

THE ROOTS OF THE CURRENT EXPANSION

A JOINT ECONOMIC COMMITTEE STUDY



Jim Saxton (R-NJ)
Chairman

Joint Economic Committee
United States Congress

April 1997

Executive Summary

After briefly summarizing recent macroeconomic experience, this paper explains why the current economic expansion has been sustained -- despite growing tax burdens partly related to the Budget Act of 1993.

The key reasons for this sustained recovery include:

- ➔ The economic and financial market stabilizing effects of a credible anti-inflationary monetary policy.
- ➔ The fact that monetary policy has produced stable growth in total spending dominating fiscal policy's influence on both aggregate demand and interest rate movements.

The paper concludes with an assessment of the longer term prospects for growth.

Joint Economic Committee
G-01 Dirksen Building
Washington, DC 20510
Phone: 202-224-5171
Fax: 202-224-0240

Internet Address:
<http://www.house.gov/jec/>

THE ROOTS OF THE CURRENT EXPANSION

INTRODUCTION

After briefly summarizing recent macroeconomic experience, outlining salient features of the current expansion, and discussing likely near-term trends, this paper explains why the current expansion has been sustained -- despite growing tax burdens partly related to the Budget Act of 1993.

The key reasons for this sustained recovery include:

- the economic and financial market stabilizing effects of a credible anti-inflationary monetary policy;
- the fact that monetary policy has produced stable growth in total spending, dominating fiscal policy's influence on both aggregate demand and interest rate movements; and
- the export-promoting effects of lowered tariff barriers and free trade.

The paper then briefly assesses both longer term economic prospects and likely future Federal Reserve policy action.

RECENT PERFORMANCE OF THE MACRO ECONOMY

The current economic expansion is now six years old and continues to proceed at a moderate, albeit below-normal pace. Despite a frequent "saw-tooth pattern" in various month-to-month or quarter-to-quarter economic statistics, the current expansion has persisted, now ranking among the longer post-World War II economic expansions. Furthermore, this sustained expansion is expected to continue into the foreseeable future since no obvious cyclical imbalances are evident that have disrupted earlier recoveries.¹

Characteristics of the Current Expansion

A Sustained Recovery

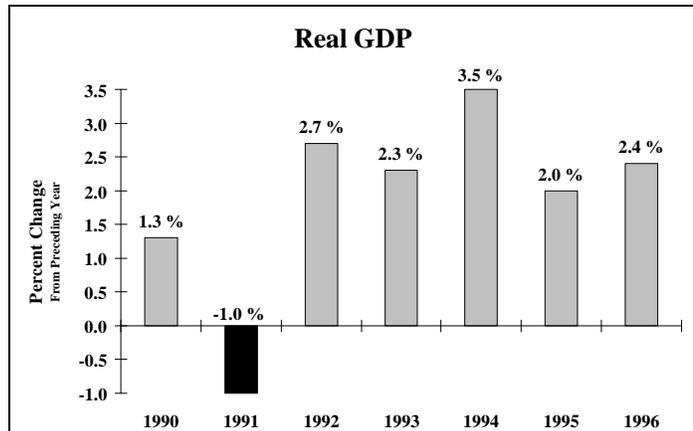
While the current expansion would rank below average in terms of its overall strength compared to earlier recoveries of comparable length, this recovery has been remarkably sustained. Real gross domestic product (GDP) growth, for example, has averaged 2.4 percent compared to

¹In particular, inventory imbalances, corporate or bank balance-sheet distortions, overbuilding in the construction industry, resurgences of inflation, or sharp interest rate increases are neither evident nor expected.

earlier expansions of similar length of about 3.6 percent (see Chart 1). Yet, the recovery has lasted 72 months compared to the average post-war peacetime expansion of 43 months². Similarly, nominal GDP growth has expanded at a sustained pace of 5.0 percent, somewhat below its typical post-war recovery growth rate (see Chart 2).

