Whither the US economy?

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Introduction

There is near unanimity among professional analysts of national economies that the performance of the US economy in recent years has been by far superior to that of other major industrialized countries. Evaluations of this tenor became more frequent after the issue of a brochure by the U.S. Government at the Denver Summit Meeting in June 1997 (U.S. National Economic Council 1997). This brochure presented a comparative analysis of the performance of the G-7 countries and, referring to the US performance, pointed to "An economic strategy that has worked" and stated, *inter alia*, that "the US is now leading the way with a new economic paradigm" (p. 2). It also pointed out that "Every year since President Clinton took office, job growth in the U.S. has been stronger than the G-7 average" (p. 4). This was followed, in October 1997, by an appraisal by the International Monetary Fund which cited "solid growth in output and employment with low inflation and a diminishing fiscal imbalance" (IMF 1997, p. 4); although it tempered this favorable appraisal by mentioning the need to raise national savings and reduce the external deficit (IMF 1997). Similar positive evaluations were included in recent Annual Reports of the Bank for International Settlements (BIS 1997, pp. 9-11 and 1998, pp. 11-13) and in reviews by the Organization for Economic Cooperation and Development. Finally, Alan Greenspan, the widely respected Fed Chairman, recently depicted in glowing terms the national economy, by emphasizing the rate of growth, low inflation, high employment, and so forth.[1]

☐ Wilmington, N.C. (USA).

[1] "The current economic performance, with its combination of strong growth and low inflation, is as impressive as any I have witnessed in my near half-century of daily observation of the American Economy" (Greenspan 1998).

Some economists refer to the recent US experience as the 'New Economy', the 'New Era', or the 'New Paradigm'. Its characterization is a combination of a sustained economic growth, a low rate of inflation, a low unemployment and, at times, a low interest rate.[2] Other economists, however, dismiss the notion of a new model and argue that the concomitance of the above mentioned features can be explained by conventional analysis (Krugman 1997). Both extollers and critics of the 'New Paradigm', however, develop their arguments by focussing on the three (or four) features mentioned above.

Unfortunately, the use of averages and aggregates carries the danger of producing an obfuscation of knowledge, and the case under discussion is no exception. The above parameters offer only a first superficial impression, and they conceal certain important underlying trends whose analysis not only offers a better insight into the factors behind those parameters, but, even more importantly, they give indications of a likely future course of events and of a performance which could well be much less positive than the one portrayed by the 'New Paradigm'.

This article describes four selected trends which will show: 1) that past economic performance of the US economy was in large part the result of abnormal economic factors operating under favorable circumstances; 2) that the four selected trends cannot be sustained over an extended period of time, and are bound to be reversed; and 3) depending on the timing of their reversal and on their interactions, the US economy may enter a period of significant recession, or of a stagflation, or of something in between.

1. The analysis

The four trends which we selected depict economic factors which have an important bearing on the performance of the national economy: 1) rising consumers' indebtedness (and consumers' bankruptcies); 2) accumulation of the country's net indebtedness to the rest of

[2] To be sure, there is no commonly accepted definition of the 'New Paradigm'. Some writers place emphasis also on budget deficit reduction, and on 'investment in people'; whereas others focus on technological improvements and related increases in productivity.

the world, and, correspondingly, of liquid dollar assets and securities by non-residents, both resulting from persistent large balance of payments deficits; 3) lags in wages and salaries of middle-class individuals and families (and emerging income and wealth maldistribution); 4) abnormal increases in price-earning (P/E) ratios of sensitive stock indices. It is almost intuitive that changes in any of these trends interact into each other.

The trend in consumers' expenditures financed by installment credit between 1982 and 1998 is shown in Table 1. The importance of this indebtedness is due to the fact that consumers' expenditure is about two thirds of gross domestic product. As the figures indicate, personal consumption expenditures financed by installment credit rose at a rapid rate. In 1998 the outstanding balance of this indebtedness was almost 4 times as large as that in 1982, whereas GDP was 2.6 times as large. In fact, total consumers' indebtedness was larger than the figures in Table 1. The reason is that, as stated in a later paragraph, during the last twelve years, due to the tax treatment of personal debt introduced in 1986, consumption expenditures were also financed by a percentage of so-called 'home equity loans'.[3] Another factor was the widespread and increasing use of leasing of automobiles which replaced contracting loans for outright purchases. These factors are difficult to quantify, but even without them, nearly 18% of the increase in GDP during the period 1982-98 resulted from installment credit obtained by consumers. That percentage was higher – almost 22% for the period 1992-98, which includes the 'New Era'.[4] If home equity loans were included, the percentages would be much higher.[5] In other words, personal deficit financing, as a major factor of economic growth, accelerated during those six years.

[3] Home equity loans are essentially second mortgages on real property. When in 1986 interest on installment debt became no longer deductible from gross income, home equity loans started being used to consolidate (at a lower interest rate) installment debt and also to finance personal consumption.

[4] In addition, the data on installment debt compiled by the monetary authorities almost certainly understate the extent of loans contracted by individuals. The reason is that statistics of this type are a consolidation of lenders' balance sheets which do not include loans which had been written off because of bankruptcies or other reasons (see later).

[5] If equity loans and lines of credit were added to installment credit, the estimated ratio for 1991 was about 27.4% instead of about 17.6% for installment loans alone (Eugeni 1993).

TABLE 1

CONSUMER DEBT. GROSS DOMESTIC PRODUCT. PERSONAL SAVINGS

Year	A Installment credit ($ bill.)	B Dispos. pers. income ($ bill.)	C A as % of B	D Gross dom. product ($ bill.)	E Personal savings as % of DPI
1982	330.4	2,355.8	14.1	3,242.1	9.0
1983	374.5	2,531.5	14.8	3,514.5	6.7
1984	449.5	2,819.8	16.0	3,902.4	8.6
1985	526.5	3,012.1	17.5	4,180.7	6.9
1986	581.8	3,198.5	18.2	4,422.2	5.9
1987	619.8	3,374.6	18.4	4,692.3	5.0
1988	674.7	3,652.6	18.5	5,049.6	5.4
1989	727.6	3,906.1	18.7	5,438.7	5.0
1990	796.4	4,179.4	19.1	5,743.8	5.1
1991	781.1	4,356.8	18.0	5,916.7	5.6
1992	784.9	4,626.7	17.0	6,244.4	5.7
1993	844.1	4,829.2	17.6	6,558.1	4.4
1994	966.5	5,052.7	19.2	6,947.0	3.5
1995	1,103.2	5,355.7	20.7	7,269.6	3.4
1996	1,194.6	5,608.3	21.3	7,661.6	2.0
1997	1,230.7	5,879.4	20.7	8,110.9	2.1
1998*	1,282.1	6,049.7	21.2	8,573.9	1.2
1998					Q1 1.2 Q2 0.4 Q3 0.2

