End of the Expansion: Soft Landing, Hard Landing, or Crash?[1]

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The last three years have witnessed a period of superb U.S. economic performance. Across nearly every measure the U.S. economy has registered improvement. The unemployment rate fell from 5.4% in 1996 to 4.2% in May 1999. Inflation fell from 3% in 1997 to 2.3% in April 1999, and productivity growth has increased to over 4% in the manufacturing sector and over 2% in the non-farm private sector. Between 1996 and 1998, real average hourly wages increased by 4% and the median hourly wage increased 5%. Even the two decade long increase in inequality also appears to have leveled off.

This performance has surprised most people. Given the dismal performance between 1990 to 1995 when downsizing was rampant, inequality widened, and real wages fell, the U-turn has been completely unexpected. Moreover, the fact that the expansion has continued despite the global financial crisis which undermined U.S. exports and caused a surge of imports, is further cause for surprise.

Now, there is uncertainty as to whether the expansion can continue. Unemployment is at a twenty-nine year low of 4.2%, raising the prospect of tighter monetary policy as the Fed moves in response to its belief that higher inflation is just around the corner. There is also doubt about the sustainability of growth of personal consumption spending, which has been the principal engine of expansion over the last two years. In 1997, personal consumption expenditure contributed 59% of GDP growth, and in 1998 it contributed 85% of GDP growth. From the Federal Reserve's perspective, this pattern is not sustainable since consumption is growing faster than potential output which implies that the economy will eventually hit an inflationary wall. An alternative interpretation is that such growth is not sustainable because households must inevitably run short of financial wherewithal, and when this happens an economic slow down will ensue. According to this view, recession rather than inflation is the danger.

Where to next?

An examination of the economic tea leaves suggests three possible future paths - a soft landing, a hard landing,

[1].The views expressed in this paper are those of the author and do not necessarily reflect those of the AFL-CIO.

and a crash. A soft or hard landing are by far the more likely outcomes, but that said it is possible to imagine conditions in which a crash occurs. Japan's prolonged recession, east Asia's crisis, and last October's near meltdown of global financial markets have all added plausibility to such a scenario.

A "soft landing" has the rate of growth gradually slowing to a level consistent with potential. According to consensus thinking, this potential rate of growth is somewhere between 2 and 2.5%, though new economy optimists claim it is as high as 3%. A "hard landing" has output growth turning negative so that the economy is pushed into recession and unemployment rises significantly. Finally, a "crash" involves a collapse in output growth, and the economy enters a deep recession that could even border on a depression. For policy makers at the Federal Reserve the goal is a soft landing.

Soft landing

The ingredients necessary to realizing a soft landing are as follows:

(1) First and foremost, consumption spending growth must slow below the rate of potential output growth. This would remove much pressure on the Fed to raise interest rates, thereby avoiding a negative interest rate shock to investment spending. Slowed consumption growth would also help improve the trade balance by reducing import growth, and this would diminish the trade deficit as a potential source of international financial instability.

(2) Second, productivity growth must continue at its recent high pace. This would hold the lid on inflation and take pressure off the Fed to raise interest rates. It also helps maintain profitability which is good for investment, and to sustain existing stock market values thereby avoiding a financial crash. Lastly, it also creates the capacity to increase exports which is needed to improve the trade deficit.

(3) The government continues to run a sizeable surplus. This is needed to placate the bond market and the Federal Reserve, both of which believe fiscal deficits to be inflationary. However, this belief is controversial, and an opposing argument is that sizeable surpluses could contribute to the makings of a hard landing (see below).

(4) The world economy enjoys a sustained recovery that increases U.S. exports and improves the trade balance. Such a recovery would unwind the role of “global buyer of last resort” which the U.S. has played for the last two years.

(5) The dollar gradually depreciates by up to 20%, thereby increasing exports and reducing imports. Equally important, this would increase the dollar value of U.S. financial income earned abroad, helping offset the huge

amounts that the U.S. now owes on its foreign debts.

