

Post-Traumatic Slack Syndrome and the Economic Outlook

***(With Thanks to Finn Kydland, Dolly Parton
and John Kenneth Galbraith)***

*Remarks at the Laboratory for Aggregate Economics and Finance,
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The views expressed are my own and do not necessarily reflect official positions of the Federal Reserve System.

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Thank you, Professor [Peter] Rupert. I am grateful to you and especially to our mutual friend, Finn Kydland, for inviting me to speak at this magnificent university tonight under the auspices of the Laboratory for Aggregate Economics and Finance.

If I may, before starting my speech, I would like to say a few words about Finn. I am half Norwegian: My mother descends from the seafaring Andersen clan of Sandefjord, a former whaling town roughly 400 kilometers east of the farmlands of Jaeren, where Finn was born. You can't have a trace of Norwegian blood and not be proud of Finn. Only 11 Norwegians have ever won a Nobel Prize, and only six have done so in my lifetime. Three of those were prizes in economics.

Which brings to mind the old saw that there are three kinds of economists—those who can count and those who can't.

Finn can count. And reason clearly. And teach, patiently and lucidly. He has been of great help to us at the Federal Reserve Bank of Dallas in improving our understanding of time inconsistency and the business cycle. And he honors us by serving on the advisory board of the Dallas Fed's Globalization and Monetary Policy Institute. I am most thankful to Finn for his contributions to economics, to the Federal Reserve and to Norwegian pride.

Now to the subject at hand.

As Professor Rupert mentioned, my wife Nancy and I are bibliophiles. We collect rare books. This is an expensive hobby that began when I wrote a paper as a student at Stanford's Graduate School of Business on the imperfect auction market for out-of-print first editions. As you might guess, the recent financial crisis has ratified much of what I wrote about over 30 years ago, and that, as Peter mentioned, is what enabled my recent bargain-priced purchase of the original *Oxford English Dictionary* and a near-mint-condition 1841 printing of Mackay's *Memoirs of Extraordinary Popular Delusions*, a book I recommend to anybody who wants to understand the pathology behind the recent—and any other—financial crisis.

Our interest in books led us to serve on a committee that advises the Library of Congress. It was through the library that we were introduced to the country singer Dolly Parton. Most people think of Dolly as the caricature of Marx's—Groucho's, not Karl's—swarmy quip: "She has eyes that folks adore so, and a torso even more so." But Ms. Parton has a prodigious brain for music and business—and a passion for books. She has done a great deal for education—her foundation now gives out, free of charge, over 6 million books a year to pre-K children in more than 40 states, the District of Columbia, Canada and the United Kingdom to start them on the road to reading.

What does this have to do with the economy? Well, in thinking about what I wanted to say tonight, I was reminded about an incident that occurred when Ms. Parton was given the Library of Congress' Living Legend medal for her contributions to American culture. At dinner

afterward, a rather indignant woman, offended by Ms. Parton's ... topography, thought to diminish her by noting how disproportionately small her feet seemed to be. Dolly's saucy riposte was a classic: "Well, you know, sweetie, it is very hard to grow anything in the shade."

Tonight, I wish to speak of the difficulty of growing our economy in the shade of an abundance of excess capacity for the production of goods and services worldwide.

The Present Situation

You will have read in this morning's newspapers of the minutes released yesterday of the Federal Reserve's Open Market Committee meeting of Aug. 11–12 and the conclusions drawn at that meeting regarding the status of the economy. The collective sense of our group was that the economy was leveling out. We noted that conditions in financial markets were continuing to improve; household spending was stabilizing but remained constrained by ongoing job losses, sluggish income growth, lower housing wealth and tight credit; and businesses were making progress in aligning inventories with still-anemic sales and were continuing to cut back on fixed investment and payrolls. The committee concluded, given both the monetary accommodation we had put in place and fiscal policy, that it was reasonable to expect a gradual resumption of economic growth in a context of price stability.

The operative words in that sentence were "gradual" and "in a context of price stability." Just what are the prospects for economic growth? And what is the outlook for prices?

In explaining how the economy will transition from recession to recovery, we at the Dallas Fed have been referring lately to "the Johnny Mercer effect," after the Hollywood lyricist who penned the refrain "Ac-cent-chuate the positive [and] e-lim-i-nate the negative."

Here is how it works. Residential investment, inventory investment and consumer spending together account for 3 percentage points of the 3.9-percentage-point decline in real gross domestic product (GDP) that we've seen over the past four quarters. So, if we eliminate these negatives, we go a long way toward stabilizing the economy.

The latest monthly indicators suggest that the drag from residential investment has stopped. Indeed, our latest estimate is that residential investment will add roughly half of 1 percentage point to GDP growth in the current quarter. Inventory investment is likely to remain negative, but as long as it does not become even more negative, it will cease to be a drag on GDP growth. And if the pace of inventory liquidation moderates, you eliminate a powerful negative and begin to accentuate the positive.