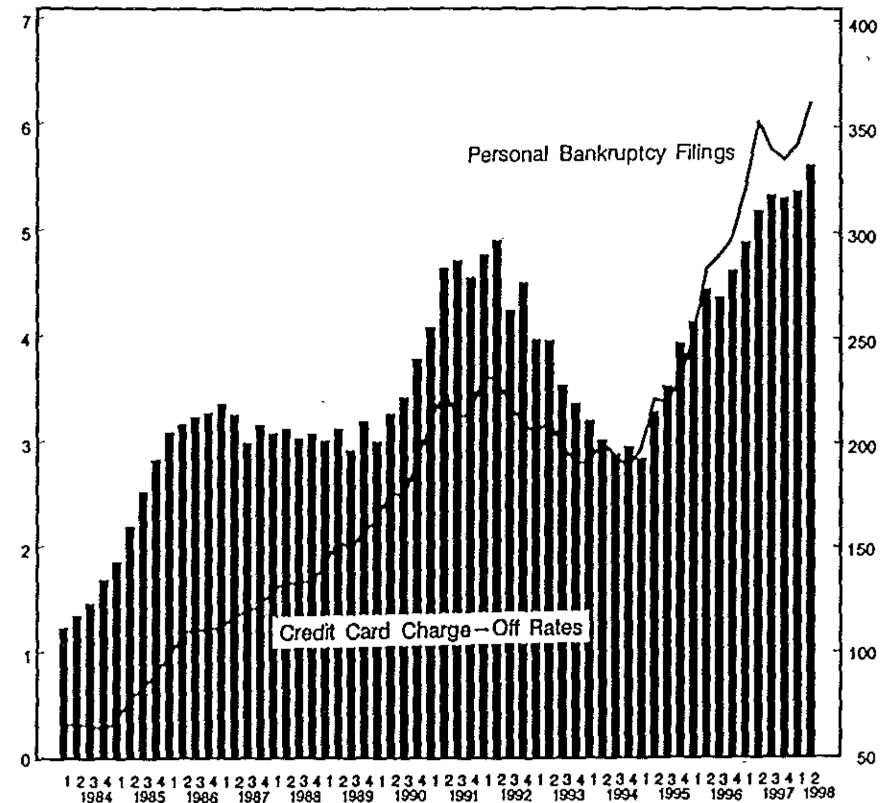
* First 3 quarters.
Source: U.S. Department of Commerce.

A conventional measure of consumer's indebtedness is the ratio of the latter to disposable personal income (DPI). As shown in Table 1, that ratio has exhibited an increasing trend during the 16 years covered by the Table, though there was a small downturn in 1991 – which coincided with the 1991-92 minor recession. From the beginning to the end of that period that ratio increased by about 50%. In the past, a widely accepted rule-of-thumb was that the upper limit of the ratio in question is 17-18%, beyond which the debt cannot be safely carried. This notion was implicitly held in a 1993 study of consumer's debt made by the staff of the Federal Reserve Bank of Chicago (Eugeni 1993).[6] The figures in Table 1, column C show that such

[6] The study noted that the ratio had not declined dramatically from 1989 to 1992 and went on to suggest that "households might not be able to sustain higher level of spending in the near future" (Eugeni 1993, p. 3).

CHART 1

CREDIT CARD LOSS RATES AND PERSONAL BANKRUPTCY FILINGS, 1984-1998
(Loss rates in %. Filings in 000s)



Source: FDCI Banking Profile, second quarter 1998.

a 'norm' was exceeded after 1993, as the ratio rose from 17.6% in that year to 21.2% in 1998. The validity of that 'norm' appears to be indirectly confirmed by other factual data. As shown in Chart 1, there was a dramatic increase in bankruptcy filings by individuals from mid-1994 to the second quarter of 1998. Actual data publicized by the Administrative Office of the US courts show that filings were at an annual rate of 806,000 during the fourth quarter of 1994 and at an annual rate of 1,469,000 during the second quarter of 1998. Moreover, the percentage credit card losses (charge-off) suffered by insured commercial banks alone rose at a fast rate after the end of 1994, al-

most as fast as that of bankruptcy filings. Finally, figures of credit card delinquencies (the percent of accounts 30 days or longer overdue) have also reached very high levels.

The above figures and considerations strongly suggest that the contribution that consumer spending financed by debt has given to the growth of GDP may disappear sometime in a not too distant future. The trend may even be reversed; and a decline in the rate of increase in consumption expenditures would reduce considerably the rate of growth in the economy and in employment. The probability of this occurrence (and even negative growth) would be greatly increased if and when there should be a halt in the rise of perceived wealth (both real estate and financial). A recent study on the sharp increase in charge-offs in credit card loans (Morgan and Toll 1997) concluded that increased (perceived) wealth was one of the two major factors which explain both the increase in the ratio of debt to income and the increase in bad debt.

There are two mirror images of the growing consumers' indebtedness. One is the trend in personal savings, the other is the trend in the deficits in the balance of payments which show heavy, increasing reliance on foreign savings. The ratio of personal savings to disposable personal income has steadily declined from 9.0% in 1982 to 0.2% in the third quarter of 1998. In fact, preliminary estimates indicate that the ratio was 0.2% negative in both September and October 1998. As to the country's dependence on foreign savings, Table 2 shows continuous balance of payments deficits over the same period of time. The cumulative total of annual deficits on current account between 1982 and September 1998 was $ 1,759 billion (see Table 2). Deficits were incurred in during every single year of the above mentioned period, even during the minor recession of 1991-92. After 1992, the deficits have increased at a rapid rate, and in the 5 years 1992-97 they rose by 202%.[7] This was a reversal of the decline which had taken place between 1987 and 1991; and both the speed and the size of the upward trend appear to be significant. They suggest, *inter alia*, that there are deep seated factors which cause the economy to fail to produce enough goods and services to meet domestic demand; and that the correction of those imbalances will be difficult to achieve. An analysis of those factors is beyond the scope of this article, but it can be stated that the exchange rate (i.e., a possible dollar overvaluation) was not a determining factor (though a contributing one), since the US dollar depreciated, with some fluctuations, between 1991 and 1995 *vis-à-vis* the DM, and even more *vis-à-vis* the Japanese yen, while the deficit on current account kept rising.