(6) Finally, the stock market must remain close to its current value, or if there is a downward correction, it should come gradually. This would help maintain consumer confidence and consumer spending, thereby preventing a sudden collapse of demand. It also means firms can continue raising equity capital to finance investment on relatively favorable terms, which supports investment spending.

Together, these six ingredients ensure that output grows, the trade deficit is reduced, financial market stability is maintained, and inflationary pressures are vitiated. Under such conditions, output is gradually shifted away from household and government consumption toward investment and exports, paving the way for an improved external position and increased productive capacity to support a higher future standard of living.

Hard landing

A soft landing scenario has the economy avoiding a recession, and instead the expansion just slows to a sustainable pace. The hard landing scenario involves a recession.

Economists have identified three different approaches to explaining recessions. The first is that expansions die of "old age", with forces internal to the economy operating to ineluctably push the business cycle into a downward phase. The second is that expansions die because of "shocks" from outside the system that bring the boom to a sudden close. The third is that expansions end because of policy mistakes, particularly on the part of the Federal Reserve which mistakenly raises interests rates and causes a down turn to grab hold. All three explanations are compatible with the hard landing scenario, and all three may plausibly contribute to such an outcome. It is for this reason that a hard landing has to be considered a not unlikely event.

Old age. The current expansion has now endured for almost eight years.[2] Though some quibble with the formal dating of the recovery, claiming that it only started in late 1992, it is still clear that the expansion is getting long in the tooth. The 1980s witnessed the emergence of a new type of business cycle in which upswings appear to be longer. Prior to that, upswings lasted 4 to 6 years, and were driven largely by the dynamics of investment spending.

[2].The National Bureau of Economic Research dates the beginning of the recovery as the second quarter of 1991.

Inventory dynamics also played an important role. However, since then cycles have lengthened and appear capable of lasting up to 10 years. The key change has been the emergence of a finance driven cycle that reinforces and extends the investment spending mechanism. This new finance driven cycle is the result of the 1980s deregulation of financial markets and subsequent innovation in financial markets.

The key feature of the new cycle is debt financed spending which generates both an expansion of income and the accumulation of debt burdens, and the latter ultimately bring the expansion to a close.[3] In the early phase, borrowing finances spending which in turn leads to an expansion of output and incomes, and this expansion then supports additional borrowing. Speculation also plays a role, with bankers and financiers becoming more optimistic, and then easing lending standards by allowing increased leverage predicated on increasingly optimistic projections of future earnings. However, debt is a two edged sword: new borrowing finances spending but it also results in debts on which interest must be paid. Over time, interest payment burdens rise, and the contractionary impact of these burdens eventually come to dominate the expansionary effect of new borrowing, and the expansion ends.

Such a mechanism has been present in the U.S. economy throughout the entire post-war period, but it has acquired greater prominence over the last two decades. Growth of consumer credit, auto leasing, and home equity loans have all given consumers increased access to credit. The shift from defined benefit to defined contribution pension plans has allowed households to borrow against pension wealth, and the stock market boom has increased the value of the collateral in these accounts. In the business sector, expanded bond markets and increased competition between banks and between banks and other financial intermediaries for corporate borrowers, have increased business access to credit.

These developments explain why financial factors have become more prominent in the business cycle, and why the cycle has lengthened. Moreover, since innovations continue to take place, the cycle continues to lengthen. All of this is visible in the persistently rising household debt to income ratio which is shown in figure 1. This ratio follows a step function pattern, rising to new highs with each new expansion as financial innovations emerge and spread, then temporarily leveling off with each recession, only to begin a new upward movement with each recovery. Such a pattern has been evident in the current expansion.

[3].This characterization of the business cycle is attributable to Minsky (1982, 1986). Palley (1994) examines the formal dynamics of such a cycle.

Outside shocks. A second cause of downturns is outside shocks. In the 1970s, these shocks took the form of oil price shocks. The recent global financial crisis was another such shock, but this time the U.S. economy was able to absorb the negative impact of the shock.

It is easy to imagine a number of possible exogenous shocks. The stock market could fall precipitously. Many believe that share values reflect an asset price bubble, though as Chairman Greenspan (1999) cautions "bubbles generally are perceptible only after the fact." If there is a bubble, it can always suddenly burst. The run up in stock prices has fueled the expansion by increasing household wealth and collateral with which to borrow: a decline can be anticipated to work in reverse.

