

THE US ECONOMY IN 1999: GOLDBLOCKS MEETS THE BIG BAD BEAR?

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In the last year or two, the US economy has been called the "Goldilocks economy" because it has been rolling along "just right, not too hot and not too cold," with both unemployment and inflation at the lowest levels in 30 years, a booming stock market, etc. Business Week has even proclaimed in a series of prize-winning special issues that the US economy has entered a "new era" in which rapid technological change (especially information technology) will make it possible for the US economy to continue to achieve both low unemployment and low inflation for the foreseeable future.

Meanwhile, most of the rest of the world is suffering through its worst economic crisis since the Great Depression of the 1930s, with no end in sight. Most of Asia is already in a severe depression, with output declines ranging from 3% in Japan and 6% in Korea to 15% in Indonesia. This worsening depression is having devastating effects on the population of these countries; unemployment is soaring (real unemployment rates of 25% or higher) and there is little or no unemployment insurance. Real wages have declined by 10-30% and will almost certainly continue to decline in the next year or two. Tens of millions of people will fall below the poverty income line (an estimated 40 million in Indonesia alone), wiping out several decades of improving living standards and declines in poverty.

The Russian economy is experiencing almost a complete breakdown. Many workers have not been paid in months, and in some cases even years. More and more of the transactions are by barter trade. The Russian government has defaulted on part of its foreign debt and is likely to default on most of the rest of it, which means that foreign loans are not likely to be made again to Russia for many years to come.

Furthermore, there is an increasing likelihood that the depression will spread to Latin America - which in the last few years was finally starting to grow a little bit after the "lost decade" of the 1980s (really almost two lost decades). Brazil has been forced by the IMF to adopt very restrictive fiscal and monetary policies, as the condition for a \$43 billion loan in December. These restrictive policies are certain to land the Brazilian economy in a recession, and perhaps even a depression, which will carry most of the rest of Latin America with it (especially since these countries are also being forced by the global crisis to defend their currencies by means of restrictive policies). For workers, unemployment will rise sharply and real wages will decline sharply, as in Asia. Hence the "Asian crisis" is no longer just an Asian crisis. It is now a spreading global crisis.

So the urgent question for the moment is: how long can these divergent economic trends continue, between prosperity in the US and depression in the rest of the world? Even Alan Greenspan has asked recently : "How long can the US economy remain an island of prosperity in an world of depression?"

Almost all mainstream economists seem to think that the US economy is so strong that it will suffer only slightly from the spreading global economic crisis, and in particular will not suffer a recession. I disagree with this prevailing view. I think it is very likely that the US economy will suffer more significantly from the spreading global crisis, and that it will fall into recession within the next year or so. In other words, I think that Goldilocks is about to meet the big bad bear. Such a recession in the US would in turn have devastating effects on the rest of the world, especially the Asian countries, for whom increasing their exports to a booming US market is about their only hope for recovery.

In what follows, I will examine the various effects of the global crisis on the US economy and will attempt to determine the likelihood of a recession within the next year or so.

Paradoxically, so far the Asian-global crisis has had mostly positive effects on the US economy. In the first place, it has contributed to a lower rate of inflation. The sharp devaluation of the Asian currencies has resulted in cheap imports from Asia (computers for under \$1000, Honda Accords for \$16,000, Hyundais for \$6,000, cheap consumer electronics, etc.) and this has in turn reduced the overall rate of inflation. The crisis has also reduced the global demand for oil and other primary materials, which has led to a significant decline in the prices of these commodities (e.g. a 30% decline in its price of oil, so that gasoline is now under \$1.00 a gallon), thereby contributing further to a lower overall rate of inflation. In addition, interest rates in the US are lower than they otherwise would be, both because of the lower rate of inflation and because of a large influx of foreign capital fleeing Asia and seeking a "safe haven" in US Treasury bonds.

