Towards 1984:
~~The American Economy in Mid Year 1983~~:
Recovery in the Context of a Continuing Fragile Financial Structure

by
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~~Once again~~ The sky did not fall. In 1982, A serious recession, ~~and~~ a multitude of ominous financial trauma and a flock of local financial crises did not lead to an open ended decline in income and employment and a general collapse of the financial structure. At year end 1982 a ~~Furthermore in mid year 1983 the~~ recovery began in the United States ~~apparently is~~ which is stronger and sharper than was generally anticipated as recently as the spring of the year. The concensus forecasts for 1984 are for a continuing robust expansion, although caveats abound about the circumstances that can accelerate or abort the expansion. Although the financial structure has been able to absorb bankruptcies such as Baldwin United, Tennessee banks and Continental Airline fears ~~abound~~ abound that the overseas ~~the~~ exposure of the giant banks ~~to overseas losses~~ can lead to an out of control cascading of ~~losses~~ loan losses and therefore "bank" "refinancing" by their respective Central Banks. The ~~economy may be analagous to a live limb - it bends~~ economy's behavior over the past several years may be compared to a limb that bends but does not break — but we know that there are limits to the resilience of a limb. The resilience exhibited in 1982 is no assurance that future pressures will be overcome. Furthermore we should not be complacent and assume that the "success" in surviving without disaster was the result of "natural" market forces; the government's deficit and the accommodating stance of the Federal Reserve after mid-year 1982 ~~had~~ were in good measure responsible for the ~~recovering~~ ~~which~~ exhibited resilience

The behavior of the economy over the past ~~18 months~~ 2 years ~~confirms~~ is further evidence for the view that our economy now lurches from one crisis to another. Smooth and long lasting contractions, stagnations and expansions are not characteristics of our economy. Instead of coherent expansions and mild, non threatening, cycles, such as ruled in 1946-66, our economy's recent path ~~through history~~ is ~~now~~ marked with financial crises, inflations, and industrial bankruptcies that seem to threaten the fundamental coherence of the economy. In ~~recent~~ the years since 1966 incoherence has been averted by Federal government and Federal Reserve interventions and constraints upon the "free working" of market processes that are built into the ~~economy's~~ institutional structure. Even as the official rhetoric extolls the virtues of free markets and free enterprise interventions, bail outs and market rigging have become regular occurrences

The crisis that was contained in 1982 centered around the viability of financial institutions, (in particular ~~the savings banks~~ a breakdown in prudent banking (Penn-Square, etc)), the repercussions of a collapse in bond prices (long term market closed), a fall in asset values in oil and related industries ~~(Penn Square etc.)~~ and an international financial trauma best characterized as a run to the dollar (Mexico, Poland, the appreciating dollar). The crisis that we ~~are~~ may be lurching towards is that of a speculative investment boom, another round of inflation, high and rising interest rates, and a flight, both domestic and international, from the dollar. However this "crisis" might be delayed because the continued fragility of the international structure might well force another ~~round~~ round of deflation and renew the recession. ~~We may have a cycle~~

~~dollar.~~

To lurch towards does not mean an instantaneous transition to. It will take time for a crisis due to an investment boom, deregulated finance inflation, and high and rising interest rates to develop. Before ~~the~~ a flight from the dollar (as in 1979) takes place there will have to be an accumulation of offshore holdings of short term dollar assets that is large relative to payment commitments on offshore debts and a decline of inflation adjusted interest rates on short term dollar assets relative to expected ~~(extrapolated)~~ price increases on various classes of ~~assets~~ goods.

On the basis of experience since the mid 60's -when the economy entered upon its current mode of operation with the credit crunch -the expansion phase a business cycle lasts from two to four years: we are now about ~~six~~ nine months into the expansions. ~~We~~ The United States should ~~now~~ experience a rapid expansion of output (up to 10% annual rate in some quarters), an appreciable decline in unemployment rates (down to the neighborhood of 8.0%-8.5%) and modest inflation rates (~~quarterly~~ inflation rates of from 4% to 7% per annum). Unless there is a quick development of international ~~monetary pressures on the dollar and~~ financial turbulence or strong Federal Reserve constraint, either in response to ~~the~~ pressures on the dollar or a ~~persistence~~ return of inflation ~~at~~ to the upper end of the 4% to 7% "acceptable" annual rate range, this expansion phase should last through 1984 and into 1985. Domestic considerations indicate the next cyclical peak and financial crisis should take place between year end 1984 and year end 1986.

