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FINANCIAL MARKETS' VEREDICT ON THE ECONOMIC OUTLOOK

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Mr. Chairman and members of the Senate Budget Committee, thank you for this invitation to talk about the US economic outlook. I will focus on the role of financial developments in the economy's recent performance and the implication of current financial market signals for the economic outlook. To get right to the punch line…financial market signals indicate that folks believe the economy is in a stall, but will begin to regain altitude some time this summer, with the help of forceful actions by the Fed; the market is not anticipating a recession, or problem that can't be fixed by lower interest rates.

We Americans enjoy exceptionally good economic times. Household net worth is near record highs. Even those haven't been investing in the stock market are benefiting: mortgage rates are very low; unemployment is close to World War II lows; and the standard of living of our citizens is rising more quickly, thanks to accelerated productivity growth that is boosting real income.

The economic boom was a challenge for the Fed, which prudently worked cautiously to slow growth to a more sustainable (noninflationary) pace. Continued above-trend growth almost certainly eventually would have boosted inflation, jeopardizing long-run growth prospects. And until last Thanksgiving, most of us believed that the Fed would successfully bring the economy down to a soft landing.

In recent weeks, however, news has indicated that the economy hit an air pocket late last year. Growth appears to be slowing more quickly than the Fed expected. Soft landing forecasts have quickly morphed into hard landing and, in some cases, even recession scenarios.

Is the economy at risk? I doubt it, at least not by anything that can't be fixed by lower interest rates. That's the implication of the view reflected in financial market signals

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THE FINANCIAL MARKETS A KEY TRANSMISSION

Financial markets are a key factor in the US economy's performance. They help to guide resources in the most efficient way from savers to those who are helping to build productive capital. They reflect expectations about policy and economic developments helping to facilitate economic adjustments to shifting conditions. And importantly, everyone has a chance to share in the fortunes of the economy by participating in the stock market.

Two aspects about the financial markets are key:

1. Credit 'rationing'…New roads linking businesses and households to the credit markets have opened as a result of deregulation that has transforming finance from one dependent predominantly on banks as the principal source of credit to a system dominated by securitized finance. This transformation has diminished the threat of credit crunches found in the past—when rising interest rates would result in bank disintermediation that often disrupted economic activity—and that continues to haunt Japan, where bank financing remains the chief source of funds for businesses.

2. Wealth creation…Many more Americans own shares in the stock market today than in the past, and certainly more than in other countries. This trend took hold with the growing popularity of mutual funds a decade and a half ago. The growing use of incentive-based compensation plans to reward workers no doubt has exposed many more Americans to the market.

The beneficial aspects of the first function of financial markets are subtle and difficult to measure. The benefits of the second are visible and powerful.

The bull market in stocks was a dynamic element of the recent economic boom. The broad stock market tripled in value between the end of 1994 and last year, as it appeared to investors that the economy's growth limits, and therefore corporate profits, were far more favorable than consensus beliefs.

Investors drove the shares of American corporations to unprecedented levels in relation to the current corporate earnings, reflecting expectations that new technologies would revolutionize the American business landscape and with it future corporate earnings. In dollar and cents, the aggregate value of all equity shares held by Americans surged about $9.5 trillion; $5.5 trillion of capital gains were accumulated on directly-held stocks; $2 trillion accumulated in equity mutual fund shares; another $2 trillion accumulated on indirect holdings of stocks in trusts, insurance companies, and pension funds. This unprecedented rise in wealth lifted household net worth to a historical record, where it remains.

We estimate that the rise in stock market wealth raised consumer spending by about $300 billion higher than it would have been, accounting for about a full percentage point of consumer spending growth in each of the last five years. As a result of this 'wealth effect', consumer spending grew more rapidly than income for most of the past half decade and brought the household saving rate down, as many households found they were achieving their financial objectives without having to save (Appendix II).

What about going forward? The equity market has stalled in the past year, but at a high level. This was inevitable at some point—of course, no one knew at what point—as share prices floated to ever higher multiples in relation to the current corporate earnings. The return to more normal stock market trends implies that the wealth stimulus that supercharged consumer spending growth in the past no longer will be present. In this case, consumer spending will expand at a more moderate rate this year, in line with income. That's what happened last fall. This indicates that the household saving rate will stabilize going forward.