Consumption, the most prominent of all GDP components, has suffered its biggest four-quarter drop since 1951.¹ But, as Milton Friedman taught us, households adjust their spending levels quickly as the economic outlook changes, without waiting for the changes to be realized. In other words, they cut their spending as job prospects deteriorate rather than wait for layoffs to actually occur. This means that the worst may well be over for household consumption, barring some new shock. We certainly do not expect American consumers to come surging back to fuel a global boom any time soon, but the latest data on personal consumption expenditures (PCE) and retail sales are broadly consistent with Friedman's theory. Real household spending rose for the third month in a row in July and is up 0.6 percent (not annualized) so far this year, though some of this growth undoubtedly reflects the cash-for-clunkers program, which has now expired.

In a similar vein, the latest report from the Institute for Supply Management shows export orders swinging into positive territory as the economies of our overseas trading partners begin to turn around. Again, we have a reversal of signs and the elimination of a negative: Falling exports subtracted 1.9 percentage points from GDP growth over the past four quarters. Nonresidential fixed investment has been an even larger drag on the economy, subtracting 2.4 percentage points from GDP growth. But, as with consumption, the latest monthly indicators suggest a bottoming out and hint at the beginnings of a modest expansion.

Meanwhile, government stimulus spending is kicking into gear, accentuating a positive: Government purchases added 1.3 percentage points to GDP growth last quarter, up almost 1 percentage point from the average of the previous three quarters.

The point is: A lot of former negatives are being eliminated or even turned into positives. Former positives, like government purchases, are being accentuated. The combination is beginning to propel the economy upward.

The question is: How robust and sustainable will the recovery be?

Inventory adjustments, while welcome, are of temporary utility. Any boost to growth we receive as firms achieve control of their inventories will be the result of a rebalancing of supply and demand that is inherently transitory. Sustained growth will have to come from somewhere else.

I doubt it will come from housing or a return to the bad old days of financial Bacchanalia. We do not want—and cannot expect—massive foreign capital inflows or domestic investment indifferent to risk to finance another boom in household spending and residential investment. That means we will need to see a massive reallocation of capital and labor away from such formerly hot growth areas as construction and finance. This reallocation will be impeded by financial markets that—while improving—continue to operate at less-than-full efficiency. I surmise that the re-gearing will take time and that, in the interim, households and businesses will focus on shoring up their savings and balance sheets rather than spending money. For consumption, that translates into a slow crawl out of purgatory. For capital expenditures and employment rolls, it means an emphasis on tight budgeting and a continued focus on absolute needs rather than wants.

For the past four years, I have personally surveyed 30 or more chief executives of key companies in a broad array of sectors before every Federal Open Market Committee meeting to get a read on how they are positioning their enterprises.

These operators of our economy—private-sector operators whose teams decide what to purchase, what to produce and how many workers are needed to turn inputs into products and sales—are still suffering from shock induced by the trauma of the crisis. I would say they are suffering from “post-traumatic slack syndrome.”

Until the summer of last year, businesses were emboldened by a prolonged period of ready money and robust global demand. They were geared toward the expansion of plants, equipment and payrolls. At the same time, inflationary pressures were building. Businesses took every measure possible to boost their top lines by passing on rising costs through higher prices. As we entered the summer of 2008, the inflation data exhibited frightful tendencies. Of the 178 items in the consumer’s basket used to measure PCE, 77 percent were rising, and the number rising above 3 percent per annum was the highest we had seen in nearly two decades.

There are limits to the costs that can reasonably be passed on to consumers without damaging top-line revenue performance. Thus, simultaneously, businesses worked like beavers to preserve their bottom lines by controlling the costs of goods and services they sold, shifting their management models and budgeting accordingly.

Then they experienced a traumatic shock. Demand imploded. The equity and fixed-income markets seized up. Bank credit evaporated. The growth of the global economy hit a wall. Whereas just over a year ago managers were coping with a pervasive scarcity of inputs and escalating prices, there is now an abundance of almost every input and output and no pricing power. There are too many ships at sea; too many rail cars; too many airplanes and trucks; too many homes; too many hotels and apartments and office buildings; too many retail stores and malls and convenience stores; too much oil, natural gas and corn; and, according to *Wall Street Journal* reports this week, even too much champagne and bottled water.²

And yes, thank you Lord, we have finally come to realize there are too many lawyers.

In almost every sector of the economy—save for nonelective medical services and a few basic commodities being hoarded by the Chinese—the CEOs I survey are struggling to cope with excess capacity and slack.