[7] The rate of change during the last quarter of 1998, and probably the first quarter of 1999, was much faster. The calculated annual rate in 1998, based on the first three quarters, was $ 219.6 billion, but in actuality it is expected to be much higher due to the increased trade deficits during the last three months of the year related to the currency depreciations *cum* recessions in East Asia countries.

TABLE 2

BALANCE OF PAYMENTS AND HOLDINGS OF FEDERAL SECURITIES BY NON-RESIDENTS

($ billion)

Year	Balance on current account: deficit		Securities held by non-residents
	Yearly	Cumulative	
1982	11,443	–	149.5
1983	43,985	55,428	166.3
1984	98,951	154,379	205.9
1985	123,927	278,366	224.8
1986	153,154	431,520	263.4
1987	168,013	599,673	299.7
1988	128,201	727,874	362.2
1989	104,139	832,013	429.6
1990	91,624	923,637	458.4
1991	4,383	928,020	491.7
1992	51,374	979,394	549.7
1993	86,133	1,065,527	622.9
1994	123,825	1,189,352	640.7
1995	115,254	1,304,606	814.2
1996	134,915	1,439,521	1,087.6
1997	155,215	1,594,736	1,230.6
1998*	164,724	1,759,460	1,217.2

* 9 months.

Sources: U.S. Department of Commerce. *Federal Reserve Bulletin*.

Past deficits, and their apparent tendency to continue, mean that foreigners have been, and are, accumulating claims *vis-à-vis* the United States. The question then arises until what time this accumulation can continue. Already in 1984, at the time when the country was still a net creditor *vis-à-vis* the rest of the world, that very question was raised in a study by the Federal Reserve Bank of New York. Noting that in the case of payments made in US dollars the exchange risk is born by foreign investors, the paper envisaged circumstances under

which foreigners would be reluctant to continue financing large external deficits by the United States (Palash and Radeki 1984).[8] After the publication of that study, however, the deficits on current account continued unabated (see Table 2), and in 1986 the country became a net debtor to the rest of the world. At the end of 1997, the US *net* international investment position was *minus* $ 1,322.5 billion, i.e., about 16% of gross domestic product. At the end of September 1998, the amount of public debt securities held by public and private (non bank) foreign investors reached the figure of $ 1,217.2 billion. This represents about 36.5% of total outstanding marketable interest bearing debt securities held by the public: a very high proportion, especially since the United States has no control on decisions by foreign holders as to whether to keep the securities in their portfolio or liquidate at least part of their holdings.

As to bank deposits and other similar liquid assets in US dollars held by non-residents, information is not complete or precise, but the picture is not different from that presented above with respect to public debt securities. During the period 1982-98 total reserves (minus gold) held by all the countries covered by the statistics of the International Monetary Fund rose by some $ 913 billion. Excluding the change in the US reserves, the total increase was about $ 891 billion. Since the change in SDR holdings and in the reserve position in the IMF, taken together, were only some $ 14 billion, the increase in total reserves of countries outside the United States consisted essentially of foreign exchange: they rose by $ 877 billion. No publicized figures are available as to the composition of that amount of the change in reserves, but it can be safely assumed that a very high proportion of those additions, and of reserve holdings, consisted of US dollars. Other holders of US dollar assets, i.e., other than central monetary authorities, cannot be easily indentified; nor is it possible to estimate with reliable accuracy the amounts which are potentially subject to discretionary decisions by such other holders. They could decide to continue to hold until a certain time (or even accumulate); but at a

[8] In the late 1980s numerous books and articles expressed concern about the vulnerability of the US financial position in world markets. For example, one article (*Business Week* 1987, p. 53) pointed out: "It's time for America to wake-up" and "Americans have spent too much, borrowed too much, and imported too much. Now it is time to stop" and, referring to the external imbalance, "And now the bill comes due".

given point in time they may decide to liquidate, by converting into other currencies.

The accumulation of consumers' indebtedness has an intuitive relationship with the trend – a near stagnation – in incomes of salaried persons, and with the changes in income distribution. These and other matters will be discussed in the following paragraphs. Our main intent is to show that the various factors that caused the above two developments – i.e., a stagnation in lower and middle incomes and a redistribution in favor of high incomes – are unlikely to continue indefinitely; and that a reversal of those two developments is quite possible, perhaps not far in the future. The subject is complex and multifaced, and it is only possible to review the factors involved in a cursory manner. Moreover, while some of them can be quantified, others have to be left to the intuition and deductive reasoning of the reader.

As a background, two phenomena have to be highlighted, which have taken place almost simultaneously: a loss of bargaining power by labor; and a return of businesses' pricing policy to a mode close to textbook competition – as different from the policy of 'return targeting' which had prevailed during the 1970s (and earlier), and which characterized stagflation. Combined with the continuous efforts to cut costs by replacing labor inputs with technologically advanced devices (computers, robots, communication equipment, etc.), by consolidating production operations in fewer plants, and by shifting them to lower cost areas abroad, these phenomena resulted in what has been called 'downsizing', i.e., a massive reduction in work force by businesses in practically all sectors of the economy, and at all levels, from mid-management to manual labor. At the same time, labor unions gradually lost power for a number of reasons. One was sheer numbers. The percentage of organized non-farm work force, which had reached the highest level in 1954 (at about 32%) gradually declined thereafter, to about 14% in 1998. A second reason was the relative shift in total employment from manufacturing, where unions are more effective, to the services sector. This was a major change in composition.[9] Two additional factors reduced the effectiveness of the

[9] In 1975-76 the number of employees in manufacturing was about 18 million, and has remained practically unchanged, with some ups and downs, in the intervening period until this time. On the other hand, the number of employees in the services sector (including government) rose by some 85% from 55 million in 1975-76 to about 102 million at this time.

