withdrawing liquidity resulting in rising interest rates, the end result usually is a termination of the expansion and the start of a new recession.

The expansion of the 1980s began at the end of 1982, after a particularly brutal recession, which by many accounts, was the worst downturn the U.S. economy had experienced since the Great Depression of the 1930s. The jobless rate was close to 11 percent, the highest since 1940, while nearly one-third of industrial capacity lay idle, also a postwar high. As you might imagine, this gave the economy lots of room to grow before either labor or business was able to obtain enough leverage to boost wages or prices. Labor was also reeling from the firing of the air traffic controllers by President Reagan, after they defied his orders and went on strike. Another reason why inflation remained quiescent was the jump in the value of the dollar in foreign exchange markets. This caused prices of imported goods to fall, thus keeping pressure on

With the passage of midyear, the economic expansion has reached an important milestone. After lagging behind its predecessors in just about all respects right from its very beginning (Economic Report – January/February 2006), the country’s 11th postwar upswing is now equal in at least one dimension: longevity. Since the National Bureau of Economic Research, the generally acknowledged umpire of the business cycle, has judged that the last recession ended in November 2001, this means that the current expansion turned 55 months old at the end of June 2006. To put this in perspective, this is three months longer than the average of the eight peacetime cycles that the United States has experienced since 1945, and it is just two months shy of the average of all 10 cycles, which include the Korean and Vietnam wars.

However, being average is a long way from being the best. Since the end of World War II, four expansions were longer than average, with the last two especially long. The expansion of the 1980s lasted 92 months, or a bit longer than 7-1/2 years, while its counterpart of the 1990s logged in a full 10 years – 120 months. Neither occurred during wartime, which has tended to lengthen expansions because of the stimulative effect of stepped up government spending on defense. Both, however, benefited from the rise of a number of developments that kept the rate of inflation low, thus delaying the point at which the Federal Reserve began tightening its monetary policy in order to keep inflation down. Because of the imprecise nature of monetary policy – not to mention unforeseen developments that tend to affect the economy during any given cycle – whenever the central bank switches to a policy of

AS THE CYCLE TURNS

Most major players in the U.S. economy have discovered that inflation might be better than the alternative (a recession) and are acting in a way that gives inflation an upward push.
domestic products as well. A surge in capital spending boosted productivity, which helped business become more profitable without raising prices. Later in the decade, oil prices tumbled from $30 per barrel to under $10 as Saudi Arabia opened up its oil resources in an effort to regain market share. The Tax Reform Act of 1986 held down inflation, although that was not its intent, as did the stock market crashes of 1987 and 1989.

A decade later, the expansion of the 1990s saw a number of events arise that also served to hold down inflation, thus keeping the Fed from having to tighten money. While this expansion did not follow a lengthy recession such as the one that preceded the 1980s upswing, it did benefit from other anti-inflation developments. The early 1990s saw the rise of downsizing, as Corporate America sought to slim down in order to better compete with their counterparts abroad as the dollar once again began to appreciate. This cut into labor’s bargaining power as it cut business costs. But business soon saw the shoe go on the other foot, since consumers lacked the wherewithal to spend, thus limiting business sales. The resulting excess capacity limited companies’ ability to raise prices. The nineties also saw a quantum leap in technology, which changed the way many firms did business. Outsourcing to lower-cost areas both here and abroad lowered firms’ costs, thus increasing their profitability without the need for price increases. Finally, and for the first time in years, if not decades, fiscal policy contributed to restraining inflation as Washington’s budget went into surplus owing to a combination of tax increases earlier in the decade and spending cuts—especially on defense—later on.

