Policy Note 1998/7

Goldilocks and the Three Bears

L. Randall Wray

Goldilocks's trusted attendants assured her that it had been scientifically proven beyond any doubt that bears cannot exist and thus are nothing more than figments of the imagination of those who would impose constraints on the unbridled pursuit of fun. Alas, one night, while she was on a romp through the woods, three bears ate Goldilocks.

Once upon a time there was a Goldilocks economy that was a beauty to behold. She was the fairest of the fair, ever so even-tempered-neither too hot nor too cold-and envied throughout the world. She took residence in a fine house with all the modern accoutrements and the tastiest porridge in all the land. If the truth be told, she was a bit of a libertine, perhaps a hedonist, who did what she liked when she liked virtually free from constraint and without a thought to the consequences. She was surrounded by assorted grovelers and sycophants who praised her every action and indulged her every whim. Sure, there were some people who warned her of the dangers that might lurk in the woods. They had seen signs of bears and urged her to take care. Once or twice our little Goldilocks heard growls that sounded a lot like what she imagined bears might sound like. But her trusted attendants assured her that it had been scientifically proven beyond any doubt that bears cannot exist and thus are nothing more than figments of the imagination of those who would impose constraints on the unbridled pursuit of fun. Alas, one night, while she was on a romp through the woods, three bears ate Goldilocks.

Goldilocks

Since the early 1990s the United States has enjoyed reasonably robust economic growth and low unemployment with low and stable inflation. The economy has been neither too hot to induce inflation nor too cold to allow unemployment to rise. This poses a conundrum for conventional theory, which holds that robust growth and low unemployment are supposed to generate inflation, and for conventional policy, which uses higher unemployment as a means to fight inflation. Nearly every analyst has argued that the low unemployment rates could not continue for much longer without sparking renewed inflation. And, as late as July 1998—well after the growls of the three bears had been clearly heard—Chairman Greenspan was still warning of the dangers of inflation.

Actually, inflation disappeared as a serious economic problem in 1983 as the economy began to recover from the Volcker recession. There has been only a minor upward blip at the end of the 1980s during the Bush/Greenspan recession, which double-dipped into the beginning of the 1990s. Indeed, excluding that recession, the highest inflation rate since 1983 was only 4.4 percent and the average rate was 3.1 percent. As the famous Boskin Report explains, the official consumer price index (CPI) significantly overstates inflation (the report's conservative estimate places the bias at 1.1 percentage points), so inflation was even lower than the official figures indicate. Besides, all careful studies have shown that there are no significant economic costs associated with low or even moderate inflation; Bruno and Easterly (1996) have demonstrated that inflation as high as *40 percent per year* has no perceptible impact on growth.

Furthermore, as Dimitri B. Papadimitriou and I have shown in a series of papers, most measured U.S. inflation has nothing to do with what is happening to market prices. This is not opinion or even theory, but rather a simple statement of fact: Most "inflation" as measured by the CPI comes from imputed increases in prices of things that are not bought or sold in markets. At both post-World War II inflation peaks (1974-75 and

1979-81), fully half of the measured inflation came from the housing sector, and most of that was due to price increases *imputed* to the "rental services" accruing from housing, mainly owner-occupied homes. Thus, it is not surprising that our worst bouts of inflation have not coincided with an "overheated" economy, since inflation of the CPI has little to do with rising market prices. Our only serious inflations since 1970 have occurred during downturns and have resulted primarily from a combination of bad luck (crop failures, energy price shocks), perverse policy (high interest rates, which get passed along in prices), and poor sales (which induce firms to raise markups to protect revenue)-although Bureau of Labor Statistics decisions about methods used to impute prices (of, for example, housing services and a portion of medical care) are an important and confounding variable.