A second possible shock is renewed global financial instability. Though the situation in Brazil has stabilized, Latin America's economies remain vulnerable with Brazil, Argentina, Colombia, and Chile all in recession. In east Asia, recovery has tentatively taken hold, but Hong Kong is in recession and China is using expansionary fiscal policy to wrestle with a growth slow down. Both economies could still be the source of further currency market instability.

Thirdly, there is the U.S. current account deficit which appears to be headed to almost 2.5% of GDP. Blecker (1999) has pointed out that our continued trade deficit has led to a build-up of U.S. foreign indebtedness which imply larger future interest payments to foreigners. Extrapolating existing trade deficit numbers forward just a few years shows that these payments balloon to levels that are probably unsustainable at existing exchange rates. At some stage, financial market participants may reach the same conclusion, thereby triggering a sharp dollar depreciation. This could then have multiple negative knock on effects that initiate a hard landing.

Thus, a dollar depreciation could trigger a severe stock market correction as foreign investors seek to exit U.S. markets. It could also trigger accelerated inflation which has the Fed responding by raising interest rates, and faster inflation is fairly likely given the increased reliance on manufactured imports. Alternatively, if the Fed responds by raising rates to protect the dollar and prevent inflation, this will slow the economy by checking investment spending and new household borrowing, and by raising household debt burdens. It will also lower stock market values. A weaker dollar could also undermine economic recovery in east Asia, Latin America, and Europe, all of which are relying on a strong dollar to fuel their export-led growth. This could then trigger renewed global financial market

instability.

Finally, a fourth possibility is a Y2K induced recession. Here, it is not so much the possibility of a recession result from glitches in production on 1 January 2000, but rather the possibility that business has brought forward its investment spending plans as part of fixing the Y2K problem. Computer spending has been a big component of the capital equipment investment boom, and firms may have spent forward which augurs a future slow down in investment spending.

Policy shocks. A third cause of recessions is mistaken increase in interest rates by the Fed. There is much evidence supportive of this view point. The Fed clearly caused the mini-recession of 1979, as well as causing the deep recession of 1981. There are also reasonable grounds for arguing that it caused the recession of 1990. A repeat of this pattern is a real possibility given the two increases in rates over the summer. The Fed's argument is that it needs to act pre-emptively to head off future inflation. Its response to its critics is that its job, unpopular though it may be, is to take away the punch bowl just as the party is beginning.

The problem is that a policy of pre-emption risks stopping the economy before it has reached full employment. The only way to ensure such an outcome is to push the edge of the economic envelope until there is clear evidence of an over-heated economy. At that stage, monetary policy can be tightened.

A second policy development that makes a hard landing more likely concerns fiscal policy. Over the last two decades there has been a retreat away from use of counter-cyclical activist fiscal policy on the grounds that inside and outside lags make such policy unwieldy.[4] There has also been a shift toward running a structural budget surplus which is reflected in predictions of a surplus for the next decade. Thus, not only is fiscal policy not being used as an instrument of stabilization policy, but the automatic pilot has also been set such that it is sucking demand out of the economy.

It is likely that fiscal policy will change in the event of a recession. However, this change will be politically contested which means that it will take time and that it will only be moderate in scope. Consequently, nascent recessionary tendencies will have an easier time gaining hold, which increases the likelihood of a hard landing.

[4].Inside lags refer to the time taken to legislate changes to fiscal policy. Outside lags refer to the time it takes for those changes to have an economic impact.

Crash?

A last scenario is a full scale crash or economic depression. Such an outcome is the least likely of the three scenarios, but that said, it is more likely than it used to be. In the 1960s and 1970s, the possibility of a depression was truly far removed. However, in the 1990s such a notion has surfaced as plausible, even if unlikely.[5] Recent events in the global economy have added further credibility to this possibility.

