IS REAGAN ANOTHER COOLIDGE?

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In a year end interview Lee Iacocca is reported to have said that "The next president, he's going to feel like Herbert Hoover after the jazz age of Coolidge and he's going to bear the rap." Iacocca was recalling that in March of 1929 Calvin Coolidge left an apparently strong economy to Herbert Hoover, who then presided over the great collapse of the American economy that began in October of 1929 and continued for three and a half years until the inauguration of Franklin Roosevelt in March of 1933. In this interview Iacocca was expressing a quite common view of the prosperity of the 1920's and the Great Depression of the 1930's! The Coolidge prosperity was false and planted the seed for the Great Depression. Furthermore, even though the depression may have been made worse and prolonged by Hoover's policies, it was really not Hoover's fault.

Iacocca's scenario is that the American economy will sustain the current prosperity through two more years and that the next President will need to deal with a depression which will be as serious as that of the thirties. This depression will not be the next President's fault: The sins of Reagonomics will come home to roost after Reagan retires.
This is not likely to happen. If 1986’s slack performance turns into a recession in 1987 or 1988, Ronald Reagan would be both the Calvin Coolidge and the Herbert Hoover of the next serious depression. In this alternative scenario the next President will have the opportunity to be another Franklin D. Roosevelt, to be a second savior of American capitalism.

Iacocca’s statement reflected a not uncommon fear, which is that the economy is heading for another depression that will be as bad (if not worse) than that of the 1930’s. In a recent article in The Atlantic Magazine, Professor Galbraith noted some distinct parallels between 1929 and 1986, especially the fever of stock market speculation, the proliferation of new financial instruments, the aroma of let us call it hanky-panky in financial markets, and the evident incompetence in the board rooms of industry and finance.

Galbraith and Iacocca are not alone in recognizing that a recession may begin before the election in 1988. Polls of economists and forecasters indicate that a substantial majority of those polled hold that a recession is likely to begin in 1987 or 1988. The press has noted that a fear of such a recession haunts Republican politicians: They feel that a recession added unto the emerging evidence of slack leadership in foreign policy by Reagan would well nigh guarantee a Democratic victory next year.

Nevertheless the fears of another 1929-1933 are exaggerated. The transformation of our economy that began in 1933 erected
barriers against a repetition of the Great Depression. Even though aspects of Reaganomics lowered these barriers and the evolution of the economy attenuated their effectiveness, they have neither been fully dismantled nor lost all their effectiveness. The economic forecast for the intermediate term, say the next five years, cannot rest either upon a glib recall of the dreadful events of 1929-33 or the naive proposition that some unspecified "they" won't let it happen again.

In order to determine what a rational decision maker is to take seriously about the prospects for the economy we need to understand what there is about our type of economy that makes it susceptible to deep recessions or even great depressions, why such phenomena are rare, and how the institutional structure that is now in place acts as a barrier to another depression that is comparable in length and duration to the Great Depression, even though it may not prevent a recession (or a depression) that is more serious than any of our recessions experienced during the past forty years. It must be recognized that there is an enormous amount of economic space between the worst recession we have experienced since the end of World War II and the depression of the 1930's. Something that is distinctly worse than either the recession of 1974-5 or 1981-82 may well start quite soon, but this does not mean that the fears of Iacocca are well taken.

It is now more than fifty years since the great collapse of 1929-1933, and we have to try to understand whether the apparent
immunity to a great depression is permanent or transitory. Of course given the fears of a great depression that Iacocca articulated, even a mild recession between now and the election in November 1990 will have serious political consequences.

The curious phenomena of a sharp fall in the dollar on the exchanges occurring even as the Dow Jones jumps by some ___ points as happened on January 14 and 15 makes an observer wonder where the money is coming from and going to. Before the world was blessed by the wonders of floating exchanges a fall in a currency such as the dollar experienced was a sure sign that interest rates would be raised to protect the dollar. Rising interest rates should lead to a falling market, nevertheless the market rose. The United States is now a major international debtor, and increasingly the debt is not denominated in dollars. Each period income is being earned on account of the ownership of assets in the United States by Japanese and European interests, and the lower the dollar the greater the burden of debt that is denominated in currencies other than the dollar.

It used to be said that if the United States catches a cold the rest of the world will have pneumonia. This is no longer unequivocally true, for the importance of the United States in the world economy has greatly diminished. Japan and Europe have accumulated large enough stores of international assets so that if they have the political will they can be largely independent of the gyrations of the United States' economy.
The United States' deficit on international trade is a major support of the prosperity of the strong East Asian and European economies, an United States recession or depression will decrease this deficit. A major weakness of the world economy is that the now financially powerful Japanese and German economies seem unwilling or unable to support world prosperity by running a deficit in their international trade. Their global trade deficit should be of the same order of magnitude as their net income on their accumulation of foreign assets if world prosperity is to be sustained. Even if Japan and Germany were willing to act in this manner, the initial consequences of a depression in the United States will depress those Asian and the European export industries that have major markets in the United States. But it must be noted that if Germany is willing to take the initiative, Europe can be insulated from all except the initial adverse effects of an American recession.

