MACROECONOMIC PERFORMANCE SINCE 2000

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Abstract

This paper briefly reviews events and highlights debate surrounding U.S. macroeconomic performance since 2000. The paper establishes <u>three key points</u>:

(1) <u>First</u>, several critics of Bush policy have advanced the view that the initial subpar performance of the macroeconomy following the change in Administrations (January 2001) was directly related to the adoption of inappropriate macroeconomic policies on the part of the Bush Administration. That is, they contend that the Bush Administration's economic policies caused the subpar economic performance. <u>This argument is shown to be incorrect for several reasons.</u>

<u>Timing Inconsistencies:</u> A host of key data series unequivocally show that the macroeconomy began to slow shortly after the stock market decline (or bubble bursting) in early 2000, well before the change in administration in January 2001.

<u>Policy Lags</u>: There are unavoidable lags between the Inauguration, the implementation of new policy, and the economic effects of that policy. Accordingly, the economic effects of the new administration policies could not have been observed until mid-2001 at the very earliest. In other words, the earliest possible effects of new policies could not have occurred until <u>after</u> the 2001 recession began.

<u>Concessions by Opponents</u>: The Clinton Administration's own CEA chairman and Nobel Prize winner Joseph Stiglitz, for example, explicitly recognized that "the economy was slipping into recession even before Bush took office," that seeds for economic slowdown were sown during the Clinton years, and that any new administration (like Bush's) inevitably inherits economic problems it had nothing to do with.

(2) <u>Second</u>, the Bush Administration inherited a number of economic problems from earlier periods: i.e., the "seeds were sown" in the late 1990s for some key economic problems surfacing in recent years. In particular, the late 1990s' expansion and bursting of the stock market bubble left behind imbalances in most major sectors of the economy. Those imbalances entailed unavoidable, painful, protracted adjustments that adversely impacted economic growth in the years 2001-2003.

(3) <u>Third</u>, the improved, healthy economic performance in late 2003 and 2004 provides further evidence that once administrative economic policy took root, it worked as anticipated. Those successful policies were clearly not the cause of earlier economic sluggishness.

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Macroeconomic Performance Since 2000

Introduction and Summary

This paper reviews events and highlights debate surrounding U.S. macroeconomic performance since 2000. The booming, "new economy" period of the late 1990s, when stock prices and consequently investment and household net worth increased sharply, is examined and found to be unsustainable. This period is associated with a behavioral response to this stock price inflation. This response took the form of commitments or debt obligations as well as increased risk taking that, during the period of asset price inflation, seemed perfectly appropriate. Unfortunately, however, during this boom period the ground work was laid for future painful, protracted economic adjustments and lengthy subpar economic performance following the decline of asset prices.

When the stock market "bubble burst" early in 2000, conditions deteriorated dramatically. Balance sheet distortions became evident as asset (stock) prices fell but the value of nominal debt remained unchanged, inducing net worth to decline. As a result, a host of economic variables (e.g., investment, industrial production, manufacturing activity, employment, real GDP, consumption, net wealth) began to slow or even decline. Notably, the slowdown of these variables was underway in the Summer of 2000: i.e., before the change in administration. But the adjustment to repair balance sheet deterioration was not rapid. These adjustments can take many months, if not years, to complete. In short, the "seeds were sown" during the booming "New Era" period of the late 1990s for a lengthy, subpar period of growth. The associated lengthy adjustment process was inherited by the new Administration when it took office in January 2001.

After reviewing these relevant events in more detail, the paper discusses important policy questions. In particular, the paper establishes three key points about policy:

(1) The paper shows that assertions associating the subpar economic performance in early 2001 with the policies of the newly inaugurated administration are misleading and inaccurate for a number of reasons. The data clearly show that an economic slowdown was underway following the stock market bubble burst in early 2000. A number of important economic variables were clearly slowing by mid-year 2000, well before the January 2001 inauguration date. Furthermore, well-known policy lags imply that the impacts of the new administration's economic policies could not have been observed until mid-2001 at the earliest: i.e., the economic effects of these policies could not have occurred until after the commencement of the 2001 recession.[1] The previous administration's own CEA Chairman and Nobel Prize winner Joseph Stiglitz (among others) explicitly recognized that "the economy was slipping into

[1] The 2004 Economic Report of the President analyzed the revised data and concludes that the recession actually began in the fourth quarter of 2000. (See, Report, pp.30-1.)

recession even before Bush took office,"[2] that seeds for an economic slowdown were sown during the late Clinton years, and that any new administration (like Bush's) necessarily inherits economic problems spawned previously.