One reason why a crash has become more likely is that many of the factors precipitating a hard landing are already in place, and many of them could be realized simultaneously. Indeed, many of these factors are linked in trip-wire fashion so that if one occurs, it triggers another. Thus, a mistaken Federal Reserve interest rate increase could trigger a stock market crash, which could then end the spending boom and trigger renewed global financial instability. Alternatively, a run on the dollar or renewed global financial instability be the precipitating factor that pricks the stock market bubble. Lastly, simple aging of the expansion could be the precipitating factor, since this would contribute to lower profitability which could then trigger a stock market crash.

However, it is not just the inter-connectedness of negative factors that lies behind the increased plausibility of a crash. Deeper forces concerning changes in the structure of the domestic and global economy are at work. These have diminished the presence of "automatic stabilizers," and replaced them with "automatic destabilizers."[6] Whereas automatic stabilizers smoothed booms and busts, automatic destabilizers do the opposite. On the cyclical upswing they make for stronger and longer expansions, but on the downswing they make for deeper and more sustained contractions.

One change concerns patterns of employment relations and remuneration. In the past, labor hoarding was a common practice whereby firms held on to workers through downturns in order to retain their skills and avoid future hiring costs. Today, firms operate on hire and fire, which makes labor incomes more pro-cyclical. In manufacturing, overtime has increased as firms have sought to save on employment costs by extending hours rather than hiring new personnel. It means that wage income is more vulnerable to downturns since hours can quickly be cut back. Finally,

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[5]. See Palley (1996).

[6].This argument is developed at length in Palley (1998a).

casual evidence suggests that there has been an increase in the use of incentive pay, with greater reliance on stock options and profit related bonuses. In a downturn these forms of pay are likely to fall off rapidly, contributing to a larger decline in household income and spending. In sum, all of these changes make wage income more pro-cyclical, thereby making spending more pro-cyclical.

Another development concerns flexibility of wages. In the period from 1950 to 1980, recessions were characterized by a slow down in wage inflation, but wages still rose in recession. The recessions of 1981 - 1982 and 1990 - 1991 suggest a new pattern. Now, not only does wage inflation slow, but wages actually fall. This is a major change when considered in conjunction with the new debt driven business cycle. Consumers' ability to repay debt depends on the their wage income. The value of debts remains unchanged in recessions, but now wage incomes may fall. This increases debt burdens, raises the prevalence of bankruptcy, and deepens recessions.

Changes in financial markets have also contributed to the emergence of automatic destabilizers. Households now have significantly increased access to credit, and are able to borrow more heavily against their assets. Home equity loans and margin borrowing are the most prominent examples of the developments. Their effect is to increase debt to income ratios, and fuel spending on the upswing. Side-by-side, they create the potential for greater financial fragility, and on the downswing occurs households can be saddled with greater indebtedness which worsens and lengthens the downturn.

Lastly, it is worth noting that prices in the stock market may have been at bubble levels for over three years - recall that Chairman Greenspan gave his "irrational exuberance" warning back in 1996. This means that much borrowing and spending has taken place on the basis of these bubble prices, so that the bubble may be deeply embedded in the balance sheets of agents. This means that a market correction is likely to be more severe because the negative impact of bubble burst is positively related to the duration of the price bubble.

Accompanying these changes in the domestic economy, have been changes in the global economy that have contributed to the emergence of international automatic destabilizers. Increased international financial capital mobility means that it is easier for wealth holders to exit and a stampede when a country's financial markets begin to tumble. A second development is increased international integration of goods markets. Table 1 which shows how economic openness (measured as exports and imports as a share of GDP) has increased dramatically since 1965 in almost every country. This has increased international economic interdependence so that economies are more

interlinked, and this makes for greater amplitude in the world business cycle. In the 1950s and 1960s it was said that when the U.S. economy sneezes, the world economy catches a cold. Globalization of goods markets may have created a situation in which the U.S. economy sneezes and the world economy catches pneumonia.

What should policy makers do?

A reading of the tea leaves suggests that a plausible case can be constructed for each of the above three scenarios -- though the current level of the stock market indicates that market participants are confident of a soft landing. Indeed, arguing the hard landing or crash scenario effectively involves a judgement that hundreds of thousands of informed investors and Wall Street's professional investors have got it wrong.

