Symposium of Institute for International Monetary Affairs
"Prescriptions for Recovery of the World Economy"

Remarks by
John Lipsky
Chief Economist and Director of Research
The Chase Manhattan Bank

Before anything else, I would like to thank Gyohten-san, the esteemed Director of the IIMA, and his colleagues for the opportunity to appear today together with such impressive presenters and before such a distinguished audience.

The topic of the Symposium is critically important: What can be done to help reverse the global growth slowdown that has been underway since Asia's crisis began in mid-1997? And how can the international financial and economic system be made more stable?

Global growth this year likely will be the slowest of the entire 1990's, perhaps no more than one percent. At the same time, the rise in volatility and the heightened risk in global financial markets – that reached crisis proportions during September/October last year – has not been reversed or solved in any meaningful way.

Recent developments aren't purely negative, of course. In particular, the industrial countries of Europe and North America have moved toward sustainable price stability, accompanied by relatively low budget deficits, or in the case of the United States, a budget surplus. With no end to the expansion in sight, low inflation and relatively low interest rates have boosted investor optimism, powering equity market values higher, further reducing the cost of capital to corporations.

The potential for new progress is particularly evident in Europe, where the creation of the euro hopefully will enhance momentum toward regional integration and structural reform. The Japanese economy also is showing signs of structural improvement, if not yet of stronger growth. These latter two issues will be covered by other speakers today.

My main point should be obvious. That is, the latest developments have created both dangers and opportunities to an unusual degree.

I am going to address three issues today: First, I am going to discuss the U.S. outlook, and explain why I am optimistic, but still expect a substantial slowdown in 1999 U.S. growth. In addition, I will discuss briefly the role of hedge funds. Finally, I will make a few remarks about the current debate with regard to what is now called "the international financial architecture".

The U.S. Outlook

First; the U.S. outlook: One of the most clearly positive aspects of current developments has been the exceptional recent performance of the U.S. economy. Of particular note, U.S growth has exhibited impressive resilience during the past year and one half, despite falling growth elsewhere. More broadly, the current U.S. expansion is now the longest peacetime expansion on record, following the 1982-90 expansion, that was the second longest on record.

This U.S. “Long Boom” is notable in itself. Nonetheless, the U.S. performance has been particularly impressive during the past three years. Sustained brisk growth has reduced the unemployment rate to thirty-year lows. Despite the low and falling unemployment rate, however, unit costs have not accelerated. Rather, broad inflation measures have slowed to the lowest pace in more than thirty years.

Sustained strong growth in business fixed investment has been concentrated in high technology equipment. Productivity gains have been accelerating, following a twenty-five year slowdown. These developments have encouraged optimism that the U.S. economy’s long-term growth potential may be increasing, at least to some degree.

With growth strong, unemployment low, and inflation slowing, it is not surprising that interest rates have fallen substantially. Together, these factors have pushed the federal budget into a surplus last year of about $70 billion dollars, an outcome unimaginable only a few years ago. Moreover, the latest budget forecasts -- that we consider broadly plausible -- indicate that the surpluses could be sustained far into the future.

Given the striking contrast of the U.S. economy’s performance with that of other G-7 countries, it is natural to wonder what factors explain the exceptional U.S. results, and to ask whether they will endure.

In my opinion, the United States – among other things -- is finally reaping the benefits from 20 years of sustained anti-inflationary monetary policy. During that period, the Federal Reserve has been more forward-looking in its analysis, more decisive in its actions and more clearly focused on achieving low inflation than was the case previously. As a result, not only has inflation fallen persistently, but expectations of future inflation also have declined, reflecting the growing credibility of U.S. policy.

The resulting drop in long-term interest rates has encouraged capital-intensive investment, while new funding instruments have been developed that are particularly suited to financing investment in new technologies.

For example, it should not be surprising that innovations such as venture capital funds and high-yield debt -- in addition to new equity issuance -- have been used frequently to fulfill the substantial up-front capital requirements that characterize much of the latest advances in communication and other network-based technologies.

The point here is straightforward: The combination of sustained anti-inflationary monetary policy and financial deregulation have played an important role in improving U.S. economic performance.