(2) Careful analysis shows the boom years of the late 1990s laid the groundwork for an inevitable, lengthy economic adjustment during the period following the stock market decline. Because of the timing of this stock market decline, these necessary adjustments were pushed into 2001 and 2002: i.e., into the new Bush Administration.

(3) The healthy economic rebound in late 2003 and 2004 provides further evidence that once the administration's economic polices were allowed to take root, they boosted economic performance and were not the cause of earlier economic sluggishness.

The Late 1990s' "New Era" Economy

During the late 1990s, economic activity was robust. The macroeconomy was experiencing the longest economic expansion on record. This record-breaking expansion followed the 1980s' expansion, so that the U.S. economy experienced back-to-back two of the longest economic expansions in U.S. history. Although there was a recession in the 1980s, it was short and mild. Accordingly, optimism about control of the business cycle and a more certain future was prevalent. Because economic downturns had become so infrequent and mild since the early 1980s, and the current robust growth was viewed as sustainable, the term "new era" was increasingly used to describe the period's economy. Additional ingredients of this "new era" economy included rapid stock market increases, significant technological innovations and advances, the fall of communism, increased globalization, and a more market-oriented Congress.[3]

Chart 1

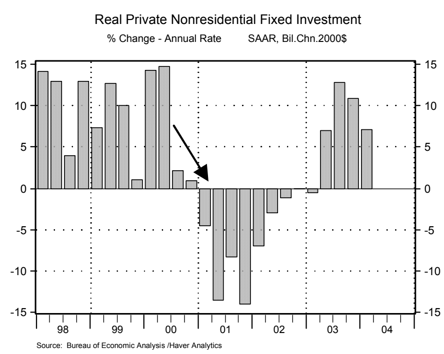
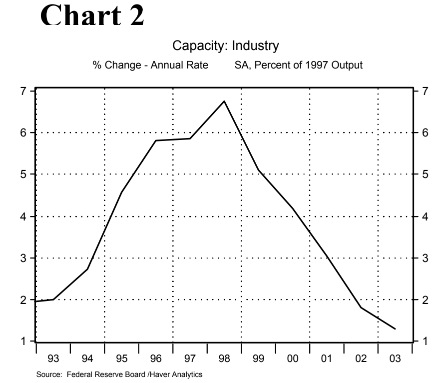


Chart 2



These events of the "new era" were associated with important economic developments such as rapid investment (and capacity) growth, (see Charts 1 and 2), rapid productivity growth, persistently strong consumption and housing advances, net wealth gains, healthy job growth, low unemployment rates, low inflation and interest rates, and a strong dollar.

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[2] Joseph Stiglitz, "The Roaring Nineties" Atlantic Monthly, October 2002, p. 2.
[3] See Robert J. Shiller, Irrational Exuberance, Broadway Books, N.Y. 2001, Chapters 5, 6.

The Late 1990s: Sowing the Seeds for Future Painful, Protracted Economic Adjustments

These economic trends, while impressive, were unsustainable. In particular, the "New Era" economy was associated with an environment where the behavior of households, business, and government changed. Partly to take advantage of expected sustained increased returns to stock and other asset price gains, and partly because of the perception of improved balance sheets, households, businesses, and government invested and consumed more while taking on commitments as well as debt obligations. The 2004 Economic Report of the President (ERP) describes the resulting structural imbalances as stemming from the rapid investment growth in the late 1990s and resulting in rapid capital accumulation and excess capacity. Stock market advances boosted both investment (by lowering the cost of capital) and consumer spending (through increased wealth effects), thereby promoting low savings rates. Research by economist Ray Fair shows that the stock market boom caused (1) increased investment (relative to output), (2) lower budget deficits, and (3) lower savings rates.[4] In this environment, government spending increased as government revenues advanced and constraints on spending eroded. These actions were premised on the expectation of continued sustainable robust gains in asset prices and the perception that balance sheets had improved by some measures (e.g., business debt/equity ratios) during this period. As long as asset prices continued to advance, these decisions appeared to be reasonable. The assumption of more debt obligations produced a financial system more vulnerable to asset price disturbances. A sharp fall in asset prices, for example, would adversely impact or expose balance sheets of households, business, and government, and would force adjustments on these sectors.