However, this is exactly when economists may be most useful. If markets always gets it right, what is the use of economists? On this note, there are a number of reasons to believe that the hard landing story has real substance. Godley and Martin (1999) show how the current expansion has been driven significantly by consumer spending financed by consumer borrowing. Extrapolation of this pattern implies exploding private sector borrowing as a share of GDP and an exploding decline of the private sector saving rate into negative territory. Blecker (1999) undertakes a similar exercise in extrapolation with the trade balance which shows an exploding current account deficit driven by exploding financial income payments to foreign asset holders. Finally, Baker (1997) shows how appreciation of the stock market at a 7% real rate implies an exploding price to earnings ratio. All of these exercises reveal profound consistency problems with soft landing projections that assume a continuation of the status quo.

A soft landing can be achieved but it will require adjustments to policy both here and abroad, and it will also require the continuation of favorable developments (such as faster productivity growth) that are outside the Fed's control.

Independent of the relative likelihoods of each outcome, there is still a strong case for making adjustments to policy that guard against a hard landing or crash. At the moment the Fed fears inflation as public enemy number one. However, policy makers should adopt a balance of relative risks approach. This is the appropriate way to conduct policy in an environment in which the future is uncertain. An acceleration in inflation is undesirable, but it can be undone at relatively low cost. However, a hard landing would be more costly and harder to undo. Given this asymmetric pattern of costs, policy makers should err on the side of avoiding a hard landing or crash.

Applied to the Fed, the implication is clear: hold the line on interest rates, and be prepared to cut rates quickly if any weakness emerges. There is also a need to shift away from the current deflationary stance of fiscal policy - though this will be difficult until the debate over social security is resolved. A gradual depreciation of the dollar is also needed. There is also a need to reflate the global economy, and the European Central Bank should cut rates further. However, such a European rate cut must be accompanied by co-ordinated dollar - yen - euro exchange rate management to avoid financial instability. In the developing countries growth must be jump started by debt relief conditioned upon improved economic governance.

Finally, there is a need to make changes to the global economic architecture (and not just the financial architecture) to ensure a shift away from excessive reliance on deflationary export-led growth, and to ensure containment of competitive pressures that have promoted a race to the bottom in labor markets. However, these are measures that move the debate to a longer term policy horizon.[7]

[7]. These measures are explored in Palley (1998b).

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Footnotes

1.The views expressed in this paper are those of the author and do not necessarily reflect those of the AFL-CIO.

2.The National Bureau of Economic Research dates the beginning of the recovery as the second quarter of 1991.

3.This characterization of the business cycle is attributable to Minsky (1982, 1986). The formal dynamics and workings of such a cycle are examined in Palley (1994).

4. Inside lags refer to the time that is taken to legislate changes to fiscal policy. Outside lags refer to the time that it takes for these legislated changes to be implemented.

5. See Palley (1996).

6.This argument is developed at length in Palley (1998a).

7. These measures are explored in Palley (1998b).

	1966	1995	Change 1966 - 1995
United States	9.9%	23.6%	138%
Canada	39.1%	72.3%	95%
Japan	19.4%	16.8%*	-13%
Germany	51.1%+	63.4%*	24%
United Kingdom	37.8%	57.3%	52%
France	25.0%	44.5%	78%
Italy	28.1%	43.2%*	54%
Austria	51.4%	76.2%	48%
Belgium	73.5%	137.2%*	87%
Denmark	58.5%	63.3%	8%
Finland	41.3%	67.5%	63%
Netherlands	89.8%	100.0%	11%
Norway	83.2%	70.6%	-15%
Portugal	54.1	61.0%*	13%
Spain	20.2%	47.3%	134%
Sweden	43.8%	75.3%	72%
Switzerland	58.7%	66.9%	14%
G-7	30.1%	45.9%	53%
Europe	51.2%	69.6%	36%

Table 1 Openness of OECD countries, 1966 - 1995. Openness = [Exports + Imports]/GDP. Source: Author's calculations using IMF statistics. G-7 and Europe computed using population weights. * = 1994 data.