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The Economic Expansion of the 1990s: Implications for Progressive Economics

Abstract

The U.S. economy exited the twentieth century on a high note. Given progressives tendency to focus on economic contradictions and looming crisis, one might think that progressive economics should stand discredited by this fact. Yet the reality is entirely different. On a range of issues - the natural rate and the relation between inflation and unemployment, the minimum wage, the twin deficits hypothesis and the causes of the trade deficit, the instability of financial markets, and the dangers of deflation - progressive economics has been vindicated by events in the 1990s. Moreover, progressive accounts of the business cycle provide the best explanation of the current cycle. These accounts emphasize asset price inflation and consumer borrowing. Higher asset prices and new borrowing finance spending, which in turn leads to an expansion of output and incomes, and this supports additional borrowing and higher asset prices. Where progressives have gotten it wrong, it has been not so much the substance of their arguments, but rather their positioning. The focus on the dangers posed by inconsistencies within the existing economic configuration has imparted a Cassandra - like tint that sounds out of tune in the midst of a boom.

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I Retrospective: the surprising strength of the U.S. economy in the late 1990s

The U.S. economy has ended the twentieth century on a high note. In December 1999 the unemployment rate stood at 4.1%, a twenty nine year low. CPI inflation for 1999 was 2.6%, and if the volatile food and energy component is stripped out it was only 2.1%. GDP grew during the third quarter at an annualized rate of 5.5%, and over the first three quarters growth averaged 3.7%. Moreover, this strong performance came late in the expansion and after three prior years of strong growth - 4.3% in 1998, 4.5% in 1997, and 3.7% in 1996.

Behind this surge in GDP growth lies sharply accelerated productivity growth, with third quarter non-farm business sector productivity rising at an annualized rate of 4.9%. For the first three quarters of 1999 it averaged 2.7%, after having been 2.4% in 1997 and 1998. These productivity gains, in conjunction with low unemployment and inflation, in turn spurred strong real wage growth with average hourly real wages rising 2.2% in 1997, 2.6% in 1998, and 2.2% in 1999. Finally, this strong real economic performance was matched by the stock market, with the Dow Jones index rising 318% from 2,753 in December 1989 to 11,496 at the end of 1999. This increase surpassed even that of the 1980s when the Dow rose 229% from 838 to 2,753.

The strengthening of U.S. economic performance has come as a surprise for two reasons. First, the U-turn in performance that occurred in 1996 did so despite any obvious changes. For the six years prior, the American economy was stuck in a rut with job downsizing remaining stubbornly high, productivity growth remaining persistently low (except for the recovery year of 1992), and average real hourly wages falling in every year except 1994 when they managed a meager 0.7% increase. Second, the strengthening of economic performance occurred despite the global financial crisis which began in 1997 and sent much of the developing world into economic recession. Though the U.S. manufacturing sector was hit hard by the crisis, much of the rest of the economy seems to have benefitted. The dollar’s role as global store of value served to raise asset prices and keep the lid on interest rates, while falling import prices kept a check on inflation and contributed to rising real wages.

The strength of the economy has been even more surprising for progressive economists. Inclined to see the economy as subject to internal contradictions, there has always been a proclivity to focus on downside risk. Side-by-side, the move to structural budget surplus and the surge in social security contributions which has resulted from the baby boom’s passage into middle age imparted a contractionary stance to fiscal policy, which should have hindered economic expansion.

In light of this it is worth asking what progressive economists can learn from the economic expansion of the 1990s? Where did progressive economic analysis get it right, and where did it get it wrong? It transpires that an evaluation of the record shows that progressive economics got it right on most of the important policy issues, and for this reason has cause to enter the twenty first century on a confident note. However, that said, there is also an important need to recast the rhetoric of progressive economics which often has a Cassandra-like tone that sounds out of touch in times of economic expansion.

II Evaluating the record: surprises for all

Whether or not the U.S. economy has transformed itself into a "new economy" remains an open question.[1] What is clear is that the strength of the U.S. economy in the period since 1995 has been a pleasant surprise for all, and it is not just progressives who have been surprised. In March 1996 the *New York Times* ran a week long special on the downsizing of America that reflected the then prevailing gloomy mood. The economy had been in recovery mode for almost five years, yet downsizing continued at a significant pace, household confidence remained low, productivity growth was anemic and below the already depressed average for the 1980s, and average hourly real wages remained stuck in a two decade long decline. Economic pessimism about the real economy was therefore justifiably widespread.