Businesses trying to sell products and services feel they are pushing on a string and are adjusting their behavior accordingly. To maintain sales volumes and clear inventories in the face of weakened demand, they are cutting prices. Beginning in the fourth quarter of last year, we began to see an upward shift in the number of items falling, rather than rising, in price. In the July data just released, almost 50 percent of the items in the PCE basket—weighted either by simple count or expenditure—were falling in price. Small wonder that headline inflation was negative over the year ended in June: This is the first time since 1955 that we have seen deflation.

And top lines have evaporated. In this most recent quarter, for example, the 376 nonfinancial companies in the S&P 500 reported a nearly 20 percent decline in top-line revenues. This is the third sales decline in a row—the first time we have seen this since 1965.

Evaluating the Numbers

The new numbers tell me two things. First, for the immediate future, the risk to price stability is a deflationary risk, not an inflationary one. And second, given they are operating in the shadow of the absence of pricing power and the pervasive difficulty of expanding top-line revenues in the face of weak demand, businesses will continue to run tight budgets as they try to preserve profit margins. They will continue to focus on cost control, most painfully by shedding workers and driving those who remain on the payroll to higher levels of productivity.

All of which means that we are likely to see a prolonged period of sluggish economic performance and uncomfortably high unemployment as businesses reallocate capital and labor to fit the new economic landscape.

The needed reallocation of labor and capital has been, and will continue to be, impeded by financial markets. Although substantially improved from last fall—due in significant part, I would argue, to the work of the Federal Reserve—markets are still a long way from having normalized. We know from our own experience and from the experience of other countries that financial headwinds like these take years to abate.

To offset those headwinds, fiscal authorities have stepped forcefully into the breach, putting in place a massive stimulus effort. They have done so with the intent of limiting the damage to disposable income from unprecedented declines in wage and salary income—while trying to goose up capital expenditures on infrastructure.

If you go back to the rudimentary formula taught in high school economics to account for the makeup of GDP—consumption plus investment plus government expenditures plus net exports—the “G,” or government, variable is receiving enormous emphasis, while “C” is flaccid, “I” is hesitant and net “X” is tentative. At the present rate, federal, state and local authorities are expected to spend, net of intragovernmental transfers, \$5.4 trillion in 2009—just under 40 percent of expected GDP.

The problem is that government stabilization measures come with a real long-term price tag: higher tax rates, greater national indebtedness and the prospect of higher interest rates driven by the government’s issuance of debt. These long-term costs of a larger government limit the American people’s willingness to rely on the public sector to drive overall economic growth. A fiscal gag reflex ensues, and the public-sector option looks less and less attractive as anything other than a temporary source of growth.

The major challenge facing U.S. fiscal authorities is meeting the need for near-term economic stimulus while pursuing a practicable plan to stabilize the government’s debt-finance obligations. The Secretary of the Treasury is doing his level best to reassure investors—both overseas and here at home—that the programs put in place by the Obama administration will work their magic and then be gradually withdrawn as the economy gets back into stride. But this is no simple task. It is now common knowledge that deficits are growing at \$3 million per minute and will accumulate to some \$9.1 trillion over the next decade. And our fiscal predicament is compounded by the embedded unfunded liabilities of Social Security and Medicare. By our calculation at the Federal Reserve Bank of Dallas, the present value of the unfunded debt of these two entitlement programs has reached \$104 trillion, with \$88.9 trillion of that due to Medicare alone.

The legendary actor Errol Flynn is reported to have quipped that his problem lay in “reconciling [his] gross habits with [his] net income.” I imagine the American public and its representatives are close to their limit of tolerance of the “gross habits” of government and the net new indebtedness they are willing to pass on to their children, all of which suggests that, as an antidote to what ails the economy, government spending is a thin reed on which to rely. Given the expected slow adjustment rate of the other components of final demand, my guess is it will be a long time before we see growth strong enough and sustained enough to make an appreciable dent in excess capacity. I envision an output path going forward from here that looks something like a check mark, with the Johnny Mercer effect giving us a near-term snapback from the short, intense downstroke, followed by a transition to a long period of slower growth corresponding to the elongated side of the mark.

Now, mind you, this is what I foresee from my vantage point, standing before you tonight. Yet well before I met Finn Kydland or could afford to collect rare books, or was taught economics by Dolly Parton, I took an undergraduate course from John Kenneth Galbraith. Galbraith warned his students that “[T]he only function of economic forecasting is to make astrology look respectable.” My forecast for the economy might be totally wrong. But that is how I see it as a Piscean, and I’m sticking with it.

Peter, thank you. I would now be happy to avoid answering any questions the audience might have.

Notes

¹ Consumption surged after the outbreak of the Korean War in June 1950 because people feared a return to World War II-style rationing. Once it became apparent that rationing was not in the offing, consumer spending fell back.

² “Bottled-Water Price War Heats Up as Demand Falls,” *Wall Street Journal*, Aug. 31, 2009, p. B1, and “As Champagne Fizzles, Makers Squash Supply,” *Wall Street Journal*, Sept. 3, 2009, p. B1.