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Jean-Paul Fitoussi

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**by Jean-Paul Fitoussi**

## Monetary Policy confronted with the possibility of a double dip

## A double dip?

There are various factors affecting one's conjecture about the future of the world economy. One is the "objective" content of current evolution as it is reflected by economic indicators (the second pillar, to speak in the language of the ECB); another is the increased degree of uncertainty which has followed September 11. Unfortunately the macroeconomics of political uncertainty is not a well developed field in economics.

On the first factor evidence is mixed. All over the world, economists are currently revising downward their growth forecast for the global economy and especially for the US, Japan and Europe. The most shared view is that the "recovery" is and will continue to be softer than expected.

***The US economy***

In this context the scenario of a double dip in the US is gaining voices as stock values continue to recede and household moral seems to become hesitant.

The story goes as follows. The first dip was the consequence of past overinvestment which led in 2001 to an abrupt and deep decline in investment. Notice that a recession caused by overinvestment should resemble more the pre WW2 business cycle, and thus be deeper, than the ones which typically since WW2 are caused by an acceleration in the inflation rate. It takes time to get rid of excess capacity, especially because bad loans will lengthen the convalescence of the private sector. But contrary to what one would have expected consumption did not follow the path of investment. So the recession was one of the mildest of US economic history: three quarters of negative growth in 2001 followed by a strong recovery in the first quarter 2002, at a rate of about 5% (annual rate). But, the story goes, the robustness of consumption spending is artificial and will sooner or later fade away. US capitalism has been put under an oxygen tent, as Shumpeter would have said, through one of the most expansionary policy mix of US history. One can read in the "Monetary Policy Report to the Congress" of the FED ( 16 July 2002), " the federal reserve had moved aggressively in 2001 to counter the weakness that had

emerged in aggregate demand"; and indeed from the beginning of 2001 the interest rate has been cut eleven times, to reach 1,75%. On top of that tax cuts, investment subsidies, the decrease in the inflation rate, all helped to increase disposable personal income. Real disposable income increased at an annual rate of 8% between the fourth quarter of 2001 and May 2002. The budgetary surplus, which was 207 billions dollars in 2000 turned to a deficit of approximately the same size (186 billions dollars).

All that served to sustain interest sensitive consumption, and especially purchase of motor vehicles and residential investment. Low interest rates on mortgages helped to sustain the robustness of the level of activity in the sector and home prices which have continued to move up strongly. The consequent increase in home prices helped to mitigate the effect of the destruction of several trillions of equity wealth on household net wealth.

But the gulf between the increase of private consumption and the decrease of private investment cannot continue for ever, and the moment of truth has to come. As the gulf will not be closed by an increase in businesses investment – businesses seem unwilling to expand capacity, increase capital equipment investment or increase headcount – household consumption has to recede. In fact the sharp decline of the financial market is now damaging the economy as it leads to a desire of consumers to save – the saving rate has already increase from 1.5% in 2001 to 3% in 2002 – and limits the willingness of firms to invest. In addition, borrowing costs have increased sharply for most companies, and others are credit rationed. If one adds that no new tax cut will happen before January 2004, and that consumer confidence is falling again, the case for a double dip seems convincing, the more convincing indeed, if we consider that the "corporate governance shock" and the prospect of a war with Iraq cumulate a mounting economic uncertainty with a mounting political uncertainty.

But the case for a double dip is not so strong when confronted with current evolution. It is true that the second quarter GDP growth has been a meagre 1.1%, but what we know about the third quarter lead to expect a growth of about 3.5% and even if GDP growth is expected to be much lower in the forth quarter, the yearly growth rate for 2OO2 will be about 2.4% at least. Inventories are now so lean in relation to sales that production has to accelerate for the next several months. On the other hand, even if growing, unemployment remains moderate by historical standards. For both reasons the moderation in the growth of wage and salary disbursement may come to an end, especially because the productivity acceleration remains important (even if data revision has lowered productivity growth estimate since 1998). Finally, the consequence of past overinvestment in NICT has not to be exaggerated in view of the rapid obsolescence of the goods incorporating these new technologies.

***The euro-area economy***

The euro area seems to replicate in an attenuated way the evolution of the US economy. Here we should not perhaps speak of a double dip but a double

slowdown of growth. Investment is down, less sharply than in the US, but household consumption exhibit still positive figures, save for the first quarter 2002 where it was modestly negative (-O.2%). The corporate governance shock has been almost absent, but stock prices have fallen by 50% from their pick level in 2000. Nevertheless direct equity holdings of households are still not as widely distributed in the euro area as in the United States. This is why, according to rough estimations, the marginal propensity to consume out of equity wealth is much lower in the euro area than in the US (Cf. ECB monthly bulletin, September 2002). Residential investment seems to resist, and home prices to be up. But still the prospect for future growth are weak: 1% in 2002; 1.6% for 2003 according to latest estimations. That means that unemployment will continue to increase, and most probably at a faster pace than in the 12 last months. The non nil probability of a double dip in the US will almost certainly obscure the outlook, absent policy reactions in Europe. The US economy is already no more a centre of external demand addressed to the rest of the world, and the euro appreciation, mild as it were until now, may become stronger in the case of a double dip.