The only harbinger of the good news to come was that the unemployment rate had already fallen below 6% in September 1994 and CPI inflation had shown no tendency to increase. And even here this news was legitimately subject to a more cautious interpretation that emphasized a danger of deflation over the horizon (Palley, 1996a). Thus, if the economy exhibits systematic price and nominal wage weakness that has the rate of inflation falling even as the unemployment rate falls to levels deemed widely to be unattainable, this would suggest a threat of generalized deflation in the event of a recession.

Just as economists of all stripe have been surprised by the recent performance of the real economy, so too they have been surprised by the strength of the stock market. Finance theory holds that excess returns in the stock market are not predictable, and it is therefore not surprising that economists did not predict them. At the same time, since these excess returns can also have a significant impact on consumption spending, this helps explain the surprising

[1].This issue is surveyed by Madrick (1999) who concludes that more years of solid economic performance are needed before we can accept the existence of a new economy.

strength of real economic activity. Rising stock prices have increased household wealth and consumption spending. Even those not owning stocks may have become caught up in the consumption boom as they have been infected by media optimism about the roaring stock market and the prospect of an endless new economy prosperity.

This wealth effect has translated asset price inflation into real prosperity, yet that prosperity may prove short lived if the rise in asset prices proves to be a bubble. No one has been more open on this possibility than Federal Reserve Chairman Alan Greenspan. On December 5, 1996, when the market stood at just over 6,500, Greenspan uttered his now famous remark "How do we know when irrational exuberance has unduly" inflated stocks? Again on October 30, 1997, he indicated his concern about excess valuations when he called the Dow's recent decline "a salutary event", and as recently as January 20, 1999 he mused about market over-valuations and the "possibility" that the market "will have difficulty" staying strong.

Though asset price bubbles can be explained theoretically they are impossible to identify *ex-ante* since they violate the core axiom which economists use to guide their understandings of the economy - namely, that economic fundamentals determine prices. Moreover, even when a bubble is suspected there is every reason to hold back on one's judgement. This is because warning of an asset price bubble inevitably involves a judgement that thousands of informed investors and Wall Street's professionals have got it wrong, which invites the retort "How come if you're so smart you aren't rich?"

III Evaluating the record: where progressives got it right

The strength of the American economy and the rise in stock prices have surprised almost all. But that said, there are a number of specific issues on which progressive economics has clearly been proved right by events in the 1990s. First and foremost is the failure of the theory of the natural rate of unemployment to explain inflation. Since the mid-1970s the theory of the natural rate has been the foundation stone of orthodox macroeconomics. According to this theory the actual rate of unemployment cannot fall below the natural rate without triggering accelerating unemployment, and for most of the 1980s and 1990s natural rate theorists maintained the natural rate to be about 6%. Thus, Blanchard (1997, p348)) writes "most estimates of the natural rate today in the United States are around 6 percent." However, the U.S. unemployment rate has been below 6% since September 1994 and below 5% since May 1997, and throughout this period inflation has shown no tendency to increase. This inconsistency between fact and theoretical prediction has cast profound doubt on the theory.[2]

Whereas the pattern of inflation in the 1990s challenges orthodox macroeconomics, it vindicates progressive macroeconomics which has advanced two alternative theories of inflation. One theory (Rowthorn, 1977; Myatt, 1986) emphasizes the role of conflict between capital and labor over income distribution, with inconsistent claims giving rise to inflation. According to this theory inflation has not accelerated because the income share conflict of the previous two decades has been resolved in favor of capital, a conclusion which is consistent with the rise in the profit rate since 1980 and the widening of income inequality (Mishel et al., 1999). A second theory (Tobin, 1972; Palley, 1994a; Akerlof et al., 1996) argues that inflation - unemployment outcomes depend jointly on the mix of excess demands across the different sectors that constitute the national economy, and inflation is higher when more sectors are at full employment and sectoral demand shocks are more varied. Palley (1998a) reports that during the 1990s the variance of sectoral demand shocks in the U.S. economy has fallen, and this explains why inflation has been more muted.

Both the conflict and sectoral excess demand theories provide coherent accounts of the inflation process, and they are mutually consistent. Together they can explain the pattern of U.S. inflation in the 1990s. Most importantly, they both suggest that their exists a trade-off between inflation and unemployment, which suggests running the economy at non-zero inflation rates. Contrastingly, natural rate theory provides no justifications for this. Interestingly, over the course of the 1990s most central bankers, though continuing to pay lip service to the theory of the natural rate, have implicitly accepted the progressive point of view by moving away from targeting price level stability (zero inflation) to targeting low inflation.