Of course, many other factors have contributed to the rapid downshift of economic activity (Appendix I).

THE VERDICT OF THE FINANCIAL MARKETS ON US ECONOMIC PROSPECTS

Financial markets—because they are focused on the future—represent the jury in the economic outlook debate. Now, financial markets are a chorus of many voices, so it is a slight exaggeration to talk about a market view. But we can draw reasonable conclusions about the consensus view of investors from the various market signals.

Long story short…the verdict of the financial markets on the future is straightforward and optimistic. The market implicitly sees: a period of anemic growth in the months ahead, but not a recession; an aggressive Fed response; falling inflation expectations and with them lower long-term interest rates; a light at the end of the tunnel in the area of corporate credit quality. In other words, the financial community implicitly does not believe the US economy is suffering from the kind of imbalances that triggered recessions in the past.

One caveat…When I talk about the financial markets, I'm going to exclude the developments in the commercial paper market, which is under pressure because of concerns about the potential for California's energy crisis to trigger defaults in the utility industry.

To put financial market perspective into context, it is helpful to sketch out a road map of the opinions about the economic outlook. Views about the economy stack up along the lines marked by the following bipolar themes:

- The pessimists talk quietly about the risk that we are headed Japan's way—after their bubble burst. They view record current account deficits, negative household saving, record corporate leverage, and credit excesses, spurred by unrealistic expectations to be signs of excess that only a prolonged recession can purge (Appendix III).

- The optimists interpret the same factors—what pessimists view as imbalances—to be symptoms of the US economy's good points. The absence of inflationary strains casts a soft light on those 'imbalances', because it indicates that aggregate demand has not pushed past the economy's capacity limits. Optimists assert that, because the economy's growth potential has doubled in the past decade, what look like imbalances, including the current account gap, low saving, high borrowing, high valuations, are merely an indication that the US is outpacing the rest of the world (Appendix IV).

Not surprisingly, policy prescriptions of the pessimists and optimists are sharply at odds. Pessimists fear there is little the Fed should or can do other than to cushion the needed ‘flushing’ that comes with recession; they view any effort to prop up demand with interest rate cuts as prolonging needed adjustments. The policy prescription of the optimistic view indicates that, with inflation at bay and the economy’s growth potential elevated, the Fed can and should respond forcefully to support demand.

What do financial markets have to say about this? The perspective of the financial markets can be drawn from the following key markers (Appendix V):

<u>The shape of the yield curve…</u>The Federal Reserve anchors short-term interest rates through its overnight interest rate target, whereas long-term interest rates are determined by market forces and reflect, among other things, investors’ views about the future, beyond the current economic developments. The yield curve reflects investors assumptions that the Fed will ease its rates back to around 5% by the end of the spring, that long-term interest rates will hold around 6%. This implies that investors see no recession, that the expected actions by the Fed will be sufficient to restore growth some time in the second half of the year. If investors feared that we were on the brink of recession, market participants would anticipate that the Fed would drop its interest rates substantially further, into the range of 3%, and the yield curve would steepen much further, as it did a decade ago.

<u>Credit spreads…</u>The differential between interest rates on high- and low-rated corporate debt—referred to as credit spreads—reflects concerns about credit risk. Credit spreads widened substantially last fall, particularly for non-investment grade debt.

Credit spreads widened last year for reasons generally unrelated to the economy—that is, reflecting event risk, as it is referred to in the markets. For example, interest rate differentials for high-yield debt soared. Almost half of outstanding high-yield debt has been issued by telecommunications companies who need large sums to build the infrastructure for wireless data/voice communications, the so-called 3G technology. A widening of high-yield spreads reflects principally nervousness about the public’s demand for 3G technology. We won’t know this for years. In other cases, a widening of credit spreads was triggered by worries about companies’ exposures to asbestos and tobacco litigation. Still other stresses reflected disappointment over companies whose business models are becoming obsolete.

Credit spreads have narrowed somewhat since the Fed’s surprising rate cut early this month and liquidity in the corporate bond market has improved. This is notable, because ordinarily, credit spreads would be expected to widen ahead of an economic slowdown. Investors anticipate that credit quality will deteriorate early this year as the economy continues to slow. But these concerns are being partially offset by the Fed’s forceful response and a general expectation that it will continue to respond in kind. Against this backdrop, the Fed’s aggressive response is forcing investors to take the long view and look over the valley of expected subpar economic performance.