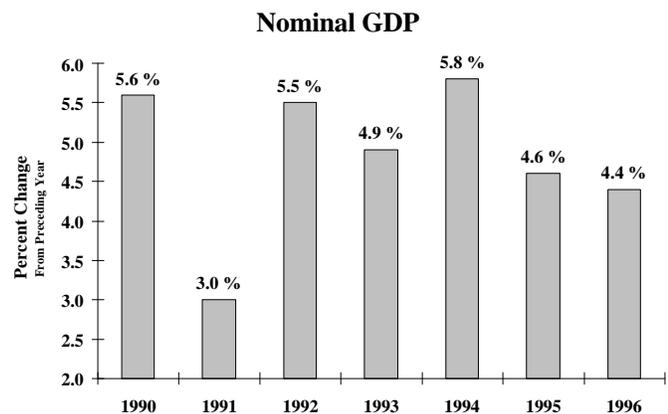
Other aggregate measures of economic activity tell a similar story. The expansion's employment growth, for example, has been sustained, but below average when compared to earlier cycles (see Chart 3). Partly because of weak labor force growth, however, the unemployment rate has dropped considerably to 5.3 percent. This recovery's increases in wage income and productivity growth have been especially sluggish by historical standards. In fact, real median weekly earnings have actually fallen since 1993; annual data show a continuous decline of real earnings during this period. These earnings data suggest some groups have not participated in the recovery. Specifically, unlike during previous expansions, many middle class income earners have not shared in the gains attained by others during this expansion.

While most private-sector GDP components have shared in this moderate below-average growth, a few sectors have made notable, healthy contributions. One such sector which led the recovery was investment spending, especially equipment investment. Information processing investment accounts for a sizable portion of this increase. Another notable sector contributing significantly to the recovery was the export sector. Export growth has consistently exceeded GDP growth; therefore, this sector's GDP share has steadily grown during



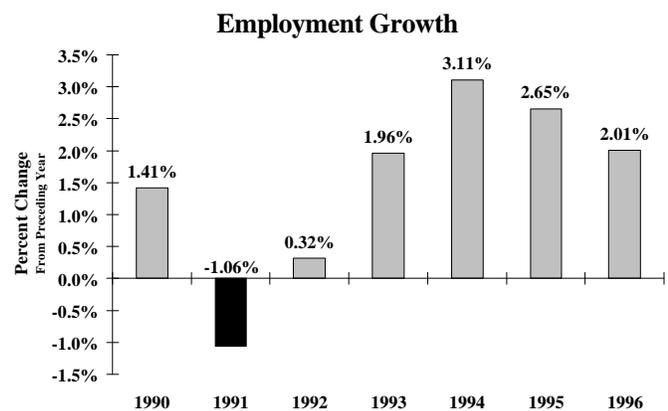
Source: CEA, *Economic Indicators*, February 1997.

Chart 1



Source: CEA, *Economic Indicators*, February 1997.

Chart 2



Source: CEA, *Economic Indicators*, February 1997; and JEC calculations.

Chart 3

²Source: National Bureau of Economic Research, Inc.

this expansion. Inventory investment, however, has been increasingly better managed, as evidenced by lower inventory/sales ratios (see Chart 4). This development, of course, enhances the likelihood of continued economic expansion since it minimizes the likelihood of important inventory corrections.

Lower, More Stable Inflation

Another important characteristic of this expansion is the notable absence of inflationary pressures that have often plagued previous recoveries. Most broad-based measures of inflation (such as GDP deflators, the Consumer Price Index, and the Producer Price Index) have been remarkably well-behaved (see Chart 5). Similarly, wage costs remain relatively tame despite unemployment rates remaining below these levels previously associated with rising price and wage pressures. Furthermore, forward-looking market price indices (such as various commodity price indicators), which in the past have accurately signaled rising expectations of future inflation, currently remain well behaved (see Chart 6).³



