1985

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by

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In midyear 1982 the country was in a deep recession, which was exacerbated by the fight on inflation. The high interest rates of 1980-82 led to the collapse of the Mexican peso and contributed to the collapse of the Penn-Square bank of Oklahoma City. The Federal Reserve under Volcker met these crises in a fine fashion. Mexico received emergency refinancing and the immediate repercussions of the Penn-Square failure were contained.

Rapid monetary expansion and massive government deficits began at this time and are still continuing. The recession ended in November 1982. The recovery which followed is now three years old. The history of business cycles shows that expansions rarely last more than four years; history indicates that a recession should be expected to start in 1986.

Unless reinforced by analysis, history is not a good predictor of the course of the economy. A multitude of changes have occurred since Reagan took office. Some were the result of legislation, while others were the result of an evolution of institution and of the way of doing business in response to perceived profit opportunities. Our economic history is replete with financial crises, recessions and deep depressions. Nevertheless there has always been a Utopian belief that if we only got things right we would achieve what Herbert Hoover characterized as "a new era of permanent prosperity".

Have the dramatic changes of the Reagan era created an economy which is conducive to permanent prosperity? The economy of January 1981, which was mainly the legacy of the Roosevelt reforms of the early 1930s, was fiscally conservative. Even though expenditures were high the tax system was designed to balance the budget when times were good. Deficits were tolerated to contain and control recessions. By the criteria of not having a deep depression the economy from Truman through Carter was more successful than the economy from Washington through Hoover.

A main policy innovation of the Reagan years was to abandon fiscal conservatism. Taxes were cut even as defense spending was accelerated. The stated hope was that accelerated "growth" would yield the revenues to finance spending even with the gutted tax system. The hoped for accelerated growth has not occurred; there never was any solid reason to expect that it would take place. A large structural deficit was the result; the current defcit reduction bill is a gadget that evades the issues of fiscal responsibility.

The great deficits of Reagan's first five years fed an enormous amount of government debt into the portfolios of banks, pension funds, insurance companies, households, and foreign holders. The need to facilitate the absorption of this debt forced the Federal Reserve to provide for an accelerated growth of available bank credit. The growth of the government debt to the $2000 billion range tended to unbalance private portfolios. Unless they did something banks etc. would have too much government debt. The something to do was to acquire private debt. The massive growth of government debt since 1962 has led to a strong market for the debt of business and households.

When the Reagan administration and a compliant Congress gutted the personal income tax the supply siders argued that the decrease in taxes would lead to a rise in savings. They were wrong; the decrease in taxes has led to a spending spree that has reduced the savings rate of out of household income to an all time low of 1.9% in September 1985. But such a spending spree means that households on the whole increased their indebtedness as a ratio to household income to an all time high. Every day the financial press carries news of more corporate take overs, of additional leveraged buy outs, and of further creative uses of debt to finance business. The sale by CBS of Channel 4 is a repercussion of Turner's bid for CBS. Whoever buys Channel 4 will do so with debt. Corporate debt is also at an all time high.

Debt, whether of households, or governments, has to be serviced. The jump in household and business debt over the expansion that began in November 1982 means that a high percentage of household and business income of 1986 will go to service debt -- just as a high percentage of the 1986 government spending will be interest on the government debt.

The increase in the rate of expansion of the economy in the third quarter of 1985 was largely due to the decrease in the savings rate by households. That source of accelerating the expansion is now used up and we can expect households to return to a more normal (5% or 6%) rate of savings. This will mean that the rate of increase in household debt will taper off; there will be a fall in the debt financed demand for automobiles and other consumer goods.

A rise in the household savings ratio will have a strong negative effect on business cash flows. The increased indebtedness of business means that their cash flows are heavily committed to servicing debt. Any decline in demand increases the already heavy burden of debt and decreases the willingness and the ability of business to debt finance investment spending. It also is a signal to businesses and their bankers that a decrease in inventories should take place.

The massive increase in the federal debt after 1982 and the monetary ease that it required triggered a recovery. The growth of the outstanding Federal debt together with the incomes due to the Federal deficit created a strong demand for business and household debts. The corporate take over, leveraged buy outs and the household spending spree supplied the debts. The result is familiar from our history; we now have an economy that is vulnerable to an interactive process in which the debt burden, due to servicing requirements, reduces consumption, investment and employment. The reduced spending leads to lower incomes, lower incomes raises the burden of indebtedness, which further lowers spending etc.

If this takes place there will be a replay of a familiar scenario. The collapse of wage income and business cash flows will be aborted by massive government deficits. The depth and the length of the recession depends upon how promptly and how forcefully the Federal Reserve and the Administration intervene. If government spending contracts as this process takes hold, then the length and the depth of the recession will be increased.

Last year, at election time, the Reagan aura made many believe that a new era of permanent prosperity had been achieved. It is now clear that what prosperity we enjoy is not universal and is very tenuous. As things now stand a modest downturn can be the trigger for a serious recession.

Because of the accumulation of public and private debt the economy will be in largely "unchartered waters" in 1986. It is still true that the most likely result will be a recession that will be contained before it gets to be substantially more severe than the recession of 1981-82. But the present is sufficiently different from the past so that inept or reluctant policy will permit the economy to break through the barriers that have contained the recessions of the past forty years. If this happens a recession that is substantially more severe then that of 1981-82 will take place.