Other factors have been important as well, of course, including the success over the past twenty years of gradually restoring fiscal balance. Moreover, for the first time in three decades, taxpayers and investors no longer fear huge, unanticipated increases in the federal deficit –events that in fact had occurred in the 1960's, the 1970's and again in the early 1980's.

One conclusion is that the good U.S. performance of the past few years resulted more from good policy than from good luck. Thus, there is reason to think that the relatively favorable U.S. performance can be sustained in the future, if policies remain appropriate.

But that does not mean that there are no risks, or that the rapid growth pace of the past few years can be sustained unaltered. In fact, many analysts have pointed to potential vulnerabilities of the US expansion: For example, the U.S. current account deficit widened last year to nearly 3.5% of GDP, similar to the deterioration that occurred in the mid-1980's. Put another way, continued U.S. economic growth appears at present to depend upon large inflows of foreign capital.

However, comparisons with the mid-1980's are misleading: Today, the dollar likely is modestly undervalued. In the mid-1980's, it was grotesquely overvalued. The recent widening of the U.S. trade deficit has not reflected a surge in imports, as was the case 15 years ago. Rather, the principle problem is a shortfall of exports, caused mainly by weakening economic growth outside the United States. If global growth were to be restored, the U.S. deficit would be reduced significantly, as would the use of foreign saving.

Nonetheless, with the current account deficit widening at a record pace last year, the U.S. expansion depended entirely on the willingness of households to expand consumption spending in inflation-adjusted terms at a pace much faster than the increase in real disposable income. As a result, the household saving rate fell to record lows.

According to the Chase Research forecast, this rapid consumer spending growth will not be sustained in 1999. Rather, we expect that spending will slow gradually to be more in line with income gains. If so, GDP growth this year will diminish to a pace of about 1 percent, down from about 4 percent in 1998. Rather than emphasizing the implied risk of an eventual downturn, it would be more accurate to characterize our forecast as one of a natural re-balancing of household finances, following the unprecedented impact of two major windfalls – that is, record wealth gains and unexpected real income gains – whose effects are waning and that are not likely to be repeated. As a result, while there is good reason to expect a slowdown in growth, there is no reason to expect that we have reached an end to the U.S. expansion.

To understand the U.S. outlook, it is necessary to ask why consumer spending has remained strong, especially during last year's second half. Many observers claim that this was solely a result of the “wealth effect” of rising stock and real estate prices on household balance sheets. Households feel wealthier, so the story goes, and therefore they spend a higher percent of their income….in fact, all of it and more. According to this view, the Federal Reserve’s rate cuts last year helped to spur the stock market, boosting consumption.

This view also would suggest that future U.S. growth depends more than anything right now on Wall Street. To the optimist, this means that the U.S. economy will continue to expand at a rapid pace, despite the lack of saving. To the pessimist, the United States risks suffering the after-effects of its own “bubble economy”, especially if the U.S. stock market weakens, as many expect.

To the optimist, the expansion is secure: According to this view, there is no reason to expect households to slow down their spending: Consumer confidence is high, job growth remains strong, and interest rates have fallen. As a result, the stock market isn’t under threat.

To the pessimist, it is easy to conclude that U.S. equity values are too high: After all, aggregate corporate profits probably declined last year, and it is likely that they will decline again this year. In this pessimistic view, the US equity bubble surely will burst, dropping the US into a recession.

Although the latest U.S. GDP figures have encouraged the optimists, my Chase Research colleagues and I do not agree fully with either view. However, we have concluded that the “wealth effect” boost to US spending has been over-estimated. If the recent past is any guide, the increase in consumer spending last year was about twice as high relative to wealth increases as would have been expected. Either U.S. households suddenly have become highly sensitive to wealth increases, or an additional explanation is needed for the 1998 consumption surge.

Moreover, claims that the U.S. equity market is in a bubble phase ignore the clear 1997 inflection point in the market’s rise. That is, between the end of Fed tightening in February 1995 and the outbreak of the Asian crisis in July 1997, the Dow Jones Industrial Average increased at a compound annual pace of 30%. Since then, the equivalent rate has been about 9%. This doesn’t mean that a stock market drop is out of the question – markets can go down as well as up. But it does suggest that the market hasn’t been as “irrationally exuberant” as some critics have claimed. Still, unless there is a new acceleration in stock market gains, the wealth effect should begin to wane this year.