## The ECB and Macroeconomic Policies

When comparing the US and the euro area economies, one is lead to an obvious question: why have public policies been so passive in the euro area? After all the private sector functioned rather well in Europe as compared with the US, and a modicum of expansionary policy would have done a good job. The recession in the US and the uncertainty surrounding its growth prospect, would anyway have called for a revision of economic policy as it changed the relative weights of internal and external demand. Europe cannot just wait for the wind to blow and should activate its own wind machine. Since November 2001 – which is the date of the last cut in interest rates by the ECB – the expectations of growth have been revised downward in a quasi continuous way. The ECB itself recognise that: “The acceleration of economic activity to growth rates in line with those of potential growth is now expected in the course of 2003 rather than by the end of this year. This delay broadly corresponds with the change in the world economic outlook..” (ECB, Monthly Bulletin, September 2002, P.5). At the same time the rate of inflation has decreased from 2.5% in 2001 to a figure of about 2% since the month of may. How can these changes be without effect on monetary policy? What is worrying is that in Europe we consider a 2% rate of inflation as dangerously close to the ECB’s upper limit, whereas in the US such a rate is considered low and associated with a slack. It has to be emphasised that core inflation rates are almost identical in both sides of the Atlantic. Both the ECB and the FED decided at their last meeting (respectively the 12 and the 24 of September) to leave their interest rates unchanged (respectively 3.25% and 1.75%), but the motivation of the decisions where rather different: “the risks to price stability appear to be rather balanced and ..the current level of interest rates is therefore appropriate to maintain price stability over the medium run”, says the ECB. On the contrary, the Federal Open Market committee considers that “the risks are weighted mainly towards conditions that may generate economic weakness”, statement which lead to the expectation of a further decline in the interest rates.

What this makes clear is that whatever rule the ECB is following, it should have lead to a change in interest rates as the expectations of future inflation and growth have markedly changed say between January and July 2002. Most economists think that the cut should have been of 75 basic points, and that a cut of 25 points would serve no purpose. Hence a move of 50 basis points should be the minimum than one can expect. With a wait and see approach to monetary policy and with a fiscal policy conditional to the fate of the rate of growth – one hears strange statements according to which governments should delay planned decrease in taxes because growth is lower than expected! – it is no wonder that internal demand cannot easily rebound.

Table 1 below attempt to measure the slack in demand in both sides of the Atlantic. The difference between potential and actual growth has been respectively of .9% in 2001, 1.4% in 2002 and is expected to be of about 1% in 2003. Notice that this difference is expected to be much lower in the US for 2002 and 2003.

## Table 1. Excess of GDP growth over potential growth in the Euro area and in the US

| **EURO area** | **1991** | **1992** | **1993** | **1994** | **1995** | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** | **2003** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **GDP growth, market prices** | 4,8% | 1,4% | -0,9% | 2,3% | 2,3% | 1,4% | 2,3% | 2,9% | 2,7% | 3,5% | 1,6% | 1,0% | 1,6% |
| **Potential growth of total economy, volume** | 5,6% | 2,5% | 2,0% | 1,8% | 1,8% | 2,0% | 2,1% | 2,2% | 2,2% | 2,3% | 2,4% | 2,4% | 2,4% |
| *Excess* | | -1,1% | -2,9% | 0,5% | 0,4% | -0,6% | 0,2% | 0,6% | 0,4% | 1,2% | -0,9% | -1,4% | -0,8% |
| **Labour force** | 9,0% | 0,0% | 0,0% | 0,5% | 0,3% | 0,8% | 0,9% | 1,2% | 1,1% | 1,2% | 0,8% | 0,7% | 0,9% |
| **Unemployment** | 7,8% | 8,7% | 10,3% | 11,0% | 10,7% | 10,9% | 11,0% | 10,3% | 9,5% | 8,5% | 8,0% | 8,2% | 8,1% |

| **USA** | **1991** | **1992** | **1993** | **1994** | **1995** | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** | **2003** |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **GDP growth product, market prices** | -0,5% | 3,1% | 2,7% | 4,0% | 2,7% | 3,6% | 4,4% | 4,3% | 4,1% | 4,1% | 1,2% | 2,5% | 2,8% |
| **Potential growth of total economy, volume** | 2,6% | 2,4% | 2,7% | 2,7% | 2,9% | 3,2% | 3,7% | 3,7% | 3,8% | 3,7% | 3,4% | 3,0% | 3,1% |
| *Excess* | | 0,7% | 0,0% | 1,3% | -0,2% | 0,4% | 0,8% | 0,6% | 0,3% | 0,4% | -2,2% | -0,5% | -0,3% |
| **Labour force** | 0,4% | 1,4% | 0,8% | 1,4% | 1,0% | 1,2% | 1,8% | 1,0% | 1,2% | 1,1% | 0,7% | 0,4% | 1,1% |
| **Unemployment** | 6,8% | 7,5% | 6,9% | 6,1% | 5,6% | 5,4% | 4,9% | 4,5% | 4,2% | 4,0% | 4,8% | 5,6% | 5,3% |

Attempts at measuring the output gap are more complex, as the measure depends of the year taken as a reference. Table 2 try to give some insights, in selecting various reference years. It clearly appears that whatever the reference year, the output gap in Europe is sizeable, contrary to the US. It has to be emphasised that both tables give very conservative estimates of the output gap, as the data used are from OECD, which has lower estimates of potential growth than most others institutes.