In any case, our Goldilocks economy was not nearly so beautiful as imagined unless it is compared to a few, carefully selected aberrant years (mainly in the late 1970s). The inflation rate from 1992 through 1997 averaged 2.6 percent, or less than half a percentage point lower than it has since the Volcker recession (throwing out the Bush/Greenspan recession); still, this was a bit higher than the 2.5 percent posted in the "Keynesian" 1960s-during which a war was conducted against Viet Nam and social spending soared for Great Society programs and to house, educate, adjudicate, incarcerate, and transport the baby boom. The civilian unemployment rate (for the population 16 years and over) of the Goldilocks economy averaged nearly 5.9 percent, never dropping below 4.6 percent; in contrast, the unemployment rate of the Keynesian period dropped to 4.5 percent in 1965 and remained well below 4 percent for the remainder of the decade.

Our worst unemployment periods, as well as our most serious inflations, have come during economic downturns (that is not surprising); and that means that our worst unemployment periods have come during periods of high inflation (that is surprising). In other words, robust growth has generally been associated with low inflation and low unemployment, so the Goldilocks economy is not as unusual as is often believed-at least, not in the pundits' sense of "neither too hot nor too cold."

The Three Bears

What the pundits missed, or at any rate discounted, was the danger that lurked in the woods-the three bears. Unlike the Papa, Mama, and Baby Bears faced by the storybook Goldilocks, our Goldilocks faced three ferocious grizzlies: a cascading, global financial crisis; global deflation and excess capacity (or insufficient demand); and a domestic fiscal surplus in conjunction with record private deficits.

A Grizzly Flu

How many market "corrections" does it take to make a financial crisis? One correction blew in from the East. After a couple of decades of rapid development and a huge number of testimonials holding up Asia as an example of the benefits of liberalization (and nearly as many speeches denigrating Asia for the barriers to trade it had erected), all hell broke loose-to put it in strictly technical terms. Faced with more than a 50 percent devaluation of the yen against the dollar between 1995 and 1997, which reduced competitiveness of East Asian countries that had maintained stable exchange rates against the dollar, countries in the region abandoned a commitment to their currencies. In July 1997 the Bank of Thailand allowed the baht to move outside its exchange rate band with the dollar; rather than interpreting this as a good sign because it would restore competitiveness, markets responded by trying to sell out the whole region. In addition to the obvious problems that rapid devaluation brings, currency devaluation increased the real burden of foreign currency-denominated debt far more than it could increase export earnings through increased price competitiveness. Foreign lenders began to call in loans, domestic firms and financial institutions tried to sell domestic assets to obtain dollars, and East Asia imploded in a classic Minsky-Fisher debt deflation.

After a couple of decades of rapid development and a huge number of testimonials holding up Asia as an example of the benefits of liberalization (and nearly as many speeches denigrating Asia for the barriers to trade it had erected), all hell broke loose—to put it in strictly technical terms.

Pundits immediately calculated that the Asian crisis would knock half a percentage point off U.S. growth, max. They then waited an hour or two, and when the U.S. economy did not perceptibly slow, they concluded that their calculations had been overly pessimistic. With the benefit of 20/20

hindsight, they explained it was obvious all along that Asia had been a hopeless wreck from the start, with overvalued currencies and real estate and, worse still, with "crony capitalism" that misdirected resources. This proved to be a versatile explanation, which was applied in due course to Russia and Latin America as the crisis spread. Such things could never happen in the United States, we were assured, because the United States doesn't mix government with business, family, or pleasure and it has greater transparency in financial markets.

The U.S. stock market stumble in the summer of 1998 was said to be just a momentary correction because, as Social Security reformers assure us, the stock market will rise an average of 7 percent per year in real terms forever. (Those who actually play the market recoil in horror at such pessimism, for they expect returns to average more than 30 percent per year.) As the market fell, financial advisers appeared on all the talk shows trying to calm small-time investors and assure them that no matter how far the market might fall, it is always best to stay in because stocks beat bonds over the long run. At the same time, the advisers got out. (Admittedly, some, perhaps temporarily, got back in just before each interest rate cut by the Fed in order to sell out after the rate change.) Eventually, everyone will recognize that it is better to earn 4 percent on government bonds over the short run than to lose 50 percent on stocks-no matter what the long run might bring. Besides, the Fed has only a few more hundred basis points of room to move. As David A. Levy recently said, "Never since World War II has it been more appropriate for investors to emphasize preservation of capital over other objectives."