Chart 4

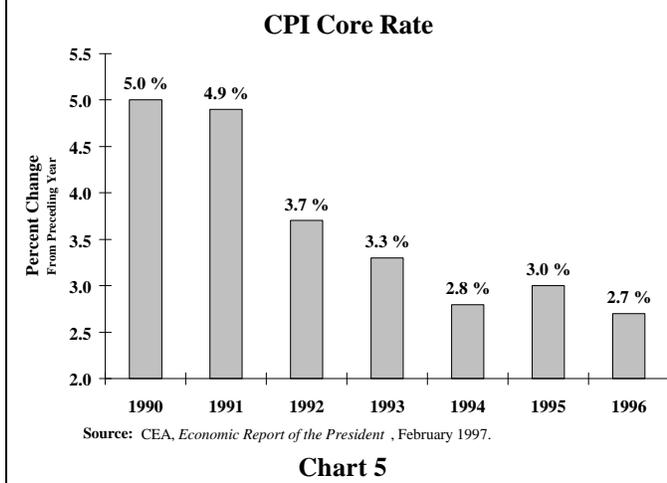


Chart 5

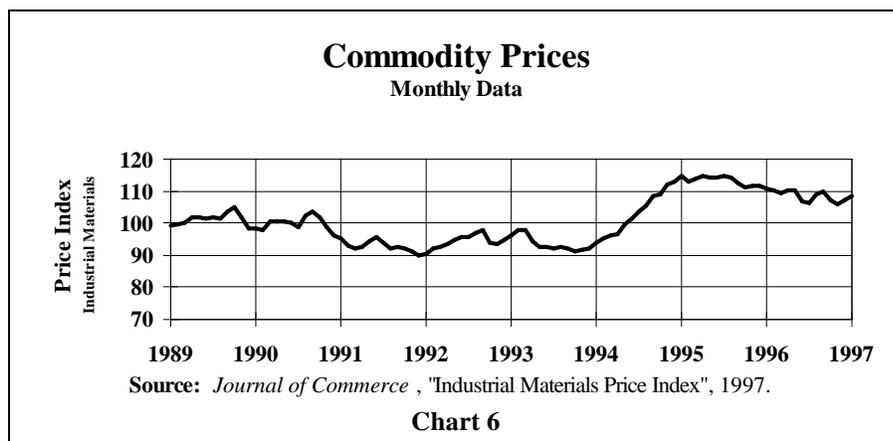


Chart 6

This benign inflation performance has a number of important implications which will be further examined below. Nonetheless, it is important to note that the gradual diminution of inflation and expectations of future inflation have been associated with a gradual reduction of both

³Commodity prices (as measured by the *Journal of Commerce* commodity price index) began increasing in late 1993. This increase was soon accompanied by a 300 basis-point increase in the Fed funds rate (from February 1994 to late January 1995). In short, the Federal Reserve responded to forward-looking signals of heightened inflationary expectations and acted pre-emptively to stifle such expectations before the increases became self-fulfilling.

short- and long-term interest rates (see Charts 7 and 8). At the same time, it is noteworthy that this lower, more stable inflation is associated with reduced inflation volatility (as well as lower volatility of inflationary expectations). Accordingly, those financial markets sensitive to inflation expectations will be more stable than otherwise. This enhanced financial market stability is evident in recent years' performance of the bond, money, commodity, foreign exchange, and equity markets.

Expansion Expected to Continue

The current expansion is expected to continue; consensus forecasts call for continued expansion of real GDP in the neighborhood of 2.5 to 3.2 percent in 1997. The reason for this expected continued expansion is that no important imbalances have emerged that typically have derailed expansions in the past. In particular, inflation appears to be in check with little evidence of an imminent resurgence. Accordingly, none of the imbalances typically associated with inflation or expected inflation are evident; i.e., neither individuals nor businesses appear to be making decisions based upon expectations of important increases in inflation. More specifically, total debt is rising but relatively slowly, and the overall balance sheets of individuals, businesses, as well as banks appear to be in reasonably good shape. Banks, for example, are much better capitalized than they were earlier in the decade. The commercial real estate overbuilding which characterized the late 1980s appears to be significantly worked off. Inventories are increasingly better managed with current inventory-to-sales ratios low by historical standards.⁴

Furthermore, no important policy adjustments are anticipated that could derail the recovery. Should monetary policy be adjusted, sharp interest rate movements are not anticipated; the Federal Reserve appears to be close to a "neutral" monetary policy stance so that any changes will likely be marginal in nature. Currently, only a modest Federal Reserve tightening is imbedded in short-term interest rate futures markets. Similarly, no sharp change of fiscal policy is anticipated that might disrupt the economic expansion; viewed from a conventional perspective, fiscal policy is expected to remain modestly restrictive since it has been constrained by concerns about budget balance.