A second area where progressive economics has been vindicated is the minimum wage. Orthodox economics maintains that raising the minimum wage causes unemployment, especially among young and unskilled workers who are concentrated at the low end of the wage distribution. The best that can be said of the minimum wage is that

[2]. Staiger, Stock and Watson (1997) detail the policy uselessness of econometric estimates of the natural rate. These vary widely over time and are subject to enormous variance at any moment in time. Galbraith (1997) and Palley (1999a) provide policy critiques. There is a defense against the predictive failure of natural rate theory in the 1990s which is that inflation has not accelerated because of (i) structural changes in the economy that have lowered the natural rate, and (ii) the east Asian financial crisis which caused a flood of cheap manufactured imports that kept the lid on prices. However, this defense is increasingly theological because it offers no basis for ever rejecting the hypothesis.

it may help equalize income distribution if labor demand for low wage workers is inelastic, since in this event it will raise total wage income of the group even if there is a small decline in employment. However, this approach to understanding the minimum wage has been dramatically challenged by the empirical work of Card and Krueger (1995), and it has been vindicated by the increase in the minimum wage between 1996 and 1997 which had no statistically significant negative effects on employment (Bernstein and Schmitt, 1998). These findings provide empirical support for a new economics of the minimum wage (Palley, 1998b) which builds on progressive views of how labor markets function. Whereas the orthodox demand and supply model of labor markets sees them as devoid of considerations of power, the new economics places bargaining power at its center. All workers, union and non-union, are implicitly engaged in bargaining with their employers. The amount firms are willing to pay clearly depends in part on the productivity of workers, but this only sets an upper bound to the wage. How much of that productivity workers actually get to keep depends on their bargaining leverage. In such a world a modest minimum wage is not a market distortion that causes unemployment. Instead, it is an institutional mechanism that enhances the bargaining power of low wage workers and serves as a corrective to a market failure of extreme imbalance of power. This new economics is strongly supported by the evidence of the last several years during which the real minimum wage has increased substantially without any negative employment impacts, and at the same time there have been significant real wage gains at the low end of the wage distribution which have contributed to a small gain in income share for those in the bottom quintile.

A third area where orthodox macroeconomics stands discredited by events in the 1990s is the trade deficit. In the 1980s both the U.S. trade deficit and the federal budget deficit ballooned, and this gave rise to the “twin deficits” hypothesis which maintained that the trade deficit was the result of the budget deficit. The thinking embodied in this view is captured by Cline (1991, p.40): who asserts that “It is widely recognized that the root reason for the failure of the US external accounts to reach balance in recent years has been the corresponding failure to close the fiscal deficit.” In stark contrast to this view, progressive Keynesians (Blecker, 1992) maintain that the trade deficit is a result of a combination of macroeconomic and microeconomic factors, and that budget deficits only matter indirectly to the extent that they impact the macroeconomic environment. The 1990s have clearly disproved the twin deficits hypothesis since the trade deficit has mushroomed even as the unified federal budget has shifted into surplus. This pattern is clearly consistent with the progressive Keynesian viewpoint. The trade deficit has been the result of the U.S. enjoying a cyclical boom while much of the world economy has been stagnant or in recession. In addition, the U.S. trade position has been aggravated by declining competitiveness caused by the strong dollar, and by factors which have driven the de-industrialization of America.

Though Keynesians have been vindicated in the twin deficits debate, that debate is only part of a larger war on the role of government in the economy and the relation between saving and investment (Palley, 1998c, Chapter 8). One function of the twin deficits debate was to blame government for the trade deficit and thereby advance a case for shrinking government. A second function was to argue that government deficits reduce national saving, and thereby lower future standards of living which depend on past saving. This second argument is clearly visible from the national income identity which can be arranged as follows

(1) $[T - G] + S = I + [X - M]$

where T = tax revenues, G = government spending, S = private saving, I = investment spending, X = exports, and M = imports. Orthodox economists argue that an increase in the government deficit reduces national saving and must either reduce investment spending or the accumulation of foreign wealth. Their reasoning embodies the assumption that saving drives capital accumulation, so that increasing accumulation requires increased national saving. And one way to do so is to reduce the government deficit. However, from a Keynesian perspective the direction of causation runs from investment to saving, with saving adjusting to accommodate investment (Gordon, 1998; Palley, 1996b). This accommodation is effected either by the generation of new income through the act of investment, or by firms increasing retained profits to finance investment spending.