From the financial perspective, as stock prices advanced during the 1990s' new era boom, the (marked to market) balance sheets of households improved significantly. Household net worth advanced as liabilities fell relative to assets. Similarly, household debt service burden (as a percentage of GDP) improved. At the same time, business balance sheets improved. Business debt/equity ratios (on a market value basis) fell, signaling improved business financial strength (see Chart 3). Taking advantage of balance sheet improvements, business assumed more debt and extended commitments. Stock market price advances lowered the equity cost of capital and encouraged investment. This is evident as investment grew relative to GDP (see Chart 4.) Further, as government revenues increased owing to economic and stock market advances, the balance sheet of government improved. As households,

Chart 3

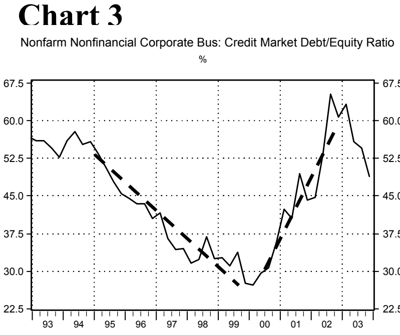
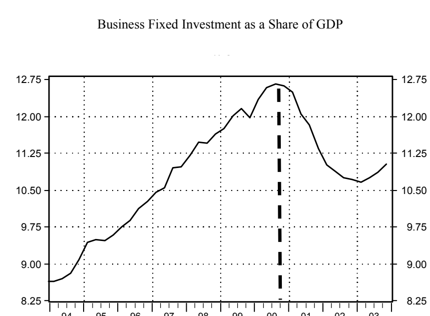


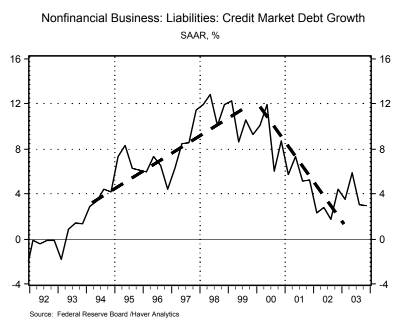
Chart 4



[4] See Ray Fair, "Testing for a New Economy in the 1990s," Business Economics, January 2004, pp. 43-53.

businesses, and government recognized persistent, significant improvement of their balance sheets, however, they began to expect these gains to continue. Accordingly, their behavior began to change; they began to take on additional debt and make commitments premised on the belief of a continuation of stock market and asset price gains. The growth of business debt increased materially (see Chart 5). This increased the vulnerability of the financial system to future asset price disturbances.

Chart 5



In short, in the late 1990s the "the seeds were planted" for future economic adjustment problems should asset prices deteriorate. That is, the die was cast for painful protracted adjustments, which are often associated with extended subpar economic performance.

The Bubble Bursts

Various measures of the stock market indicate the stock market bubble burst early in 2000[5] (see Chart 6). Most of these stock market measures were falling sharply by spring 2000. Notably, most of the decline of the NASDAQ composite index occurred before January 2001, prior to the inauguration of the new Administration. This sharp market decline impacted the market's capitalization as well as the balance sheets of key sectors of the economy. It reduced, for example, household net worth (wealth) and adversely impacted business balance sheets (see Chart 7.) For purposes of brevity, this paper focuses on the adjustment of the business sector.

Chart 6

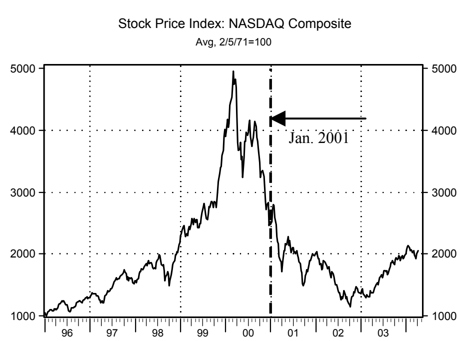
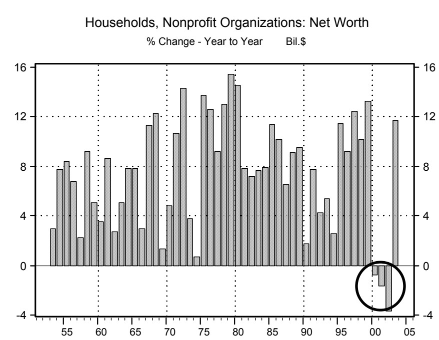


Chart 7



The business sector's debt/equity ratio, for example, had fallen through most of the 1990s when the stock market was advancing sharply (see Chart 3.) This occurred despite a rapid accumulation of debt by the business sector (see Chart 5.)