However, the negative effects of the global crisis are starting to kick in and are likely to intensify in the months ahead and overwhelm these positive effects. There are three components of aggregate demand through which the global crisis could negatively affect the US economy: net exports, investment spending, and consumer spending. I will examine in turn each of these three components.

DECLINE OF NET EXPORTS

The component of aggregate demand that will suffer immediate and direct impact from the global crisis is net exports (exports minus imports). most immediate negative effect of the Asian-global crisis on the US economy is through a reduction of exports and an increase of imports. Because of the very large devaluation of the Asian currencies, US goods are now relatively much more expensive, both US exports and US goods competing with cheaper imports on the domestic market. In addition, the sharp decline in the Asian economies reduces their demand for US exports even more. Furthermore, it is alleged that some Asian producers are "dumping" their goods on the US market (i.e. selling them at a loss, for less they they cost to produce) just to obtain some revenue, because their sales in Asia have collapsed. The loss of export markets and the loss of domestic markets to imports not only reduces

aggregate demand in the US economy, but also means fewer jobs for US workers and hence a higher rate of unemployment.

So far, US exports to Asia have declined about 20% and imports from Asia have increased about 5%. Since total US exports is only 12% of US GDP, and the percentage of US exports that goes to Asia (including Japan) is only about 30%, this reduction in US net exports (exports minus imports) has had only a small negative effect on the rate of growth in the US economy (less than 1%). Many economists have concluded that the worst of the Asian crisis is over (i.e. that these economies have "bottomed out" and will start to recover next year) and hence that the negative effects on US exports and imports should not worsen further in the year ahead. If this prevailing view is correct, then this small negative effect should not be enough to cause a recession in the US.

However, I doubt very much that the Asian crisis is over. Rather, I think that this crisis is still in its early stages, with much more to come, and the worst to come. The main reason why I think this is that many (and perhaps most) capitalist enterprises in Asia today (including in Japan) are technically bankrupt - i.e. they are losing money (their revenue is less than their costs) and they are unable to meet their current debt obligations. Joseph Stiglitz, chief economist for the World Bank, was recently quoted in the New York Times as saying: "In Indonesia, 75% of the firms are bankrupt. How can you run an economy when 75% of its firms are bankrupt?" The short answer is - you can't. Similarly, estimates for Korea show that cash flow (profits plus depreciation) for the corporate business sector as a whole is less than the current interest payments due (CHO). In other words, depreciation charges are being used to help make interest payments, and even this is not enough. The negative gap between cash flow and interest payments in Japan's corporate sector is similar to Korea's, and perhaps even worse. As these economies continue to decline in 1999, the bankruptcy of business firms is likely to increase still further.

The high incidence of bankruptcy in Asian economies today is due in part to an important characteristic of Asian-style capitalism: capitalist enterprises rely much more heavily than their Western counterparts on borrowed funds (mostly from banks) to finance their investment. Typical debt-equity ratios in Asia are 300-400%, where as in the US and Europe a debt-equity ratio of 100% is considered to be dangerously high. This high-debt style of capitalism helped make possible the very high rates of growth in the Asian economies for several decades, but it has also made these economies much more vulnerable to any downturn in the economy. With the sharp declines in these economies over the last year or so, the sales revenue of most firms has also declined sharply. In addition, interest rates were raised sharply to try to stop the outflow of capital, and this added greatly to the debt burden of firms. As a result, many firms are now suffering losses and are unable to meet their current debt obligations. In the US, such a situation would usually result in the creditors forcing the insolvent firms into bankruptcy; i.e. insolvent firms would be shut down and its assets auctioned off so that the creditors could recover at least part of their loans.

FNOTE Finally, the killer-blow for many firms with foreign debts denominated in dollars was the 50% devaluation of the Asian currencies, which doubled the debt burden of these firms in terms of their own currencies. DEBT BEING SERVICED ??

