# US economy on the way to recession

**Nick Beams**
**30 December 2000**

Less than three months ago the International Monetary Fund gave the following assessment for the US and world economy.

"Growth is projected to increase in all major regions of the world," it declared, "led by the continued strength of the US economy, the robust upswing in Europe, the consolidation of the recovery in Asia and the rebound from last year's slowing in emerging markets."

This optimistic assessment was shared in most of the financial press, with only a few voices warning that at some point the unsustainable growth in the US balance of payments deficit, the unprecedented decline in savings and the growth in corporate and personal debt would have major economic consequences.

In the period since the IMF delivered its report, the economic scene has undergone a significant change. The decline in US stock markets—with the technology-based Nasdaq index now down 50 percent on the highs reached last March—coupled with the rapid slowdown of the US economy—growth is down from 5 percent per annum to around 2 percent—have prompted warnings of a possible US recession and world slump.

A recent article in the *San Jose Mercury*, for example, warned that the collapse of the Nasdaq was comparable to the Wall Street crash of 1929. According to financial analyst Doug Noland, cited in the article, the stock market fall is only the early stage of "unfolding dislocation." He maintains that the high-tech boom is largely the result of a growth of easy lending, with the "excesses" during this period making the Roaring Twenties look small by comparison. "We have borrowed unbelievable amounts of money, we've consumed it, we've wasted it and now we're in a real pickle."

While most pundits still maintain that the US will sustain a so-called "soft landing"—that is, a decline in growth without a recession—the *Financial Times* noted that "a growing number of economists now believe that the US is well on the way to recession in 2001" with some arguing that it has already arrived. While that assessment may be "too pessimistic", it continued, the "threat of a serious downturn for the US is as great as it has been at any time in the past decade."

The main economic indicators are pointing in the same direction: consumer spending is falling, with less than expected sales over the holiday period, the stock market continues to fall, and since the middle of the year the manufacturing industry has been losing jobs at the fastest rate in 10 years.

After years of promoting the so-called "new economy" and the allied theory that changes in technology had made the US recession proof, the mood in the press has changed dramatically. Typical of the articles now appearing is a comment by Robert J Samuelson in the December 26 edition of the *Washington Post* entitled "Goodbye, New Economy."

According to Samuelson: "The theory of the New Economy held that computers and the Internet have so enhanced the prospects for higher wages and profits that people could spend lavishly. By its logic, the New Economy was unassailable. Strong investment would improve efficiency, enabling companies to raise wages and profits without increasing prices. Worsening inflation wouldn't threaten recession. High stock prices today were justified by higher expected profits tomorrow. People could borrow more today because their higher future incomes would make repayment easier."

Pointing to the importance of high technology in the promotion of the boom, Samuelson noted that from 1994 to 2000 "about 70 percent of the increase in business investment occurred in computers, software, communications networks and advanced instruments."

Now the previous virtuous circle, in which increased spending fueled investment, greater profits, higher stock prices leading in turn to greater spending, is threatening to turn into its opposite as weaker consumer spending brings lower profits, falling investment and stock process leading to layoffs and lower confidence.

While, in Samuelson's words, there are "already signs of this savage cycle" little or no analysis is made of the reason for its emergence. Samuelson, for example, concludes his article as follows: "The uncertainties and risks accumulate. They mock the promised calm and certitude of the New Economy. It cannot be said to have died, because it never existed. It was a mood, and—almost without warning—it has passed."

To ascribe the imminent demise of the longest period of continuous economic growth in US history to a change in "mood" is about as scientific as the assertions of just a few months ago that the US economy had somehow overcome the business cycle and the threat of recession. And to ascribe the expansion of the past few years to psychology is to cover over the deep-going structural changes in the US economy which took place in this period—changes which mean that even a mild recession could have a devastating impact.

While there is no question that productivity increases associated with advanced technology had a significant impact on the US growth rate, an even more decisive role was played by the expansion of credit and the growth of indebtedness.

As the *Financial Times* columnist Martin Wolf pointed out in an article published on December 5: "Between 1992 and 2000, the US private sector moved from a financial surplus of 5 percent of GDP [gross domestic product], about 2 percentage points above its

1983-93 average of 2.7 percent, to a historically unprecedented deficit of just over 5 percent. This swing of 10 percent of GDP in the US private sector financial balance has, in turn, been the principal engine of demand for the US economy and, to a significant extent, for the world."

