From 1997 through 1999 the economy continued to surpass the predictions of the most optimistic analysts. From the time of the budget agreement between the president and Congress until the day this edition went to press, every new calculation of how fast the economy would grow, how quickly the deficit would shrink to zero, and how big the surplus would be proved wrong. As noted earlier, in 1998, the Clinton Administration presented a proposal for a balanced budget in fiscal 1999, three years earlier than predicted in the summer of 1997. However, because even those predictions proved pessimistic, it was in the fall of 1998, not 1999, when the surplus was achieved.

Not only did the economy grow faster than expected but inflation stayed low. From 1996 through 1999 the inflation experience contradicted a basic tenet of conservative economics that there is a level of unemployment (the NAIRU) below which it is impossible to go without accelerating inflation (see pp. 45–46 in this volume). In the spring of 1997, when the unemployment rate dropped below five percent for the first time since 1973, the Federal Reserve raised the short-term interest rate in an effort to slow down the economy. When they did this they followed a pattern that occurred in 1984, 1989, and 1994 when it appeared the economy was growing too rapidly and unemployment was in danger of becoming “too low.” This time, however, when unemployment continued to fall and no slowdown occurred, the Fed refrained from further rate hikes and in fact took no more steps to slow down the economy until 1999.
This nonaction by the Fed in the face of both an unemployment rate clearly below anyone’s definition of the NAIRU and a 3.9 percent rate of economic growth that was well above the 2.5 percent considered “sustainable” represents the first reversal of the Volcker-Reagan policy. One might even call it the beginning of a Keynesian counterrevolution. What did the Fed implicitly signal by its failure to do what it had done in 1984, 1989, and 1994? It signaled that it wasn’t too sure about the theory of the NAIRU. The Fed would wait to see inflation before it took action.

It was very fortunate that the Fed took this position in mid-1997. Within a year, the international fallout from the Asian financial crises and the Russian default (in effect) caused the Fed to twice cut the short-term rate in an effort to calm international lenders. It was only with the rate hike in late 1999 that the short-term rate regained the level it had been before the cuts. The rate cuts in 1998 had their desired effect and despite the steep stock market decline of the middle of 1998 there was no recession. Instead, 1998 saw the lowest unemployment rate in 29 years (4.5 percent), while the rate of growth remained an “unsustainable” 4.2 percent.

For much of 1998 and 1999, economists were puzzled by the fact that the NAIRU theory wasn’t reflecting reality. Some argued that the concept was flawed as theory and empirically incorrect. Some tried to argue that the long investment build-up of computers in business, at home, and in government agencies (begun in the early 1980s and continuing to accelerate) was finally translating into productivity increases, thus reducing the NAIRU. Certainly productivity growth was faster between 1997 and 1999 than in the previous three years.

Others suggested that the “globalization” of the economy was the explanation. The intense international competition in most goods-producing markets had made it very unlikely that firms could raise prices at will, even if demand grew dramatically. Meanwhile, the continuous downsizing of large business entities (while more than counteracted by the tremendous job creation elsewhere in the economy) kept workers “fearful” and less likely to press for wage increases. At the American Economic Association’s national meetings in January 1999, one participant in a symposium on the difference between the 1990s recovery and previous ones proposed that the...
“traumatized worker” theory might go a long way towards explain-
ning the failure of wages to rise as much as predicted by the NAIRU
theory. Thus, wages rose slowly enough that the productivity accel-
eration permitted businesses to increase profitability despite the fact
that international competitive pressure made it impossible for them
to respond to rising demand for their products by raising prices
significantly.

The Federal Reserve refused to hit the economy over the head to
slow its growth. Instead it quietly presided over a partial counterrevo-
lution to Volcker-Reagan macroeconomics. Note, I say partial. This
was no return to 1960s-style Phillips curve policy-making where the
“menu” of a slightly higher inflation for the targeted four percent
unemployment rate was acceptable to the Kennedy administration’s
economists. If inflation were to accelerate, there is no question that the
Federal Reserve stood ready to slam on the monetary brakes. Never-
theless for three years, it has permitted the U.S. economy a “mini-
experiment” in full employment economics.

**Full Employment “Works” as Policy**

The result, at least in the three years from 1997 through 1999, was a
striking confirmation of what die-hard Keynesians and left-liberal
economists had been saying for decades. The Economic Policy Insti-
tute, the Jerome Levy Economics Institute, the Financial Markets
Center, the Center for Popular Economics, the AFL-CIO, and even the
National Association of Manufacturers (at times) had argued that full
employment was a worthwhile goal. The four percent level envisioned
in the 1962 report by the Kennedy administration’s Council of Eco-
nomic Advisors and enshrined into law by the Humphrey-Hawkins
Full Employment and Balanced Growth Act of 1978 would not auto-
matically accelerate inflation, they claimed.