Pundits immediately calculated that the Asian crisis would knock half a percentage point off U.S. growth, max. They then waited an hour or two, and when the U.S. economy did not perceptibly slow, they concluded that their calculations had been overly pessimistic.

Long-Term Capital Management exploded the transparency myth. No one knew what Long-Term was doing, but with former Fed vice chairman David Mullins and Nobel Prize winners Robert Merton and Myron Scholes running the show, Chase Manhattan, Merrill, Morgan Stanley, Goldman, Sachs, J.P. Morgan, Deutsche Bank, Sumitomo, and the central bank of Italy (!?) queued for a piece of the action. According to Reuters, the Union Bank of Switzerland estimated that Long-Term's leverage ratio might be 250 to 1, but no one knows for sure. On September 23, 1998, 14 firms agreed to inject $3.6 billion into the hedge fund, which to that point had an estimated 1998 return of negative 90 percent. In the weeks that followed, shares of Bankers Trust, Citigroup, Lehman Bros., and Merrill Lynch all fell to about half their peaks of the previous year. Bankers Trust announced a half-billion dollar loss for the third quarter, unrelated to hedge funds, although it admitted it has more than a billion dollars in loans or investments to hedge funds. Nomura Securities lost $1.76 billion in the first half of 1998; Citigroup suffered $1.33 billion in trading losses; J.P. Morgan's profits fell by nearly 70 percent; and BankAmerica suffered a third of a billion dollar loss from a loan to a hedge fund, D.E. Shaw. Perhaps with a year of hindsight, Long-Term's negative 90 percent return may look pretty good for hedge fund performance for 1998.

The Deflation Grizzly

The second of the three bears had been in the woods long before the flu grizzly started its rampage. As Martin Mayer explains, Moody's downgraded Thai ratings in May 1996 and *Grant's Interest Rate Observer* printed negative indicators about Korea for a year prior to the collapse. Japan had been mired in chronic recession, and Europe had suffered a long recession with high unemployment (although it had begun to recover in 1997). In 1996 Brazil and Chile had actually introduced restrictive policies in fear that their countries were in danger of overheating. By 1997 Latin America had a current account deficit of $60 billion (up from $35 billion in 1996); China's domestic economy began to slow, although exports allowed total production to continue to grow quickly; and African growth fell from 4.6 percent in 1996 to 3.3 percent in 1997. It must be admitted that world economic growth still looked pretty good in 1996 and 1997 and continued to appear strong in 1998 (with some exceptions, such as Chile and Brazil), but this impression was at best only partially correct.

One problem with the belief that the world economy was strong in 1996 and 1997 is that prices-particularly for labor, commodities, and intermediate goods-had been stagnant or even falling for quite some time. Some commentators presume that deflation is good, drawing primarily on the correlation between robust growth and deflation in the 1990s and in the late nineteenth century or between rapid innovation and falling prices in the contemporary experience of particular sectors (most notably, the computer industry). This presumption confuses cause and effect. Robust growth and rapid innovation under the right conditions can indeed depress prices, but stagnant or falling prices increase the difficulty of servicing debt and accumulating earnings to finance expansion.