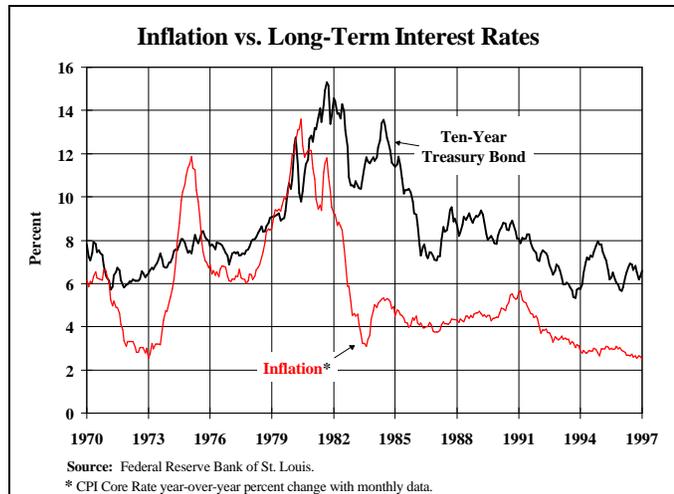


Chart 7

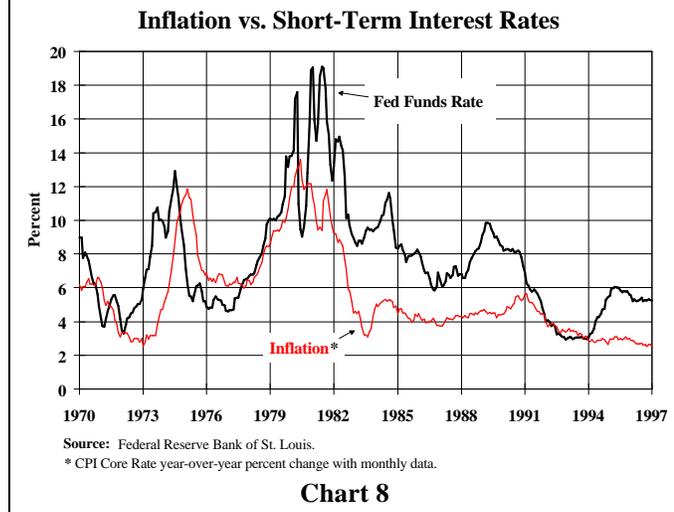


Chart 8

⁴Both lower, more stable inflation and technological advances partly explain this improved management.

REASONS FOR THE SUSTAINED ECONOMIC EXPANSION

Perhaps the distinguishing characteristic of the current expansion is its **sustainability**. In particular, this expansion has persisted despite recent increases in tax (and regulatory) burdens as epitomized by the Budget Act of 1993. The expansion has continued because certain positive factors have worked to offset the perverse effects of these recent tax increases. The key positive ingredients contributing to this offset include: 1) the potent stabilizing effects of a credible price stabilizing monetary policy; 2) the stable expansion of aggregate spending and output which has been principally determined by monetary, not fiscal, policy and which has contributed significantly to reduction in the budget deficit, and 3) the export-promoting effects of lowered tariff barriers.

The Stabilizing Effects of a Credible, Price-Stabilizing Monetary Policy

A key ingredient of recent Federal Reserve monetary policy has been a persistent emphasis on price stability as a key policy objective. Federal Reserve officials have repeatedly endorsed the goal of price stability in speeches, testimony, interviews, and official publications. The preemptive policy move to tighten monetary policy, beginning in February 1994, was important in demonstrating that these public pronouncements were genuine; the move also served to condition market expectations, thereby, enhancing the Federal Reserve's inflation-fighting credibility. Market participants now expect Federal Reserve policy action at the first signs of resurgent inflation.

As a result of these actions, most broad-based measures of inflation registered modest increases and continued to moderate. Indeed, a sustained reduction of inflation has brought some broad-based measures of inflation to their lowest rates of inflation in 30 years.⁵ And few signs suggest that a meaningful resurgence of inflation is imminent.

This credible, sustained reduction in inflation has several very important implications relating to the durability of the expansion:

- **Lowers interest rates:** First, this convincing, sustained reduction in inflation has gradually lowered expectations of future inflation. Accordingly, the inflationary expectation's component of interest rates dissipated from the structure of both short- and long-term interest rates; interest rates are lower as a result (see Charts 7 and 8).
- **Stabilizes financial markets and interest sensitive sectors:** Second, as inflation diminishes, the variability of inflation also is reduced. Lower inflation is associated with lower volatility of inflation. Accordingly, financial markets have less tendency to overshoot or undershoot their fundamental values. This lower volatility has the effect of reducing uncertainty premiums of interest rates; financial markets tend to become more stable and predictable. In short, lower inflation stabilizes financial markets.

⁵GDP prices in fourth-quarter of 1996 measured by the chain-type GDP price index, for example, registered the lowest year/year percent change in 30 years.