In our view, the unexpected drop in inflation last year was the extra element that explained the strength of consumer spending. Even after Asia’s crisis had begun in mid-1997, 1998 forecasts anticipated U.S. inflation of 3% or higher. The unexpected drop in inflation last year to about 1.5% or less converted last year’s 4% average wage gains into a substantial increase in real wages, helping to boost spending. At the same time, the drop in inflation eroded corporate profits, as firms were unable to pass on wage and other increases, as they had anticipated. In effect, the sudden decline in inflation transferred income from producers to consumers.

In typical U.S. cyclical slowdowns, rising capacity utilization rates and declining unemployment eventually produce higher inflation and interest rates. These factors generally lead to slowing job growth and stagnant wages, thus providing a signal to households to slow their spending. Last year, these slowdown signals simply were not transmitted.

In the absence of the standard warning signals, therefore, it was not so surprising that household spending growth surged when measured in real (that is, inflation-adjusted) terms. Only some of this spending was financed by realizing capital gains on equities. Much more was financed by new borrowing – after all, household debt service burdens reached an all-time high.

We expect, however, that income growth and job gains will slow this year, weakening spending. With profit margins squeezed, and with pricing power diminished, corporations will have to reduce the rate of unit cost growth in order to restore profits. The signs of such action already are emerging. For example, the volume of layoff announcements associated with corporate restructuring has surged back to the record highs recorded during the so-called “jobless recovery” of 1993/94. At the same time, corporations likely will try to restrict real wage increases this year by slowing nominal wage increases. If these trends are sustained, as we expect, consumer spending growth likely will slow to about 2% in real terms, from more than double that pace in 1998.

At the same time, the continued slowdown in growth outside the United States, mainly in Europe and Latin America, will continue to weaken the U.S. external balance, although not at the record pace of 1998. Moreover, the rise in excess capacity, the drop in corporate profits, and the rise in credit spreads in the U.S. corporate bond market all indicate that business fixed investment will slow somewhat from the double-digit pace of the past few years.

Thus, despite widespread expectations that the US expansion will remain rapid, the Chase Research forecast is much more muted. But there is no reason to expect that the United States will have reached the end of the “Long Boom”.

This a very positive outlook, despite the expected slower growth, in part because we expect that inflation will fall again in 1999. Even more important, we expect that the low inflation will not be viewed simply as the result of temporary external factors. Rather, with inflation expectations still well above actual inflation -- and with wage gains slowing – the surprise of 1999 will be the sustainability of low U.S. inflation for years to come.

Not surprisingly, then, we are optimistic about the likelihood of a new U.S. bond market rally that will carry long-term Treasury yields into a 4% - 5% range. At the same time, we expect that the Federal Reserve will lower the funds rate by at about 75 to 100 basis points by the end of the year, simply in order to establish a neutral policy stance. We also expect the dollar to strengthen moderately versus the yen, as Japanese monetary policy appropriately becomes more expansionary. The dollar likely will remain strong against the new euro.

I should warn you that these views are not at all consensus views. Right now, market prices suggest that the Federal Reserve is expected to hold rates steady, and my guess is that most analysts and investors expect the bond market to remain within current ranges.

Hedge Funds

Turning to the issue of the role of hedge funds, much has been made about the hedge funds' importance in fomenting last year's severe financial market turmoil. And I expect that you are aware that a recent Federal Reserve report has been critical of private sector risk management in the case of Long Term Capital Management.

No doubt, the importance of the hedge funds in the 1997-98 financial market instability will be debated for a long time. Rather than enter into this debate, however, I would like to express my confidence that these funds are not likely to represent a significant new threat to stability anytime soon.

As a result, I am somewhat concerned that the policy debate about the hedge funds could lead to recommendations that easily could cause more harm than good. For example, the claim that hedge funds should be compelled legally to increase their disclosure sounds reasonable. It should be recognized, however, that U.S. hedge funds typically operate off-shore. Therefore, implementing binding reporting and control requirements could imply the creation of a debilitating and bureaucratic system for registering offshore transactions.
The impact of such a move easily could stifle markets, without any clear gain.