However, so far in Asia, many of the insolvent firms have been allowed to continue to operate. Many small and medium-sized firms have been forced into bankruptcy, but most larger firms have been allowed to continue to operate and even extended new loans by their creditors, the banks, often at the urging of national governments. In some cases, the Asian governments themselves have loaned money directly to firms - mostly very large firms who are considered "too big to fail" because of the deeper depression and higher unemployment that would ensue. The banks have been willing not to force the bankruptcy of these firms because they would probably be able to recover only a small percentage of their original investment, which would show how little the loans on their books are actually worth. Indeed, the acknowledgment of the full extent of these losses would cause many of the banks themselves to fail (because their losses would be greater than their net worth).

However, these bank and government bailouts of bankrupt firms do not solve the fundamental problems of declining incomes, insufficient profits, and heavy debts. Eventually, most of these insolvent firms will have to be forced into actual bankruptcy. That is the perverse way that capitalism works. Bankruptcies of some firms are the means through which the rate of profit of surviving firms is increased, thereby creating the conditions for an eventual economic recovery sometime in the future. However, in the short run bankruptcies would also of course cause a deeper depression.

The bankruptcies of firms would also of course result in large losses for the Asian banks, as just mentioned, which would worsen the already severe banking crisis in these countries. Many banks would themselves go bankrupt, resulting in a further contraction of the economy.

The most important economy by far in Asia is Japan's, which accounts for roughly 60% of Asia's GDP. The banking crisis in Japan is worse than in the other countries, because Japan's banks have been the most important lender to the rest of Asia in recent decades. So Japan's banks are now suffering losses, not only from defaults by Japanese firms, but also from defaults by borrowers in these other countries. It is estimated that Japanese banks have at least \$1 trillion of "non-performing" loans (about 25% of GDP). As a result, most banks have essentially stopped lending, thus resulting in a very severe "credit crunch." The Japanese economy declined almost 3% in 1998, and it is very likely it will decline at least that much in 1999 and probably more. This deepening depression in the world's second largest economy (accounting for 20% of world GDP?) is bound to have very strong negative effects around the world, especially in the rest of Asia and including in the United States.

In sum, I think that the Asian crisis is far from over, and that further significant declines in these economies, and hence in the demand for US exports, are to be expected.

Furthermore, many Latin American countries, led by Brazil, are also falling into recession, which will further reduce the demand for US exports. And even Europe will suffer at least a slowdown of growth; England appears to be already falling into recession. In these circumstances of a declining world economy, it seems likely that US exports will decline another 10-20 % next year. The US balance of trade deficit increased in 1998 from around \$100 billion to roughly \$150 billion. It will increase even further next year, perhaps to \$300 billion or more. HIGHEST IN HISTORY %GDP ?? The negative

effect of this further decline in exports might not be enough by itself to push the US economy in recession, but it would certainly reduce the rate of growth to at most 1-2%, down from the 4% rate of the last few years.

DECLINE OF BUSINESS INVESTMENT

Another possible negative effect of the global crisis on the US economy is a reduction of business investment. Investment spending has already declined slightly in the 3rd quarter of 1998, after several years of strong investment (with average increases of about 10% a year). This sharp slowdown of investment is due to primarily to stagnant or declining profits (see Moseley 1998 for a discussion of the failure of the rate of profit in the US economy to fully recover from the prior decline in the rate of profit that occurred in the 1960s and 70s). Other causes of the slowdown of investment spending include a declining capacity utilization rate (i.e. the percentage of existing production facilities that are currently being utilized) and declining expectations of future demand. If there is a further decline of investment in the months ahead due to the global crisis, which seems likely, this reduction would bring the US economy closer to the brink of recession, if not over the brink.