[5] The Dow Jones Industrial index, for example, peaked in January 2000, whereas the NASDAQ composite peaked in March 2000.

Nonetheless, during the "new era," a falling business sector debt/equity ratio signaled improved financial strength.

As asset prices fell sharply and the stock market "bubble burst" in early 2000, however, the business sector's debt/equity ratio began to increase sharply: i.e., debt increased relative to equity, thereby increasing businesses debt burden. In short, the financial strength of corporate America deteriorated as business balance sheets weakened. This deterioration elicited significant and protracted adjustments on the part of business.

Adjustments following the "Bursting of the Asset Price Bubble"

The requisite adjustments following an asset price "bubble-bursting" are multi-dimensioned and complex. They involve adjustments in both the economic and financial realms. These adjustments have been underestimated by economists partly because stock market (and wealth) variables have not been well integrated into many income-expenditure (flow) macro models of the economy. Further, these adjustments occur only infrequently. The recent stock market bubble, for example, was the largest in several generations.

The recent stock market "bubble bursting" episode affected a number of sectors; its impact was widespread and it has not been assessed comprehensively. Fair's research, one of the few empirical studies of this episode, reminds us that recent stock price movements caused changes in the savings rate, in the investment/GDP ratio, and in the budget surplus, among other variables.

After the stock market peaked and began falling sharply in early 2000, widespread slowdowns followed in a number of the economy's key sectors. Significant slowdowns followed, for example, in the growth of investment and to a lesser extent the growth in consumption. Stock price declines, after all, directly translated into increases in the cost of investment capital and into diminished wealth effects adversely impacting consumption. Stock and Watson found that while many traditional leading indicators failed to predict the 2001 recession, stock prices correctly predicted that economic growth would slow. Further, they showed that investment declines lead to falling manufacturing output.[6] Declines also occurred in the growth of real GDP, manufacturing and industrial production. Compared to earlier business cycles, the slowdown was particularly pronounced in investment (and consequently manufacturing) as well as in employment. The employment weakness, however, was concentrated in manufacturing. Requisite adjustments forced on these sectors were lengthy and protracted; they sometimes lasted several years to work themselves out of the system.

The adjustments foisted on the economy also have a financial dimension. The asset price deflation associated with the "bubble bursting," after all, is a financial event

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[6] See James H. Stock and Mark W. Watson, "How Did Leading Indicator Forecasts Perform During the 2001 Recession?", Federal Reserve Bank of Richmond Economic Quarterly Vol. 89, No. 3, Summer 2003, pp. 71-90.

that impacts the balance sheet of key sectors of the economy and forces lengthy adjustments on these balance sheets. Deflating asset prices may cause debt burdens to increase and balance sheets to deteriorate. This, in turn, forces downward adjustments in the growth of debt and business spending (investment). Debt-equity ratios increase while debt accumulation slows. Responding to an asset price "bubble bursting" can involve a lengthy adjustment process taking years to complete. When such adjustments occurred after 2000, they often reflected events that occurred earlier, during the previous administration.

Implications for Policy

"Bubble-bursting" events have both economic and financial effects. These effects are associated with lengthy, time-consuming, protracted adjustments of key economic sectors and their balance sheets. In this instance, adjustments – which were necessitated by the excesses of the late 1990s – were foisted on the economy during the period following the stock market decline, during late 2000 and the early years of the Bush Administration. In short, the Bush Administration inherited these lengthy, delayed adjustments. This does not imply that Clinton Administration officials were responsible for, or acted to undermine the early Bush economy, but rather that this bubble and its delayed adjustment effects were sown earlier, before the Bush Administration took office.

Contemporary Policy Issues

Having reviewed relevant economic circumstances surrounding the events of the recent price "bubble," we turn to a discussion of related policy issues. An understanding of economic and financial events surrounding the bursting of the stock market bubble makes for better policy evaluation.