The normal path of ~~our~~ the United States economy is a "business cycle" which has some seven identifiable stages. These stages reflect both the internal ~~relations~~ dynamics of our institutionally complex, financially sophisticated private economy and the impact of government and Central Bank interventions. If we start from (where we are now) an expansion, an expansion (stage 1) gains momentum until it leads to an inflationary investment boom (stage 2). During the expansion and investment boom the of the previous cycle

liquidity accumulated by business and financial institutions during the
liquidity stretching
earlier stagnant period (stage 7) is used up and new financial practices and
the inherited fragile financial structure becomes even more fragile.
institutions emerge: ~~As a result~~ During the later part of stage 2 prices and
Federal Reserve fights inflation which leads to a
interest rates begin to rise rapidly. The fall in asset prices and the rise
This
in the carrying costs of debts. leads to financial dislocations and failures
i.e. an attempt to unwind complex extensive liability structures. The need financial consolidation
and a rush to liquidity (stage 3). ~~This~~ leads to a sharp drop in investment
seem to be
and income (stage 4). ~~With~~ Severe financial dislocation ~~apparently~~ imminent.
The Federal Reserve intervenes and refinances threatened organization and
adopts an accomodating stance in financial markets (stage 5). A large
due to
seemingly open ended government deficit emerges that is due to both the built
in stabilizers and policy initiatives; this brings the decline in income to a
and even increases
halt and sustains profits (stage 6). A period of reliquidification of private
as a result
which has a positive impact on profits even as
units ~~even as~~ the government ~~runs a huge~~ deficit ~~and~~ the economy apparently
stagnates ~~follows~~ (stage 7). Quite unexpectedly stage 7, stagnation, gives
way to stage 1, expansion.

In this cyclical progression policy is important in determining how long and how thorough going the expansion, whether ~~the~~ intervention takes place early or later in an emerging financial crisis (which incidently determines who gets hurt and how badly units get hurt) and whether the government
in place
augments or perhaps offsets the deficit due to ~~existing~~ tax and spending
someday
will
schedules. It is conceivable that a Federal Government ~~will some day~~ try to
offset recession induced deficits by decreasing spending and increasing taxes
and ~~that~~ a Federal Reserve will stand aside and allow "nature to take its
course" in financial markets in the aftermath of a Penn-Square failure or a
1929/33 business cycle policy
Mexican default, but the possibility that such a ~~1920's~~ ~~approach~~ will ~~surface~~
Such policy would lead to a full fledged debt-deflation
rule in the near future is disregarded. The cycle that has ruled since the
mid-sixties reflects policy interventions in the form of government deficits

of the type that Irving Fisher described fifty years ago and Federal Reserve intervention ~~to~~ that refinance ~~serious~~ positions that ~~become vulnerable.~~ are in or close to default and have carrying costs over budgets. I assume that the objectives of the policy interventions of 1982 will ~~be replicated~~ ~~adhere to~~ service in any ~~future~~ recession~~ary perio~~d in which financial disturbances occur in the near future. or interventions

The ~~Volker~~ reappointment of Volcker as Chairman of the Board of Governors is significant in forming expectations about the likelihood of early and effective Federal Reserve intervention~~s~~ to abort financial crises. In the 1979 run from the dollar, the 1980 Hunt-Bache, Chrysler and First Pennsylvania episode~~s~~ and the multidimensional trauma of 1982, Volker ~~never failed to~~ took the initiative and intervened to protect the stability of the financial structure. With Volcker as Chairman, the Federal Reserve System will first be a lender of last resort to the financial system as it is ~~and only secondly be~~ its concerned with inflation and employment is secondary. Thus the ~~mid year 1982-mid year 198~~3 rapid growth in the money supply to mid year '83 ~~is best~~ interpreted as the result of the ~~need to~~ Federal Reserve intervention ~~to~~ to abort an incipient crisis in mid year 82 and a need to accomodate financial markets ~~during~~ to facilitate the reliquidification phase of the cycle. The financial system structure that Volcker will intervene to protect is not ~~just the United States financial structure but it also includes the dollar based international financial structure~~ just within the United States. It includes the dollar based international financial structure. If inflation is the only way to float off the international indebtedness that now exists then we can expect the Federal Reserve under Volcker to "go along."