The marginal improvement credit spreads comes amid a pickup in issuance of non-investment grade and investment grade issues, following a lull late last year. The pickup in corporate bond issuance says as much about confidence in the corporate sector as it does about the condition of financial markets. Companies wouldn't be raising so funds so aggressively if they were preparing for a recession.

The equity market…Sentiment in the equity markets has stabilized in recent weeks. The overall market is up about 3% so far this year after declining about 12% last year. And techno-centric Nasdaq is up 12%, following last year's dismal performance. The recent stability as companies generally are still warning about a difficult time ahead, and 2000 S&P 500 corporate profits are looking flat.

The Fed is a big plus for equity markets. It's not that the Fed's half point rate cut would make much of a difference for stocks, although the tone of the equity markets has improved since the 3 January. It's the message the Fed is sending by its bold actions, that something is different this time and that it has leeway to do the best it can to keep demand in line with supply. That is a powerful message and one that the Fed couldn't always offer in the past!

CONCLUSION…THIS TIME IT'S DIFFERENT

People often claim that Fed easing is like pushing on a string, when it comes to guiding this complex economy. I doubt that's true today. In fact, I suspect that the Fed's actions are felt quicker and its policy are more potent for several reasons. This will go a long way toward thwarting recession forces.

One reason is the inflation backdrop. The one red flag that has accompanied all 20th century recessions—inflationary pressures—is absent today.

Benign inflation is a load off the Fed's back. The Fed has always had to respond cautiously to emerging recession threats in the past for fear of stoking up inflation. The benign inflation backdrop indicates that the economy is not overheating. It means that the Fed is free to respond forcefully to any threats to the expansion, much sooner than it might ordinarily be able to.

The financial markets, acting as a partner with the Fed, are strengthening the Fed's hand, because they are—on cues from the Fed—building in a bold policy response. For example, since Christmas, market prices have been anticipating that the Fed would drop its rates to around 5% by summer 2001. In this, they are far ahead of the Fed, more so than at any other time in memory. This means when Americans go take out a mortgage today at 7%, they already are benefiting from the market's assumption that the Fed will cut rates aggressively, well before the Fed actually eases.

The dynamic response of the economy, resulting from improved information flows today and more flexible adjustment of prices, is another factor that has strengthened the Fed's hand. Decades of economic liberalization and reform have transformed the economy into a more dynamic economy. Businesses are quicker to adjust their prices in response to changing demand conditions. This transformation is muting the economic disruption resulting from unexpected falloff in demand growth and giving the Fed greater latitude to resist threats to the expansion.

It is these two profound developments—greater Fed leeway and more dynamic economic response—that underpins the implicitly optimistic views reflected in financial markets that the economic slowdown will be a temporary lull in a sustained expansion.

Appendix I. The Economic Downdraft…An Economic Perfect Storm

Why has growth downshifted so suddenly? Only last May the Fed hiked interest rates ½ percentage point and analysts widely believed that the economy had so much momentum that the Fed would have to tighten substantially further to slow growth. As recently as last Thanksgiving, the consensus view in the markets and at the Federal Reserve held that the economy would settle down to a soft landing—with growth easing to the long-run sustainable pace.

It now appears that the economy has flown into an economic 'perfect storm', hit by the convergence of a number of negative factors. Financial developments were a key element of boom and are one of several factors in the slowdown.

There is no surprise that the economy is slowing—after all, the Fed has been tightening cautiously for the past two years to brake the economy to a more sustainable pace. Only the speed of the slowdown is catching folks off guard. A number of adverse factors appear to have converged to produce a more sudden growth downshift than anyone expected:

1. The Fed has been tightening since early 1999 to slow the economy to a noninflationary pace of around 4%. It now appears, with the benefit of hind sight that it did not need to tighten as much as it did. The Fed is reverse its stance and this already is reflected in mortgage and other rates that individuals pay.

2. Y2K preparations likely masked the economy's underlying trend, as outsized spending and stockpiling of household items by consumers exaggerated activity in the winter of 1999/2000.