This paper makes three policy-related points relevant in current economic policy discussion. **First**, a frequent criticism of the Bush administration policies has been repeated by various opponents of those policies. Their contention is that following a "near perfect" economic performance under the previous administration, the sluggish, subpar macroeconomic performance recorded during the early years of the Bush Administration was directly attributable to the adoption of inappropriate Bush economic (tax cut) policies. That is, Bush administration policies caused the subpar economic performance which began in January 2001. A review of the circumstances surrounding the "bubble bursting" episode clearly indicates that this argument is factually incorrect for the following reasons:

- ***Timing Inconsistencies*:** A host of key economic data series shows that the macroeconomy began slowing shortly after the stock market decline (or "bubble-bursting") in early 2000, well before the change in administration in January, 2001. A comprehensive list of economic data supporting this argument is extensive. The list highlighted here is illustrative. Clearly, the stock market (as measured by the Nasdaq composite) fell sharply beginning in March 2000.[7] Indeed, a forty-five percent decline in the Nasdaq composite index took place prior to the change in administration in January, 2001. This reduction translated into losses in household net worth beginning in the fourth quarter, 2000[8] prior to the Bush administration. Indeed, the decline in net worth on a year-over-year percentage change basis occurred in 2000 for the first time since flow of funds data were collected in 1953. This decline was <u>unprecedented</u> and adversely impacted the growth of real consumption, which slowed significantly from a better-than 5.5 percent annual rate in the year prior to the stock market crash, to about the 3.3 percent range immediately after the stock market declined, but before the change in administration.

The deflation of stock prices, of course, adversely affected <u>investment</u> as well. A decline in stock prices raises the cost of capital, thereby reducing investment. Business investment growth, in fact, fell from double-digit rates in the year prior to the crash to about 1.5 percent in the two quarters immediately prior to the change in administrations. The investment decline was concentrated in the equipment and software component. With the growth slowdown of both investment and consumption, real GDP growth slowed significantly as well. In fact, real GDP growth declined from about a 4.7 percent annualized rate prior to the stock market decline to a 0.8 percent annualized rate in the two quarters immediately preceding the change in administration.

Other key economic variables also follow this pattern; they weakened after the stock market decline as well as prior to the inauguration of January 2001. Industrial production, after advancing for a considerable period, fell in both the third and fourth quarter of 2000, after the stock market decline but prior to January 2001. Manufacturing activity – as measured by the Institute of Supply Management (ISM) index – began contracting in August of 2000 and continued to contract until well after January 2001. The same pattern is evident in changes in payroll employment: i.e., gains in employment fell from robust monthly advances to meager gains in mid-2000. Notably, manufacturing employment had been declining since March 1998.

In sum, most key economic variables began slowing shortly after the stock market decline and well before the change in administrations in January 2001. The economy began weakening, therefore, well before the Bush inauguration. Consequently, a sluggish economy cannot be attributed to Bush economic policies since the sluggishness predated the Bush administration.

- ***Policy Lags*****:** It takes time for policy to be implemented and for it to take effect. A number of unavoidable lags exist between the inauguration and recognition of the need for new policy, the implementation of new policy, and the economic

[7] The Dow Jones Industrial index peaked earlier.
[8] These flow of funds net worth data include contributions from homes.

impacts of that change in policy. Additionally, when a new administration comes into power, understandably, there is an "organization lag."

The combined duration of these various time lags is likely (conservatively estimated) to be 6 months at a minimum. Accordingly, the economic effects of the new administration's economic policies could not have been observed until mid-2001 at the very earliest. In other words, <u>the earliest possible impacts of new Bush policies could not have occurred until **after** the 2001 recession had begun. Therefore, the sluggish, weak economy (and recession) in the early months of the Bush Administration cannot properly be attributed to Bush economic policies.</u>

- ***Concessions by Opponents*****:** A number of these views were explicitly endorsed by certain economic spokesmen of the previous administration. President Clinton's own CEA Chairman and Nobel Prize winner Joseph Stiglitz explicitly recognized that "…The economy was slipping into recession even before Bush took office…."[9] Stiglitz also noted that the seeds for future economic retrenchment and slowdown were sown during the Clinton years.[10] Stiglitz stated, for example, that "…in the very boom were planted some of the seeds of destruction, <u>seeds which would not yield their noxious fruits for several years</u>…"[11] Further, Stiglitz recognized that any new administration, like Bush's, inevitably inherits economic problems it had nothing to do with. Such new administrations have to "play with the hand they are dealt."[12] The finishing touch to this argument was added by the previous administration's CEA member, Jeffrey Frankel:

> As convenient as it would be for the Democrats to be able to claim that Bush fiscal policies caused the weak economy of the last three years, good economic logic does not support that contention.[13]

Furthermore, it is relevant to note that newly released transcripts of the (detailed) FOMC minutes, indicate that the Federal Reserve Board Chairman, several Federal Reserve Bank Presidents, and some senior Board staff all recognized recessionary indicators (especially in manufacturing) as early as 1998. [14]

In sum, the argument that Bush administration economic policies caused and are responsible for the sluggish, weak economy in the early years of that administration is factually incorrect because of time inconsistencies and the lags of economic policy. Further, key officials of the previous administration conceded

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[9] Joseph Stiglitz, "The Roaring Nineties," <u>The Atlantic Monthly</u>, October 2002, p. 2 of 10. See also Joseph Stiglitz, <u>The Roaring Nineties</u>, Norton, NY, 2003, p. 322.
[10] <u>Ibid.</u>, pp. 9, 219, 3.
[11] <u>Ibid.</u>, p. 9, underline added.
[12] <u>Ibid.</u>, pp. 33, 322.
[13] Jeffrey Frankel, "It's a Tough Job to Create Jobs," <u>Washington Post</u>, Saturday April 11, 2004, p. B30. (Frankel was a member of President Bill Clinton's Council of Economic Advisers from 1997 to 1999.)
[14] See Federal Open Market Committee transcripts released in late April 2004 (after a five year embargo). See also, for example, Greg Kaza, "Clear Signs of Deterioration," <u>National Review Online</u>, May 4, 2004.

that this was the case. And those concessions were (implicitly) corroborated by observations of Federal Reserve officials.

A **second** important point related to assessments of the economy in recent years is mentioned above: namely, that the Bush administration inherited a number of economic problems from earlier periods. That is, “seeds of destruction” were sown during the stock market boom of the late 1990s. These “seeds of retrenchment” would yield their “noxious fruit” only over an extended period of time (perhaps for several years.)[15]

The bursting of the stock market bubble, for example, left distorted portfolios in most sectors of the economy, investment imbalances, and household net worth losses requiring large, protracted (multi-year) financial adjustments to regain normal equilibrium. These required protracted adjustments, in turn, adversely impacted several years of economic growth in 2001-2003. In short, the effects of the various imbalances associated with the late 1990s brought about adjustments causing consumption, investment, and hence, economic activity to be weaker than otherwise. These adjustments help to explain weaker-than-normal economic activity in 2001-2003.

A **third** observation relating to the policy debate about macroeconomic performance pertains to the recent improvements in economic growth. In particular, the economy has expanded at a robust 4.9 percent annualized growth rate over the last four quarters (an improvement over more modest growth during the first seven quarters of recovery.) Further, consensus forecasts of the economy project better-than 4 percent growth for the near-term future. This improved performance provides further evidence that once the administration’s economic policy finally took root, it worked as anticipated. This vigorous economic expansion indicates that the prescribed economic and tax cut policies proved potent. These successful policies boosted the economy and therefore were obviously <u>not</u> the cause of the earlier economic sluggishness.

<u>Summary and Conclusions</u>

After reviewing economic and financial events influencing U.S. macroeconomic performance since 2000, this paper establishes three points related to economic policy. <u>First</u>, Bush administration policies did not cause the subpar economic performance experienced immediately after January 2001. Timing considerations and evidence, recognized policy lags, and concessions by opposition economic spokesmen support this contention. <u>Second</u>, the Bush administration inherited a number of economic problems associated with the stock market bubble and its various remnants. These problems were created in earlier periods and left adjustments unfinished for later periods. <u>Third</u>, the recent improvement in economic growth provides further support for Bush economic policies. This recent economic performance suggests that once Bush economic policies took root, they proved to be potent and were not the cause of earlier sluggishness.

[15] See Stiglitz, <u>op. cit.</u>, p. 9.