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The New Old Economy

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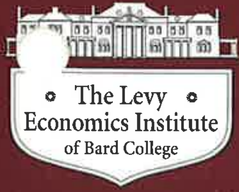

LEVY INSTITUTE

Policy Note

2001 / 7

THE NEW OLD ECONOMY

BILL MARTIN

Consensus opinion sees the U.S. economy growing by around 3 percent per year over the next few years, a high enough rate to keep unemployment low and outpace Europe. One problem with the consensus view is that it pays little heed to the very unusual nature of the American expansion. A minor downturn prompted by a bit of inflation and higher interest rates is one thing, and easily fixed by conventional means. But America's boom was unique and so, alas, will be its bust.

IT WOULD SEEM THAT THE REPORTS announcing the death of America's business cycle were somewhat exaggerated. New Economy productivity gains and the wonders of whiz-bang technology have not prevented a collapse in American growth. And the repercussions have spread: Europe is slowing, Japan's depression is deepening, and in the rest of Asia, yesterday's economic superstars are today's collateral damage. The world is experiencing a synchronous slowdown of a kind not seen since the 1980s.

This consensus view may well prove far too sanguine, however. Although the tax rebate now enlarging pay packets should give a short-term lift to American activity, the economy's fortunes over the medium term are likely to be dominated by the attempts of previously overexuberant companies and households to reduce their rate of borrowing. Whatever the short-term ups and downs, the result on average may well be a prolonged period of anemic growth accompanied by a substantial loss of jobs.

One problem with the consensus view is that it pays little heed to the very unusual nature of the American expansion. A minor downturn prompted by a bit of inflation and higher interest rates is one thing, and easily fixed by conventional means. But America's boom was unique and so, alas, will be its bust. Since the mid 1990s, that boom has been based on a premise, increasingly spurious, about the scale of future expansion and the durability of stable economic conditions. Amid visions of a shiny techno wonderland, growth expectations became too high and assessments of risk too complacent—changes of mood aided and abetted by a

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liberalized financial system. Credit flowed easily, enabling households and businesses to rai their collective rate of spending relative to income, and at a quite remarkable rate.

By autumn of last year, the flaky official figures suggest, the excess of private spending over income had reached 6 percent of America's gross domestic product (GDP), oddly enough, a rate of borrowing identical to that seen in Britain 11 years earlier during the heady Lawson Boom. As in Britain, the shift in American spending behavior represented a profound change from the norm. In the 40 years up to the mid 1990s, spending by American households and companies was typically less than after-tax incomes, to the tune of 2.5 percent of GDP.

Was this remarkable shift in behavior justified by America's New Economy? It seems unlikely. Some experts point to the genuine post-1995 improvements in productivity as justification, but average productivity growth was materially higher in the Golden Age of the 1960s when private spending behavior was "normal." Others say that economic stability justified higher stock market prices, a boost to shareholders' wealth that propelled private spending upward. So convinced were Glassman and Hasset of the low-risk nature of the stock market that they titled their 1999 polemic *Dow 36,000.*

It is certainly true that the U.S. economy was unusually stable during the 1990s, a fact sometimes attributed to better monetary policy and sometimes to the better control by businesses of their inventories. The latter explanation gives no basis for optimism, however, in view of Japan's depressed condition, notwithstanding its lead in best-practice inventory management.

More important is the possibility that America's unusual stability was something of fluke, aided by the decoupling of its business cycle from those in Europe and Japan. Big events in the 1990s peculiar to these economic regions, such as German unification, Japanese deflation, and the U.S. productivity surge, meant that strength in one region coincided with weakness or normal growth elsewhere. This decoupling was the main reason why the industrial world collectively avoided large, destabilizing cycles in the 1990s. It would be surprising if U.S. stability did not owe something to this unusual turn of events, which is now being rapidly overtaken by more normal forces that encourage synchronization.

Booms are born in depression, come of age in skepticism, mature in confidence, and die in euphoria. Once irrationally exuberant expectations of higher growth and stability took hold, U.S. progress became a knife-edge. There could be boom, there could be bust, but there was most unlikely to be a soft landing. Wynne Godley and I spelled out the precise reasons way back in 1998: with the dollar firm and the budget restrictive, the expansion of overall demand would be dependent on further increases in private spending relative to income. But what would encourage households and businesses to borrow ever-larger amounts, and at a record rate? The answer would have to be continuously upward reassessments of future growth and increasing complacency about risk, both serving to drive the stock market higher and higher. In other words, the bubble had to inflate forever.

The boom was self-evidently unsustainable, but there were strong forces of persistence at work. The economy was on a roll and stock market investors, discomforted by the sight of othe

etting effortlessly rich, drove stock prices up, ignoring all warning signs. Wall Street's industry of spin gleefully egged them on. For these reasons, we could not forecast the timing of the end of the boom and described our predicted crunch as a medium-term likelihood.

But we were sure of two things. First, the longer the boom and excess borrowing persisted, the more vulnerable the economy would become to seemingly innocuous shocks. This is why the economic forecasters who knew all about higher oil prices and interest rates last year failed to predict the collapse in activity. Second, we knew that the bigger the boom, the bigger the bust. Although budgetary policy is no longer restrictive and the dollar is weakening, it would be remarkable if the United States avoided the post-bubble trauma that has afflicted all other economies that have experienced similar prolonged periods of excessive exuberance and borrowing.

The collapse in activity is now taking place, and the fallout from the U.S. crunch will be global. Canada, Asia, and Latin America are the most vulnerable, but all economies are being affected by the reduction in trade and decline in stock markets. Although Britain is one of the least exposed via trade, a shock to its large financial services industry will have repercussions, and not only on the consumption of champagne.

The wobbly Washington consensus that still influences global economic policy making will be further challenged. It will turn out that economic instability is not just the fault of mischievous or incompetent politicians. Reinforced by liberalized financial markets, the private sector is itself prone to profound instability thanks to persistent waves of optimism and pesimism. This fact, once understood, has been airbrushed out of the mainstream. It leaves the world vulnerable to a backlash. More effective than any anticapitalist protest, America's hard landing is likely to call into question the future of globalization.

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