3. The surge in oil prices last year, which drove petroleum prices up to $37 per barrel early last spring from $25 at the end of 1999 represented a significant 'tax' on the global economy, shaving as much as 1 percentage point from global growth. Oil prices are a 'tax' on the global economy, at least until the revenues received by oil producers—referred to in the past as petrodollars—are 'recycled' in spending by OPEC for goods and services produced by us. OPEC misjudged the strength of global demand and hopes to stabilize prices in the $22 to $28 per barrel range for a blend of Middle East grades of petroleum.

4. The stock market fell last year, after rising 20% to 30% each year for the previous five years. Optimism about the profound changes offered by electronic commerce doubled the Nasdaq in the span of five months, between Columbus Day 1999 and spring of 2000. The runup couldn't be sustained and the Nasdaq retreated over the course of the year, but not before fueling a considerable amount of spending that subsequently fell back.

5. The winter of 1999/2000 proved to be unusually mild again. This allowed builders to start projects earlier than normal in the winter months, or to keep projects running that normally would

be shut down in the winter. As a result, economic activity was exaggerated in the winter and early months of last year, followed by exaggerated weakness later in the year as the normal spring and summer rise in construction activity failed to materialize, because it had already taken place in the winter.

6. Households have been investing in high-tech and durable goods in recent years, just as businesses have. In the case of individuals, all spending other than for new housing, is classified as consumption. But in truth much of the household spending represents investment in items whose services are consumed in the future. It was only a matter of time before investment purchases would slow on their own, as Mr. Greenspan noted in Humphrey-Hawkins testimony last year, as households reached desired levels for big ticket items.

7. The US economy's outstanding economic performance has drawn foreign investors to our shores, in the form of portfolio and direct investment flows, lured by the attractive return on assets. This has bolstered the dollar, which has climbed against the euro and a number of Asian currencies. The rising dollar has undermined the appeal of US products on global markets, and weighted on the manufacturing sector.

8. California's energy crisis likely is exacerbating the slowdown. Power disruptions and related surge in the cost of natural gas, a result of shifting electric generation to gas-dependent technologies, are producing dislocations in manufacturing, agriculture, and the petrochemical industry. State data indicate that unemployment insurance claims are mounting in California more than in other states. A the same time, new pressures on natural gas markets may be forcing some operations to shut down. Industrial production of chemicals and price spikes for natural gas, may already Industrial production figures provide hints of dislocations in the petrochemical industry.

Appendix II. Footprints of the Stock Market Wealth Effect

The surge in the US stock market in the past five years helped to boost household net worth to 604% of disposable personal income most recently from 500% at the end of 1994. The footprints of the wealth effect are evident in the outsized rise in consumer spending relative to income (Figure I.1) and historical plunge in the household saving rate (Figure I.2). Because consumer spending represents the lion's share of domestic demand growth, supercharged US consumer spending, combined with subpar global growth, led to a massive rise in the US current account deficit (Figure I.3).

Appendix III. The Pessimistic View

The pessimists privately worry that the US economy risks facing the same problems hit Japan's bubble economy a decade ago. Until last summer, the pessimists view was rooted in a belief that the US economy was overheated, challenging many of the new economy claims. More recently, the pessimism rests on a claim that corporate America is over-leveraged and that credit excesses of the past are coming home to roost.

Pessimists claim that the record US current account deficit (Figure III.1), negative household saving (Figure III.2), high corporate leverage (Figure III.3), excessive private debt growth (Figure III.4), and historically-high stock price-earnings ratios (Figure III.5) are all symptoms of a bubble economy that faces a serious risk of recession in the coming year.

Appendix IV. The Optimistic View

TWO KEY SURPRISES DEFINE THE NEW ECONOMY

Optimists claim that the new economy is real and its foundation deeply rooted. Two key surprises define the new economy: (1) inflation is more benign than expected; and (2) capital spending has soared to unheard of levels in relation to the size of the economy.

On the inflation surprise, low unemployment is proving to be far less inflationary than believed. For decades, economists have believed that inflation would accelerate if unemployment fell below 6%. Instead, unemployment has fallen to 4% and underlying inflation stable.