unions. The first was that in 1982 the union of the air traffic controllers suffered a defeat in its confrontation with the Federal government, and this had a major negative impact on the attitude of unionized labor. The second was the in-fighting in certain large unions. Both weakened the unions' strength inside the labor movement; and one consequence was that whenever businesses decided to introduce reductions in remunerations, employees, in large part, offered little resistance.[10]

Whether or not the above cursory review of labor-business relationships includes the principal factors that led to 'downsizing', the fact is that the latter, together with stagnant or lower pay, continues to be a phenomenon of major proportions in the national economy, and not just in the sectors involved. It was extensively described about two years ago in a series of articles in *The New York Times* (Uchitelle *et al.* 1996). For the purposes of this paper, the main aspects highlighted in that review were: 1) from 1981 to 1995 about 41 million employees were terminated; 2) both factory workers and office workers were affected, although in the initial years the former group was more severely affected than the latter; 3) the persons involved were of different sexes and ages (particularly below 50 years); 4) a vast majority of the downsized employees had annual incomes of up to $ 50,000, though the persons more frequently affected had incomes between $ 15,000 and $ 30,000; 5) the state of the economy was not a determinant factor, as, on an annual basis, more persons were terminated during prosperity periods than during recessions, with the exception of 1991.

The downsizing has continued until this time (it was extensive in 1998), and, because of this, an explanation is necessary of its coexistence with a gradual decline in the rate of unemployment. This is not just a statistical exercise, since one of the essential aspects of that phenomenon is the near stagnation of incomes (except at the very high and very low levels) and the resulting income inequality. To a very large extent, the employees that were downsized: *a*) found another occupation, most of times at a lower salary; *b*) became part-time employees; *c*) found occupation as temporary employees, with no

[10] A contributing factor of diminished employees' resistance was that, to avoid a default on mortgage payments, and a loss of the home, a reduction in pay was the preferable, however unpleasant, option.

benefits while receiving a lower income; *d*) became self-employed; and *e*) became discouraged and abandoned the search for new employment. Moreover, *f*) some of the part-time employees held multiple jobs; and *g*) the spouses of employees in the other categories listed above entered or re-entered the labor force to supplement the reduced family income. Category *e*) reduced the number of unemployed persons, while there was an increase in employment due to the phenomena under *f*) and *g*). Finally, the increase in the number of families where both spouses worked had its own multiplier, of sorts, since jobs were created in all those areas of the services sector which meet the demand of persons working away from home (restaurants, cafeterias, transportation, apparel, etc.); and also created jobs for persons in 'day care centers', caretakers of children at home, housekeepers, and for persons attending the needs of elderly individuals left alone in the house. All, or most, of the above created what could be called a 'downward rotation' of incomes, except in the case of minority employees who found jobs at the same, or higher pay; and of successful self-employed persons. The additional incomes came from employment in the enlarged areas in the services sector, and the recepients were mostly women whose pay is normally lower than that of men.[11] The end product of all this was a marked income redistribution in favor of the top quintile, resulting in substantial inequalities.

The income changes mentioned above were extensively covered in all their aspects in a recent publication by Mishel, Bernstein and Schmitt (1996). The following Table 3 is derived from that book, and the data are based on those of the U.S. Bureau of the Census adjusted by the authors. The chosen years are those of the peaks in the business cycles.

Even though the period 1973-79 included the effects of the first 'oil shock', real median incomes rose in that period; whereas it declined between 1979 and 1994, and even more between 1989 and 1994. Another aspect of the phenomenon was illustrated in the 1997 annual review of the economy by the U.S. Government (1997). That publication included a whole section dedicated to income inequalities. The

[11] While it is impossible quantitatively to differentiate between women who entered the labor force as a sociological phenomenon and those who started working out of necessity, the data of employment by sex appear to be significant. From 1982 to 1998, male employment rose from 56.2 million to 71.2 million (27%), while female employment rose from 43.2 million to 61.3 million (42%).

following Chart 2 is reproduced from that book, and shows that between 1979 and 1995 only the top quintile increased its share in total income. The other four quintiles suffered sizable declines in their shares.

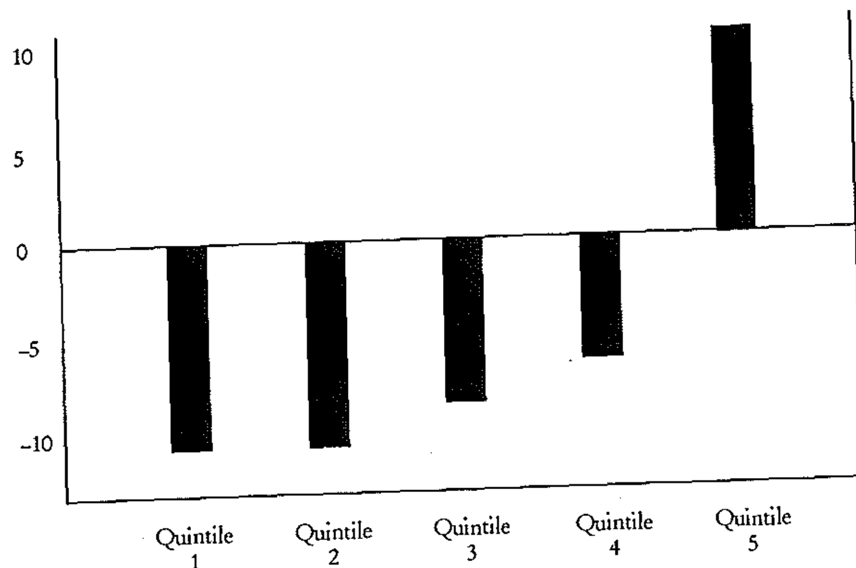
TABLE 3

MEDIAN FAMILY INCOMES
(1995 dollars)

Year	Median incomes	Annual rates of change from preceding data	
		Amount	Percent
1947	19,088	--	-
1967	33,305	711	2.8
1973	38,910	934	2.6
1979	40,339	238	0.5
1989	42,049	171	0.5
1994	39,881	–434	–1.0
1994 from 1979		–92	–0.2

CHART 2

CHANGES IN SHARE OF INCOME RECEIVED BY EACH QUINTILE
1979-1995



Families with stagnating incomes or near-stagnating incomes found it possible to overcome their difficulties by taking advantage of two major facilities. One was the recourse to consumer's credit and other forms of credit discussed in previous paragraphs (as well as the recourse to the bankruptcy courts). The other was the remarkable resiliency of the trade system which continuously adapted itself to the changing income structure. This consisted of an increase in the number of discount stores and of stores offering low price/quality merchandise (while some up-scale went out of business due to the shrinking demand from the upper middle income section). In addition, there was a considerable increase in so-called 'warehouse clubs' where consumer goods are sold on a self-service basis at lower prices than in traditional stores. There has been a similar trend in stores which sell electrical, plumbing, and construction materials as low- and medium-income receivers increasingly engaged in do-it-yourself activities, thus replacing home repair and similar work traditionally done by outside contractors.

