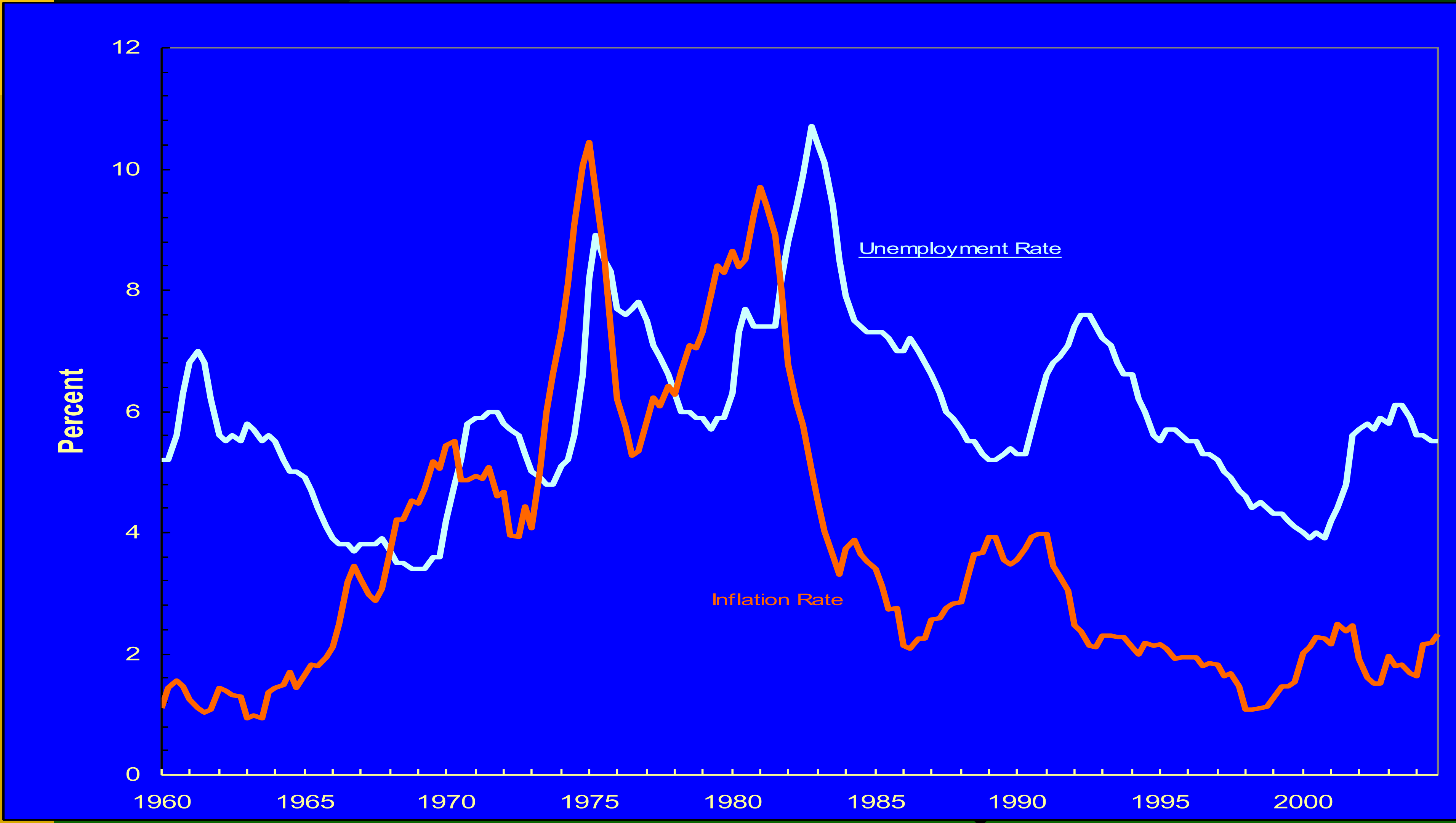
Remaining Sources of Weakness

- State and Local Government cutbacks: offset 1/3 to ½ of Federal Stimulus
- Upward Creep of Interest Rates
  - Consumers have Bought Too Many Cars
  - Housing Finance Boom Depends on *Falling* Interest Rates, Housing Re-fi is Over but New Construction Continues
  - Real mortgage rates are still low, especially compared with soaring house prices
- Last but not Least: Oil Prices!

Nominal and Real Oil Prices: Why Minimal Effect on Inflation?



So Far Inflation Has Hardly Budged



Why the Small Impact of Oil Prices?

- The *percentage* increase in real oil prices has been much smaller than in 1973-75, 1979-81
- The U. S. is much less dependent on energy
  - BTU use per $ of Real GDP is only 45 percent of 1972
- Minimal impact on overall economy doesn't spare transportation industry from painful impact

The Consensus Forecast

- Very stable quarter-by-quarter, 3.5 percent real GDP growth through 2005
- Overall CPI 2.7 in 2004, 2.5 in 2005, 2.3 in 2006
- Unemployment rate flat throughout 2005

Reasons for Skepticism?

- Usually I' m a skeptic, but since mid-2003 I' ve been on board, and the consensus has been right (steady real GDP growth, tame inflation, gradual decline unempl)
- This time: too sanguine about inflation?
- Ignoring future interest rate effects?
- But one leading forecaster has 2005:Q1 at 4.5

Guiding Star: the “Big Mo”

- History Since 1985 is that Real GDP Growth Hovers around 3.5 percent unless disrupted by a big shock
- The main part of the oil shock has already happened
- Investment⇔Consumption⇔Export Mutual Feedback
- Investment Boom will eventually Fade Away, starting with Residential, but that takes us well beyond the Two-Year Horizon