

tinued expansion. Over the past year, consumption has risen 4.7%, with the rate of increase rising above 6% in the first two quarters of this year. This spending spree has outstripped the growth in household income (as measured by the Commerce Department), causing the personal saving rate to fall to only 0.1% of disposable income in the third quarter.² Clearly this surge has been driven partly by the enormous increase in wealth resulting from the remarkable stock market advance of the past three years. The question for the immediate future is how consumers would react to market performance more in line with historical norms, or even to a period of market weakness. At the least, a continuation of the recent rapid growth in consumption seems unlikely.

In the face of these problems, we expect economic growth to slow in 1999. We also expect inflation to worsen a little from its current very low level. To be more specific, we expect real GDP to rise about 2% during 1999, with inflation rising back over 2%. If this is the case, employment will increase about 1 million, considerably below the rate of recent years and slow enough to boost the unemployment rate back to about 5%.

In part, this scenario is premised on our expectation that the Fed will continue its easing of monetary policy begun in late September. The Fed will probably feel constrained from a drastic reduction in short-term rates by the potential inflationary pressures mentioned above. If, however, the economic picture becomes darker than we foresee, more significant easing by the Fed would certainly occur.

Our outlook presumes that the international environment, though remaining weak, does not experience significant further deterioration, allowing U.S. exports to stabilize and then begin growing again later in the year. Households should be more restrained next year, leading to a retrenchment in purchases of durable goods and in residential investment. If households pull back more drastically than we anticipate, or if the international situation continues to worsen, the outlook for the U.S. economy will be darker and an end to the expansion cannot be ruled out.

In summary, the past year has been a very good one for the U.S. economy. Output has grown strongly, leading to rapid job creation and falling unemployment. Inflation, already low, has come down even more. Interest rates have fallen to very low levels. We think the next year will be one of continued growth, though not at recent rates. Growth will decelerate, while unemployment and inflation will edge up a little.

We do not, however, view this as a pessimistic outlook. At some point, a continuation of growth like that of the past three years would lead to excess, requiring a potentially painful correction. Given the problems in other parts of the world economy, and

the imbalances in the domestic situation, a slowdown seems better than the possible alternatives.

Notes

1. Alan Greenspan, statement before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 21, 1998. Reprinted in *Federal Reserve Bulletin*, Sept. 1998, pp. 735-742. The testimony and accompanying report can be accessed at: <http://www.bog.frb.fed.us/boarddocs/hh/>.

2. Income, as defined in the National Income and Product Accounts, does not include capital gains on security holdings. Recently, the definition was revised to also exclude capital gains dividends paid by mutual funds.

The Financial Markets

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The past few years have been kind to the investor. It hardly mattered if your choice was bonds or common stocks; both provided favorable performance. Now, unfortunately, some fundamental questions are hanging over the financial markets like a black cloud:

- Are the problems in Asia, Russia, and Latin America behind us? Or will these economies, particularly those in Russia and Southeast Asia, continue to be a drag on the world financial markets?

- Will interest rates continue to slide downward, generating solid returns on long-term bonds and common stocks? Or, in the process of interest rate declines, will we catch the "Japanese disease" of low interest rates and no economic growth characteristic of an economy in deflation?

- Will the establishment of trading in the euro, the common European currency, be a positive or negative influence on U.S. financial markets?

- In light of all the turmoil around the world, will the profits of U.S. corporations hold up? What will this mean for the stock market?

- How will the risk in the markets be perceived by investors? Will there be a flight to quality?

Economic Problems Around the World

The Asian, Russian, and Latin American economies continue to suffer. Southeast Asia grew fast, expanded capacity, and watched currencies collapse last year. Just recently, however, hopeful signs of recovery have

been observed. The currencies have stabilized and common stock values have risen modestly. In South-east Asia, the good news is that most of the riots have been quelled. Moreover, the economies fell so hard last year that they have no place to go but back up! The bad news is that the fundamentals of these economies remain weak: high unemployment rates and a corporate governance system that favors political connections over merit. In our opinion, a long period of restructuring is required to rehabilitate the countries to become truly capitalistic. The old political operatives may be in the background now, but they are still there waiting to ascend to power once again. The work ahead for the IMF and other organizations is to stabilize the economies first and then restructure them to be healthy growth engines in the future. This will take time to accomplish.

