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Michigan COMMENTARY

1929 REVISITED?

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> "The stream of time often doubles on its course, but always it makes for itself a new channel."
>
> Frederick Lewis Allen

The stock market collapse of 1987 inevitably invites comparisons with the crash of 1929, but there are more differences than similarities between the two events. It is too early to be certain about the effect of the 1987 crash, but there is no evidence that it will lead to a depression or even to a serious recession. What is certain is that the United States will have to act to correct the economic weaknesses that caused the October crash. This paper contains some recommendations for corrective action.

The speculative excesses of the 1920s far exceeded the excesses of the 1980s, and economic policy was much less sophisticated then than today. When the stock market crashed in October 1929, many stocks were selling at sixty and seventy times earnings. The price-earning ratio before the 1987 price collapse was only about twenty to one.

The crash of 1929 was caused, in part, by years of speculation that could no longer sustain itself and exacerbated by the widespread practice of buying stock on margins of as little as 10 percent. At the time, buyers had to put up only 10 percent of the value and could use the stock as collateral for the remaining 90 percent. When prices fell, many stockholders had to sell stock to cover their loans. Today, 50 percent of the value of the stock is required to buy on margin, which means investors do not have to come up with as much money when prices fall.

The crash of 1929 led to the Great Depression partly because of inappropriate economic policies. In the early 1930s, the Federal Reserve Board reduced the money supply by about one-third, which contributed to the sharp decline in economic activity. Following the stock market crash of 1987, the Federal Reserve Board reduced the discount rate (the interest rate at which member banks borrow from the Fed) and increased the money supply, partially offsetting loss of liquidity due to lower stock values and boosting investor confidence.

Although the recent crash probably will not precipitate a serious recession, we again could be at a turning point in our economic history. Without question, America has been living beyond its means and reforms are needed. As Business Week put it in the November 16, 1987 issue:

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> At some point in the next few years, the U.S. will have to throw its amazing dream machine into reverse and start paying its bills. Inevitably, this will mean a reduction in the U.S. standard of living as Americans are forced to produce more than they consume to service a soaring foreign debt.

America has been accumulating debts at a record pace. The federal deficit has averaged almost $200 billion for the last five years, and the national debt now totals $2.4 trillion.

The only way the nation has been able to run triple-digit deficits year after year was by piling up huge debts abroad. This caused high real interest rates that attracted foreign capital and made the dollar too strong. It made buying imports cheaper for Americans and buying exports more expensive for foreigners (imports increased from 10 percent of GNP in 1970 to 22 percent in the second quarter of 1987), which caused the trade deficit that wiped out one million manufacturing jobs.

The trade deficit was $125 billion in 1986 and will likely exceed $140 billion in 1987. As recently as 1982, the United States had a trade surplus of $26.3 billion. We now owe foreigners about $400 billion.

Consumers also have been piling up debts. Consumer installment debt as a share of disposable income has reached a record level (increasing from 14 percent in 1982 to almost 20 percent in 1986), and Americans continue to spend more than they earn. Consumption in 1987 will increase about three times as fast as disposable income.

Deficit spending gives rise to an overly optimistic view of the economy and the institutions operating within it. Foreign investment allows the federal government to increase spending without crowding out domestic private investment or stifling economic growth by raising taxes. During the last few years, optimism sparked record stock gains. The stock market crash was due, in large part, to the worldwide realization that the U.S. government cannot live on vast amounts of borrowed money forever and that foreigners may not be willing to continue to carry our debt.

Our ability to compete in world markets is being undermined by our craving for instant gratification. America's spending binge has driven the saving rate to about 3 percent, down from 7.5 percent in 1981. In contrast, the saving rate is 16 percent in Japan and 12 percent in West Germany.

Low savings mean there is less money for business to borrow for capital investment. At a time when American business must become more competitive, much-needed capital investment has been declining rather than increasing as a share of GNP. Capital investment also has not kept pace with economic growth because of the rapid defense buildup. Defense spending increased from 5.1 percent of GNP in 1979 to 7 percent in the second quarter of 1987. While it creates jobs in the short run, defense spending reduces funds available for capital investment and makes us less competitive over the longer term.

What does all this mean? First, it is too soon to be certain of the full effect of the stock market crash on the economy. Recent surveys indicate some negative reaction among consumers. Many are less wealthy than they were a few weeks ago and are likely to be more cautious in their buying. One indication of this is October domestic auto sales, which declined 17.4 percent in October and 10 percent in the first ten days of November.

Second, even before the market crash there were signs that the recovery, which at 60 months is the second longest since World War II, was beginning to run out of steam. For several months, Public Sector Consultants has been forecasting a recession beginning in late 1988 or early 1989. Recent events could move the starting date up to the middle of 1988.

Third, unless actions are taken to reduce the federal budget and trade deficits and bring increases in consumption more in line with income gains, further declines in stock prices and a long, deep recession are very likely.

Our view is that the best solution is to raise taxes by about $40 billion a year, earmarking this money to reduce the deficit. This must be combined with a tight control on spending, particularly defense spending. Because the economy is showing signs of weakness, a large tax increase presents some risk to the economy. However, just as a deep recession was required to curb inflation, a mild recession may be required to reduce significantly the federal budget and foreign trade deficits.

We favor the enactment of a value added tax (VAT) as a source of new revenue. This tax would be paid at each stage of production by business, but the cost would ultimately fall on the consumer. In addition to reducing the deficit, a VAT would slow increases in consumption. A 4 percent VAT (assuming exemptions for food and other necessities) would be needed to raise $40 billion. An alternative would be to combine a lower VAT rate with a gas tax increase or a tax on imported oil.

One way to ease the effect on the economy would be to set the VAT rate at one or two percent in the first year and increase the rate as the economy improves. Tying the rate to economic activity would provide an automatic stabilizer for the economy.

In the short run, a tax increase would dampen economic activity and could cause a mild recession. In the long run, however, the benefits of reducing the federal budget deficit would far outweigh the short-term pain. A balanced federal budget would cause lower real interest rates, which would result in less foreign investment and a weaker U.S. dollar. This, in turn, would increase U.S. exports and reduce imports. Imports would fall because they would be more expensive and because higher taxes would dampen consumption. In a few years, the United States would again be running a positive trade balance.

A balanced (or near-balanced) federal budget, lower real interest rates, lower defense spending, and less consumption would each contribute to higher capital investment. The pool of funds for investment would be larger because of reduced consumption and higher savings and because the federal government would need to borrow less to finance lower deficits. The cost of capital also would be lower with more funds available relative to the demand for these funds. The United States would become more competitive and would again control its own destiny.

This scenario may sound too simple, and perhaps it is, but only because our political leaders may not have the courage and the wisdom to take the actions necessary to restore our economic vitality.

The 1987 stock market crash does not have to be all bad news. A bear market may well portend a recession that could be long and painful; it may also be a signal to the citizens and the government of the United States that, to protect our economic future from repeated deep recessions, we must take our debts seriously. We must reduce our accumulated debt now or suffer the consequences in the future. To do so will not be pleasant, but it is the necessary price to be paid for financial overextension.

Robert J. Kleine, senior economist at Public Sector Consultants, has extensive experience in state budget, taxation, and economic issues. As director of the state Office of Revenue and Tax Analysis, he was responsible for state revenue and economic forecasting, tax analyses, and assessment of the implications of proposed tax legislation. More recently, Mr. Kleine was senior analyst in public finance at the Advisory Commission on Intergovernmental Relations in Washington, D.C. His studies on cigarette tax evasion, value added taxation, federal tax reform, revenue and program turnbacks, and state and local tax systems received national recognition.

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