Given that stage 1 of the business cycle, expansion, started in late 82 or early 83, we can look for the factors that will affect whether the time in this stage will be towards the short (2 years) or the long (4 years) side of the duration of recent expansions. The economy is not a replicating system - it does not repeat its history in detail. ~~This is very explicit~~ In the business cycle formulation used here this is explicit because Federal Reserve interventions as a lender of last resort are always discretionary and often improvised. ~~and~~ They always ~~depend upon~~ reflect the Federal Reserve's diagnosis of the situation. Furthermore each expansion has some unique ~~initial~~ conditions which affect the details, even as they do not affect the broad contours, of the development of the economy. ~~In particular~~ These in fact initial conditions ~~will~~ affect the duration of an expansion.

Thus if the system is now ~~six~~ nine months into the expansion phase that will be succeeded by an inflationary investment boom with high and rising interest

after an interest
rates that leads to the emergence of a threat of a financial crisis, the questions of how long will the expansion last, how far will unemployment fall, and to what heights will interest rates rise are relevant. At the time of financial disruption the question becomes how effective will the Federal Reserve's interventions be. Among the factors that characterize the initial conditions and effective constraints for the current expansion are:

1) the weakness of trade unions.
2) the strength of corporate market power.
3) the initial high unemployment rate~~s~~.
4) the structural deficits implicit in government spending and tax commitments.
5) the effect of the "supply side" tax changes of 1981.
6) the inherited national financial structure.
7) the inherited international financial structure and the United States balance of trade.
8) the willingness of the government to eliminate the structural deficit in this expansion.
9) the willingness of the Federal Reserve to constrain as the expansion proceeds.
10) the impact of financial deregulation.

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For some of these factors we have to estimate the political climate ~~some~~ over two years ~~from now~~ since However the basic assumption is that the laws of motion of our economy have not been changed by recent 'political' decisions. In particular the financial fragility so evident in 74/75, 79/80, ~~and~~ 1982 and in the current international indebtedness picture remains a dominating factor determining what happens in our economy. Even though the crises of '82 were contained the ways of doing business and of financing activity have not changed. This makes it very likely that another episode of financial trauma will occur not very far in the future.

1) Large scale unemployment, the economic difficulties of the older industries that were their stronghold, an "apparent" decline in the reason for trade unions with the maturing of "paternalistic" managements, lack of a "class" identity and an unfriendly government have all contributed to the decline in union power. The emergence of concessionary contracts following in the

recession of 81-82 is evidence of how weak unions are in the face of declining business profits. This weakness together with ~~the high~~ continuing unemployment rates indicate that the wage-push dimension to the inflationary process will come late and will not be strong during this recovery. We can expect that the productivity wage, adjusted for inflation, will decline ~~at least~~ in the early stage of the expansion. Whether a ~~stable~~ declining or even ~~slowly rising~~ a stable real wage in the context of a profit "explosion" will lead to a hot season two or more years from now is purely conjectural. For the time we must view the weakening of trade unions as a factor making for a longer expansion and ~~a~~ the slower ~~shift towards~~ emergence of a wage push component to inflation. To the extent that the expansion will give way to an investment boom there is likely to be a sectoral wage inflation in construction, but that shouldn't occur until well into or even beyond the summer of 84. Inflation will occur without a wage push although ~~a~~ lagged de-facto indexing of wages ~~will~~ is likely to be prevalent.