Though progressive economics has won the skirmish over the twin deficits hypothesis, the war over saving - investment causation remains unresolved. As long as saving is viewed as driving investment this will promote policies aimed at shrinking government. It will also push policies that increase the profit share and worsen income distribution, the logic being that the propensity to save is larger out of profit and increases with household income. However, just as the 1990s undermined the twin deficits hypothesis, so too they have undermined the claim that savings causes investment. This is because the U.S. has had a significant investment boom measured in terms of real investment as a share of real GDP, and the nominal investment share has also remained stable. This has occurred despite the fact that the household saving rate has declined to record lows.[3]

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[3].As ever in economics there is a potential defense of orthodoxy which involves claiming that the increase in

Another area where the 1990s have proved supportive of progressive economics concerns supply-side economics and the Laffer curve. As part of the budget deficit reduction strategy the Omnibus Budget reconciliation Act of 1993 raised the top tier of the income tax from 31% to 39.6%. Supply-siders have long claimed that the existing tax system is on the right hand side of the Laffer curve, and that higher tax rates would reduce income tax revenues and also have a negative impact on productivity growth owing to their disincentive effects. Yet, neither of these predictions have occurred. Table 1 shows that income tax revenues have grown steadily in absolute value, as a share of total federal revenues, and as a share of GDP. Moreover, this outcome is not the result of a business cycle boom since the revenue share increased relative to the late 1980s which was also a period of boom. Finally, as noted in the introduction, productivity growth has accelerated dramatically in the period 1996 - 1999 which undermines supply-sider claims.[4]

A fifth area where the 1990s have validated progressive economic positions concerns the international economy and the stability of the international financial system. Over the last twenty years the international policy agenda has aimed at increasing international capital mobility. The claim has been that this would lead to increased efficiency in the allocation of capital, thereby making both borrowers and lenders better off. It would also raise global growth by raising the rate of return on investments and by providing investors with greater portfolio diversification opportunities that in turn enabled them to undertake more high risk - high return projects. Now, in the wake of the east Asian financial crisis and the near melt-down of global financial markets in October 1998, there is a realization that increased capital mobility also carries significant downside risk.

Progressive Keynesian economists have long identified these downside risks. One problem, emphasized by Keynes (1942), is that capital mobility can give rise to settings of national interest rates that are inconsistent with non-inflationary full employment because in an open system rates are determined by average global conditions rather than national conditions. Thus Keynes writes:

"In my view the whole management of the domestic economy depends upon being free to have the appropriate rate of interest without reference to rates prevailing elsewhere in the world. Capital control is the corollary of this....."

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investment has been funded by increased government saving (i.e. a reduced budget deficit) and by borrowing from abroad (i.e. an increased trade deficit).

[4]. Moffitt and Wilhelm (1998) empirically document the tax inelasticity of the labor supply decisions of the affluent.

A second problem with capital mobility concerns financial instability that results from speculation and herd behavior.[5] Such behaviors can produce asset bubbles. On the way up the increase in asset prices generates large increases in financial wealth that stimulate demand, and credit is also readily available for entrepreneurs. However, once the bubble bursts, the economy is left saddled with a debt over-hang that acts as a drag on investment and consumption spending, while the channels of financial intermediation are destroyed as the banking system collapses under the weight of bad debts. This type of financial business cycle is clearly evident in the work of Minsky (1964, 1977, 1982), and events in east Asia have provided strong support for the Minsky model. In the early 1990s financial capital flowed in to east Asia, with initial investors earning substantial returns. These returns gave rise to a herd movement into the region, and money flowed in on the basis of expectations that were increasingly detached from economic fundamentals and paid little regard to risk. This produced an asset price bubble that was accompanied by significant over-investment in capacity. When the bubble burst, asset values and the exchange rate collapsed leaving lenders saddled with bad debts that restricted their ability to lend more, while borrowers were saddled with debt burdens that restricted their ability to invest.

