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Viewpoint: Expansion - But Not Tranquility in 1983-1987

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The January economic reports of the Administration and the initial reactions to them are now on the record. The "authorities," public and private, forecast a mild recovery to be followed by years of non-inflationary, tranquil expansion. This forecast contradicts the evidence. The past decade and a half clearly indicates that our economy is now incapable of sustained tranquility. Ours is now a lurching economy. It moves albeit not immediately from one set of unsatisfactory, threatening conditions to another. The major forecasting problem is to determine the forces that will create the next lurch and ~~the time at which~~ when it ~~will~~ is likely to occur.

Our economy is trapped in a ~~dynamic~~ cyclical process in which the recovery, after a recession, turns into a boom that leads to an accelerating inflation. Inflation continues until the demand for financing outruns what financial markets are able to supply at modest interest rates. When this happens, interest rates rise rapidly, disrupting financial markets and leading to financial disturbances. These disturbances, in turn, lead to an incipient financial crisis. However, intervention by the Federal Reserve to refinance distressed organizations contains the crisis, even as government deficits brake the recession and sustain profits to induce a recovery. In the recovery, the weakened balance sheets of businesses and banks are first strengthened (this is the stage in which we are now). The boom-inflation crisis sequence follows. Such an inflation-prone business cycle has prevailed since the middle 1960s.

During 1981 and 1982 interest rates "exploded." As a result, business used much more of its cash flows to carry debt than had been anticipated when the debts were incurred. More debt than desired, and debt at higher interest rates than anticipated, is a legacy from 1980-1982 to 1983 and the succeeding years. In 1983 businesses, urged on by their bankers, will take advantage of their sustained profits and more favorable financing conditions to reduce debts, refinance short-term debts into longer-term debts and equities, and build buffers of financial assets. Commercial banks and savings institutions will be building their liquidity. Such financial rebuilding behavior assures that the recovery will be modest.

The timing of the boom--during which business shifts to an increased use of debt financing--depends upon how the events of 1980-1982 are interpreted. Two "polar" interpretations of what happened might be:

1) The thrust toward expanded debt financing which leads to crises is a fundamental characteristic of our economy. We must manage our affairs so as to protect ourselves against being trapped when conditions such as those that occurred in 1980-1982 are repeated. We escaped disaster by the skin of our teeth and, next time, we may not be so lucky.

2) The recovery, together with the Reagan reforms, prove that concerns about the overuse of debt, financial crises and the threats of deep depressions are unwarranted. The economy has entered a "new era.".

The first interpretation assumes that the future will be like the recent past. The second interpretation assumes that the various crises of 1980-1982 were due to poor management and were the legacy of an unwisely regulated and poorly structured financial system. It also assumes that reformed and deregulated financial structures, together with the tax reforms of the Reagan years, assure that a replication of 1980-1982, 1974-1975 and 1969-1970 will not happen in the foreseeable future.

Starting in early 1983 we should enjoy a period of from four to six quarters of relatively tranquil expansion with modest inflation. The continuing high government deficits will sustain business profits and allow the balance sheets of businesses and banks to improve. Initially, the "we escaped disaster by the skin of our teeth" view of 1980-1982 will prevail, so that financial behavior will be conservative. As time goes by, it will be replaced by a "new era of permanent prosperity" interpretation of 1983 and beyond--which means that the use of debt will increase.

Once 1981-1982 is taken to show that a great depression cannot again happen, the climate of expectations will be ripe for a "lurch" into boom.

Thus, the recovery of 1983 and the development of the economy in the years that follow will be conditioned by the way businessmen, bankers, households and the "authorities" interpret what happened in 1980-1982. Businessmen and bankers, the principal performers in our economy, will not only remember how badly they were mauled by adverse conditions, but they will also know that they survived. Although times were hard, the worst that might have happened--a deep depression similar to that of the 1930s--did not happen. Once again, our "big government" economy proved to be resilient: It experienced serious financial and economic distress and bounced back. Confidence and a willingness to experiment with debt will, therefore, increase.

The timing of the next inflationary lurch depends on the pace at which the interpretation of recent experience changes. The longing for a replay of the "golden era" of the American economy (1946-1966) is strong; the will to believe that the turbulence of 1967-1982 is only a transitory phenomenon is strong. This combination of beliefs will provide a climate in which a replay of a lurch to inflation and crises seems inevitable. The timing is an open question, but in the next five years, the sky will once again seem to be falling.

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