As a result, market participants tend to become more confident or self-assured and more willing to invest, take risk, and innovate. Businesses are able to better plan, coordinate, and control inventories, thereby improving efficiency. Furthermore, this enhanced financial stability works to stabilize various interest-rate sensitive sectors of the economy and, therefore, the macro economy as well.⁶

- **Enhances workings of the price system:** Third, lower inflation is associated with lower (relative) price dispersion. Lower inflation lowers the variability between individual prices or reduces the noise and distortions in the price system.⁷ As a result, the price system can better serve its information and allocative functions. Consequently, the economy operates more efficiently and, therefore, grows faster.
- **Acts like a tax cut:** Fourth, lower inflation is analogous to a tax cut in several important ways. Like a tax cut, for example, lower inflation removes distortions in the price system. Lower inflation minimizes those interactions of inflation with existing non-indexed portions of the tax code that effectively result in higher taxation.⁸ Furthermore, lower inflation effectively lessens inflation as a source of government revenue; it minimizes seignorage as well as government's ability to reduce its outstanding debt via inflation.

In short, credible disinflation works to lower interest rates, stabilize financial markets and interest-sensitive sectors of the economy, promote efficient operation of the price system, and effectively lower taxation. All of these effects contribute to promoting the sustainability of the expansion.

The Gradual but Stable Deceleration of Total Spending

Another contribution to the expansion's persistence has been the Federal Reserve's management of nominal aggregate demand; the macro economy has experienced a very gradual but stable deceleration of aggregate spending. Nominal aggregate spending is principally determined by monetary, not fiscal, policy, and it must be reduced in order to diminish inflation.⁹

⁶This enhanced stability is documented in G. Bigg, "Why Has the Economy Become Less Volatile?," Prudential Economics, November 1996, volume 12, number 11. This analysis shows that real GDP growth has become less volatile in recent years. The standard deviation of real GDP growth has fallen significantly from 1985 (as has a moving 20-quarter-standard deviation of real GDP growth). The primary reason for this reduction is a large decline in the volatility of the interest rate sensitive sectors of the economy (consumer durables, equipment investment, and residential spending).

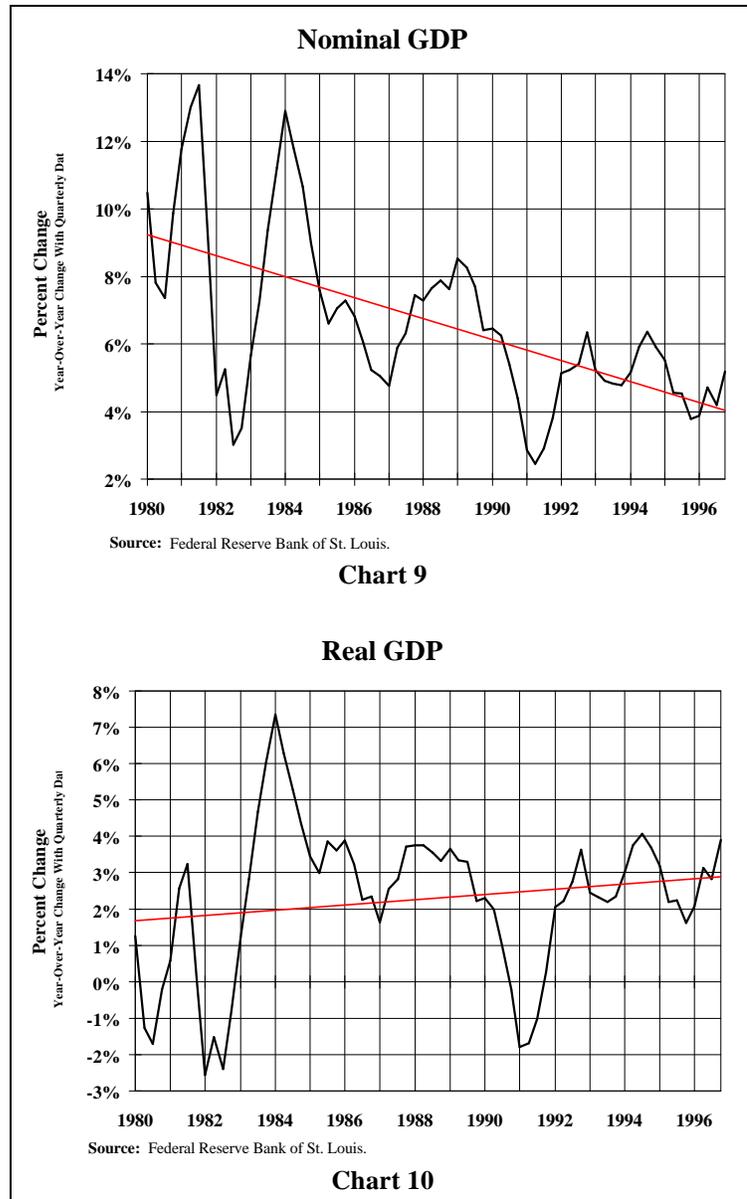
⁷See, for example, Guy Debelle and Owen Lamont, "Relative Price Variability and Inflation: Evidence from U.S. Cities," Journal of Political Economy, February 1997, vol. 105, no. 1.