Data on those changes in the trade network are not easily available on a consistent basis. Data derived from the Economic Census conducted by the Bureau of Census for the years 1982, 1987 and 1992 (1997 is not yet available) are available only for certain categories, but not for warehouse clubs. The latter, therefore, had to be estimated, and may contain more than minor errors. Nevertheless, the trends shown in Table 4 below are revealing for our purposes.

TABLE 4

RETAIL SALES BY CATEGORIES OF STORES
(Billions of current $)

	1982	1987	1992
- Total retail trade	1,085.9	1,503.6	1,894.6
Percentage change	-	38.5	26.0
- Department stores (incl. leased stores)			
National chains	28.6	35.4	36.1
Percentage change	-	23.8	2.0
Discount or mass merchandizing	38.8	69.4	103.4
Percentage change	-	78.8	49.0
- Misc. gen. merchand. stores warehouse clubs	7.9	18.8	30.7
Percentage change	-	127.8	63.3

Unfortunately, no separate data are available for self-help stores for electrical, plumbing, construction materials purchased by do-it-yourself consumers, and for so-called 'fast food stores', i.e., restaurant-type establishments where food is either purchased at the counter or is delivered to homes.

The fourth trend under consideration for the purpose of this article is that of prices of shares in different stock markets in the country. The significance of this trend is that: *a*) share prices have risen considerably in recent years, well in excess of any commonly regarded standards; and *b*) it is widely believed that the higher valuation of stock holdings has created a so-called 'wealth effect'. This means that individuals who have seen their portfolio increase in value have been inclined to increase their consumption expenditures, and even to borrow against the collateral of their highly priced shares. A possible secondary effect is that even those who do not have shares regard the rising markets as an indicator of the health of the economy and, accordingly, increase their consumption expenditures. Even though the Dow Jones Industrial Average is, at the time of writing, slightly below the recent peak, its level is extremely high. In support of this statement we use the price/earning (P/E) ratio of the 'composite SP 500'. Table 5 shows the figures for this ratio from 1982 to date. They show that from 1982 to 1990 the ratio remained below 15, with some exceptions. A notable exception was the period leading to the market 'crash' of October 1987, during which the ratio rose from a 16-17 range to 22.10 in September 1987.

The 'conventional wisdom' has been for many years that the 'norm' for P/E ratios is 15. As the figures in Table 5 show, the ratio has been above the 'norm' for most of the 1990s. At the end of 1998 it was about 32. Should it return to 15, the decline in market valuations would be of the order of 53%. Using the widely quoted Dow Jones Industrial Average (assuming that the same percentage applies to it), the index would decline from about 9300 at the time of writing to 4371. Such a decline would take place over a period of time during which investors would suffer great losses, which would be hard for various groups of people, especially those who had used the overvalued stocks as collateral for loans, and those who had invested retirement savings in the stock market at the time of high valuations. A predictable general consequence would be the disappearance of the 'wealth effect' and of the consumption expenditures based on it.

TABLE 5

PRICE/EARNING RATIOS FOR SP 500 COMPOSITE

(Averages of the month at the end of each quarter)

Year	Quarter	P/E	Year	Quarter	P/E
1982	I	7.32	1991	I	17.48
	II	7.41		II	17.96
	III	8.50		III	19.88
	IV	10.17		IV	21.85
1983	I	11.95	1992	I	25.45
	II	13.25		II	25.08
	III	13.28		III	24.52
	IV	12.41		IV	24.09
1984	I	11.20	1993	I	23.64
	II	10.08		II	22.71
	III	10.22		III	23.74
	IV	9.93		IV	22.84
1985	I	10.70	1994	I	20.36
	II	11.40		II	19.56
	III	11.51		III	18.36
	IV	13.47		IV	16.80
1986	I	15.36	1995	I	16.34
	II	16.75		II	16.68
	III	16.44		III	16.97
	IV	16.77		IV	17.51
1987	I	19.99	1996	I	19.2
	II	19.87		II	19.1
	III	22.10		III	19.7
	IV	15.41		IV	-
1988	I	15.22	1997	I	20.7
	II	14.61		II	22.8
	III	12.38		III	24.1
	IV	12.10		IV	23.6
1989	I	12.28	1998	I	27.7
	II	13.01		II	26.3
	III	13.73		III	24.4
	IV	14.70		IV	31.9
1990	I	14.77			
	II	16.60			
	III	14.90			
	IV	15.19			

Sources: Standard and Poor, *Security Price Index Record*, 1996 edition for 1982-1995. *Business Week* for 1996-1998.

2. Possible developments

The four trends described in the preceding Section 1 are clearly abnormal. As such they are bound to be reversed or, at least, brought to an end. It is not conceivable that the United States can continue indefinitely to register deficits in its external account, and that non-residents will be prepared to continue to accumulate without limits financial claims *vis-à-vis* the United States. Likewise, it is not conceivable that residents will continue indefinitely to accumulate installment debt and similar debt at a pace in excess of that in personal income; and that the rapid increases in personal bankruptcies will continue. It is also likely that the income maldistribution, which is partly responsible for the rise in consumers' indebtedness, will be corrected, especially for incomes in the middle range. And, finally, the extraordinary rise in the P/E ratio may be reversed, and the ratio may return to its traditional norm.