The investment boom—the second key feature of the new economy—has been under way for a decade. With business investment in equipment and software expanding at a double-digit rate for most of the decade, the level of investment rose to a record level in relation to GDP (Figure IV.1). Much of this investment was concentrated in purchase of high-tech equipment. As a result, growth of the nation's capital stock accelerated to 8% annually last year from 2% at the beginning of the decade (Figure IV.2). The faster growth of the nation's capital stock indicates that companies are providing workers with more and better equipment to do their jobs. As a result, underlying labor productivity growth has accelerated markedly, to about 3% annually at least from around 1% between 1973 and 1995. Faster productivity growth has raised the economy's growth potential to around 4% annually from near 2% in recent decades.

Given the surprises on inflation and investment, which both imply more favorable sustained output, there is little mystery in the profits boom, bull market in equities, high and rising federal surplus, record current account deficit, and falling household saving. For example, it is inevitable that the US current account deficit will widen, with the US economy's growth potential rising and exceeding that of its trading partners.

FACTORS…LIFE IMITATES ART

1. Economic liberalization…

- On the macroeconomic policy front…

In the fiscal arena, the pursuit of disciplined fiscal policy has freed resources to be employed more efficiently in the private economy, helping to keep interest rates down. At the same time, the reliance on the Fed instead of fiscal policy has produced better-timed macroeconomic policies that have been counter-cyclical rather than pro-cyclical, as was often the case in the past.

Changes in the conduct of monetary policy too have strengthened the Fed's hand in managing the economy. First, the increased transparency of the Fed has resulted in a better-informed public and investment community and an increased awareness at the Fed of the need for public support. This has allowed the Fed to act more pre-emptively than in the past, with the support of the Fed. Third, the Fed and the financial community have learned how to evaluate the stance of monetary policy taking advantage of market signals, for example by distinguishing between real and nominal interest rates.

- In industrial policy…

The US, under the leadership of the government, has deregulated a number of industries, including airlines, banking, telecommunications, trucking, railroads, energy production, and now electricity generation. The road hasn't always been smooth, but the economic benefits have been without question. Deregulation has removed barriers to technological innovation and increased competitive pressures in the American economy.

At the same time, the growth of a stockholder culture among the American workforce has strengthened work incentives. This is evident in the growing use of incentive-based compensation for workers. It is evident in the unprecedented rise of options and stock distributions in the compensation of managers. And it undoubtedly is an important element in the improved relations between unions and management. The growing public acceptance of international trade has opened our borders to the global economy. This is evident in the high and rising share of imports in domestic demand. The rise of trade has unleashed the benefits of comparative advantage promised long ago by Adam Smith.

Innovation in the financial markets has opened up new sources of funds for risky but promising ventures. Venture capital, for example, has been the lifeblood of small startups.

2. Technological innovation

The investment boom, which has lifted productivity growth, has reflected rapid changes in technology. Deregulation of the telecommunications industry and innovations in financing, including venture capital financing, may have helped to speed the pace of innovation.

The rapid pace of technological change is marked by the rapid fall in the price of computing and data storage that reflects rapid advances in microprocessor speeds. The decline in the relative price of technology and data storage has made a wide range of high-tech equipment available for business applications. And the high levels of investment indicate that businesses are taking to technology in a big way.

Rapidly improving information technology has helped to increase the flow of information so critical for keeping track of activity and inventory. This has allowed businesses to respond more promptly to a mismatch of customer demands and products.

3. Collapse of the 'Evil Empire' The collapse of the Soviet Union and the centrally-planned model triggered a global shift to economic liberalization that is having repercussions in many ways. First, the easing of tensions generated a peace dividend. The shift from a guns to a butter economy that paralleled a sharp decline in the defense budget freed considerable resources to private activity.

The emergence of China represents a related development, as the Chinese government attempts to adopt market principles to guide its allocation of resources. The rapid emergence of China on the global markets—for example, the US-China bilateral trade deficit over the most recent 12 months now exceeds the US-Japan goods deficit—almost certainly has been an important source of disinflation.