Likewise, the already shaky Russian economy worsened when it decided to place a moratorium on the debt payments to its creditors. This evidently came as a surprise to many speculators, who were fat and happy earning large returns by investing in Russian bonds. To complicate matters, the health of President Yeltsin is in question and the recent shakeup of the government calls into question who is really in control in Russia. Similar concerns exist in the other former Soviet republics. At the same time, Brazil recently witnessed large capital outflows from the country, and other Latin American economies are not experiencing the fast growth rates enjoyed in the past.

The financial markets responded negatively to these economic developments. But now that help is on the way from international agencies, and some signs of recovery are visible, the outlook has improved somewhat. Thus, we see stabilization in these countries and signs of slow but positive economic growth that will modestly reduce the drag on our economy.

Interest Rates

We forecast a continuing decline in interest rates, but at a much slower pace than in the past few years. Rates have declined dramatically in recent years, providing fuel for the powerful rallies in the stock and bond markets. Homeowners have refinanced mortgages at a rapid pace, some of them two or three times in the past couple of years. The refinanced mortgages at lower rates put more monthly income in the pockets of homeowners, enabling them to keep spending. In a similar vein, lower refinancing rates have enabled the U.S. government to borrow at lower rates, furthering progress on reducing the federal budget deficit. All of us have benefitted from the lower interest rate environment.

Looking ahead, the interest rate outlook should remain favorable. The Fed has just completed two rate cuts to stimulate the economy and stem the weaken-

ing financial mood in the country. As of late October, the medicine has worked. We see another round of modest rate cuts by the Fed. We forecast low levels of inflation, so there will not be large inflationary pressures on interest rates. We do not see the deflation some pundits are predicting. The only upward influence on interest rates we can see is if the Japanese sell massive holdings of U.S. government bonds. A sell-off earlier in the fall spooked the markets and sent interest rates higher. Fortunately, the move was temporary and not indicative of a fundamental portfolio adjustment on the part of the Japanese. The episode did, however, remind the government bond markets of the influence of the Japanese debt holdings.

The Impact of the Euro

On January 4, 1999, a new era begins in Europe: The euro will become the official currency of 11 key European economies, with the exception of the United Kingdom. Whether this move will be good or bad for the U.S. is a concern. Clearly, the euro should be strong initially to gain the support of trade partners and financial markets, but not so strong as to hurt exports and economic activity. This is a big issue in Europe in light of the relatively high unemployment rates there. Given the recent interest rate cuts in the U.S., there will likely be a round of European interest rate cuts to keep the European export position from deteriorating. In our opinion, this would be good news for the world economy and the United States.

In the long run, the establishment of the euro should be a positive development for all European trading partners, including the United States. No longer will a tangle of foreign currency exchange rates need to be negotiated as goods and services are supplied to all of continental Europe. Trade will be simplified, which is good. Unfortunately, there will probably not be as strong a tendency to adhere to fiscal and monetary discipline in a group setting as with an individual nation. A key here is the position of Germany, which has been firmly resolved against any measures hinting of inflation. Will the same resolve be evident in the combined governing body supervising the euro? Will the leftward tilt in recent European elections affect this resolve negatively? We hope the collectivist nature of the body will not lean toward rapid inflation, which would be highly detrimental.

Corporate Profits

Our forecast is for corporate profits to decline for three reasons. First, there will be some increase in unit labor costs due to moderate wage rate inflation. Second, the wage inflation will not be offset by productivity increases. Third, price inflation will not be high enough to offset the other two effects. Thus, we predict a squeeze on corporate profit margins next

year, resulting in lower profits. Easy corporate cost-cutting measures taken in the past to raise profits are virtually exhausted, and the economic environment we project for 1999 does not lead to higher profits.