In fact a note of clarification likely is worthwhile here; Despite typical press reports, the problems that afflicted LTCM's creditors largely reflected their relations with securities firms, not with U.S. commercial banks. The involvement of those few U.S. commercial banks included in the "rescue" effort reflected mainly concerns about the potential weakness of securities firms, rather than their direct exposure to LTCM.

As such, this indicates that in assessing the potential difficulties, the primary focus should begin with the relation of securities houses to hedge funds. In the U.S. context, this is an issue for the Securities and Exchange Commission, rather than for bank regulators.

At the same time, it is reasonable to expect that bank reserve requirements with respect to hedge fund lending should be reviewed. While changes in these requirements may be adopted, market conditions and heightened lender caution already has limited the leverage of hedge funds even in advance of any regulatory action. Finally, bank lending to hedge funds overwhelmingly remains covered by high-quality, liquid collateral.

My principal point should be clear: The hedge funds at this time do not represent a significant threat to financial stability, even in the absence of new regulatory and legal measures.

International Financial Architecture

I was asked to comment on the implications of recent events for the “architecture” of the international financial system – as it is now called typically. This is a topic that defies a simple summary, so my remarks will be very limited.

First of all, the events since July 1997 have demonstrated that the international crisis management system is itself in crisis. In short, our “system” -- the ad-hoc combination of the IMF supported by key G-7 countries -- is not well adopted to a world of open capital markets in which cross-border financial transactions take the form of marketable securities.

A market-based system works well if market discipline is effective. Such a system cannot rely for regulation primarily on discretionary, after-the-fact attempts to throw together IMF-led “rescue packages”, complete with instant structural reform programs. This point has become recognized widely during the past year.

I will leave aside today any theoretical discussion about whether open international capital markets -- if implemented sensibly -- spur long-term economic efficiency and stability. Despite the problems of the past few years, and the widely-reported remarks of prominent skeptics, the proposition that capital market liberalization is a justifiable goal still seems to be accepted widely. The challenge is not to define an alternative to market liberalization, bur rather how to reach the goal of openness successfully, while avoiding new episodes of financial and economic disorder.

Just as the success of the post World War II system was based on the gradual move toward more open current account transactions – coordinated through the IMF and the GATT – today the IMF’s Articles of Agreement should be amended to include capital account liberalization as a goal of IMF membership. In that case, the international community can organize and supervise the liberalization of capital account transactions on a gradual, rational basis. But this measure, that was endorsed by the IMF’s Interim Committee as recently as the 1997 IMF Annual Meetings, seems to have fallen to the side in the wake of recent troubling events.

Rather than attempting to discuss “international financial architecture” in any detail, I will only suggest that the current discussions underway in many forums are not likely to result in any sweeping agreements any time soon. By the way, this topic is summarized very well in the current edition of the London-based *Economist* magazine[1]. As is pointed out there, a basic problem for the current debate is that the three most widely-held goals for reform – including preserving national sovereignty, cushioning financial market instability, while benefiting from global capital mobility – likely cannot all be achieved at the same time.

In practical terms, the latest reform effort likely will produce results that are modest, rather than grand. The industrial countries should improve their own markets, including a review of bank capital requirements, and expanding disclosure

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requirements. For the emerging market countries, proposals for contingency financing facilities should be explored, especially in the context of IMF-sponsored programs.

Finally, the 1990's have not been the decade of globalization, as is usually claimed, as much as it has been the decade of regionalization. The growth in trade, capital flows, and financial flows has been much more rapid within regions than between regions. Chase Research discussed this point in some detail in our October 1997 publication, *Globalization is Regionalization*.

The practical implications are clear: The moves toward European financial integration already are profound, but they are far from complete. One way or another the financial ties between the United States, Canada and Latin America are going to become even more intense.

The greatest challenge for regional integration however, is found here in Asia. Nowhere has the trend toward greater regional flows been more striking. Asia's economies continue to undergo dramatic change. Japan is embarking on a profound period of structural reforms. The outcome of Chinese reforms is not yet certain, nor is that country's timetable set for increased financial openness Thus, it is difficult to imagine the exact role of an "Asian Monetary System" or "Asian Monetary Fund" at this time.

In practical terms, the most powerful aid for Asia would be a restoration of Japanese growth, and success in implementing structural reforms.