In fact, from 1997 to 1999 inflation averaged lower than in the pre-
vious three years even though unemployment averaged below five per-
cent. Again economists wedded to the theory of the NAIRU were at a
loss to explain this. Many grasped at the idea that the productivity
improvements of the 1990s had actually created what was called “the
new economy.” Fed Chairman Alan Greenspan, in a speech delivered
in October 1999, proposed: “Although it is still possible to argue that
the evident increase in productivity growth is ephemeral, I find such arguments hard to believe. . . .” He felt the Fed was in uncharted territory because

We do not have enough experience with technology-driven gains in productivity growth to have a useful sense of the time frame in which market pressures contain demand. . . . The rate of growth of productivity cannot continue to increase indefinitely. (New York Times, 29 October 1999)

Greenspan appeared to be arguing that the good combination resulted from “technology-driven gains in productivity growth.” An alternative analysis argues that it is low unemployment that has led to higher productivity. The key to this argument is that the high aggregate demand associated with low employment also creates high utilization of capacity. Whenever there is an increase in capacity utilization, productivity increases faster because capacity (plant and equipment) is being used more efficiently. This utilization is independent of any technology-driven improvement in productivity; in fact, it would exist during slow or nonexistent technological change. The sustained three-year period of dramatically lower unemployment—something the economy had not seen since the late 1960s—produced an increase in productivity growth because of the impact of low unemployment and high capacity utilization.

We will know the correct explanation for the higher levels of productivity growth only after the next recession when we see the rate of growth of productivity in the early years of recovery. As noted above, up to 1994, the rate of growth of productivity since the end of the last recession was disappointing. However, new measurements produced by the Department of Commerce just before this edition went to press revealed a significant improvement in the relative performance of the economy since the end of the 1991 recession as compared to the Volcker-Reagan recovery. For the “new economy” hypothesis to be accurate, the next recovery will have to outdistance even the revised picture of the period from 1991 to 1999.

Has the Reagan Revolution Been a Success?

As the economy chugged along through 1999, it seemed to some that the promise of the Reagan Revolution as completed by the Clinton
administration (balanced budget, controls on the growth of government spending, even some tax cuts) had been fulfilled. Even low-income workers were seeing their incomes rise in real terms. The percentage of the population in poverty was continuing to fall (though not nearly as fast as the shrinkage in welfare numbers).

However, before we prematurely judge the Reagan Revolution a success, we must remember that the major element in the aggregate prosperity of the past three years has been the partial reversal of the original policy thrust of Paul Volcker’s Federal Reserve Board (a policy that featured the pursuit of reduced inflation even if it meant unemployment above six percent). Low unemployment as a policy tool has worked. Government spending has been somewhat constrained but the budget has been balanced primarily because revenues have grown much faster than predicted. Again, this revenue growth has been made possible by economic growth at rates considered unsustainable.

The true test of whether or not the Greenspan Fed has escaped from the Volcker policy straitjacket will come with the next recession. Will they vigorously push interest rates even lower to combat the recession or will they react the way they behaved in 1991? More important, what will the new administration do in 2001 if the next recession begins then? If the administration adheres to the policy changes described in this book and if the Fed does not vigorously push an expansionary monetary policy to quickly reverse the next recession, then all the long-term effects of the Reagan Revolution will come to pass.

The poor who have exhausted their benefits and been pushed off welfare will have no support for their spending except their very low-paying jobs. The newly impoverished will crowd the temporary state welfare programs which are now dependent on fixed sums of money from the federal government. Medicaid enrollments will rise dramatically, but the constraints built into the Balanced Budget Agreement of 1997 will restrain spending increases, leading either to unreimbursed service from providers or outright decrease in available care. The percentage of the population without medical insurance will continue to increase, and all efforts to increase coverage for some of the uninsured will founder on the “we have more will than wallet” rhetoric that will once again come to the fore as government revenues decline.

The high-consuming upper middle class, who have watched their stock portfolios and home equity balloon in recent years, will reduce their consumption dramatically as their paper and property wealth shrinks. Government revenues at all levels will decline, but government
spending on real goods and services, particularly those expenditures classed as investments, will not rise. The budget surplus will quickly become a deficit again making a discretionary increase in spending or a tax cut to correct the recession very difficult politically. The final blow will be a decline in private investment as the fall in consumption sours business expectations.

This dire scenario doesn’t have to occur. The fact that the Greenspan Fed abandoned one of the major tenets of conservative economic analysis is an encouraging sign. Unfortunately neither they nor the Clinton administration show any signs of understanding that the budget balance is not the be-all and end-all of fiscal policy. To fight the next recession both the Fed and the federal government must abandon what Nobel Prize winner Vickrey called “financial fundamentalism.” What a surprising but hoped-for turn of events it would be if one of the individuals most celebrated for the successes of the Volcker-Reagan-Clinton economy, Fed Chairman Alan Greenspan, were to abandon the right-wing orthodoxy just in time to help reverse the next recession before it were to do substantial harm.