4. Demographics…an older/wiser work force The average age of the American work force has risen noticeably over the past decade, and now ahs returned to the high level evident in the 1950s. The graying of the population accounts is in the background of new economy developments. For one thing, for both the more stable performance of wage trends as well as some of the attitude shifts

Appendix V. Financial Market Signals

Appendix VI. The JPMorgan Research Economic & Inflation Outlook

The economy is slowing to a below-trend pace, and the full implications of the slowdown have yet to be seen. The new J.P. Morgan Research forecast indicates that growth will fall to 1% to 2% annualized in the first half of this year, before recovering slowly over the second half of the year, in lagged response to Fed easing.

Demand growth is slowing abruptly...

There are no surprises in the consumer sector. Spending growth is moderating gradually as expected. Real consumer spending rose at a respectable 3% to 3.5% annualized rate in the fourth quarter. This was slower than the third quarter's 4.5% annualized growth pace and well below the 4% to 5% annualized growth spurt of the past four years. But with the stock market down this year and income rising at a moderate 2.5% annualized rate, consumer spending is likely to decelerate still further.

In contrast, business investment spending appears to be braking much harder than expected. Capital spending growth apparently stalled in the fourth quarter. For example, orders and output of capital goods are little changed according to the latest durable goods figures. At the same time, businesses have not been able to slow the growth of their inventories, in the face of moderating demand growth. Belatedly they will lower the pace of inventory growth in the coming quarters, depress real GDP growth in the process.

In response to the signs of spreading weakness, the Fed likely will ease by even more than is reflected in market prices. With growth expected to slow to 1% to 2% annually and unemployment likely to rise noticeably, the Federal Reserve is expected to lower its federal funds rate target by 200 basis points in the coming quarters, taking its target rate to about 4.5% from 6.5%. This action would turn from the restraint that was put in place in recent years to applying some stimulus to cushion the economy's deceleration.

Growth Potential … Slower but Still Impressive

Accelerated productivity growth is one of the defining features of the new economy. Booming capital spending is in the background. Will a slowdown in investment spending growth bring this to an end? It's doubtful.

Business investment spending growth may be decelerating. That's what the latest durable goods figures indicate. But business investment in equipment and software grew at double-digit rates in almost every year since the 1990 recession, pumping the level of investment to the highest level ever in relation to GDP. As a result, the net stock of capital has accelerated to an 8% annualized growth rate in recent years, in response to the high level of investment, up from 2% annually in the early 1990s.

The connection between investment and productivity is more complex. There is likely to be a cyclical—and thus temporary—slowdown in productivity gains as the economy cools off. But the underlying trend productivity is driven by growth of the capital stock and benefits that flow from the application of new technologies. Because the level of investment has been so high, any slowdown in investment would be expected to have a limited effect on the growth of the stock of business equipment and software. It is the rapid growth of the capital stock—capital deepening—not the rapid growth of investment that is the principal driver of productivity.

Still, with business investment in equipment and software expected to be flat this year, the growth of the capital stock would be expected to decelerate somewhat. Productivity advances reflect not only capital deepening but also advantages offered by new technologies—referred to as multifactor productivity—that have represented a growing contribution to potential output growth in recent years. Therefore, it remains to be seen whether slower gains in investment undermine underlying productivity growth.

Inflation … Down and Out

Many observers expect inflation to fall this year, as oil prices ease. Last year's surge in petroleum prices, to $35 per barrel (West Texas Intermediate) from $25 per barrel at the end of 1999, directly added 0.5 to 0.75 percentage points to the PCE and CPI consumer inflation measures, respectively. Consumer energy prices surged 10% to 15%. So, if oil prices had merely stabilized at $35 level and energy prices held steady, headline consumer inflation would drop back to the core inflation rate.

In recent weeks, however, oil prices actually have retreated back into OPEC's target range[1], in lagged response to earlier output boosts and slowing global demand growth. OPEC anticipated this and in fact has been more concerned about a potential glut of oil this year than insufficient supply. This implies that actual inflation may fall below core inflation in 2001, reversing much of the 0.5 to 0.75 percentage points energy boost in 2000. In this case, core inflation might also ease slightly in response to indirect energy price relief—for example, reflected in airline fares and other

1. That is $22 per barrel to $28 for a blend of Middle East grades, or $24 to $30 for West Texas Intermediate.

transportation costs, production of energy-dependent materials line steel, and a host of petroleum derivatives, including fertilizer, plastics, chemicals.

