The American Economy in Mid Year 1983:
Recovery in the Context of a Fragile Financial Structure
by

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Once again the sky did not fall. In 1982 a serious recession and a multitude of financial trauma and local financial crises did not lead to an open ended decline in income and employment and a general collapse of the financial structure. Furthermore in mid year 1983 the recovery apparently is stronger and sharper than was generally anticipated as recently as the spring of the year.

The behavior of the economy over the past 18 months confirms 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 path through history is now marked with financial crises that threaten the fundamental coherence of the economy. In recent years incoherence has been averted by government and Federal Reserve interventions and constraints upon the free working of market processes that are built into the economy's institutional structure.

The crisis that was contained in 1982 centered around the viability of financial institutions, (in particular the savings banks), 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 lurching towards is that a speculative investment boom, another round of inflation, high and rising interest rates, and a flight, both domestic and international, from the

dollar.

To lurch towards does not mean an instantaneous transition to. It will take time for a crisis due to an investment boom, inflation, and high and rising interest rates to develop. Before the flight from the dollar 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.

On the basis of experience since the mid 60's -when the economy entered upon its current mode of operation -the expansion phase lasts from two to four years. We are now about ~~six~~ months into the expansions. We 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 strong Federal Reserve constraint either in response to the pressures on the dollar or a persistence of inflation at the upper end of the 4% to 7% annual rate range, this expansion phase should last through 1984 and into 1985. The next cyclical peak and crisis should take place between year end 1984 and year end 1986.

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

liquidity accumulated by business and financial institutions during the earlier stagnant period (stage 7) is used up and new financial practices and institutions emerge. As a result during the later part of stage 2 prices and interest rates begin to rise rapidly. The fall in asset prices and the rise in the carrying costs of debts leads to financial dislocations and failures and a rush to liquidity (stage 3). ~~This~~ leads to a sharp drop in investment 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 ~~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 halt and sustains profits (stage 6). A period of reliquidification of private 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 augments, or perhaps offsets, the deficit due to ~~existing~~ tax and spending 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 an ~~Mexican~~ default, but the possibility that such a ~~1920's approach~~ will ~~surface~~ in the near future is disregarded. The cycle that has ruled since the mid-sixties reflects policy interventions in the form of government deficits.

and Federal Reserve intervention to refinance serious positions that become vulnerable. I assume that the policy interventions of 1982 will be replicated in any future recessionary period in which financial disturbances occur.

The Volker reappointment is significant in forming expectations about the likelihood of early and effective Federal Reserve interventions to abort financial crises. In the 1979 run from the dollar, the 1980 Hunt-Bache episode and the multidimensional trauma of 1982, Volker never failed to intervene to protect the stability of the financial structure. With Volker 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 concerned with inflation and employment. Thus the mid year 1982-mid year 1983 rapid growth in the money supply is best interpreted as the result of the need to intervene to abort an incipient crisis in mid year 82 and a need to accomodate financial markets during the reliquidification phase of the cycle.

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 this cyclical formulation because Federal Reserve interventions as a lender of last resort are always discretionary and always depend upon 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 the in fact initial conditions will affect the duration of an expansion.

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

For some of these factors we have to estimate the political climate some two years from now. However the basic assumption is that the laws of motion of our economy have not been changed. In particular the financial fragility so evident in 74/75, 79/80 and 1982 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 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 unemployment rates, indicate that the wage-push dimension to the inflationary process will come late and 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 or even slowly rising ~~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 slower shift towards 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 de-facto indexing of wages will likely 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 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 unit profit inflation will lead to a pause in the rate of expansion of the economy during the months this is prominent.

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 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 combination of high unemployment, which implies transfer payments, and high defense spending, which yield no useful output, is certain to rule as the expansion matures. This almost guarantees a virulent inflation.

5) The supply side tax changes of 1981 are 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 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 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 firm balance sheets and many financial institutions that were hurt by the financial trauma of 1982. Even though massive government deficits and large scale refinancing at lower interest rates and by means of new equity issues has taken place, the representative balance sheet in 1983 is weaker than in '75; there has been a trend of diminishing interest

coverage etc.

The demand for 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) 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 debt depend 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 interest rates and the depreciation of the dollar will lead holders of dollars to try to move their assets out of the dollar to other 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 larger movement in exchange rates. The development of an international financial situation such as ruled in late summer and the fall of 1979 is quite likely. At that time the Federal Reserve will have to intervene to prevent both domestic and international flights from the dollar: monetarism may well take on a new life.

The inherited international financial structure is sufficiently volatile so that the development of a massive U.S. government trade deficit and an

increase in the holdings of dollar balances by central and commercial banks, as a result of the trade balance, will result in a fall in the dollar on the exchanges. This can lead to a flight from the dollar. Whether the relatively low U.S. interest rates that are implied in this situation 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.

8) 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 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 tax and spending schedules means that the expansion will degenerate into an inflationary boom earlier rather than later in the time frame for expansions.

9) If inflation "accelerates" to the top edge of the 4%-7% annual rate range, the Volker Federal Reserve Board may be tempted to constrain the system. Given the likelihood that 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 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 the threat of a policy induced financial crisis.

10) 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 eligible for bank portfolios only as collateral for margin loans.

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, 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.

These organizations 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 the traditional margins of safety for business loans. The prospect therefore is that financing terms for business loans will be more lax than otherwise during the current 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 ultimate instability of bank lending to keep up with the exploding demand 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.

What do these 10 initial conditions and possible interventions imply for the duration and strength of the recovery? First of all the recovery's life can be shortened by an international flight from the dollar that would be the result of too great an accumulation of short term dollar balances in the hands of offshore, mainly European, Central and private banks. A combination of concessionary funding of existing offshore short term debts, rapid expansion of the U.S. economy with an explosion of trade deficits and a resumption of long-term lending abroad can lead to such a rapid expansion of short term dollar balances. The combination of downward pressure on the dollar and continuing inflation can quite quickly lead to a repeat of the 1979 flight from the dollar.

The internal economic situation, as exemplified by weak unions, the slack labor markets, the continuing government deficits and the availability of financing from deregulated financial markets, indicates that the expansion should stretch out for more than the minimum eighteen additional months. However, the potential of a shortening of the time span for the expansion

because of international financial developments cannot be neglected. ~~The way the Brazilian etc. debts are handled will be an important early indicator of what to expect.~~ A ~~serious~~ funding of international debts at concessionary interest rates followed by a resumption of long term international loans would be evidence that a buildup of "unwanted" United States short term balance is beginning. By year end 1983 we should have some reading on the time frame before the next crisis and what combination of internal and external forces will bring it on.

~~Meanwhile~~ It looks as if the next six to nine months -the ~~second half~~ remainder of 1983 and early 1984 -is a window for long term financing. The ever present will to believe, to transform transitory success into a belief that a permanent change of the laws of motion of the economy has taken place, may mean that long term funding on terms that make little sense in the light of history will be available.

But most important, there is no reason to believe that conditions for the resumption of on the whole tranquil economic growth, interrupted only by mild cycles, now exists. The main precondition for tranquil growth is a robust financial structure. The deregulation of financial industries, the structural imbalance in the Federal Government budget, the inherited debt structure of business and the overhang of international indebtedness all point to the continuation of financial fragility. ~~and~~ Therefore the lurching economy is here, if not to stay then for at least another round.