2) Even as the Reagan administration ~~has~~ contained labor's market power, it has been permissive with respect to business market power. The first step in the increase in the rate of inflation (of manufactured goods and services) will be a "markup" inflation; a strong increase in the nominal profits per unit of output will come early in the emergence of higher inflation rates. Incidently ~~the~~ a unit profit inflation ~~will~~ leads to a pause in the rate of expansion of the economy during the months ~~this~~ it is prominent — profit rate inflation differs from wage rate inflation in this sense.

3) The initial high unemployment rate will not be cut very much in the next year and a half. An unemployment rate in the neighborhood of 8.0%-8.5% should rule by mid year 85 if the expansion lasts that long. This means that the contraction that will follow this expansion will begin with a higher unemployment rate than that which ruled at the beginning of the decline that ended at year end 82.

4) The ~~Reagan~~ tax and spending decisions ~~of~~ since January of 1981 led to a structural imbalance between government spending and taxation. As a result of the programs in place at this time there will be a sizeable deficit in fiscal 84 even as income and employment are doing relatively well. This means that the inflationary potential is enlarged by the imbalance between government spending and taxation. Given the "independence" of Social Security payments from current activity, ~~the~~ a combination of high unemployment, which implies high transfer payments, and high defense spending, which yield wage absorbing no useful output, is certain to rule as the expansion matures. This almost guarantees that with a lag a virulent inflation will take place.

5) The supply side tax changes of 1981 ~~are~~ were designed to encourage saving and investment. Over this expansion the impact of the tax changes on investment spending will be important. To the extent that ~~investment will~~ the tax changes result in higher retained cash flows from income by investing firms, the debt carrying capacity of firms will be increased. The supply side tax adjustments will tend to prolong the expansion and increase inflation because it facilitates an accelerated ~~the~~ pace of private investment. By year end 1984 the tax policies of 1981 will tend to make inflation worse than it would have been with the 1981 tax structure.

6) The breakdowns of the expansions in 1974/5 and 1979/80 as well as in 1969/70 and 1982 occurred when the demand for finance outran the ability of the banking and financial system to finance. Today's national financial structure includes many firms ~~balance sheets~~ and ~~many~~ financial institutions where "balance sheet" and cash flows" ~~that~~ were hurt by the financial trauma of 1982. Even though massive government deficits, ~~and~~ large scale refinancing of debt at lower interest rates and ~~by means of~~ new equity issues ~~has~~ will ~~taken~~ take place, the representative balance sheet will be ~~in 1985~~ ~~is~~ ~~now~~ weaker than in '75; there has been a trend of diminishing interest

coverage ~~etc.~~ in business.

The demand for external financing is quite likely to develop tendencies to explode as this expansion matures. The initial financial fragility together with the inflationary investment boom that should result from continuing government deficits and the supply side tax reform virtually guarantee that the end of this expansion will be associated with a financial crisis.

7) Neither the Congress nor the Administration seems willing to eliminate the structural deficit built into the economy by the 1981 tax legislation, the ~~continuing~~ arms buildup and the continuing government transfer payment schemes. For government to function as an efficient stabilizer, not only must there be a substantial deficit when income ~~declines~~ is below target but at a level of income that is "realistic" the budget must be balanced. Furthermore tax and spending programs must be such that inflation at more than some modest rate will tend to bring about a budget surplus. A high order of fiscal responsibility is needed to constrain the inflationary potential of our economy. The unwillingness to build such ~~reformed~~ "fiscally responsible" tax and spending schedules means that the expansion will degenerate into an inflationary boom earlier rather than later in the time frame for expansions.

8) If inflation "accelerates" to the top edge of the 4%-7% annual rate range, the Volcker Federal Reserve Board may well be tempted to constrain the system. Given the ~~likelihood that~~ the internal operations of the sophisticated financial structure will lead to an elastic supply of finance ~~will rule, due to the virtual deregulation of financial institutions~~, such early constraint will have limited effectiveness unless it is extreme enough to cause a rapid rise of interest rates. ~~Such an escalation~~ A rise that will lead to a disruption of bond markets and a serious deterioration of the various economies with large

amounts of dollar denominated debt: Mexico, Brazil etc. Such problems will have repercussions on the equity and incomes of the major banks. The Federal Reserve will be forced to back off from extreme constraint by their threat of a policy induced financial crisis.