In addition, there is another danger that might lead to an even greater decline of investment spending: a "credit crunch" in which lenders refuse to lend to firms, or are willing to lend only at much higher interest rates. The traditional type of credit crunch has happened through banks, who in times of recession or impending recession tighten their eligibility requirements and reduce their lending activities. This traditional credit crunch does not seem to be much of a danger in the US economy right now. However, this could quickly change if US banks suffered significant losses in the months ahead as a result of the spreading global crisis - due to loans to "emerging market" countries, or loans to "hedge funds" with risk exposure to these countries, or to the banks' own "derivative" contracts related to these countries. ("Derivatives" is a general catch-all term for many different types of new investment instruments developed by banks over the last decade or so. Many derivatives ultimately involve a loan to one of the "emerging market" countries, and hence are subject to the risk of default (and also to the risk of currency devaluation).

In addition, in recent months, a new type of credit crunch has appeared and threatens to be more severe: a credit crunch in the bond markets, in which investors are no longer willing to buy corporate bonds (except the highest grade), or are willing to do so only if these bonds offer a significantly higher interest rate (i.e. only if these bonds offer a higher "risk premium"). Investors have been spooked by the Russian defaults and the near-bankruptcy of Long-Term Capital Management. As a result, there has been a "flight from risk to safety" (i.e. from corporate bonds to US Treasury bonds). It was this new kind of credit crunch that Greenspan was especially worried about when he engineered the "triple play" reduction of interest rates in October. The panic of the late summer and early fall has subsided somewhat in recent weeks (so it looks like the Fed's actions have been successful so are in reassuring investors that it has "both hands on the wheel" of the economy and will not let it veer out of control). However, these fears no doubt remain just below the surface and would very likely reemerge in full force in the event of the next unexpected "nasty surprise" in the world economy - e.g. further defaults by Russia, capital flight and currency crisis in Brazil, a deepening depression in Japan, intensified class

conflict in S. Korea or Brazil or elsewhere, a devaluation of the Chinese renminbi, or even the US dollar, etc.). If a severe credit crunch were to develop, then investment spending would decline sharply (since businesses would no longer be able, or would be less able, to borrow funds for purpose of investment). Such a sharp decline of investment due to a credit crunch would almost certainly land the US economy in a recession.

CONSUMER SPENDING SPREE: HOW MUCH LONGER CAN IT LAST?

The only component of aggregate demand in the US economy that continues to increase at the present time is consumer spending. Indeed, US households are on an all-out spending spree. The percentage of after-tax income that US households spend (as opposed to save) has always been higher than most other countries - around 94% (compared to 80% on Japan and 85% in Germany). But in recent years, the US spending rate has increased even further, and in the last few months has even exceeded 100%! That's right - US households are spending more than their after-tax income (i.e. the US "saving rate" is negative). Normally, a country with such a low saving rate would have a correspondingly low rate of capital investment, since household savings are one of the the main sources of funds for business investment. However, the US economy in recent years has been able to maintain a high rate of investment, in spite of a very low savings rate, because of a very large inflow of foreign capital into the US during this period. In other words, the rest of the world has been willing to provide the savings necessary to maintain the investment in the US, thereby enabling the US to eat its cake (consumption) and have it too (investment). (See Moseley 1999 for a further discussion of the important role of the inflows of foreign capital in supporting the relative prosperity in the US economy since 1983 and especially since 1995.)

The main factor propelling consumer spending forward in recent years has been the booming US stock market. Stock prices have increased roughly 50% over the last two years, and have increased 150% since 1993. This very rapid increase of stock prices has greatly increased the wealth of US households, especially the small minority of households that own most of the corporate stock. This increasing wealth from the stock market has had a strong positive effect (called the "wealth effect") on consumer spending - on the consumer spending of the rich, that is, who have enjoyed this wealth windfall. These households evidently feel that their increasing stock market wealth provides all the saving for the future that they need, and hence they do not have to save out of their current income (instead, they can spend all of their current income, and more!).