The same processes are reflected in the growth of the US balance of payments deficit that has risen from around 1.6 percent of GDP in 1996 to an estimated 4.3 percent this year. The growing payments gap has been financed by an inflow of foreign capital which resulted in a US external debt of around $2 trillion.

It is this dependence of the US on foreign capital inflows to sustain its debt which means that the most commonly prescribed action to prevent a recession—a major interest rate cut by the Federal Reserve Board—may give rise to deepening economic problems, rather than alleviate them.

Criticising the claim by *New York Times* columnist Paul Krugman that "the best news of all" in the event of a recession "is that the Fed will be able and ready to react", the latest report of the Financial Markets Centre, a US-based think tank, noted that "the same financial-sector developments that have introduced the possibility of recession will probably prevent a quick or real fix by rate cuts alone."

It pointed out that the previous interest rate increases by the Fed had boosted the foreign capital inflow used to support consumption spending and business investment and that during the first two quarters of 2000 "foreign investors' purchases of corporate bonds and other US credit market instruments outdistanced combined purchases by all domestic insurance companies, pension funds and mutual funds by more than two to one on a net average annualised basis."

The FMC report pointed to the growth of indebtedness of the banks and other financial institutions over the past decade. "Between 1989 and 1999, the financial sector doubled its share of the annual increase in borrowing among all sectors of the economy—from 24 percent to 49 percent of all new debt. With the Fed looking on passively, US credit markets have grown more oriented to financing speculative bets on changes in asset prices, leaving the financial system susceptible to shocks like the failure of Long Term Capital Management."

Instead of basking in praise for engineering a sustained expansion, it continued, the Fed should have been pointing out the "potential pitfalls of relying on an overvalued dollar and massive foreign borrowing to propel domestic growth."

Lowering interest rates just enough to prop up debt-financed consumption spending would not solve the problem but merely postpone the day of reckoning. "Deeper rate cuts might allow households and businesses to refinance their debt on substantially better terms and provide a superior alternative to the cleansing ritual of failure and liquidations. But cutting interest rates deeply in the face of a huge trade deficit and overvalued dollar could easily jeopardise the massive inflows of foreign borrowing on which the '90s boom was built. Ultimately it could turn investor sentiment against the dollar.

"America has endured such shifts before—but never with such a massive exposure to foreign creditors or so much capacity for contagious destruction wired into the world's financial system. In theory, a weaker dollar could translate into lower rates and revived US exports. Under the circumstances, a combination of [a] devalued dollar and high rates is more likely."

A recession or even a slowdown in the US economy will have major global ramifications, given that the US expansion has provided the main impetus for world growth over the latter half of the 1990s. US GDP now accounts for around 30 percent of world output, up from 26 percent in 1992, and it has been estimated that US companies now make up half of all world corporate profits, representing a 33 percent increase from a decade ago.

While a fall in the value of the US dollar will benefit exporting countries in Latin America and South East Asia, as their currencies will also fall in value making their exports more competitive, it will create serious problems for the Japanese economy. A rise in the value of the yen will cut export markets, leading to further falls on the stock market, thereby undermining the position of banks and financial institutions.

Indeed the rapid slowdown in the US is being accompanied by indications from Japan that economic recovery there has stalled once again. With one eye clearly fixed on developments in the US, the governor of the Bank of Japan Masaru Hayami warned earlier this month that the prospect of deflation had returned.

Speaking to business leaders, he said that "seeing as the pace of recovery is gradual, we need to pay close attention to risks that the Japanese economy may worsen and deflation fears may re-emerge due to external shocks."

His warning has been underscored by the most recent economic statistics. Industrial production for November fell 0.8 percent after rising 1.5 percent in October, retail sales declined for the 44th month in a row, unemployment reached an eight month high and Tokyo prices fell by 1 percent over the past year, the largest annual decline since records began in 1971.

While there are vast differences between the US and Japan, the history of the Japanese economy over the past decade points to some of the problems confronting US policymakers if the downturn in financial markets leads to a full-blown recession.

Of particular significance, given claims that a few quick moves by the Fed will restore growth, is the fact that the stagnation in the Japanese economy since the beginning of the 1990s has taken place despite a zero interest rate policy and the greatest government spending increases in history.

And it is also worth recalling, as the promises of the New Economy in the US turn to dust, that only a decade ago Japan too was being hailed as the new economic paradigm.