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Not Yet a Collapse

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Not all gestation periods are nine months. In the Great Depression of the 1930's the event that was analogous to the market decline of October 1987 took place in October 1929. The climactic events of the Great Depression - the utter collapse of the banking system and the well nigh complete stoppage of the economy - took place in February 1933 . The gestation period of the Great Depression, the time between the conception and the full flowering, was forty months.

Several years need to pass before the full effects of the crash of the ninteenth of October and the yo-yo behavior of the stock market that has followed are known. The wiping out of some $800 to $1000 billions of asset values on the American exchanges reinforced recesssionary tendencies, but it did not make a depression or even a recession inevitable. The evidence from the past two decades is that apt policy can contain recessions.

My view is that a recession is likely to start in either the fourth quarter of 1987 or the first quarter of 1988. If the scale of the recession is contained by apt policy, which makes credit readily available and sustains aggregate profits through a larger government deficit and a smaller trade deficit, then the events of the second half of October will go down in history as a correction rather than as the beginnings of a collapse. The events of 1987-88 will be interpreted as further evidence of the resiliance of modern capitalism, that the economy is self correcting.

On the other hand if over the next six months the aftermath of the crash of Monday October 19 includes failures of significent banks and other financial institutions anyplace in the world (or even of some of the conspicious players in the international take over and merger games) then the recessionary forces will be reenforced and the likelyhood of a major contraction will increase. Before a major contraction can take place the weaknesses and turbulances will have to spread from the security markets to institutions.

The catastrophe of 1929-33 was the result of institutional weaknesses, policy errors and the internal dynamics of a capitalist economy, by which market reactions to an event like the stock market crash makes things worse. Intervention is needed to dominate market reactions if from time to time a catastrophe is to be avoided.

The policy errors during the Hoover presidency reflected the ignorance of how our type of economy works that was characteristic of that ill fated administration.

As a result of their ignorance they depended upon the assumed self correcting features of markets, which even if they exist were too weak to for the situation of 1929-33.

Because the Keynesian Revolution in economic thinking greatly increased our knowledge of how Capitalism works and developed a logic for intervention, we have to expect that Hoover like errors will not be made now. However we should never underestimate the ability of the political leadership of capitalist countries and and their economic advisers to do the wrong thing: to take steps that make a bad situation worse. This is so because these political leaders wear blinders that reflect a market oriented ideology and their advisers wear blinders that were crafted in graduate school, where they learned the conventional economic theory which emphasises the self correcting feature of markets.

The initial policy response to the crash of October 19 was apt: the Federal Reserve increased bank reserves and official intervention to prop up the dollar has been abandoned: the dollar is being allowed to fall against the Yen and the Mark. The fall of the dollar on the international exchanges puts pressure on the exports of Japan, Germany and those countries whose currency is tied to the German mark. Presumably this will force them to lower interest rates and to engage in fiscal measures (lower taxes or increase spending) to expand domestic demand to offset the loss of jobs and profits that will occur as they are priced out of the United States market. The current situation is different from that of the prior recessionary periods of the post World-War 2 era in that whether a serious world recession occurs depends at least as much upon the aptness of Japanese and German policy as upon what the United States does. A serious change in the balance of world economic power is now evident for all to see.

If the decline of the dollar corrects the United States's trade deficit and if Japan and Germany take measures to prevent any serious decline in their economies, (and therefor in the world economy) then the large drain of profits from the United States by way of the trade deficit will diminish or even be reversed. If this occurs United States profits will increase and any recession induced by the stock market crash will be contained. An expanding American economy with its international trade accounts in balance or surplus is necessary if a new burst of world expansion is to take place. However this can occur only if Japan and Germany end their dependence upon a massive export surplus for their prosperity.

There seems to be universal agreement among the purveyors of conventional wisdom and our complaisant political leadership that the United States Government's budget deficit was in some way responsible for the stock market decline and that this deficit has to be cut if the market decline$_d$ is not to be a giant step to catastrophe.

The government deficit was not the cause of the stock market collapse and by itself lowering the government deficit will only add to the forces making for a recession.

An inept American budgetary structure which made unproductive government deficits a permanent feature of the American economy may have contributed to the market's crash by undermining confidence in the competence of the leadership of the United States.

The United States's tax and spending structure needs to be changed so that at an appropriate income level - what used to be called full employment - the budget is balanced and at any downside from that level the government runs a stong deficit. (Inflation should act to generate a large surplus.) This policy of a balanced budget at a target performance level is in the sharp contrast to the permanent deficit that the Reagan administration's ideology has produced.

The White House and Congress are engaged in budget cutting exercise. A deadlock is devloping over what package of tax increases and spending cuts is to be enacted. This exercise is a symbolic offering to loudly voiced sentiments, nothing serious is likely to happen. In the give and take among the White House, the Republicans in the Congress, and the Democrats in the Congress there is no recognition that the cavalier changes in the tax and spending programs that took place over the past seven years compromised the integrity of the United States fiscal system and that these changes need to be undone.

One step towards correcting the deficit impasse would be to increase taxes by reintroducing progressivity, i.e. taxation according to the ability to pay, into the revenue system. I suggest that two levels of surtax be introduced: The first would be a 10% surtax on all income between $100,000 and $500,000 and the second would be a surtax of 20% on all income in excess of $500,000. Given the late date and the likelyhood of a recession in 1988 I would have these surtaxes begin January 1, 1989.

Simultaneously we should make a downpayment on disarmament by shifting some $10 billion dollars from the military budget to a high employment content works program: a combination of a modernized Works Progress Administration and a new Civilian Conservation Corps. These would be reminiscent of the successful programs of the New Deal days. Such programs which replace doles by jobs are a necessary ingredient of any successful capitalism.

As the repercussions of October 19th work their way through the economy, we must keep in mind that it was a combination of government budget deficits and prompt and apt intervention by the Federal Reserve that first contained and then promptly reversed the recessions of 1967-68, 1974-75, and 1981-82. Trying to eliminate recession induced budget deficits can only make recessions worse, not better. It would be a good confidence builder if the signals from the negotiations on the budget were that the deficit would be allowed to increase as a recession takes hold, but that fundamental tax and spending reforms were being put into place so that when private demand drives economic expansion budgets would be either in balance or in surplus.

Whoever takes over the White House January 1989 will have to set in motion programs to undo the harm that Reagan has done to the economy. The election campaign and the inauguration may very well take place while the country is in a recession. This will make the political task somewhat easier, for in recession, when it is obvoious to all that things could be better, the people will listen to programs of reform. In these efforts nothing will be more important than to make the distinction between a budget that is in surplus, balance or deficit, depending upon whether the economy is above at or below some well defined target, and a budget that is in permanent deficit because of an unwillingness or inability to tax enough to fund expenditures.