1. Editorial

The current economic expansion has reached 100 months and if trends continue, by spring of next year, it will become the second longest in 160 years. On the one hand, for most Americans, the current cycle has failed to raise living standards as is customary during expansions. On the other hand, there are fears that the cycle is nearing its end and the next recession is around the corner.

The current cycle will go as one of the most disappointing in modern history. Despite sustained expansion, between 2010 and 2017, growth in real GDP per capita averaged 1.4%, almost one percentage point lower than 1950-2007. Had real GDP per capita grown at the historical average, each person and household would be 7% and $3,000 more wealthy, respectively. In addition, while each expansion has winners and losers, the current cycle appears to have created only a few winners. Between 2007 and 2017, average real weekly earnings for people with college degree or higher in the top 9th decile increased 6.4%, while for those in the first decile with less than a high school diploma declined 0.3%. Moreover, since 2007, the share of income for all but the highest quintile has declined, worsening income distribution and awakening feelings of frustration and polarization, which have intensified brinkmanship. Not surprisingly, recent polls highlight that one-half of individuals between 18 and 24 years-old have a positive view on socialism and a managed economy, reflecting the strong dissatisfaction with capitalism and the market economy.

While some of these outcomes may have been inevitable due to global trends and changes in demographics and technology, it is also evident that policymakers failed to use the expansion period as an opportunity to fix some of the most daunting structural challenges facing the economy. For example, according to the American Society of Civil Engineers, the U.S. is facing a $2 trillion infrastructure gap. Different reports suggest that entrepreneurial activity has declined or remains below historical averages, federal obligations for R&D stand near their lowest share of GDP since the late 50s, and although the U.S. ranks 6th in spending per pupil among 73 countries, it ranks 19th and 31st in science and mathematics performance, respectively.

On the duration of the current cycle, Chair Yellen once said, “I think it's a myth that expansions die of old age”. This is particularly true for postwar expansions, which have lasted longer than prewar cycles. In part, this reflects a structural shift away from tangible goods in favor of services, which has reduced the importance of inventory cycles and moderated business fluctuations. In fact, although industrial production declined at an average of 1.4% year-over-year for 20 consecutive months between April 2015 and November 2016, GDP growth still managed to expand 1.5% in 2016, without ever recording a single negative quarter. In addition, the economy has also experienced a more comprehensive and active role of the federal government in managing economic outcomes and taming business fluctuations.

However, for the same reasons, the economy has become more exposed to financial and asset price fluctuations, and policy mistakes. In fact, some common features of the last few recessions include forceful monetary, fiscal and regulatory policies aimed at extending the expansion cycle, which resulted in unsustainable leverage ratios and significant asset price appreciation that in turn led to sharp asset price corrections.

Not surprisingly, a prolonged period of low real interest rates, excessive liquidity, elevated asset valuations, and the potential of detrimental fiscal and regulatory actions are seen by some people as a prelude to the next crisis. However, while it is true that a sharp correction in asset prices could be highly damaging for consumer and business expectations, a comparison between previous pre-recession periods and a range of key economic fundamentals suggests that the current expansion could last for several more quarters. For example, no postwar recession has occurred without the share of fixed investment (excluding intellectual property) to GDP exceeding 14%; the current value is 12.4%. In addition, households' balance sheets remain healthy as evidenced by the low leverage and financial obligations ratios. Corporate profits are also expanding at a solid pace amid muted cost pressures. Although inflation- and cycle-adjusted valuations of equity and home prices stand at high levels and continue to increase, recessions have historically started around 12 months after these indexes began to decline.

Additionally, even if the Federal Reserve continues raising interest rates, there is still some way to go before monetary conditions become restrictive. In fact, a source of risk could arise if the Fed delays normalization amid accelerating inflation and inadequate fiscal stimulus that force the Fed to raise rates faster at a later stage. Moreover, we cannot ignore the risks of counterproductive regulatory policies that would damage the well-functioning of labor markets, foreign trade and capital flows.

With what we know about the current business cycle and the retrospective view of the recovery, it is imperative that in 2018, the administration and Congress engage in a collaborative dialog and implement sweeping reforms that will improve economic fundamentals. Some key challenges include modernizing decades-old entitlement programs and improving performance in education and healthcare while reducing wasteful spending. In addition, there is an urgent need to modernize the current system that creates vast distortions and unnecessary costs, encourages rent-seeking behavior, and picks winners and losers opting instead for comprehensive tax reform that is fair, efficient and simple.

These changes should also include fundamental reforms to the institutional and regulatory frameworks that boosts competition, reduces burdensome costs on businesses and individuals and facilitates access to technology like computers, internet and mobile technologies. Policymakers should avoid the temptation to take short-cuts or seek short-term gains at the expense of future generations. These steps are needed to boost productivity growth, real income gains, and living standards for the next generation.

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