Thus we can see that the main force moving the US economy forward at the present time - i.e. the main force keeping the US economy from a recession - is the booming US stock market which is fueling consumer spending. But how much longer can this stock-market-led consumer spending spree last? In order for it to continue, the stock market must not only maintain its current high levels, but also must continue to increase rapidly as in recent years. However, fears about the global crisis have already caused a 15% decline in stock prices in August and September. Since then, the stock market has recovered this lost ground (due in large part to the expansionary monetary policy of the Fed), but I don't think it will rise much further in 1999. The current average "price-earnings" ratio of US stocks (the ratio

of the price of stocks to current profits) is already at unprecedented high levels of around 25:1; the long-run historical average is about 15:1. By this historical measure, stock prices are currently overvalued by 67% (the recent recovery in the stock market is now being called by some people "Greenspan's bubble"). This large overvaluation by itself suggests at least that stock prices are not likely to go much higher in the year ahead. If stock prices do not continue to increase, then the positive "wealth effect" on consumer spending would disappear.

Furthermore, these very high stock prices are based on extremely optimistic expectations about the future profits of corporations. For example, securities analysts seem to be expecting on average a 17% (!) increase in corporate profits next year (SOURCE??). However, in the aggregate, corporate profits increased only X% in 1998 and, with a slowing economy next year, are likely to increase even less and perhaps even decline. Therefore, these very optimistic profit expectations are almost certainly to be disappointed. This disappointment is likely to cause a sell-off of stocks and hence a decline in stock prices. Greenspan said back in July: "We know from history that a stock market correction is likely. What we cannot say is when." I think the "when" will be 1999. Such a stock market decline would in turn result in a further reduction of consumer spending, as the "wealth effect" goes into reverse.

Hence, the key support of the US economy at the present time - strong consumer spending fueled mainly by increasing stock market wealth - is likely to be removed in the year ahead. At best (with a stagnant, but not declining stock market), the increase of consumer spending is likely to slow down, thus becoming another factor slowing down the US economy and pushing it toward recession. At worst (with a declining stock market), consumer spending is likely to decline, which would definitely push the US economy into recession.

CONCLUSION: THE BIG BAD BEAR?

I conclude that it is very likely that the US economy will fall into a recession within the next year or so. It is possible, although not very likely, that the US economy will only slow down and will not fall into a recession. If everything in the world goes just right - i.e. if the Asian and Latin American economies start to recover (Japan and Brazil in particular); if no other unexpected "nasty surprise" happens somewhere in the world economy; if a credit crunch is avoided in US banks and US bond markets; if the US stock market continues to increase, despite all historical precedents and actual profits; if US households continue to spend more than they earn, etc. - in short, if all these conditions are fulfilled, then perhaps the US economy will only slow down and will escape a recession. However, if just one or two of these requirements is not satisfied, which seems to me to be a high probability (e.g. lack of recovery in Japan and/or Brazil), then it is very likely that the global crisis will come home. Goldilocks will meet the big bad bear.

If a recession does occur in the US economy, then I think there is a danger that it will be a bad one. The main reason for this danger is that, in the event of a recession, consumer spending is likely to decline sharply. As discussed above, households are stretched to the limit of their spending capacity and beyond, and this spending spree has been fueled mainly by the booming stock market. However, a recession

would surely bring the stock market boom to a halt and would probably cause a significant decline in the stock market. As discussed above, such a decline in the stock market would almost certainly lead in turn to a sharp reduction of consumer spending. Households would not only have to finance their saving out of their current income, they would also need to replenish their lost savings in the stock market by saving even more out of current income. The saving rate of US households could increase suddenly from 0% to 5% or more, which would further reduce consumer spending and push the economy even deeper into recession. In addition, US households are also very heavily in debt (the percentage of household debt is now approximately 100%, an all-time record). SEE CC PAPER

A recession would mean loss of jobs and income for many of these heavily-indebted households, which would then have to scale back their spending drastically in order to avoid personal bankruptcy.