## Table 2. Output gaps, Euro area and US

| | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Potential productivity** | | 2,5% | 2,1% | 1,4% | 1,6% | 1,2% | 1,2% | 1,0% | 1,1% | 1,1% | 1,6% | 1,7% | 1,4% | |
| Output gap | **1991** | **1992** | **1993** | **1994** | **1995** | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** | **2003** | |
| | 100,0 | 98,9 | 96,0 | 96,5 | 96,9 | 96,3 | 96,5 | 97,2 | 97,6 | 98,7 | 97,9 | 96,5 | 95,8 | **1991** |
| | | 100,0 | 97,1 | 97,6 | 98,0 | 97,4 | 97,6 | 98,2 | 98,7 | 99,8 | 99,0 | 97,6 | 96,8 | **1992** |
| | | | 100,0 | 100,5 | 100,9 | 100,3 | 100,5 | 101,2 | 101,6 | 102,8 | 101,9 | 100,5 | 99,7 | **1993** |
| | | | | 100,0 | 100,4 | 99,8 | 100,0 | 100,7 | 101,1 | 102,3 | 101,4 | 100,0 | 99,2 | **1994** |
| | | | | | 100,0 | 99,4 | 99,6 | 100,3 | 100,7 | 101,9 | 101,0 | 99,6 | 98,8 | **1995** |
| | | | | | | 100,0 | 100,2 | 100,9 | 101,3 | 102,5 | 101,6 | 100,2 | 99,4 | **1996** |
| | | | | | | | 100,0 | 100,6 | 101,1 | 102,3 | 101,4 | 99,9 | 99,2 | **1997** |
| | | | | | | | | 100,0 | 100,4 | 101,6 | 100,7 | 99,3 | 98,6 | **1998** |
| | | | | | | | | 100,0 | 100,4 | 101,6 | 100,7 | 99,3 | 98,6 | **1999** |
| | | | | | | | | | 100,0 | 101,2 | 100,3 | 98,9 | 98,1 | **2000** |
| | | | | | | | | | | 100,0 | 99,1 | 97,7 | 97,0 | **2001** |
| **Potential productivity** | | 1,0% | 1,8% | 1,3% | 1,9% | 1,9% | 1,9% | 2,6% | 2,6% | 2,7% | 2,7% | 2,6% | 2,0% | |
| Output gap | **1991** | **1992** | **1993** | **1994** | **1995** | **1996** | **1997** | **1998** | **1999** | **2000** | **2001** | **2002** | **2003** | |
| | 100,0 | 100,7 | 100,7 | 102,0 | 101,7 | 102,1 | 102,9 | 103,6 | 103,9 | 104,3 | 102,0 | 101,5 | 101,2 | **1991** |
| | | 100,0 | 100,0 | 101,3 | 101,1 | 101,5 | 102,3 | 102,9 | 103,2 | 103,6 | 101,3 | 100,9 | 100,5 | **1992** |
| | | | 100,0 | 101,3 | 101,1 | 101,5 | 102,3 | 102,9 | 103,2 | 103,6 | 101,3 | 100,9 | 100,5 | **1993** |
| | | | | 100,0 | 99,8 | 100,2 | 100,9 | 101,6 | 101,9 | 102,3 | 100,0 | 99,6 | 99,2 | **1994** |
| | | | | | 100,0 | 100,4 | 101,2 | 101,8 | 102,1 | 102,5 | 100,2 | 99,8 | 99,4 | **1995** |
| | | | | | | 100,0 | 100,8 | 101,4 | 101,7 | 102,1 | 99,9 | 99,4 | 99,0 | **1996** |
| | | | | | | | 100,0 | 100,6 | 100,9 | 101,3 | 99,1 | 98,6 | 98,3 | **1997** |
| | | | | | | | | 100,0 | 100,3 | 100,7 | 98,5 | 98,0 | 97,7 | **1998** |
| | | | | | | | | 100,0 | 100,3 | 100,7 | 98,5 | 98,0 | 97,7 | **1999** |
| | | | | | | | | | 100,0 | 100,4 | 98,2 | 97,7 | 97,4 | **2000** |
| | | | | | | | | | | 100,0 | 97,8 | 97,3 | 97,0 | **2001** |

On the other hand, the graph below shows that the rate of capacity utilisation is much higher in Europe than in the US (overinvestment was much less of a reality in the euro area). But it is clear that both rates have decreased, and that in Europe the degree of slack in the economy could be usefully combated by a more aggressive monetary policy.

**Rate of capacity utilisation (in %), manufacturing sector (quarterly data)**