A third critique of capital mobility concerns its impact on national policy autonomy. Capital mobility allows financial capital to veto policy by voting with its feet. Industrial capital, financial capital, and labor are engaged in a struggle to control economic policy so that it works in their interest (Epstein, 1992; Palley, 1996c). Capital mobility enhances the relative power of financial capital and helps promote a policy stance that it favors (low inflation and higher interest rates), and in doing so it works against the interest of labor. Thus, in the 1980s international capital markets compelled France's President Mitterand to abandon his Keynesian reflation program and adopt the policy of *franc fort* which tied the franc to the Deutsche mark. In the 1990s, after the collapse of the European exchange rate mechanism, European country central banks were forced to follow the tight money policies of the Bundesbank in order to prevent further currency and bond market disruption.

The progressive critique of capital mobility has been significantly vindicated over the course of the 1990s,

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[5]. There are two different approaches to herd behavior. Banerjee (1992) focuses on information considerations, and shows how the actions of others can produce herd behavior when those actions are believed to contain useful information. Palley (1994a) provides a "safety in numbers" explanation that shows why rational managers will behave in herd-like fashion when they are risk averse and their remuneration depends on relative performance. Both types of explanation can help explain the east Asian financial crisis.

especially with regard to financial instability. Events in east Asia have dramatically shifted the terrain of the debate, and even the IMF (which has been the foremost proponent of international capital market openness) has significantly revised its positions. Now, the IMF maintains that integrating national financial markets into the international system needs to be presaged by the development of strong regulatory structures and the adoption of transparent accounting standards, and that opening needs to be sequenced with long term capital flows being opened before short term flows. These new precautions reflect a new awareness of the dangers of capital mobility, but for critics of the orthodoxy they measures do not go far enough. Measures that discourage excessive flows of capital (such as the Tobin tax or Chilean style speed bumps that impose reserve requirements on short term inflows) are also needed. Moreover, application of explicit exchange controls, such as those imposed by Malaysia, may be appropriate in terms of financial crisis.

Though the IMF has not accepted these latter positions, it is clear that events have compelled it to move in a direction that is more sympathetic to them. The east Asian crisis, the prevalence of economic cronyism in much of the developing world, the failure to kindle growth in the economies of the former Soviet Union, and the collapse of economic growth in Africa, have all served to derail the Washington Consensus. This derailment is evident in the IMF's call for a "second generation of reforms" that are to supplement the first generation of reforms which emphasized macroeconomic stability predicated on fiscal and monetary austerity and export-led growth.[6]

A final area where progressive economics has been vindicated concerns the dangers of deflation. The east Asian financial crisis also imparted a global deflationary shock as commodity prices fell in response to decreased east Asian economic activity. This flirtation with global deflation, in conjunction with Japan's long recession and mini-deflation, have alerted the orthodoxy to the dangers of deflation, again vindicating Keynesian macroeconomics. For the orthodoxy, economic activity is neutral with regard to both money and inflation, and it is therefore also neutral with regard to deflation. For Keynesians, both money and inflation are non-neutral, and deflation is especially disruptive because of the existence of inside debts. Krugman (1998) has revived popular concern with the dangers of deflation, focusing on the interaction of deflation and nominal interest rate floors. However, his analysis remains

[6].The IMF sponsored a conference titled "Second Generation Reforms" at its Washington headquarters on November 8 - 9, 1999. Both Michel Camdessus, Managing Director of the IMF, and James Wolfensohn, President of the World Bank Group, spoke of the need for a new policy paradigm.

unsatisfying because it continues to assert that price level reductions can solve the problem of aggregate demand shortage. As such it continues to lend itself to policies that promote downward nominal wage and price flexibility. In fact, price and nominal wage reductions may aggravate the problem of demand shortage to the extent that they (i) worsen the service burden of debtors (Tobin, 1980; Palley, 1996d, 1999b) and (ii) cause defaults which destroy the banking system. This is the foundation of Fisher's (1933) debt - deflation theory of depressions which pairs with Minsky's (1982) concerns about financial market instability. Unstable financial markets give rise to credit booms and asset price bubbles that are unwarranted on the basis of economic fundamentals. When the euphoria recedes, agents are left saddled with debts and depreciated assets that undermine aggregate demand, and at this stage falling prices (deflation) further aggravate the problem.

IV Evaluating the record: where progressives seem to have gotten it wrong

A reading of the record shows that progressive economics has been right on many of the economic "particulars" of the last decade. Yet, there are also areas in which progressives have been wrong, or at best half-right. First and foremost is the fact that the U.S. economy has enjoyed a prolonged expansion even though fiscal policy has been contractionary. Second, the expansion has flourished despite a persistent and growing trade deficit, yet since the early 1980s an enduring refrain of many progressives has been that such deficits portend economic collapse just around the corner.