In the United States 1986 was a good year if you were deeply involved in the stock market, and a truly exceptional year if you were a professional employee or a partner in a financial house; the year end bonuses on Wall Street were terrific. For the "industries" that promote business mergers and take overs and develop and market sophisticated financial "products" 1986 may very well have been the best year since 1929.

In the United States to a very marked degree employment and income earned in farming, manufacturing and extracting industries have become less important even as employment and income earned
in the financial services industries have increased in importance. The new products of American business in 1986 were not new generations of V.C.R.'s or high quality automobiles, but were equity mortgages, platinum credit cards, and synthetic equity instruments created in securitizing credit. This change in the industrial mix is one reason the dollar is under pressure in the international exchanges; the innovations of the 1980's do not yield export earnings.

Because of the United States' huge deficits in foreign trade over the past several years, the mark bloc (which includes Italy) and the Japanese banking institutions have accumulated massive amounts of dollars. Salomon Brothers Inc, one of the most important financial houses of the world, estimates that in 1986 there was a gross capital inflow into the United States of $191 billions and a gross capital outflow of $50 billions; the net selling of American assets and foreign borrowing amounted to about $140 billions. In essence the United States is able to support Star Wars and a consumption boom by selling assets. The economics of Reagan has become the economics of a wastral state; the nation's inheritance is being sold off even as the provision for the future is being neglected.

1986 was a bad year for those seeking work in the United States (unemployment did not get below 7%). The capital development of the country suffered a set back for investment in plant and equipment declined. It was also a bad year for the Government budget, the Treasury's debt grew by $194 billions.
But bad as 1986 was, 1987 may very well be worse.

The current expansion, which is now in its 50th month, began in November of 1982, when the deepest recession of the forty years since 1945 ended. This expansion is now longer than the average post-war expansion, so that a recession may be said to be due. If a recession begins in the near future it will start from a higher level of unemployment than earlier post-war recessions.

During the recession of 1959-70, which was associated with the failure of the Penn-Central Railway and a run on the market for commercial paper, unemployment rose from just under 4% to 6%. In the recovery that followed unemployment never got much below 5%. During the recession of 1974-75, which was associated with the failure of the Franklin National Bank and a run on the Real Estate Investment trusts, unemployment rose from 5% to 9%. In the long 54 month recovery that followed it never got significantly below 5%.

There was a brief recession in 1980 that was quickly followed by a long and deep recession in 1981-82 (during Reagan's first term). Over this period unemployment rose from 6% to 11%. This recession was associated with the failure of the Penn Square Bank in Oklahoma City, a bank which sold billions of dollars of paper based on oil and gas properties to other banks, and the Latin American (in particular Mexican) debt crisis. The Reagan prosperity that started in late 1982 has not lowered unemployment to below 7%. It has been characterized by a continuing high level of bank failures (The Continental Illinois Bank of Chicago...
"failed" in 1984) as well of financial adventuring of the merger and take over movements that has left much of American business heavily indebted.

The overbuilding of commercial real estate in many cities, the enormous indebtedness of businesses and households, the public problems of General Motors, the perhaps terminal illness of the Bank of America, and an expected decline in business investment all point to a poorer 1987 than 1986. Salomon Brothers which has a reputation for being realistic, forecasts that real GNP will increase by only 2.1% in 1987 - the increase in the unsatisfactory 1986 was 2.7%. The Congressional budget office is forecasting the economy will grow at about 3.0% and the Reagan administration is forecasting a growth rate of 3.2%. The higher forecast of Congress and the administration reflects the use of the forecast to estimate tax receipts and spending, the higher the forecast the lower the estimated government deficit, the easier the problem they face of controlling the deficit.

The Salomon Brothers forecast places the economy close to or below its stall speed, the momentum of the economy is likely to be insufficient to induce much in the way of investment. Furthermore the financial structure, which encompasses the now more highly levered business sector, a household sector whose installment debt is approaching 20% of disposable income, and a banking structure which has 10% of the banks on a danger list, is obviously more fragile than earlier in the post war period.
If the Salomon Brothers forecast is only a bit on the optimistic side so that a downturn occurs then a recession in which the unemployment rate quite quickly runs up from the present 7% to well in excess of 11% is likely to occur. This does not mean that a prolonged three and a half year contraction, like that of 1929-33, will take place: the Federal Government is now much too large a part of the economy for that to happen.

However the last two recessions, those of 1974-5 and 1981-2 were deep enough to be characterized as depressions, but they were short: the recovery came quickly. On a graph they trace out a U, this next recession is likely to trace out a U: the time spent in the trough is likely to be substantially longer than in 1974-75 and 1981-82.

Thus Iscocca is likely to be wrong on two counts. The first is that Reagan is unlikely to turn over a prosperous economy to his successor. The second is that although the recession that may start in 1987 is likely to be longer than the prior post World War 2 recessions, it will not be as long or as deep as the Great Depression.

It is worth noting that when Reagan became President the United States was clearly the dominant economy of the capitalist world. When he leaves office the United States will have to share world economic power with Japan and with Germany as a proxy for Europe. In American history Reagan will have to take the rap not only for being Coolidge and Hoover, but also for presiding over the loss of dominance of the American economy.