9) Financial deregulation has been a buzzword over the past six or so years. Whereas "deregulation" of industry, especially where health and safety are involved, has proceeded slowly, the deregulation of finance has proceeded rapidly. The only serious constraint that remains on the financial industry is the separation of investment and commercial banking; commercial banks cannot serve as full line underwriters and equity shares are not eligible for bank portfolios.

Savings and Loan organizations can now offer liabilities that compete with bank deposits and they can now compete with banks for business loans. ~~There are~~ Now, quite suddenly, with the banks ~~a large number of potential competitors for business and household loans from~~ savings banks, that range in size from multi-billion dollar inter state organizations to quite small local institutions, are potential competitors of banks for business and household loans

These organizations will enter this new line of business with no prior competence and no tradition. They will have to buy their talent in the market. Questions of internal controls within the organizations and the professional status of bought loan officers and supervisors of loan officers naturally arise. We can expect the pressures of competition and the pressures of "performance compensation" to lead to a compromise of traditional margins of safety. The prospect therefore is that financing terms for business loans will be more lax than otherwise during the expansion, so that the expansion -and the inflation -will last longer and go further. However there will be entirely new dimensions of financial trauma when the expense of financing activity and the inelasticity of bank lending finally brings the expansion to a halt. All our previous experience with financial innovation on a broad scale is that it takes on aspects of a bubble. The financial deregulation of recent years can be interpreted as an innovation that introduces new sources of financing of business activity.

The money market funds are hard pressed to maintain their position in the face of competition from banks and Savings institutions. We can expect these institutions to look for ways to acquire higher yielding assets than they now hold. Introducing short term business assets into their portfolios is a obvious solution to their "needs". Once again a "bubble" potential exists which will tend to extend the expansion and which has a potential for severe repercussions when "asset values" and debt viability come under pressure.

~~Int~~

We now see that deregulation of the airlines had a delayed impact which has brought the ability of the airlines to honor contractual commitments into question. In an analogous manner ~~[illegible]~~ the deregulation of financial institutions might very well have an impact upon the viability of financial organizations

(10) The strong dollar internationally reflects the existence of massive dollar denominated international debts that can be validated only if the United States runs a strong trade deficit. The number of dollars required to validate this debt depends upon the interest rate; a low interest rate leads to a smaller need for dollars and a high interest rate leads to a greater need for dollars to validate foreign debts. If the various components of the balance of payments behave so that a large increase of overseas dollar balance takes place, then, in contrast to what has been happening recently, the dollar will depreciate on the exchanges and short term interest rates will tend to be low relative to longer term rates. Low United States interest rates and an expectation that the depreciation of the dollar will continue will lead holders of dollars to ~~try to~~ move their assets out of the dollar to ~~other~~ alternative currencies.

A mild correction in the exchange rates, if there is no preset point of intervention (as with the gold standard) will tend to induce a ~~longer~~ further movement in exchange rates. The development of an international financial situation ~~such a development~~ such as ruled in late summer and the fall of 1979 is the outcome of this development quite likely. ~~At that time~~ If a "run" from the dollar develops the Federal Reserve will have to intervene to ~~prevent~~ halt both domestic and international flights from the dollar: Monetarism may well take on a new life as a response to a dollar depreciation.

The ~~inherited~~ present international financial structure is sufficiently volatile so that if the development of a massive U.S. government trade ~~deficit and an~~ leads to a payments deficit so that ~~increase in~~ the holdings of dollar balances major by central and commercial banks increase ~~as a result of the trade balance, will result in~~ a fall in the dollar on the exchanges will occur. This can ~~lead to~~ trigger a flight from the dollar. Whether ~~the~~ relatively low U.S. interest rates that are ~~implied in~~ required for this situation to develop or the balance of payments ~~of the country~~ is mainly responsible for the flight is not an issue: what is at issue is that a sufficiently strong run from the dollar can develop so that Federal Reserve intervention to "protect" the dollar will be forced. Such developments could abort the recovery before inflation matures.