Whereas a future break in the trends is *certain*, and a reversal in at least some of them is *probable*, the timing of these events is *uncertain*. It is even more difficult to anticipate which of the four trends will be first in reaching a turning point, and most of all what will be the dynamic sequence which may develop. The uncertainty as to timing is suggested by simply observing that the analysis in this paper, and the considerations in this section, could have been made many years ago; and yet the trends have continued. In fact, there have been occasional warnings; and, as an evidence of the durabilities of the 'abnormalities', two studies made as far back as 1988 can be cited. One of the conclusions of a detailed review of US external imbalances by Akhtar (1988, pp. 31-33), Vice President of the Federal Reserve Bank of New York, was that,

> "a continuation of large external imbalances poses a most serious threat to the medium- and long-term health of the U.S. and global economy. The international deficit, therefore, appears to us to be one of America's most pressing economic problems, which must be reduced much further or perhaps even eliminated, in coming years".

In fact, the deficit on current account, which reached $ 155 billion in 1997, is expected to rise to $ 225 billion in 1998 (from $ 128 billion in 1988).

In a book published also 10 years ago, Benjamin M. Friedman focussed on the broader problem of Americans having lived too long beyond their means by running up debt and selling assets (Friedman 1988). He anticipated an inevitable protracted and persistent decline in the standard of living of most Americans.[12] Other warnings and predictions of a similar nature were not uncommon at the end of the last decade. Economists and analysts lamented the growing of what came to be called the 'three deficits', i.e., the foreign trade deficit, the budget deficit and the transportation infrastructure deficit. As to the latter, a detailed study by the U.S. General Accounting Office (1989) highlighted the growing of the traffic congestion at an alarming pace, a significant deficiency in road pavements, and the need to repair or replace thousands of bridges. To this, one should add an outdated system of air traffic control.

After the end of the last decade, warnings and dire predictions have become less and less frequent. One of the reasons may arguably be that people have continued to live on borrowed money, and the country has continued to rely heavily on foreign capital without yet suffering any of the consequences that many had feared. In fact, fading apprehensions have been replaced by optimism and the self-congratulatory 'new paradigm' which was referred to at the beginning of this article. That paradigm appears, however, simplistic, superficial and devoid of any underpinning when viewed against the background of increased borrowing by consumers (and businesses), dangerously declining rates of savings, increasing indebtedness to the rest of the world and alarming levels of stock market valuations.

At the beginning of this section it was stated that a reversal in at least some of the four trends is quite probable – even though the timing is uncertain. Even with the awareness that similar expectations made public at least ten years ago have not been validated by actual developments, there are reasons to believe, at this time, that reversals may not be far in the future. The reasons for this statement will be given in the following pages.

A possible turn in the trend of wages and other remunerations, and a change in income distribution, may be under way. Average real weekly earnings (in 1982 dollars) in the private sector had declined

[12] Friedman's book focussed on the Federal Budget deficit; but it also expressed great apprehension about the foreign deficit. "Foreign lenders will not continue indefinitely to accumulate our I.O.U.s without growing fears that we will not pay or that when we do it will be in inflated dollars" (Friedman 1988, p. 34).

from $ 301 in 1977, to $ 271, $ 254, $ 256, in 1982, 1992, 1996, respectively; but they rose to $ 261 in 1997 and to $ 268 in 1998 (see Table 6). In our view, some of the reasons for this are as follows. There are indications of some resurgence in the strength of the trade unions, such as the outcome of major contract negotiations in the industrial and transportation sectors. Another factor is the reduced availability of qualified manpower. Both appear to have contributed to improvements, though limited, in the incomes of working persons in the large area between the lowest and the highest income levels. Whether or not these developments are symptomatic, there are other factors and constraints which make it appear that increases in the remuneration of the labor force, in general, are inevitable.

Over the last 15 years, or so, the ability of families and individuals, but especially the former, to maintain their standard of living, in the face of reductions in incomes and benefits, has been made possible by three 'safety valves'. One was the increase in the number of spouses who went to work to add to the family income. According to the Bureau of Labor statistics, in 1960 18.6% of all women with children under 6, and living with their husbands, were working. That percentage increased to 45.1 in 1980 and to 62.7 in 1996. Considering the varying social and professional circumstances of families, it is difficult to anticipate that major additions to family income may derive from this source. A second 'safety valve' has been the previously reported change in the retail network. This has offered the possibility to increase the purchasing power of a given income by purchasing goods at discount prices in a variety of stores. Despite the dearth of data in this respect, it appears significant that between 1988 and 1995 consumption purchases have gradually shifted from conventional department stores to discount stores, so that the share of the latter in total sales rose from 44% to 60%. Since the possibility of shifting from one type of stores to another is conditioned by the limited variety of goods available at discount stores (generally low priced items), and since services, with some exceptions, are not available at discount stores, the possibility of increasing the purchasing capacity of one's income through this device may be nearing a ceiling.

A third 'safety valve' – apart from increasing recourse to indebtedness – has been the declaration of personal bankruptcy. As previously stated, these bankruptcies reached a record level of 1.4 million during the year ending June 30, 1998. They grew gradually until 1995, but rapidly thereafter. Between 1995 and 1996 they grew at an annual

rate of 21.4%, and at an annual rate of 26.4 % between 1996 and 1997. These were the years of the 'New Era', with economic expansion, declining unemployment and lower inflation. The pace slowed down to 8.6% between 1997 and 1998. Whether or not this sudden drop in the rate of increase is the beginning of a declining trend, this 'safety valve' for the low and medium income earners is likely to be less accessible in the future.[13] One reason is that, under pressure from banks and other lenders, Congress has been considering legislation which would make it more difficult, or more costly, or both, to declare personal bankruptcy.

TABLE 6

CHANGES IN EMPLOYMENT AND EARNINGS, 1979-1998

Year	Employment/Population ratio		Average weekly earnings* (1982 dollars)	
	Male	Female	Level	% change year to year
1979	73.8	47.5	291.66	
1982	69.0	47.7	267.26	-1.2
1983	68.8	48.0	272.52	2.0
1984	70.7	49.5	274.73	0.8
1985	70.9	50.4	271.16	-1.3
1986	71.0	51.5	271.94	0.3
1987	71.5	52.5	269.16	-1.0
1988	72.0	53.4	266.79	-0.8
1989	72.5	54.3	264.22	-1.0
1990	72.0	54.3	259.47	-1.8
1991	70.4	53.7	255.40	-1.6
1992	69.8	53.8	254.99	-0.02
1993	70.0	54.1	254.87	0
1994	70.4	55.3	256.73	0.7
1995	70.8	55.6	255.29	-0.6
1996	70.9	56.0	255.73	0.3
1997	71.3	56.8	261.31	2.2
1998	71.6	57.1	268.11	2.6

* Private non-agricultural industries.