Sudden surges in the trade deficit do indeed cause manufacturing job loss as was shown in the first half of the 1980s, and has again been shown in 1998 and 1999. However, surges in the trade deficit need not cause general economic contraction if they are accompanied by growth of demand from other sources. Thus, during the second half of the 1990s both consumption and investment demand have been strong, and this has more than compensated for the trade deficit. Indeed, when macroeconomic conditions associated with domestic expansion are the principal cause of the trade deficit, then the deficit will actually be accompanied by rising employment.[7]

The progressive refrain that the trade deficit portends collapse is misplaced. The trade deficit is a flow, and it can endure for a very long time as long as it can be financed by selling U.S. holdings of foreign assets, by selling U.S.

[7]. Economists talk of a "structural budget deficit" which is benchmarked by reference to full employment. The notion of a "structural trade deficit" which is also benchmarked on full employment and assumptions about exogenous export demand might also prove useful.

domestic assets to foreigners, or by borrowing from foreigners. That said, the fact that deficits can persist for long periods does not mean that progressive concerns are entirely misplaced. Rather, the problem is that the dislocations associated with breakdowns in the ability to finance trade deficits appear very abruptly. This abrupt character can be understood in terms of a bathtub metaphor. The flow of water into the tub represents the trade deficit (accumulation of new indebtedness): the amount of water in the tub represents the stock of existing indebtedness. New water (accumulation of debt caused by the trade deficit) can flow very rapidly into the tub, and there will be no problem as long as there is room in the tub. However, as soon as the tub reaches capacity, it over-flows and causes flooding. In an instant, the situation is transformed from one of tranquility to crisis.

Such a metaphor corresponds to the financial dangers posed by the trade deficit. Progressive economists have consistently focused on the fact that the U.S. trade deficit has been running at levels that imply the bath tub is filling up rapidly, but that does not imply trouble today. Forecasting the exact time when trouble will occur is very difficult since there are automatic mechanisms that staunch the flow into the tub (i.e. reduce the deficit), while the size of the tub (i.e. the ability to incur debt) is uncertain because foreign demand for U.S. financial assets is uncertain. Moreover, the tub is growing in size because the U.S. economy is growing. The lesson for the progressive policy conversation is that focusing on the long term logic of the situation and worst possible case outcomes is a rhetorical misjudgement. Such warnings can strike an inconsistent note of doom and gloom during times of expansion, and it can take a long time before economic logic asserts itself.

Another area where progressive policy conversation has been off note concerns the impact of contractionary fiscal policy and the move to budget surplus. The shift in fiscal stance should have imparted a contractionary bias to the economy, yet over the last four years the economy has prospered. This has led to a new view that sustained budget surpluses are good for economic growth because they promote financial stability and lower interest rates.[8] The progressive counter is that the shift to budget surplus did indeed impart a contractionary impulse, but this impulse was more than offset by expansionary impulses coming from the rise in stock prices and from consumer borrowing. The rise in stock prices increased household wealth and gave rise to a significant positive wealth effect on consumption spending. Side-by-side, U.S. households have been engaged in a borrowing binge that has financed

[8]. An alternative argument, constructed in terms of the orthodox perspective on saving - investment causation, is that government surpluses provide the saving which funds investment.

increased consumption spending. In 1996, consumption spending accounted for 60% of the increase in GDP; in 1997 it accounted for 56%; in 1998 it accounted for 75%; and in 1999 it has accounted for 96%.[9] Over this period personal consumption has risen faster than personal income, and there has been an increase in household debt to income ratios and a persistent decline in the personal savings rate. As Godley (1999) points out, this pattern of rising debt to income levels is not sustainable, and when it does reverse it will need to be compensated for if recession is to be avoided. At that time, fiscal policy will be required to adopt an actively expansionary stance.

As with the conversation over the trade deficit, the progressive conversation over fiscal policy has not so much been wrong as out of tune. The focus on the long term logic of the situation again leads to concentration on the contradictions of the situation which sounds out of tune in the midst of expansion. Moreover, as with the trade deficit, when the contradictions will bite is extremely hard to predict. Household debt to income ceilings change through time owing to financial innovation and the spread of new practices in credit markets. In particular, financial markets have been very successful at increasing the ability of households to borrow against non-liquid assets, the prime example of this being home equity loans that have allowed households to borrow against home equity. If the Fed lowers interest rates this reduces household debt service burdens, and can thereby make room for further consumption spending. Finally, if household wage income begins to increase this also creates space for further borrowing and spending. Considered together, these features mean that credit financed consumption booms can be extremely prolonged.