In recent years, investors have shrugged off oil gyrations as a relative-price rather than an inflation event. This has contrasted with the fears of many observers who associate oil gyrations with past inflationary spirals. For example, at the time investors tended to view the 1998 plunge in oil prices to be a result of a temporary imbalance between output and demand. Symmetrically, they viewed the 1999 and 2000 rise in oil prices, and associated rise in inflation, as a renormalization of supply and demand, rather than an attempt by OPEC to flex its muscles; investors have seen that cartel have power only over the short run.

Benign core inflation trends have made it easier for investors to take the long view and peer through energy-related inflation gyrations. Underlying inflation, represented by the core chain price index for personal consumption expenditures, has held steady near 1.75% annualized for several years. The slight upcreep evident in the core CPI—core CPI inflation has edged up marginally to about 2.5% from 2% earlier—is notably absent in the PCE measure.

Investors underlying optimism about inflation is reflected in stable inflation expectations. Surveys indicate that investors' inflation expectations, which fell moderately in the mid-1990s, have held steady since then. Most respondents believe that CPI inflation will average about 2.5% annually over the coming decade; surveys do not track views of other inflation measures. Market-based indicators of inflation expectations have actually eased somewhat in recent months.

With the economy expected to grow well below potential this year, inflation expectations are likely to ratchet down. Inflation psychology will be influenced by underlying inflation trends, not by the aberrations associated with oil price swings. Any lowering in inflation trends would imply a reduction in perceptions about equilibrium—sustainable—level of interest rates. Therefore, a drop in inflation expectations would justify a sustained fall in equilibrium risk free interest rates.

Against this backdrop, the year 2001 represents an important crossroads for the inflation outlook and financial markets. Most economists—drawing on conventional theory—anticipate that inflation has considerable inertia and may actually creep higher until a sufficient amount of 'slack' has emerged to ease pressures on resources. From this conventional perspective, an extended period of subpar growth alone will insufficient to check inflation.

In contrast, the J.P. Morgan Research outlook indicates that underlying inflation will fall in 2001. The current level of resource utilization—that is 4% unemployment rate—appears to be sustainable. Therefore, a period of subpar growth, and accompanying easing of demand pressures on resources, will intensify competitive pressures. Underlying core inflation is forecast to fall at least 0.25 percentage points.

Swifter Fed Response to Economic Threat

The Fed must respond more aggressively to a growth threat when inflation is low than when it is high. It can't push its nominal interest rate target below zero. So, when inflation is high, it can push real interest rate deeply negative if necessary. But when inflation is low, the Fed can push real rates down only so far. The ineffectiveness of the Bank of Japan's zero interest rate policy is a demonstration of the limits of monetary policy in a deflationary setting.

The Fed must compensate for the challenges of low inflation by responding more promptly and forcefully to a potential economic threat than it would if inflation were higher. Many of Japan's problems today stem from the central bank's failure to recognize and head off deflationary forces early on.

Market participants implicitly understand today's policy context. The market usually front runs the Fed when it anticipates a pending shift in policy. But in the past the market usually has never moved more than a couple of steps ahead of the Fed, because investors understood that rising underlying inflation, that often accompanied past economic slowdowns, would prevent the Fed from easing aggressively. The rapid evolution of market prices in recent months is striking in this regard, because it has been quite unusual for the market to front run the Fed by 125 basis points of easing that now is reflected in market prices. The presumption that the Fed will move swiftly if economic news validates perceptions that growth is slowing, rests importantly on as assumption that inflation risks have died down.

Market Implications

The issues for financial markets are straightforward:

- The weaker the economy, the more aggressive the Fed, and the steeper the interest rate yield curve. The JPM Research 2001 economic outlook anticipates an aggressive Fed response to a significant growth slowdown. In this case, the interest rate yield curve will steepen notably.

- The outlook for credit quality in this setting will be more adverse, all else equal. But aggressive Fed easing will partially alleviate concerns about credit quality over the longer run and credit spreads could actually narrow somewhat in coming quarters.

- Renewed disinflation would lower equilibrium risk free yields, indicating that the fall in interest rates in recent months should be sustained.

- The dollar hinges on the underlying productivity performance. The dollar will continue to draw support on a trade-weighted basis from sustained rapid underlying productivity growth.

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