Getting back to the current situation, midway 2006 also represents a milestone of another sort: it’s been two years since the Fed began to tighten monetary policy. Since interest rates had reached 45-year lows by the middle of 2004, and the Fed has boosted them only 25 basis points (a quarter of a percentage point) at a time after each meeting, monetary policy may no longer be accommodative, but it is not yet restrictive (Economic Report—May/June 2006). On this basis alone, there would appear to be no imminent threat of an end to the ongoing expansion. However, when one looks at the reason why the Fed’s been withdrawing liquidity, inflation, one has to become cautious regarding the outlook for 2007. This is because the rate of price increases has been picking up in recent months—the result of the earlier injection of liquidity into the economy. In addition, most major players in the U.S. economy have discovered that inflation might be better than the alternative (a recession) and are acting in a way that gives inflation an upward push.

Leading the pack are the nation’s homeowners, some 75 million strong. As Chart 1 shows, there is a pretty good relationship between the rise in home prices of the past 15 years or so and the increase in household net worth. Any rise in home prices enables those who bought when prices were lower to sell at a higher price and pocket the difference. However, the doubling of home prices over the past 10 years, which was faster than the overall rate of inflation, has changed consumers’ behavior. Since this occurred at a time when employment gains were weaker than usual for an economic expansion, the jump in home prices has enabled homeowners to substitute the rise in the equity they have in their homes for insufficient growth in personal incomes. As a result, many families have been able to buy what they needed in the face of soaring costs of such necessities as health care and energy by taking out a home equity loan. These folks clearly prefer rising prices to those that fall.

Another group that’s a fan of rising prices is businesses of all types. Money illusion aside, most firms like it when prices in general are rising because they can raise their own prices without standing out. In other words, when their customers are conditioned to rising prices, they are less likely to complain about any particular price hike. As you might imagine, this boosts the dollar value of corporate profits (Chart 2), making managers look better than they might actually be, thus lifting their compensation accordingly. The prospect that prices will continue to rise also encourages consumers to buy sooner, rather than later, thereby providing another reason why businesses like inflation.

Very rarely do business and labor agree on something of an economic nature, but inflation appears to be one of them. That’s right; labor likes it when prices are rising for several reasons. The most obvious has to do with the fact that in a climate when business can raise prices, it is more likely to agree to pay its workers more, since any cost increases above productivity gains can be easily passed along (see Chart 3). But there’s another reason why labor likes inflation, and it goes back to the period immediately following the end of World War II. At that time there were fears that, without the stimulus of wartime spending, the economy would lapse back into a slump such as it had experienced in the 1930s. That period was characterized by deflation, or falling prices. So when prices started to rise following the lifting of wartime price controls, it was welcomed, since it was viewed as a sign of good times. After all, the thinking went, business could not raise prices if sales were falling.

Notwithstanding statements by some elected officials, governments at all levels like inflation—indeed, they are major beneficiaries of it. Again discounting the money illusion, governments stand to gain from inflation because it boosts their tax revenues (Chart 4). Clearly, those governments that levy an income tax will see their revenues rise, since incomes go up more in a period of inflation than when prices are steady or falling. The bromohaha over the Alternative Minimum Tax (AMT) is a classic example. Enacted years ago to make sure the wealthiest taxpayers paid at least some income tax to the federal government, the AMT was never adjusted for inflation. As a consequence, more and more taxpayers are now subject to this tax, which has actually increased their tax burden at a time when the Administration believed it was cutting it. In addition, states and local governments that rely on sales and property taxes for their revenue base get more when inflation boosts the dollar value of goods and services sold as well as the value of real estate.

There are others who are fans of inflation. Borrowers like inflation because they can repay their debts with cheaper dollars. If they over-look the money illusion, lenders don’t mind inflation, since they’re more likely to be repaid. Savers like inflation because it is usually associated with higher interest rates. On the other hand, the stock market is leery of inflation, notwithstanding its salubrious effects on corporate profits, since it invariably leads to higher interest rates, which, if carried too far, are anathema to earnings. Others who dislike inflation are bond buyers, foreign investors and those who live on fixed incomes.

These people are glad when the Fed declares war on inflation, but if it gets to the point where this battle produces a recession with rising unemployment, pressure usually arises for the Fed to back off.

After all, inflation has more constituents than recession.