If a recession were to occur in the US economy over the next year or two, then this US recession would in turn have a devastating effect on the rest of the world economy, especially Asia and Latin America. The main hope for these countries for recovery from their current depression is to increase their exports to the "booming" US market (an earlier hope was to increase their exports to Japan, but that hope has evaporated as Japan has fallen into its own depression). If the US economy falls into recession, then the US demand for Asian exports would decrease, not increase. Without their main hope for recovery, these economies would likely remain in a serious depression for years to come. And if the global depression continues, this would in turn continue to drag down the US economy.

Could such a recession in the US economy (and depression in much of the rest of the world) be avoided by expansionary monetary policy? In other words, could the Fed save Goldilocks from the big bad bear? If such a recession in the US were to threaten, it is almost certain that the Fed would adopt an aggressively expansionary monetary policy, as it did last fall, in order to lower interest rates and by this means stop the slide of the economy into recession. Almost all mainstream economists seem to think that such expansionary monetary policy would be successful, i.e. would enable the US economy to avoid a recession. This confidence in the Fed's powers, already very high, was bolstered further by the recent success of expansionary monetary policy in calming fears and alleviating a credit crunch and generating the stock market recovery. However, this successful episode of expansionary monetary policy came at a time when the US economy was still growing briskly due to strong consumer spending. If the US economy were instead slowing down and threatening to fall into recession, due to the combined effects of declines in net exports and investment spending, which in turn would reduce household incomes and hence consumer spending, would expansionary monetary policy be successful in these more difficult circumstances?

In particular, would expansionary monetary policy be able to avoid a credit crunch in the bond markets and the resulting collapse of investment spending? The Fed has more control over the ability and willingness of banks to increase lending than it does over investors in the bond markets. It remains to be seen whether the Fed's traditional policy tools will be successful in the bond markets under conditions of a declining economy.

Furthermore, would expansionary monetary policy be able to rally the stock market again, if the economy were slowing down and profits falling? Success would be less likely under these circumstances because of the already very high valuations of stocks at the present time. If profits are falling as a result of a declining economy, then either price-earnings ratios will rise even higher above today's very high levels or stock prices will have to fall along with profits. At some point, it seems likely that the stock market bubble will burst and there will be very little the Fed can do about it.

The ability of expansionary monetary policy to avoid recessions and depressions is a long-standing debate in macroeconomics. Keynes argued in the 1930s that expansionary monetary policy is often unsuccessful in conditions of recession or depression; expansionary monetary policy and lower rates of interest are often not enough to persuade lenders to lend and businesses to invest in a deteriorating economy with increasing risks. In Japan, expansionary monetary policy has been applied relentlessly in the 1990s (so much so that interest rates have fallen below 1%!), but has clearly failed to overcome the severe credit crunch or to revive investment spending. Expansionary monetary policy has also so far not been able to stop the slide of the UK economy into recession. It appears that we will soon witness a historic and very important empirical test of the effectiveness of expansionary monetary policy to save capitalist economies from recessions and depressions.

If expansionary monetary policy were to fail in the coming months in the US economy, then the other main government policy option that could be used to try to avoid a recession is expansionary fiscal policy (increase government spending and/or reduce taxes). However, expansionary fiscal policy takes months to legislate and more months to implement and still more months to take effect on the economy. Therefore, if expansionary fiscal policy is to have a chance to help the US economy avoid a recession, then it should be proposed and legislated as soon as possible. However, no one in Washington is talking about expansionary fiscal policy at the present time. Expansionary fiscal policy is not seen as necessary to avoid a recession and, secondly, it would result in a budget deficit, which runs counter to the main goal of fiscal policy in the US at the present time of a balanced budget. Therefore, expansionary fiscal policy is not likely to save the US economy from a recession.

Wray and EPI BW: tax cut SPCEIFICS ??

Republicans have proposed a tax cut to eliminate the budget surplus

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ENDNOTES