⁸Remaining portions of the tax code that are not indexed, for example, include capital gains taxation, estate taxation, and forms of corporate taxation.

⁹Articles reviewing the argument that monetary policy dominates fiscal policy as a determinant of aggregate spending include, for example, Bennet T. McCallum, "Monetary Versus Fiscal Policy Effects: A Review of the Debate," in The Monetary Versus Fiscal Policy Debate: Lessons From Two Decades, edited by R.W. Hafer, Rowman & Allanheld Publishers, Totown, N.J., 1986 (see esp. pp. 10, 23-24); and Lawrence Meyer and Robert Rasche, "Empirical Evidence on the Effects of Stabilization Policy," Stabilization Policies: Lessons From the '70's and Implications for the '80's Center for the Study of American Business, 1980 (see pp. 51,54).

Accordingly, the way in which the Federal Reserve manages the required reduction in aggregate spending is important in determining the expansion's durability.

In recent years, the Federal Reserve -- while maintaining a focus on price stability -- has conducted monetary policy so as to foster the forward momentum of spending growth while at the same time very gradually reducing its growth. This has worked to slowly squeeze inflation out of the system while at the same time allow for stable real GDP growth. Specifically, the Federal Reserve has adopted a "gradualist" approach to managing aggregate demand so that nominal GDP growth decelerates in a very gradual manner. Over the last 12 quarters, for example, nominal GDP growth has advanced at about 5 percent annualized. The Fed's central tendency forecast for fourth-quarter nominal GDP for 1997 over 1996's fourth-quarter is 4.50 to 4.75 percent. Thus, the Federal Reserve expects a modest slowdown. Nominal GDP's growth since the early 1980s has two important characteristics: downward long-term trend growth and successively lower peaks in nominal GDP growth (see Chart 9).



The Federal Reserve, therefore, has not attempted to achieve price stability too quickly, to avoid jolting or shocking the economy into a slowdown or recession. By avoiding such sharp disruptions, monetary policy has not been subject to the subsequent strong political pressures to "jump start" or reflate the economy, thereby re-introducing the type of stop-go policies that historically produced policy-induced business cycles. By conducting policy in this gradualist manner, the Federal Reserve has sustained the expansion. Real GDP growth, for example, has persisted, albeit at a below-normal rate of about 2.6 percent annualized since the expansion began in the second-quarter of 1991. Notably, unlike the downward stopping trend characterizing the growth of nominal GDP, real GDP trend growth is positive, albeit only modestly so. Furthermore, successive peaks in real GDP do not show the downward trend evidenced by those of nominal GDP (see Chart 10).

The stable growth in GDP in recent years not only has fostered the durability of the current expansion but has contributed importantly to reducing the Federal budget deficit.¹⁰ Tax revenues, for example, have consistently been stronger than expected. In promoting the above-described stable growth in total spending, monetary policy has dominated fiscal policy's influence on both aggregate demand and interest rates.¹¹

The Export-Promoting Effects of a More Open Economy

Persistent growth in exports, related to lower trade barriers implemented in recent years, has also contributed to the sustained nature of this expansion. The U.S. economy has become increasingly open as measured by the fraction of GDP accounted for by the sum of what is exported and imported.¹² Moreover, export growth has exceeded GDP growth in every year of this expansion. Accordingly, exports have become a steadily larger fraction of GDP (increasing from about 10 percent in 1991 to about 12 percent in 1996). The U.S. dollar, of course, has helped to foster this export growth since, in general, it has been relatively stable, especially when viewed historically and measured on a trade-weighted basis. Furthermore, the growth and increasing openness of newly emerging markets also have supported this growth and have helped exports contribute to the sustained U.S. expansion.