World primary commodity prices fell by 2.5 percent in 1992 and 3.5 percent in 1993. Nonfuel commodity prices fell by 1.3 percent in 1996, by 3.7 percent in 1997, and by a projected 7.4 percent in 1998. Fuel prices fell by 0.3 percent over the decade of the 1980s and by a projected 0.1 percent during the 1990s. By September of this year, *The Economist's* all-items commodity price index had fallen by 30 percent since mid 1997—to its lowest level in 25 years. Agricultural raw materials prices fell by a whopping 10 percent in both 1996 and 1997. Manufactures prices in developing countries fell by 1.2 percent during the 1980s and by a projected 0.1 percent in the 1990s; in the developed economies, manufactures prices fell by 3.6 percent in 1996 and by 5.7 percent in 1997. Throughout 1997 unit labor costs fell in the United States, Japan, Germany, and France. The GDP deflator has been consistently below 2 percent for the major industrialized countries since 1994-in other words, sufficiently low that one might suspect that official inflation is nothing more than a measurement error. What is ironic is that central banks around the world have only in the last few weeks given up fighting a battle against a non- existent problem, all the while aiding and abetting the true enemy—deflation.

High investment is, of course, a good thing—as long as the demand for final products is sufficiently high. However, much of this investment was oriented toward production for export, which requires rapid world growth to validate it.

The second problem with the belief that the world economy was strong in 1996 and 1997, related to the first, is the tremendous buildup of capacity around the world. Robust growth in the past few years has been to a large extent investment-driven—especially in Asia and the United States. For example, investment as a percent of GDP over the first half of the 1990s averaged 35 percent in China, 39 percent in Malaysia, 37 percent in Korea, and 41 percent in Thailand (the U.S. case is examined separately below). High investment is, of course, a good thing-as long as the demand for final products is sufficiently high. However, much of this investment was oriented toward production for export, which requires rapid world growth to validate it.

With stagnant demand in Japan, fiscal austerity in most of the developed world, reduction of the number of high-paying middle management positions through downsizing and relatively stagnant wages in the wealthy nations, substitution of low-wage labor in developing countries for high-wage labor in developed countries, and spread of the Asian flu to Russia and some Latin American countries, it becomes increasingly evident that the investment boom led to the creation of excess capacity relative to world demand by consumers and government. (Phillips has just announced it will close a third of its plants around the world due to overcapacity—and this is before the U.S. recession has hit.) If world output growth slows to 1.5 percent in 1998 and 1.7 percent in 1999, as projected by J.P. Morgan, investment will, indeed, prove to have been excessive.

The Grizzly Surplus

The last of the three bears is the U.S. budget surplus and private sector deficit. As Wynne Godley has been arguing for some time, the Clinton-era expansion is unusual because of the extent to which expansion has been financed by private borrowing and the size of the private sector deficit—which is now larger as a percentage of GDP than at any time during the last 35 years. Godley argues that given the fiscal surplus and the trade deficit, the U.S. economy can continue to expand only as long as the private sector deficit increases; as soon as private expenditure stops rising relative to income, the boom will end. Since consumer debt is already at record levels, consumer saving has fallen to depression levels, and market "corrections" are wiping out financial wealth, it is highly unlikely that firms can look to consumer demand to be a source of the spending that would be required to turn around the financial situation of firms.

Many commentators have presumed that the movement toward a fiscal surplus fueled the boom, but as Papadimitriou and I have argued, this is another presumption that reverses cause and effect. Economic booms generally do reduce fiscal deficits (through the automatic stabilizers), but the reduction then acts as a fiscal drag on the economy. It is not surprising that the official announcement of the surplus achieved in the last fiscal year comes precisely as commentators finally are recognizing signs that the economy is slowing. The pundits, as usual, are behind the curve. Recent consumer surveys and earlier business surveys indicating a sharp drop in confidence have sent analysts scrambling to explain the incongruity between this pessimism and an economy that still appeared to them to be neither too hot nor too cold. Why the sad faces, they argue. Goldilocks has only lost a couple of legs and arms.