Sources: U.S. Department of Labor. Bureau of Labor Statistics.

[13] Under the law, persons who have filed for bankruptcy are denied access to credit for up to seven years. During the period 1991-98 the cumulative number of personal bankruptcies was about 8 million; i.e., about 7.7% of total non-agricultural private employment. Considering that certain sections of the working force may not be inclined to declare bankruptcy, that percentage is not insignificant.

The upward trend in consumer borrowing in all forms[14] is not likely to continue for an extended period of time. This is suggested by two indicators which have been covered in Section 1. One is the ratio of debt to disposable personal income. The other is the ratio of personal savings to DPI. The latter reflects the general picture of household finances and expenditures. As stated on page 74, that ratio, which has steadily declined during the last 15 years, has become nil, or possibly negative. This is a national average. It means that some income groups, probably the middle income group, has had a negative ratio for much longer, and to a larger extent. Normally, low savings are expected to be associated with societies whose government provides ample benefits during one's lifetime. This is not the case in the United States. Moreover, an incentive to save could originate in the fear, at this time, that Social Security benefits may not be available, or fully available, starting with the second decade of the next century. As to the ratio of indebtedness to DPI, its rise to about 21% in the recent past is cause for concern. While it considerably exceeds the historically safe 'peak' of 16-17%, consumers' balance sheets have been burdened, as was mentioned in a preceding paragraph, by payments for home equity loans, for leasing equipment (besides the first mortgages on the primary residence), which also have been rising at a rapid pace. When all these payments are added up, a *calculated* ratio of debt to DPI may well be about 30% at this time. In conclusion, net borrowing to finance purchases of goods and services may reach a turning point in a not too distant future.

An improvement in the US external financial position is inevitable, but difficult to achieve. The factors that caused the country's current account deficits are numerous: some are of a 'structural' nature, while others are due to developments in the outside world, such as currency devaluations, a rapid technical education of the labor force, acquisition of modern technologies, to mention a few. Those of a 'structural' nature include the de-industrialization of the country, especially during the period (until 1985) of a large and rapid appreciation of the dollar; the development abroad of competing industries in

[14] One type of borrowing which receives little attention is 'students loans'. Until late 1970s these loans were negligible, but rapidly rose in the early 1980s to about $ 15 billion (in 1996 dollars). After stabilizing in the early 1990s, they increased at an average annual rate of about $ 3 billion thereafter until 1997 when the level was about $ 33 billion.

fields where the US had previously a practical monopoly (typically the aircraft industry); and the progress made in developing countries, including India and China, in grain production. Even during the mini-recession of 1991-92, the country continued to run current account deficits, though minor ones. A similar recession at this time would produce an even smaller correction due to the increase in payments to service the large foreign debt. To give a rough impression, since 1991-92 non-residents have accumulated large dollar financial assets. These are of different types; but the holdings of US Treasury bonds alone have increased by some $ 700 billion, and this requires additional annual gross interest payments of some $ 30 billion. It is, therefore, very difficult to envisage what set of measures and circumstances can produce a gradual elimination of the deficits in the US external accounts, a goal which is clearly unavoidable.

A different, though closely related, problem arises from the accumulated holdings of claims *vis-à-vis* the US by non-residents. They will not disappear even when the current external accounts were brought into balance. Predictions that foreigners will not continue to hold, and try to liquidate America's IOUs – sometime presented with dramatic images –, have been made since the country became a *net* debtor in 1986. And yet, foreign debt has continued to accumulate to this day. While it is extremely unlikely that non-residents will increase their holdings of dollar denominated assets without limits in time and amounts, a turning point may not be caused by endogenous factors, even if the current account were to be balanced. This is based on the observation that the monthly publication of large current account deficits, and the knowledge of an increasing foreign debt, appear to have no impact on the financial markets. A more likely triggering event could be exogenous in nature, such as a return to normal conditions in Asia and Latin America, a conflict in the Middle East, a gradual increase in preference for, e.g., the euro as a reserve currency, and so forth. It should be emphasized that sales of US dollar liquid holdings by non-residents on the foreign exchange markets will not change, by themselves, the amount of outstanding claims. For a reduction in those claims to occur, they would have to be exchanged against non-financial assets in the United States.

Finally, the upward trend in the stock market is bound to be reversed, and it is to be expected that a declining trend, once established, will continue until more 'normal' valuations are attained. As

noted above, at the end of 1998 the P/E ratio for the SP 500 composite, at about 32, was more than double the 'norm' of 15. This is, however, an abstract concept for investors. The turning point may be triggered by more tangible circumstances. A decline in dividends, caused by shrinking profits, would highlight the large, and increasing, gap in individual returns from investments in stocks and bonds. At the end of 1998, the dividend yield from the shares in the SP 500 was about 1.3%, whereas the yield from 10-year Treasury bonds was about 4.7%, and that from AA industrial bonds was 6.1%. So far, a hope to realize capital gains has induced many investors to remain in the stock market. When it should become apparent that capital gains are less and less likely, a move away from stocks may begin. To be sure, the valuations in the stock market benefit from an upward bias. This is due to a number of factors. These include: the gradual accumulation of stocks in tax-preferred pension accounts held by individuals who are counselled not to sell during the so-called 'temporary corrections'; the dominance of mutual funds whose managers advise to 'stay for the long haul'; the pervasive unfamiliarity with short-selling and, perhaps, the general psychological orientation towards the 'positive'. Should a protracted decline, however, set in, those same factors could act in reverse and produce the P/E ratio to fall beyond the 'norm'.