V Into the next century: repositioning the progressive message

The U.S. economy exited the twentieth century on a high note, in the midst of what has become the longest economic expansion on record. Given progressives tendency to focus on economic contradictions and looming crisis, one might think that progressive economics should stand discredited by this fact. Yet the reality is entirely different. On a range of issues central to economic policy - the natural rate and the relation between inflation and unemployment, the minimum wage, the twin deficits hypothesis and the causes of the trade deficit, the instability of financial markets, and the dangers of deflation - progressive economics has been completely vindicated by events in the 1990s.

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9. Author's calculations using BEA 3rd quarter 1999 GDP release.

Where progressive got it wrong, it has been not so much the substance of their arguments, but rather their positioning. Amidst the longest economic expansion on record, the focus on the dangers posed by inconsistencies within the existing economic configuration has imparted a Cassandra - like tint.

However, economists of all stripes have been surprised by the strength and duration of the current expansion, especially in light of its initial weakness. Moreover, with the benefit of 20/20 hindsight it is progressive accounts of the business cycle that give the best account of what has been happening. The business cycles of the 1980s and 1990s have been finance based cycles driven by asset price inflation and consumer borrowing, and these cycles have been longer than before because of innovations in the financial sector that have facilitated borrowing and shifted the demand for wealth toward equities.[10] In the expansionary phase new borrowing finances spending, which in turn leads to an expansion of output and incomes. Rising asset prices also encourage increased spending and reduced saving. The expansion of income then supports additional borrowing. Speculation can also enter the process, with bankers and financiers becoming more optimistic as the cycle advances, and then easing lending standards which enables a continuation of borrowing and spending. Similarly, speculation can enter equity markets, resulting in higher equity prices which further encourage consumer spending. But debt is a two-edged sword. New borrowing finances additional spending, but it also contributes to a build-up of debts and debt service obligations which are contractionary. Over time these debt service burdens accumulate and come to swamp the expansionary effect of new borrowing, and at this stage the expansion ends.

This clear relevance of progressive Keynesian accounts of the business cycle to current conditions, combined with the fact that progressive economics has been right on most of the important policy debates of the decade, reveals the vitality and coherence of progressive economics at the beginning of the new century. That said, if progressive economists are to capitalize on these strengths in debates over economic policy, then they will have to adjust their rhetoric. In particular, there is a need to break with the tendency to focus on imminent crisis. Instead, progressives must learn from their own theories which account for both booms and busts, and also explain why booms can be long lived. Rather than seeking to predict a future which is inherently uncertain, the message should

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[10].Minsky (1982) and Palley (1994b) provide accounts of the role of asset prices and credit in the business cycle. Palley (1999c) describes how financial innovation has contributed to a lengthening and amplification of the financial business cycle.

be tilted to making the case for what is possible. By working to raise expectations through an understanding of the economically possible, progressive economists can contribute to fostering an environment in which people demand more of the system. In doing so, they will help realize a system which delivers shared and growing prosperity. This is the political analogue of the fundamental Keynesian message, namely that demand leads supply.

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	Income tax	Federal Revenues	GDP	Income/Revenues	Income/GDP
	<--------Billions of nominal dollars		---------->	<----------------Percent	---------------->
1985	334.5	734.1	4,180.7	45.6	8.0
1986	349.0	769.2	4,422.2	45.4	7.9
1987	392.6	854.4	4,692.3	46.0	8.4
1988	401.2	909.3	5,049.6	44.1	7.9
1989	445.7	991.2	5,438.7	45.0	8.2
1994	543.1	1,258.6	6,947.0	43.2	7.8
1995	590.2	1,351.8	7,269.6	43.7	8.1
1996	656.4	1,453.1	7,661.6	45.7	8.6
1997	737.5	1,579.3	8,110.9	46.7	9.1
1998	828.6	1,721.8	8,573.9*	48.1	9.7

Table 1 Shows Federal income tax as share of total tax revenues and as a share of nominal GDP. Source: Economic Report of the President, 1999 and author's calculations. * = annualized output for 3rd quarter 1998.