The huge grizzly that will gobble up the last bits of our poor Goldilocks is the U.S. budget surplus. It is sheer folly to attempt to maintain a budget surplus in the face of a looming world crisis-which many commentators, including President Clinton, have already admitted is the worst since the 1930s. The obvious solution is to abandon the commitment to a surplus, which is depressing income and sucking profits out of the economy. Our president insists that a surplus be "set aside" to rescue Social Security in preparation for the baby boomers' retirement. But, as John Macon of the American Enterprise Institute rightly argued, "I don't think many voters are lying awake worrying . . . about running out of money to pay social security in the year 2020. I think you'd find most people saying I'd really rather have a job tomorrow so let's get the government going on some stimulus packages."

The United States, together with the world's other industrial powers, must put together a plan that would lower interest rates, increase government spending, and target tax cuts to low-income consumers. Such a plan would help to counter the threat of worldwide deflation and could put the world's economy back on track for renewed growth.

Bibliography

Bruno, Michael, and William Easterly. 1996. "Inflation and Growth: In Search of a Stable Relationship." *Federal Reserve Bank of St. Louis Review,* May/June.

Godley, Wynne, and Jan Kregel. 1998. "Levy Bulletin on the Real Effects of the Asian Crisis." Policy Briefing Paper. Annandale-on-Hudson, N.Y.: The Jerome Levy Economics Institute.

International Monetary Fund. 1998. *World Economic Outlook.* Washington, D.C.: IMF.

Mayer, Martin. 1998. *The Asian Disease: Plausible Diagnoses, Possible Remedies.* Public Policy Brief no. 44. Annandale-on-Hudson, N.Y.: The Jerome Levy Economics Institute.

O'Brien, Timothy L., and Laura M. Holson. 1998. "A Hedge Fund's Stars Didn't Tell, and Savvy Financiers Didn't Ask." *New York Times,* October 23, A1, C22.

Papadimitriou, Dimitri B., and L. Randall Wray. 1996. *Targeting Inflation: The Effects of Monetary Policy on the CPI and Its Housing Component.* Public Policy Brief no. 27. Annandale-on-Hudson, N.Y.: The Jerome Levy Economics Institute.
———. 1998. "The Fed Should Lower Interest Rates *More*." Policy Note 1998/5. Annandale-on-Hudson, N.Y.: The Jerome Levy Economics Institute.

Rynecki, David. 1998. "Banker's Trust $488 Million Loss Shows Wall Street's Vulnerability." *USA Today,* October 23, B1.

United Nations Conference on Trade and Development. 1998. *Trade and Development Report*, 1998. New York: United Nations.

Welling, Kathryn. 1998. "Prozac, Please: An Interview with David A. Levy."*Barron's,* October 26.

Ypsdie, John, and Bob Edwards. 1998. "How to Spend the Budget Surplus." *NPR Morning Edition*, October 29.

Related Publications

For Levy Institute research on this subject, see:
David Alan Aschauer, *How Should the Surplus Be Spent?* Policy Note 1998/2
Wynne Godley and Jan Kregel, *Levy Bulletin on the Real Effects of the Asian Crisis,* March 11, 1998
Jan Kregel, "Derivatives and Global Capital Flows: Applications to Asia," Working Paper No. 246, August 1998
Jan Kregel, "East Asia Is Not Mexico: The Difference between Balance of Payments Crises and Debt

Deflations," Working Paper No. 235, May 1998
Jan Kregel, "Yes, 'It' Did Happen Again-A Minsky Crisis Happened in Asia," Working Paper No. 234, April 1998
Martin Mayer, *The Asian Disease: Plausible Diagnoses, Possible Remedies,* Public Policy Brief No. 44, 1998
Dimitri B. Papadimitriou and L. Randall Wray, *The Fed Should Lower Interest Rates* More, Policy Note 1998/5
Dimitri B. Papadimitriou and L. Randall Wray, *Targeting Inflation: The Effects of Monetary Policy on the CPI and Its Housing Component,* Public Policy Brief No. 27, 1996
Dimitri B. Papadimitriou and L. Randall Wray, *What to Do with the Surplus: Fiscal Policy and the Coming Recession,* Policy Note 1998/6

Copyright © 1998 by The Jerome Levy Economics Institute.