LONGER TERM PROSPECTS FOR GROWTH

While near-term economic activity has been sustained principally by the judicious, gradual disinflation of the Federal Reserve, monetary policy's ability to enhance long-term economic growth is limited to minimizing the growth-inhibiting effects of inflation. Monetary policy, therefore, can help to foster an environment in which growth can occur but has little influence on actually promoting the long-term growth potential of the economy.

As indicated above, while this expansion's longevity is impressive, its overall strength is well below that experienced in typical recoveries in the past. Furthermore, such modest growth is expected to persist into the foreseeable future. Part of the reason for this below-average performance has been perverse fiscal and regulatory policy in recent years. Although marginal income tax rate increases in 1990 and 1993 retraced only a portion of the marginal rate cuts of the 1980s, other forms of taxation have steadily increased. Increases have occurred in payroll taxes, excise taxes on gasoline, alcohol, tobacco, and various luxuries, state and local taxes, and federal user fees. Additionally, because significant portions of the tax code are not indexed for (persistent, albeit lower) inflation, taxation has effectively increased for unindexed items such

¹⁰For documentation of this assertion, see Chris Frenze, *Whither the Budget Deficit -- and Economy?*, Joint Economic Committee study, July 1996.

¹¹For a survey of the relationship between deficits and interest rates, see George Iden and John Sturrock, "Deficits and Interest Rates: Theoretical Issues and Empirical Evidence," *Staff Working Papers*, Congressional Budget Office, January 1989.

¹²This fraction has steadily increased in recent years to about 25 percent and increased more during this expansion than in previous expansions of similar length. See, for example, Gail Makinen, "The Current Economic Expansion: How Does it Compare with the Past," Congressional Research Service report for Congress, June 1996.

as capital gains, estate taxation, and various aspects of corporate and capital taxation. Also, our progressive income tax system -- while indexed for inflation -- is not adjusted for real growth. Hence, as the economy grows, individuals eventually are pushed into higher tax brackets. Much of this increased taxation not only creates distortions (and adds to deadweight loss) but it adds to multiple layers of taxation on saving and investment, thereby adversely affecting incentives to save, invest, and innovate, consequently thwarting longer term growth. All of these factors help to explain why taxation as a percentage of GDP has increased to record levels in recent years.¹³

In addition to this increased taxation, regulatory burdens have also increased substantially since the late 1980s. Available measures of the costs of regulation show a substantial increase in regulatory costs since about 1988. One study, for example, documents that total macroeconomic regulatory costs increased about 23 percent from 1988 to 1996.¹⁴ Such regulatory burdens have been shown to adversely affect economic growth.¹⁵

In order to improve on this recent subpar growth, policies focusing on and promoting long-term growth are essential. A variety of policy initiatives are consistent with such a goal. They include tax reforms reducing the multiple layers of taxation on saving or capital (and moving toward consumption-based taxation); spending control (and privatization); persistent deregulation efforts; continued open-market, free-trade policies; and a price stabilizing monetary policy.

Inflation should remain well contained with the Fed's likely continued commitment to price stability. This commitment would be enhanced with explicit inflation targeting, which has already been successfully adopted by a number of other countries.¹⁶ (Expanded issuance of inflation-indexed bonds by the U.S. Treasury might also enhance the credibility of such an inflation targeting effort.) Moreover, Federal Reserve attention to key forward-looking market price indicators might also contribute to the necessarily pre-emptive nature of such efforts.

This report was written by the Joint Economic Committee's Chief Macroeconomist, Dr. Robert Keleher.

¹³In 1996, total government receipts as a percent of GDP rose to 30.4 percent. *Historical Tables: Budget of the United States Government*, Fiscal Year 1998, Table 15.1, p. 260.

¹⁴See Thomas D. Hopkins, "Regulatory Costs in Profile," Center for the Study of American Business, Washington University in St. Louis, Policy Study Number 132, August 1996, p. 6.

¹⁵See, for example, Wayne B. Gray, "The Cost of Regulation: OSHA, EPA, and The Productivity Slowdown," *American Economic Review*, December 1987, vol. 77, no. 5, pp. 993-1006.

¹⁶See Robert E. Keleher, *Lessons from Inflation Targeting Experience*, Joint Economic Committee Report, February 1997.