These are the factors which may cause turning points in each of the four abnormal trends discussed in this paper, when taken in isolation. In fact, however, changes in those trends interact with each other. When this occurs, cumulative effects are likely to take place possibly in a circular manner. To give an example, increases in labor costs not accompanied by equal changes in productivity are bound to exert a downward pressure on earnings. This could cause a protracted decline in financial markets; in turn, this could cause a reversal of the 'wealth effect', i.e., it could induce reductions in consumers' purchases.[15] These reductions could result in still lower earnings due to a

[15] It is broadly recognized that there is a 'wealth effect' on consumption expenditures, but estimates of its size are conjectural, and vary within a wide range. The conventional view seems to be that for each $ 100 increase in the value of stocks held by households there is a $ 3.00 addition to consumption expenditures. This coincides, more or less, with the opinion expressed by Mr Greenspan (1998); but others estimate the amount of additional spending at as much as 10% (Standard & Poor/DRI). Estimates using different measurements have been made by the BIS (1998) and by Macroeconomic Associates of St. Louis. An unanswered question is the size of a possible symmetrical effect in the case of protracted declining markets.

decline in the volume of sales, unless businesses revert to 'target return' pricing, in which case prices would increase. Considering that an annual increase in consumers' expenditures financed by borrowing of $ 100 billion represents roughly 1.5% of GDP, a mere cessation of that borrowing would, by itself, reduce *pro tanto* the rate of growth. Unemployment would likely increase.

Quantifying possible results within a time frame of, say, 2 or 3 years, of major changes in the four trends is an impossible task. The dynamics is so complex and characterized by uncertainties, that any sequence of events is highly hypothetical. In addition, policies are bound to be changed in the face of developments which are deemed undesirable, and the nature and direction of these policy changes are also difficult to predict. There is a very large number of possible sequences; one could not exclude that among them there is a 'virtuous' one in which one after another of the four abnormal trends would slowly correct themselves. This is, however, highly unlikely, as is the other extreme, i.e., a 'vicious' sequence in which the interaction of the various changes would lead to a depression, a decline of more than 60% in stock market valuations, and a similar decline in the dollar exchange rate. Sequences between these two extremes are more likely.

Two plausible, though hypothetical, scenarios will be outlined below. A straight line projection of the current account deficit – the most intractable of the four trends – would add, over a three-year period, some $ 750 billion to the US liabilities to the rest of the world, and would raise, *ceteris paribus*, the net international investment position to some $ –2 trillion. This is, however, unlikely, since some major corrections may take place during that period. A possible manifestation of a reduced preparedness of the rest-of-the-world to continue to accept claims in US dollars could be a requirement that US importers make payments in the currency of the exporting country. The resulting addition to the supply of dollars in the foreign exchange markets[16] would cause a depreciation which, if sufficiently large, could induce holders of past accumulated claims *vis-à-vis* the US to liquidate them. A resulting increase in the yields of US Treasury bonds would widen the spread between them and stock yields, and this, together with a depreciating dollar, would induce large disinvestments in the

[16] Up to now, dollars given in payment for imports may largely result in shifts within the US banking system from balances in payors' accounts to payees' accounts.

stock market by non-residents and residents alike. The proceeds from sales by non-residents could result in further pressure on the dollar in the foreign exchange markets.

A sufficiently large and protracted decline in stock valuations would likely create a negative 'wealth effect' and, thus, a reduction in consumption expenditures. The resulting negative impact on GDP growth and business earnings would induce declines in investment spending. A decline in employment associated with a fall in GDP growth would reduce further consumption expenditures. To be sure, there would be offsetting changes, such as an increase in some exports and a decline in imports; but these would be lagging effects, behind the events in the financial areas. The monetary authorities would be facing a serious dilemma between injecting liquidity to try to reduce the rise in interest rates, on the one hand, and reducing money supply to keep inflation under control in the face of rising import prices, on the other hand.

A second hypothetical sequence could be triggered by higher wages and salaries unmatched by increase in productivity. They would put pressure on costs; prices would rise; earnings would decline. Because of the resulting fall in yields from stocks and a rise in P/E ratio, stock prices would undergo a major correction. As in the previous hypothetical sequence, non-residents would liquidate part of their dollar denominated financial instruments as well as currency balances. Once again, a falling dollar and reduced consumption and investment expenditures would cause GDP to decline and prices to increase and the monetary authorities could face the same dilemma outlined in the preceding paragraph.

These hypothetical sequences have the sole purpose of showing how reversals and normalizations in the four abnormal trends may interact with each other. They constitute oversimplifications as a number of unexpected and unforeseen factors may enter the picture and significantly alter the dynamics of the events. *A fortiori*, any attempt at building an econometric model based on precise assumptions as to dimensions of changes in each trend, their timing, probability and lags in interactions, would be an exercise in futility. Nevertheless, our conclusions, however imprecise, are that the United States are bound to experience a period of economic and financial difficulties within the next 2 to 3 years. The most visible ones will be in the financial areas, particularly the stock and bond markets; and the former will undergo a sizable 'correction'. Similarly, the US dollar is bound to depreciate *vis-à-vis* other currencies. The large US foreign debt may not correct by itself, and it cannot be excluded that it will be the subject of an international 'understanding'. The balance of payments will improve due to income effects (recession) and price effects (dollar depreciation), but the elimination of the current account deficit will prove to be a difficult undertaking in a short period of time. The economy is likely to fall into a mid-size recession which may extend over many quarters.

A final commentary relates to the state-of-the-arts in economic evaluations. The facts presented in this article are in sharp contrast with the positive, at times glowing, portrait of the US economy at this time. The latter is based on what is sometimes called 'the fundamentals'. It is also a reflection of pronouncements by persons in authority. To be sure, this is not new. Without implying parallels, it may be recalled that, in October 1929, no lesser an academic authority than Irving Fisher stated that stock prices had reached "what looks like a permanent high plateau". On the business side, Charles E. Mitchell, president of National City Bank of New York (now Citigroup) gave, at the same time, a solid endorsement of the stock markets, stating specifically: "The market values have a solid basis in the general prosperity of the country".[17] In more recent times, highly regarded international institutions issued positive evaluations, based on 'fundamentals', of South Korea, Indonesia and other East Asia countries. These evaluations had not taken into account a number of internal features and maladjustments in the financial and economic systems; which features and maladjustments were amply described, and deemed to be at the roots of the problems. This article has tried to bring to light internal maladjustments in the United States, and, accordingly, to sound warnings about forthcoming 'corrections' in the economic, financial, monetary, and foreign exchange fields. Unfortunately, such 'corrections' are bound to have repercussions in other countries. The only comforting thought is that, at this time, as different from the late 1920s and early 1930s, most academicians and policy makers are free of dogmatic schemes, and there is an international institutional set-up which offers fora for discussions of remedial measures, after the problems have come out in the open.

[17] These quotations are reproduced from a book by Klingaman (1989, p. 253).

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