Of course, lower corporate profits generally lead to declines in stock prices. Damage to the overall stock market already occurred in late summer and is continuing for some individual firms that do not match up to earnings expectations. This is a particular problem now for the banking sector. The lower interest rates we forecast will help offset the decline in profits for all firms, including banks, indicating that the stock market will drift sideways next year. Also helping the market overcome the profit decline is the lower probability of a recession occurring this year. This probability was much higher earlier in the summer.

Market Risk and the Flight to Quality

A big determinant of stock market direction in 1999 will be investor perception of risk. Because the market has been a powerful wealth creator for investors over the past few years, most investors are sticking with it after the late summer sell-off. If many decide to leave the market because it is viewed as too risky, buying support could weaken and stock prices will fall.

A number of factors influence the risk of the market. Interest rate uncertainty, global crises, banking failures, negative profit surprises, and political upheaval could all lead to a judgment of more risk in the market. Higher risk perceptions would lead to stock price declines greater than we currently expect.

In our opinion, the market is fragile right now concerning risk. We have weathered the collapse and rescue of the Long Term Capital Management hedge fund, impeachment proceedings against the president, numerous international problems, and some poor earnings reports from important companies. Unfortunately, more could happen. In particular, a severe crisis could occur in the Japanese banking sector because the banks in Japan continue to sit on bad loans that need to be written off. Given the importance of those banks in funding Japanese business, a banking crisis there could be very harmful to its economy and the others in Asia. Further, such a crisis would hasten the Japanese to sell U.S. government bonds to raise liquidity. Such a move would put upward pressure on interest rates in the United States. Although there is always a chance of such a crisis, we do not see it developing.

Summary

To sum it all up, we expect financial markets in 1999 to drift sideways, with a modest reduction in interest rates. Inflation will be under control and, with a bit of luck, we will avoid the international crises that could negate this forecast and put all of us in a bad mood.

International Trade and Foreign Investment

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The Asian crisis that began in the latter part of 1997 ushered in a global financial crisis in 1998. It affected not only stock markets and exchange rates in Asian countries, Russia, and Brazil, but also a broad spectrum of the world's economic conditions. Tremendous fluctuation in economy and business—a repeated theme everywhere these days—will likely continue in 1999. The Dow Jones Industrial Average has gone through several near-record ups and (mostly) downs thus far this year. The Japanese yen appreciated from ¥145/\$ to ¥110/\$ in a couple of months and had a record daily gain recently. Our trade deficit reached an all-time high, and foreigners have amassed their investments in the U.S. at a record pace. The prediction of international trade and foreign investment for 1999 has naturally become more difficult in this tumultuous period. A good prediction is all the more important, because global trade and foreign investment now play a greater role in our economy than ever before.

At the end of second quarter 1998, the accumulated four-quarter U.S. merchandise trade deficit was a record \$220 billion, compared to \$197 billion a year ago. After continuous increases in our merchandise exports, we had two consecutive quarters of decline in the first half of 1998. The second-quarter merchandise exports were \$165 billion, \$9 billion less than the figure for fourth quarter 1997. On the other hand, our imports steadily increased from \$224 billion to \$230 billion over the same period. Exports in services were flat in the same period at around \$65 billion, whereas service imports increased slightly with the second-quarter figure of \$45 billion.

A broader measure of trade, the current account balance (which includes merchandise, services, investment income, and unilateral transfers), had a deficit of \$186 billion—an all-time record—over the same four-quarter period. We will likely have a larger deficit in 1998, followed by another record in 1999, although the change from 1998 to 1999 is not expected to be as large as that from 1997 to 1998. This record-setting pace of foreign trade is nonetheless dwarfed by the enormous changes in foreign direct and portfolio investments.